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California’s Economic Recovery May Hinge on Changing Financing of New Housing

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California’s ability to rebound from its current 12.4 percent unemployment rate and depressed economy is significantly dependent upon the revival of its residential housing industry, which at its peak in 2005 contributed over $67.7 billion to the state’s economy and nearly 487,000 jobs, according to a recent study by the Center for Strategic Economic Research. By 2009, the study showed a drop to $13.8 billion in economic impact and only 77,000 jobs. Critically, the Center’s analysis found that “the entire housing industry generates close to $347 billion of economic output, supports about 1 million jobs and accounts for 11 percent of all economic activity in California.”

While the foreclosure of homes remains the most visible impediment to a housing recovery, accelerating impact fees are likely to take a more prominent role as the foreclosure issue subsides. Much like the era of the late 1970s in which homeowners rebelled against inflation-driven property values that drove property tax rates on average to 2.67 percent of assessed value, housing developers are resisting rising infrastructure, environmental mitigation, and public service costs required to accommodate new housing that are driving impact fees on new homes to similar unsustainable levels in the current marketplace, making the housing industry’s and as a byproduct, California’s economic resurgence more difficult.

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To understand how new and existing residential development has in essence, switched places pertaining to local property taxes, a revisit to the period prior to enactment of Proposition 13 in 1978 is necessary. Until Proposition 13, California’s local property taxes were assessed by cities, counties, special districts, and school districts annually to cover operating and, in many cases, at least a portion of capital costs. Each taxing agency within a county’s jurisdiction set its own tax rate in accordance with its funding requirements.

It was not uncommon for local jurisdictions to make capital improvements on a pay-as-you-go basis, by increasing the property tax to fund such improvements. Otherwise, local agencies typically issued General Obligation Bonds to finance new schools, roads, and other infrastructure required to accommodate growth. As the decade of the 1970s progressed, inflation ravaged the economy causing a precipitous rise in wages, prices, and commodities including housing. Property taxes surged to meet the increased government costs for labor and capital expenses. The passage of Proposition 13 reduced property taxes by approximately $7 billion and capped them at 1 percent of the assessed valuation of property, excluding debt service. But Proposition 13 did more than merely cut and cap property taxes. It simultaneously took away the ability of local jurisdictions to adjust property tax rates to finance the infrastructure needed for a state that grew by over 13 million people between 1980 and 2009.

Local jurisdictions have primarily used community facility districts, through the Mello-Roos Act of 1982, to fund new community facilities in the past three decades. Implicit in the creation of the new community facility districts were the policy assumptions that new growth should pay for itself and that growth was not necessarily a goal supported by the larger community and should be accommodated only so far as it imposed no financial burdens on existing residents.

While housing prices were accelerating and sales brisk, which was generally the case between 1982 and 2005, developers could obtain project financing from Wall Street and other financial institutions to front the millions of dollars needed for new infrastructure costs and either incorporate these added expenses into home prices or, more frequently, add taxes onto the new homes. This model for residential development financing has declined dramatically in recent years. The California Debt Advisory Commission reported that California created 192 Community Facility Districts in 2005, dropping to 24 in 2009, with just 8 established through the first five months of 2010.

Several developments suggest that community facility district financing is unlikely to reemerge in its original form unless some changes occur. First and foremost, developer impact fees imposed to fund infrastructure and
increasingly expensive environmental mitigation and public safety service fees now range from $40,000 to $100,000 per housing unit in many new growth areas. With declining housing values the average home in California now sells for less than $370,000 and considerably less in areas away from the coast where most new homebuilding has occurred in recent years. Consequently, most new houses cannot be built at a profit if required to pay this level of impact fees. Second, burdening new homeowners with special taxes that can double property taxes compared to existing homes of similar market value is no longer financially feasible, and its fairness is questionable. The drop in housing values for newer homes has accentuated the equity issue as the overall property tax rate exceeds 2 percent on many homes in recently created Mello-Roos Districts. Furthermore, given the crushing financial losses experienced by the housing industry and their financiers, the ability of developers to obtain the large sums of future funding needed to spread the costs of major residential developments is going to become more problematic, and more expensive.

As a result, the reduction in community facility districts is a manifestation of a financial model that cannot continue to support sizeable new residential construction without a substantial rebound in housing prices or a different and less costly way of providing public infrastructure, environmental mitigation, and public safety services. It also poses the larger policy question of whether new growth should be financed solely from project revenues or if communities at large perceive the cost-benefits of additional growth and are, therefore, willing to assume some of the financial burden associated with such growth. At stake is the need to accommodate an additional five million California residents in the next decade and a California economy that could continue to struggle with excessive unemployment and meager growth if a new model for building homes does not emerge.

This problem can be attacked on both the revenue and expense sides. On the revenue side, the state could create a capital improvement fund derived from existing tax revenues rather than issuing more debt. State capital funds would then be matched with regional transportation and local government capital funds and an acceptable portion of developer impact fees. Projects receiving state capital funds would have at least one common element; they would be congruent with regional as well as local planning documents. Projects seeking these public funds would not only need to have broad support from the local community, since the local government would have to provide a certain level of capital funding, but would also need to obtain consent from the regional government. As a result, these projects would need to demonstrate positive economic effects for not just the local jurisdiction where the project would be built, but for the region as a whole.
Regarding the expense side, there needs to be limits on the amount of environmental mitigation costs required of projects that are congruent with local and regional planning goals and policies. As an example, some form of a flat per acre regional fee would provide certainty and fairness for developers seeking to build within specific regions. One way to manage this expense would be to establish regional habitat conservation plans, funded from a combination of local government, state and developer financing, as opposed to current methods that rely on specific local jurisdictions to create habitat conservation plans that are funded primarily from developer impact fees.

Ultimately, these revenue and expense proposals would seek to reduce developer impact fees to no more than 15 percent of the cost to build a home. At this level, new residential housing can be profitably built and California can begin to emerge from its beleaguered economy once the foreclosure storm subsides.