Land-Use Regulation, House Prices and The New Social Contract

To understand the recent worldwide rise in house prices, we need to look at supply as well as demand, and at some of the factors behind the crunch in land supply.

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ONE OF THE MOST important business stories of the last decade has been the astonishing run-up in housing prices in cities throughout much of the industrialized world. Even if prices fall in some markets during the next year or two, housing prices will remain much higher than they were ten or twenty years ago. The ratio of median house price to median household income appears to be unprecedented in the recent history of the affluent world.

According to the recently released *Third Annual Demographia International Housing Affordability Study*, by the last quarter of 2006, the median house price in Vancouver, for example, had reached

$385,000 in an area where median household income was less than $50,000; in Sydney, the median house went for $337,000 in an area where the median household income was about $42,000; in London, the figure for the median house price was $490,000 and that for median household income $60,000 (all prices in U.S. dollars). At the very top of the price list was the San Francisco market, where the median house price had reached the astonishing figure of $750,000 but the median household income was only $74,000. That produced multiples of median house price to median income of 7.7 in Vancouver, 8.3 in London, 8.5 in Sydney, and 10.1 in San Francisco. Although the house prices were highest in San Francisco, this wasn't even the least affordable market. That honor went to Los Angeles, where the median house price of $582,000 and median income of $51,000 produced a multiple of 11.4.

This phenomenon has caused considerable concern. Some observers have termed this rapid escalation a "housing bubble," suggesting that prices have lost any clear relationship to income levels or the performance of the economy in general. If this is the case, there is considerable worry about both what will happen if the bubble bursts and what happens if it doesn't. On the one hand, prices remaining high will prolong a major crisis of affordability, could make it difficult for a number of cities to attract new residents or businesses, and could lead to falling homeownership rates. If prices fall sharply, it could be even worse. Because a house is the most important asset of most families in the affluent world, a sharp decline in prices could have devastating effects on the world economy.

The phrase "housing bubble" is telling. It suggests that houses have become a commodity traded the way stocks and bonds are traded. The most common explanations given for the bubble are similar to those given for movements in the stock market. For some individuals, the explanation for much of the upward spike in stock markets and housing prices is "irrational exuberance," a herd mentality that seems to take over markets from time to time, allowing prices to float free from any relationship to the income value of the underlying assets.

Although there may be some truth to this hypothesis, it is probably more fruitful to explain most of the price rise by rational human behavior. Most explanations of this sort to date have targeted the demand side of the equation. One currently favored explanation is that investors, awash with capital and a dearth of other attractive investment opportunities, are swelling demand for housing beyond what the market would otherwise support. Another is that as people become more affluent, they want larger houses, and sometimes second and third houses. People also want to live in better places, leading to a dramatic upward pressure on certain neighborhoods and cities.

URBAN GROWTH BOUNDARIES

While few people would disagree that all of these factors have undoubtedly played a role in raising prices, at least in some markets, there is another simple and potentially quite powerful explanation that has been much slower to gain wide acceptance. For several years now a relatively small group of individuals has been making a case that government policies and constraints on the supply side, particularly environmental, anti-sprawl and growth management policies, have played a large—perhaps the dominant—role in the escalation of housing prices.

This argument is not new, particularly in the United States. It was forcefully made as early as 1979 by MIT professor Bernard J. Frieden in *The Environmental Protection Hustle*. More recently, the role of land use regulation in pushing up housing prices has been put forward most prominently in the United States by economists such as Harvard's Edward Glaeser and the University of Pennsylvania's Joseph Gyourko. In a series of articles, they have pointed to more intensive zoning, environmental, anti-sprawl and other regulations limiting supply as a driving factor in sharply higher housing prices.

