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Reforming Land Use Regulations through Conditional Federalism

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Introduction

Many major American cities such as San Francisco and New York have faced a growing housing affordability crisis as housing costs surge to levels that place a severe strain on middle- and lower-income residents.[1]

The primary cause of inflated housing costs in certain jurisdictions is the plethora of land-use regulations (LURs) imposed by some American local governments.[2] LURs restrict how or whether land can be utilized for construction and development. An excess of these regulations can induce local housing scarcities. By leading to higher housing costs, LURs discourage interregional migration by making economically growing cities prohibitively expensive to live in for low- and middle-income workers. Less migration to economically vibrant cities contributes to lower economic growth and national economic welfare.[3] Moreover, housing costs spurred by excessive LUR increase political pressure on state and local governments to adopt other economically damaging public policies, such as rent control.

This paper proposes incentivizing state and local governments to adopt deregulatory reforms to LURs to liberalize housing markets and reduce pressure on housing costs by conditioning selective federal aid programs to local governments on recipient jurisdictions liberalizing LURs such as zoning laws. As local governments would stand to lose federal funds if they failed to comply, they would face powerful incentives to comply and encourage greater volumes of new housing construction.

A Guide to LURs

LURs are the rules (generally imposed by local governments) that regulate land development. LURs can range from limiting the amount of land available to development (so-called smart-growth rules) to controls such as zoning, which designate what categories of property (i.e., residential or commercial) can be built in a given area of a municipality.[4] The most common types of LURs include zoning rules, smart-growth rules, and maximum allowable density rules.[5]

In many (though by no means all) American municipalities, the volume of these regulations has increased precipitously.[6] LURs in certain areas were often implemented as part of well-intentioned efforts to promote environmental objectives or other goals. However, whatever the intent of these regulations, a significant consequence of expanding LURs has been to deter construction and reduce the supply of housing.[7] With artificially reduced supply, many of the most regulated American cities suffer from housing affordability challenges.

How LURs Increase the Cost of Housing

Simple economic reasoning supports the contention that the extensive application of LURs negatively impacts housing affordability. If, as some suggest, supply-side restrictions had no real effect on impeding housing development and that demand alone drove prices, areas of the country with the highest housing costs would likely also have high levels of new housing construction. However, the reverse is true.[8] Between 2000 and 2015, cities with some of the most restrictive LURs, as measured by the Wharton Residential Land Use Regulation Index (WRLURI), and the highest (and most rapidly rising) housing costs such as Honolulu had some of the lowest levels of new housing starts. By contrast, during the same period, Las Vegas, with relatively lax zoning and density restrictions (and thus a lower numerical score on the WRLURI), boasted the greatest amount of new housing development and far more moderate absolute and relative housing costs.[9] In sum, LURs, in their various forms, increase the inelasticity of housing supply. When inelastic supply is coupled with growing demand, housing costs inevitably rise.

Empirical evidence supports the reasoning outlined above. To analyze the affordability of housing in the United States, the economist Edward Glaeser compared the minimum profitable construction cost (MPPC) of housing in multiple cities across the country to home prices and rental costs.[10] A competitive housing market would be expected to have home prices that are tied closely to the cost of construction. By this standard, most American cities have competitive housing markets. A 2017 study estimates that approximately 73 percent of America's housing stock is priced at 125 percent or less of MPPC.[11]

However, while the country does not face a general housing affordability crisis, it faces several local ones. Presently, housing costs impose significant burdens on residents in major American cities like New York and San Francisco. For example, a study by the real estate listing firm StreetEasy found that the prevailing citywide median rent in New York City in 2016 constituted 65.2 percent of the median, pretax, household income.[12] Similarly, as of 2017, estimates for San Francisco suggest that the average home sells anywhere from 200 to 400 percent of the local MPPC.[13] Further data suggest that housing expenditures toward monthly rent or mortgage payments on average make up 40.3 percent of household consumption expenditures in San Francisco.[14] Abundant data from multiple other key American municipalities such as Boston and Washington, DC, paint a picture of high and rising housing costs relative to income. These data suggest that too many American cities are becoming too expensive for much of their populace to comfortably reside in.[15]

In spite of these high prices (which should incentivize home builders to increase housing supply to meet growing demand), cities with some of the highest housing costs (both in absolute terms and relative to income) tend to have some of the lowest levels of new house construction. This indicates that there are pervasive supply-side barriers to increased home construction.

In America's highest priced housing markets, those barriers are pervasive LURs. The WRLURI attempts to measure the range and severity of controls that municipalities in the United States impose on land use and housing development (a high numerical score on the index indicates a restrictive land-use regulatory regime).[16] A 2017 study found that after controlling for other potential causal variables (such as population growth) among the one hundred largest American cities, the higher the score a city has on the index, the lower its level of new housing construction and the higher its housing costs.[17] Put simply, there is a clear and statistically significant negative relationship between the intensity of local LURs and the amount of new construction and housing prices.[18] Glaeser's estimates indicate that in the nation's most expensive cities (which have correspondingly high WRLURI scores), stricter LURs serve as an implicit tax on housing development and account for up to 50 percent of home values in and explain up to 30 percent of the variation in housing costs between the least and most regulated American cities.[19]

