LOOKING BACKWARD AND FORWARD: ECONOMIC RESTRUCTURING AND UNITED STATES REAL ESTATE MARKETS

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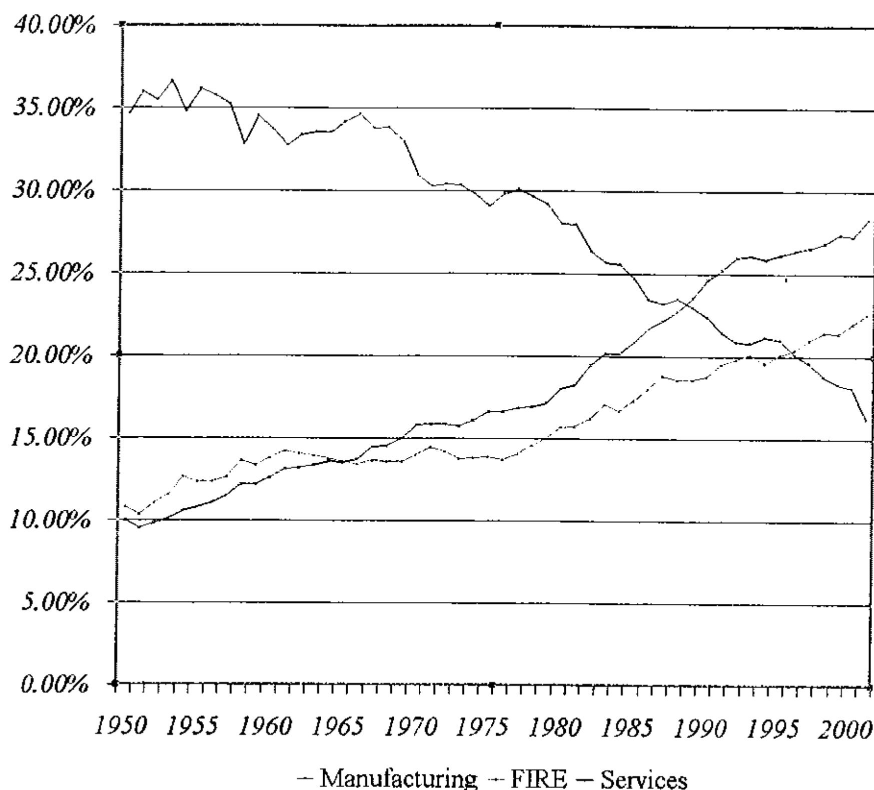
Two interconnected trends with far reaching implications for the real estate industry have evolved in the United States over the last 50 years. First, the nation has steadily moved away from its traditional manufacturing base to become more specialized in services and information-producing industries, creating a demand for new kinds of employees and workplaces. Second, people have realized outstanding gains in personal wealth and disposable income and, as an outcome, are increasingly able to define where and how they want to live. Working in combination, these changes have dispersed growth from older, more built-up areas in the Northeast and Midwest to newer, less developed areas in the South and West and, at the same time, from the core to the periphery of metropolitan areas nationwide. What is the connection between economic restructuring and real estate markets? How does it manifest itself? And, looking forward, where is the relationship heading?

This article explores these questions by first placing them in an appropriate historical context, then discussing how economic restructuring has altered real estate markets, and, finally, suggesting the possible shape of things to come. The core idea is that, increasingly, people no longer choose to live where physical things are produced; they use land

Figure 1—Percent United States Earnings in Manufacturing, FIRE, and Services, 1950—2001



and value location not just for its economic productivity but also for its aesthetic or intrinsic characteristics. In response, the real estate industry should explicitly embrace the notion that non-market goods are responsible for a growing proportion of market value.

