ORER Letter

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Special Section: Race and Housing

The Price of Zoning

David E. Mills

Zoning originated as a tool to provide comprehensive urban planning. The reality, of course, has always been something different from that original ideal. Zoning practice is more about acquiring and swapping property rights than it is about planning *per se*. Reduced to simplest terms, the laws and institutions of zoning merely create a line of division between the private rights of land owners and the collective rights of communities. What a land owner is free to do with his land the community is bound to accept; what the land owner is forbidden to do with his land the community is entitled to be spared.

Comprehensive planning would require that the assignment of rights be stationary, complete, and beyond dispute. The fact that none of these conditions are met explains why most of the action in land use regulation these days does not involve planning. Negotiation and litigation are the main events in the zoning arena.

Zoning and Exchange

The economic rationale for zoning is to remedy market failure arising from externalities among land uses. By restricting or excluding uses with undesirable spillover effects, zoning has the potential to improve the use of land under a zoning authority's jurisdiction. In theory, zoning can extract more social benefit from land than would a regime of *laissez-faire*.

Yet while zoning is sound in theory, the economic performance of zoning has been disappointing. One reason for this disappointing performance has been the tendency for zoning officials to quash mutually advantageous exchanges of property rights between land owners and communities. If the spillovers from nonconforming land uses were small in relation to the private gains that would accrue to the land owner if such uses were permitted, then zoning-based restrictions would penalize everyone.

Suppose there is a land owner who wants to build a convenience store at the edge of a residential area in a city. The land is zoned for residential uses exclusively. A convenience store on the site would create spillovers like noise, traffic, and so forth, but gaining the right to build the convenience store would be worth \$100,000 to the land owner. (That is, the land owner's next best development option would be worth \$100,000 less.)

ORER News

Scholarship Assistance Available to Minorities

1989 amendments to the Illinois Real Estate License Act created a program to provide financial assistance to individuals of racial minority status who wish to pursue courses of study in the real estate field. The Illinois Minority Real Estate Scholarship Program is funded through fees paid by holders of Illinois real estate brokers' and salespersons' licenses. The legislation, which was sponsored by Senator Emil Jones (D-Chicago), appoints the Office of Real Estate Research to administer the program; ORER does so under the guidance of an advisory committee of minority real estate professionals. Those currently serving on the committee are Chicago Realtors® Dempsey Travis (chairperson), Alvin Pearson, and Frank Williams.

Black, Hispanic, and Native American residents of Illinois are eligible for financial assistance in support of activities ranging from pre-license training to professional designation programs to collegiate study. Application forms are available from most local boards of Realtors® in the state, and from the Office of Real Estate Research. Questions regarding the program can be directed to ORER.

Fall Alumni Luncheon

The Office of Real Estate Research has organized another luncheon for University of Illinois alumni working in fields relating to real estate. The event will be held at the Chicago Yacht Club on Friday, November 1. Thanks to Gene Stunard for again providing access to the Yacht Club.

The speaker will be Charles H. Wurtzebach, a Managing Director of

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Suppose further that, for the sum of $60,000, the land owner and the city could undertake measures to reduce the spillovers and to compensate any parties unavoidably affected.

Consider the options open by law to the zoning commission in a case like this. In permitting the nonconforming land use, the zoning commission would consign the community to suffering $60,000 in damage from the spillovers. Yet in denying the land owner the right to build the store, it would deprive him of a development opportunity worth $100,000. Neither choice would be very appealing.

Instead of completely banning or unconditionally accepting the offending but remunerative land use, would it not be better for the zoning commission to sell the land owner the right to develop the land, for a price that compensates the community for spillovers? Any price between $60,000 and $100,000 would put both the land owner and the community in better positions than they would be in absent the development. It is ironic that selling the zoning is not an option. The commission can give property rights of the community to the land owner, or it can keep these rights, but ordinarily it cannot sell them.

The opposite problem also occurs; a permitted land use might create spillovers that are large in relation to the financial loss the land owner would suffer if new restrictions were imposed. In such a case, the community and the land owner alike would be made better off if the community could just buy the land owner's right to practice the offending use. Yet the rigidity of zoning can keep the community from acquiring new rights in a transaction that does not penalize the land owner. The problem with zoning is that it gives and takes what instead should be bought and sold.

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It's Hard to Squelch a Good Deal

Economic history and our experience teach us that mutually advantageous exchange is hard to suppress. Contemporary zoning practice affords a good illustration of this principle. As it evolves and matures, zoning practice moves ever closer to the notion of "zoning for sale."

