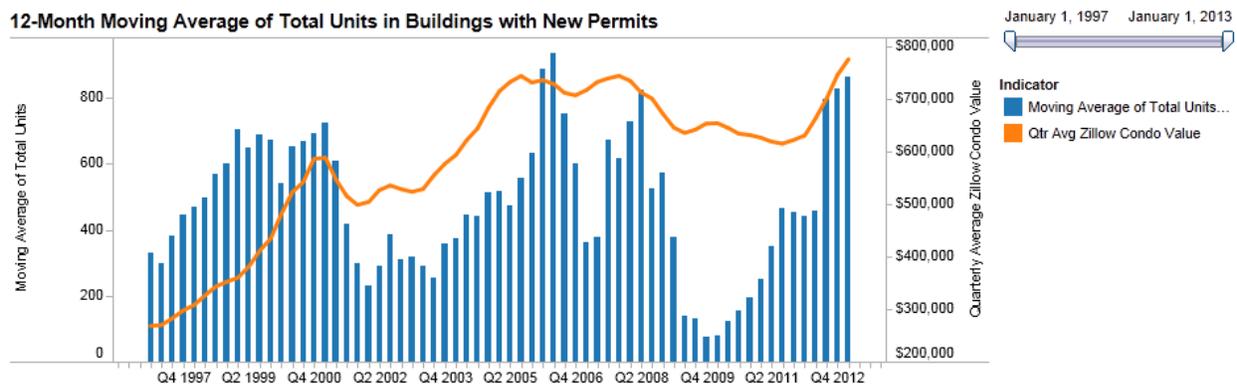


# SF Controller Shows “Supply & Demand” Does Not Work in the San Francisco Housing Market

Calvin Welch, San Francisco Information Clearinghouse, October 2013

The San Francisco Controller’s Office of Economic Analysis produces a web page called the **Economic Barometer** which features snapshots of “major sectors of the City’s economy, including real estate...” One of the sub pages of the real estate section is on “New Building Permits” from which the graph reproduced below is taken.<sup>1</sup>



What the graph shows is that, more often than not, an increase in production from one quarter to the next, as measured in new building permits issued, is accompanied by an increase in average price, as measured by the average Zillow condo value. In 41 of the 65 quarters (63%) covered, housing production increased over the previous quarter, yet in 44 of the quarters measured ( 68% of the total quarters measured) condo prices increased.

This paper will attempt to describe what the facts revealed by the chart are, and why the “law of supply and demand” fails to work when applied to new construction of market rate housing in San Francisco, and therefore why we will never “build our way” to housing affordability by increasing the production of market rate housing. Finally this paper will point out what does work to provide affordable housing in San Francisco.

## The Graph

The graph includes data from 65 quarters spanning the period between January 1997 and January 2013.<sup>2</sup> It shows both quarter-to-quarter figures for sale price for condominiums (the major housing type newly constructed during this period) and the total number of units issued a building permit during the same quarters. During the period covered by the graph, condo prices increased by 288%, from \$268,000 in January of 1997 to \$775,000 in January, 2013. During the same period the graph shows a total of 31,324 units were issued building permits.

<sup>1</sup> <http://sfbarometer.weebly.com/new-building-permits.html>

<sup>2</sup> <http://sfbarometer.weebly.com/data-export-guide.html>

The period covered included both the run up to the late 1990's "dot com boom" including the "live work loft" craze, the mid to late 2000's "housing bubble" and the more recent early teens "tech boom" now underway. In short, it covers a period in which market rate housing production became the primary real estate development activity in the City, far surpassing commercial office development which dominated the real estate market in the 1970's and 1980's. The period covered by the graph also includes the three most productive years of housing development in the 45-year history of housing production as reported in the Planning Department's annual "Housing Inventory:" 2,730 new units in 2003; 3,019 new units in 2008; and 3,366 new units in 2009.

If there ever was a real life demonstration of increased supply reducing price then the 16 years covered by the graph would be the period in which it would have occurred since at no other time in the modern history of San Francisco has more market rate housing been built. Yet there was a 288% increase in average price recorded in the graph over the period of unprecedented market rate housing production.

In fact, the data used in the graph indicates that when there is a decline in production of market rate housing, there is a decline in price. A year-long decline in production between January 2001 and January 2002 (the "dot com bust") saw a three quarter long decline in price, from \$588,000 to \$499,000. Again, a year-long decline in production from October, 2008 to October 2009 (the period of the housing bubble "bursting") saw a drop in price from \$671,000 to \$653,000.

