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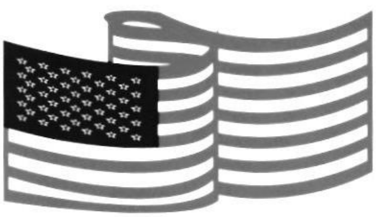

THE * IMPACT * OF GOVERNMENT AND * POLITICS ON * REAL * ESTATE

THE COUNSELORS OF REAL ESTATE™ ®
(American Society of Real Estate Counselors)

ABOUT THE COUNSELORS OF REAL ESTATE

The Counselors of Real Estate, now in its 40th year, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on real property and land-related matters.

Membership is selective, extended by invitation only on either a self-initiated or sponsored basis. The organization's **CRE Designation** *(the Counselor of Real Estate)* is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, workouts, valuation, feasibility studies, acquisitions/dispositions and general analysis.

Networking is the hallmark of The Counselor organization. Throughout the year, educational programs provide Counselors with opportunities, both nationally and locally, to meet with fellow members and professional colleagues to discuss the latest trends affecting commercial real estate. A publications program, highlighted by our award winning professional journal, *Real Estate Issues*, provides a venue for members to showcase their knowledge of such areas as office buildings, retail centers, hotels/motels, real estate counseling , etc.

What is a real estate counselor?

A counselor is a real estate practitioner whose primary business is providing expert, experienced advisory services to clients for agreed-upon fees. Counseling denotes an activity that is, by its nature, relational. The client relies upon the counselor for skilled and objective aid in the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor. The counselor typically has acquired a broad range of experience in the real estate field, possesses technical competency in more than one real estate discipline, and places those competencies at the service of the client. While objective in analysis, the counselor directs his efforts toward the client's best interests through the development of particular strategies, evaluating options available to the client, advocacy of the client's interests, and - where required - execution of strategy on the client's behalf.

Those designated as Counselors of Real Estate (CRE) have been recognized and esteemed by their peers as persons meeting the above definition in an exemplary fashion. They have demonstrated knowledge, experience, integrity and judgment in their real estate expertise. The CRE subscribes to and is bound by The Counselors' Code of Ethics and Standards of Professional Practice and endeavors to generously assist fellow CREs who are performing client services in a spirit of collegiality. Thus, the commitment to the individual client is complemented by a commitment to raise the standard of counseling practice for the industry as a whole.

Users of counseling services

The demand increases for expert counseling in real estate matters worldwide. Through the years, institutions, estates, individuals, corporations and federal, state and local governments have recognized the necessity and value of a Counselor's objectivity in providing advice. These real estate professionals honor the confidentiality and fiduciary responsibility of the client-counselor relationship.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. The Counselor has the benefit of proven knowledge and experience which qualifies him for practical application and proper interpretation of trends affecting real estate. A major player in the technological revolution, the Counselor regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

Determinants of compensation

The CRE is compensated by pre-agreed fee or salary for services, rather than by commission or contingent fee. The counseling fee itself is assured and rendered for advice rather than achievement or outcome of the transaction. Overall compensation can be determined by the complexity of the service performed, its value to the client, the time and expense involved, the breadth of the Counselor's knowledge and experience, and the responsibilities assumed. **Anyone involved in real estate should consider consulting with a CRE.**

For more information on The Counselors of Real Estate, contact The Counselors' office, 430 North Michigan Avenue, Chicago, Illinois 60611; 312.329.8427; fax 312.329.8881. ■

CONTRIBUTOR INFORMATION FOR REAL ESTATE ISSUES

The journal is published three times annually (April, August and December), and reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

Subscribers to *Real Estate Issues* are primarily the owners, chairmen, presidents and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries and Realtor© boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies and law firms.

Real Estate Issues is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate.

Review Process

All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

Every effort will be made to notify the author on the acceptance or rejection of the manuscript at the earliest possible date. Upon publication, copyright is held by The Counselors of Real Estate (American Society of Real Estate Counselors). The publisher will not refuse any reasonable request by the author for permission to reproduce any of his contributions to the journal.

Deadlines

All manuscripts to be considered for the April edition must be submitted by January 15; for the August edition by May 15; for the December edition by September 15.

Manuscript/Illustrations Preparation

1. Manuscripts **must be submitted on disk** (along with hard copy): ASCII file format, Word Perfect or Word for Windows 2.0 preferred. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Recommended number of manuscript pages is not to exceed 15. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement**.

2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.

3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction.

4. Number all tables consecutively. All tables are to have titles.

5. Whenever possible, include glossy photographs to clarify and enhance the content in your article.

6. Title of article should contain no more than six words including an active verb.

7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

REAL ESTATE ISSUES 1995 Editorial Calendar

April (Deadline for manuscript submission—January 15)
Articles on general topics real estate-related

August (Deadline for manuscript submission—May 15)
Focus Edition "Impact of Government and Politics in Real Estate"

December (Deadline for manuscript submission—September 15)
Special Edition "Counselors and Institutional Investment"

Readers are encouraged to submit their manuscripts to:

Halbert C. Smith, CRE, editor in chief
Real Estate Issues
The Counselors of Real Estate
430 North Michigan
Chicago, IL 60611

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The editorial board of *Real Estate Issues (REI)* is accepting manuscripts in competition for the 1995 William S. Ballard Award. The competition is open to members of The Counselors of Real Estate and other real estate professionals. The $500 cash award and plaque is presented in November during The Counselor's annual convention to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three person subcommittee comprised of members of The Counselors of Real Estate. Any articles published in *REI* during the 1995 calendar year are eligible for consideration and must be submitted by September 15, 1995.

THE PRESIDENT SPEAKS

WANTED: QUALIFIED, COMPETENT COMPANIES FOR GOVERNMENT CONTRACTS

For many of us, the experience of working with the government may at best be declared frustrating. Whether it is local, state or federal government, a successful working relationship and the feeling of a "job well done" are too often marred by a large bureaucracy, unclear decision channels, needless time delays and politically motivated decisions that frequently contradict sound real estate and business judgments.

In addition to the frustrations of working with a large, many times unmanageable organization, the real estate expert is frequently met with onerous regulatory and legislative entanglements before a government contract can ever be executed. It seems government is more interested in awarding contracts to companies who have designed themselves to slide through the sieve of political correctness and political regulations. The thought of hiring the best company or individual to tackle the task at hand is too often relegated to the bottom of the list of importance.

The end result, in a majority of instances, is that the contracts let by government are given to those organizations that specialize in meeting the obscure requirements imposed for government contractors. Companies that are successful in the "real world" have little incentive to work through the complex bureaucracy, regulations, and ensuing frustration needed to win government contracts. Established companies with reputations for innovation and getting the job done on time and within budget just do not need government work to survive.

This is a sad commentary on the state of affairs for so many of our local, state and federal government agency contracts. This is particularly true when one considers that the government is the largest owner of real estate in the United States and has extensive interests in real estate overseas. My comments are not meant to imply that there are not good people working within local, state and federal government. Often they too are frustrated by government bureaucracy and recognize the need for serious change in the way business is conducted. We frequently hear of governmental waste and overspending, particularly in large capital expenditure projects. Yet, if government could conduct business in the same manner as successful commercial enterprises, its cost of doing business would be greatly reduced and the ultimate success and timeliness of the projects greatly enhanced.

With the new wave of change underway in Washington, D.C., perhaps government will begin changing to award its contracts on the basis of merit... to the organization best qualified to execute the assignment. Perhaps the time is right for us as Counselors of Real Estate to again help government to change and bring improvement both to the excellence in government within the United States and to the excellence in government-owned real estate for our country. Perhaps this edition of *Real Estate Issues* will serve to motivate the changes so sorely needed to bring the best professional service and product excellence to government assignments.

Macdonald West.

Macdonald West, CRE
President, The Counselors of Real Estate

REAL ESTATE ISSUES

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POLITICAL REALISM

The impact of government and politics on real estate is a matter of crucial interest to anyone involved in real estate, especially Counselors of Real Estate. We know the government can *make* or *break* the market. A glance back recounts the 1981 and 1986 tax laws and their effects on the real estate market. The first stimulated the market to unparalleled excesses, while the second dragged it to a profound and long recession from which some sectors have yet to fully recover.

Then, there are all the other laws at the federal, state and local levels—laws providing for and regulating real estate financing, laws whose aim is to protect the environment, water, air and endangered species and laws regulating real estate transactions, development, land use, transportation, housing and health and safety, to name a few broad categories that affect our daily lives. While most of us, at one time or another, complain about laws and regulations (and some of us complain most of the time about most of the laws), the fact is that laws and regulations come about because voters and our representatives support them, at least at the time of enactment. This support often derives from social problems—real or perceived—such as inadequate funds for housing, discrimination in selling, workplace injuries or deterioration of the environment. And we find that if the need passes, or the costs become greater than the benefits, or the nature of the problem changes, or the problem goes away (as it does occasionally), the laws still remain.

We may ask ourselves, "But why doesn't the government just establish a set of laws that provide a level playing field and then leave them alone?" Ah! That is to deny human nature. Our perception changes; we always think we can improve on the existing condition, and some group or another is always able to muster enough support (money and/or votes) to pass another law. For a few years it's the liberals who want to fight social problems; then for a few years it's the conservatives who want to put fiscal affairs in order; and then for a few years we react to some unforeseen problem such as terrorism, national bankruptcies or nuclear accidents.

I don't think anyone will deny that the impact of government and politics on real estate is complex and profound. But dealing with such issues is what The Counselors are all about. We are prepared to analyze and provide solutions to problems, including those created by government and politics. Thus, it is very appropriate, perhaps overdue, that *Real Estate Issues* publishes a Focus Edition devoted to this topic. Some highly talented authors have contributed a great deal of analysis and insight to the nature of and solutions to real estate issues stemming from government and politics. I highly recommend this edition to you for provocative and informative reading.

Hal Smith

Halbert C. Smith, CRE
Editor in chief

GOVERNMENTS & REAL ESTATE: SHAPING THE FUTURE

by John J. Hentschel, CRE

With Congress' recent passage of landmark legislation to eliminate the federal budget deficit by the year 2002, the nation is witnessing a fundamental realignment of national priorities and responsibilities the likes of which have not occurred since the New Deal over 50 years ago. Meanwhile, debate continues to rage over tax cuts for the middle and upper income earners and the equanimity of balancing the budget at the expense of children, the poor and the elderly.

As the federal government implements its policies of retrenchment, its once pervasive role in regulating and funding America's activities can be expected to diminish as many of its present responsibilities are either abdicated or transferred to the states. This development is inopportune, if not devastating, for many of the nation's cities, towns and counties which developed a dependence on, if not an addiction to, Uncle Sam's generosity.

Having endured a decade of dwindling financial resources in federal allotments, accompanied by an erosion of the local tax base and the elimination of federal tax incentives for local economic and community development initiatives, local government leaders now must face the prospects of going it alone. They will be forced to rely more heavily on local resources to deal with monumental issues such as escalating crime, an overburdened criminal justice and correction system, an aging and deteriorating physical infrastructure and delivery of near bankrupt social welfare and medical assistance services.

To complicate matters even more, in an era of dwindling resources and mounting constituent expectations, local officials must also reckon with the simultaneous emergence of not one, but two other potent forces:

1. an aging population which is radically altering the demographic landscape;
2. a revolution in technology and telecommunications which is changing traditional perceptions of spatial patterns, relationships and linkages.

This article discusses the role of real estate in local government, how it is changing and what steps public officials can take to adapt and cope with a changing world.