An illustration involves Jim and Ted Pedas, developers who plan to build an office building a few blocks down Pennsylvania Avenue from the White House. Stymied by the District of Columbia zoning ordinance, which precludes structures as tall as the ten stories they propose, the Pedas brothers sought to strike a deal with the District Zoning Commission. In exchange for permission to proceed with their plans, the brothers offered the Commission a jumble of side payments and incentives: $1 million for low-income housing in the District, another $1 million for scholarships for DC residents, and so on. Once the stakes were raised high enough, the Commission agreed to lift restrictions and to allow the developers to proceed.[1]

The Pedas case is not an isolated incident. Cutting deals, or establishing "linkage," has become a prominent feature of zoning practice throughout the country. The city of Los Angeles exacted a new $20 million facility for its Museum of Contemporary Art from Bunker Hill Associates. In exchange, the development firm received the right to develop an eleven-acre, mixed-use project in a prime section of the city.[2] In other cases local governments have exacted municipal infrastructure, such as roads, parks, and schools, from developers in exchange for rights to develop land.

Requiring tangible contributions to enhance the general welfare of communities as a condition for granting development rights is, of course, a form of exchange. This exchange arguably benefits all parties involved. When the Pedas brothers sought relief from the zoning restrictions along Pennsylvania Avenue, they asked the community (the District of Columbia) to relinquish its collective right to an unimpaired view of the sky and to a less congested environment. Naturally the community, whose interests the Zoning Commission looks after, demanded something in return. What the community got is better than nothing and, depending on the effectiveness of the District of Columbia Zoning Commission as an arbiter of community values, may be better than maintaining unimpaired views and less crowded streets.

scarce, zoning increases the value of the land to which these rights are attached. By denying development rights to most land owners, a community makes those rights worth much more to the fortunate land owners who can obtain them.

This situation naturally invites rent seeking efforts by land owners, developers, and other agents hoping to capture scarce and valuable rights. As is true of rent seeking in other settings, rent seeking in zoning creates social costs by squandering resources. Resources like time and money devoted solely to capturing the spoils of zoning create no value in and of themselves, and therefore could have been deployed elsewhere in the economy to produce valuable goods and services.

> *By exchanging a community's property rights for cash, we might keep zoning officials more accountable to all constituencies, rather than just to the most vocal.*

Exchange of this nature is a form of barter that serves to dodge the legal barriers to explicitly salable zoning. Yet the open sale of development rights for cash could be no worse, and might be better, than a community's dealing for such amenities as museums and sidewalks. The value to the community of tangible exactions may be considerably less than the cost borne by land owners or developers. By adopting the practice of exchanging a community's property rights for cash, we might keep zoning officials more accountable to all constituencies in the community, rather than just to the most vocal.

Zoning and Rent Seeking

Barriers to the sale of zoning have another unfortunate consequence: the dissipation of zoning's social benefits through rent seeking activities. (*Rent seeking* is the pursuit of the above-normal returns that can accompany restricted economic activities.) Zoning affects land rent because it restricts owners' development options. By making some kinds of property rights (e.g., rights to build tall office buildings along Pennsylvania Avenue)

It is possible, in theory at least, for rent seeking to dissipate the entire social dividend created by zoning. (The situation is not unlike one in which the quarreling and litigating of heirs dissipates a disputed inheritance.) In these instances it could be argued that *laissez-faire* with spillovers galore is better than zoning.

Rent seeking does not always totally destroy the prize. Yet nearly all rent seeking activity imposes social costs, and efforts to gain favorable zoning are no exception. To sketch out some possibilities, we can consider two kinds of rent seeking efforts that zoning might invite. Zoning practice is complicated, diverse, and ever-evolving, so these illustrations do not exhaust the possibilities.

Zoning "Contests"

In the 1970s, the city of Petaluma in northern California set out to limit residential growth by rationing building permits. Annual quotas on the number of permits were established, and home builders were invited to compete for the limited number of available permits

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JMB Institutional Realty in Chicago and former Senior Vice President of Prudential Real Estate Investors. Wurtzebach holds a Ph.D. in Finance from the University of Illinois. He served for many years on the faculty of the University of Texas at Austin, and is the co-author of a popular real estate textbook. His topic will be "Emerging Trends in Institutional Real Estate Investment."

A registration form appears on page 15. **There will not be a general mailing to alumni to announce this upcoming luncheon**. Anyone with questions about the luncheon, or about registration procedures, should write or telephone the Office.

Yavas Joins ORER Staff

An economist whose work focuses on markets facilitated by intermediaries and agents has joined the ORER staff. Dr. Abdullah Yavas, a recent University of Iowa graduate, will serve as a post-doctoral research associate. His research efforts will focus on economic analysis of the real estate brokerage industry. Interested readers can look forward to his articles in future *ORER Letter* issues.

