HOUSING BLUES

The Fiscal Impact of Residential Property Valuation on California Law Enforcement

By

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This Command College Independent Study Project is a FUTURES study of a particular emerging issue in law enforcement. Its purpose is NOT to predict the future, but rather to project a number of possible scenarios for strategic planning consideration.

Defining the future differs from analyzing the past because the future has not yet happened. In this project, useful alternatives have been formulated systematically so that the planner can respond to a range of possible future environments.

Managing the future means influencing the future--creating it, constraining it, adapting to it. A futures study points the way.

The views and conclusions expressed in the Command College project are those of the author and are not necessarily those of the Commission on Peace Officer Standards and Training (POST).
The demands facing contemporary policing in America are ever-increasing in complexity and criticality. Traditional law enforcement responsibilities have not abated, even as new and compelling obligations come into existence. Consider as an example the eruption of extreme juvenile mass violence in the sanctity of the public schools, a new and tragic phenomenon we must confront. Technology is racing forward, creating at once powerful and rapidly changing information tools as well as vulnerabilities to new methods of criminal attack and exploitation. Further, we must scour the crevices of our communities for the malignant presence of terrorism. Simultaneous with these demands, we struggle to attract and retain qualified candidates for employment. Speaking pragmatically, apart from organizational philosophy or strategies, one of the most significant variables in determining law enforcement effectiveness in this setting is the level and dependability of public safety funding.

Public entity funding, considered as an aspect of the modern general economy, is subject to a myriad of influences. Fortunately, many impacts to revenue are moderated in the totality of municipal or county budgets rarely requiring meaningful alteration in the behavior of public safety agencies. As we look at the future of the California economy, though, housing values present us with a potential threat of significance greater than more ordinary and transient fiscal conditions. Public safety organizations must pay attention to this issue. At a time of such acute community need, we absolutely do not want to get surprised by a plateau in property tax or an associated drop in sales tax.

Historically, in relation to the policing function, residential property valuation has often tended to describe the economic conditions of the communities in which we serve. It has been more a circumstance than a component of our mission. The importance of the impact of housing values on our agencies, however, is potentially changing. The purpose of this article is to explore some of the factors related to California housing to encourage law enforcement managers to engage others in a dialogue about the future of their economic exposure related to this question. It will also raise the issue of housing as an aspect of our organizational decision-making.

**Correlation Between Housing Values and Public Agency Revenue**

From the earliest days of the American democratic economy, the ownership and beneficial use of real property has been a cornerstone among the various means of enterprise. This remains the case today. Despite having undergone a dramatic change in our economic focus from an agricultural based market to one of information and manufacturing, property ownership remains one of the most significant means by which individuals and entities accumulate wealth. Real property has also become an important basis for public taxation. This is particularly the case for local governments possessing only specified ability to levy tax.

Municipal governments derive their funding from a finite number of sources. These include property tax, sales tax, utility user taxes, various fees and charges, and transient occupancy taxes.
The chart appearing below depicts approximations of the budget proportions associated with each significant revenue stream.¹

**California City Revenues**

When we consider local government revenue, the allocations become more significant if viewed in terms of the portion of the funding that is discretionary. As can be seen in the figure below, property tax and sales tax comprise a majority of this essential component of municipal budgets.² Recognizing the chart depicts averages, the proportion would be greater for cities not benefiting from a utility user tax or other discrete funding source. When considering the potential impact to law enforcement, one can see police services are the single largest consumers of this volume of discretionary funds.

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¹ Source: Coleman Advisory Services, State Controller. FY01-02 data adjusted for 2004 YLF – PropTax swap.

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Property tax in California is substantially controlled by the terms of Proposition 13, an initiative passed by the voters in 1978. iii The value of real property is taxed at 1%; upward adjustments are restricted to 2% of assessed value each year. Assessed values fully adjust to fair market value at the time of property ownership change. As a consequence of the adjustment restriction, California property taxation produces some aberrant results. Two properties of remarkably similar character, location, and fair market value can have dramatically different assessed values based upon the date of last ownership change. The result can be significantly different tax liability despite similar demands on public service. Depending on the rate of increase in value, properties can also shield significant levels of untaxed equity.