John J. Hentschel, CRE, *is founder and president of Hentschel Real Estate Services and The Millennium Group in Baltimore. He provides real estate counseling, valuation, management and development services including structuring and implementation of public-private joint ventures to state and local governments, economic development agencies, developers, investors and financial institutions. His 20 plus years in real estate include experience in both the public and private sectors. Hentschel previously served as the real estate officer of the City of Baltimore during 3 mayoral administrations.*

TABLE 1

Types of Property Owned or Leased by Jurisdictions

		Averages Reported	
Property Type	%	Number	Approximate Square Footage
Office Space	81%	11	124,218
Warehouse/Storage	65%	5	60,553
Residential	32%	162	133,954
Recreational	70%	21	1,949,263
Business/Industrial Parks	32%	3	2,972,050
Public Buildings	59%	12	261,287
Schools	14%	14	225,000
Historic Buildings	43%	3	73,800
Specialized Buildings	62%	14	342,661
Public Parking	68%	7	422,078
Civic Centers	49%	2	541,997
Stadium	32%	3	44,595

Source: City & State/The Counselors of Real Estate, 1993 Real Estate Management Survey

Real Estate—A Public Sector Perspective

A 1993 survey sponsored by The Counselors of Real Estate in conjunction with *City and State* newspaper provides some useful insight.[1]

Without a doubt, local governments, large or small, control a more diverse and extensive inventory of property than most major business enterprises. Large cities and counties typically oversee real estate portfolios far greater in number and value than many financial institutions and participate in more transactions annually than some of the largest real estate concerns. (Table 1). The very nature of local government often places real estate in the vanguard of many of its activities.

Whether or not a jurisdiction's organizational chart specifically identifies or defines a real estate function or employs real estate personnel, each participates in real estate from four distinct perspectives:

1. Property used in the conduct of business and delivery of services, e.g., a capital asset such as office, warehouse, police/fire station etc.
2. Property acquired by default, e.g., nonpayment of taxes, abandonment, etc.
3. Economic/community development resources intended to preserve or improve a locality's economic vitality, e.g., financing, development, operation, sale of business/industrial parks, parking garages, residential/commercial urban renewal projects, public-private joint ventures, etc.
4. Private property influenced by the exercise of police power, the most subtle yet influential involvement of local government in real estate, e.g., comprehensive plans, subdivision and zoning regulations, building codes, etc.

TABLE 2

Importance of Real Estate Issues

	Relative Importance	
Issue	Above Average Importance	Highest Importance
1. Capital Constraints	89%	46%
2. Environmental Preservation	69%	23%
3. Lack of Reuse Strategies	55%	9%
4. Asset and Facilities Management	50%	9%
5. Restricting Growth	46%	23%
6. Restrictive Federal Funding Policies	43%	13%
7. Oversupply of Distressed Properties	36%	12%

Source: City & State/The Counselors of Real Estate, 1993 Real Estate Management Survey

These diverse perspectives are readily discernible among real estate issues identified as critical by survey respondents (Table 2), but they also are a source of difficulty when organizing to manage and coordinate the various real estate resources and activities within a jurisdiction.

In the private sector, real estate is addressed from a single perspective, viz. profit, whether generated directly as revenue from its sale or lease as in the case of a developer, or indirectly as a commodity used in the production, distribution and/or sale of another product or service which yields revenues for the enterprise. The method and manner in which the enterprise organizes to manage its real estate affairs, as well as the criteria for making real estate decisions emanates from and is dictated by this orientation which imposes discipline on the process and guides the conduct of the firm's real estate activities.

Such singularity of purpose and the ensuing discipline often is absent in public sector settings. Rather, real estate opportunities and decisions often are spawned by the simultaneous pursuit of the independent parochial agenda of agencies and departments, whose objectives may not necessarily correspond with each other or with the elected administration. Without the cohesive discipline imposed by profit motivation or a concise statement of goals, objectives and criteria set forth by elected officials, in conjunction with a mechanism for implementation and enforcement, erratic, chaotic and uncoordinated real estate decisions can result. Only 35% of the survey respondents reported the existence of a centralized oversight function to enforce property utilization and decision making within the context of unified goals and objectives.

The Profit Motive And The Public Sector

While some real estate decisions made by a locality may have eleemosynary motivations, e.g., investments in low income housing, others are purely utilitarian with little if any social significance or impact. In all instances, decisions concerning the latter should be subject to the same evaluation procedures, techniques, criteria, and disciplines as those employed in private sector decisions. Likewise, even eleemosynary investments are susceptible to quantitative analysis, evaluation and ranking of relative risks and rewards, financial as well as intangible (including perceived political ramifications) afforded by competing alternatives. Yet the survey reports that less than half the respondents (43%) have personnel engaged in the performance of strategic decision analysis to identify and select alternatives which yield the highest net benefit.

Government real estate managers and executives seldom enjoy the luxury of specializing in a single market segment or property type. However, according to the survey, like their private sector counterparts, they routinely grapple with complex issues involving development, management, portfolio administration, financing, valuation, acquisition, leasing and sales, but rely extensively on in-house resources to accomplish such tasks (Table 3). The reluctance to privatize and/or outsource activities is evident from the data presented (e.g., 81% of the survey respondents report they had not privatized real estate management services within the prior 12 months; 86% of respondents maintain in-house personnel to conduct property acquisitions, although 83% report acquiring less than 10 properties during the preceding 12 months, with 47% acquiring no property at all). The reasons, however, sometimes transcend such conspicuous motivations as featherbedding, self preservation or turf protection.

TABLE 3

Real Estate Services Performed by Jurisdictions

Real Estate Activity	In House	Outsourced	Total
Building Management	86%	8%	94%
Property Inventories	89%	11%	100%
Sales/Dispositions	73%	8%	81%
Leasing	68%	11%	79%
Market Research	32%	27%	59%
Loan Resolutions	32%	3%	35%
Joint Ventures	32%	3%	35%
Construction Management	68%	35%	100%
Appraisal/Valuation	43%	78%	121%
Purchase/Acquisition	86%	24%	110%
Site Assemblage	73%	5%	78%
Development/Feasibility	57%	38%	95%
Highest & Best Use Studies	57%	27%	84%
Strategic Decision Analysis	38%	5%	43%
Architect/Design Services	30%	62%	92%

Source: City & State/The Counselors of Real Estate, 1993 Real Estate Management Survey

Government accounting systems traditionally are expense oriented and tend to focus on the operating statement, which is commonly organized around specific programs, services or departments. While financial reporting systems may post real estate-related expenses (e.g., heat, rent, utilities, etc.) to a department's operating statement, they might not be consolidated or reported in a format which enables evaluation of comparative performance on either a systemwide or building-by-building basis, or with reports for similar properties in the private sector. While elementary in the private sector, neither standardized systems nor a uniform chart of accounts for real estate reporting are universally employed by local governments.

Moreover, government fiscal analysts focus most attention on those activities with the largest concentrations of personnel and payrolls, by far the most significant component of government expense. Real estate functions involve comparatively small numbers of employees (particularly when the function is decentralized within operating line agencies), and thus tend to attract scant interest from government finance officers. While the amount of space or number of properties controlled by a jurisdiction may indeed be extensive, such items are creatures of the balance sheet, a financial statement with little relevance, familiarity or concern to government line agency executives.

Since return on assets and asset turnover ratios historically have held little meaning for government agencies and traditionally have not been computed, property management information systems seldom establish performance criteria or include protocol for the conduct of periodic utilization audits. Nor do they detail the nature, extent or value of the components of the jurisdiction's property inventory beyond its mere identification. For instance, a local government capable of reporting the exact number of workers employed by a specific department, may be unable to identify those assigned and working in a specific building or complex, precluding an accurate, informed assessment of space utilization. So, while real estate is obviously an integral component of local government affairs, its potential to yield cost savings, revenue enhancement or positive returns on economic development investments is often unrealized.

Change And Its Impact On Local Government

In the wake of technological innovation, old adages like "Under all is the land" and "Location...location..location..." are being revisited, revised and rewritten to "under all is the interactive computer," with the "location" being the family living room. Consider the impact on shopping patterns and the inventory of retail space as virtual reality and holographic technology advance where the consumer can view fashion merchandise at home, not from a two dimensional photograph on a catalogue page, but modeled by three dimensional holographic images which can be manipulated and "morphed" to mimic and match the viewer's own size and shape.

Also imagine the consequences on the need for library space or space used to produce, distribute and market videos, music, books, newspapers and magazines as technology advances to deliver them on demand directly into the home; the impact on hotel and food and beverage space, particularly in CBDs, as virtual meetings are conducted via telecomputer links and networks; the effect of telecommuting and the "virtual office," not just on the inventory of traditional office space, but on strip commercial spaces along commuter routes; or on the location, design and functional composition of residential communities housing the "virtual worker."

Science fantasy? Hardly. Too far in the future to have practical relevance? The lead time for a major development venture is 3-5 years; typical holding period projection for real estate investing is 5-10 years; mortgages typically mature or balloon in 5-15 years. Personal computers were considered exotic and cost prohibitive only 15 years ago; now they are commonplace and cheap. Financial spreadsheets were novel and nice 12 years ago; now they are indispensable. Most businesses didn't own a fax machine 10 years ago; now they can't survive without one. The Internet was virtually unknown to the masses 5 years ago; now "surfing the net" is today's latest craze.

The rate of change is accelerating at an ever increasing pace as technology breeds on itself—the "accelerative thrust" envisioned by Alvin Toffler in his prophetic tome of the 1970's Future Shock.[2] But, while technological change is implemented globally, its effects are manifested, experienced and must be addressed locally. Despite the emergence of a global marketplace for properties, the immobile and nonfungible nature of real estate forever tethers it to the local market, the bailiwick and occasional bane of local officials.

Keeping Up With The Times

Anticipating and planning for change must become the primary mission and focus of local government as it mobilizes the resources of the private sector and assembles the economic development and regulatory framework to shape, rather than respond, to the future.

As technology continues to blur conventional spatial relationships between residence, workplace, recreation and store, communities must be prepared to facilitate the transition with adaptive reuse strategies and flexible land use, zoning, subdivision and building codes to assuage rather than aggravate the evolution of the traditional neighborhood.

Local governments cannot remain complacent and content in a passive role as cheerleader and occasional conduit of depleting federal and state funds. They must graduate to the role of catalyst for coordinating and directing public and private sector resources to accomplish clearly defined and communicated goals. Whether large or small, urban or rural, they must leverage their resources whenever and wherever possible and stand ready to enhance credit or assume risks, create feasibility and devise new, creative mechanisms to mobilize and channel funds from the private sector. In light of the finite resources at their disposal, such decisions cannot be indiscriminate but must be made only after careful evaluation of relative risks and rewards.

In the 1970s and 1980s at the pinnacle of federal financing, financial feasibility for economic/community development of real estate projects in an ad valorem property taxing jurisdiction was preferable but not required. Getting the project built was of paramount concern, because even if a project developer failed, the creation of the property would spur momentum and synergy for additional development as well as increase the jurisdiction's assessable base. Besides, local politicians enjoyed being able to bask in the favorable limelight of progress, with little accountability to the electorate if a project failed. In the future, however, localities will be more concerned with matters of feasibility and the recoverability of funds invested since local, not federal, funds will probably be at risk. In addition, recent experience has taught many localities a tough lesson about the downside of financing and investing in community and economic development projects which promise momentum and synergy but lack the underlying market support to succeed.

Aging Buildings, Population

Shifting population trends are not only reshaping the demographic but the geographic and physical landscapes as well. The exodus from the aging standing stock of properties in urban centers has created overt imbalances in supply and demand. Once stable communities now have to resolve blight and eroding tax bases. As baby boomers age and march toward retirement, further imbalances in supply and demand can be expected. The winds of demographic and technological change carry the seeds of functional and locational obsolescence for the inventory of standing housing stock originally built for a younger, family oriented population, along with the office, commercial and industrial structures initially constructed for a non-technologically oriented society.

While breeding its own set of problems, latent opportunities for the vigilant also abound. Those urban communities who gain control over the incidence and perception of crime and who have the vision and resolve to create projects which impart a sense of security and community, will have an exceptional opportunity to reverse population declines by attracting retirees and empty nesters searching for a city's cultural vibrancy. But to do this, communities must first exert a concerted effort to:

1. devise progressive land use plans with features targeting specific market segments;
2. adopt balanced regulatory codes which not only promote the public good and protect public safety, but complement the land use plan to further rather than frustrate developer efforts;
3. contrive aggressive revitalization programs to assemble development sites suitable in size and physical traits to achieve the critical mass essential for success;
4. formulate fund financing initiatives in amounts and on terms and conditions sufficient to assure the economic feasibility of those projects selected for support.

A Prescription For Success

What steps must local governments, regardless of size, take to thrive? It is axiomatic that with less resources available, jurisdictions must seek the biggest bang from every buck by:

1. Maximizing the benefits (return) from economic/community development investments; and
2. Optimizing utilization and maximizing productivity of all real estate resources (human as well as property).