In the last few years there has also been a growing recognition of the divergence of housing prices across the United States. While prices in certain markets—for example, Los Angeles, San Francisco, New York and other large coastal urban areas—were soaring, prices remained affordable in many cities in the middle of the country—for example, Atlanta and Houston. The country was being split, in the terminology of economist Paul Krugman, into an expensive "zoned zone" and the less regulated and less expensive "flatlands." Journalist and blogger Virginia Postrel made the analogy to red states and blue states. In red states—those voting Republican in the 2004 election and presumably not favorable to intensive government intervention into land use—housing prices tended to remain fairly stable. In blue states, on the other hand—those voting Democratic and presumably more favorable to more land use regulation—housing prices have skyrocketed.

The equation of surging prices with land use regulations has been highly controversial. Many environmentalists and anti-sprawl advocates are unwilling to see their policies blamed for declining housing affordability. They maintain that the rise in prices in an urban area such as Portland, Oregon is not due to curtailed housing supply, but to demand. They contend that it is precisely because these areas have created important regulations on land development that they have become attractive to people who might wish to move there.

One of the most important reasons this debate has remained so acrimonious and unresolved is a basic lack of data. There are really two separate issues here. The first is knowing exactly how high prices are in various markets and how fast they have been rising. The other is measuring the amount of regulatory control and the degree to which this control has affected prices.

Regulatory control is difficult to measure. Portland, again, provides a good illustration. For opponents of the growth management system, it is the growth boundary around Portland, as well as all of the other growth control measures, that limit the amount of land available and thus drive up prices. Anti-sprawl advocates, on the other hand, counter that because the Portland growth boundary must, by law, include a reasonable supply of land for growth, and governments have included incentives and streamlined procedures for redeveloping existing built-up areas at higher densities, the growth management system should not be blamed for higher prices. If anything, in their opinion, the system probably keeps prices lower than they would be otherwise, given the way the Portland planning system has made living there so attractive. Anti-sprawl advocates also argue that prices in San Francisco and other West Coast cities without growth boundaries rose at least as quickly as those in Portland. This fact, in their opinion, proves that it is unfair to blame the Portland growth management system.

However, this explanation in turn has been attacked by skeptics and opponents of growth management regulation because, for them, it is clear that although San Francisco does not have a single growth boundary or growth management system, it has dozens of smaller growth management systems that are, if anything, even greater intrusions into the land market than those in Portland. The real test, for those individuals, would be to compare Portland to other fast-growing urban areas without many intrusive regulations, for example Houston or Atlanta, where, despite massive growth, there has been no comparable spike in housing prices and little loss of affordability.

REGULATED VS. UNREGULATED

Recently there has been a major shift in the debate, due in part to vastly larger and more reliable sets of data. The most important collection is contained in the latest edition of the *Demographia International Housing Affordability Survey* assembled by

Wendell Cox, an American consultant, and Hugh Pavletich, a developer and real estate professional from New Zealand. For their index (see demographia.com), they computed the ratio of median house price to median household income for all large urban areas across the United States, Canada, Britain, Ireland, Australia and New Zealand. What they found was an astonishing range among the various markets. In many lightly regulated markets in the United States and Canada (Atlanta, Houston, Ottawa), the ratio remained what it had apparently been for generations, in the range of two or three to one. However, in tightly regulated markets such as London, Vancouver, and Sydney, the ratio reached seven or eight to one and in Los Angeles more than eleven to one. Such figures are, Cox and Pavletich claim, unprecedented in modern history.

Of course, this compilation, admirable as it is, does not decisively answer the question of how much land use regulations have driven the current "housing bubble." It is quite possible that other factors are involved. For example, it might well be that physical constraints have had a major influence. The fact that the center of the Los Angeles area is ringed by mountains and desert, for example, must have some impact on housing prices there, compared with an urban area like Houston where there are fewer restraints. Or it is possible that San Francisco is more expensive than Houston simply because so many people find it a better place to live.

Another set of studies has shed light on some of these issues. In the pamphlet *The Planning Penalty: How Smart Growth Makes Housing Unaffordable*, Randal O'Toole of the Thoreau Institute, an Oregon think tank advocating free-market positions, has collected affordability figures for various markets over time since the 1970s, showing that prior to 1970 most markets in the United States were affordable and that the date when they started to become unaffordable does seem to correspond fairly closely with the introduction of important land use controls. For example, Hawaii, an American pioneer in land use regulations, first became unaffordable in the 1950s. It was followed by the New York City region in the 1960s, coastal California in the 1970s (in the wake of an entire battery of stringent land use controls in the late 1960s and early 1970s), and an escalating number of markets elsewhere since the 1980s. This seems to contradict the notion that it is the inherent desirability of the San Francisco region or the undesirability of the Houston region that accounts for most of the dramatic loss in housing affordability.

