

What the Housing Crisis Means for State and Local Governments

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As the U.S. housing market experiences its largest contraction since the Great Depression, the Lincoln Institute of Land Policy and the Urban–Brookings Tax Policy Center took a closer look at the consequences of this crisis for state and local governments in a May 2010 conference. A major theme of the discussion was the fallibility of conventional wisdom. For example, some participants questioned whether easy credit was in fact the cause of the housing bubble and thus to blame for the subsequent loss of state and local tax revenues. Papers presented at the conference (see page 13) document the complexities researchers face in determining the causes and lessons of this crisis.

- While easy credit did motivate homebuyers, its effect was not sufficiently strong to fully account for the housing boom.
- The housing market downturn was largely predictable, but only by looking at state-level rather than national data.
- Although state budgets have been battered by fallout from the recession in the form of lower income and sales tax revenue, these declines have been triggered more by the broader economic downturn than by the collapse in housing markets.
- Local governments seem to have been largely spared the severe budget shortfalls plaguing many states. While housing prices have fallen, property taxes have held up fairly well—supporting city budgets while other revenue sources have shrunk. However, there is great geographic variation in these results.

The Housing Market Boom and Bust

According to Byron Lutz, Raven Molloy, and Hui Shan, house prices at the national level increased by 64 percent from 2002 to 2006, before falling nearly 30 percent over the following four years. From 2006 to 2009, existing home sales dropped 36 percent and the number of newly constructed homes fell 75 percent. Could we have seen it coming? Was the housing market bust predictable? Yes, according to Yolanda K. Kodrzycki and Robert K. Triest, but only by looking at state-level data.

Conventional wisdom held that while house prices could fall in specific markets, national housing prices would not decline. This had been the historical pattern, although some markets, for example the Boston and Los Angeles metropolitan areas, experienced declines in the 1990s after strong increases in housing prices. Other areas, such as Detroit, had been declining or stagnant even when the country as a whole experienced consistent upward movement in house prices.

Much of the modeling and analysis of the housing crisis has used national-level data, which provided insufficient evidence to measure the peak of the housing bubble. Since economic cycles are more apparent at the state level and can act as early warning signs of housing trouble on a national scale, analyzing state data collectively can improve national forecasts.

Nevertheless, even the ability to recognize a housing bubble does not provide an easy prescription for preventing a crisis. Previous episodes of state-level housing price declines show that booms do not necessarily end in busts, Kodrzycki said. Rather, downturns are closely related to economic cycles. In most cases housing prices did not fall



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until after a recession had begun within a region—a pattern that is different from the current crisis.

The cause of the housing bubble is a crucial and unsettled question. Many economists have argued that easy credit was responsible, but Edward L. Glaeser disputed that view in a paper written with Joshua Gottlieb and Joseph Gyourko. Widely available credit and low interest rates do encourage more people to buy homes, increasing demand and raising housing prices. “This goes along with an older view,” Glaeser said, “that interest rates are very powerful in determining housing prices. There is some truth to that, but I think...those claims are overblown. Certainly the changes in the credit market can’t explain what we went through.”

Between 1996 and 2006, real housing prices rose by 42 percent, according to the Federal Housing Finance Agency price index. Glaeser and his colleagues found that low interest rates can likely explain only one-fifth of that increase. Other factors, including an elastic housing supply and credit-constrained homebuyers, can mute the effect of interest rates on prices. Buyers contemplating future moves or refinancing can take those factors into account when deciding how much to pay for a home. If the link between interest rates and house prices is smaller than expected, that knowledge

can inform future federal housing policies and estimates of their effects on the housing market.

Impacts on State Revenues

State revenues plummeted in the recession, leading to record-high budget shortfalls just as demand for public services was growing. Inflation-adjusted state tax revenue fell nearly 15 percent during the downturn—the biggest drop in more than 50 years.

Donald Boyd noted that many of the first states to see their tax revenues decline also had been hit hard and early by the housing downturn. Arizona experienced its revenue peak in 2005, and by 2009 its real per capita tax revenue fell by 23.5 percent. Meanwhile, housing prices in Arizona tumbled 19.7 percent from 2006 to 2008.