But how can local governments achieve these results?

Recognize that resources, both human and financial, are finite, and therefore, must be allocated and, when possible, leveraged.

Acknowledgment by local leaders that government cannot be everything to everyone, nor by any means, do everything, is a fundamental prerequisite. However, it requires politicians to make choices, some politically painful. It also requires educating constituencies to the realties of limitations and the balancing and prioritization of needs rather than political appeasement. It means knowing the product and the market, as well as what can and cannot be done.

Strategic planning is essential if resources are to be judiciously allocated. It requires formulating clearly defined, appropriately prioritized and realistically attainable goals, developed only after a careful, honest assessment of a locality's strengths and weaknesses. The process is more than compiling a wish list. It requires introspection of the highest order to avoid selecting goals which are inconsistent with the characteristics and resources of a locality.

Too often, however, local officials believe that the task is complete once goals are established and communicated to the organization. But, goals without pertinent criteria to employ in the selection of alternatives is like a blindfolded marksman shooting at a target without the means to determine if the target was hit.

Unless criteria are specified, clearly communicated and uniformly applied throughout governmental units at all levels, goal attainment is likely to be haphazard, since finite resources, rather than being focused, will be randomly and disproportionately distributed. Criteria is also essential to adopt and apply resource allocation models and procedures which facilitate a rank ordering of competing choices in terms of their relative risks and rewards to identify and bring about goal fulfillment.

Whether employed in public or private sector applications, the techniques are identical. The distinction is the criteria applied and the benefits received. Unfortunately, too many local government executives believe that such models are based solely on the application of financial criteria and rewards that are not applicable to public sector decision making. However, like private enterprise, government has a measurable cost of capital as well as a discernible opportunity cost which can be used to establish minimum hurdle rates.

Furthermore, financial returns in the form of direct cash flows from the commitment of public capital to real estate applications are supplemented by intangibles which are quantifiable to evaluate potential benefits versus risks. The application of specified criteria within a process of strategic decision analysis is germane regardless of whether a locality is contemplating an economic development opportunity, an eleemosynary endeavor or the utilitarian deployment of capital assets. Sadly, a jurisdiction's failure to establish such criteria is often interpreted by government personnel as carte blanche permission to forego the performance of what, in the private sector, constitute indispensable analytical procedures to effectively and efficiently allocate scarce capital resources to stipulated goals and objectives.

Conduct a comprehensive review of real estate operations to evaluate organizational efficiency and eliminate redundant activities.

Despite all the electoral promises to streamline government organizations, the results of The Counselor's survey suggest that local political leaders have not recognized the latent potential for cost savings and organizational efficiency in the real estate arena. When the real estate function is so often decentralized, as the survey indicated, there tends to be considerable and expensive overlap and duplication. In addition to redundant costs, this contributes to foregone and missed opportunities the result of indeterminate responsibility, vague accountability, uncertain jurisdiction and/or a lethargic atmosphere and attitude.

High priorities on the agenda of every newly elected or appointed chief executive or operating officer should be a thorough review and evaluation of the strategic deployment and utilization of both property and personnel, identification of opportunities for consolidation and/or reduction of space, privatization or outsourcing of functions, elimination of personnel and the targeting of excessive expenditures. Counselors, with their diverse background and experience, represent an ideal resource for performance of such evaluations.

Private sector to implement public policy goals/ objectives

The characteristic of a good manager is the ability to leverage his own time and productivity through the efforts of others. In the wake of depleting resources (both human and financial), local governments must become more adroit as managers who coordinate and direct the resources of others, especially the private sector. Ready to be tapped are a vast array of specialized real estate services in the private sector to solve problems and exploit opportunities in an environment fraught with change. Yet according to The Counselor's survey, local governments still are opting to replicate and perform such services rather than direct and manage the efforts of others.

In terms of economic and community development activities, it is essential to explore and develop new, creative mechanisms which foster public-private partnerships capable of capturing and channeling funds to local economic and real estate activity. Such alliances may at times transcend jurisdictional boundaries, some or all of which may not necessarily be physically contiguous.

Localities may also seek to identify and cultivate symbiotic relationships with pension funds, mutual funds, insurance companies and/or other originators and assemblers of capital whose members or investors might either benefit from jobs created by projects promoted and financed by the jurisdiction or from the general economic vitality of a region which creates jobs. Likewise, as investment bankers, progressive jurisdictions need to court private enterprises, not only to invest in opportunities specific to their own business interests in the region which creates jobs, but to commit surplus earnings for investment in pooled funds organized and coordinated by the locality. Here, the proceeds would be earmarked for projects and ventures of unrelated area developers or firms to fuel growth of the local economy.

Financial institutions in search of opportunities to satisfy Community Reinvestment Act requirements as well as citizens may be similarly enticed into pooled ventures promoted by local jurisdictions designed to attract and channel capital to fund and sustain economic growth, especially those which offer risk reduction by virtue of local government guarantees or insurance, and liquidity. While public private-joint ventures are by no means new, the novelty is that the public sector investor will likely become a true partner, not just a money conduit. This investor will be capable of applying investment underwriting criteria to achieve a return on capital (including intangibles) consistent with the risks assumed along with a return of capital to ensure preservation and replenishment of funds for future endeavors. It is interesting to note that while in the survey local government respondents (89%) reported capital constraints as the most pressing real estate issue of the day, a mere 35% currently indicated that they engaged in joint venture activities. Possibly this is the result of restrictions codified within local laws, ordinances or charters limiting or prohibiting the local government's participation in such arrangements or in equity investments generally.

Shaping The Future

Robert Kennedy once observed that some people look at things the way they are and wonder why, while others look at things that aren't and wonder why not? This simple philosophy highlights the distinction between dealing with problems versus exploiting opportunities. As the federal government retrenches, local governments will continue to encounter massive challenges resulting from unprecedented technological innovation and radical shifts in demographic patterns. Only those with the capacity, capability and propensity to seek out, embrace and exploit opportunities arising from the inevitable change and who exhibit the foresight and resolve to shape their destiny will succeed and thrive in tomorrow's world.

NOTES

1. City & State Newspaper & The Counselors of Real Estate, 1993 Real Estate Management Survey
2. Alvin Toffler, *Future Shock* (New York: Random House, 1970), pp.19-35.

FLAT TAX: SLANTED AGAINST REAL ESTATE

by John A. Tuccillo and Orawin T. Velz

The authors gratefully acknowledge George Green, senior economist, Investment Real Estate Research, for the project analysis of a typical investment real estate. The contents of this article have not been approved by the NATIONAL ASSOCIATION OF REALTORS® Board of Directors, and therefore does not necessarily represent official policy of the Association. Any opinions expressed here are those of the authors and not of the Association.

Here's the way it's gonna be
One for you, nineteen for me
"Taxman," by George Harrison

Einstein once said there's a simple answer to everything, and most of the time it is a wrong answer. The rising complexity and cost of compliance with the existing tax system make the flat tax a seductive route to a simpler tax code. But, as far as the real estate industry is concerned, a flat tax, as currently proposed, is Einstein's simple but wrong answer.

The idea of a flat tax has been floating around for years at both ends of the political spectrum, from California's former governor, Jerry Brown on the left, to the new house majority leader, Representative Dick Armey of Texas on the right. A decade ago, no one paid much attention to such a radical overhaul of the tax system. However, with the Republican party sweeping into control of both houses of Congress for the first time since 1954, a flat tax has emerged at the center of the tax reform debate. The new Congress is considering tax measures that would profoundly change the federal tax system. There have been discussions on several tax reforms—a consumption tax and a flat tax—as possible replacements for the federal income tax. This article focuses on the flat tax and discusses the impacts it might have on the real estate industry.

What Is A Flat Tax?

All flat tax proposals have three features in common.[1] One deals with the tax rate and the other two with the tax base.

- *Single Tax Rate*: A single rate applies to all income subject to taxation, as opposed to the graduated rate system that has been in existence for over 70 years. The actual tax rate is different from proposal to proposal.
- *Elimination of Deductions and Credits*: Flat tax proposals eliminate or limit preferential tax treatment on certain behaviors and activities. Examples of such preferential treatment include tax deductions for housing, such as home mortgage interest and property taxes, and nonhousing tax deductions, such as charitable contributions and state and local taxes. Additionally,

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depreciation of capital expenditures would be altered, in some cases moving to an expensing system.

- *High Exemption Thresholds*: The minimum income subject to taxation would be increased substantially from the current law. For example, under current law the 1994 standard deduction for single taxpayers was $3,800. Under Representative Armey's proposal (H.R. 4585), the standard deduction for single taxpayers would be $13,100.

Table 1 summarizes major differences between current law and flat tax proposals.

TABLE 1

Comparison Of Current Law And Flat Tax Proposals

	Current Income Tax	Flat Tax Proposals
Tax Structure	Individuals: from 15% to 39.6% Businesses: 35%	Individuals: 21% - 23% Businesses: 21% - 23%
Income Tax	Net of wages, dividends, commissions and interest less standard deduction or itemized deductions	Gross income not including dividends and interest (no itemized deductions)
Capital Gains	Real Estate: 28% Securities: 28%	Real Estate: Fully Taxable (21%-23%) Securities: No Tax (0%)
Business Deductions	Ordinary and Necessary—Yes Taxes Paid—Yes Interest Paid—Yes Salaries—Yes Benefits—Yes Depreciation—Yes Cost of Assets—Yes	Ordinary and Necessary—Yes Taxes Paid—No Interest Paid—No Salaries—Yes Benefits—No Depreciation—No Cost of Assets—Yes
Business and Personal Taxes	Integrated	Not Integrated

Flat Taxes And Consumption Taxes

Some flat tax proposals involve significant broadening of the income tax base while others actually change the basis of taxation from income to consumption. The latter is referred to as a consumption-based flat tax. In this form of a flat tax, taxpayers claim no deductions for savings, but their returns on savings, whether in the form of interest, dividends, rents, royalties or capital gains, are excluded from the tax base. An income-based flat tax would include the return to savings in the tax base.

The treatment of capital expenditures is one distinguishing feature between a consumption-based business tax and an income-based business tax. In general, consumption-based taxes allow the immediate deduction (expensing) of the cost of capital purchases. Under an income-based system, businesses are only allowed to deduct a portion of the cost of capital purchases each year. A second distinguishing feature is the treatment of interest expenses. They are deductible under an income-based tax as a cost of producing income but are not deductible under a consumption-based tax.

What Is Included In The Tax Base In Current Proposals?

In order to impose a low single rate, the base must be broadened from current law. Dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable contribution deduction, deductions for state and local income taxes, the earned income tax credit and the dependent care credit, were contained in the original law or added to the tax code by Congress. All are intended to provide incentives for particular kinds of activities or to provide relief to particular kinds of taxpayers. In principle, a pure flat tax would be free of all behavioral bias and would be focused on raising specific amounts of revenue in the simplest possible fashion.

In practice, however, the actual tax base varies from proposal to proposal. For example, all deductions were eliminated under Representative Armey's 1994 flat tax proposal, but the flat tax proposed by Senator Arlen Specter of Pennsylvania would provide deductions up to $2,500 for charitable contributions and up to $100,000 for mortgage interest paid on loans. As an aside, the variety of specific flat tax proposals suggests that once passed, no law would be immune from Congressional tinkering to reward or punish different sectors or groups.

Arguments For A Flat Tax

There are a variety of valid reasons for adopting a flat tax.

- *Simplicity*: At the heart of the flat tax approach is the redefinition of the tax base; the replacement of multiple tax rates with a single rate is really a sideshow. By eliminating deductions, the flat tax simplifies record keeping and fosters tax compliance. In fact, under most proposals, the high exemption threshold removes the need of many taxpayers to even file a return.
- *Pro-Growth*: The current tax system, with its high rates and double taxation of savings and investment, discourages these activities and ultimately cripples the economy by reducing growth. By lowering rates and, in some cases, excluding returns from savings and investment from the tax base, proponents of a flat tax claim that it boosts the economy's performance. The low marginal tax rate reduces tax distortions, thereby encouraging employment and discouraging unproductive tax avoidance activities.

Arguments Against A Flat Tax
Of course, there are equally valid arguments *against* the flat tax.

