

## CHAPTER 1

# TEACHING URBAN ECONOMICS TO PLANNERS AND THE ROLE OF URBAN PLANNING TO ECONOMISTS

NANCY BROOKS

## INTRODUCTION: COMMUNICATING ACROSS DISCIPLINES

A leading progressive urban planner, Thomas Agnotti (2008) describes the critical dilemma facing urban planners as “how to win the struggles against the concentration of noxious land uses without contributing to displacement and gentrification” (10). The Harvard urban economist Edward Glaeser (2007), who describes the spatial equilibrium as the “central theoretical construct of economic geography and urban economics,” characterizes the power of the spatial equilibrium concept as its ability to “predict that if something is particularly good in one location, then we should expect to see something bad offsetting it” (3). Initially, many students seem not to realize that Agnotti and Glaeser are saying the same thing because the disciplines of planning and economics tend to use different language and vocabulary,

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as well as different methodological tools. Yet the two disciplines of urban planning and urban economics clearly overlap at this very fundamental level. Part of teaching urban economics to planners and vice versa is providing the tools (analytical and linguistic) to make this point obvious to both professions.

Understanding the microeconomic foundations of the array of problems facing urban planners is a key step to gaining insights that can lead to innovative and effective planning policy. For example, with basic microeconomics it is straightforward to make the connections from profit- and utility-maximizing behavior to land value capitalization (via Ricardo 1821; von Thünen 1826) and to the spatial equilibrium (via Alonso 1964; Muth 1969) and the bid rent model. One can directly tie these theories to Henry George's (1879) ideas on land taxation and then to contemporary planning policies such as today's growing land trust movement (Davis 2010) that provides perpetually affordable housing in many communities or to insights into how to finance rail transit in a transit-oriented development (TOD) project (Anas 2008). Along with the efforts of intermediaries, such as the Lincoln Institute of Land Policy, faculty can help students make these cross-discipline connections and develop the theoretical links between the underlying economics and good planning policy.

Moreover, helping urban economists (and microeconomists in general) to appreciate the complex environment in which the planner operates and the relative importance of equity and sustainability in their work is another teaching goal. For example, the first-best solutions that economists often advocate can be too simplistic for the second-best world that planners inhabit. Scholars like Arnott, Rave, and Schob (2005) have made contributions in discussing second-best policy with regard to traffic congestion and candidly state that "until recently urban transport economists ignored the interactions between urban transportation inefficiencies and inefficiencies outside the urban transport sector" (2).<sup>1</sup> Planners would benefit from economists focusing more on models that are more realistic reflections of the situations where they operate. First-best or second-best, the goal is to structure pragmatic urban policy that can be effective in complicated urban settings.

In addition, how economists and planners frame equity concerns and the language they use has real policy implications. I think it is fair to say that economists in conducting welfare analysis focus primarily on Kaldor-Hicks efficiency. Economists work to identify policies where the net benefits are positive or maximized given the menu of policy choices. The efficiency-enhancing policy leads to a new resource allocation that typically makes some better off and some worse off. The positive net benefits imply the gainers could compensate the losers so that at least one person would be better off and no one would be worse off. In other words, with the new policy there exists a potential Pareto improvement, but instead of unpacking the distributional impacts, economists may be satisfied that social welfare has increased. Planners are likely to be more concerned with actual compensation of the losers

1. Zoning and other land-use regulations are also worth considering more thoughtfully as second-best policies.

(i.e., moving closer to a Pareto superior allocation), if not for equity reasons, then for pragmatic reasons. Many of the controversial issues planners face such as rent control, displacement from gentrification, loss of manufacturing jobs, and NIMBYism are ones in which a broader common vocabulary that incorporates a more nuanced understanding of efficiency and acknowledges its winners and losers could lead to better housing, land use, and local economic development policy.

