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The Politics of Sky-High House Prices

How government jacks up the price of owning your home.

Joel Miller from the July 2006 issue

Lance Uyeda bought his first home in the San Francisco Bay Area almost 30 years ago. Today his oldest son rents an apartment and works in retail sales. But because the market is tougher now than when his father bought, he probably will need more than a good performance review and a raise to buy four walls and a set of shingles. Unless he "wins the lottery," says Dad, "he's not going to have a home to call his own."

The reason is that housing prices in the Bay Area and Silicon Valley have shot up faster and higher than almost anywhere else in the country. In 1985, according to the National Association of Realtors, the median price for a home in the San Francisco Bay Area was about $258,000 in inflation-adjusted dollars; today, it's over $720,000.

These rapidly escalating costs are sparking an exodus. Fully 40 percent of respondents in a 2006 survey by the Bay Area Council said they'd considered leaving the region; more than two-thirds of that number flagged high-priced homes as a major reason. Similarly, a 2004 survey by the Public Policy Institute of California found that more than 30 percent of people between the ages of 18 and 31 were considering new digs beyond the Bay.

Not everyone is sympathetic to the predicament of such people. Janet Yellen, president of the Federal Reserve Bank's San Francisco branch, argues that "high housing costs are a symptom of the Bay Area's success." Prices have shot into the stratosphere, she says, because the region "is such a magnet for certain kinds of high-skilled, high-tech companies."

She's correct, to a point. The booming tech industry in the Bay Area and Silicon Valley has created high demand for real estate in those regions, which has not just driven up prices but created a solid constituency for the huge price tags: people who bought low and are now millionaires because their humble stick-and-stuccos morphed into miniature mansions. But what about everyone else?

The Debtors' Prison

In their book *The Two-Income Trap*, Elizabeth Warren and Amelia Warren Tyagi use the term "house poor" to describe middle-class homeowners who stretch themselves too thin

financially to buy the roof over their heads. They often become slaves to their mortgages because they over-borrow; worse, they're prone to default because they don't have enough savings to cushion the impact of a divorce or job loss—two fairly common occurrences.

Warren and Tyagi blame zero-down and sub-prime loans, the fruit of interest rate deregulation. But zero-down and sub-prime lending simply creates financing options for people who otherwise would be unable to borrow. And who can blame banks and mortgage companies for catering to a strong and otherwise unmet demand?

Not that there aren't problems here, principally in what many observers call the "housing bubble." In the words of former U.S. Labor Secretary Robert Reich, "Bubbles form when it's easy to get capital to invest in something, and when investors assume that somebody else will come along after them and pay even more for it." But Reich warns that when mortgage rates rise—when the easy money dries up—"buyers can no longer assume that future buyers will pay more, because some future buyers won't be able to." That's when the bubble bursts and people are stuck with more house than they can afford and no way of offloading it.

But cheap money and investor enthusiasm don't fully explain the problem. In many areas, housing prices were rising before the bubble began to bulge.

There is another side of the housing cost swell that Warren and Tyagi overlook. It is rooted not in deregulation but in limited supply and inelastic costs—the reasons people have to overextend themselves to purchase a home. These factors will remain even if the bubble pops, which means high-priced homes will survive the investor hype.

For Want of a Snake

Yellen is right about this much: Many people want to live near the hustle and bustle of a thriving economy, where they can enjoy vibrant job markets, decent commutes, good pay, fun play, lots of shopping, and a wide variety of leisure-oriented diversions. In or near big urban settings, variety and opportunity appear unlimited.

But land *is* limited. Soil stretches only so far, and there's a finite number of plots on which to plop a house. As any Econ 101 student could tell you, high demand for a limited good creates high prices as potential buyers try to outbid each other.

The way to mitigate this problem is to build more houses—either cram more of them in less space by constructing smaller or taller, more tightly clustered homes or build them further out by expanding the building area. The way to exacerbate the problem is to stop building, which is what planners in places like San Francisco have done. In so doing, they have artificially crimped the supply of land, creating higher property values for existing homeowners and higher prices for everyone else.

Edward L. Glaeser and Joseph Gyourko explored the problem in a paper prepared for the Federal Reserve Bank of New York, which hosted a conference on affordable housing in 2002. Glaeser, an economist at Harvard, and Gyourko, a professor of real estate and

finance at the Wharton School of Business, wanted to find out whether the country was facing a shortage of affordable housing and what might be causing such a shortage. What they discovered was that the nation as a whole has no real shortage of cheap digs; it's just that the cost of land and homes in certain areas has gone through the roof, mainly because zoning and other land use restrictions have made usable land scarcer.

