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Zoning Reform and Arizona's Housing Market

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About the Author

Glenn Farley is CSI Arizona's Director of Policy & Research. Before joining CSI in 2022, Glenn worked in the Office of the Arizona Governor, most recently as Gov. Doug Ducey's Chief Economist and a policy advisor. In that role he advised on issues of tax, fiscal, and regulatory policy, and was one of the Governor's lead architects of his two major tax reforms – including the 2021 income tax omnibus which phased in a 2.50% flat tax (the lowest in the country). Glenn also led the budget team that produced the Executive revenue forecasts and caseload spending numbers that have helped ensure the longest run of structurally balanced budgets in State history. Glenn has a Master's Degree in Economics from Arizona State University's WP Carey College of Business, as well as a B.S. from Arizona State University. He was born and raised in Arizona where he now lives with his wife and two daughters.

ABOUT COMMON SENSE INSTITUTE

Common Sense Institute is a non-partisan research organization dedicated to the protection and promotion of Arizona's economy. CSI is at the forefront of important discussions concerning the future of free enterprise and aims to have an impact on the issues that matter most to Arizonans. CSI's mission is to examine the fiscal impacts of policies, initiatives, and proposed laws so that Arizonans are educated and informed on issues impacting their lives. CSI employs rigorous research techniques and dynamic modeling to evaluate the potential impact of these measures on the Arizona economy and individual opportunity.

Teams & Fellows Statement

CSI is committed to independent, in-depth research that examines the impacts of policies, initiatives, and proposed laws so that Arizonans are educated and informed on issues impacting their lives. CSI's commitment to institutional independence is rooted in the individual independence of our researchers, economists, and fellows. At the core of CSI's mission is a belief in the power of the free enterprise system. Our work explores ideas that protect and promote jobs and the economy, and the CSI team and fellows take part in this pursuit with academic freedom. Our team's work is informed by data-driven research and evidence. The views and opinions of fellows do not reflect the institutional views of CSI. CSI operates independently of any political party and does not take positions.

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INTRODUCTION

SB 1161, SB 1163, and HB 2536 would make various changes to Arizona's home permitting and zoning regulatory environment, enabling developers and builders to increase the pace of home construction relative to current law. For example, they would allow 'by-right' construction of low-income multifamily housing; limit municipal zoning and design requirements on new housing; and require cities and towns to issue regular reports on their local housing supply. These changes are at least partially consistent with 4 of 19 recommendations CSI made in last year's housing policy paper. That research found that, in general, stringent state, local, and federal regulatory requirements on housing contribute to supply shortages and price increases.

KEY FINDINGS:

- **+6.5%:** Increase in annual residential building permits projected to occur due to regulatory changes like those being contemplated in Arizona.
- **-4.8%:** Forecasted change in Arizona housing prices by 2033 under these rules, relative to the baseline price level (that is, home prices and rents would rise 4.8% more slowly).
- **35,150:** Number of additional housing units that will be built by 2033.
- **28,560:** Number of additional jobs supported by the state's expanded residential construction industry by 2033, including approximately 10,000 jobs directly in the construction sector.
- **$22.8 billion:** Increase in Real Arizona Gross Domestic Product after 10 years under these rules. **That activity would support $2.8 billion in cumulative new state & local government tax revenue.**

Overview & Background

CSI's December, 2022 bi-partisan housing study - authored by CSI housing fellows Jenn Daniels and Sean Bowie - identified rapid home price growth after 2020 as a matter of serious and statewide concern. Using its in-house methodology that looks at historical vacancy rates as a sign of local housing market health, CSI discovered that every county in the state had insufficient housing to maintain a balanced market. These conditions enabled rapid home price appreciation when – after years of slowing population growth after the Great Recession – 100,000 new interstate migrants arrived in Arizona during 2020. Once mortgage interest rates began climbing rapidly in late 2021, the combined impacts of high prices and high rates have created the greatest housing affordability crisis in the state's history (Figure 1).

