

## Bubble, Bubble, Toil and Trouble

By John Hood - October 24<sup>th</sup>, 2012

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RALEIGH — Randal O’Toole is an observant fellow. A senior fellow at the Cato Institute and longtime analyst of state and local growth management, O’Toole took a close look at the Great Recession and its antecedent, the Great Housing Bubble, and saw something that few others did.

After a lengthy period of only gradual increase in the average inflation-adjusted price of American homes, the price began growing at 4 percent a year in 1995. By 2004, the annual rate of growth was 7 percent. By 2006, average U.S. housing prices had skyrocketed by 61 percent from a decade earlier. Then, as we all know, they came crashing down – a 40 percent drop by mid-2011. Families saw their net worth plunge. Investors panicked. Banks wobbled, and in some cases collapsed.

But the more O’Toole examined the data, the more puzzling this official story became. He didn’t see “a” bubble at all. He saw many bubbles. He saw massive boom-and-bust cycles in some local housing markets, such as San Francisco and other Bay Area cities, while very little variation in other markets, such as Dallas and Houston.

As a specialist in housing policy, he realized that blending all the local housing trends into a single national average obscured what was really going on. It was our old friend, the fallacy of the average, in stark relief. Using national averages, analysts of all political persuasions had tried to attribute the origins of the Great Recession entirely to the actions of clumsy congressmen, clueless regulators, greedy bankers, or the Federal Reserve’s easy-money policy of 2002-05.

While the Fed’s excessive monetary creation was indeed a causal factor in the story, that didn’t explain why so much new credit ended up in housing rather than other investment categories. Nor did the standard explanation from the Left, that free-market ideologues had recklessly deregulated the American financial sector, comport with the actual timeline of events or the fact that housing booms and busts had plagued many other economies around the world during the same period.

In his new book *American Nightmare: How Government Undermines the Dream of Homeownership*, O’Toole set out to correct the record. After defining a housing bubble as housing prices growing by more than 50 percent from 2000 to 2004-05, and then falling by more than 10 percent from their peak, O’Toole then examined home price data for all 50 states and 381 metropolitan areas.

Which jurisdictions exhibited true housing bubbles during the 2000s? O'Toole found that almost without exception, they were places either subjected to growth-management laws or, like Washington, D.C., adjacent to and affected by such restrictions. The states with the biggest bubbles – California, Florida, Maryland, Nevada, and Rhode Island – saw prices rise by more than 80 percent from 2000 to 2004-05 and then drop by 30 percent to 60 percent from their peak. Other states saw much less pronounced trends. In Texas, for example, average housing prices went up 17 percent and then fell 7 percent. In North Carolina, they went up 20 percent and dropped 14 percent.

Because we know that many North Carolina homeowners have still had a rough time of it since 2007, we know that you didn't have to live in a true housing-bubble state to get hit by the Great Recession. But the differences are important. Without the extreme cycles evident in places such as California, Florida, and Maryland, the resulting financial shocks would have been much easier for the nation's capital markets to handle.

O'Toole also notes that the growth-control dynamic was present in other countries, too. Many jurisdictions in Britain, France, and Spain have experienced housing bubbles from the late 1990s to today that were even more pronounced than America's. Germany, on the other hand, experienced no real bubble at all. Why? A key reason is that the German housing market is far less constrained by intrusive regulation and permitting delays. There is even a "right-to-build" clause for private landowners in the German constitution.

In his fascinating book, Randal O'Toole explains in detail why growth-management policies and barriers to home construction and redevelopment fuel housing bubbles. Excessive regulation makes the housing market rigid – amplifying even small initial changes in investment flows or housing demand into booms and busts. In places where builders are freer to respond to market signals, such as Houston, average housing prices tend to track fairly closely with changes in average incomes, leading to smoother trends and fewer shocks.

I found his argument attractive for two reasons. First, it seems to fit the facts better than alternative theories. Second, it emphasizes that state and local policies matter. Restoring and maintaining the vitality of the American economy will require not just more fiscal responsibility and monetary restraint in Washington, but more sensible public policies from governors, legislators, county commissioners, and mayors.