- *Discriminates Against Middle Income Taxpayers*: Any flat tax would reduce the tax burden on high-income taxpayers by lowering their effective tax rate and on low-income taxpayers because of high exemption thresholds. The difference in revenues comes from the middle-income taxpayers. Research from the Treasury Department shows that taxpayers earning up to $100,000 of adjusted gross income would actually pay close to $2,000 a year in additional taxes under Representative Armey's 1994 flat tax proposal, compared with current law if the tax rate was increased to the level required to bring in the same revenue under current law (revenue-neutral tax rate).[2] However, families with income over $200,000 would get tax cuts averaging more than $50,000.
- *Inequities Among Taxpayers*: Eliminating tax deductions would create horizontal inequity because individuals base long-term commitments on existing tax law.[3] Taxpayers who made tax-preferred investments under the old tax rules would experience an abrupt decline in their current after-tax income and wealth (the capitalized value of future income). The real estate sector is an obvious victim under a flat tax. If the mortgage interest and property tax deductions are repealed, it will hurt taxpayers who made investment decisions based on tax policy in existence since the inception of the Federal Income Tax in 1913.

Phase-In Period
Proposals such as Representative Armey's do not provide any phase-in period for the transition of present-law income taxation to the new tax. For example, home owners who borrowed money to finance their mortgage in anticipation of interest deductions under the present income tax system would be denied such deductions under the new law. Robert Hall and Alan Rabushka, whose book has been used to model Representative Armey's flat tax proposal, suggest softening the blow to current home owners by allowing them to deduct 90% of the interest paid on existing mortgages.[4] While improving the cash flow of current home owners, it would not materially change the outlook for housing prices. The price a prospective buyer would be willing to pay would still reflect the fact that they would not be granted any mortgage deductibility.

Revenue Neutral Flat Taxes
Major proponents of replacing the income tax with a new tax system, such as Senator Pete Dominici of New Mexico, have stressed the importance of maintaining the same level of federal revenues. However, some flat tax proposals, such as Representative Armey's proposal, do not meet the goal of revenue-neutrality at the proposed tax rate and standard deduction. The Treasury estimates that a revenue-neutral flat tax would need to raise $178 billion more than would the Armey proposal. This requires an increase in the tax rate from 17 percent to 22.6 percent or a decrease in the proposed standard deduction of about 87 percent (or some combination of both).

For any flat tax proposal, increasing the tax rate or decreasing the standard deduction would reduce its attractiveness. While Representative Armey claims that he would achieve *deficit* neutrality by spending cuts, this is a separate issue and could be achieved under the current tax system (allowing rates to be decreased) by a more disciplined Congress.

Negative Impacts On The Real Estate Sector
Under any flat or consumption-based tax system, expenses incurred in raising debt capital (e.g., mortgage or construction loan interest) are not deductible. Thus, debt-financed activities are discouraged. Since real estate activities are generally highly-leveraged, they tend to suffer under a flat tax system relative to current law.

Flat tax proponents claim the lost deduction would be made up through declining interest rates. According to Hall and Rabushka, exempting interest from taxation will bring about lower interest rates. Lower interest rates reduce monthly mortgage payments, which offset the loss of the mortgage interest deduction for most taxpayers.[5] However, for the lost deduction to be made up through declining interest rates, rates would have to fall by about two to three percentage points. Given the spread between taxable and tax-exempt yields of similar risk bonds, a large decline in the interest rate does not seem likely. In 1994, the interest rate on 10-year U.S. government bonds averaged 7.08 percent, while tax-exempt bonds yielded about one percentage point lower. For example, the Bond Buyer index of municipal general obligation bonds was 6.19 percent. Perhaps a one percentage point decline in interest rates seems plausible, but this will not be enough to offset the loss of the mortgage interest deduction. As a result, housing affordability will decline.

The Impact Of A Flat Tax On Home Prices
The total cost associated with owning an asset is imputed into the purchase price of the asset. For example, the price of property in a county with high property taxes will be lower than for a similar property in a county with lower taxes. Thus, higher costs of owning a home are associated with lower purchase prices. Since income tax deductions for mortgage interest and property taxes have long been a part of the income tax system, home owners

expect and depend on these deductions to afford their homes. A flat tax that eliminates the mortgage interest and property tax deductions would increase the cost of owning a home and therefore, depress home prices.

According to the Congressional Budget Office (CBO) and based on calculations from the Joint Committee on Taxation, eliminating the deductibility of mortgage interest would raise the taxes of about 28 million home owners by an average of $2,100 in 1996 and raise revenues by about $313 billion between 1996-2000. The CBO argues that eliminating the mortgage interest deduction would increase net mortgage payments sharply for current home owners, making it impossible for some to meet their monthly mortgage payments. It would also cause the value of homes to fall and would hurt home builders.[6]

TABLE 2

Tax Savings From Mortgage Interest Deductions

Tax Bracket	Before-Tax Payments	After-Tax Payments	Present Value of Tax Savings
15.0%	$ 9,118	$ 7,862	$ 15,372
20.0%	$ 9,118	$ 7,444	$ 20,496
25.0%	$ 9,118	$ 7,025	$ 25,620
30.0%	$ 9,118	$ 6,607	$ 30,744
39.5%	$ 9,118	$ 5,803	$ 40,582

Assumptions: Home price of $109,800, 10% down payment, 30-year fixed-rate mortgage at 8.5%, 2 points, the discount rate used to calculate the net present value is 5%.

The impact of eliminating the mortgage interest deduction would hit home owners differently, depending upon their income tax brackets, as shown in Table 2. For a typical example, assume that an individual purchases a 1994 median-priced home for $109,800. Under current law, a home buyer in the 20% tax bracket (federal and state) can expect a tax savings equal to 20% of all the interest on the loan. During the first year after purchase, before-tax principal and interest will be $9,118. The mortgage interest deduction will lower the after-tax principal and interest by $1,524. The net present value of this deduction, throughout the life of the loan, is equal to $20,496. If the mortgage interest deduction is eliminated, the tax savings disappear. As a result, home prices would be forced downward. In this example, the home owner would suffer a net present value loss of about 18.7% of the home price ($20,496/$109,800). The effects of a flat tax on home price could be even greater if the property tax is repealed as well.

Cumulatively, household wealth would be significantly reduced. Even though some home owners may pay less in income taxes under the flat tax, it would take years of low tax rates to recover the loss in the value of their homes.

If a flat tax bill is enacted, it is uncertain whether taxpayers will be able to count on future tax rates being as low as the rate initially set in the bill. But a look back gives cause for concern. In the Tax Reform Act of 1986, numerous deductions and credits were eliminated in return for lower income tax brackets. Since then the number of tax brackets has increased from two to five, the top tax rate has increased sharply from 28% to 39.6% and the number of deductions has continued to be limited.

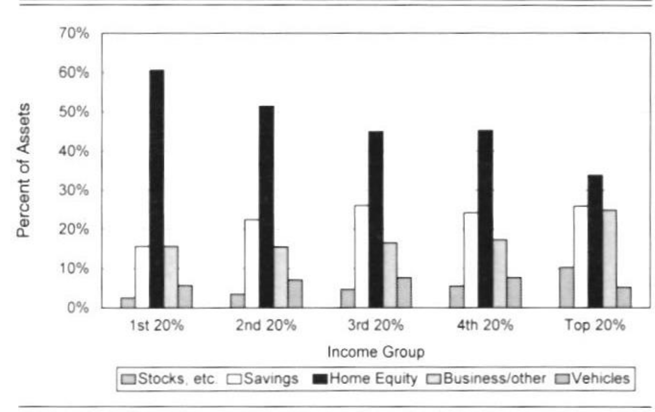
The Impact Of A Flat Tax On Property Taxes
Reductions in house values would reduce the property tax revenues of local governments proportionally. For example, a 10% decline in housing values could reduce the tax base by up to 10% and, unless property tax rates are adjusted, local revenues would also decline. A revenue loss of this magnitude would strain local government budgets. Spending on education, the primary use of local property tax revenues, would be particularly hard hit.

The Impact Of A Flat Tax On Housing Construction
The decrease in housing demand as the after-tax cost of home ownership rises would also adversely impact the construction of new homes. This would lead to a loss of employment in the construction industry. Consequently, a flat tax could lead to a downturn in the construction industry.

The Impact Of A Flat Tax On Net Worth
Home equity is the largest single asset for every income group, but more so for lower-income home owners (see Figure 1). It is also the largest single

FIGURE 1

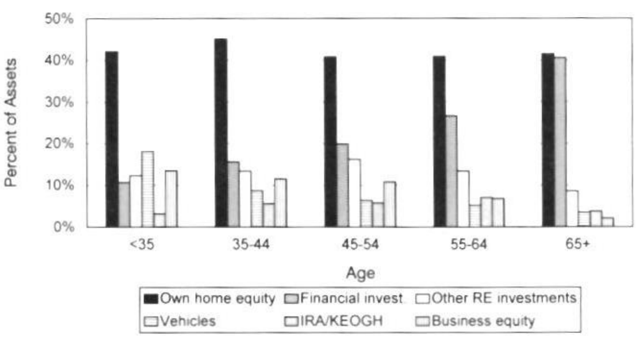
Distribution Of Assets By Income Group



Source: U.S. Department of Commerce, Bureau of the Census, "Household Wealth and Asset Ownership, 1991", Current Population Reports P70-34.

FIGURE 2

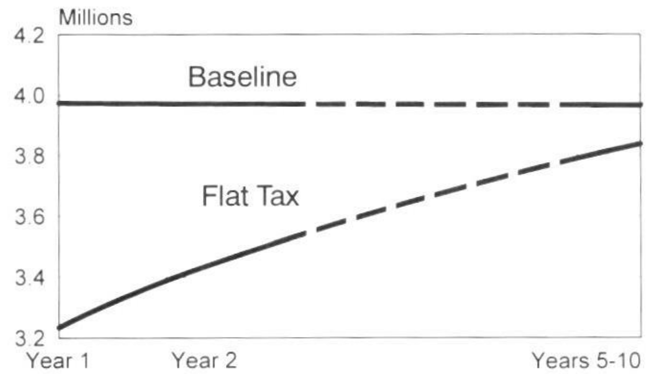
Distribution Of Net Worth By Asset Type And Age



Source: U.S. Department of Commerce, Bureau of the Census, "Household Wealth and Asset Ownership, 1991", Current Population Reports P70-34.

FIGURE 4

Existing Single-Family Home Sales



Source: DMI/McGraw-Hill.

asset for every age group (see Figure 2). Repealing the mortgage interest deduction and the property tax deduction would reduce the value of homes and depress the value of the most important asset for home owners. This would have a tremendous impact on the value of household net worth (household assets minus household liabilities).

The most comprehensive analysis of Representative Armey's flat tax proposal is one conducted by DRI/McGraw Hill Inc. For a relevant comparison with the current tax system, the study uses a tax rate of about 21 percent to maintain revenue neutrality. The results of the study suggest that the impact of such a tax on residential real estate would be immediate and enormous. In the first year of a flat-tax regime, starts of new homes and sales of existing single-family homes would be significantly lower than under the current law (see Figures 3 and 4). After a second year of flat taxes, the average price of single-family homes sold would be 15% lower, a depressed level which would remain well into the next decade (see Figure 5).

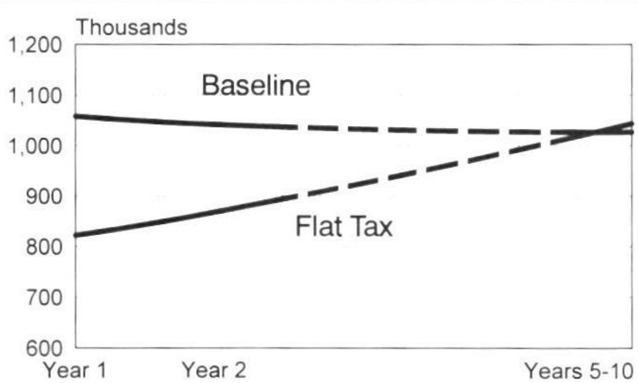
The Impact On Commercial Real Estate

The flat tax proposals also alter the tax treatment of commercial real estate—no deduction for interest paid, no deduction for property taxes paid, and the full purchase price is deducted on acquisition, with an allowance for carrying forward any unused deductions. However, no depreciation deductions are allowed and the full sales price is taxable on sale after operating expenses and the remaining tax carryforward have been deducted from the sale price.