Kletzer (2002) empirically demonstrates the concentrated costs of economic integration for job loss and employment change: "Free trade, open markets and economic integration can facilitate economic growth. The benefits of free trade are considerable and widespread. But open engagement with the world does not help everyone.... Proponents of expanded open trade and investment face an obligation to address the concerns of workers, companies and communities who can be hurt by free trade" (150). Downs (2004) similarly walks through the typical economist's arguments on the efficiency gains from market-based approaches to congestion reduction compared with regulatory policies (e.g., even-odd license plate rationing) but then emphasizes that "unless the funds from peak-hour tolls can be used to compensate low-income drivers directly, road pricing may have regressive effect" (81) because the spatial organization of communities is such that, in many communities, poorer people spend a larger percentage of their income on gas and with spatial mismatch may have longer commutes. Economics will be more helpful to equity planners, and economists will find it easier to talk to planners if the efficiency is discussed not just in terms of the magnitude of net benefits but also in terms in the distribution of losses.

In this introduction, I have attempted to underscore the fruitfulness and importance of opening the pathways of communication between economists and planners. Their agendas broadly overlap, but many in either profession do not realize it for lack of a common foundation in microeconomics enlightened by a rich understanding of the role of a planner in today's communities. While I largely agree with Arnott's sentiment in chapter 3 of this volume that "economists see the strengths of markets; planners see their weaknesses," it is better not to make a straw man of either discipline and instead consider their mutual interests. In the rest of the chapter I will focus on some areas of microeconomics that I think are especially relevant for a cross-discipline dialogue. Microeconomics, as a discipline, can provide an analytical framework and vocabulary for planners and economists to use, but that certainly does not imply agreement will occur. Even if planners and economists do fundamentally look at the world differently, the common language, in fact, generally makes it easier to critique others' work because it makes it easier to understand the sources of disagreement. Brad Delong once blogged, "When a questioner suggested a summit of the nation's best economists, Krugman said something like: 'We know what will happen if we bring together the greatest economic minds. It's spread across the blogosphere every day, and it's not pretty.'"<sup>2</sup> Maybe it is not always pretty

2. <http://delong.typepad.com/sdj/2009/02/the-worlds-greatest-economic-minds.html>.

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but a lively discussion between planners and economists who can speak to each other is likely to be more constructive over time than the straw man approach.

Instead of running through the necessary ingredients for a course syllabus on urban economics and microeconomics for planners<sup>3</sup> and/or planning concepts for economists, this chapter will instead focus on topics that I think are important but perhaps less emphasized than they should be.

## BEHAVIORAL ECONOMICS AND URBAN PLANNING

It would be hard to overstate the importance of a rich descriptive model of human behavior in developing urban policy and for planning in general. But before discussing behavioral economics, it is useful to say a few things about normative utility theory. In economics, market efficiency is judged with respect to the well-being of the individuals in an economy and by the principle of consumer sovereignty in which each person is the judge of his or her own well-being. Even with their professional interest in place-making, most planners (like economists) would agree with a statement of this sort by Ed Glaeser (2007) that “economics judges policies by whether they increase the choices available to people, not on whether they help rebuild a particular locale. Economics does not preclude policies that are place-based such as urban redevelopment, but economists do insist that these policies be judged on whether they improve individual’s lives not on whether they made a place more pleasant” (5).

Utility theory gives us a framework to have a conversation about which policies make people better off and why. Of course, being the judge of one’s own well-being does imply that planners and economists need to think about how they want to define the ambiguous rationality concept. Robert Frank’s (2004) articulation of the differences between the present-aim standard of rationality, the self-interest standard, and the concept of adaptive rationality is useful. In particular, he defines adaptive rationality as requiring that people be efficient in their choice of means to achieve a given goal (this is the definition of present-aim rationality), but, in addition, they also “regard goals themselves as objects of choice and, as such, subject to a similar efficiency requirement” (Frank 2004, 47). Frank then uses an evolutionary framework to show that an adaptively rational individual might very likely have preferences that are not narrowly self-interested and instead be more altruistic and more concerned about fairness.

