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Land-property markets and planning: A special case

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ABSTRACT

Land use policy often intervenes in land-property markets. This raises a question that may have critical implications for land use policy: are these normal markets? This paper addresses that question: are land and property ordinary market goods, or do they lack some of the preconditions necessary for markets to work properly? We find that land-property has limited substitutability, due to the critical factor of location; qualified by location, land is limited and sometimes unique. These attributes make land and property investment assets risking speculation, warranting public intervention to mitigate negative social consequences. Land-property markets need market or administrative support to work, which planning provides through public and private agents. The paper reviews the different forms of planning and development control in land-property markets.

Introduction

Land use policy often involves intervention in land-property markets.[2] This raises a question that may have critical implications for land use policy: are these normal markets? Are land and property ordinary market goods, or do they lack some of the preconditions necessary for markets to work properly?

"Markets work." wrote the financial guru of *The Economist*, to open his column headed: "A Special Case." (Buttonwood, 2010). His heading referred to the financial market, which clearly did not work, and his article showed why financial markets are a special case that warrants public intervention.

Markets work, according to classic economics, as the most efficient way to allocate resources, because they aggregate the individual decisions of multiple consumers and producers, processing vast amounts of information to set prices as a function of supply and demand. The market produces better collective decisions and preferable outcomes, because it is superior to the limited information processing capacity and decision making capabilities of any structured planning process or institutionalized system. Consequently, advocates of markets (like Buttonwood) usually oppose public intervention, which only impairs the effective functioning of the competitive market: leave the market (private enterprise, spontaneous order) free to do its thing.

But the free market of classic economics is also subject to preconditions, without which it cannot function properly. These include free or easy entry and "arms-length" interaction of actors: when this condition is violated (e.g. in industries that depend on economies of scale, such as automobile manufacture or 19th.c. railroads) monopolies or oligopolies threaten and anti-trust legislation ensues. Other such prerequisites are: substitutability of goods; divisibility of goods and services and excludability of nonpaying users (otherwise these are public goods that the market cannot effectively supply); lack of internalization of significant externalities, etc.[3]

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[2] As its title indicates, the interventions with which this article is concerned are planning and development control. Relevant land-property markets are those involved with and affected by planning, which excludes a large part of conventional real-estate markets. Transactions involving pre-owned property are not considered, because they (and consequent regulation of real-estate markets) have little or nothing to do with planning. Other land-use related policies, such as fiscal policies and banking regulation (affecting mortgage interest rates and prescribing creditworthiness) are also not discussed. A complete model of the land/real-estate market comprises activities that involve planning (from land accquisition/assembly to construction) and others not included here: property transfer, reconstruction and rehabilitation (Alexander, 2001a).

[3] 20th century welfare economics focused on these to discuss limitations of markets and identify market failures (Bator, 1958; Arrow, 1970).

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Two other premises, originally unstated but more recently extensively discussed, qualify the existence and performance of the classic competitive market. One is the definition of the actor in this market as the rational, well informed, self-interested *homo economicus*. This premise has been questioned, first by critics of instrumental rationality who proposed alternative models for realistic decision making for economic and political markets alike (Simon, 1957; Lindblom, 1965) and later by economic psychology, which identified pervasive biases that produced irrational decisions through systematic errors of judgment (Kahneman and Tversky, 1979; Kahneman and Slovic, 1982).

The second is the neglect of transaction costs: classic economics assumes zero transaction costs. Institutional economics, starting with Coase (1960) explored the implications of relaxing this patently unrealistic assumption, discovering plausible explanations for the modifications in the "free" competitive market of multiple individual buyers and small producers/sellers that are obvious: consolidation of markets and integration of producers into large firms and global corporations. Transaction cost theory, developed in institutional economics, identifies the kinds of transactions that fit the classic competitive market, and other kinds that produce predictable modifications in parties' interactions (Alexander, 2001b: pp. 50–55).

Buttonwood (2010) applies some of this conceptual framework to justify the public intervention in financial markets that began with the 2008 "bust" and continues. His argument for public intervention in financial markets is based on the difference between these and normal markets that work; this difference makes financial markets "a special case":

"Financial markets do not operate in the same way as those for other goods and services. When the price of a television set or software package goes up, demand for it generally falls. When the price of a financial asset rises, demand generally increases."