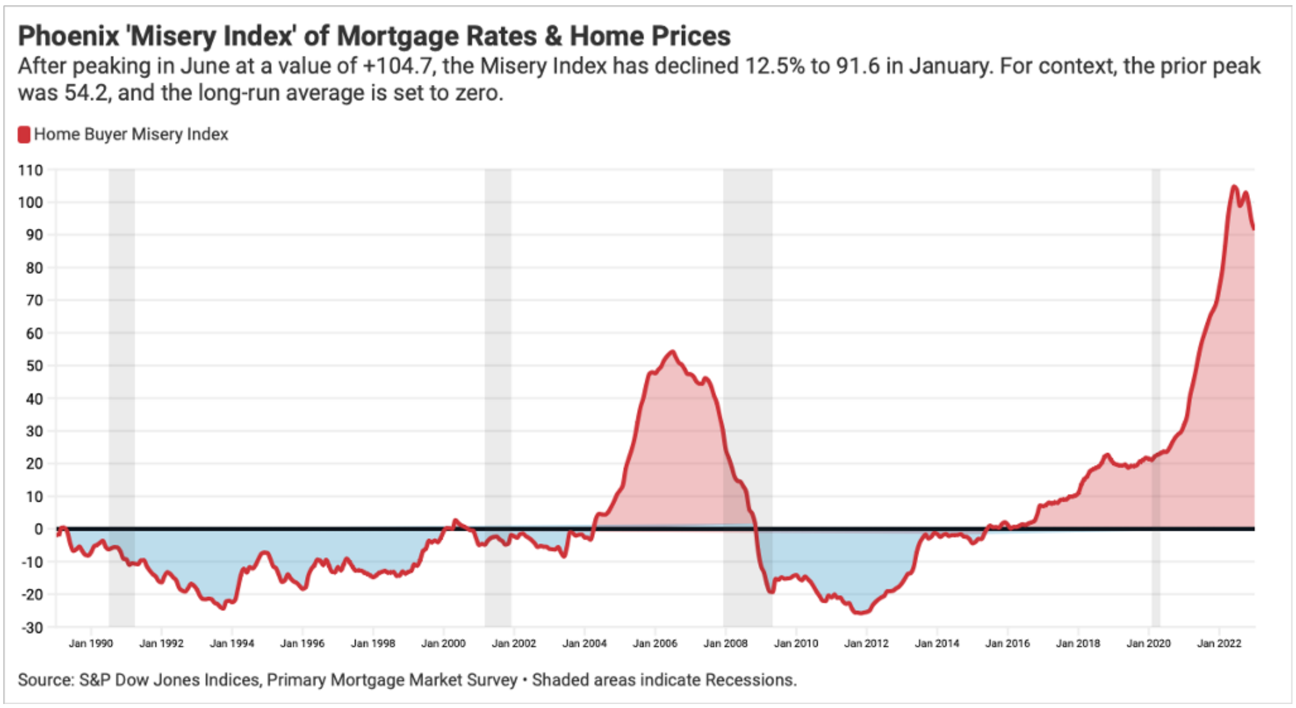

Figure 1

These conditions have created policy impetus for state and local solutions, and many jurisdictions – including Arizona – are considering or have enacted some form of zoning reform. Substantial evidence (both theoretical and practical) exists in support of the idea that increasing building design, environmental, and other zoning standards over time at the federal, state, and local levels have limited the ability of the housing market to respond to demand pressure rapidly and efficiently; **CSI's own housing fellows identified 19 areas where state and local policies limit new housing development.** This supply-demand imbalance has created an unstable environment where rapid increases and decreases in prices are much more common.