3. I will note that aside from the generally excellent market leading urban economics textbooks, I have found Friedman (2002) to be a very good textbook for teaching economics to planning and public affairs students.

While I think future research will create more linkages like this connecting normative utility theory to actual human behavior, in the rest of this section I will consider behavioral economics to be a mostly descriptive/positive model of individual behavior where our actual behavior can deviate quite substantially from that predicted by the normative theory even when markets are seemingly well-functioning. As Barr, Mullainathan, and Shafir (2008) put it, “The introduction of richer psychology complicates the impact of competition. It helps us understand that firms compete based on how individuals will respond to products in the marketplace, and competitive outcomes may not always and in all contexts closely align with improved decisional choice and increased consumer welfare” (1). Planners and policy makers, like economists, are becoming very interested in behaviorally informed policy and regulation. Given the newness of the behavioral economics field along with its success in providing descriptive insights about behavior, there is likely a fair amount of low-hanging fruit whereby efficiency-enhancing policies can be implemented with just “nudges” or what Thaler and Sunstein (2008) call “libertarian paternalism.” Mullainathan (often with coauthors) has, along with Thaler, been a leader in thinking about the policy implications of a richer psychological model of decision making (see, e.g., Congdon, Kling, and Mullainathan 2011; Mullainathan 2005).

If there is one other distinguishing characteristic of planners, aside from their concern with place, it is their focus on the future. Consequently, a particularly salient issue for planners is the behavioral finding that many individuals have inconsistent time preferences. Most of us have strong present-biased preferences that would imply a hyperbolic discount function. This aspect of human behavior gives rise to a basic question: Who should planners care about, the present selves of their community or the future selves? Policies where the costs are up-front but the benefits delayed, such as climate change policy, human capital investment, promoting energy efficiency programs, or even taxing cigarettes, have important implications for cities and their local economies. Planners need to think about how to frame policies or structure choices so that present selves will choose to take better care of their future selves.

The behavioral economics enterprise to a large degree has been about cataloging anomalies like the one described earlier that would be hard to explain given conventional utility theory. Kahneman and Tversky’s prospect theory (1979) has provided a logical framework for connecting some of these anomalies, which I will review in brief, but mainly in the next paragraphs I will share a few more examples where behavioral economics might be particularly useful to planners.

Kahneman and Tversky (1979) proposed that people evaluate alternatives not with a conventional utility function but instead with a value function that is defined over changes in wealth and that has the characteristic that this value function is steeper in losses. In this purely positive model of decision making, individuals consider their losses and gains compared with a reference point (which we can assume to be the status quo) instead of calculating the total utility associated with their consumption bundle. Given this framework, there are several interesting insights.

First, framing matters because it determines our reference point for evaluating gains and losses. Second, because of the kink at the reference point, individuals will be more sensitive per dollar to small losses than to small gains—this finding is called *loss aversion*, and the endowment effect is a form of loss aversion. Moreover, the shape of the value function implies that utility will be affected depending on whether losses and gains are lumped together or separated and by how salient they are.

Thaler and Sunstein (2008) give an example consistent with the tenets of prospect theory that illustrates the challenges of encouraging people to get rid of their cars even if the net benefits of car ownership are negative. Their thought exercise is to “consider the example of members of an urban family deciding whether to buy a car. Suppose their choices are to take taxis and public transportation or to spend \$10,000 to buy a used car, which they will park on the street in front of their home. The only salient costs of owning this car will be the weekly stops at the gas station, occasional repair bills, and a yearly insurance bill. The opportunity cost of the \$10,000 is likely to be neglected. In contrast, every time the family uses a taxi the cost will be in their face, with the meter clicking every few blocks” (98). This hypothetical family’s relevant reference point is one in which they have already incurred the costs of car ownership and thus feel that each car trip is relatively inexpensive. On the other hand, if they are without the car, they intensely feel the losses incurred in regularly paying for taxis or buying subway tokens for the entire family. Even if the total costs of public transit are significantly lower than those of owning a car, the family might still choose the latter. Nudges, like offering methods of prepaying for public transit (especially methods where people are not handicapped if they lose their transit pass) that take this behavioral insight into account could promote use of public transit or at least give planners a new angle from which to look at the problem of urban automobile congestion.

