Housing Economics: An Introduction

ECON 490

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Slides Overview

These slides cover:

1. Why economists care about housing
2. What determines housing prices
3. Why housing in Orange County costs so much

Why Do Economists Care About Housing?

- The **largest purchase** most households ever make
- A major store of **household wealth** (for those who own)
- A key determinant of **where people can live and work**
- Heavily influenced by **government policy**

What Determines Housing Prices?

If you ask 10 Californians why housing is expensive, you might get 10 different answers

- Overall demand/CA's large population
- Amenities like the weather/beaches
- Macro factors (e.g., interest rates)

The Basic Economics of Housing Prices

Demand Side:

- Population growth/decline, changes to income, etc.
- Interest rates (cheaper borrowing = more buyers)
- Preferences (people want to live in nice weather)

Supply Side:

- Available land
- Construction costs
- **Regulation** (zoning, permits, environmental review)

Let's Think About Supply

Question: If housing demand increases in a city, what happens to prices?

The answer depends on the **elasticity** of housing supply

- **Elastic supply:** Builders can easily construct new homes → prices stay relatively stable
- **Inelastic supply:** Hard to build new homes → prices rise

California has inelastic housing supply

Three Types of Housing Markets

From the journal article we'll read, define three archetypes:

1. **Declining cities** *(think: Detroit)*
    - Lots of old housing stock, falling demand
    - Prices often below construction costs
2. **Elastic cities** *(think: Houston, Atlanta)*
    - Plenty of land, few building restrictions
    - Prices stay close to construction costs
3. **Inelastic/regulated cities** *(think: San Francisco, LA, Orange County)*
    - High demand + restricted supply = high prices

Orange County as an Example

Median home price in Orange County (2024): ~$1.1 million

Physical cost to build a house: roughly $150-200 per square foot for construction

- For a 2,000 sq ft home, that's maybe $300-400K in construction costs — including land improvements.

So where does the other $700K+ come from?

The Gap Explained

Price gap reflects several things:

- **Land scarcity**: We're squeezed between the ocean and mountains
- **Zoning restrictions**: Limits on what can be built where
- **Environmental review**: California's CEQA adds time and cost
- **Local opposition**: Existing homeowners often fight new development

In economic terms, we'd say there's a large **regulatory tax** on housing in CA.

Why Does This Matter?

- **Wealth inequality:** Homeowners gain, renters fall behind
- **Labor market distortions:** Workers can't move to productive cities
- **Longer commutes:** People "drive until they qualify" for housing they can afford
- **Delayed household formation:** Harder to move out, buy homes, start families

A Local Example

Consider someone with a job offer in Irvine paying $80,000/year.

- If they're coming from Houston, with ~$350K median home prices, that sounds great.

If they're trying to move from Riverside to Irvine?

- The math gets harder.
- They might turn down the job even if they'd be more productive here.

Economists call this **spatial misallocation** of labor.

The Political Economy Problem

If high housing costs are bad, why don't we just build more?

Existing homeowners benefit from restricted supply.

- Your home value goes up when fewer homes get built
- New development brings traffic, noise, "changes the neighborhood"
- Homeowners vote; potential future residents don't

This creates a political economy trap that's hard to escape.

Looking Ahead

The assigned journal article covers:

- A framework for measuring housing regulation (comparing prices to construction costs)
- Evidence on which cities are most restricted
- Estimates of the economic costs of housing restrictions

Homework: Read the Glaeser and Gyourko article, specifically:

- Introduction section (first 3 pages) laying out general questions/analysis
- "Variations in Regulations on Land Use and Building" and "A Closer Look at Three Types of Markets" sections
- You should be able to describe how demand shifts affects prices in each market type

Key Takeaways

1. Housing prices depend on **both supply and demand**
2. **Regulation** plays a huge role in constraining supply, especially in California
3. The gap between housing prices and construction costs tells us something important
4. The politics of housing make reform difficult