

The Problem and Opportunity in Land Use and Building Restrictions

Joe Gyourko

Martin Bucksbaum Professor of Real Estate & Finance

The Wharton School, University of Pennsylvania

and

Senior Advisor and Director

AMC Delancey Group

High and rising housing prices have been the subject of much discussion. Recent speculation about a housing bubble aside, house prices have been appreciating strongly over the past decade. Real price growth over the last ten years has been four times greater than the real appreciation over the previous two decades. Some of this longer-term price growth is due to strong demand-side fundamentals such as real family incomes, which have risen more than real house prices over the past three decades (but not the last few years).

However, demand-side factors alone cannot explain this situation. House prices in many markets, including the Philadelphia metropolitan area, are now substantially higher than physical construction costs, implying that it is land, not structure that has become increasingly expensive. In fact, data from various industry consultants shows that the real cost of putting up the physical structure of a house has been declining modestly over the same time period that overall real house prices have been rising. Philadelphia is an exception to this national trend in declining real construction costs, largely because of the strength of unions in the building trades, but there is no doubt that land has become more expensive in this market, too.

The reason for this is increasingly restrictive land use and building regulation at the local level. The Zell/Lurie Real Estate Center at Wharton, which I direct, has conducted a nationwide survey of land use regulations. In this survey, we asked questions about the regulatory costs of development, the effects of regulation on builder uncertainty in the sense of how long are approval and review times, and where the impetus for regulation arose.

Starting with the last issue, the responses show that local pressures and actors drive the regulatory process almost everywhere in the country. No matter whether a zoning board, county commission, or community pressure is involved, the impetus for regulation almost always is local. Only 14% of the communities in our sample responded that state-level influences were very significant, and the vast majority of them are in California, Florida, and New Jersey.

The severity of land use and building restrictions is not correlated with community size or population density. Stated differently, low density places are just as likely as high density places to have long project review times, lengthy permit lags, and rapidly rising lot development costs. The same is true for small versus big towns.

If population level and density cannot explain regulatory strictness, what can? Our survey results clearly show that the wealth, income, and education level of the community are important drivers of local regulation. The higher are house prices, household incomes, and the percentage of college graduates in the community, the larger are increases in single-family lot development costs, the longer are review times even for standard projects, and the longer are permit lags between application and approval (whether or not rezoning is required).

For example, the Wharton survey results indicate that single-family lot development costs more than doubled over the last ten years in communities with median house prices above \$150,000, while they rarely doubled in places with typical house values below \$100,000. Higher house value communities were 25 times more likely than lower house value communities to have more than a year's time lag between permit application and issuance for a completely standard project involving less than 50 homes that did not require rezoning. In addition, very few communities presently impose binding limits on permits or construction amounts, but over 80% control density with increasingly strict minimum lot size requirements. In over one-third of our sample, there is a half-acre minimum that is prevalent in the richest and most highly educated communities.

Restrictions on home building can bring many benefits to the communities imposing them, but they also bring higher house prices whenever demand is strong. This is one of the most basic implications of economics—if you restrict supply in the face of strong demand for any product, its price will rise. That is precisely what has been happening in the housing market, here in Philadelphia and in virtually all coastal markets in the United States.

The growing challenge and opportunity for homebuilders and investors is to find land that can be developed in the near future. While the risks associated with increasingly long regulatory delays are rising, so are the potential profits. Projects that are approved typically sell at values well above construction costs in this environment and do not necessarily indicate an overheated or 'bubble market'. This also suggests there is a premium to be paid for people and firms that can manage the regulatory process, not just build homes. For those who can navigate the increasingly complex regulatory maze, the gains are likely to be very large. But, investors still should be aware that those who get stuck in the maze will lose big even if they possess great construction skills.

AMC DELANCEY GROUP, INC.

AMC Delancey Group, Inc. is a leading real estate investment and development firm that co-invests with a growing number of real estate operating partners throughout the United States. Headquartered in Philadelphia, Pennsylvania, the Company's unique approach focuses first on the quality of potential operating partners, next on their investment strategies, and finally on the specific properties proposed for acquisition. The Company's current investment programs include hotel, office, retail, multi-family, condominium,

mixed use, and land development. AMC Delancey plans to expand these and other investment programs into existing and new territories, with existing and new operating partners, with investments targeted over the next several years in excess of one billion dollars. For more information on AMC Delancey Group, visit www.amcdelancey.com.

###