In an economic development example, Thomas (2007) discusses how loss aversion can lead to a possible winner's curse in his description of how companies use threats of consolidation or relocation to trigger bidding wars between locations. In this paper, he uses the example of Mastercard International's decision in 1997 to announce its intention to consolidate its several St. Louis area facilities into a single location, not necessarily in St. Louis or even Missouri. Mastercard reportedly considered fifteen cities before narrowing the decision to Dallas versus suburban St. Louis. Thomas argues that "without having access to Mastercard decision-makers and documentation, it is impossible to say what the lowest amount of subsidy the company was willing to accept, but it likely was considerably less than what it received" (49). While other papers (e.g., Friedman and Mason 2004) discuss the winner's curse with regard to economic development decisions such as public subsidies for sports facilities, and, of course, there is the *DaimlerChrysler Corp. v. Cuno* Supreme Court case, Thomas emphasizes the possibility that loss aversion is part of the reason St. Louis outbid Dallas. The flypaper effect (Hines and Thaler 1995) is also a local economic anomaly that can be tied to loss aversion.

There are many more examples of how behavioral economics can be useful to planners. Some planners are already using these insights in their research, for example, Mohamed (2006) on the motivations of land developers.

## CONTEXT MATTERS

Dani Rodrik's recent book, *One Economics, Many Recipes; Globalization, Institutions and Economic Growth*, may or may not be of direct interest to urban planners, but the key lesson of the book should be of interest to them; moreover, many economists could probably use the reminder. Rodrik defines basic economic philosophy in the following way: "Social phenomena can best be understood by considering them to be an aggregation of purposeful behavior by individuals—in their roles as consumer, producer, investor, politician, and so on—*interacting with each other and acting under the constraints that their environment imposes*" (3, italics mine). He goes on to say that "the tendency of many economists to offer advice based on simple rules of thumb, regardless of context (privatize this, liberalize that), is a derogation rather than a proper application of neoclassical economic principles" (3). Economists have useful general principles that can help structure our thoughts, and the planners in our communities and cities understand the specific context. It takes both parties working together with a rich understanding of both the economic principles and the characteristics of the locality and region to create vibrant, well-functioning places.

This message, that context matters in determining policy, is important. Let us consider the role of fiscal federalism in urban policy. Oates (1999) reviews the normative assignment of policy functions to different levels of government, giving the central government the basic responsibility for income redistribution and assistance to the poor and for macroeconomic stabilization. Of course, the federal government does much more than this, and many federal policies impact our cities and communities. Some of these centrally administered policies tend to be one size fits all, which may be inappropriate because local conditions matter. Glaeser and Gyourko (2008) give nice examples in their recent book on federal housing policy, including how the incidence of the federally administered mortgage interest deduction varies by location. While statutory incidence falls on the homeowners who itemize their taxes, economic incidence is a function of local housing markets (specifically the elasticities of the supply and demand in the relevant market) and can thus differ widely from region to region. In San Francisco, where demand for housing is strong but where there has been little new building in recent years, the mortgage interest deduction acts to increase price, making housing even more unaffordable especially to those who do not itemize. Compare this situation with Atlanta, where new home construction has kept pace with population growth. In Atlanta, the subsidy encourages building, and home prices remain relatively stable. In Atlanta, the mortgage deduction does, in fact, make it less expensive to own one's home. Glaeser and Gyourko (2008) argue for a new federal housing policy that is context-dependent in that it is designed to incentivize construction in areas with currently inelastic supply.<sup>4</sup>

4. Understanding the determinants of housing supply elasticity and affordability is currently an active research area for both planners (e.g., Pendall 2000) and economists (e.g., Saiz 2010). Saiz (2010) explores both geography and regulations and using ideas from Fischel (2001) argues that stricter land-use regulations are endogenous and positively correlated with physical land constraints.