The mechanism to adjust assessed value at time of ownership change also impacts the manner in which market fluctuations are reflected in available tax revenue. Increases or decreases in public revenues are not realized until enough properties have changed owners for the collective assessed value of property to reflect the market change. This shifting in assessment is enhanced by the conveyance of properties with high levels of equity that have not experienced an adjustment for a prolonged period of time. The effect is described in the graph appearing below comparing assessed valuation and median home price over time. iv
In addition to directly expanding the base for property taxation, escalating residential values have arguably been a factor driving the retail economy and corresponding sales tax. The rapid creation of equity has made it possible for homeowners to finance this growth in value and expend it in the retail market. Estimates are this source of funding accounted for as much as 8-10% of disposable income in 2005.\textsuperscript{v} We can comfortably conclude a substantial number of new cars, boats, vacations, and big screen televisions were attained as part of this phenomenon.

Many of our communities have also benefited from the industry of residential construction. This is quantified in a comment by economist Ryan Ratcliff, “The increased pace of new construction plus the high turnover in the market for existing homes has caused the biggest five-year revenue increase since the passage of Proposition 13. Property tax revenues jumped by 58% between 2001 and 2006.”\textsuperscript{vi} Examples of this type of influence also include employment associated with housing construction as well as regional taxable sales of products used in the housing industry such as building and remodeling materials or home furnishings.

\textbf{Historical Perspective}

The startling increases in value of California real estate are a well recognized trend. To varying degrees, median values have continued in an almost uninterrupted upward progression. This pattern is reflected in the chart appearing below describing median home values from 1968 through 2005.\textsuperscript{vii}
It is apparent there have been few periods of actual decline. The following graph is a representation of percentage changes in value during the same historical period. As can be seen, although the rates of value growth differ, actual regression is very infrequent. The only conspicuous decline occurred during the early 1990s. It is particularly worth noting the growth did not falter during the economic downturn associated with the technology bubble.
Period of Change

The real estate sector is clearly experiencing a meaningful transition. Commentators differ, though, regarding the future of home valuation and the extent to which a decline might occur or the degree to which it could impact our economy. A number of economists are projecting a “soft landing”\textsuperscript{ix} as a result of the market adjustment. Others are offering more dire predictions. For example, the Center for Economic Research, in a paper issued in November of 2005, commented, “The costs of a collapse of the housing bubble will be even greater than the costs of the collapse of the stock bubble, because housing wealth is much more evenly held.”\textsuperscript{x} More recently, the National Association of Realtors provided the more optimistic comment, “After bottoming in the fourth quarter of 2006, existing-home sales are forecast to gradually rise through 2007 into 2008, while new-home sales should turnaround by summer.”\textsuperscript{xi} Conversely, Moody’s Economy forecasts notable declines in California communities such as Stockton and Merced of -15.7 \% and -16.1\% respectively as well as a -3.6\% constriction of the national median value.\textsuperscript{xii} At the time of this writing, DataQuick statistics tell us for the month of December 2006 the southern California counties of Los Angeles, Riverside, San Diego, Ventura, San Bernardino and Orange experienced a new record median value of $495,000.00 but a drop in sales volume to a level not experienced since 1995. The Bay Area median price declined to $612,000.00 from a record of $644,000.00 the preceding June and sales volume dropped 19.9\% below the level of the previous December.\textsuperscript{xiii}

Is it home values or the sky that is falling?