As with residential real estate, neither interest nor tax expenses are deductible. Thus, all investors would experience an increase in carrying costs and, with no deduction for taxes paid, double taxation would exist.

FIGURE 3

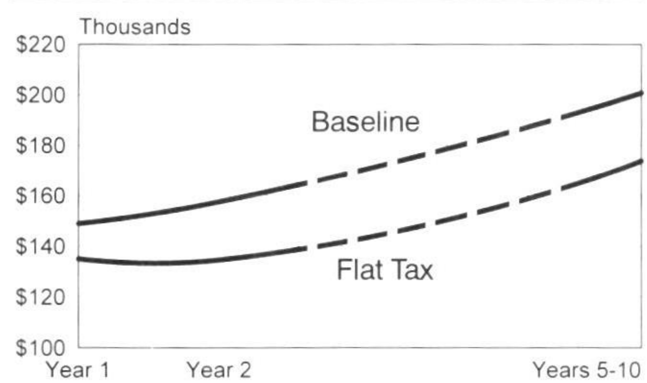
Housing Starts



Source: DRI/McGraw-Hill.

FIGURE 5

Average Price Of Existing Single-Family Homes Sold



Source: DRI/McGraw-Hill.

Additionally, for all its claims to neutrality, the Armey flat tax introduces distortions among forms of investment. Under the flat tax, capital gains on financial assets (e.g., stock, bonds, derivatives) escape the tax base. By contrast, the full amount of any real estate gains would be subject to tax at the maximum rate of the tax regime. Moreover, the taxable amount of gain would be the full sales price less tax carryforward and operating expenses. Using the sales proceeds as the measure of the gain would have the same effect as requiring full ordinary income recapture under the current system.

Flat tax proponents argue that capital gains from financial assets arise from the increased earnings of the corporation, and thus reflect a gain in value that already has been once-taxed before a sale. To avoid double taxation, such gains from the sale are not a taxable event. But many real estate practitioners believe that capital gains on real property stem from increasing rents that also would be taxed once before the sale of the property.

This approach to the taxation of capital gains destroys the level playing field of current law. At present, income-producing properties generally qualify for capital gains treatment. These flat tax proposals put real estate at an immediate disadvantage compared to financial assets, because they fail to recognize the unique qualities of real estate. Thus, real estate could be made a less liquid investment, especially when compared with cash equivalents or financial assets.

The next section analyzes the impact of the flat tax on a hypothetical office building. It describes how the flat tax will have a negative impact on the cash flow and the internal rate of return of a typical real estate investment project.

Project Analysis

The flat tax represents a radical departure from how tax liability currently is calculated. Under the flat tax, taxable income is calculated by subtracting operating expenses from project income. Unlike the current tax system, items such as mortgage interest and depreciation would not be deducted from project income to determine tax liability. Consequently, the amount of income subject to taxation will increase substantially.

Perhaps the largest difference between the two tax systems is that the flat tax would allow 100% of the purchase price to be expensed against the income of a project during the year of purchase. This creates a large operating loss for the year the project is purchased. The operating loss is then multiplied by the flat tax rate of 21%, the same rate used in the DRI study to calculate the loss carry over. The loss carry over is escalated at 6% annually and is credited against income tax liability.

Since income from the sale of the property is treated as ordinary income, it creates a spike in the project's income upon the sale of an asset. After operating expenses have been deducted from income, the operating income is taxed at 21%. The tax carryforward will offset operating income for a period of years. However, under the flat tax, tax liability at sale is higher than under current tax code.

For example, a hypothetical $10 million office building is analyzed here to compare the tax liability under the existing tax code and the flat tax. The income, expense and building size assumptions utilized in the analysis are from published secondary sources. (A detailed spreadsheet of the project is available upon request.)

The total tax liability for the office building is $2,086,425 under the flat tax, versus $1,400,741 under the current tax code. Despite the lower tax rate of 21% under the flat tax, compared to 39.8 percent under the current tax code, the overall tax liability under the flat tax is higher.

The larger tax liability under the flat tax has a direct impact on the internal rate of return (the overall rate of return received on the funds invested in a project). The internal rate of return for the sample project was 9.1% under the flat tax and 10.5% under the current tax code. The results of the analysis shown indicate that the flat tax could have a negative impact on a typical real estate investment project. The internal rate of return is depressed because of the large tax payment required when a project is sold.

Figure 6 compares the after-tax cash flows of the office project under the flat tax and under the current tax code. Figure 7 shows the difference between the after-tax cash flows. After-tax cash flow

FIGURE 6

Comparison Of Flat Tax And Current Tax Code

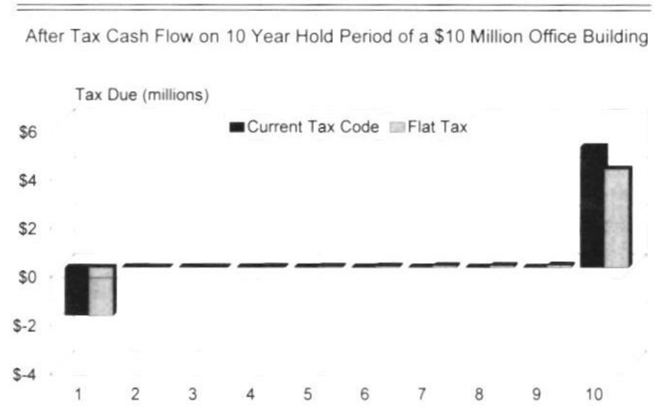
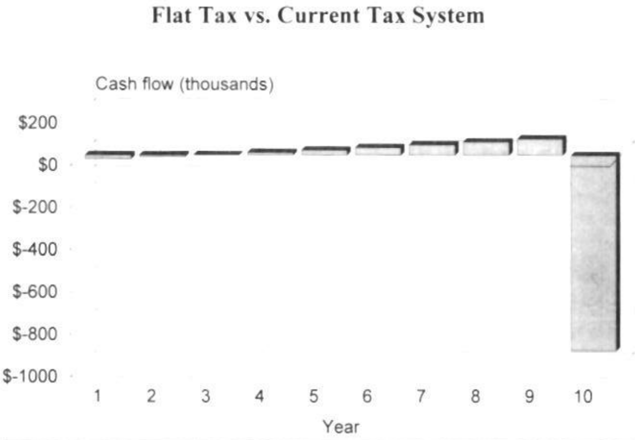


FIGURE 7

After Tax Cash Flow Differential



Note: Based on a 10 year hold of a $10 million office building

under the current tax system is greater than under the flat tax. The large negative cash flow in year one of both scenarios reflects the $2 million equity contribution. After the first year, the after-tax cash flow remains positive under the current tax code. Because all taxes are paid when the project is sold under the flat tax, the yearly cash flow is higher than the current tax code. However, taxes due at the sale of the project, $2.1 million for the flat tax, versus $1.1 million for current law, far outweigh the higher yearly cash flows.

Overall, the flat tax will have a detrimental impact on investment real estate for two reasons. First, the total amount of taxes paid would be higher than under the current tax code, despite a lower tax rate. Second, the flat tax will backload the tax liability of a project. This creates a problem similar to what exists today with high capital gains taxes. Owners tend to hold on to investment real estate longer because of potential difficulties in paying the taxes when the project is sold. This is especially true for owners who have refinanced their projects and have already expended their equity positions. The high taxes paid upon the sale of the project will deter the transfer of properties and will inhibit the efficient transfer of capital.

The Treatment Of Self-Employment Income

Despite claims of simplifying the tax process, flat tax proposals also could complicate the filings of many real estate practitioners, chiefly through their separation of baskets of income—one for individual income, consisting of salary, pension distributions and wages, and one for business income, such as commissions and rents. Moreover, the flat tax proposals are not clear or are silent on a number of issues, such as deductions for rental losses from income and mortgage revenue bond purchases which are crucial to the real estate industry.

Conclusions

A flat tax claims some benefits; however, it would hurt many taxpayers who have relied on long-standing tax policy. Owner-occupied housing is the biggest investment made by most Americans. It encourages neighborhood maintenance and socially responsible behavior. Damaging home ownership, indeed, all forms of real estate, is too high a price to pay for tax reform.

NOTES

1. On March 2, 1995, Senator Arlen Specter introduced S. 488. On January 4, 1995, Congressman Philip Crane introduced H.R. 214, "The Tithe Tax," in the House of Representatives. On June 16, 1994, Congressman Richard Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." In the 103rd Congress, on January 26, 1993, Senator Jesse Helms introduced S. 188, "The Tithe Tax." Each of these bills may be generally described as flat taxes.
2. U.S. Treasury Department, Office of Tax Analysis, "A Preliminary Analysis of a Flat Rate Consumption Tax", 1995.
3. Feldstein, Martin, "Compensation in Tax Reform," *National Tax Journal, Vol. XXIX, No. 2,* June 1976, p.123.
4. Hall, Robert E. and Alvin Rabushka, "The Flat Tax", Hoover Institution Press, Stanford University, CA, Second Edition, 1995.
5. *Reducing the Deficit: Spending and Revenue Options*: Congressional Budget Office, February 1995, p. 343.
6. Hall, Robert E. and Alvin Rabushka, *op. cit.*, p. 110.

DOES CHINA MEET THE PRECONDITIONS FOR LONG TERM INVESTMENT IN REAL ESTATE?

by Bowen H. "Buzz" McCoy, CRE

As part of an Urban Land Institute study tour to China last spring, we visited three cities: Beijing, Xiamen and Shanghai. This article summarizes the long term investment prospects for China at the present time, with special emphasis on political, economic and social factors, as well as an examination of market conditions. The data gleaned in this article from the study tour will prepare us to become "China Watchers" in preparation for The Counselors' 1997 High Level Conference, "China Revisited."

The study tour program was developed by S. L. Chen, a U. S. citizen who was born in China. Mr. Chen has devoted his career to investment banking and management consulting involving China. He pioneered secondary trading in China government debt, and he helped to re-open the Shanghai Stock Exchange. In the interests of full disclosure, the author wishes to acknowledge that one of his daughters is happily married to one of Mr. S. L. Chen's sons.

The choice of Beijing and Shanghai as destinations was obvious; they are the Washington D. C. and New York City of China. We also wished to visit a second tier city which was benefiting from strong development and was less dependent upon the central government. Xiamen (formerly Amoy) fit the bill. Not only is it located in south China (a long way from the central government), but it is the mainland deep water port nearest to Taiwan, and it would benefit spectacularly if any rapprochement occurred. Other interesting information on Xiamen: the islands of Quemoy and Matsu lie offshore, and it is a city where Mr. Chen is quite active as an entrepreneur.

Preconditions For Long Term Investment

Here is a short list of preconditions for long term investment in any emerging market country. We are studying real estate investment in particular, but these conditions might apply to any form of long term investment. These pre-conditions are being evaluated here against political, economic and social criteria prior to drawing a conclusion. I am indebted to fellow CRE Christopher Jonas for sharing some of these criteria at the High Level Conference in Scotland.

(1) There is a general perception of confidence about where the country is headed. No major conditions must be set. No major hurdles need be overcome.

Bowen H. "Buzz" McCoy, CRE, is an officer of The Counselors of Real Estate and has chaired three High Level Conferences. He is also a trustee of the Urban Land Institute and a recent chairman of the ULI International Council. McCoy owns and operates a real estate and business counseling practice in Los Angeles.

(2) There is a broad diversity of investors who are interested. We will not be out on a limb.

(3) There is an ability to value investment returns which is generally understood, professionally supported and linked to the local currency.

(4) There is the prospect of a secondary market. There is a pre-existing exit strategy—a way out.

(5) There is a professional data base readily available providing comparable rents, costs, sales prices and the like. (Query: Does such a data base exist for real estate in the U. S.?)

(6) There is the ability to repatriate rents, dividends or sale proceeds.

(7) The local currency is convertible externally. There is a free currency market, as well as ability to hedge the local currency.

(8) There are systems in place to manage the investment.

(9) There is a regulatory system in effect to regulate the marketplace from malpractice and corruption.

