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(The Concise Encyclopedia of Economics, David Henderson, editor, Indianapolis: Liberty Fund)

Compared to many parts of the world, housing prices in the United States are relatively unregulated, and impediments to construction are relatively low. Still, government involvement in the housing market is significant. Government officials argue that they must regulate housing and also help those priced out by the market. They administer a number of programs: public provision of housing, public subsidies for housing, and numerous zoning regulations. By distorting market forces and restricting supply, these government programs can end up making housing more expensive. Much of the support for these policies stems from a misunderstanding of the economics of housing.

First, let us look at the positive aspects of the housing market. Private developers make money by giving consumers the type of housing they want. Developers have an incentive to design homes and even entire neighborhoods in ways that consumers value most. The average U.S. consumer now enjoys larger and higher quality homes than ever before. In 2001, the average home was 1,693 square feet; in 1960, it was less than 1,200 square feet. In 2001, 58 percent of homes had three or more bedrooms and 57 percent had 1.5 or more bathrooms. Compare that to 1970, when less than half of homes had three or more bedrooms and only 30 percent had 1.5 or more bathrooms. Housing amenities have also improved. In 2001, 76 percent of homes had a washing machine, 73 percent had a dryer, 56 percent a dishwasher, and 44 percent a kitchen sink garbage disposal. Fifty-eight percent of homes had a garage and 80 percent an outdoor deck or patio. In 2001, 82 percent of homes had some form of air conditioning and 55 percent had central air; in 1970 only 36 percent of homes had air

conditioning and 11 percent had central air. Housing has improved almost across the board, so now 98.7 percent of homes have complete plumbing compared to 93.5 percent thirty years ago.

While the size and quality of homes has increased, so have prices. Between 1970 and 2001, the median price of owner occupied housing rose from \$78,051 to \$123,887 (in 2001 dollars). This has led a number of groups to declare a national affordability crisis. But despite noticeable price increases, housing is not necessarily unaffordable. The Census's 2001 *American Housing Survey* estimates the cost of owning the median home at \$725 per month. If 30 percent of income is spent on housing, any household earning \$29,000 per year can purchase the median home. Median household income in the U.S. is much higher, at \$41,994, and so spending \$8,700 per year on the median home is well within reach. Although a nationwide affordability crisis does not exist, the numbers in certain regions are less rosy. In many areas of California and the Northeast, housing is much more expensive.

Most commentators attribute elevated prices to high demand for scarce land. A number of economists, however, point to another explanation. High prices may not be due to intrinsically valuable land but instead result from housing regulations. Density restrictions, height restrictions, design restrictions, building fees, drawn out approval processes, restrictions on growth, and preservation laws all make constructing homes more costly. One way of measuring whether high prices are due to regulations or high demand for land is to look at how much increased lot size increases the value of a home. If land scarcity drives housing prices, doubling the lot size would increase the difference between construction costs and home value by 100 percent. But Edward Glaser and Joseph Gyourko (2002) find that consumers in most cities only value homes on 20,000-square-foot lots \$10,000-\$20,000 more than equivalent homes on 10,000-square-foot lots. This indicates that intrinsically valuable land is not the main cause of high prices. These

economists conclude that that the scarcest input for housing is government permission to build. Econometric estimates indicate that only 10 percent of the gap between construction costs and home prices is caused by intrinsically high land prices; the other 90 percent is caused by zoning and land-use regulations. Glaser and Gyourko's evidence suggests "that land-use regulation is responsible for high housing costs where they exist." Another study with a different methodology reached the same conclusion. Stephen Malpezzi (1996) constructed an index of seven different land-use regulatory variables and ranked 56 different metropolitan areas according to how strictly land use was regulated. Regulatory variables included measures such as changes in length of approval time, time required to get land rezoned, amount of acreage zoned for residential development, and percent of zoning changes approved. Malpezzi found that a change from a lightly regulated environment to a heavily regulated one increased home values by 51 percent and decreased the number of permits to build by 42 percent. Home ownership rates also declined about 10 percentage points. Regardless of methodology, evidence shows that areas with high levels of regulation have higher housing prices, higher rents, and lower home ownership rates.

Although no national affordable housing crisis exists, prices are quite high in some high regulation jurisdictions. In Santa Clara County, California, for example, the median price of a newly constructed home in 2003 was more than \$638,000. Assuming a family can spend 30 percent of their income on a mortgage, even with low 5 percent interest rates a family must earn more than \$135,000 per year to afford the median priced new home. If the above estimates are correct, regulation raises home prices as much as \$300,000 in this county. Put another way, the portion of purchase price paid by residents of Santa Clara County due to regulation is almost enough to buy three complete homes of median value in the U.S.

Unfortunately, governments fail to recognize that they might be the source of the problems. Their solution is almost always to add new programs and additional regulations. At the federal level in particular, government is constantly devising new plans. Real federal outlays for housing have steadily increased since the early 1960s to reach their current level of approximately \$30 billion per year. Today approximately six million renter households receive federal housing subsidies, and 1.5 million households live in public housing. But the public sector lacks a profit incentive, and government programs are highly inefficient. One study estimated that for every hundred dollars of government spending on housing production, housing worth only forty-three dollars to the residents is produced (Mayo, 1986). Public housing also usually deteriorates rapidly through poor upkeep, in many cases becoming uninhabitable within 20 years. John Stossel (2004, p.228) reports, "Between 1996 and 2001, HUD demolished 44,089 units in 90 housing authorities in Atlanta, Chicago, Detroit, New Orleans, Philadelphia, Washington, D.C., and other cities." Some of the worst effects of public housing have been on the very residents the housing was created to help. Public housing projects are often plagued by high crime and thus considered undesirable places to live. In contrast, private developers and landlords have an incentive to make sure customers are satisfied: they lose business otherwise.

