Meeting Global Challenges at Home: High Residential Land Costs Deter Productivity and Innovation

Trends

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by Claude Gruen

The U.S. trade deficit hit $725.6 billion in 2005, another record high. Japanese cars continue to wrest market shares from financially pressed U.S. automakers. Unions representing high wage workers often have to choose between accepting cuts in benefits and pay or having special masters from bankruptcy courts at the bargaining table. Outsourcing costs enough jobs to warrant the President to review his anti-protectionist stance.

The three best responses to global challenges to the growth of domestic living standards and the equitable distribution of incomes include: (1) increasing comparative advantages through innovations that maintain marginal profit margins and market shares for U.S. producers selling goods and services internationally; (2) increasing the production of goods and services whose demand best can be served if they are produced locally; and (3) increasing real wages without increasing money wages. All of these responses are made much more difficult if rising land costs push up housing costs.

Most increases in productivity and innovation occur within spatially limited clusters of urban agglomerations, such as the cluster of San Francisco Bay Area communities that spread out from Stanford, and the Greater Boston cluster that sprang up around MIT and Route 128. Both would be more fertile grounds for innovation if housing costs had not been driven up at rates that far exceed the costs of construction.

The constraints put on the use of land for housing have driven the costs of labor to the point where much of the specialty manufacturing that once took place in proximity to research and design has left the areas. Because the manufacturing of semiconductors increasingly is automated, there was no need to move this type of manufacturing to extremely low-wage, third-world countries. The loss of manufacturing within the agglomeration has detracted from the effectiveness of the agglomeration as a seed bed for knowledge industry innovation. A study of innovative clusters in Europe concluded "specialization in innovative activity is positively and significantly influenced by specialization in production activity," according to the December 2005 issue of *The Annals of Regional Science*.

High wages also make it more difficult to attract and hold the services of newly minted engineers and other skilled labor. Information technology firms report that wage costs are at least 25 percent higher for engineers and similar knowledge workers in Silicon Valley than they are in Arizona and New Mexico, where Silicon Valley-based firms also have operations. "Two out of five residents of the nine-county region have given serious thought to moving away -- mostly because of high housing costs, according to a survey released today by a business and public policy group," reported the February 27 *San Francisco Chronicle*. Reducing the costs of good housing would help keep skilled workers where they will do the most good.

Innovation in products and technology is not the only answer to the shift in comparative advantages occasioned by the advent of globalization. Housing markets are still mainly local. Older agglomerations are growing more slowly, or not at all, as workers are attracted to newer agglomerations where they can get more of the house they want for a smaller slice of their income. Unless the land allocation systems of areas like Northern California and Greater Boston are liberalized, only the growth of new agglomerations in the United States can keep the country at the forefront of innovation. If the areas around such agglomerations adopt policies similar to those of Northern California and Boston, they will limit densities in urban centers and stop development on the urban fringe, which would retard the powering up of new agglomerations.

Housing is also demand elastic -- as incomes rise, people are willing to spend more on housing. Therefore, only rising costs keep people from buying more housing as their incomes increase. This creates an opportunity for the production of more houses if prices stabilize. The local jobs and income opportunities this creates cannot be shipped overseas.

Lowering land cost back to where it accounted for less than 25 percent of housing costs, rather than over 40 percent, would decrease the price of housing. A competitive land market not constrained by large lot zoning would probably cause an increase in the per-square-foot value of large lots, but the opposite would apply to higher density residential uses.

Stabilizing or lowering the price of housing would work to effectuate the third of the recommended strategies. As housing prices decrease, real wages would increase while money wages would stabilize or even decline. This stability would buy more time for those industries that have the potential for retaining domestic production through raising productivity and innovation.

The costs of continuing to ignore the role rising residential land values play in dampening the country's economic response to globalization are high, but solutions do exist.

Claude Gruen is a Principal with Gruen Gruen + Associates, a research and consulting firm with offices in San Francisco and the Midwest.

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