Why?

## The "Law of Supply and Demand" Amended in San Francisco's Housing Market

First, let's be clear on just what the "law of supply and demand" requires if it is to set prices in a market economy. In classic economic theory prices are set by supply and demand only when the market is "competitive" when neither consumers nor suppliers have the "market power" to set the price by themselves. Clearly, that is not the case in San Francisco where owners of land have huge market power since there is so little of it. Of the City's 47 square miles, only 13 square miles is available for housing uses, the rest being used for streets, schools, parks, beaches, office building, shops, hotels, convention centers, hospitals, police and fire stations. And all 13 miles are developed and owned by somebody. There is no "free land" in San Francisco. The owners have total "market power" over its price.

Second, the housing "supply and demand" argument is usually linked solely to the "supply" being filled by new construction(see for example a June 10, 2013 Op Ed piece in the Chronicle on "How to make SF Housing More Affordable" by Enrico Moretti of UC Berkeley in which he only lists new construction as the solution.), forgetting the City's existing 370,000 units of which 140,000 are in single ownership and therefore subject to sales in any given year.<sup>3</sup> ( Indeed, some year's sales of existing homes are a significant portion of all housing sales in San Francisco, exerting huge influence on housing price. In 2009 and 2010 "preexisting home" sales totaled over 4,400 units, nearly equal to the 4,600 new units built over the same two year period.

Any theory of price that ignores half of the sales is bound to be wildly inaccurate.

Third, in a market economy, housing is a commodity like soy beans or pork bellies. Speculation in commodities, driving wild swings in price, is a structural part of the market. Housing speculation in a "hot market" like San Francisco is simply part of the market with powerful impacts on price no matter what new construction is happening. In June 2013, the SF Chronicle reported that speculators (or

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<sup>3</sup> <http://www.sfchronicle.com/opinion/openforum/article/How-to-make-SF-housing-more-affordable-4590271.php>

“investors” as the Chronicle calls them) using “all cash” made up nearly a third of all buyers in the Bay Area.<sup>4</sup> (). The whole point of this speculation in housing is to buy cheap and sell dear, thus driving up prices. Speculators exert tremendous “market power” on prices. The New York Times recently reported that a large portion of these “all-cash” buyers are Wall Street based with huge “portfolios” willing to suck up any number of housing units no matter how many are produced.<sup>5</sup>

We will never build our way out of high housing costs if we rely on a market dominated by a handful of landowners and an ever growing number of cash rich speculators. The real scarcity in San Francisco is land, and since we are not producing any more of it (indeed, given sea level rise we are actually about to see its decline), we cannot really expect “supply and demand” to work here.

### **What does work to produce affordable housing in San Francisco?**

What works in San Francisco are policies designed to control housing costs and conversions, and the development of publically funded, permanently affordable housing.

Currently some 190,000 units in San Francisco are subject to some sort of price controls either partial through rent control (145,000 units) or Section 8 contracts (10,000 units), or “permanently” through public ownership (6,500 public housing units), non-profit ownership (25,000), or Below Market Rate inclusionary units (2,000). Some 160,000 or so (including some rent controlled buildings) are protected from either condo conversions or conversions to market rate hotel rooms.

Public Housing and the Section 8 program are under extreme pressure currently and must be reformed and maintained. Rent control is a diminishing asset as all new construction is exempt from rent control and existing apartments are under constant pressure of being converted to TICs and condos. We need to rededicate our efforts to make these critically important programs work.

Those policies and programs which seek to insulate residents from the wild swings of a market that is dominated by a few owners able to exert powerful market control that repeals the “law” of supply and demand and speculators who take advantage of “the market,” actually offer the best chance of affordable housing for the overwhelming majority of San Franciscans. New construction of market rate housing will never meet the housing needs of current residents and we should move on from that dangerous “urban myth” that we can, through the “laws” of supply and demand, build our way to affordability.

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<sup>4</sup> <http://www.sfchronicle.com/realestate/article/Home-prices-soar-in-Bay-Area-4599496.php>

<sup>5</sup> <http://dealbook.nytimes.com/2013/06/03/behind-the-rise-in-house-prices-wall-street-buyers/>