Another example is the debate on the incidence and efficiency of the property tax where there are two conflicting views: the property tax as primarily a benefit tax (Fischel 2001a, 2001b) versus the property tax as a distortionary tax on capital (also called the “new view” [Zodrow 2001]). Both views require fairly strong assumptions, and at least some of those assumptions (residential mobility, elasticity in the number of competing communities, and zoning issues) are functions of place. Thus context is important in interpreting the effects of the local property tax.

Identifying best planning and policy practices by using states as laboratories for policy can be beneficial, but economists and planners must understand how the general principles of economics combine with the characteristics of space and place. This will give guidance about when successful practices can be successfully transplanted and where those policies will need, at a minimum, to be tailored to local conditions. This does not necessarily imply decentralization of activities such as redistribution that normative fiscal federalism assigns to the central government, but it suggests that local, state, and regional governments should be allowed more flexibility in designing place-specific policy. How HUD allocates its Community Development Block Grants (CDBG) is one example of how this is already done. HUD provides the grant, but localities decide how the funds will be used.

## THE MIXED ECONOMY

Since Adam Smith’s invisible hand and the fundamental welfare theorems, public economists have rationalized government involvement in the market economy in large part by identifying market failures. Bartik (1990) argues that using a market failure approach to develop a region’s economic development policy provides a useful conceptual framework for evaluating trade-offs and rationalizing policy choices. He argues that the market failure approach focuses our attention on the areas of the local economy where private market performance is the weakest and thus where government policy may be most effective. Economic development policy can be a controversial area as mentioned in the first section of this chapter and as discussed in the popular press (see, e.g., LeRoy 2005). Thus, illuminating how an economic development policy reduces a particular market failure should reduce controversy by making the goals of the policy more transparent and open to evaluation.

Of course, identifying a market failure is not a sufficient condition for a government response.<sup>5</sup> How responsibilities for the operation of a well-functioning market economy are devolved between the public and private sector can be a hot-button

5. Obviously, a market failure is also not a necessary condition for a government response as purely distributional concerns can merit policy action.

issue. On the one hand, good government is a pure public good (nonrival and non-exclusionary) and, therefore, likely to be inadequately supplied and not always up to the task of solving societal and market problems. Principal-agent models can help planners and economists understand sources of both government and market failure and are a key tool in political economy analysis. Besley (2006) argues that good government requires both a well-designed institutional framework to affect the incentives of government officials and also selection mechanisms to encourage good leaders to seek roles in government. The disillusionment with traditional planning and planners that triggered the growth of equity and advocacy planning (Davidoff 1965) is a mechanism design issue.<sup>6</sup> Political and bureaucratic institutions matter, and both planners and economists have a shared stake in this research agenda.

On the other hand, though, the argument for privatization is frequently made somewhat disingenuously. John Roberts’s book (2004) on the modern firm may not initially seem relevant to an urban planner,<sup>7</sup> but the book’s core questions—“Why are there firms? Why do we often use firms to coordinate and motivate behavior instead of relying on individual markets?”—are fundamental to understanding the privatization and devolution issue. Roberts cites an interesting statistic from McMillan (2002), who estimates that less than a third of all the transactions in the U.S. economy actually occur through markets, and instead more than 70 percent are within firms (Roberts 2004, 78). This statistic illustrates the need to reframe the market-versus-government debate. The rhetoric of privatization cannot rely primarily on the virtues of the market when the actual privatization might mean devolving responsibility from government to a very large firm—perhaps even a (natural) monopoly. The intellectually more interesting and arguably more honest way to frame the issue is not simply market versus government but why would a (regulated or unregulated) private firm be better than a government structure, and what aspects of that firm’s and industry’s structure are important in improving upon a government’s performance? In summary, the key idea is that market approaches (including promotion of competition and incentivizing) should not be conflated with privatization.