States that were spared the worst of the housing crisis did not see revenue losses until the recession was in full swing. Texas had a 7.4 percent increase in housing prices from 2006 to 2008. Its tax revenues did not peak until late in 2008; roughly a year later, however, Texas saw its revenue drop by 17.5 percent.

Steven Craig and Edward Hoang examined how state government expenditures and taxes fluctuate with changes in underlying economic activity. They found that in general state responses initially



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tend to lag behind changes in gross state product, but in the long run states tended to overadjust to economic shocks.

Boyd found that in response to their budget gaps states cut spending in 2009 and 2010 primarily through furloughs and layoffs, and by stretching out payments of obligations into the future. States also cut grants to local governments, according to Howard Chernick and Andrew Reschovsky, who examined whether state budget crises lead to greater tax competition between states and their large cities. They find that in the long run cities with diversified revenue will be in a stronger fiscal position, but in the short run own-source revenue has declined more in cities with a diversified tax base (due in part to the strength of property tax). They also find that state aid is highly stimulative, but that increases in states sales tax rates will make it more difficult for cities to increase their sales taxes. The authors conclude that the current economic downturn will force significant public service reductions for large central cities.

Rachana Bhatt, Jonathan Rork, and Mary Beth Walker examined how higher education fared during the recession. While there have been highly publicized cuts in funding for higher education from general revenues, the overall level of expenditures for higher education has increased from 1996 to 2008. The authors find that across the business cycle states tend to substitute earmarked support for higher education (whether in the form of federal grants, lottery revenues, or other special accounts) for general fund support.

Federal stimulus spending in the American Recovery and Reinvestment Act (ARRA) helped boost state budgets and mitigate cuts in state aid to local governments, but those funds are set to expire in 2011. Boyd examined earlier recessions and found that the declines in state revenues have been more extreme this time. The good news, Boyd said, is that state tax revenue declines are showing signs of slowing and local revenues have not yet declined in aggregate.

“We might be stabilizing,” Boyd said. But, “it’s going to be a long ways before states are likely to have the capacity to finance the kinds of spending programs they have had...which means a lot of budgetary pain ahead still.” Indeed, the stabilization of state revenues on average was due in large part to tax increases in only two states, New York and California. Boyd predicts that it will be some time before other state revenues return to prerecession levels.

But, was this damage caused by the housing crisis? The recession may have been sparked by failing subprime mortgages, but it was fueled by overleveraged financial institutions—turning a housing slump into a global economic downturn. Lutz, Molloy, and Shan sought to separate the effects of the housing downturn on state and local tax revenues from the broader impact of the recession. They identified five main revenue streams that are influenced by the housing market: property tax revenues; transfer tax revenues; personal income tax revenues (related to construction and real estate jobs); direct sales tax revenues (through construction materials); and indirect sales tax revenues (when homeowners adjust their overall spending in response to changes in property value).

Property tax revenues remained high, and even grew in some states. The other four revenue streams declined, but had only a modest effect on overall state and local tax revenues. Lutz, Molloy,

and Shan estimated that the combined decreases from these four revenue streams reduced total state and local tax revenues by \$15 billion from 2005 to 2009, which is about 2 percent of state and local tax revenues in 2005. They found that in aggregate housing-related declines are responsible for only a fraction of the overall decline. Widespread unemployment and shrinking family incomes are more significant in cutting personal income and sales tax revenue. Thus, while the housing market and the economy are closely intertwined, the severe drop in state tax revenues can largely be attributed to the broader economic downturn, not the housing crisis specifically.