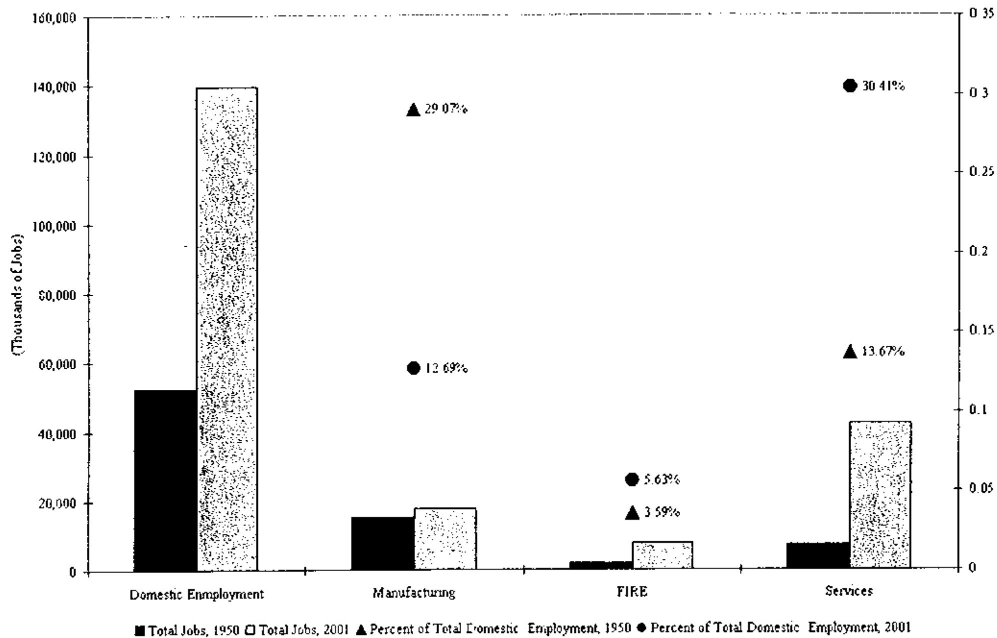
LOOKING BACKWARD

It is well known that the population of the United States has spread steadily from the Northeast and Midwest to the South and West over the past 50 years; less widely understood, are the underlying economic mechanisms involved, and how they affect where people end up living. The driving force behind the process of population deconcentration, as it is called, is the expansion of the information economy and the increased locational flexibility that it offers both people and firms. A significantly smaller proportion of Americans works in manufacturing jobs than did a half-century ago, and a greater proportion works in service-related industries. This is illustrated in Figure 1, which shows the percentage of national income earned in the manufacturing, finance, insurance, and real estate (FIRE), and service sectors between 1950 and 2001, the most recent year for which data are available.

Figure 2 provides another look at how the nation's industrial structure has changed over the last 50 years. The columns show the total number of domestic jobs, plus the number of jobs in manufacturing, FIRE, and services in 1950 (dark grey) and 2001 (light grey). Meanwhile, the black symbols show the percentage of total domestic jobs in the three industries in 1950 (triangles) and 2001 (circles). The figure demonstrates the scale of employment growth in the country, and how its economic base has shifted steadily from manufacturing to the two service sectors. In 1950, FIRE and services accounted for 17.26% of employment combined; by 2001, the proportion had more than doubled to reach 36.04%, at the expense of manufacturing, which fell from 29.07% to just 12.69% of all jobs. In short the U.S. economy has undergone a fundamental restructuring over the last half-century.

At the same time, investment in different kinds of real estate has changed in a similar way. Figure 3 shows the amount of money spent on new industrial, commercial, and housing developments in 2000 constant dollars over the same timeframe. Beginning in the early 1970s—when proportion of employment in the FIRE and service sectors began

Figure 2— United States Economic Structure, 1950 and 2001



to take off—investment in commercial space rose sharply, and investment in industrial space for the most part leveled out. Investment in housing continued to grow over the five decades, following cycles corresponding to the prime interest rate. Figure 4 illustrates another aspect of these trends, illustrating that investment in new commercial structures as a proportion of all private fixed investment in structures has also grown significantly: in 1950 the share within the asset class was under 5% but, by the turn of the century, it accounted for over 15%. During this time, the proportion of investment in new industrial structures and new housing remained relatively stable, fluctuating only with cycles in the economy as a whole.

