



CALIFORNIA FACES IMMEDIATE AND LONG-TERM HOUSING CHALLENGES

California is still experiencing the aftereffects of the most recent housing bubble, and the long-term challenges of housing California's population haven't gone away. The housing bubble, which inflated and popped over the past decade, has left the state with a foreclosure problem and large losses of construction jobs, which accounted for 6 percent of California's employment when housing prices were at their peak (according to the California Employment Development Department). Millions of California's homeowners remain "underwater," owing more on their houses than they are worth.

There are a few signs of hope. Housing price declines, along with low interest rates, have led to historically high rates of affordability. In many Inland areas of California, a large majority of households can afford the median-price home, and half of the state's households can afford to pay the median price for a home even in California's most expensive metropolitan area, San Jose. Housing values are not increasing at a significant rate, but they are not falling as sharply as they were a few years ago and may have leveled off. Vacancy rates are low in California compared to the rest of the country, and there will be strong population growth among adults old enough to establish their own households, which should increase housing demand. Of course, high unemployment and difficulty in borrowing undercut these hopeful signs.

In both the short and the long term, California's economic performance and livability depend on its housing market. The perennially high cost of housing in coastal California reflects the fact that people and businesses are willing to pay more to be there than almost any other place in the U.S.; it also reflects barriers to building new housing in those areas. In the inland areas, economic recovery could partly depend on policies designed to address the acute negative equity and foreclosure crises in that part of the state.

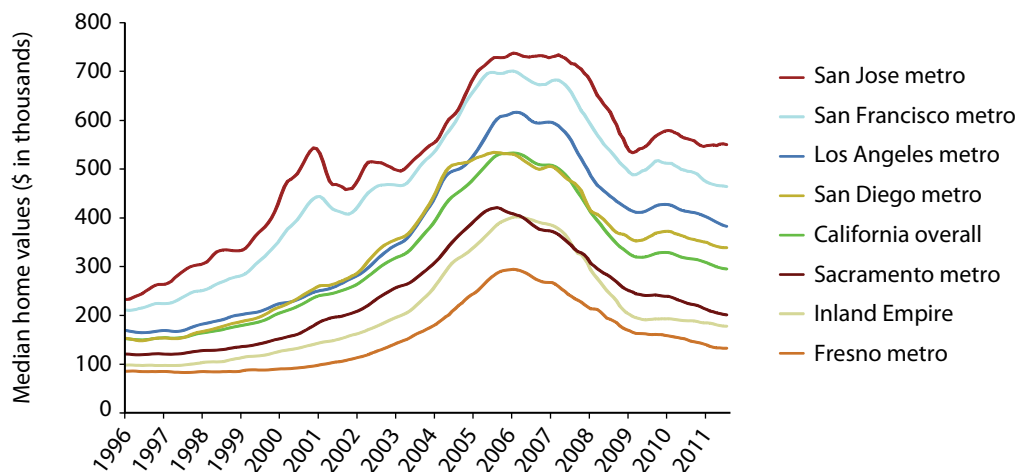
THE HOUSING BUBBLE AFTERMATH IS FAR FROM OVER

The housing price bubble and its deflation in the century's first decade helped trigger a national recession and global slowdown. Prices rose and fell more in California than in most of the country. Prices remain at or near their post-bubble lows, construction remains slow, and 30 percent of mortgaged residential properties are underwater, according to CoreLogic.

- **Home prices in California are down more than 40 percent from their bubble-era peak.**

After growing rapidly earlier in the decade, home prices peaked in 2006, fell sharply in 2007 and 2008, and have fallen modestly since then. By October 2011, the average home value in California had returned to its October 2002 level of just over \$295,000 (Zillow). Nationally, home prices have fallen 24 percent from a peak in early 2007 of \$194,000 to a median of \$148,000 in October 2011.

MEDIAN HOME VALUES IN CALIFORNIA: BOOM AND BUST



SOURCE: Zillow.
NOTE: Values are in nominal dollars.

