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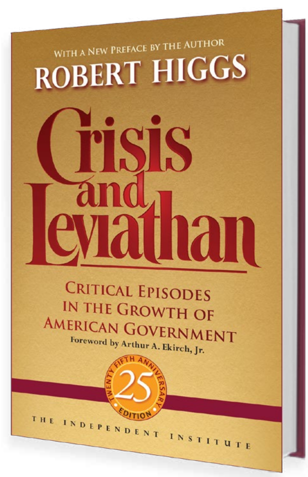

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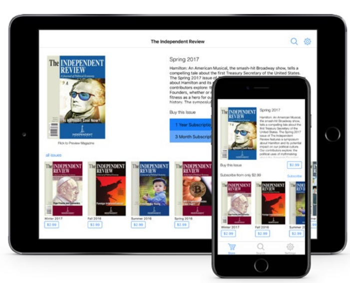

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Urban Land-Use Controls and the Subprime Mortgage Crisis

EDWIN S. MILLS

In the United States, urban house prices rose at several times the overall rate of inflation from the early 1990s until the beginning of the subprime mortgage crisis in 2007 (Glaeser, Gyourko, and Saks 2005; Mian and Sufe 2008). Most house-price indexes show trends similar to that of the best index, the Case-Shiller index of repeat sale prices: nearly a tripling of real home prices from 1992 to 2006, which implies an average annual increase of close to 8 percent.

Why did housing prices increase so rapidly? Increases in construction costs are not the cause. Construction costs rose less rapidly than the consumer price index during most of the postwar period, and after 1980 they fell because of general technical progress (substitution of new, better, and cheaper materials, increased use of machinery), shifts of construction from on site to factories, and, probably, increases in the employment of immigrant workers (Glaeser, Gyourko, and Saks 2005). In addition, the costs of housing finance have fallen steadily during recent decades.

In fact, the underlying cause of the recent rapid escalation of house prices is the increasingly stringent, local government land-use controls that restrict urban housing supply (Glaeser, Gyourko, and Saks 2005; Ihlanfeldt 2007; Mills 2007). The most stringent controls and the most rapidly increasing house prices have occurred on the two coasts. The upper Midwest has lagged behind until recently (Mills 2007), and the South is for the most part far behind.

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The Independent Review, v. 13, n. 4, Spring 2009, ISSN 1086–1653, Copyright © 2009, pp. 559–565.

That land-use controls have become increasingly stringent during the postwar years is hardly in doubt. (See the analysis and references in Ellickson 1977 and Glaeser, Gyourko, and Saks 2005, and see Mills 2007 for a case study of Chicago.) The courts have made themselves nearly impotent in the local governments' gradual nullification of the Fifth Amendment as it applies to urban property rights. In Illinois and elsewhere in the country, courts have taken the view that unless the local government prohibits all uses of private land, the local zoners' assertion that their restrictions serve a public purpose places those restrictions beyond legal challenge (Yandle 1995). In particular, the courts' permissiveness gives local governments a free hand in instituting density controls.

In Chicago, where as many as fifty restrictions may apply to a private lot, perhaps half of them are intended to limit residential densities (Index Publishing Corp. 2007; Mills 2007). Although existing structures are "grandfathered in" when restrictions are made more stringent, most Chicago zoning documents require that the structure be placed in full compliance with current restrictions if its exterior is altered. That provision in effect outlaws substantial improvements in the standing housing stock.

If developers are not allowed to build up, they must build out, causing what is popularly called *sprawl*. The only sensible defense of low-density zoning is that residents prefer low density. Of course, a resident can have an immediate environment with any density he wishes by buying a sufficiently large lot. Maximum lot-size restrictions are unknown. However, a reasonable interpretation of responses to public-opinion polls that show a preference for low density is that the preference is for low density in a broader environment than one's own lot. "Open space" is a common referent, but that must be distinguished from a desire for parks and recreational space, which local governments provide without restriction, presumably in amounts and kinds that roughly satisfy residents' wishes. Whether by intention or not, government restrictions on housing supply make housing expensive, tending to deprive moderate-income and minority people of residences in strongly controlled neighborhoods (see Mills 2005a for a case study of Chicago).