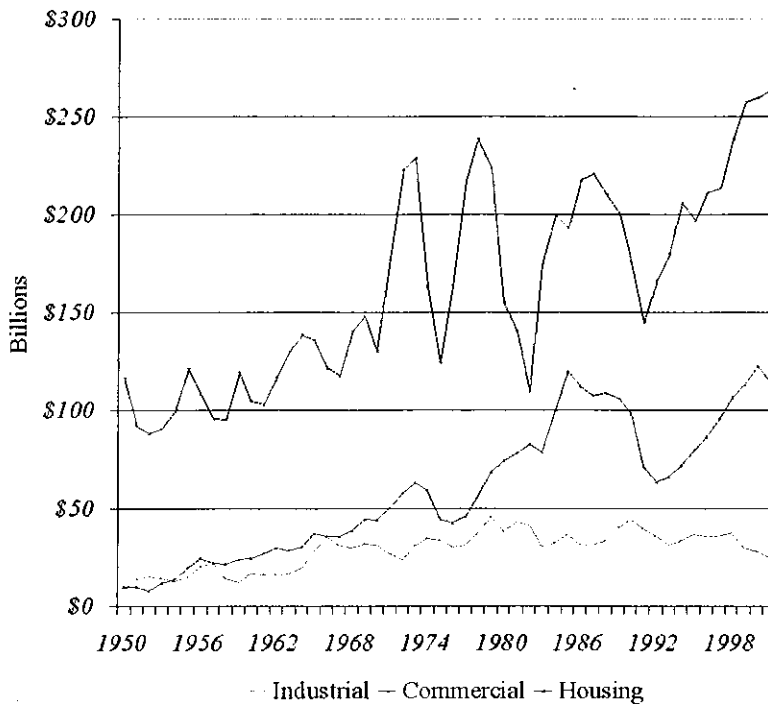
Finally, the associated rise in the per capita gross domestic product and per capita income and disposable income in constant 2000 dollars is shown in Figure 5. Although income and wealth are not the same thing, the figure provides an indication of just how much more people have to spend on nonessential goods and services or to invest than they did 50 years ago: each of the three series shown in the figure has grown by more than 250%, even after adjusting for inflation. Not only are Americans more productive than ever before, they increasingly have the means to define for themselves where and how they want to live.

THE CONNECTION TO REAL ESTATE MARKETS

What emerges from the preceding discussion is a portrait of a nation that has undergone massive economic restructuring, precipitating equally large changes in the kinds of employees and workplaces demanded. This, coupled with the corresponding increases in productivity, income, and wealth, have transformed the economic landscape of the United States in ways that have far reaching implications for the real estate industry. The following paragraphs elaborate on this connection.

According to Janet Pack, a Professor in the Wharton School at the University of Pennsylvania, the restructuring shown in Figures 1 and 2 has been accompanied by economic convergence, or a redistribution of people and firms to smaller places. General movement to less developed areas partially explains the rapid growth of the South and West, which are attractive to firms for their inexpensive land and comparatively low wages, but not completely. A more thorough explanation incorporates the residential consumer preferences of people, who choose locations based on their relative desirability as places to live. Moreover, despite the visibility of growth in the South and West, economic restructuring has not favored these places. Matthew Drennan, a Professor of City and Regional Planning at Cornell University, finds that information-producing industries have grown nationwide, but mostly in places with high endow-

Figure 3—Investment in New Industrial, Commercial, and Housing Developments, 1950—2001



ments of human capital. So, while population and employment growth exhibit an uneven spatial distribution that is easily visible, the expansion of quality, high-paying jobs does not.

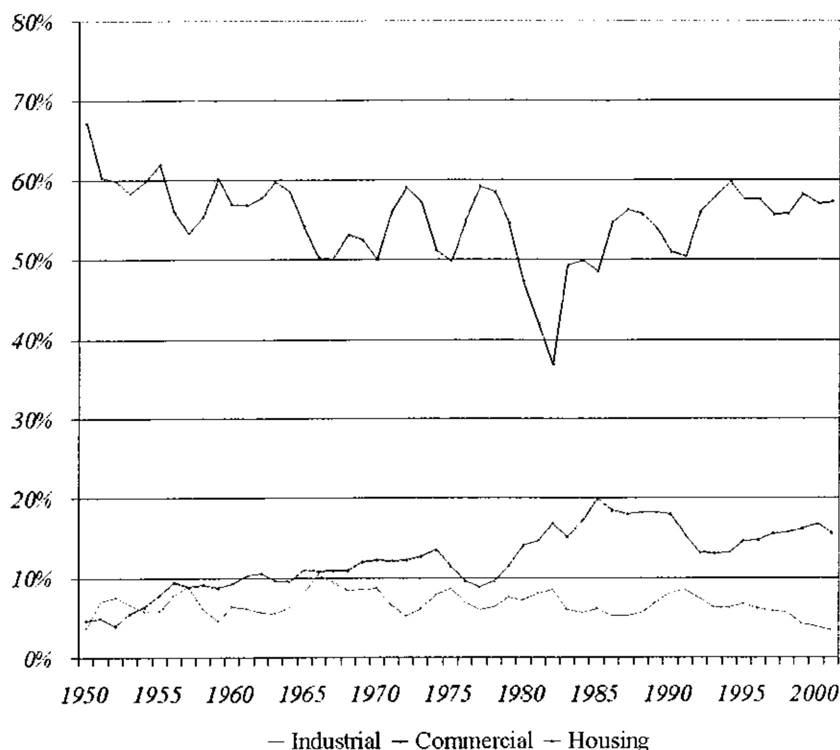
The distribution of positions in information-producing industries is determined in large part by where the workers they employ wish to locate. Expanded infrastructure systems, including affordable airfares, fiber optics, cellular networks, the Internet, and others, provide contemporary firms with an unprecedented degree of locational flexibility; companies may easily interface with clients or branch offices that are hundreds, or even thousands, of miles away. Mundy Associates LLC, for example, is based in Seattle but draws a relatively small proportion of its business from the local market. Further, its researchers commonly collaborate with people from other firms and universities in distant parts of the county, all without ever meeting face-to-face.

