August 31, 2007

A Critique of "The Housing Bottom Line: The Fiscal Impact of New Home Construction on California Governments"

Published by the California Home Building Foundation,
Prepared by the Blue Sky Consulting Group June 2007

-Michael Coleman

In June 2007, the California Home Building Foundation released a study of the fiscal effects of new housing development on state and local governments prepared by the Blue Sky Consulting Group. I was consulted on the topic by the Blue Sky staff in the early stages of the report in Fall 2006. The report, titled "The Housing Bottom Line: The Fiscal Impact of New Home Construction on California Governments" attempts to quantify the average fiscal effect of the construction of a new median priced home (defined regionally) in California. The report has been trumpeted by the building industry as no less than definitive categorical proof that "housing pays its way." But a closer examination of the study reveals that the conclusions are actually quite limited in application and provide no insights into the most difficult problems of residential development including the fiscal barriers to infill and affordable housing. Moreover, certain methodological leaps and assumptions in the report have drawn criticism from experts and practitioners in the field of land use fiscal impact analysis.

Prior Studies

As the authors of the study point out, previous analyses of the fiscal effects of housing have focused on specific projects or localities. Indeed, my cursory analyses may be the only prior attempts to draw broader generalizations about the nature of the fiscal impacts of housing development in California. In conducting a broad based analysis, it is a challenge to make the focus specific enough to be meaningful, while still broadly useful and insightful to the statewide nature of the subject.

My studies have demonstrated that 1) affordable (i.e. lower value) housing on its own often results in more costs than added revenues; 2) there is wide variation in these effects depending on what services the city provides, its tax rates and shares, service levels, ability to capture local tax revenues, etc. and 3) for any development to make fiscal sense to a community, land use development needs to include a mix of uses: high and low cost residential and commercial development to support. My analyses have also shown that it is incorrect to simply say that "new housing doesn't pay its way" because, yes, higher end housing is more likely to generate sufficient additional revenue than the additional local service costs it residents bring.

The Bottom Line on the Housing Bottom Line Report: It Misses the Point

The building industry funded "Housing Bottom Line" study examines a specific class of new home and attempts to calculate how that home and its occupants use state and local public services and pay taxes. But a substantial portion of Californians do not fall into the study's focus of new home-owners with substantial incomes. Moreover, some methods and assumptions of the study are ill-considered.

2217 Isle Royale Lane • Davis, CA • 95616-6616
Phone: 530.758.3952 • Fax: 530.758.3952

The study examines a **median priced single family home** (in each of several defined regions in California) with residents having **incomes high enough to purchase** that house and therefore **using public services and making tax payments relative to that income level**. The study implicitly assumes that **the home will result in new jobs** for the residents of the home that are 1) **located in the city** where the home is built and 2) **at the income level** needed to purchase the home (i.e. not retail, construction, etc.). The study essentially **credits new residential development with all new business and economic development**, crediting new housing with the tax revenues paid by businesses as well as their costs of public service.

The study generally assumes that these new higher income residents **pay for public services** (through state and local taxes) **but don't "use"** many of them (i.e. prisons, social services, mental health, etc.). They have private health insurance so they don't rely on publicly funded social services and they don't even benefit from their "use" by others. The study implies that the growth in population that comes from new residential development does not increase the demand for publicly funded social services or the prison population.

The study implicitly assumes that the **fiscal effects of a new house don't change over time**: once a "new house," always a "new house," never an "existing house" even though the study concludes that existing homes cost more in state and local public services than they generate in tax revenues.

The study examines only this "median house" and **does not consider the wide variations over time and place**. Substantial differences in circumstances mean that the example described by the report does not accurately describe any real circumstance.

The real problem with the fiscal impacts of residential development in California concerns **affordable housing and infill development**, where higher costs are not matched by sufficient on-going revenues. This study does not address these circumstances.

The Focus of the BIA Study: Median Priced New Home

Attempting to draw broadly applicable conclusions, the study focuses on the fiscal effects of a median priced home in eleven regions. Assuming the assumptions are valid and the math is correct, this analysis will tell you about a median priced home – and if a median priced home "pays for itself," perhaps we can reasonably draw conclusions about homes above median price. But what does it tell us about homes below median price? Well … really nothing.