If residents desire lower residential densities than competitive housing markets provide, it is easy to place an upper bound on government restrictions that can improve residents' welfare. With or without restrictions, residential densities invariably decrease with distance from the metropolitan center. In the absence of density controls, a resident can obtain as low a density as desired by living at whatever distance from the center provides the desired density—of course, at the cost of a longer commute the farther the desired-density location is from the center. If controls are so restrictive that they impose longer-distance commutes than would be incurred in the absence of controls, then controls must make residents worse off. A crude calculation indicates that Chicago's density controls cause several miles more commuting, on average, than the distance required to improve residents' welfare (Mills 2005b).

Why Are Controls So Stringent That They Make Residents Worse Off?

At first glance, it seems odd that local governments impose controls on residential densities that are too stringent to serve the residents' interests. In U.S. metropolitan areas, local governments typically have jurisdiction over relatively small areas, and they certainly are responsive to residents' strongly felt interests.

The answer to this seeming puzzle almost certainly pertains to the influence of neighborhood homeowner groups. (The best study of this subject is Glaeser, Gyourko, and Saks 2005.) Although there is no census of such groups, they are pervasive, at least in high-income neighborhoods of metropolitan areas. They invariably favor and lobby for low and reduced densities. Their arguments are ritualistic and typically unsupported by data or serious analysis: tall buildings are claimed to cause congestion, interfere with sunlight, and impair the neighborhood's character.

In Chicago, an elaborate bureaucracy stipulates density controls, hears appeals, and makes changes; laws govern appeals to courts. City council members represent relatively small districts and have no legal function related to zoning, but everybody knows that the council members are the persons to see to get the city to approve a zoning change. In press conferences, the mayor has favored the council members' dominance in zoning matters. Every zoning document displays each district council member's name, office address, and phone number. The inevitable conclusion is that each district's elected local representative effectively dictates the district's zoning code. Council members typically know almost nothing about competitive market efficiency or urban planning, but they have a carefully expressed indication of neighborhood homeowners' wishes and can count noses and votes in elections.

Why would homeowners urge lower than optimum residential densities for the neighborhood, taking account of their preferences for lower than competitive market densities? The reason is easily stated: neighborhood homeowners advocate densities that are optimum for them, taking account of the capital gains that accrue to them because of such housing-supply restrictions. Existing homeowners incur little or no extra commuting because of supply restrictions. Most of the excess commuting is done by those who would live in the neighborhood if there were no such excessive restrictions, but who cannot because of the restrictions. They cannot vote or lobby in the neighborhood and do not even know they are controlled in this way. In short, members of homeowners' associations who, through their aldermen, receive the benefits of density controls impose the costs on other residents, who must incur excessive commuting costs as a result.

Mayors and city council members have an additional incentive to impose stringent density controls. The capital gains that result from stringent residential and commercial controls generate 10 to 12 percent annual increases in real estate taxes without the need to increase tax rates. In election campaigns, mayors advertise that owing to their careful management, they have not needed to raise taxes (meaning tax rates).

Finally, increasingly stringent land-use controls may benefit homeowners in another way as well. Controls are most stringent in upper-income neighborhoods (Mills 2007). The national civil rights laws of the mid-1960s began to have teeth by the early 1970s. Sellers and realtors became realistically threatened by civil and criminal prosecution for racial and ethnic discrimination in the sale and rental of dwellings. Increasingly stringent density controls increased housing prices and rents in upper-income neighborhoods relative to those in lower-income neighborhoods. The result was a substantial decrease in the percentage of dwellings occupied by minorities in stringently controlled neighborhoods, at least in Chicago (Mills 2007). Thus, whether intentionally or accidentally, upper-income neighborhoods turned the dirty work of racial discrimination over to local governments when private discrimination became legally risky.

Increases in the price of owner-occupied dwellings are legally capital gains and are virtually free of federal and state taxes. From an economic point of view, however, they are not really capital gains. Real capital gains result either from increases in the productivity of existing capital or from businesses' retaining part of their earnings and reinvesting it in additional assets instead of distributing the earnings to owners. Of course, asset values rise with overall inflation, but only about as fast as the overall price level. Dwelling-price increases in excess of the overall inflation rate represent increasingly strong monopoly prices created by increasingly stringent government density controls.

Relationship to the Subprime Mortgage Crisis

U.S. financial markets have been thrown into confusion since 2007. The confusion has several causes and several consequences. Here, I focus on only the part of the crisis that relates to subprime borrowers.