Local Governments and Property Taxes

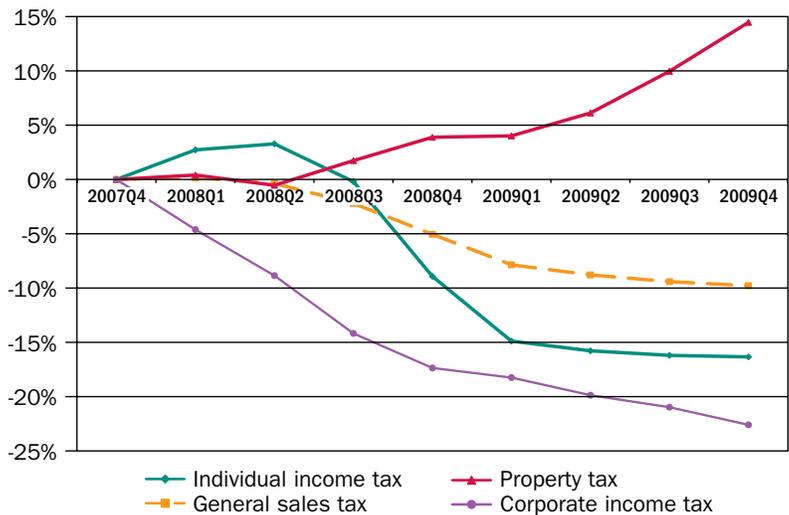
As state revenues fell, local government revenues as a whole continued to grow because property tax revenue, which stayed strong in the recession, supported municipal budgets. States typically rely on income and sales taxes, which are more volatile than the property taxes that largely fund local governments. From 2007 to 2009, corporate and individual income tax revenue declined rapidly and sales tax revenue fell—but property taxes grew (figure 1).

In most states, housing price declines are not immediately reflected in assessed property values, and that lag makes property taxes a fairly resilient source of revenue. Also, policy makers tend to offset declines by raising tax rates (figure 2). James Alm and David L. Sjoquist backed these findings with their study of national trends in property tax collections. Although experiences varied among cities, they noted that local governments' reliance on property taxes has been an advantage, allowing them to avoid some of the more severe effects of the recession.

Variable Effects in Selected States

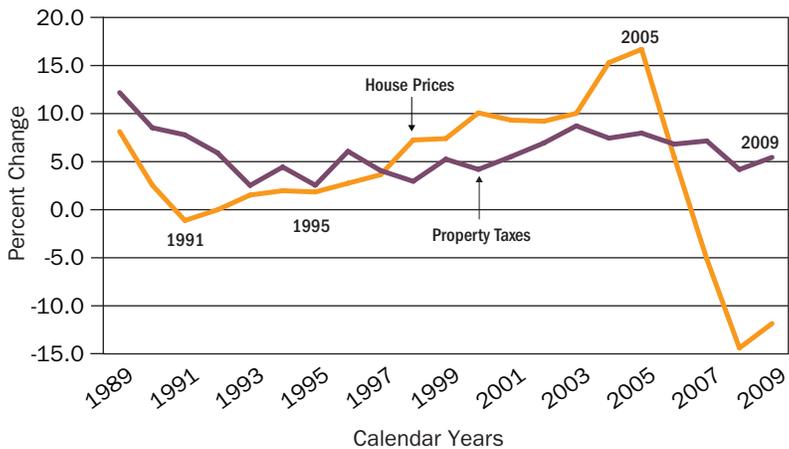
While the conference focused on national trends, a recurrent theme was the dramatically variable experience of specific states and regions. Bruce Wallin and Jeff Zabel examined the effects of an earlier decline in Massachusetts house prices in the aftermath of a tax limit. Proposition 2½, passed in 1980, is a voter initiative that limits property tax levies (to 2½ percent of assessed values) and limits revenue growth to 2½ percent per year. There are exceptions for new growth, and Proposition 2½ does allow local voters to pass overrides to increase

FIGURE 1
Inflation-Adjusted State and Local Revenue, Underlying Trends



Source: Boyd (2010).

FIGURE 2
House Price Appreciation and Property Taxes



Source: Lutz, Molloy, and Shan (2010).
Note: 2002:Q2 property tax value is an estimate.

the growth percentage. Wallin and Zabel found property tax revenues overall did grow 4.58 percent between fiscal year 1981 and fiscal year 2009, largely due to these exceptions. A maximum of 547 overrides were proposed in 1991, but as few as 51 in 1999. However, poorer towns have been less likely to approve tax increases, relying instead on spending cuts, and leading to a growing gap between poor and wealthy towns over time.

