Brookings Report by Jenny Schuetz
January 17, 2020

Who's to Blame for High Housing Costs? It's More Complicated Than You Think

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Public debate falls into two schools of thought as to why housing costs are so high in many parts of the U.S. The YIMBY ("Yes In My Backyard") school argues that housing is expensive because local governments—and voters—have adopted overly restrictive land use regulations that limit the construction of new housing. On the other hand, left-leaning politicians like Bernie Sanders contend that housing is expensive because "corrupt real estate developers are gentrifying neighborhoods."

So, which is it? Are government regulations making it impossible to build new homes, or are developers price gouging homebuyers and renters? Who really pockets the profits from building—or not building—new housing?

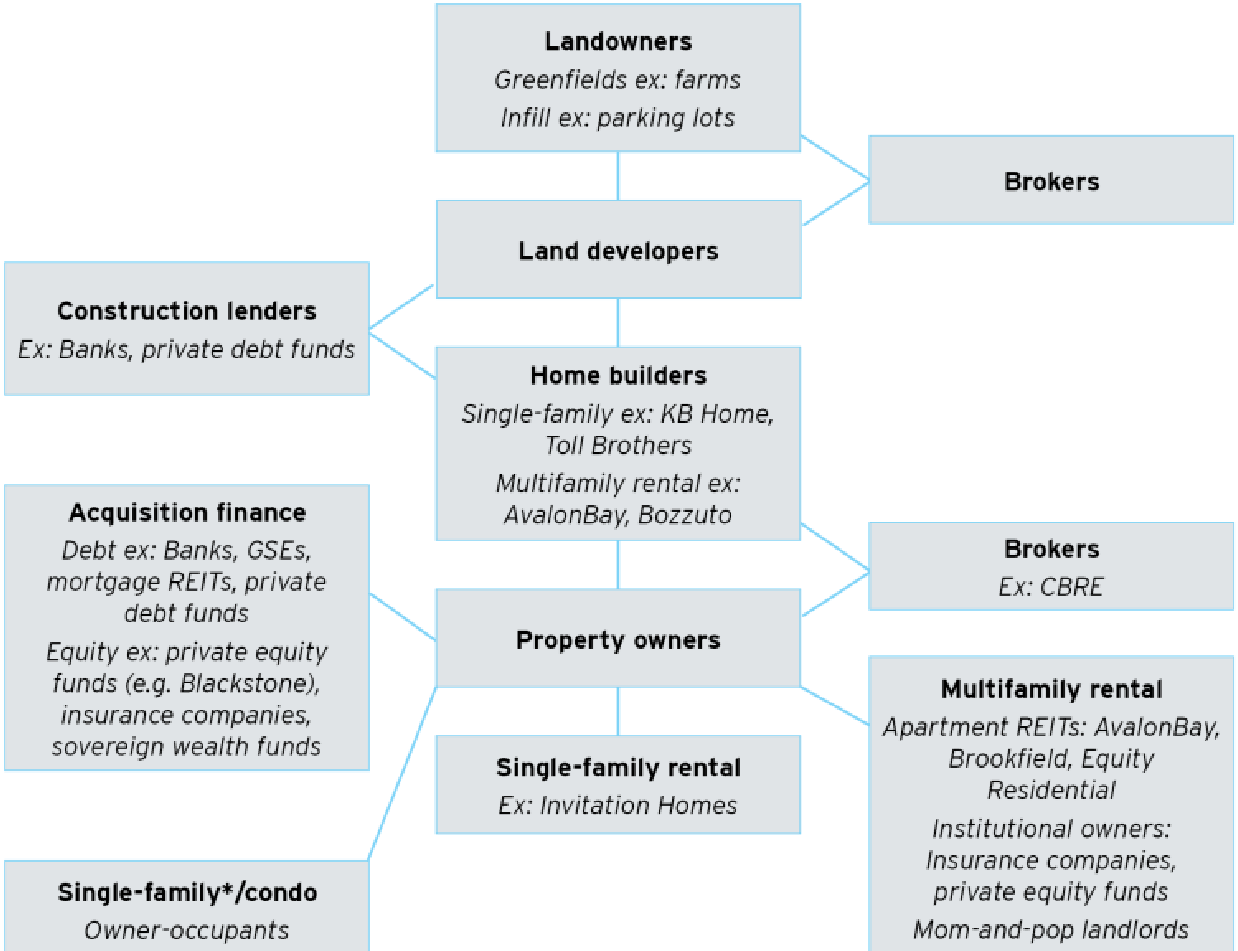
In this piece, I lay out some basic facts about the financial ecosystem of housing development, and discuss the ways land use regulations affect development decisions. How do regulatory barriers impact the profitability of a new housing development? And how are the costs of development (including complying with regulations) shared among developers, lenders, and investors?