The sweep of this transformation is so wide that it has created a whole new class of workers—what Richard Florida, a professor of public policy at Carnegie Mellon University, calls the creative class. "If you are a scientist or engineer, an architect or a designer, a writer, artist, or musician, or if you use your creativity as a key factor in your work in business, education, health care, law, or some other profession," Florida writes, "you are a member."

Further, the advent of this group may even be transforming the very economic function fulfilled by American cities. Edward Glaeser, a Professor of Economics at Harvard University, and his colleagues argue that the role of cities has essentially been turned on its head: they are becoming centers of consumption rather than centers of production, as evidenced by the growth in urban rents outpacing the growth in urban wages and the large number of people who choose to reverse commute. In short, the economic restructuring discussed above has changed not only where Americans live, but how, in meaningful and lasting ways.

One of the most significant outcomes of this is a "chicken-or-egg" situation where employment growth drives population growth and the other way around—that is, jobs are drawn to people even as people are drawn to jobs. For example, research by John Carruthers, of Mundy Associates LLC, and Gordon Mulligan, a Professor of Geography and Regional Development at the University of Arizona, reveals a positive relationship between the two types of growth in metropolitan areas nationwide during the 1980s and 1990s. What this means, is that many people are first choosing where to locate, then finding or creating a job. This kind of (labor) supply induced growth has very different implications for real estate markets than more traditional forms of (labor) demand induce growth: in both cases rents rise but only in

Figure 4—Percent Private Fixed Investment in Structures, 1950—2001



the latter do wages rise correspondingly. One possible negative outcome of this is that those who can afford to locate where they choose will, but those without similar means will find themselves edged out, due to heightened competition over urban space. Other possible implications are explored below.

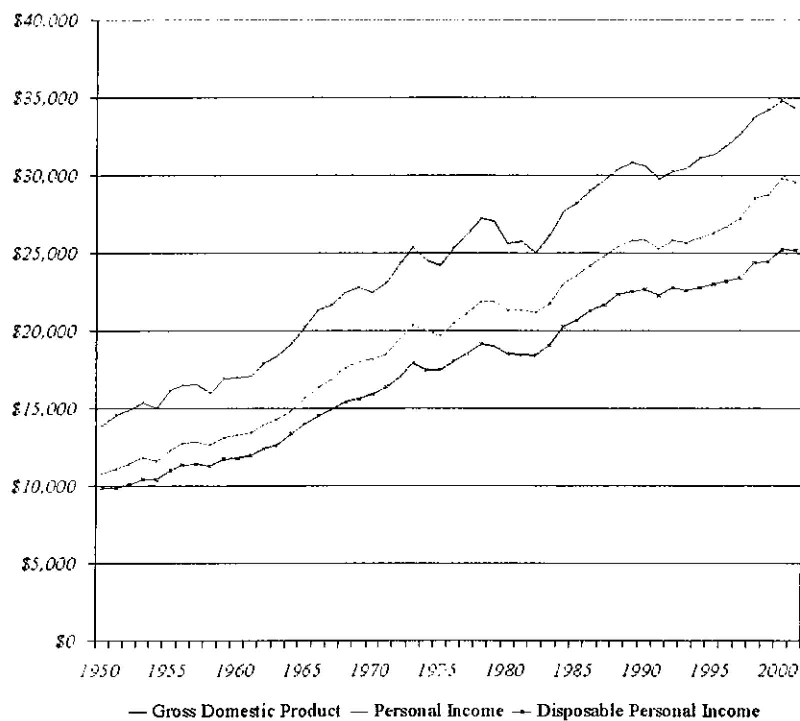
LOOKING FORWARD

Picking back up on the idea advanced in the introduction—that, because many Americans no longer choose to live where physical things are produced, they increasingly use land and value location for its aesthetic or intrinsic characteristics—the article concludes by outlining several future implications of the connections between economic restructuring and real estate markets. The emphasis here is on the possible shape of things to come—raising questions about how members of the real estate industry can respond or adapt to them.