Here's my paraphrase of what the study concludes: *People who are wealthy enough to purchase a new median priced home*[1] *pay more in government fees and taxes than they cost the government in public service costs - at least initially*. I agree with that overall conclusion. Unfortunately, the BIA and the Howard Jarvis Taxpayers Association's Jon Coupal have been quick to erroneously apply meaning to all housing development from this limited finding.

[1] According to the builders themselves, no more than 15% of California families can afford a median priced home.

Once a New Home, Always a New Home

Moreover, other discussion provided in the report leads one to the following conclusion: *Overtime, as that new median-priced house becomes an existing (not new) house, the residents use a greater proportion of state and local government services (schools, social services, corrections, while paying a decreasing proportion of state and local taxes and charges for these services.*[2] *On average,* (the report states) *existing houses do not pay their way.* (p8)

The study does not imagine that this new median priced home might ever be anything else but new and median priced, assuming for expediency that these same fiscal impacts apply for the life of that home. But clearly the study's conclusions only apply to the initial months or years of that property. What lies beyond, for the longer duration of the life of that home, is another and perhaps quite different story.

The proper approach, used by academics and practitioners familiar with this subject matter is a life-cycle analysis which examines impacts over time.

Little Regard for Variance among Jurisdictions

The study examines the effect of constructing housing in the aggregate, that is, on multiple agencies statewide. It is a "multi-jurisdictional analysis") taking in the impacts (+ or -) on not just the city in which the housing is located – but on all others as well. But the finances of state and local government vary widely. Without some attention to the affect of these variations, the study's conclusions are of very limited applicability.

The study fails to take into account that fiscal impacts will vary depending on the specific jurisdiction in which a home is located. If revenues or costs occur to other communities, the effect will be altered. For example, to the extent the residents make taxable sales outside the city, the city will not get the sales tax revenue. To the extent the residents work or travel elsewhere, related service costs and revenues will occur elsewhere.

The study does not apply any sensitivity analysis to examine very the significant variations over time and place including:

- Over time costs and revenues change. New homes, having been recently purchased, are assessed and pay taxes closer to market value, but older homes – farther away from purchase date – are assessed and pay property taxes well below market value. Service demands change, the payment of taxes changes.
- Effects vary because costs and revenues are spread among various localities. The amount of sales tax revenue captured by a locality varies; most do not capture the full revenues associated with the taxable sales of their residents.

---

[2] Notably for Coupal, the fact that older homes are less likely to cover their local service costs is due in large part to provisions of Proposition 13, specifically the 2% annual cap in AV growth. Over time, the ad valorem property tax revenue from a house only increases 2% per year, unless that home is resold, rebuilt or remodeled. Service costs are likely to exceed this annual growth relate - if only due to inflation.]

- Service responsibilities and associated costs vary (especially fire service, also library, parks). Service demands and levels vary. Tax rates vary (add-on sales taxes, UUTs, Hotel taxes, etc. property transfer taxes). Tax shares, especially property taxes, but also sales taxes (many cities leave a portion to the county).
- Revenues and costs do not match up agency by agency. Some agencies are well off, others not, some types of development provide a net gain, others a net loss.

New Home Buyers Never "Use" Many Public Services?

The study applies the costs of social services only to those who "use" social services. Since residents of a median value new home are going to have decent incomes and will be unlikely to use much in the way of social services, the study applies very little of these costs to the new house. So by this logic, if we build more new housing, social service costs will go down proportionately right? Wrong. Over time, residential areas become "existing houses" and social services are more in demand. So impact on social services should be total cost per capita statewide.

> *"People in income brackets high enough to purchase a new house are likely to be insured or purchase (*health*) care privately (*so will not increase government costs*) for hospitals, mental health facilities, etc."* (p33)

Education Cost Method is Inconsistent

To be consistent with the "new house" versus "existing house" distinction, isn't it intuitive that new homes and neighborhoods have more K-12 age children than older existing neighborhoods? This would assign more costs to these new homes. But in this instance the authors depart from this approach and instead assign the same cost for K-12 to all households in a community. (p35) They start by taking total K-12 cost per student, then multiplying by public K-12 students per household in Calif to get a cost per household, the same for older (existing) residential areas as newer residential areas. This might be a valid approach if using a life-cycle approach (which I would recommend) – but it differs from the method use for social services.