Apart from the startling velocity of value increase, other circumstances cause uncertainty about California real property valuation and its potential economic impact. Among these is the question of whether the mechanisms of home finance supporting present values are truly sustainable. For example, of the top 25 metropolitan areas in the nation for use of interest only loans during the period spanning January through June of 2006, ten are in California. They include Ventura, Santa Cruz, San Diego, Santa Barbara, San Luis Obispo, San Francisco, Orange County, Santa Rosa, Los Angeles, and San Jose. Percentages range from a high of 46.3\% in Ventura to a low of 38.9\% in Los Angeles. This compares against a 17\% national average.\textsuperscript{xiv} Some of these communities are among those appearing near the top of the PMI United States Market Risk Index.\textsuperscript{xv} Similarly, California leads the nation in use of negative amortization loans at 25.8\% against a national average of 6.6\%.\textsuperscript{xvi} The question to be answered by the future is how many of these borrowers are dependent on a rising market to allow them to further finance, sell, or maintain their homes.

Concern about stability of financing finds support in recent review of lending guidelines as well as anecdotal modification of lender practices.\textsuperscript{xvii} At issue are techniques in use by some members of the lending community (such as full value financing, no requirement to prove income, nor any need to demonstrate the ability to pay) to grant loans to prospective homeowners. The inference is perpetuating these practices would tend to place more homeowners in risky or untenable situations.

According to analysis by Dr. Christopher Cagan of First American Real Estate Solutions, California also saw the modest development of foreclosure discount in the first six months of 2006.\textsuperscript{xviii} Foreclosure discount is the loss of value lenders suffer when they sell property at
reduced prices out of motivation to avoid the costs of extended possession of a property (tax, insurance, etc.) The estimate places this figure at $25,000 per property. In a rising market, foreclosing lenders or financially imperiled owners can ordinarily sell a property and avoid this forfeiture.

Personal savings rates also declined to negative one percent during 2006, “the lowest level since the Great Depression.” In the preceding year, 47.7 percent of people owning their own residence in California exceed the Census Bureau threshold of 30 percent of income being applied to housing. Households above this level are viewed as “cost burdened” by housing expenses threatening revenue for other personal demands. The portion of California homeowners devoting more than 30 percent of their income to housing substantially exceeds the national level of 34.5 percent. These concerns echo the suspicion about sustainability of financing. They are also entwined with law enforcement revenue in the extent to which they may impinge property tax base. Further, the debt accumulation is at least associated with some element of taxable sales revenue funding our agencies and pulls us closer to this situation.

In a more optimistic tone, the performance of other sectors of the economy such as manufacturing, information and technology, and services may curtail or flatten whatever impact is implied by potential frailties in the housing sector. The same benefit may also result from the overall strength the United States stock market. Additionally, investments residing in the housing market differ from the funds placed in more volatile holdings. In fundamental terms, while a piece of real property may gain or shed some market value, it does not share the vulnerability of Initial Public Offerings (IPO) made for high tech ventures or companies created with unsuccessful business plans.

Another safety valve for California real property is population growth. Whether or not we may face temporarily escalated present day values, immigration and birth rate exceeding deaths leads to a projection the state will grow from 37 to 44 million residents by 2025. Apart from our immediate circumstances, this growth will create a demand purporting assurance of sustained property values over the protracted future.

**Long Term Housing Trends of Importance to Policing**

Looking past future economic variances, other influences are impacting the housing sector in ways warranting law enforcement’s attention. In May of 2006, a diverse panel of experts with insight into issues of public funding and real property assembled at the Fremont Police Department to jointly study the future of this issue. Panelists were experts in disciplines including municipal governance, public safety, public accounting, land use, finance, and corporate operations. The following are among the prominent comments regarding trends affecting public revenue derived from home ownership:

**Urbanization**: The desire to achieve maximum utilization of available real property can be expected to give rise to the creation of infill housing developments in areas already having an established presence of residential or commercial activity. In terms of revenue, the trend is beneficial to policing and public entities. It creates a greater tax base where moderate or high value housing replaces existing dilapidated structures. Additionally, it creates housing opportunities closer to areas of established commerce. However, an increase in service level is also associated with this development. One approach to this concept surfaced in the California
Legislature in the form of SB 1754 introduced in 2006 to create pilot infill housing districts similar to redevelopment areas. From the perspective of public safety, infill housing as a means to meet residential needs offers a benefit of creating housing in areas where public services already exist as opposed to previously rural property. Housing types may also correspond more closely with future home buying populations such as the growing number of retired citizens in the communities we police.