In general, markets that were more accommodative of new home construction – and construction of multi-family or other unconventional home types other than traditional large-lot, single family projects – exhibited lower volatility and price appreciation during the 21st century than more restrictive markets[i ii iii iv]. One of the least healthy markets in the country, California (where the average home price increased from $389,000 to $695,000 between 2015 and 2022), embarked on various state-level policy changes between 2017 and 2019 that aimed to reduce the influence of local zoning regulations on the state's ability to add housing supply which now appear to be having some impact on development. Historically, developer use of the so-called "builder's remedy" and other alternative pathways to project approval has been limited , suggesting to observers elsewhere that the ability of statewide legislation to truly curb local officials influence over housing development may be limited.[v] Since the end of 2022, however, anecdotal evidence suggests developer interest has exploded[vi vii] – spurred on by a combination of support from the State and the failure of local government to meet assessed housing needs via their conventional approval routes, an 8-year planning cycle unique to California that ended last year, and the rapid run-up in housing costs and demand since 2020[viii]. While it is too soon to say based on housing data how effective California's state pre-emptions and 'builder's remedy' will end up being, initial reports are compelling.

One major municipal area with a longer history of housing planning and development not subject to the whims of local zoning is Houston, TX. Both regions (Phoenix and Houston) have had similar population and economic growth; have comparable demographic profiles; and offer similar state and local amenities. Indeed, between 2000 and 2022, both the Phoenix and Houston metropolitan areas saw roughly the same level of cumulative population growth, but Houston effectively saw no boom-bust cycle in its housing market during the 2005-2008 period, while prices in Phoenix first spiked and then collapsed. Between 2010 and 2020, Houston was able to add over 400,000 housing units, while the Phoenix area added less than 200,000. And since 2020, home price appreciation in Houston was in line with the national average and about half of the growth seen in the Phoenix area (Figure 2).

Change in Housing Market Characteristics Since 2010

Of the 4 metro areas examined, Houston permitted the most housing and beat Phoenix by over 6% on a population-adjusted basis

Metro Area	Avg Home Price, 2022	Change in Home Prices	Cumulative Population Growth	Change in Population	Cumulative Residential Permits	New Residents Per Permitted Home
Houston	$296,083	111%	1,419,000	23.9%	696,839	2.04
Atlanta	$359,251	147%	953,000	17.9%	363,055	2.63
Los Angelges	$863,938	120%	(138,000)	(1.4%)	342,161	-0.40
Phoenix	$439,385	180%	791,000	18.8%	364,896	2.17

Source: U.S. Census Bureau, Zillow Data

Figure 2

Modeled Impacts of Liberalized Home Permitting in Arizona

The three active bills under consideration by the Arizona state legislature that CSI identified and analyzed would **make 4 changes to housing policies at least partly consistent with recommendations in last year's research pape,** including:

- Adopting reporting requirements for cities and towns about their home construction market,
- Allowing by-right construction of certain low-income housing,
- Limiting zoning restrictions (lot sizes, setbacks, etc.) on residential lots,
- Limits the time cities and towns can spend reviewing applications and limits what factors can be used in making administrative decisions related to new housing development.

To assess the implications of SB 1161, SB 1163, and HB 2536 on Arizona's homebuilding market, we assumed that relaxed permitting process under the bill would increase annual approvals in Arizona by 6.5% relative to the baseline. This estimate assumes that body of reforms contemplated are roughly equivalent to moving the state's largest cities closer to a jurisdiction like Houston, TX in terms of zoning processes; further or more aggressive reform could have a larger impact than projected here. Absent the policy change, the reference assumption is that Arizona would permit approximately 55,000 residential units for construction annually over the next decade; under a more permissive regulatory system that rate would increase to approximately 59,000 units/year. 30-year mortgage rates and population growth are fixed at 5.0% and ~1.3%/year, respectively (by assumption). To assess the impact on prices, CSI uses a simple model of housing units per person and average 30-year rates to predict prices under both the baseline and alternative scenarios and attribute the difference to the policy change.

