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How Smart Growth Exacerbated the International Financial Crisis

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The U.S. mortgage meltdown has dominated business news for months. The crisis seems to deepen daily, and its impacts are felt throughout an increasingly interdependent financial world. Only recently, the Organization for Economic and Development (OECD) and the International Monetary Fund (IMF) have suggested that losses of an *additional* \$250 billion to \$1 trillion may yet be in the offing. In the ongoing debate over the causes and cures of the mortgage meltdown, one of the most important factors has been virtually absent: the role of excessive land use regulations in exacerbating the extent of losses.

What Is Excessive Land Use Regulation? As we know from introductory courses in economics, scarcity raises prices. In a number of metropolitan markets across the country, excessive land use policies have been adopted, such as urban growth boundaries, huge areas recently declared off-limits to development, building moratoria, confiscatory and unprecedented impact fees, and excessively large minimum lot sizes.

These policies, often referred to as “smart growth,” create a scarcity of land, artificially raise the price of housing, and, again, have increased the exposure of the market to risky mortgage debt. When more liberal loan policies were implemented, metropolitan areas that had adopted these more restrictive policies lacked the resilient land markets that would have allowed the greater demand to be accommodated without inordinate increases in house prices.

A few voices in the wilderness on both sides of the political spectrum have pointed to the role of excessive land use policies in driving up housing costs. For example:

- Liberal economist Paul Krugman of *The New York Times* put most of his conservative colleagues to shame in noting that the house price bubble has been limited to metropolitan areas with strong land use regulation.
- Conservative Thomas Sowell, no stranger to being a voice in the wilderness, has made similar points.
- More recently, Theo Eicher of the University of Washington produced a working paper placing much of the blame for house price escalation on land use regulation in cities around the nation.

Consequences of Excessive Land Use Regulation. How does all of this relate to the mortgage meltdown and the subprime crisis? It is very simple. There is no question that more liberal loan policies were the proximate cause. But the strict land use regulations forced prices up much more than would have been the case if the previous more traditional yet environmentally sound regulation had been retained.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1906.cfm

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Excess Price of the Housing Stock and Excess Mortgage (From 2000)

By Average House Price Increase	Number of Excessive Land Use Planning (Smart Growth) Markets	Estimated Excess House Prices over 2000 Average Price/Income Ratio	Rise in Aggregate House Value Relative to Average Price/Income (in Billions)	Rise in Mortgage Exposure Relative to Average Price/Income (in Billions)	Share of Excess Mortgage Escalation
Highest 10	100%	\$277,400	\$3,400	\$3,060	64%
Higher 10	100%	\$135,900	\$1,020	\$920	19%
Middle 10	50%	\$76,500	\$520	\$470	10%
Lower 10	10%	\$32,000	\$190	\$170	4%
Lowest 10	0%	\$5,200	\$30	\$30	1%
Total Major Metropolitan	52%	\$134,100	\$5,160	\$4,650	98%
Other Areas			\$110	\$100	2%
United States			\$5,270	\$4,750	100%

Notes: Assumes excess mortgage exposure is at the same ratio as aggregate value increase. Detailed metropolitan area excess housing value estimates are available at <http://www.demographia.com/db-overhang.pdf>.

Table 1 • WM1906  heritage.org

Places like California, the Northeast, the Northwest, and Florida have implemented excessive land use controls. As a result, their land use planning systems have not been able to accommodate the stronger demand created in the more profligate lending environment. At the same time, as a result of its more relaxed land regulation, much of the rest of the nation was far better able to accommodate the higher demand. This includes the high-income world's three fastest-growing metropolitan areas with a population of more than 5,000,000: Atlanta, Georgia, and Houston and Dallas-Fort Worth, Texas.

This is illustrated by developments in the nation's 50 largest metropolitan markets. Between 2000 and 2007, house prices increased an average of more than \$275,000 compared to incomes (house price to household income ratio) in the 10 markets with the greatest price escalation or the greatest affordability loss. Among the second 10 markets with the greatest affordability loss, prices rose \$135,000 relative to incomes. By contrast, in the markets with the least affordability loss, house prices increased only \$5,000. (See Table 1.)

What the 20 markets that have lost the most affordability have in common is excessive land use regulation. Virtually everyone knows the distress that such cost increases mean for America's households.

But there are broader economic consequences that have expanded to the international market. From 2000 to 2007, the gross value of the U.S. housing stock rose \$5.3 trillion relative to household incomes. It is estimated that \$4.4 trillion of this increase occurred in the 20 most escalating markets, all of which are characterized by excessive land use planning. In each of four markets (Los Angeles, New York, San Francisco, Washington, and Miami), the aggregate escalation above incomes was a third of a trillion dollars or more.

While there have been modest house price reductions in the most expensive markets, far larger drops would be required to restore previous levels of housing affordability in the most expensive markets. Moreover, Bureau of the Census estimates indicate that many of the markets that have lost so much affordability are also losing large numbers of households to more affordable areas of the country, which could suggest that house prices may well drop even further.¹

Over the same period, the nation's gross residential mortgage exposure rose \$4.8 trillion relative to household incomes. If the distribution of mortgage exposure increase tracked with the increase in excess value noted above, then 83 percent is attrib-

1. Data are available at <http://www.demographia.com/db-haffmigra.pdf>.

utable to the 20 most escalating markets—again, all with restrictive land use planning or smart growth. Stated another way, if price-escalating smart growth policies had not been adopted in state capitals, county courthouses, and local planning commissions, the financial risk in the current crisis would be at least \$4 trillion less. This is a very high concentration of excess mortgage exposure, since these markets account for only 26 percent of the nation's owner-occupied housing stock.

The tragedy is that when most of these decisions were made, there was not the slightest consideration of economics—the upward pressure on house prices—or the number of households that would be denied home ownership in the years to come. Yet these local decisions played a major role in what *The Economist* magazine called a near global collapse.

Exacerbating the International Finance Crisis.

Simply put, without smart growth, the international financial crisis that has raised so much appropriate concern would have been much less severe. Thus far, the policies of the Federal Reserve Board have failed to take notice of this important connection. Any serious effort to prevent a repeat of such destructive price volatility will require removing these destructive land use regulations that have done so much to destroy housing affordability in many markets while adding inordinately to the financial distress that is being felt around the world. Economics-challenged state and local politicians must not be permitted to steer the international economy into an iceberg.

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