Looking at Britain rather than the United States and using a quite different approach and different kinds of data, Alan W. Evans and Oliver Marc Hartwich of the Policy Exchange, a free-market think tank in Britain, seem to confirm the effects of regulations on housing prices. In a series of studies from 2005 and 2006 entitled *Bigger Better Faster More: why some countries plan better than others; Unaffordable Housing: Fables and Myths;* and *Better Homes, Greener Cities*, the authors compare policies and prices in Britain to those in Germany, Switzerland and elsewhere and conclude that it is the British planning system, put into place immediately after World War II and, despite some changes over the years, basically still in place, that has led Britain to have some of the highest prices but some of the smallest and most poorly equipped housing in western Europe. James Heartsfield's small book, *Let's Build: Why we need five million new homes in the next ten years*, has been more polemical and pointed in its criticism. Many of the conclusions reached by Evans, Hartwich and Heartsfield were confirmed in the *Barker Review of Land Use Planning*, a report by economist Kate Barker commissioned by the British Treasury and released in December 2006. Finally, Alan Moran's *The Tragedy of Planning: Losing the Great Australia Dream,* makes a similar indictment of the government imposed restraints on development in Australian cities.

CONCLUSIONS

The question I would like to pose in the remainder of this paper is why, given what seems to be a convincing correlation between housing prices and land use regulations, do so many people resist seeing regulation as a major cause? Why do so many people reject explanations that look at the supply side and attempt to explain price hikes as a simple matter of demand? Instead of answering this immediately, let's turn to another question. Why have these land use regulations and growth management regimes become so popular just now? As I report in my book *Sprawl: A Compact History*, at least in the fastest growing and most affluent countries of the English-speaking world—the United States, Canada, Australia and New Zealand—the greatest decentralization of urban areas actually occurred between the 1920s and the 1950s. The amount of land used per capita rose in these places until the 1950s, reaching a climax in the first flush of the postwar era when the quarter-acre suburban lot became an attainable ideal for millions of families in North America, Australia and New Zealand. Since then lot sizes have been declining, recently quite sharply.

Why, when lot sizes are falling and density at the edge is rising, has there been such an unprecedented push to constrict urban areas even further and make it even more difficult to build new houses? An important issue is the fact that the people moving to the edge of urban areas in all of these countries are not primarily upper-middle and middle-middle class families. A very large percentage of them are working class, and they are often young families purchasing a home for the first time. What an irony that just at the moment that so many people so far down the socio-economic ladder are looking to buy at the urban periphery, they find the drawbridge has been pulled up. Rather than the relatively affordable houses on ample lots with much of the infrastructure provided by local governments found by a previous generation of home seekers at the urban edge, they find that they are faced with very expensive houses on smaller and smaller lots and that much of the cost of local infrastructure has been passed on to them via fees paid by the developers and included in the house price.

In my opinion this situation has been the result of a set of choices made by individuals on both the political right and the political left. One of the major consequences of these choices, probably unintended by many of those on either side of the political spectrum, has been an extraordinary shift of wealth. In this transfer, wealth has been shifted away from younger, less affluent citizens and future generations and toward an "incumbents' club," a group of established, mostly older families.

To get an idea how this shift has occurred, let's take a look at the unspoken social contract that governed most of the affluent English-speaking countries until recently. Since at least the early twentieth century there had been a presumption that existing residents of an urban area would provide, though public expenditure supported by tax dollars from the entire population, the infrastructure for expansion that was needed by new residents. Underlying this was a belief in growth and progress, and a conviction that the newcomers would become wage earners and taxpayers and ultimately contribute at least their fair share to a better standard of living for the entire metropolitan area.