Recognizing that government is not a particularly good landlord, many policymakers are looking for other "affordable" housing solutions. At the local level, inclusionary zoning is becoming increasingly popular. Inclusionary zoning has a nice sounding but misleading name; it actually refers to price controls on a percentage of new homes. Builders and subsequent owners are forced to sell the homes so they are "affordable" to specific income levels. For example, in Tiburon, California, the median price of existing homes is more than \$1 million, but builders are required to sell 10 percent of new homes for \$109,825 or less. Inclusionary zoning is most

popular in California, Maryland, and New Jersey. A nationwide 1991 survey found that nine percent of cities larger than 100,000 had inclusionary zoning, and the number is increasing rapidly. In 1990, roughly thirty jurisdictions in California had inclusionary zoning; the number has increased to more than one hundred today.

Inclusionary zoning produces all the negative effects of price controls. Price controls restrict the supply of new homes and actually make housing less affordable. Because builders are forced to sell a portion of a development at a loss, inclusionary zoning functions as a tax on new construction. Estimates of the level of the tax in California cities such as Portola Valley are over \$200,000 per market-rate home. To maintain normal profit margins, builders end up passing the tax onto landowners and other homebuyers. Elasticities of supply and demand determine exactly how the burden is split, but the result is almost certainly higher home prices.

Not only does inclusionary zoning lead to higher prices, but also it leads to less construction. In the 45 San Francisco Bay Area cities with data available, new construction fell by 31 percent in the year following the adoption of inclusionary zoning (Powell and Stringham 2004). In some cases, inclusionary zoning halts development completely. The experience of Watsonville, California, illustrates this effect. In 1990 Watsonville's inclusionary zoning ordinance imposed price controls on 25 percent of new homes. Between 1990 and 1999, with the exception of a few small non-profit developments, almost no new construction occurred. The law was finally revised in 1999 because, in the words of Watsonville Mayor Judy Doering-Nielsen, "There was an incredible pent-up demand. Our inclusionary housing ordinance was so onerous that developers wouldn't come in." Jan Davison, the Redevelopment and Housing Department Director, commented, "It [the inclusionary zoning law] was so stringent, and land costs were so high, that few units were produced," but "It was completely redone in 2000, and

we got more units produced” (Morgan, 2003). Watsonville reduced the number of units under price controls from 25 percent of all developments to 15 percent on smaller developments and 20 percent on developments of 50 units or more. In the three years after easing requirements, the city’s housing stock increased by 12 percent.

In addition to restricting supply, inclusionary zoning produces a number of other undesirable effects. Price controls exacerbate shortages, decrease mobility, and are a poor way of helping those most in need. Although inclusionary zoning promises to give the benefits of homeownership to low-income families, it does not deliver. Resale restrictions prevent equity appreciation and lead families to live in the homes longer than they would otherwise. This takes homes off the market and does not help other low-income families. Even if a family’s income has considerably increased, “owners” of price-controlled homes will be less able to move because price controls prevent their homes from appreciating at market rates. These residents are stuck with an asset that they cannot fully cash out and that cannot even pass on to their children unless those children also meet low-income guidelines. This creates incentive for owners to evade the law and resell or sublet their units at market rates. Governments then must spend resources supervising the price controls. The city of Palo Alto, California, for example, spends around \$60,000 annually to administer its inclusionary zoning program, which has roughly 250 units under price controls.

Increased regulation is one of the worst ways to help low-income households. The best solution is to allow market forces to work and permit developers to build. If government stopped interfering with housing production, the increased supply would lead to lower prices at all levels. Most planners fail to realize that even high priced construction benefits all consumers. When a high-income household moves into a high priced new home, they vacate their old home for

someone else. That family in turn vacates its old residence, freeing it up for someone else. A classic study, *New Homes and Poor People*, looked at the chain of existing home sales in 13 different cities and found that each new home generated an average of 3.5 moves. Even though new housing tends to be higher priced, low-income households constitute up to 14 percent of the moves generated by new housing. When government discourages new construction, this process is stifled. Without new homes, high-income buyers bid up prices on existing homes, thus making all housing less affordable. If the goal is to make housing more affordable, zoning regulations should be cut back.

In spite of the regulations, the housing market is quite resilient. Ninety-eight percent of Americans live in privately owned and constructed homes. The size and quality of these homes have increased substantially over the past few decades. Some cities such as Houston, Texas, have gone without zoning, and some cities such as Celebration, Florida, are almost entirely privately planned. Developments such as Santana Row in San Jose, California, now provide streets, parks and even private security. A shift away from government planning to private planning is positive for renters and homebuyers (Beito *et al.* 2002). The private sector has an incentive to please the consumer, an incentive absent with government. Market forces in the housing market benefit all consumers by improving quality and keeping prices down.

Further Reading

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