Higher Education is treated differently than K-12. Here, the study applies an income test and since folks who by a median priced new home are in higher income brackets than those in existing homes, the study assumes a greater likelihood that residents will attend a public college. Again, over time (life-cycle) the odds of attending Calif Public Higher Education should not be any different. Certainly the benefits can be said to be equal.

General Fund Impact of Certain Special Funded Services May Be Understated

The study excludes enterprise fund revenues and services from the analysis, a valid and method (and conventional). But it also excludes special revenue funds (gas tax, etc.) and related services. But special revenues often do not cover all the related costs – e.g. local streets and roads (both capital and operating expenditures). Consequently, it appears the study under-estimates general fund service costs in these areas.

New Housing is What Spurs Business/Commercial Development?

The issue receiving the most criticism from experts is the study's broad inclusion of commercial sector impacts. The report includes business revenues and expenditures, apportioning these to the construction of housing. Sales tax revenues, utility user tax, property tax, and other revenues from business activity is apportioned to the house based on an estimated number of employed residents. The study essentially assumes that increasing population (i.e. by building residential housing) will de facto directly increase employment for all the employable new population. Does building a housing cause an increase in employment equal to the number of new residents in that housing? The study implicitly assumes so and based on this, credits residential construction with the net fiscal effects of business development – a very dubious assumption.

Moreover, to the extent there are business related fiscal effects of new housing, these impacts only occur if the business activity, including added jobs, occur in the community where the house is built

Everyone Buys Everything Local!

The study credits the entire local sales tax revenues from the estimated purchases of the new home residents to the city. The study therefore implicitly assumes 100% capture of local sales and use expenditures – including business sales tax related to the jobs held by the residents of the house (i.e. the taxable spending of their employers) (p29). Moreover, the study ties the spending of the residents to the income bracket of a new home purchaser. But clearly this overstates reality: If we took this revenue per household and multiplied by the total number of households in California the total would far exceed the amount of local city and county sales and use tax collected.

Effect of VLF – Property Tax Swap Ignored

The study uses fiscal data from before the 2004 VLF – property tax swap. The VLF swap altered $4.5B of state and local finances, increasing city and county property tax revenues, decreasing city and county VLF revenues, decreasing school property tax revenues, and shifting state expenditures from VLF subventions to school funding. The importance for this sort of analysis is that property tax increases with property values but VLF increases with population and statewide VLF collections (which in turn relate to auto purchases and values). Whereas VLF revenue growth flowed mostly to population/residential growth, property tax revenue growth is directly related to the assessed value of property. So now, higher value development means higher property tax revenue – rather than the population driven effects of the VLF.

Given the particular limited focus of this study, taking into account the swap probably would have had little effect on their figures or conclusions. And yet, the VLF-property tax swap has had the effect of making higher value land use development more fiscally viable (for cities and counties), but lower cost residential development (i.e. affordable housing) less fiscally viable. Since the study generalizes based on a median value home and does not attempt to examine the distinction between higher end homes and lower cost homes, it would also have missed this important issue.

Conclusion

Blue Sky Consulting Group's 2007 "Housing Bottom Line" study essentially finds that *people who are wealthy enough to purchase a new median priced home pay more in government fees and taxes than they cost the government in public service costs - at least initially*. The building industry and others have trumpeted the study as validation that "new housing pays for itself" but in actuality, the findings of the study are far more limited in scope.

Some dubious methodological choices by the authors also call into question the usefulness of the analysis, including the treatment of business impacts, the lack of accounting for variance among localities through sensitivity analysis, or changes over time through life cycle analysis.

Unfortunately, the study tells us nothing regarding the real problems with the fiscal impacts of residential development : specifically those concerning affordable housing and infill development.

mjgc

Michael Coleman is Fiscal Policy Advisor to the League of California Cities and operator of **CaliforniaCityFinance.com**. *He may be reached at* 530-758-3952 *and* coleman@cal.net.