(10) There is a rule of law and an established process to resolve conflicts between international investors and local partners: the decisions of international arbitration agencies are enforceable in the local court system.

(11) Investment returns include a risk premium which will adequately compensate for all the risk. Investments in the emerging market will clearly outperform investments at home.

For many readers, the answers to these queries may be apparent without reading further. If all these conditions were met, China would be a mature market. This article attempts to utilize the following analysis as a means of conveying some of my impressions from the study trip. In the conclusion, I will attempt to indicate an investment strategy which might work at the present time in an emerging market nation such as China.

Political Conditions

For those of us in the West who are trained to think linearly—or since the computer age, binarily—the yin and the yang of the Orient, which is very much a reality, makes assessment truly puzzling. Commentators on China have come up with wildly optimistic as well as wildly pessimistic predictions for the evolution of the political system which must replace the current aged leadership.

A threshold query might be: "Who is Deng?" Deng is the ruler of China. Is he head of state? No. Is he head of the Communist Party? No. Is he generalissimo of the Peoples' Liberation Army? No. The only title the *Los Angeles Times* could come up with for Deng, is chairman of the All China Bridge Association (presumably contract and not structural). Identifying future leadership is a problem inherent for prospective "China Watchers."

A more optimistic scenario might call for gradual change from the top. A continuation of Dengs' "to get rich is glorious" policy has provided a vision and a relative stability since its promulgation in 1979. This has been one of the most stable political eras in China during the past 150 years. Certain economic zones and certain cities have enjoyed exponential growth and resulting wealth as foreign capital has poured in.

Economists insist that the only persistent underpinning for a free political system is an open and free market system. Sectors of China have headed this way for the past 15 years with the support and even the participation of the senior party leadership. Yet many commentators observe that China today is a system in which authoritarianism has fragmented. There are both vertical and horizontal bureaucracies, with huge power vacuums everywhere. Dissent is crushed, yet the taxes are not collected. It is a structure which is elaborate, but institutionally weak. Governance is personalized. It is a rule of men and not of laws. It is a government of relationship, bribery and corruption. The nation state is in a twilight zone, moving out of authoritarianism into some form of market socialism. The ideological vacuum at the core leads to individual bargaining instead of rule under law. Regulations are constantly changing, and they are seldom promulgated, giving great power to the bureaucrats who have a copy of the law.

Local municipalities compete with Beijing for foreign capital. Individual state ministries compete for foreign capital. There is chaos in central planning, fragmentation, regionalism and wanton regulatory change. At the center is a cadre of old, weak leaders. There is no charismatic leader or an agreed upon vision. What set of established institutionalized values will govern irregardless if the current movement toward individual entrepreneurship persists or goes the way of the Cultural Revolution or the Great Leap Forward?

The optimistic theory of slow democratization from within flounders on the realities of having the will to re-engage tens of millions of workers in new jobs, reforming state ministries and industries, providing a long term vision to comfort the populace during the accompanying individual economic hardship and democratizing the institutions without losing control. Other scenarios would include a Sun Yat Sen-type of emerging charismatic leader from outside the present structure who would provide the will to manage change and the vision to comfort the populace during the hardship which will certainly accompany it. This, too, is one of the more optimistic turn of events. Less optimistic would be a military coup, a break up of China into super-regions, a fall back to the old war lord society and the like.

The author has no basis for guessing at the political outcome. The military could certainly play a key role. Just who are the Peoples Liberation Army (PLA) prepared to shoot? The people? There was some ambivalence in 1989, and there would probably be a great deal more today. Even the military is engaged in the economic boom. The PLA owns a few super high rise multi-use structures. A new form of neo-fascism? This is not as strange as it sounds. In Bhutan, the army has a monopoly concession to brew and sell malt whiskey to supplement its pension plan. The odds are there will be an authoritarian government in China with accompanying human rights abuses, conscripted labor, lack of freedom to travel internally and the like for as long as any prudent investor cares to project.

From this brief and superficial analysis, we can comfortably conclude that pre-condition #1 is not met. There is not an unconditional premise of political stability. Moreover, there is no clear rule of law, protection against corruption, regulation against malfeasance, nor a process that is enforceable in the local court system for resolving disputes with local partners.

Economic Conditions

Buying Power
Deng predicted that national wealth would quadruple between 1979 and 2000. His goal will be exceeded. Foreign investment has poured in, and many Chinese have escaped from their own economy into the world economy. There is a sense of unreality. State cadre workers make about $30 U. S. per month. They pay $1 per month as rent for a small apartment in a seven story walk up which, although quite new, has the appearance of the South Bronx. Such an individual has a bicycle, a TV, an electric fan and a small refrigerator. The cooking facilities are one or two gas burners. There is no bath tub or shower stall. They probably eat two or three meals a day at the state enterprise. Both family members work, and their single child is cared for by a grandparent or through schooling and child care. They save 40 percent of their income. There are virtually no private automobiles, cellular telephones and the like. These luxury items come as prerequisites for higher officials in state ministries or industries.

Yet there is also a veneer of much greater wealth. Some of it comes as remittances from overseas Chinese relatives. Some of it comes from true entrepreneurship in this boiling economy. Some of it comes from corruption. As the highly regulated local economy runs into the world economy, inflation runs rampant. Official inflation at present is 15 percent. Unofficially it is said to be 20 percent per annum, but it has been as high as 40-50 percent per annum. The state controlled central bank runs the economy with rigidity, on a stop/go basis, turning on and off the credit lines to the local banking system. At present the economy is in a stop phase, due to excessive real estate speculation, and it is virtually impossible to borrow for working capital in the local Chinese currency.

Employment
China's employment in agriculture is about 73 percent, as compared to 5 percent as the Organization for Economic Cooperation and Development (OECD) average. If China were to mechanize its farms, there would be an under employment problem for hundreds of millions of individuals. Yet, at present, it is problematic whether China will be self-sufficient in grain. There are said to be 100 million persons unemployed at present in the countryside and 10 million unemployed in the cities. Each major city has pass points, preventing those in the countryside from coming in. Yet there are said to be a couple of million floating countryside people in both Beijing and Shanghai. They are invisible as otherwise they would be arrested on the street. It is said that state industry has 100 million employed, of which at least 25 million are not needed in their jobs. Thus, the unemployment potential for China is huge, and any restructuring of agriculture and industry will present very serious political problems.

Currency/Capital
The local currency is not convertible. Tourists can purchase RMB (local currency) at about 8:1 to the U.S. dollar. Estimates of the real market, if the RMB were fully convertible, range from 12:1 to 15:1. Thus, a free float would produce a situation far more serious than the one currently being suffered by Mexico.

There is a serious shortage of investment capital, even though China enjoyed the largest foreign investment inflows of any nation in 1994. Last year $30 billion of capital flowed into China. About two-thirds of the capital inflows were Chinese (25 percent Hong Kong Chinese and 40 percent overseas Chinese). This amounted to about one-third of the world's foreign investment last year. As was very visible on the study tour, about two-thirds of the foreign investment went into real estate. This year foreign investment is estimated to drop one-third to $20 billion, partly as a result of overbuilding as well as the Bank of China crackdown on speculative building. Yet, at the same time, China's infrastructure is primitive. China has huge needs for roads, railways, airports, power plants and port facilities. Much of the existing infrastructure is poorly constructed.

It has been suggested that Hong Kong will be kept as a market to the world by the Chinese for 50 years following 1997. It has also been suggested that the reason for this is the value of having the Hong Kong dollar as a currency. Further, it has been suggested that without the Bank of China having the resources to support it, the world currency dealers could overnight destroy the Hong Kong dollar.

Thus, the momentous problems facing the Chinese are unemployment and inflation. The following section will discuss in more detail the will required to sustain the populace through any economic transition. In terms of the preconditions for long term foreign investment, we may now check off, negatively, returns linked to local currencies, repatriation of investment returns and currency convertibility.

Social Conditions

Demographics

An incredible strength of China is the homogeneity of its populace. Of the 1.2 billion population, 92 percent are of Han ethnicity and share a 2,000 year history. Individuals living in the city are much better off than they were in 1979. There appears to be an energy and an optimism about the people. Having made five trips to China since 1984, this author is now more impressed by the disappearance of Mao uniforms, the color and ebullience of the street life, the local entrepreneurship and the bustle of the retail stores. However, great challenges lie ahead.

Company Restructuring

One challenge is the 25 million workers who must be restructured from state industry. A woman we had lunch with talked of her father. He works in the Ministry of Mines where he does nothing all day but read the newspaper. When he comes home, he does all the shopping, cleaning and washing, because her mother is working overtime for a foreign manufacturing company. Recently in the U.S., companies such as Sears, General Motors, Du Pont, AT&T, IBM and others have restructured hundreds of thousands of jobs. Eliminating layers of management have resulted in sharply improved competitive ability and profitability. This occurred in a market economy, where it required a decade of needling by stock and bond analysts, leveraged buy out attackers and Japanese competitors to overcome the inertia and get the job done.

I submit it is not possible for us to understand what it will take for the Chinese bureaucrats to do the same. For those of us who have spent our entire lives enjoying and applauding a free market economy, we have no sense of the mind-set of those who have risen to positions of wealth and influence by disdaining such a system. How can individuals who have lived their lives in such a different system be expected to have the will to face political instability by firing one in four individuals and emulating our system?

Family Life

Yet another challenge is the policy of one child per family which has led to unprecedented abortion and infanticide of female children. The United Nations reports that the normal ratio of girl babies to boy babies is 115:100. In China it is 49:51. The demographic impact of this massive social "experiment" is also difficult to comprehend.

As Chinese families move from the closed society of the Cultural Revolution to the global marketplace in a single bound, they are free to pluck whatever they wish from the consumerism shelf of the world without going through the 100 years of the industrial revolution that the West experienced. Preliminary Gallop Polls in China indicate strong preferences for color TVs, washing machines and VCRs. The automobile is a luxury, owned only by the state ministries, but within a decade or two aspirations will no doubt reach this level as well. In major cities such as Beijing and Shanghai, literally hundreds of high rise structures are being built with minimal parking. When China turns away from the bicycle to the automobile, all these structures will be isolated from the then preferred means of transport. Imagine also a nation of hundreds of millions of student drivers.

The key descriptive word in China today is change. Of course, China's social policies have embodied change throughout its history. I wonder how seriously the average citizen might take this sudden veer toward capitalism. Even with all the economic freedom, virtually every citizen is still the subject of a dossier which remains with them all their lives. They are not privy to the content until they require something of the central government or try to leave the country.

Revolving Door In And Out Of China

A major choice for Chinese of influence today is to get rich or to help their people. Getting rich seems to be the current preference. We were told that all the rich and powerful Chinese want to get their children out of China and into a Western university. Ironically, at the same time, the overseas Chinese are stumbling all over themselves to get back inside China. Hence, $20 billion of overseas Chinese investment came back into the country last year.

Market Conditions

Office markets in Beijing and Shanghai are extraordinarily tight at present, with thousands of foreign firms seeking world class office space where there is limited supply. Rentals are among the highest in the world, or as much as $100 a square foot per year. At present there are approximately 100 high rise, mixed use projects under construction in Beijing and almost 400 in Shanghai. In Shanghai, there will be about 40 million square feet of office space added in the next three to four years. Otis sold as many elevators in China in a month last year as they sold in the U.S. the entire year. Thus, there is classic overbuilding 1980s style against an imponderable market demand and office rentals will plummet to levels we cannot now predict; but they will go to at least one-third of their present level. As noted, the overbuilding is fueled by overseas Chinese money, international banking funds and competing Chinese ministries. Likewise luxury style villas renting for $200,000 a year or selling for $500,000 and up are vastly overbuilt. They are a target of the Bank of China's credit restraint. In all the cities visited, we viewed half completed hulks of such property. There appears to be at least 10 retail mega-projects under construction or being planned in Beijing, including the infamous Li Kha Shing/McDonalds site. Some of them are several city blocks in size. All are bicycle or street accessed. One has to wonder if the overseas remittances, the foreign travelers and the corruption payments will provide sufficient buying power to support these ventures.

