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Land Use Deregulation Should Be Part of Any Housing Reform Plan

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The New York Times reports that at a recent Houston fundraiser President Bush attributed the collapse of the housing finance market—and the economic turmoil that followed—to the fact that "Wall Street got drunk…and now it's got a hangover." He also went on to note that First Lady Laura Bush had been in Dallas scouting out the area's housing market for their next home, noting that both Houston and Dallas seemed to have escaped the market frenzy and subsequent collapse confronting many other American metropolitan areas.

In his offhand way the President sort of got it right. The impact of the housing finance imbroglio on American communities has been very uneven, and several regions—notably Houston, Dallas, Atlanta, and Indianapolis—have not suffered the declines in value or the relative rates of defaults and foreclosures common to markets in California, Nevada, Florida, and northern Virginia.

What the President may not have realized, however, is that what distinguishes the less troubled markets like Dallas and Houston from the very troubled ones like California and Florida is that the former have less severely regulated markets in land, while the latter impose tight restrictions on land use that limit supply and, thus, increase prices. In this neglect the President is not alone: Neither the media nor the many federal officials involved in the bailout have acknowledged the role that land market distortions have played in the mortgage market turmoil.

How Smart Is "Smart Growth"? Simply put, as home prices in these regulated communities rise much faster than incomes, prospective homeowners are compelled to take on greater volumes of debt in order to buy a house. At the same time, many existing homeowners, seduced by the easy credit available to convert equity appreciation into cash, took on debt burdens that were beyond their capacity to service.

This land use regulation problem is a relatively recent phenomenon. Over the past few decades, a growing number of states and communities have adopted so-called "smart growth" strategies that discouraged new construction and population growth by using restrictive zoning and tax policies to limit the amount of land available for development. In recent years the regulatory mechanisms that have been used in this effort include growth boundaries, minimum lot sizes, land set asides, impact fees, mandatory amenities, and building moratoriums. Since all of these initiatives serve to increase the cost of housing, these communities are able to both upgrade the demographic profile of their citizens and limit community population growth by discouraging moderate-income families from moving in.

A recent study by Demographia reveals the degree to which this abusive process has made

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housing less affordable in some communities compared to others. Using a concept called the "median multiple" (calculated as the ratio of a region's median house price to its median income), the study was able to rank regions by affordability. With a median multiple of 3.0 or less rated as "affordable," Dallas (2.5), Atlanta (2.8), Houston (2.9), and Indianapolis (2.3) were among the several dozen metropolitan areas with relatively free markets in land use and where housing was very affordable. In contrast, regions with restrictive land use regulations—Boston (6.1), San Francisco (10.8), Miami (7.1), Washington, D.C. (5.5), and Los Angeles (11.5)—are rated as "seriously unaffordable." As another indication of the regional affordability gap, during the first quarter of 2008, the median sales price of an existing home in Dallas was $142,400, compared to $701,700 in San Francisco.

Demand Is Not the Problem. Application of the median multiple concept also reveals that in regions such as Houston, Dallas, Austin, Atlanta, and Indianapolis, the median house price rose by less than $10,000 relative to median household incomes from 2000 to 2007. While that may seem like a lot of money, it is modest compared to what happened in the regulated markets. Over the 2000–2007 period, house prices in Portland, Oregon, rose $100,000 relative to incomes. In the Miami, New York, and Washington metropolitan areas, median house prices rose more than $200,000 relative to incomes, while in San Diego, San Jose, and Los Angeles, median house prices rose more than $300,000 relative to household incomes.

These are huge differences, and it might have been expected that analysts would have noticed them and asked why. Among the few that have noticed, some attribute the differences to higher demand in the housing bubble markets. Yet the highest demand has not been in the markets that have had the least cost inflation! Houston, Dallas/Fort Worth, and Atlanta are the fastest growing metropolitan areas in the developed world with more than 5 million in population. Indianapolis is growing faster than San Diego. People are moving out of California, New York, Washington, and Miami to places like Houston and Dallas/Fort Worth. Thus, relative differences in demand do not explain the differences.

What Is Rationed Is More Costly. In addition to suffering higher rates of subprime exposure, many of these regulated areas are also suffering from relatively large declines in house prices as the collapse of the mortgage market has eliminated the mortgage credit cushion that helped sustain these artificially high prices. According to the latest S&P/Case Schiller report on home price trends in the top 20 U.S. markets, year-over-year house price declines in Atlanta and Dallas fell by an average of 5.5 percent, while the average price decline in Washington, Miami, San Francisco, and Los Angeles was 22.7 percent. And reflecting the impact of high home prices on risky financing schemes, the percentage of outstanding mortgage loans in foreclosure in California was more than twice that in Texas during the first quarter of 2008.

What all of the cost-escalating metropolitan areas have in common is restrictive land use regulation, which led to a shortage of land for development. Economics is clear on this issue: What is rationed is more costly. The differences in the costs of construction between, say, Houston and San Diego are not that great. The home price difference is nearly all in land costs, and land costs have exploded as overly restrictive land use planning systems have been unable to accommodate the demand attributable to population increases.

Opening Up the American Dream. These severe land use regulations lead to denying young and moderate income households the American Dream of home ownership. It has also led many of these same people to use risky mortgage finance schemes to overcome the high housing costs these regulations have caused. In a time when there are increasing concerns about the rising cost of living over everything from gas prices to food prices, policymakers should hasten to dismantle the excessive land use regulations that say "no" to the next generation of American homeowners.

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