WHO'S WHO IN THE RESIDENTIAL REAL ESTATE INDUSTRY

People often define the entire housing production industry as "developers," but there are many different types of companies involved in creating new homes (Figure 1). This article focuses on production of market rate housing; the ecosystem for subsidized housing development is substantially more complex.

FIGURE 1

Housing development ecosystem



* Single-family includes 2-4 family properties with at least one owner-occupant.

Sources: Driscoll 2018, NAREIT, Real Capital Analytics 2019

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Two types of companies are primarily responsible for turning land into homes: land developers and homebuilders. Land developers purchase large land parcels and work through the regulatory process to obtain the necessary entitlements, discussed in more detail below. For large single-family projects, land developers also subdivide the main parcel into individual home plots and build the necessary infrastructure, including roads, sidewalks, and water and sewer lines.

Land developers then sell the serviced lots to homebuilders, which are companies that design and construct individual homes to sell or lease to households. Builders of multifamily rental housing may keep the buildings in their portfolio or sell it to another permanent owner.

In practice, there are two parallel housing development industries. One set of land developers and homebuilders specializes in “greenfield” development: building subdivisions of new single-family homes or townhouses on undeveloped agricultural land in suburban and rural areas (apartments are a small share of greenfield development). A separate set of companies specializes in “infill” redevelopment within the urban core, consisting mostly of multifamily buildings (both rental and condominium) or mixed residential-commercial.

Certain regulations impede infill and greenfield projects in different ways. For instance, minimum lot sizes are one of the most important density regulations for new single-family subdivisions, but are less relevant to infill projects, where land parcels already have clearly defined boundaries.

Most land developers and homebuilders cannot afford to fully self-finance their projects, so they rely on banks or other financial institutions to provide loans for some portion of development costs. Funding to purchase multifamily rental properties comes from banks, insurance companies, and other equity investors. Some vertically integrated companies, such as real estate investment trusts (REITs) may perform all these functions.

As discussed below, local regulations affect the housing development process through a variety of channels, including direct construction costs, compliance costs, and by altering financial risks and returns. These channels influence the decisions of each group of actors in the industry, from land developers and homebuilders to lenders and equity investors.

REAL ESTATE DEVELOPMENT IS A RISKY BUSINESS. REGULATORY BARRIERS MAKE IT RISKIER.

The process of building new homes is full of uncertainty and unexpected obstacles. Regulatory barriers make it riskier, longer, and more expensive, which has consequences for housing affordability.

Consider a fairly straightforward case: converting farmland into a new subdivision of single-family houses in a suburban area or small town. To start the process, the developer may buy the land outright or acquire an option to purchase at a later date. The next step is to apply to the relevant local government(s) for permission to rezone the parcel from its current allowed use (agriculture) to residential.

Local governments can grant the developer’s rezoning request, deny it, or grant it with modifications or conditions attached. For instance, the locality might agree to rezone the land to residential but at a lower density than requested, forcing the developer to build fewer units than she had anticipated. Most localities also require an environmental impact review before granting a rezoning, assessing the proposed development’s effects on traffic congestion, noise levels, wildlife, soil erosion, wetlands preservation, and more. Converting farmland to housing also involves new infrastructure—roads, sidewalks, water and sewer lines—which local governments typically require developers to build or finance. All of this must happen before construction can even begin.

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Each step required by local governments during the land development process has a purpose, whether it’s preventing environmental damage or providing essential infrastructure. But there are also costs associated with the process: fees for lawyers, surveyors, and specialized consultants as well as infrastructure costs. Time spent by local officials in reviewing documents and holding hearings also represents an opportunity cost for the public sector. Who ultimately pays the costs associated with land development—whether it comes out of developers' profits or gets passed along to consumers of new housing—may not be immediately obvious. What is clear is that a longer and more uncertain process increases the costs of development.

WANT HOUSING TO BE CHEAPER? ALLOW HOMES TO BE DEVELOPED FASTER.

A key principle of finance is the time value of money: A dollar of income received in the future is worth less than a dollar received today. In real estate development, project expenditures (land purchases, entitlements, constructing infrastructure and buildings) are frontloaded, while income derived from selling or leasing homes may not occur for several years. Regulations that lengthen the development process exacerbate the problem, causing developers to rack up expenses long before earning income from the completed homes. Riskiest of all is a development process in which both final outcomes—can new homes be built, and how many—and the duration of the process are uncertain. For example, general contractors estimate the costs of homebuilding based on current prices of construction materials and wages, which can change considerably over time. Builders try to time project completion to hit during an upswing in housing demand, when rents are high and new properties won't sit vacant. When the length of the process is uncertain—almost guaranteed when residents can create delays through political opposition—developers can't predict completion dates. Many projects started during the exuberant housing market of the early 2000s reached completion—or stopped construction altogether—during the Great Recession, forcing builders to sell land and homes at bargain prices.