Urban Spatial Structure—The United States witnessed three waves of suburbanization during the 20th Century: the early street car suburbs, the post-World War II suburban housing boom, and the decentralization of employment that has created so-called edge cities. Given rising incomes, more flexible work schedules, and falling commuting costs, American cities are likely to continue on their trajectory from a monocentric to a polycentric urban form. Further, central cities may increasingly become centers of recreation and housing for affluent professionals who choose to live in them for their nightlife and other activities. Meanwhile, other people are likely to continue moving even farther out, from the suburbs to the exurbs at the far urban fringe.

Urban Villages and Campus Style Suburban Development—As an extension, the character of the interior versus the exterior of metropolitan areas is becoming increasingly polarized. A model of growth that has become popular on Seattle, Washington, for example, is the so-called urban village concept, where planning efforts are focused around semi-autonomous neighborhoods. A similar strategy has been advanced in Phoenix, Arizona under the rubric of satellite cities. At the periphery, however, United States metropolitan areas continue to grow more spread out; indeed, Brookings Institute economist Anthony Downs, CRE, notes that key factors shaping American development patterns are people's affinity for single-family housing, low-rise, campus-style workplaces, and automobile transport. So, even as centralized areas undergo significant transformation, so too do areas

Figure 5—Per Capita Gross Domestic Product, Income, and Disposable Income, 1950—2001



located further out, simultaneously creating two new and distinct types of real estate markets, governed by very different sets of preferences and demands.

Real Estate Asset Mix—The transformation just discussed has direct implications for the kind of real estate asset mix that will be demanded. On the one hand, trends suggest that there will be increased demand from people living or working in downtown areas for high-rise apartment/condominium units, commercial space to accommodate their recreational needs, and office space designed to meet the needs of an information-intensive economy. Consider, for example, how the structure of real estate markets in Manhattan has been transformed over the last decade. On the other hand, there is every indication that more suburban areas will also continue to grow via their present trajectory. All of this has direct implications for real estate practitioners: How should a solid investment portfolio be structured, given this polarization? How should the two kinds of markets be valued? These and other important questions must be addressed explicitly within the context of the kind of change described in this article in years to come.

Valuing Places Based on Realtive Quality of Life—The rising incomes and increased locational flexibility precipitated by economic restructuring in the United States portend rapid changes in the very way people value real estate. For one thing, if people continue to choose where they want to live based on their individual preferences, places that meet these preferences will capture ever greater proportions of growth. Consequently, they will also exhibit new forms of competition over the most desirable locations within them. At the same time, places that cannot compete from a quality of life standpoint may fail to thrive in years to come. As an outcome, real estate markets will likely need to be valued in direct relation to one another; certain places may be over or under valued, depending on their relative quality of life. Measuring this-and how it translates into local prices, via the supply of and demand for location in-and-of itself-will pose significant and invigorating challenges for the real estate industry in years to come.

Economic Value of Non-Market Amenities—Last, due to rising incomes, people have greater than ever opportunity to consume non-market amenities that vary from location to location. Non-market attributes are those that are not produced, sold, purchased, or consumed in the traditional sense but, instead, attach to a commodity, such as a land. A good example of this is trophy properties, which, until relatively recently, have not been a significant

aspect of real estate investment. Due to the way the market for such properties has changed, our firm now does a significant proportion of its business in translating the intrinsic value of rare properties to monetary value; whether the subject is an old growth stand of redwood forest, a custom-built home, a remote, high-amenity ranch, or other unique form of property, valuation poses special challenges that require new and creative types of thinking about real estate markets. Even—or maybe especially—history now carries an implicit economic value that shapes people's willingness to pay.

The goal of this article has been to highlight significant changes affecting the real estate industry in the United States over the last 50 years. The thoughts provided in this conclusion are not intended to be exhaustive or mutually exclusive. Rather it is the authors' hope that they will inspire further thinking, discussion, and even healthy debate. The real estate industry is exemplary of one that changes with the times. Staying at the forefront of this change is not only important for industry leaders but, in turn, for the industry itself.