He explains this difference with an analysis of the different nature of financial assets and "normal" goods and services: the latter are bought for their inherent qualities that enable specific uses; financial assets are acquired to increase or conserve the buyer's wealth. Where a lower price for a good or service increases the product's utility for the buyer, financial assets are more valued by prospective buyers as their prices rise, because their utility is based on buyers' estimate of market expectations.

When the price of a "normal" good rises, manufacturers make more, but its intrinsic or use value does not change. When the prices of financial assets rise, more are produced as well: it is easy and cheap to issue new stocks or bonds. But if this does not reflect an increase in the underlying value of the businesses, the new shares simply dilute the wealth of the existing investors. Where "normal" markets work to produce real tangible benefits, the rise in financial markets' nominal value does not necessarily reflect any gain or increase in societal welfare, but may only redistribute wealth to some lucky speculators; e.g. "the recent bubble in which society 'gained' some empty condos in Miami and holiday homes in Spain."

Financial markets, Buttonwood concludes, are irrational, or not rational as markets are supposed to be: "If rising prices create euphoria, falling prices produce paralysis. . .(the few) rational investors. . . are overwhelmed by the force of the herd." This difference justifies public intervention to "burst" bubbles in asset markets, which are largely the result of debt-financed speculation, to preempt the high public "clean-up costs" after their collapse.

Here I will deploy the same kind of reasoning that Buttonwood applied to financial markets, to analyze the land-property market and answer the same questions that he asked. Are land and property "normal" market goods, in the same way that off-the-shelf products and services (like his television set or software package, or like the classic mom-and-pop store sold sweets or the neighborhood laundry) are? If they are not, what are the differences, and how do these affect the operation of land/property markets? Finally, as in the case of Buttonwood's financial markets, do these differences produce potentially negative consequences, which warrant public intervention to avoid – and if so, what forms should such intervention take to be effective?

Is land a "normal" market good?

What characteristics does land have that distinguish it from "normal" market goods, and what characteristics do goods need to be "normal", which land does not share? The analysis that follows is not exhaustive, but focuses on some important traits that are prerequisites for goods to be traded in competitive markets.

Substitutability

Substitutability means the possibility of replacing a particular article with another of similar qualities and equal value. The simplest examples of substitutability are "off the shelf" products, such as competing brands of television sets, or various makes of automobiles with the same characteristics, e.g. SUVs with 4-wheel drive and identical engine capacity. But substitutability can also take more complex forms that are not immediately apparent. For example, substitutability in transportation can take the form of alternative modes, such as private vehicle (car), mass transit (bus) or air travel, which can all be used for a 500-mile trip between two cities.

For land and property this kind of substitutability is limited, and for some properties it does not exist at all. So we can envisage high substitutability among single-family ranch houses in the 100s of square miles making up the San Fernando Valley, but none between those and a penthouse on Fifth Avenue in Manhattan, NY. This illustrates one obvious characteristic of real-estate: it is not one market but highly fragmented. Some substitutability is achievable by investing in adaptation through infrastructure development and construction but this is limited. More and better highway and transportation networks can increase substitutability by enhancing access to remoter locations, and redevelopment can enhance the quality of construction and the built environment in older or deteriorated areas. But even the best efforts cannot increase the limited supply of land and properties in special locations.

What is the factor that limits the substitutability of land to the extent of making many parcels almost non-substitutable, and some properties unique? It is location. Location is an intrinsic attribute of all land – every real parcel or property is somewhere. Location is also its most important attribute; as the real-estate *maven* said: "What are the three things that count in valuing property? – Location, Location, Location." Location has two aspects: absolute and relative.

Absolute location relates to the intrinsic locational characteristics of a parcel based on its physical-geographic environment. Thus the geographic location of a parcel and the topography of the site can benefit the property with unique exposures or views, e.g. a hilltop villa in San Juan des Pins on the French Riviera or an apartment overlooking Copacabana beach in Rio de Janeiro, Brazil. Absolute location may relate to proximate natural assets or amenities: the Snow Valley ski resort in Utah, USA, or the Carribean hotel.

Another aspect of absolute location is access. Traditionally, this often related to geographic location, accounting for the growth of some cities (such as New York and Rio de Janeiro) as colonial ports on coasts facing the European motherlands, others (e.g. Singapore) on densely used shipping routes, and still others (e.g. St. Louis, Missouri USA and Paris, France) at the head of river navigation. Today, modern transportation has minimized these advantages, but absolute location can still be an asset. This often relates to specialized

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