CALIFORNIA FACES IMMEDIATE AND LONG-TERM HOUSING CHALLENGES

California is still experiencing the aftereffects of the most recent housing bust, and the long-term challenges of housing California’s population haven’t gone away. The housing bubble, which popped in 2008, 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 improvement. 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 seem to have reached bottom statewide, with a slight increase over the past year. 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. It is also a consequence of barriers to building new housing. Economic recovery in the state’s inland areas could depend in part on policies designed to address their acute negative equity and foreclosure crises.

MEDIAN HOME VALUES IN CALIFORNIA: BOOM AND BUST

NOTE: Values are in nominal dollars for single family houses and condominiums.
THE HOUSING BUST IS FAR FROM OVER, BUT THERE ARE SIGNS OF RECOVERY

California appears to be in the nascent stages of a recovery from the housing bust. Home values are increasing in some of the state’s largest metropolitan areas and statewide new home construction is up 24 percent over the past year. Even so, prices remain at or near their post-bubble lows, construction is slow by historical standards, and 29 percent of mortgaged residential properties remain underwater (according to CoreLogic).

- **Home values in California have started to rise in some metro areas.**
  Home values in California are down more than 40 percent from their bubble-era peak, but over the past year values have gone up slightly. By October 2012, the average home value in California was $314,500 (Zillow). Since the post-boom low, values have increased by more than 6 percent in the San Francisco and San Jose metropolitan areas and by more than 3 percent in the San Diego, Inland Empire, and Fresno metropolitan areas.

- **Large numbers of Californians owe more on their homes than they are worth.**
  According to CoreLogic, 29 percent of California homeowners with mortgages were underwater in the second quarter of 2012, the sixth-highest share in the nation (after Nevada, Florida, Arizona, Georgia, and Michigan). In all, 2 million of the state’s 6.8 million mortgaged households were underwater. In 2011, 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.

- **Foreclosure rates are high but falling.**
  California appears to be over the worst of the foreclosure crisis. The number of foreclosures has declined by 27 percent over the past year (September 2011 to September 2012, according to RealtyTrac). Even so, foreclosure rates have remained more than twice as high as in the rest of the nation. In September 2012, only Florida had a higher foreclosure filing rate.

- **New home construction is low but increasing.**
  Turmoil in the housing market along with relatively weak population growth has discouraged new construction. New residential construction permits are on a pace to reach almost 60,000 this year, up from only 33,000 in 2009 but still far lower than the 200,000 new units built annually from 2003 to 2005 (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 55 percent of all housing units in 2011 (compared to 65 percent for the nation). Between 2005 and 2011, the number of owner-occupied housing units fell by more than 200,000 in California, while the number rented increased by almost 600,000.

- **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). The largest declines 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 first quarter of 2012, Stockton, Modesto, and the Inland Empire had the highest foreclosure rates of any metropolitan areas in the United States (RealtyTrac).
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 2012. No data available for areas in white.

HOUSING REMAINS EXPENSIVE IN MUCH OF THE STATE

Falling prices make buying a house more affordable, but rents have actually risen (in nominal terms). Even with the decline in prices, median values are almost $600,000 in the San Jose metro area and just under $500,000 in the San Francisco metro area. California’s statewide median remains twice as high as the national median, and among the state’s seven largest metropolitan areas, only Fresno has lower average home values than the rest of the nation.

• 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 nation, 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 average household size in California is 3 people, compared to 2.6 people nationally.

• Rents are high and rising.
  Rental units account for 45 percent of California’s occupied housing stock, according to the American Community Survey. According to HUD, five of the ten most expensive large metropolitan rental markets in the U.S. are in California: San Francisco, Orange County, San Jose, Oakland, and Los Angeles. And, unlike housing prices, typical rents were higher in 2012 than in 2006 in nearly all metropolitan areas, in nominal terms. Even more striking, since 2006 rents have risen more in some of the metropolitan areas with higher foreclosure rates, even though home prices have fallen more sharply in those areas.

• 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. The vacancy rates in other states with the highest foreclosure rates (Arizona, Florida, Georgia, and Nevada) are among the highest in the U.S. But even in the San Joaquin Valley and Inland Empire, residential vacancy rates are near the national average. In most other states, foreclosure often leads to abandonment, whereas in California it 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 slowly recovering, foreclosures will continue to abate.**
  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. California does not require judicial review of foreclosure actions, so foreclosures can be processed more quickly, and it is likely that the bulk of the state’s foreclosures have already occurred. 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. Recent revisions of federal programs intended to keep homeowners in their houses—for example, allowing them to refinance at lower interest rates even if they owe more than the house is worth—could help thousands of California homeowners.

• **Funding for affordable housing is threatened.**
  Affordable housing construction in California is funded partly through state housing bonds. 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. Moreover, the state and many local governments have strong land-use and building regulations, especially in the major coastal cities, which curtail construction and keep prices high.