Some might counter that high housing costs in particular cities result from demographic factors or robust regional economies. However, many American cities with healthy urban economies and higher population growth than more expensive jurisdictions have avoided a sharp rise in housing costs. For instance, between 1995 and 2015, Atlanta, Georgia, which has a relatively liberal land-use framework, experienced population growth of 18 percent, yet in 2015, housing costs constituted only 33.2 percent of average household consumption expenditures.[20] By contrast, in the same year, housing expenditures in San Francisco consumed 40.3 percent of average household consumption.[21] During the period cited, San Francisco had comparable population growth (18 percent) to Atlanta. Furthermore, the same period saw the average price of a home increase by 231 percent in San Francisco. Moreover, to consider an international example, between 1995 and 2015, Tokyo, Japan, which is known for its liberal LURs, experienced population growth of 15 percent and saw home prices increase by only 10 percent in real terms.[22]

The Economic and Social Consequences of Excessive LURs

Most of the US cities with the strongest economic growth also unfortunately have some of the strictest LURs and, thereby, some of the highest housing costs nationally.[23].Despite ample economic opportunities provided by municipalities like New York, data suggest that the regulation-induced housing affordability crisis in expensive cities is a major disincentive for many to migrate to them and is tied to declining rates of interregional migration among Americans.[24] Many medium- and lower-income workers cannot afford the high housing costs in such highly regulated cities and thus remain in cheaper, but lower-productivity, jurisdictions. If, ceteris paribus, more Americans were to relocate to these economically dynamic but expensive urban centers, national economic welfare would likely increase. This is because if more workers of all skill levels deployed their labor in more economically robust locales, national productivity growth would increase due to greater economies of agglomeration, increased scope for a more efficient division of labor, a more entrepreneurial environment, and greater opportunities to learn new skills in rapidly growing urban centers.[25] In essence, if workers cannot afford to live in the places where their labor can provide the most marginal value added, American economic welfare will suffer.[26]

A recent study indicates that these effects are significant. The study contends that excessive LUR-induced housing costs contribute to a mismatch between available job opportunities (in growing but heavily regulated cities) and labor supply. The authors of the study argue that weaker LURs could dampen housing costs and push workers to relocate to more productive urban economies. Such migration could, according to the authors, lift economic output by up to 9 percent in the long term.[27]

Additionally, the housing affordability crisis in some cities arguably has led to increased pressure for policy makers to adopt unsound public policies.[28] In many high-cost cities, activist groups, often citing the cost of housing, have pressured local governments to enact counterproductive policies such as higher minimum wages or rent controls.[29] Thus, if liberalization of LURs in expensive cities facilitated lower housing costs, there might be less public pressure to adopt deleterious economic policies aimed (in part) at allegedly addressing high housing costs.

Policy Recommendation: Condition Federal Urban Aid on Regulatory Reform

Federal policy makers looking to improve American economic welfare should thus take steps to incentivize local governments to deregulate their housing markets by relaxing LURs. One way to do this would be to condition the federal urban aid programs such as the Community Development Block Grant (a discretionary grant to local governments for initiatives in areas such as subsidized housing construction) on local governments producing and implementing a clear set of policies that reform LURs to encourage housing construction. If a jurisdiction refused to comply, federal lawmakers could reduce funds provided under grant programs by, say, 5 percent annually until the jurisdiction in question agreed to implement a credible LUR reform plan. (Other possibilities for conditional funding include aid to cities for mass-transit projects.)

While some might worry that such conditional funding would invite constitutional and legal challenges, this fear is overblown. Making federal funds contingent upon certain actions by recipient governments is hardly unprecedented. In the 1980s, Congress successfully used the threat of withholding federal highway funds from states to entice them to adopt a higher, uniform national drinking age.[30] Additionally, in 1987, in *South Dakota v. Dole*, the US Supreme Court stipulated that the federal government had wide latitude to condition federal assistance to state and local governments so long as (1) the lower levels of government had the capacity to reject the funding, (2) such funding was not inconsistent with other provisions of the Constitution, and (3) the conditions attached to the funding furthered a legitimate federal interest.[31] The above proposal fulfills all three of these criteria.

Restrictive land-use policies have placed a significant burden on many Americans and have led to unaffordable housing markets in many of the nation's most economically vibrant and important cities. Liberalizing these markets could provide greater economic benefits to all Americans. By tying certain federal assistance programs to cities to LUR reform, the federal government could provide the push local governments need to adopt housing policies that would unleash the full potential of the nation's most dynamic urban areas.

Justin Hatherly was born and raised in Hong Kong to parents from Canada and the United States. He speaks, reads, and writes Mandarin Chinese and Cantonese. He attended McGill University in Montreal and earned a BA (Honors) in political science in 2017. At McGill, he also pursued studies in economics. He has worked as an intern for various Canadian public policy think tanks, such as the Canadian Taxpayers Federation and the Atlantic Institute for Market Studies (AIMS). In 2017, AIMS published an academic study he authored advocating an overhaul of Canada's system of unemployment insurance. Since graduating, he has returned to Hong Kong and currently works in anti-money laundering in the Legal and Compliance division for China Construction Bank (Asia). His personal interests range from Canadian and US public policy to soccer and classic rock.

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