Michigan, already struggling with the loss of manufacturing jobs, provides another striking case study. Poverty and unemployment rates there are

BOX 1
Foreclosure Statistics

- Nationwide, 1 in 33 homeowners are facing foreclosure.
- In 2004, before the crisis, the national foreclosure rate was 1.1 percent.
- In 2009, 2.21 percent of all homes in the United States were foreclosed.
- Foreclosure rates hit double digits in some markets: Las Vegas, NV (12.04 percent), Fort Myers, FL (11.87 percent), and Merced, CA (10.10 percent).

Source: Figlio, Nelson, and Ross (2010).

higher than the U.S. average. In Detroit, housing prices plummeted—the average home cost \$97,850 in 2003, but dropped to a remarkable low of \$11,533 by 2009. Mark Skidmore and Eric Scorsone found that in the recession Michigan cut spending on recreation programs and delayed capital projects and infrastructure maintenance. That strategy may be effective in the short run, Skidmore said, but will likely result in higher costs down the road. He suggested that a similar fate might be in store for Las Vegas or cities in Arizona, which also experienced severe housing price declines.

Local governments in Florida and Georgia have remained fairly stable, so far. Florida experienced a tremendous increase in house prices from 1994 to 2006, before the housing market decline caused prices to fall across the state. William M. Doerner and Keith Ihlanfeldt found that city revenues in Florida rose during the housing boom, but not solely as a result of increased property values, and those revenues have stayed fairly strong following the drop in house prices. Alm and Sjoquist reported that property tax revenues in Georgia rose slightly between 2008 and 2009, while property values declined. Local governments, in many cases, maintained collections by increasing the tax rate.

What the Housing Crisis Means for Children

The housing crisis inflicted enormous costs on individuals, communities, and governments. Residents have been hurt by foreclosures and tremendous losses in property values (box 1). Vacant, deteriorating homes have weakened neighborhoods. The children caught up in the housing crisis face uncer-

tain living situations and may have to transfer from school to school. Although researchers know these changes can harm children, they do not yet fully understand how this crisis is affecting students and schools.

David Figlio, Ashlyn Aiko Nelson, and Stephen Ross are studying how foreclosures hurt children's educational outcomes. Their preliminary analysis indicates that schools serving neighborhoods with high foreclosure rates may experience declines in enrollment or community resources, with spillover effects on students whose families have not lost their homes.

The effects of the housing crisis on children, schools, and neighborhoods are also being examined by Jennifer Comey and her colleagues. The first stage of their work in New York, Baltimore, and the District of Columbia identified areas with high rates of foreclosures. They have found that foreclosures of multifamily and rental units can lead to displacement of renters, causing many families to be harmed by the upheaval in the real estate market. The second phase will track student transfers after foreclosures, comparing their former neighborhoods and schools with their new ones. Comey and her colleagues will also analyze these students' school performance through attendance, test scores, and dropout rates. They stressed the importance of coordinating housing and education services. Housing counselors need to know how students are affected by foreclosure and to understand relevant local school policies. A better understanding of these issues can help schools ease the burden on displaced and homeless students.

Looking Abroad . . . and Ahead

Government responses to the global housing crisis also vary around the world, and some countries may offer lessons for the United States. For example, Christian Hilber examined whether central government grants can help maintain housing prices and found that most such grants seemed to translate into increased property values.

Joyce Yanyun Man reported that local governments in China were encouraged to invest in real estate and infrastructure to stimulate economic growth. Rather than using property taxes, they turned to land leasing fees and borrowing to finance urban development. China's GDP growth rate is rising, but local governments are heavily in debt. Given what we are learning about the stability of

property taxes in the United States, China may need to consider a similar policy instead of relying on one-time leasing fees to generate extra revenue.

Although local governments have not suffered the same fate as states, at some point assessed values will catch up to housing price declines. Indeed, recent survey results from the National League of Cities indicate that cities are beginning to see their revenues soften. John E. Anderson warned that local governments are in a precarious position—the property tax base has shrunk and ARRA funding will end, which could create a delayed blow to revenue. If these forces cause local governments to raise rates, this could cause homeowners to push for property tax limits and other initiatives to reduce property tax rates. Anderson investigated the potential adjustments local governments may have to make as they reduce reliance on the property tax in favor of alternative taxes.