Planners Hefetz and Warner (2004) look at new public management in light of the government contracting process and argue that a theoretical framework is needed that gets beyond the market-versus-government failure dichotomy. Efficiency gains and/or cost saving are not guaranteed with privatization.

6. Advocacy planning and public choice theory overlap as advocacy planning can be seen as a response to the regulatory capture of planners and planning departments. Jane Jacobs as an urban planning hero versus professional planner Robert Moses is a commonly used example of planning activist versus “captured” planning official.

7. Throughout this chapter but especially in this section, I am defining an urban planner broadly as someone for whom local economic development and local public goods planning and provision are part of their responsibilities.

## CAPITALIZATION, SORTING, AND HEDONIC ANALYSIS

*Capitalization* is the term used by economists to describe how housing prices change to reflect changing locational characteristics.<sup>8</sup> The spatial sorting that is part of this spatial equilibrium process might have some efficiency properties as shopping between competing communities allows people to vote with their feet for local public goods and can help us understand how to think about optimal fiscal federalism (Tiebout 1956). Even though the conditions required for Tiebout sorting to lead to an efficient local public sector are strong, the dynamic sorting and spatial equilibrium process itself is an extremely useful descriptive model that connects such works as Schelling's (1956) model of segregated neighborhoods, Been's (1994) important work on environmental justice and market dynamics, Frug's (2001) frustration with the limits of city power and Vigdor's (2010) work on urban revitalization and gentrification. In summary, price adjustments and mobile residents can make the planning agenda contentious even as those same adjustments might promote efficiency. Sagalyn (2009) comments on how "a number of actions—including changes in land use regulations, designations of landmark structures and historic districts, transit improvements, district redevelopment plans, set-asides for affordable housing, and siting of public facilities (from the desirable, such as community gardens, to the less desirable, such as landfills)—can trigger intense concern about their effect on the value of land, homes and business property." (85)<sup>9</sup>

In my opinion, one source of miscommunication between planners and economists stems from a failure of both parties to be precise about their support or criticisms with regard to various aspects of models. If one disagrees with one aspect of a model (e.g., its normative implications and/or underlying assumptions), he or she is likely to ignore its other aspects (e.g., its descriptive associations). Back to Tiebout, even if a planner knows that it is virtually impossible for a region to achieve the conditions that would lead to an efficient Tiebout sorting mechanism, there is still good reason for the planner to be well versed in the characteristics of the Tiebout model. As he says, "Spatial mobility provides the local public-goods counterpart to the private market's shopping trip" (Tiebout 1956, 422). People do sort themselves, and this has real equity and efficiency implications for local public and planning policy.

The Coase theorem (1960) is another example in that one does not have to believe markets are able to solve most externality problems to agree with the theorem's usefulness in framing externalities as reciprocal problems involving at least

8. Analogously, there is a large urban economics literature on compensating differentials in wages that arise, in part, from wages capitalizing an array of locational characteristics such as agglomeration economies, amenities, and fiscal policies.

9. Fischel (2001) in his book of the same name labels this attentiveness of homeowners to the outcomes of local public policies such as those described by Sagalyn as the "Homevoter Hypothesis."

two conflicting parties. This insight is very helpful in structuring policies to address externality problems and has been fundamental to the development of the law and economics subfield. The spirit of much of law and economics is Coasian in that the goal is to achieve solutions/remedies that would have been reached had parties been able to negotiate with each other.

The capitalization process also provides a method (albeit data intensive) to find prices or opportunity costs for goods where no markets exist.<sup>10</sup> Planners are often required to do cost-benefit analyses or environmental impact analyses where the quality of the analysis is largely a function of how accurately these nonmarketed resources or local public goods are valued. A history of often poorly done cost-benefit analyses has made some critical of the method. Microeconomics, though, at its heart, is about understanding and valuing trade-offs, and the cost-benefit principle is a core concept. Thus microeconomics has its reputation based on the promise of accurately measuring prices. The challenge of how to get prices right (and how to correctly measure opportunity costs) is essential to both better economics and planning. It seems to me that it would be a fruitful enterprise to have planners and economists work together more closely on how to improve our methods for finding prices, whether through hedonics that rely on price capitalization or other strategies.