- Large numbers of Californians owe more on their homes than they are worth.**

According to CoreLogic, 30 percent of California homeowners with mortgages were underwater in the second quarter of 2011, the fifth highest rate in the nation (after Nevada, Arizona, Florida, and Michigan). In all, 2.1 million of 6.8 million mortgaged households were underwater in California. More than half of mortgaged homeowners in the Stockton and Modesto metropolitan areas and almost half in the Inland Empire were underwater. By contrast, only 10 percent of mortgaged homeowners in San Francisco, San Mateo, and Marin counties were underwater, and the average net equity for mortgage holders in those areas was \$371,000, by far the highest in the nation.

- Foreclosures remain high and new construction remains low.**

Falling prices, combined with rising unemployment and resetting interest rates for adjustable mortgages, have led to very high foreclosure rates. Foreclosures skyrocketed in 2007, peaked in 2008, and foreclosure rates have remained more than twice as high as in the rest of the nation through 2011 (RAND/DataQuick and RealtyTrac). In October 2011, only Nevada had a higher foreclosure filing rate. Falling prices and relatively weak population growth have also discouraged new construction: new residential construction permits fell from around 200,000 annually from 2003 to 2005 to tens of thousands annually from 2008 to 2011, according to U.S. Census Bureau data.

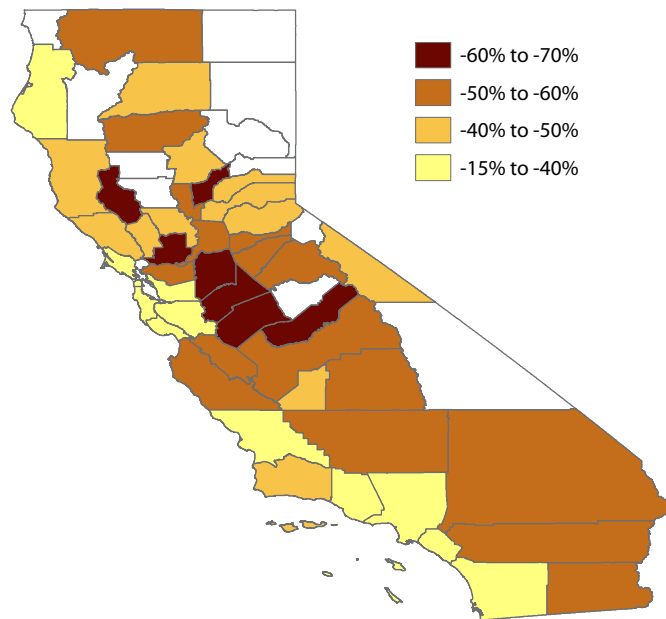
- Homeownership rates have fallen.**

Homeownership rates, already much lower in California than the rest of the nation, fell more in California than elsewhere in the country, reaching 57 percent of all housing units (compared to 68 percent for the nation). Between 2005 and 2010, the number of housing units that were owned fell by over 300,000 in California, while the number rented increased by almost 400,000.

- Coastal metropolitan centers have fared better than inland California.**

During the post-bubble years, home values declined less steeply in the metropolitan areas of San Jose (25 percent) and San Francisco (34 percent), as well as in San Diego (37 percent) and Los Angeles (38 percent). At the other extreme, the largest declines, with values falling more than 60 percent, have occurred in some of the same inland metros that had experienced the fastest run up in values, including Merced (69 percent decline, from \$351,100 to \$107,600), Modesto (64 percent decline, from \$368,200 to \$128,100) and Stockton (65 percent decline, from \$410,900 to \$144,800). Prices fell by more than 50 percent in Sacramento, Fresno, Bakersfield, and the Inland Empire. Not surprisingly, foreclosure rates have been higher in these inland areas. In the Inland Empire, for instance, the foreclosure rate from 2006 to 2010 was nearly four times that of Los Angeles and Orange Counties.

HOME VALUES HAVE DECLINED MORE STEEPLY INLAND THAN ON THE COAST



SOURCE: Zillow market value report for California counties.
NOTES: Percentage change, local price peak to October 2011. No data available for areas in white.