**Digital Technology**

The ability to convert to digital representation the media of the modern workplace is changing the way in which productivity is being accomplished. It is possible to transmit a great deal of professional material to the place where it is received by an employee and is acted upon rather than assembling employees at a common address. The consequence is far less regard for the limitations of geography. It is well identified as a force in international economics giving rise to substantial growth in other nations. However, the same pattern could serve to change the employment possibilities in California communities presently viewed as generally too distant from sites of production. This change in the way employees interact with their employers could arguably be more viable in California because employees would not be so distant from the workplace as to render intermittent meetings and personal contact impractical.

This becomes important to policing from the manner in which it can reshape allocation of real property value. One of the dominant factors in home values is proximity to employment. Minimizing this characteristic could tend to shift residential worth out across a much broader geography changing the way in which value is concentrated in the State. The long range implication is fundamental alteration in communities and corresponding tax base.

Land use attorney and project developer Sean Morley has compared digital technology in this era to the historic changes associated with the proliferation of the automobile in the way it expanded the nature of communities and gave rise to suburban environments. Certainly, some employment must be performed at a fixed location in contact with the beneficiaries of the work. However, despite this, a question remains about the condition of the communities left behind in the digital age and whether they are sufficient to sustain healthy economies.

**Other Eventualities**

The issue of public safety revenue also hovers in other forces potentially shaping the value of the California residential tax base. Some of these include economic change like dramatic movement in interest rates. Others are more global as in the case of shifts in immigration patterns. In the public discourse on immigration, one aspect of the debate often overlooked is the way in which foreign capital is infused into the housing sector becoming part of the collective value. Legislative enactments also portend impacts to valuation. An example is a restriction on the tax benefits of home mortgage interest. However, whether anything like this would ever materialize is quite speculative. Given the essential and fundamental manner in which this deduction is popularly viewed, constraining the benefit would be what residential developer and former Member of Council Dominic Dutra described as constituting a “final political act.” Lastly, certain randomness is implied from the forces of nature. “Though the city has already laid off nearly half its work force, New Orleans still needs $150 to $200 million in 2006 to fill the huge hole that Hurricane Katrina blew in its budget…The lost revenue includes tens of millions of dollars in property taxes that will go uncollected in a city in which more than 80,000 homes, according to state estimates, were severely damaged or destroyed.”


First Course of Action: Market Evaluation

Organizational success, in part, is dictated by the extent of planning associated with a potential change. In the event of an abrupt decline in available resources, the casualties can include organizational effectiveness, employee morale, and standing with the communities we police. In this regard, we are well served to evaluate, in cooperation with municipal fiscal officers, the specific circumstances our respective agencies face in relation to housing and taxation. As has been suggested, this question is complex and multifaceted. It is tempting to treat this topic as a broad unified question. In reality, however, it is as “local” as many of the other policing issues we must confront. The specifics are what make it important for each of our departments individually to consider how we are positioned as to this concern and determine whether we reasonably anticipate organizational change could result.

We can find some guidance to assess our vulnerability in a model related to residential financing addressing mortgage defaults and foreclosures described by Dr. Cagan in an article from February of 2006. Commenting on the issue of rate adjustment and loans with finite periods of low interest rates, Cagan’s basic premise is that the properties most at risk are those without sufficient equity to allow an owner to either sell or refinance if necessary. His nationally oriented estimation suggests parcels with their last encumbrance in 2003 or earlier probably have a sufficient “cushion of equity.” He estimates loans issued since that time with temporarily low interest rates will begin to reset in 2006 “but the large majority of introductory periods would not end until 2007, 2008, or later” and will enter the economy over a period of five years. The gauge to public entities can be found from the prevalence in our communities of loans circumstanced to reset now or in the near future.