## AGGLOMERATION, UNEVEN ECONOMIC GEOGRAPHY, AND ITS DYNAMICS

Krugman's 2008 Nobel Prize and the World Bank's 2009 World Development Report on economic geography have spotlighted research on the causes and consequences (both static and dynamic) of spatial economic agglomeration. Basic producer theory provides the analytical foundation for understanding why input sharing, labor market matching, and knowledge spillovers can create feedback loops that lead to economic concentration, path dependence, and punctuated equilibria and is the first step in acquiring the analytical tools to assess the rich research that is being done in this area.

Even though microeconomics is important, let us not forget that this is one area where economists such as Krugman (e.g., 2001, 2009) and Lucas (1988) have drawn inspiration from or collaborated with planning and regional science scholars, with Jane Jacobs and Masahisa Fujita being two often cited names. While turf battles between geographers, economists, regional scientists, and planners may be simmering, the key point is that economic geography is an area where all these disciplines are heavily invested in making intellectual progress. Cities are now widely understood as engines of

10. Contingent valuation is another (imperfect) method for estimating prices.

economic growth and a key part of New Growth Theory. Agglomeration economies are a primary reason for uneven spatial development and inequality and are an important part of models linking development and trade. The relationship between sources and types of agglomeration economies (urbanization or localization) and city structure and size inspires research on the merits and implications of monocentric versus polycentric urban form—an important issue for local economic developers and planners.

## CONCLUSION

In this chapter I have attempted to show that planners and economists (and allied social scientists and policy practitioners) have good reason to read each other's work and build a common language in which to share ideas. This includes, for planners, a foundation in microeconomic and urban economics and, for economists, a rich understanding of the complex environment facing planners and the multiple goals that planners must balance. The result will be more thoughtful research that carefully makes the connections from policy to market impacts or from market or individual behavior and outcomes to policy effectiveness.<sup>11</sup>

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11. HUD's 2008 report (Carliner et al. 2008) on the relationship between residential development regulation and housing markets and how these impact labor markets, business location decisions and economic competitiveness, labor productivity, industrial composition and other economic factors is a nice example of a piece that reflects an understanding and sensitivity to both planning and economics.

Kleiman's (2009) book on crime and punishment is another example of how good economics combined with clarity about the complexity of the issue can lead to new ideas that could make a major difference in policy.

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## CHAPTER 2

# PRINCIPLES OF PLANNING FOR ECONOMISTS

NIKHIL KAZA AND GERRIT-JAN KNAAP

## INTRODUCTION

The literature in economics and planning contains advice that hinges upon the distinctions between planning and market approaches to public policy. In these distinctions, the planning approach is often characterized as stiffly regulatory while the market approach is characterized as more flexible and, thus, usually preferable. This distinction, we argue, is false both in its positive formulation and in its normative implication that the market approach is always superior. Instead, we assert planning is not about market failures and regulatory remedies but can be better understood by several other economic principles. These include the Coasian notion of transaction costs, the problem of optimization over time, and the problem of non-cooperative games in which the public sector is but one of many players. We argue plans and planning make sense in situations where both single or multiple actors think before acting, using limited information. When viewed in these frameworks, research by planners and economists are much stronger complements than they are substitutes.

Economists are fond of the contrast between outcomes brought about by a social planner and those brought about through the interactions among individual agents. The conclusions of these arguments are usually that Pareto optimality can be achieved through an invisible hand guided by self-interest,<sup>1</sup> rather than a scheming

1. Self-interest is not the only motivation of a "rational" being. Adam Smith wrote *The Theory of Moral Sentiments* before he published *The Wealth of Nations*.