This social contract has frayed considerably in recent years. Despite virtually every objective indicator of urban life improving substantially since World War II, there seems to be a sour mood among urban voters. There is a pervasive feeling that the vast urban changes and increases in population predicted for most successful cities will not be a change for the better. The result has been, on both sides of the political spectrum, what appears to be a strong fear of the future and a desire to retrench, to preserve and to save what can be saved from the changes that are threatening.

On the one hand, there has been a strong movement in much of the affluent English-speaking world, championed primarily by the political right, to cut taxes and to downsize government. Typically, though, the lower tax revenues have not been matched by an equivalent reduction in the expectation of government services. This appears to have helped fuel a massive privatization of services, a rush to find other sources of revenue and a desire to use tax incentives and regulatory means rather than government expenditure to achieve public goods. So, instead of government providing the roads, sewers, and schools for expanding suburban communities, across the affluent world these services are increasingly being shouldered by developers who, in turn, have passed along these costs directly to new homeowners.

Pushing costs from public to private entitites has also been embraced wholeheartedly by much of the political left, which sees it as a way to slow down and deflect development. On this side of the political spectrum there has been a vastly expanding agenda for governmental measures aimed at conservation and preservation. From measures to battle pollution to mechanisms to save historic buildings and species habitat, the default reflex seems to be to preserve what exists or to recapture what is imagined to be a more pristine state from some previous era. The means of achieving these public goods has primarily been through regulation. Instead of buying open space or the land necessary for a greenbelt, the government will instead merely mandate a growth boundary or institute highly restrictive zoning. Instead of buying species habitat, the government will put the burden on landowners. For a landowner to develop his or her land, it is often necessary to prove, entirely at the expense of the landowner, that the land is not or could not be occupied by an endangered species. Even if the landowner prevails in the legal battles, it is often the case that these have proved so costly that no development occurs.

The double whammy of capping or reducing taxes but increasing land use regulations has undoubtedly made it much more difficult for families of modest means across much of the affluent world to buy a house. Less remarked upon has been the windfall created for families who already have a house they are happy with—that is, members of the "incumbents' club." For these families, the use of development fees helps deflect from themselves the burden of providing new infrastructure. On the other hand, environmental and other restrictions on building at the edge contribute to a reduction in developable land and a corresponding rise in the price of both new and existing houses, including their own. And the rise in property taxes that might have followed in the past are limited by tax caps.

This phenomenon cannot be explained primarily by conscious self-interest. The vast majority of people proposing tax cuts or environmental regulations genuinely believe that, on balance and over the long run, they will benefit the entire population. I believe that many of the people who have benefited most from the remaking of the social contract are probably only vaguely aware of the ways it has benefited them and entirely unaware of the harm it is doing to families of more modest means and the burden it will almost certainly impose on future generations. They realize that it is more and more difficult for newcomers to their city to own houses, but they don't connect this with policies that they espouse.

Fundamentally, the problem here is a revolution in urban expectations. In the past only the wealthiest and most powerful members of society felt that they had the right to control the environment around them. By now, a large percentage of the population feels that it has that right. This is not inherently a bad thing, but when this happens there are inevitably going to be conflicts, particularly in situations where resources are limited. The current crunch in housing affordability is a classic case of a problem that has arisen because expectations have run ahead of society's ability to satisfy them. As usual, the victims are those least able to protect themselves, meaning families of modest means and all of the future residents not yet able to vote or not yet born.

As the connection between governmental land use regulations and the spike in house prices becomes more obvious, it will be interesting to see what happens. Will the market itself solve some of the affordability problem by a real estate crash in the most costly housing markets (a move that may well be under way already)? Will prices become so high in some markets that there will be a massive move away from these areas toward less favored areas (again, something that may have already started)? Will voters in high-priced locations decide that affordability is more important than restricting peripheral growth or trying to stop high-density urban redevelopment? What will happen is far from clear. What is certain is that the stakes are high and the outcome will almost certainly have a major effect on the shape of urban development for decades to come.