Subprime borrowers are those who do not meet traditional criteria for a thirty-year, fixed-rate mortgage: a down payment of approximately 20 percent of the dwelling's value and a monthly housing payment (mortgage payment, taxes, and perhaps a maintenance estimate) that does not exceed a reasonable fraction, such as 30 percent, of the family's monthly income. Subprime borrowers often obtain adjustable-rate mortgages in which a low "teaser" interest rate is charged for one to three years, after which the interest rate becomes tied to a publicly available formula (often LIBOR, the London interbank offered rate) for the remainder of the loan's life.

Most moderate-income neighborhoods have density controls, although these controls may not be as binding as those in high-income neighborhoods. In addition, moderate-income neighborhoods experience additional housing demand, not only because of migration from outside the metropolitan area, but also because stringent density controls in high-income neighborhoods force moderate-income residents to live elsewhere (Mayer and Pence 2008; Mendoza and Terrones 2008).

Aggressive mortgage lenders and brokers apparently approached relatively low-income potential buyers (perhaps first-time buyers) with the following inducement: "I can put you into your own house at no greater monthly payment than your current rent, and with almost no down payment; your interest rate may rise in a couple of years, but by then you will have made 15 percent tax-free capital gain on the house (15 percent of a $200,000 house is $30,000, more than enough to pay the ownership costs); if you can't afford the monthly payment at that time, you can refinance (prepayment penalties are usually not legal in the United States), and you will continue to make the capital gains." The "almost no down payment" argument was persuasive for several years because the United States was awash with liquidity.

In addition, some subprime mortgages were mixed with prime mortgages to support mortgage-backed securities, a violation of transparency, if not of law. The impetus was exacerbated by the U.S. government's urging of lenders to provide more mortgages in "underserved" markets.

Such a bonanza cannot continue indefinitely. It may end because housing construction finally catches up to demand, despite density controls. Much of the construction is likely to be in distant suburbs at mandated low densities. (In 2007, the most rapidly growing county in the United States was Kendall, located fifty miles southwest of downtown Chicago.) The bonanza may end because the growth of housing demand slows as the economy approaches full employment, as the U.S. economy did in 2006 and 2007. Rapid growth sometimes ends simply because house-price inflation makes an area too expensive for businesses to prosper and for people to afford local housing, as has happened from time to time in California. Interest rates and other loan qualifications may be restricted because financial markets become disorganized, as has happened in the United States in 2008.

When house prices rise at real annual rates of 8 percent, subprime (and other) borrowers can afford a house whose value is many times their annual incomes, but when house prices stop increasing or begin to decline, many occupants quickly realize that they can no longer afford their dwellings. Moderate-income owners default on their mortgages. Owners "lose" their equity in their homes, but many had little or no equity when they bought the home. The new owners sometimes permit former owners to remain in the residence as tenants, especially if there is little demand for dwellings by potential owner-occupiers.

The current U.S. crisis is not unique. Carmen Reinhart and Kenneth Rogoff (2008) identify eighteen financial crises since World War II. The United Kingdom has had three such crises. Almost all eighteen have occurred in countries that have extremely stringent land-use controls. England and Japan certainly qualify in this regard.

What Should Be Done?

I am focusing here on positive analysis, not on desirable government actions. In conclusion, I offer only three brief comments.

First, bank-centered crises are costly. For the eighteen crises that Reinhart and Rogoff (2008) examine, they calculate that the average cost was a loss of 2 percent of real gross domestic product during each of two years.

Second, in the current U.S. crisis, the odds are that the federal government will do too much instead of too little. Most of the proposals now being entertained or executed in Washington simply transfer the cost of the crisis from borrowers to taxpayers or rely on old-fashioned "pump priming," which simply increases the federal debt and has doubtful benefits.

Third, the appropriate long-run solution is certainly to relax excessive local density controls. However, a more likely future prospect is for increasingly stringent controls, which will almost certainly lead to increasingly severe future crises. Given local governments' current structure, they have no incentive to reverse the trends of the past half-century. As noted earlier, state courts have absented themselves from any protection under the Fifth Amendment as it applies to urban real property. State governments, which are sovereign in such matters, might reverse the situation, but they show no interest in doing so. The federal government shows even less interest in reforming land-use controls. Even if federal authorities showed much more interest, battles would arise between federal and state governments concerning jurisdiction.

I conclude this pessimistic evaluation with the advice that housing is, even at best, a risky investment. Let the buyer beware.

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