In addition to financing methods, other aspects of the housing inventory in our communities offer us further direction to assess valuation stability. Among these is the composition of the inventory; e.g. the portion of the homes in a community owned by investors or developers as opposed to residents. The difference becomes important as to how the various segments respond to a declining market. For example, it is contrary to the interest of developers to retain homes for long periods of time. In an inactive or declining market, overhead expenses of ownership (insurance, tax, etc) can begin to accumulate; creating urgency to sell. This is in contrast to the priorities of occupying homeowners who have an investment interest in their home but generally subordinate economics to lifestyle considerations.

Second Course of Action: Areas Within Department Control

Beyond assessing future implications of present day market conditions, our communities and our departments would benefit from considering our policing functions and the degree to which they align with the objective of preserving the value of our respective residential communities. One example of this alignment is the severance of tenancy of criminal offenders as a means of solving long term policing problems. Evicting gang or narcotic offenders embedded in a residential neighborhood meets public safety objectives as well as helping retain the value of surrounding homes. Evictions of this nature can be accomplished through development of cooperative relationships with landlords or through involvement with investigations related to violations of housing benefit criteria. However, in undertaking enforcement of this type, we must recognize
the reach of our public authority and the very fundamental nature of human domicile. The application of this recognition is we must act in strict obedience to due process guided by transparent and objective violator criteria.

In addition to dealing with housing issues as they already exist, the interests of our communities would be advanced by law enforcement participation in land use decisions at the earliest levels. Sharing our experiences derived from policing our communities may allow us to assist decision makers to foresee liabilities that might otherwise have gone unnoticed. One of the risks of any rapidly rising market is the momentum may tend to obscure latent problems waiting to arise when the market shifts. Aside from informing the policy making process, our individual agency planning would also be enhanced with greater comprehension of intended jurisdictional growth as well as a heightened cognizance of competing priorities underpinning land use decisions.

Conclusion

As public entities, we must recognize we are in the economic tide. The certainty and perpetuity of our revenue is no longer guaranteed. It seems apparent the rapid rate of growth in public entity revenue associated with the housing sector is going to change. To most effectively protect our communities, we must fully understand our economic situation. No two communities have equivalent fiscal capacity. Sustaining our effectiveness compels us to establish strategies emanating from what we anticipate are prudent expectations about the present housing situation. However, past whatever is unavoidably going to emanate from today’s conditions, we must also participate in preserving the value of our community residential assets. In this way, our agencies are not merely forecasting but are part of forming and assuring our future.
Appendix A

Paul Afshar, Ph. D.: Paul Afshar is the CEO of Unitek College, a private technology and healthcare career college located in Fremont, California. His experience includes having been on the faculty of the University of Minnesota teaching computer technology courses, and in project development and management with Solarix Systems, INTERACTIVE Systems, and Hewlett Packard.

Council Member Dominic Dutra: Dominic Dutra has served as a member of the Fremont City Council. He is President of Dutra Cerro Graden, a development consulting firm specializing in residential entitlement and master planned communities. He also was president of Dutra Enterprises, a project development company specializing in portfolio construction of residential, retail and office developments. Until 1999, he was president of Dutra Realty, a company of over 250 agents prior to being acquired by Prudential California Realty. He holds Bachelor's and Masters degrees in Business Management from Santa Clara University.

Assistant City Manager Lisa Goldman: Lisa Goldman was recently appointed Assistant City Manager with the City of Alameda. She previously served as the Intergovernmental Relations Officer for the City of Fremont. She has five years of budget team experience and is knowledgeable in the areas of local government finance and municipal prosperity. She also served as a legislative assistant on the staff of Representative Henry Waxman. She holds an undergraduate degree from Harvard University and a Masters in Public Policy from UC Berkeley.