Examining 45 metropolitan areas around the country, Glaeser and Gyourko studied the time it takes builders to apply for and receive a permit for a "modest-sized, single-family subdivision of less than fifty units." They found that in the areas where zoning is strict and approvals are slow, the price goes up considerably. Permit lags of six months can add nearly $7 per square foot to the price of a house. That's more than $10,000 added to the cost of a 1,500-square-foot home. Double that for a 12-month lag.

"Measures of zoning strictness," Glaeser and Gyourko write, "are highly correlated with high prices." In fact, "Almost all of the very high cost areas are extremely regulated." In some places, especially California, the impact of these restrictions is dramatic. They've been instrumental in making housing prices in San Jose, 50 miles southeast of San Francisco, triple the prices in comparable cities elsewhere.

It's not just zoning and growth restrictions. Environmental impact laws raise the purchase price of homes as well. Planners in California, for example, required developer Marvin "Buzz" Oates to pay more than $2,000 extra per acre of a Sutter Basin property because it was home to roughly 40 giant garter snakes. The total "mitigation" fee was $3.8 million—$93,950 per snake. On other projects, Oates says he lost millions of dollars due to delays prompted by concerns about the fate of fairy shrimp.

A February 2005 study by the U.S. Department of Housing and Urban Development identified complex environmental regulations as one of the factors raising home prices. "A number of trends indicate that since 1991 poorly designed environmental procedures and regulatory processes have become more significant barriers to the development of affordable housing," says the report. "Major trends include the proliferation of national mandates, the increasing complexity of urban environmental regulations, layering of additional local environmental laws, and the misuse of environmental regulations by those opposed to affordable housing."

Additional impact fees such as park, wetland, and transportation mitigation expenses add up quickly, as do the costs of permits and utility hookups. Add all those factors to a price tag, and prepare for sticker shock.

In Seattle and surrounding King County, Washington, home prices have jumped more than 10 times the rate of inflation in a single year. As in the San Francisco Peninsula, an influx of new homebuyers and a fast-growing economy are partly responsible, but a study by the Vancouver-based homebuilder Taseca Homes shows regulations play a significant role as well. "The company's managers carefully itemized and tracked all the actual costs that go into some of the homes the company has built recently," writes Paul Guppy of the Washington Policy Center, pointing to the results for one particular house. "They found at least $40,486 of this home's $223,600 selling price can be attributed to government

regulation and fees...an increase of 22 percent over the cost of building the actual house."

Guppy says many of the rules that raise home prices are "good and useful, and serve the public interest." But he also notes that homeowners are kept in the dark about these added expenses, which go beyond the sales and property taxes they already pay for city services. "The overall result," he says, "is that for many working families, the dream of becoming homeowners is only pushed farther and farther out of reach."

Critics of finance options such as sub-prime loans should ask why these instruments are so popular in the first place. Regulation-fueled price hikes are making it harder for many Americans to buy houses. As a result, many are turning to creative and sometimes precarious loan packages. With housing prices so high, an interest-only loan with no money down can jack up someone's purchasing power by 25 percent, according to Brett Vratil, a realtor who works in Southern California. "Often that's what it takes to get someone into a home in Los Angeles," he told Bankrate.com last year.

But while the market is busy adapting to escalating home prices, the government is making the problem worse.

Winners and Losers

With housing costs far outside most people's reach in San Jose, at one point the city offered affordable-housing subsidies totaling $180 million. The program barely dented the problem, because the city's actual burden from increased housing prices came closer to $100 billion, according to calculations by Randal O'Toole, an economist with the Oregon-based Thoreau Institute.

Now those subsidies are long gone, and San Jose home prices are still rocketing. Glaeser and Gyourko conclude that benefits from subsidized housing are "trivial...even if well-targeted toward deserving poor households."

Other solutions are even worse. Seeing that zoning laws have the power to destroy, city planners have decided to see if they can also restore. "Many local governments have turned to 'inclusionary zoning' ordinances in which they mandate that developers sell a certain percentage of the homes they build at below-market prices to make them affordable to people with lower incomes," explain the San Jose State University economists Benjamin Powell and Edward Stringham in a 2004 paper for the Reason Foundation, the nonprofit that publishes this magazine.