Dean Search

Professor Paul Hartman of the University's Department of Economics served as Interim Dean of the College of Commerce and Business Administration during the summer of 1991. Professor Howard Thomas of the Department of Business Administration has been appointed Acting Dean of the College for the 1991-1992 academic year. A search is under way for a permanent replacement for former dean John Hogan, now at the helm of Georgia State University's College of Business Administration.

Advisory Committee Update

Dean Thomas has appointed two new members to the ORER Advisory Committee. They are Terri Murphy, a Realtor® from Libertyville, and

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by presenting their cases to a citizens' evaluation board. Builder proposals were rated numerically on the basis of architectural designs, site plans, and other features, and only those projects with the highest ratings were allowed to proceed.

In many other localities zoning authorities do implicitly what the Petaluma plan did explicitly: converting zoning procedures into contests in which development rights are given out as prizes. A community that awards permits in this manner invites rent seeking efforts by those hoping to win and, inadvertently, imposes social costs. The resources expended by developers in attempts to win these zoning contests (for instance, the fees they pay for architects, planners, lawyers and other consultants, and outlays for eye-catching design features) exceed the value they add to the community. The expending of such resources does not make the prizes distributed more valuable; it only affects who wins them. When tallying the social cost of zoning contests, we must add all the costs incurred by losers and much or all of the costs incurred by the winners.

This wasting of resources is hardly a nickel-and-dime affair. Contestants for zoning changes in San Francisco must meet stringent architectural requirements that greatly inflate the cost of development. One developer is quoted as having stated, "... the design costs for the [approved] building were double what they normally would have been." [3]

It is rent seeking of this nature that actually can dissipate all the land rent created by zoning. Consider a simple and highly stylized illustration. If zoning causes a scarcity of development rights for an intensive land use, then there is a surplus of parcels standing to profit from acquiring the desired zoning. Favorable zoning therefore becomes a prize, and land owners hoping to win this prize are drawn to engage in rent seeking.

Suppose the surplus of parcels is on the order of four-to-one; only one parcel in five will be awarded the favorable zoning. Suppose further that the sought-after zoning is worth $1 million to the land owner who wins it. If each land owner figures that (with sufficient effort and expense) his chance of gaining the prize is as good as anyone else's, then each will spend up to $200,000 in the effort to win. (An owner who feels that obtaining the desired zoning is an "even bet" in which anyone's chance of winning is 1/5 will pay up to 1/5 of the $1 million prize in order to compete.) The sum of what the owners collectively pay to consultants, attorneys, and others exhausts the prize; there are four losers and one winner, but the gains and losses cancel out in the social accounting. The community would have been better off, and no one would be the worse for it, had the prize simply been auctioned to the highest bidder.

> *Nearly all rent seeking activity imposes social costs, and efforts to gain favorable zoning are no exception.*

"First-Come-First-Served" Zoning
The preemptive timing of development is another mechanism for rent seeking in zoning. Communities are more open to zoning changes in some periods than in others. If the likelihood that a land owner can get a favorable zoning change decreases as more and more such changes are approved, then a different kind of contest emerges. This contest is a race to get inside the door before zoning authorities abruptly close it; we might think of the outcome as "first-come-first-served" zoning.

In this scenario land owners rush their development plans to avoid being preempted by others. There are social costs, mainly in the form of excessive development for extended periods. Development is excessive, from a social point of view, when it depresses prices and rental rates for developed properties to levels below their long-run marginal costs. In markets exhibiting this feature, some services are worth less to occupants than they cost, and hence should not have been supplied. The prematurely developed properties eventually become economic, as demand grows and prices and rental rates rise in response, but excessive development brought on by "first-come-first-served" zoning is nonetheless costly.

Something similar happens when owners fear that the community will confiscate rights that lie too long unexercised. We might think of this situation as "use-it-or-lose-it" zoning. An argument can be made that preemptive development, like zoning contests, dissipates all of the land rent created by zoning in the first place (see "Is Zoning a Negative-Sum Game?" *Land Economics*, February 1989).

Zoning Reform
It should be apparent that buying and selling zoning, rather than taking it or giving it away, would greatly diminish the frittering away of resources brought on by rent seeking efforts. Of course, buying and selling are not costless activities, but they would conserve resources as compared to the processes we use to ration scarce and valuable property rights today.

The goal of land use regulation ought to be the open and efficient exchange of property rights. Obstacles remain to the emergence of a consensus on improving the way we regulate land use, but encroaching "linkage" is an encouraging first step. It reveals and dramatizes that both land owners and communities understand implicitly that opportunities for mutually advantageous exchange exist. The next step is to refine the institutions to facilitate exchange. ■

Footnotes
1. *The Washington Post*, p. A1, April 30, 1991.
2. *The Wall Street Journal*, p. 33, April 18, 1984.
3. *The Wall Street Journal*, p. 35, March 5, 1986.

Dr. Mills is a Professor of Economics at the University of Virginia.