RISK AND REGULATIONS DICTATE WHAT GETS BUILT

If complex development regulations increase the riskiness of building new housing, and some local governments have more complex regulations than others, why would developers choose to build in highly regulated places? As in all financial ventures, investors will only commit their time and money to risky projects if they anticipate higher returns in the end. That goes for developers as well as the banks and equity investors that provide funds for housing development.

Land developers and homebuilders can adjust to geographic variation in the stringency of regulations in several ways. They can choose the jurisdictions in which they work, the type of housing to develop, and the price or rent of finished homes (within market limits).

Unlike the car manufacturing industry, the U.S. homebuilding industry is highly fragmented. Many small developers and homebuilders operate in only one geographic market, while a handful of very large firms operate across multiple metro areas or states.

Geographic variation in local land use regulations is one cause for the fragmented structure of the homebuilding industry. Some large, national companies—especially multifamily developers—strategically target infill locations in "supply constrained" regions. Places such as the Bay Area, Greater Boston, and the Washington, D.C. metro area have complex regulations that deter less well-financed and connected competitors from entering the market. Other firms—especially the large, single-family builders that profit from economies of scale—primarily build in less regulated suburban and exurban areas. Small, local firms—those building fewer than 10 homes per year—operate in every market.

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Within metro areas, developers can choose sites in different political jurisdictions; even neighboring communities may have quite different regulations or attitudes toward development. In jurisdictions where the development process is highly discretionary, barriers to development can vary across neighborhoods, reflecting the degree of coordinated opposition from existing residents.

Regulations also influence developers' decisions about what type of housing to build. In locations where zoning prohibits anything other than single-family detached houses, regulations are a binding constraint on smaller, lower-cost housing. Single-family-exclusive zoning limits the amount of rental housing in a community, since single-family homes are more likely to be owner-occupied, while multifamily buildings are usually built for renters. Regulatory features such as procedural complexity and high impact fees create a high fixed cost for any new development, meaning that the per-house cost declines as the number of homes in a development increases. Thus, developers are more likely to build in locations with stringent regulations only if they can build relatively large projects.

GLOBAL MARKETS, LOCAL REGULATIONS

Developers are the most visible face of the real estate industry, and therefore targets of criticism from politicians and neighborhood associations. But the developer is only one piece of the financial food chain that provides capital for new housing development. Just as most households rely on mortgage loans to help them purchase homes, developers rely on loans from banks and other funders to help finance production of new housing. Regulations that affect development risk will affect whether a bank is willing to provide a construction loan, and what interest rate it charges the developer.

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While there is an abundance of academic research on how land use regulations affect housing prices and production, we know much less about how regulations affect capital flows behind the development and acquisition of housing. One reason is that much less publicly available data exists on multifamily rental real estate finance than on owner-occupied residential real estate. Below, I suggest three potential ways that local regulations could affect capital market investment in housing. More empirical research on these factors would be helpful to policymakers.

Regulatory barriers may be encouraging upward "filtering" of existing apartments

In locations where regulations make new construction particularly difficult, more capital may flow into acquisition and rehabilitation of existing properties. These face less regulatory risk, because they generally don't require zoning changes. It's not difficult to find examples of institutional investors in tightly regulated markets purchasing older apartment buildings, conducting substantial renovations, then leasing the rehabbed apartments at substantially higher rents—the multifamily equivalent of flipping older single-family homes. This process of upward "filtering" among existing apartments is particularly worrying for housing affordability, because it results in higher rents without expanding the number of homes available.

Capital mobility may drive up housing prices in tightly regulated places

For lenders and investors who operate nationally or globally, geographic differences in land use regulation may encourage capital flows toward less regulated localities. When national financial institutions do make real estate investments in strictly regulated locations, especially where development processes are highly discretionary, investors will expect higher interest rates or returns to equity. Meeting higher minimum rates of return for investors requires developers and homebuilders to charge higher prices for completed housing—which translates into worsening affordability for renters and homebuyers.

Regional banks may allocate funds away from construction lending

Small, regional banks are prolific in construction lending. Because they primarily lend within specific geographic areas, difficult regulatory environments are unlikely to shift their capital into different locations. Within their market area, they may instead choose to reduce their overall real estate portfolio relative to other loan types. In aggregate, this may show up as "tightening" of the construction lending space.

DON'T FORGET THE OTHER BENEFICIARIES OF REGULATORY BARRIERS: EXISTING HOMEOWNERS

For all the animosity targeted at developers, landlords, and bankers, the largest group of beneficiaries from regulations that restrict housing supply aren't these for-profit corporations. Homeowners who were lucky enough to purchase their houses in earlier periods have enjoyed substantial wealth gains, most of which are exempt from taxation. Small wonder that homeowners exert their political muscle to continue restricting new housing supply.

State and local policymakers across the U.S. are grappling with how to make housing more affordable. But because our housing production system is so complicated, it's difficult to even reach a shared understanding of the problem. Making the development process simpler, shorter, and more transparent would be a good start.