The McDonalds site is a classic example of regulatory anarchy. All the land in the country is owned by the government. Most of it is granted land, which can be conveyed by the government. The rest is allocated land which has been granted by the government to a state agency. In most cases, the agency itself cannot reconvey the land without government approval. McDonalds was on allocated land, and either did not know it or did nothing about it. Thus, the government felt justified in taking the land away from McDonalds and giving it to Li Kha Shing. What other arrangements may have been made, the author knoweth not.

There is a tremendous market for lower class housing, running into the billions of square feet. The market for such housing today is the state ministries or businesses which purchase such structures and then rent them to employees at a highly subsidized rate. This market is not quality or amenity conscious. One wonders how many U.S. developers would like to be pictured on the cover of their local Sunday supplement in front of their newly developed, South Bronx style seven story walk-up. There is also a good market for industrial property and for all types of infrastructure.

The best market for a Western investor is a build-to-suit office or industrial property for a Western tenant who will pay rent in a hard currency and possibly put a year or two of rental payments up front as construction finance. These deals have been done, but the current overbuilding would seem to take away this market opportunity.

Construction costs come close to Western standards for high rise buildings once all the indirect costs are figured in. A job requiring six architects in the U.S. may require 30 in Hong Kong and 300 in China. In some cases workers appear to be dragooned off the farms, and they live in the building during the construction cycle. They have to be trained in all aspects of city life. Construction finishes are sub-standard by Western expectations.

Examples Of Manufacturing And Market Successes In China

In a huge industrial tract outside Beijing, we visited the Motorola operation. They have doubled their original capacity in an attempt to keep up with the burgeoning market in China for cellular telephones. These sell for about $3,000 a copy, or 10 months' wages. They cannot keep up with the market which is mainly state enterprises and wealthy individuals. Of most import, Motorola has established programs to train and house their employees. A long term Chinese employee of Motorola will own his own home. Training standards are the same as in any Western country where Motorola operates; likewise, for the Holiday Inns visited in Xiamen. They now have 54 hotels in China. Holiday Inns run a training university in Beijing, and they also continually train their staff onsite at each property. They opened in Xiamen with 44 middle managers, all ex-patriots.

Three years out, 75 percent of those jobs have been filled with local Chinese they have trained. If China makes the transition from within, it will be in large part due to the good work of Western companies making the kind of effort required to bring their employees as stakeholders into the market economy. It cannot be determined from this analysis if the preconditions for data base information and local management systems have been met. There are a large number of market participants, so you will not be alone; but it sure helps to be Chinese.

Land Investment

As already noted, one must be very careful about land transferability. Information is hard to come by, and locals will often give assurances which may be true. The rule by man rather than by law makes legal certainty extremely difficult. Capital gains taxes may be levied ex post facto, if your speculative profits seem too high. A good hedge is to have a local partner. Yet, there have been cases where local partners collude with planning agencies as their proxy in negotiating what the local partner could not attain for himself.

Under current conditions of credit restraint, local finance is extremely difficult. Your project must be all equity, or it must stand up to the scrutiny of the international money and capital markets. As noted, a great deal of finance is from offshore Chinese equity or prepaid rents or purchase options in hard currency.

Construction will probably be performed by huge state owned construction companies with 50,000 or more employees and concomitant feather bedding and unskilled labor trades resulting in higher costs than one might anticipate. There will be no bidding process or critical path construction planning process.

Most foreign investors are drawn to Beijing or Shanghai. In Beijing the acute shortage of top grade office and residential space has resulted in high rental rates. In 1994, top grade office rentals were about $90 per square foot annually, and top grade residential rental rates were about $80 per square foot annually. As noted, there is a large number of office and residential projects due to be completed in 1995 and 1996, which make future rent levels problematic. Prime street level retail rents are as much as $225 per square foot annually, with some 10 million square feet of retail due to be completed within the next three years. Beijing hotel occupancies are close to 80 percent, with average room rates in the five-star hotels around $170 per night.

Shanghai is little different, with perhaps a greater oversupply coming on the market. Street level retail along Nanjing Road achieves annual rents between $130 and $250 per square foot annually. Residential property suitable for expatriate living would sell for between $150 and $300 per square foot. Presales of office space range between $180 and $350 per square foot, with about 30 million square feet coming on the market by the end of 1997.

Conclusion

It comes as no surprise that, in my opinion, most of the fundamental conditions for long term investment are not fulfilled in China at the present time. So much for intellectual analysis. Why then did China receive one-third of the world's investment dollars last year? In part because of the offshore Chinese affinity. Also, up until last year, it was still possible to receive a three year investment pay-back on most major investments. Often the pay-back was in a hard currency as well.

The fact is that early investments in emerging economies are short-term investments. Discounted cash flow analysis is not appropriate. Money must come back in two or three or four years. Returns must run at 30-40 percent a year. Until the recent spate of overbuilding and the Bank of China negative reaction to speculation, China was a great place for short term investment in real estate. Unfortunately, real estate is, by its nature, not a short term asset. Liquidity must be provided by presales of office buildings, apartments villas and the like.

There should continue to be good investment opportunities in second tier cities, particularly where a reliable Chinese partner is involved. Major U.S. pension funds may wish to place a small portion of their high risk funds into Chinese real estate. A $30 billion dollar fund might risk a couple of hundred million dollars against a 30-40 percent return.

As for me, while we were in Xiamen , S.L. Chen and I became proud grandfathers for the first time. My granddaughter's name is Katherine Yu-Ting Chen. I now have a long term investment in China, and I love it.

REAL ESTATE DEVELOPMENT AND THE TAKINGS CLAUSE: *DOLAN V. CITY OF TIGARD*

by Donald C. Guy and James E. Holloway

Real estate developers have long been required to dedicate land for public use. More recently they have been required to pay development impact fees to fund public infrastructure.[1] In June 1994, the United States Supreme Court decided the case of *Dolan v. City of Tigard*[2] which represents a shift in legal doctrine. It limits the ability of local governments to impose land dedication requirements on real estate development across the United States. This is an important case which will impact the feasibility of development and its profitability.

This article describes the facts and the Supreme Court's decision in the *Dolan* case and explains how this decision will impact real estate development. The Supreme Court in the *Dolan* case set out a new test called the rough proportionality test. It establishes a closer fit between the regulation and the problem it is designed to correct and requires government to give greater justification for the regulation. We will explain this new test and how this test may be applied in other development applications.

Impact On Real Estate Development Planning

The decision in The *Dolan* case establishes more legal and economic certainty for planning and implementing real estate development where the projected impact is either an incremental or complete change to existing public facilities (e.g., social services, schools, parks and natural resources). The decision creates some legal certainty because it requires municipalities to justify their conditional demands in the application process for development approval. The rough proportionality test affects the kinds of exactions that can be justified on findings of conditions or problems created by the development project. Also, in establishing economic certainty, the financial burdens imposed under exactions must be connected to the conditions that were created by the development and thus based on findings of site-specific or individualized determinations. The rough proportionality test affects the quality (land or fees) of exactions (the degree) that can be justified on findings of the level (nature and extent) of conditions and problems created by development project.

The *Dolan* case may also create some leverage for real estate developers in working with municipal governments to design projects that are economically sound and support local public interests. Still they cannot completely design and implement projects that lead to conditions and problems inconsistent with local public interests. The case leaves

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much uncertainty in the direction of doctrine and law which limits business regulation.

The Facts Of *Dolan v. City of Tigard*

Ms. Dolan owned a 9,700 square foot building which housed a retail electric and plumbing supply business on a 1.67 acre tract in downtown Tigard, Oregon. Ms. Dolan applied to the city for a building permit to expand the existing parking lot, to remove the existing building and to construct a new 17,600 square foot building for the electric and plumbing supply business. Under the city's comprehensive land use plan, a property owner was required to leave 15% of a parcel undeveloped for open space and landscaping requirements. Ms. Dolan's proposed commercial development is permitted under the local zoning ordinance of the CBD, but the ordinance allows the city to attach conditions through the use of an overlay zone.

The Fanno Creek Basin Floodplain

A portion of Ms. Dolan's property lies within the Fanno Creek 100-year floodplain. The city's master drainage plan recommends improvements to the Fanno Creek Basin to improve storm water runoff and reduce flooding. One recommendation of the drainage plan called for the floodplain to be preserved as a greenway. The city and landowners on the creek would share the cost of the improvements as each received benefits. The Fanno Creek 100-year floodplain is virtually unusable for commercial development. The city's comprehensive plan for the community made the floodplain a part of the city's greenway system and adopted other recommendations from the drainage plan.

Pathways

The city also had conducted a transportation study to identify traffic congestion in the Central Business District (CBD) where Ms. Dolan's retail business was located. The study recommended a pedestrian/bicycle pathway in the CBD. The city's comprehensive plan required that new developments in the CBD dedicate land for pathways.

The City Planning Commission granted her application for a building permit with the requirement that she dedicate a portion of her land lying within the 100-year floodplain for improvement of a storm water drainage system. In addition, the city's comprehensive plan required that Ms. Dolan dedicate an additional 15-foot strip of land adjacent to the floodplain as a pedestrian/bicycle pathway. The city allowed land dedicated for a floodplain easement and pedestrian/bicycle pathway "to meet the 15% open space and landscaping requirement."

Ms. Dolan objected to the conditions and asked for a variance. When the variance was denied, she challenged the conditions as a taking of private property without just compensation. The city found these restrictions to be required in the public interest and also to be valid regulations under the police power. The Oregon courts, using a "reasonably related test," affirmed the validity to impose the conditions on the development of Ms. Dolan's parcel. Ms. Dolan appealed to the United States Supreme Court alleging that the appropriate test for her case was the "substantially related" test which was more stringent than what was being applied by the Oregon courts. The Supreme Court agreed that the Oregon courts had not used the appropriate test and fashioned a new test for the required degree of connection. This new test, called the rough proportionality test, significantly changed 30 years of state law. The purpose of these state tests are explained here.

Regulatory Takings Law

During the last 70 years, the U.S. Supreme Court has been trying to deal with the problem of regulating land use without violating the Takings Clause. A major case illustrating this intent is *Pennsylvania Coal v. Mahon*.[3] In that case, the Supreme Court held that a regulation can go too far in restricting the use of the land. A regulation may impose a burden on a landowner that is comparable to the burden under eminent domain. When this situation occurs, it is a regulatory taking and the landowner must be compensated as he would under eminent domain. It is well known that state governments can regulate land under the police power in order to protect the public health, safety and welfare. In *Village of Euclid v. Ambler Realty Co.*,[4] the Supreme Court permitted zoning regulations that restricted the use of land. Earlier in *Pennsylvania Coal*, it had recognized that these use restrictions often diminish the value of the land and may impose a heavy burden on property owners. It also recognized that diminished values incidental to the regulation are not generally considered to be a taking. Later, in *Armstrong v. United States*,[5] the Supreme Court stated that the Takings Clause is "to bar government from forcing some people alone to bear public burdens which, in all fairness, should be borne by the public as a whole."

To determine when the property owner's burden is too great, the Supreme Court has developed major regulatory takings' principles which have created as much confusion as they eliminated. Fundamental principles were established in *Penn Central Transportation Co. v. City of New York*,[6] where the Supreme Court stated it will determine when a regulatory taking has occurred on a case by case analysis of each case. The Supreme Court's "ad hoc, factual inquiry" approach to determine a regulatory taking has three factors. This article discusses the first of these factors, the nature of the government action, which is the center of the controversy in the *Dolan* case.[7]

In *Agins v. City of Tiburon*,[8] the Supreme Court elaborated on the nature of the government action. The Supreme Court stated that a valid regulation must "substantially advance a legitimate state interest." In *Nollan v. California Coastal Commission*,[9] the Supreme Court further elaborated on the nature of the government action by holding that an "essential nexus" must exist between the exaction (a dedication condition) as applied to the landowner and the state interest (visual access) to be advanced. In the *Dolan* case, the Supreme Court took up where it left off in *Nollan*.

The Right To Receive Just Compensation

The Takings Clause of the Fifth Amendment states that: "nor shall private property be taken for public use, without just compensation." The Takings Clause protects property rights from the exercise of eminent domain power and from some types of regulation. There has long been significant public debate on the level of protection this clause gives to property rights.

In the *Dolan* case, however, the Supreme Court explicitly gave more protection to property rights. It noted that there was no reason to relegate the Takings Clause to the "status of a poor relation" to other amendments of the Bill of Rights, such as speech, religion and unreasonable search and seizure that are fundamental liberties.