Forced to sell these discounted homes, builders offset their losses by upping the prices on surrounding homes. "We estimate that inclusionary zoning causes the price of new homes in the median city to increase by $22,000 to $44,000," Powell and Stringham report. "In high market-rate cities such as Cupertino, Los Altos, Palo Alto, Portola Valley, and Tiburon we estimate that inclusionary zoning adds more than $100,000 to the price of each new home."

The effects ripple through the market after the initial hit. After home prices go up to

accommodate the mandated discounts, they typically go up *again*, thanks to the increased scarcity caused by builders building *fewer* homes—something Powell and Stringham discovered when examining the long-term impact of inclusionary zoning. Builders leave cities that impose such mandates and construct homes in areas with better business climates.

The upside to high-cost homes is high property values. Homeowners in such cities as San Jose, Seattle, Los Angeles, Santa Barbara, and Portland benefit from soaring prices. In San Mateo County, California, a person can make $2,000 a day just watching his house appreciate. In San Francisco a person can make more money simply owning a home than working a median-income job or playing stocks. Between March 2004 and March 2005 the median price for a single-family home "soared $106,000, or 21 percent, hitting $605,000," according to *San Francisco Chronicle* reporter Kelly Zito. "That appreciation far exceeded the $74,124 the typical Bay Area household earned last year."

Housing for the Rich

With so much wealth created by government-exacerbated scarcity, the housing market has become increasingly politicized, to the detriment of the people who can least afford it. "A century of experience with regulation of various kinds has taught us that regulation typically favors the affluent and the organized over the less affluent and less organized," said American Enterprise Institute fellow Steven Hayward, testifying before the U.S. Senate Environment and Public Works Committee in 1999. "There are few groups less organized or represented than the people who would benefit from houses and jobs that do not yet exist….I think we are being naïve if we fail to recognize that growth management schemes can easily become the machinery of negation by existing residents."

Hayward provided an example of "negation by existing residents": Several months before his Senate testimony, homeowners in Fairfax, Virginia, protested at a county commission hearing that their prices were stagnant because the government was "allowing too many houses to be built." This tendency is especially problematic when you consider that planning commissions and other local government bodies tend to be dominated by the more powerful, established members of a community. New homebuyers, especially younger families, may be denied a house or forced to move further out principally because planners want to artificially enhance their own property values.

Think of the Children!

Across the country, households with children are either migrating out of city limits or never settling there to begin with. San Francisco, where falling enrollments last year prompted the city to close, merge, or relocate more than 20 schools, is the most extreme example. But similar trends are evident in other cities, including Boston, Honolulu, Miami, Denver, Minneapolis, Austin, and Atlanta.

Seattle Weekly columnist Knute Berger calls kids born and raised in Seattle an "endangered species." In Portland, Oregon, there are so few kids that city officials have been forced to close schools right and left. "After interviewing 300 parents who had left

the city," Timothy Egan of *The New York Times* reports, "researchers at Portland State found that high housing costs and a desire for space were the top reasons."

Egan also notes Seattle's attempt in the 1980s to make the town more family-friendly. "It included marketing the city's neighborhoods to younger families, building a small mix of affordable housing, and zoning and policing changes to make urban parks more child-friendly," he writes. It didn't work: With home prices in Seattle going way up, the junior head count is way down.

The possibility that cities are trying to solve a problem they helped create through misguided regulations is rarely considered by social critics who bemoan the housing squeeze. The solution offered by Warren and Tyagi in *The Two-Income Trap* isn't to cut back on regulations, zoning restrictions, property taxes, and impact fees. It's to *reregulate* interest rates so people can't take out "bad" loans.

Regulators and special interests can focus on enacting rules that have specific, narrow benefits for one particular group or another. (In the case of housing, that would be people who already own property and benefit from the price hikes.) But regulations are like pharmaceuticals: Even the beneficial ones have side effects. As the housing market shows, those side effects can pack a heavy wallop. "It is clear," write the authors of the 2005 HUD study, "that the costs of regulation in suburban and high-growth areas are causing large numbers of households to forgo their dreams of homeownership or to make difficult tradeoffs involving very long commutes."

Well-intentioned or not, those tradeoffs are diminishing some people's quality of life to pay for other people's politically enhanced life-styles.