Hui Shan stated, “Historical data and case studies suggest that it’s quite unlikely for property tax collections to fall steeply in the next few years.” The delay between the housing downturn and a drop in property taxes may give the national economy time to recover, making up for the loss of stimulus funds and property tax revenue through higher income and sales tax revenue. The forecast is not clear, but state and local governments should be prepared for what the conference participants agreed will be a slow economic recovery ahead. **L**

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Conference Authors and Papers

Alm, James, Tulane University; and David Sjoquist, Andrew Young School of Policy Studies, Georgia State University: *Rethinking Local Government Reliance on the Property Tax*

Anderson, John E., University of Nebraska–Lincoln: *Shock to the Tax Base and Implications for Local Public Finance*

Bhatt, Rachana, Georgia State University; Jonathan Rork, Reed College; and Mary Beth Walker, Georgia State University: *Earmarking and the Business Cycle: The Case of Higher Education Spending*

Boyd, Donald J., The Nelson A. Rockefeller Institute of Government, State University of New York at Albany: *Recession, Recovery and State and Local Finances*

Chernick, Howard A., Hunter College and the City University of New York; and Andrew Reschovsky, University of Wisconsin–Madison: *The Impact of State Government Fiscal Crises on Vertical Fiscal Competition Between States and Local Governments*

Comey, Jennifer, The Urban Institute; Vicki Been, NYU/School of Law and Furman Center; Ingrid Gould Ellen, NYU/Wagner and Furman Center; Matthew Kachura, The Jacob France Institute, University of Baltimore; Amy Ellen Schwartz, NYU/Wagner-Steinhardt/IESP; and Leanna Stiefel, NYU/Wagner-Steinhardt/IESP: *The Foreclosure Crisis in Three Cities: Children, Schools and Neighborhoods*

Craig, Steven G., University of Houston; and Edward Hoang, University of Memphis: *State Government Response to Income Fluctuations: Consumption, Insurance and Capital Expenses*

Doerner, William M., and Keith R. Ihlanfeldt, Florida State University: *House Prices and Local Government Revenues*

Figlio, David, Northwestern University; Ashlyn Akio Nelson, Indiana University; and Stephen L. Ross, University of Connecticut: *Do Children Lose More than a Home? The Effects of Foreclosure on Children’s Education Outcomes*

Glaeser, Edward L., and Joshua Gottlieb, Harvard University; and Joseph Gyourko, The Wharton School, University of Pennsylvania: *Can Easy Credit Explain the Housing Bubble?*

Hilber, Christian A.L., and Teemu Lyttikainen, London School of Economics and Spatial Economics Research Center (SERC); and Wouter Vermeulen, CPB Netherlands Bureau for Economic Policy Analysis, VU University and SERC: *Capitalization of Central Government Grants into Local House Prices: Panel Data Evidence from England*

Kodrzycki, Yolanda, and Robert K. Triest, Federal Reserve Bank of Boston: *Forecasting House Prices at the State and National Level: Was the Housing Bust Predictable?*

Lutz, Bryon, Raven Molloy, and Hui Shan, Federal Reserve Board of Governors: *The Housing Crisis and State and Local Government Tax Revenue: Five Channels*

Man, Joyce Yanyun, Lincoln Institute of Land Policy: *Extra-Budget Spending, Infrastructure Investment, and Effects on City Revenue Structure: Evidence from China*

Skidmore, Mark, Michigan State University; and Eric Scorsone, Michigan Senate Fiscal Agency: *Causes and Consequences of Fiscal Stress in Michigan Municipal Governments*

Wallin, Bruce, Northeastern University; and Jeffrey Zabel, Tufts University: *Property Tax Limitations and Local Fiscal Conditions: The Impact of Proposition 2½ in Massachusetts*

The complete conference papers are available for free downloading on the Lincoln Institute Web site at www.lincolninst.edu/education/education-coursedetail.asp?id=720