Zoning Reform

BY THE NUMBERS

-4.8%
Change in Average Home Prices

35,150
Additional Housing Units Built

28,560
Jobs Supported by the Expanded Housing Market

$2.8 Billion
Annual increase in state Real GDP

Given these assumptions, **zoning liberalization is projected to result in the construction of 35,150 additional housing units by 2033 and lower the housing price level by 4.8%.** New home construction in Arizona would be more than 6% faster with more permissive design and approval standards than under the status quo.

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CSI also assumes the additional residential building activity and lower housing costs would have spillover effects on the larger Arizona economy. To estimate those, we utilized the Regional Economic Models, Inc. (REMI) Tax-PI, a dynamic input-output econometric model licensed by the Institute. Using data from the U.S. Economic Census, we estimate that approximately half of Arizona's construction activity is attributable to the residential sector, and that therefore the state's annual construction output over the 10 years following enactment of this legislation would increase by roughly 3.25%. We further assume that the real estate price level would fall linearly over the next decade towards -4.83% in 2033.

Under these assumptions, **these changes increase employment in Arizona by 28,560 jobs in 2033 and increases the size of Real GDP by $2.8 billion (+0.26%).** Cumulative state personal income generated over the 10 years following the bills enactment would increase by $27.6 billion. State and local government revenues would be a combined $2.8 billion larger, again all relative to the baseline assumptions.

Under these assumptions, **CSI estimates home construction would be sufficient to eliminate the existing supply shortfall and keep up with natural new household formation**, given current demand conditions - meaning that there would effectively be no housing shortfall in Arizona approximately 5 years following the liberalization of the state's home building approval processes, based on long-run housing market and vacancy rate trends. Absent this policy change, however, new construction alone would be insufficient to keep pace both with new demand from population and household growth and resolve the current shortfall which is contributing to high prices.

Note this analysis assumes demand is fixed – it is possible that lower prices and improved regulatory conditions would induce an outward demand shift for housing in Arizona, which would confound the analysis used here (higher demand effectively absorbing the new supply and putting renewed upward pressure on prices). It is also possible that reduced regulatory oversight of new housing projects could have spillover effects on the amenity value of existing neighborhoods.

These bills collectively make relatively modest changes to the zoning and design review processes employed by municipal and local governments to slow the pace of new construction or raise the price of approved units. It is possible that more significant reforms – like those contemplated in the now-failed SB 1117 – may have induced more significant price and supply changes. It is also possible that the failure to enact individual provisions in one or more of the three reform bills currently moving through the Arizona legislature could impact the assumptions and numbers modeled here.

Home Price Model Calibration Assumptions

CSI used a simple model of home prices have a function of interest rates, housing supply, and population.

Model Parameter	Parameter Assumption	Model Constraint
30-year mortgage rates	5.0%	Interest rates are assumed fixed over the forecast period.
Population growth rate	1.5%	Household size assumed fixed; new households form at the same rate as population growth.
Residential Construction Increase	6.5%	We assume the difference between population-adjusted housing supply growth in Phoenix and Houston since 2010 is attributable to the relatively more permissive zoning rules in the latter.
Residential Construction Share	50%	Using data from the Economic Census, we assume about half of the state's construction industry is attributable to home construction.
10-Year Housing Costs Change	**-4.83%**	**CSI assumes that tenant-occupied rental rates follow the trend in real estate prices, but with a 1-year lag. So, for example, after 10 years housing prices have fallen 4.83% (relative to status quo) and rental prices by assumption have fallen 4.3%.**

The impact of increased homebuilding and lower average home prices on the state's economy is separately modeled using the REMI Tax-PI dynamic input-output model.

Finally, this analysis does not directly consider housing rents, instead focusing for simplicity on asset prices. Remember, though, that housing acts effectively as a bond, where rent is the return to the property owner on the underlying investment. The historical record is clear – in the long-run and on average rents and prices move together (though shorter-term trends can be interrupted by cyclical economic conditions or consumer preference changes).

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