DESPITE THE BURSTING OF THE BUBBLE, HOUSING IS EXPENSIVE AND THE MARKET IS TIGHT

Falling prices make buying a house more affordable, but rents have actually risen (in nominal terms) during the crisis. Even with the downturn in prices, median values exceed \$500,000 in the San Jose metro area and \$400,000 in the San Francisco metro area. California's statewide median remains almost twice as high as the national median.

- **Housing is dense relative to other states.**

California is often thought of as the epitome of sprawl, but its housing density is 35 percent above the national average and rising. Census data show that the Los Angeles and San Francisco metropolitan areas have the second- and third-highest residential density in the U.S., after New York, while San Jose and San Diego are also in the top ten. High density goes hand in hand with high prices: where real estate is expensive, developers build upward and closer together, and people are willing to live in smaller spaces. California's population density is heightened by its household structure: the typical California household has 2.1 adults and 0.7 children, as compared to the national average of 1.9 adults and 0.6 children.

- **Rents are high and rising.**

Rental units account for 43 percent of California's occupied housing stock, according to the American Community Survey. According to HUD, five of the ten most expensive rental markets in the U.S. are in California: San Francisco, Orange County, San Jose, Ventura County, and Los Angeles. And, unlike housing prices, typical rents were higher in 2011 than in 2006 in nearly all metropolitan areas, in nominal terms. Even more striking, since 2006 rents have risen more in the metropolitan areas with higher foreclosure rates, even though home prices have fallen more sharply where foreclosures are more widespread.

- **Vacancies are low, relative to most states.**

Despite sharply falling prices in recent years and increases in vacancy rates, the residential vacancy rate in California remains among the lowest in the country. Even in the San Joaquin Valley and Inland Empire, residential vacancy rates are near the national average. The other states with the highest foreclosure rates (Arizona, Florida, Georgia, and Nevada) have among the highest vacancy rates in the U.S. In these states, foreclosure often leads to abandonment, whereas in California foreclosure more often means turnover. (Vacancy rate data are from HUD, USPS, and American Community Survey.)

LOOKING AHEAD

California needs to address both immediate and long-term housing challenges with policies that help resolve the foreclosure crisis, fund affordable housing construction, and remove unnecessary barriers to expanding the supply of housing in high cost areas.

- **With the job and housing markets recovering slowly, foreclosures will continue.**

Foreclosures displace families and can ruin access to credit, but keeping people in homes they cannot afford risks slowing down recovery in the housing and financial markets. Most housing policy is set at the federal level, and most housing financial institutions—including Fannie Mae, Freddie Mac, and the large banks—are national. However, states strongly influence the foreclosure process, and the hardest-hit states (including California) have received federal money to help underwater borrowers. With these tools, the state should do what it can to help struggling homeowners who can potentially afford their homes and to speed up the foreclosure process for homeowners who can't.

- **Funding for affordable housing is threatened.**

Affordable housing construction in California is funded partly through redevelopment agency set-asides and general obligation bonds. Redevelopment has been eliminated from the fiscal year 2011–12 budget, and continued state budget troubles raise the cost of borrowing and limit the scope for authorizing and issuing new general obligation bonds. If it wants to support affordable housing construction, California needs to establish new funding mechanisms.

- **Regulations help keep housing prices high in coastal areas.**

Why is housing so expensive in California? Many people and industries are willing to pay a premium to be here, which keeps demand high. At the same time, the supply of new housing is constrained both by geography and regulation. Most of populated California is nestled against natural barriers to construction—the ocean, the Bay, and the mountains. And California has unusually strong land-use and building regulations, especially in the major coastal cities, which curtail construction and keep prices high.

We invite you to dig deeper at ppic.org. Related PPIC resources include:

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Public Policy Institute of California
500 Washington Street, Suite 600
San Francisco, CA 94111
T 415 291 4400 F 415 291 4401

PPIC Sacramento Center
Senator Office Building
1121 L Street, Suite 801
Sacramento, CA 95814
T 916 440 1120 F 916 440 1121

www.ppic.org

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