Frank Grgurina: Frank Grgurina is a Captain with the Fremont Police Department. He has substantial experience both in police operations as well as in the recruitment, selection, and retention of law enforcement employees. He has served in a wide variety of assignments and also has joint responsibility for oversight of construction of a substantial law enforcement training facility. He is also a member of the California Police Chiefs Association Technology Committee.

Michael Huffman: Michael Huffman has been with the international accounting firm of Deloitte & Touche for 25 years including 14 years as a partner. He has 18 years experience conducting financial statement audits of both public and private companies. He is a specialist in mergers and acquisitions. In this capacity, he heads the National Technology, Media & Telecommunications M&A Transaction Services Group. He has also participated in the American Institute of Certified Public Accountants’ Software Revenue Recognition Task Force.

Kurt Kessler: Kurt Kessler has been involved in the real estate industry since 1988 and a mortgage planner in Pleasanton, California for 14 years. He has owned Pleasanton Mortgage for three years and was also a partner in The Home Mortgage Superstore. He holds a Bachelor of Science in real estate from San Diego State University.

Sean Morley: Sean Morley is a principal in Morley Brothers, LLC, a real estate development company focusing on infill residential and mixed use in communities throughout the San Francisco Bay Area. As an attorney, he practices in the area of land use, real estate and public law and has represented investors and developers in acquisition and development transactions.
He also served as Senior Policy Advisor and Chief of Staff to the former Mayor of San Jose, Hon. Susan Hammer. In that capacity, he participated in major corporate, residential and redevelopment projects. He holds a Bachelor of Arts from Pomona College and a Juris Doctor from Santa Clara University.

Steve Sweeney: Steve Sweeney is a Captain with the Livermore, Ca. Police Department. He has held a number of assignments and is an accomplished law enforcement manager. He is actively involved in developing the profession apart from his work in his own organization through involvement with the California Police Chiefs Association as well as in his capacity as Region Chair of the California Peace Officers Association. He has the experience of policing a city with substantial residential development as well as commercial areas in transition.

Vic Valdes: Div. Chief Valdes has been a member of the Fremont Fire Department since 1976. He is a recognized authority in the area of disaster/terrorism preparedness and response. He participates at the local, state and national level related to emergency management and is a member of the national Metropolitan Medical Response System program review and the California CDC/HRSA Pandemic Influenza Joint Advisory Committee. He holds a Bachelor's degree from UC Berkeley.

Ibid, p. 6

California State Constitution, Article 13.


Martin Cruisinger, “East Bay housing projected to drop in market value,” in The Argus, October 4, 2006, p. 1


Youngblood, 2006.


Martin Cruisinger, “Americans are spending more than they earn,” in The San Jose Mercury News, February 2, 2007, p. 3D

Michele R. Marucci and Eve Mitchell “State housing costs through the roof,” in The Argus, October 3, 2006, p. 1

On May 3, 2006, a panel of subject matter experts generously donated their time to participate in a nominal group research panel conducted at the Fremont, Ca. Police Department. Many of the concepts reflected in this article were developed during this session. The panel consisted of Paul Afshar, Ph. D., Council Member Dominic Dutra, Assistant City Manager Lisa Goldman, Capt. Frank Grigrurina, Michael Huffman, C.P.A., Mortgage Planner Kurt Kessler, Capt. Steve Sweeney, and Div. Chief Vic Valdes. Brief resumes of each of these accomplished professionals appear at the conclusion of this article as Appendix A.


Nominal Group Panel 2006

ibid.

Thomas Friedman, The World is Flat, (New York, 2005).

Nominal Group 2006


Christopher L. Cagan, Ph.D., “MORTGAGE PAYMENT RESET The Rumor and the Reality,” First American Real Estate Solutions, (February 8, 2006).

ibid. pg. 30.