The Supreme Court gave more protection to property rights through the Takings Clause by invoking the unconstitutional conditions doctrine. It stated that the "unconstitutional conditions doctrine," heretofore applied to fundamental rights, now protects the right to receive just compensation. In the *Dolan case*, Chief Justice Rehnquist, writing for a 5-4 majority, states that:

> government may not require a person to give up a constitutional right—here the right to receive just compensation when property is taken for public use—in exchange for a discretionary benefit conferred by government where the property sought has little or no relationship to the benefit.[10]

Stating it more generally, "government may not grant a benefit on condition that beneficiary surrender a constitutional right, even if government may withhold that benefit altogether."[11] Under this doctrine, the Takings Clause prevents government from making regulations that permit it to do what it can not do with its eminent domain power—take property without paying for it.

Ms. Dolan was given the choice between surrending her right to receive just compensation or receiving a building permit, a discretionary benefit. Ms. Dolan argued that the benefit conferred on her by the city would not justify the dedication conditions and thus, should not be considered as just compensation. In addition, she argued that the city did not identify any "special quantifiable burdens" created by the impact of the expansion of her store and that the impact of the expansion would not justify the floodplain and pathway easements which were being required of her. Lastly, she argued that her situation was not so unique that she should bear a burden not borne by the public in general. Another factor influencing the court's decision regarding Ms. Dolan's challenge was that land dedication conditions require owners to grant a deed for a portion of their land as part of an application for a building permit and thus are adjudicative decisions. It noted that these decisions are unlike legislative determinations that usually are area wide, e.g., zoning. Perhaps, the Supreme Court noted the greater opportunity for extortive behavior in adjudicative decisions.

The Dissenting View

Justice Stevens, writing in dissent, believed that the Supreme Court invoked this doctrine to invalidate land use regulations that it feels are unwise restrictions on property rights. He would find that the city and Ms. Dolan engaged in a "mutually beneficial transaction"—an exchange of a building permit for a permanent public easements—and thus the doctrine did not apply. Furthermore, the right to receive just compensation exists only if the city takes Ms. Dolan's easement. It had not done so according to the dissent and if it had, the building permit should be considered as just compensation.

Justice Stevens is also concerned about the shift in the burden of proof. The Supreme Court acknowledges, in a footnote, that the imposition of the dedication conditions was an adjudicative decision and thus, "the burden [of proof] properly rests on the city"[12] to justify the dedication conditions.

The Essential Nexus And Higher Level Of Scrutiny

Both the Oregon courts and the U. S. Supreme Court generally agreed that the essential nexus existed in the *Dolan* case. The U. S. Supreme Court noted that the city had conducted a traffic study that identified traffic congestion in the city's Central Business District (CBD). The study recommended a pedestrian/bicycle path as an alternative means of transportation in the CBD. In addition, the Supreme Court also noted that the city had established a Master Drainage Plan based upon a study of Fanno Creek. That plan indicated that urbanization and natural conditions along Fanno Creek caused an increase in flooding. The plan recommended, among other things, that the city preserve the floodplain as part of its greenway system and prohibit building in the floodplain. The city adopted the recommendations of both the traffic and drainage studies. The Supreme Court concluded that the prevention of flooding and the reduction of traffic congestion were legitimate public interests. Next, the Supreme Court also concluded that an essential nexus existed between the pedestrian/bicycle pathway and providing an alternative means of transportation. It also found an essential nexus between the floodplain easement and limiting development on Fanno Creek. Therefore, the pedestrian/bicycle pathway and floodplain easement further legitimate state interests.

The State Tests

In deciding whether the City Planning Commission's findings were sufficient to justify the dedication conditions, the Supreme Court recognized that state courts have been dealing with the degree of connection between exactions and the impact of the development for approximately 30 years. The state courts have developed three tests to deal with the issue: first, the excessively lax or rationally related test that gave too much deference to government; second, the reasonable relationship test that is an intermediate level of scrutiny and is applied by a majority of state courts; (It was applied in the *Dolan* case by the Oregon courts.) third, the specific and uniquely attributable test requires an exacting scrutiny or the highest level of scrutiny. It is applied in a minority of state courts.

The Supreme Court held that the appropriate federal standard was close to the reasonable relationship test. The Court referred to the reasonable relationship test as a rough proportionality. The rough proportionality test as defined by the Supreme Court states that:

> No precise mathematical calculation is required, but the city must make some sort of individual determination that the required dedication is related both in nature and extent to the impact of the proposed development.[13]

The Oregon Supreme Court had held that the commission's findings of fact demonstrated that the dedication conditions demanded by the city bore a reasonable relationship to the projected impact of the development. In applying the rough proportionality test to the same findings, the U. S. Supreme Court did not agree.

Validity Of The Floodplain Easement And The Greenway

Finding that floodplain easement of the greenway system was for recreational purposes, it concluded that the floodplain easement was entirely without the "required degree of connection" to reduce flooding on Fanno Creek. Furthermore, it noted that the city required all owners to leave 15% of the land undeveloped for open space and landscaping requirements. Because the city prohibited development in the floodplain, Ms. Dolan could use the floodplain area as part of this 15% requirement. Effectively, the city controlled much of the floodplain for purposes of reducing flooding. Additional control of the floodplain area by the city would further limit Ms. Dolan's property rights by permitting persons to walk in the floodplain area. The Supreme Court could not find where the city had ever made an individualized determination for a recreational (floodplain) easement of the greenway system that supported additional control.

The Supreme Court also found that city-controlled public access was a loss of the rights to exclude others, thus permitting the public to trample through Ms. Dolan's floodplain area. The Supreme Court had concluded in *Nollan v. California Coastal Commission* that the right to exclude others was one of the most essential rights in property. In the *Dolan* case, it concluded that Ms. Dolan was losing this right in the floodplain area. The floodplain easement as a public greenway would be opened to the public. It saw no need why Ms. Dolan should be asked to suffer a loss of the right to exclude others when the city had already taken sufficient action to prevent damage from the flooding.

Most troubling is the Supreme Court's use of the right to exclude others as the property right to protect commercial developments. In *Nollan* the Supreme Court observed that the right to exclude others was an essential property right in the private use of land. In the *Dolan* case, the court extends that concept to property in commercial use.

The Pedestrian/Bicycle Pathway

Next, the Supreme Court turned to the pedestrian/bicycle pathway. It left little or no doubt that the pathway lacked a rough proportionality to the city's need to reduce traffic congestion caused by the impact of Ms. Dolan's development. The city's findings of fact that an increase in vehicular traffic "could" be offset by the pathway did not establish a rough proportionality where individual determination is required. The finding of an increase in vehicular traffic did not demonstrate, according to the Supreme Court, that the public (employees and customers) using Ms. Dolan's new retail store would use the pathway.

Under its rough proportionality, the Supreme Court wanted to see a direct, quantifiable connection to demonstrate that the pathway dedication "will, or is likely to" offset an increase in vehicular traffic in the CBD. Just saying it could occur, because more traffic is anticipated from the expansion of the retail store, is constitutionally insufficient to justify a dedication condition for a pedestrian/bicycle pathway. In sum, the rough proportionality means that "degree of exactions" (benefits gained by the city) must be a direct, closer fit to the problems and harm resulting from the impact of a proposed development.

Implications Of The *Dolan* Case For Land Use Regulation

The *Dolan* case deals with an on-site dedication condition for land. In this case, the Supreme Court did not say whether the rough proportionality test should be broadly applied to other development impact exactions: (1) fees in lieu of dedication conditions, (2) impact fees for improving public facilities and (3) linkage fees for social welfare programs. Under the rough proportionality test, conditional demands that are based on municipal findings could be subject to a higher level of scrutiny. Some conditional demands address needs and conditions off-site and thus provide benefits to the general public of the municipality. In many instances, these demands have been held to be valid under some federal and state tests that applied the Takings Clause of the Federal Constitution. These tests were overruled or thoroughly undermined by the *Dolan* case. Thus, the newly fashioned rough proportionality test will now be applied to off-site exactions and their validity is not clear.[14]

Real estate development planners should expect land use planners, environmental managers and natural resource conservationists to collect more quantifiable findings, where appropriate, to justify conditional demands. The impact of developments and other land use changes are not all the same. Some projects have incremental effects, such as the small site improvements. However, a series of these small projects, such as renovations of retail businesses on one street, could have a large cumulative impact. Other large developments, such as malls and subdivisions, have an immediate, broader impact on public facilities and the environment. The size of the project affects the kinds and uses of studies and investigations used to collect findings for assessing the impact of development. In determining whether a rough proportionality is present, these studies and investigations now need to show a more direct, measurable connection between exactions and the projected impact that creates the conditions and problems to be corrected by exactions. Real estate developers should encourage municipal government to make more effective use of area wide studies. When municipal governments assess the impact of smaller projects, such as Ms. Dolan's renovation, they need to relate these studies directly to the specific conditions and characteristics of a smaller site so that a correct assessment is made of its incremental impact on public facilities and the environment.

Summary

The *Dolan* case represents a shift in legal doctrine with many implications, but it still leaves many unanswered legal questions regarding the scope and application of the rough proportionality test. The most significant question is whether the rough proportionality test applies to impact fees and linkage programs that are adjudicative decisions but require real estate developers to pay money directly to the government. Next, the *Dolan* case is not entirely clear on how development impact exactions that are imposed through legislative determinations will be decided under the rough proportionality test. The Supreme Court may, at this time, seek to limit adjudicative decisions that are tailored and targeted to gain certain benefits from specific developments. Finally, the rough proportionality test consists of several factors that impact its application and outcome of its application, depending on the weight assigned by federal and state courts. These factors are as follows: (1) scope of required government determinations, (2) degree of impact exactions, or (3) nature and extent of the projected impact of the development.

NOTES

1. Smith, Marlin, "From Subdivision Improvement Requirements to Community Benefit Assessment and Linkage Payments: A Brief History of Land Development Exactions," *Law and Contemporary Problems* 50 (1987):5-30.
2. *Dolan v. City of Tigard*, 854 P.2d 437 (Or. 1993), *reversed*, 114 S.Ct. 2309 (1994).
3. *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922).
4. *Village of Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926).
5. *Armstrong v. United States*, 364 U.S. 40 (1960).
6. *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978).
7. The other two factors described in the *Penn Central* case are the economic impact of the regulation and the extent of the interference with investment-backed expectations. For a more detailed analysis of taking law, see Holloway, James, and Donald Guy, "Policy Coordination and the Takings Clause: The Coordination of Natural Resource Programs Imposing Multiple Burdens on Farmers and Landowners," *Journal of Land Use and Environmental Law* 8 (1992): 175-233.
8. *Agins v. City of Tiburon*, 447 U.S. 225 (1980).
9. *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987).
10. 114 S.Ct. 2309, 2317(1994).
11. See Sullivan, Kathleen M., "Unconstitutional Conditions," *Harvard Law Review* 102(1989): 1415-1506.
12. *Id.* at 2320n.8.
13. *Id.* at 2319-20.
14. Shortly after its decision in *Dolan*, the Court vacated judgment in a California case involving impact fees, *Ehrlich v. City of Culver City*, 19 Cal.Rptr.2d 468 (1993), judgment vacated 62 U.S.L.W. 3853 (1994). This case is still in the California courts and its outcome is uncertain at this time. See Kanner, Gideon, "In California, a Land Owner Loses Again," *The Wall Street Journal*, Feb. 8, 1995, p.A15.

DOWNTOWNS EMERGING IN NEW FORMS

by James A. Cloar

A decade ago American cities were revamping their downtown skylines. Block after block of new office towers and hotels seemed to confirm that the city center was alive and well, and reasserting its place as the community's economic hub.

This was welcome validation for downtown advocates. The increasing exodus of retail shopping that began after World War II meant fewer customers on the sidewalks and in the stores, symbolizing a loss of economic and social vitality. For many, shopping was the primary link to downtown. It was an activity open to everyone.

So, when many traditional merchants began closing or scaling back their downtown locations, the popular perception was that these areas were dying. Understandably, many cities undertook a variety of heroic but too often futile efforts to reverse or at least retard the trend.

The financial outlays incurred sent most localities to the federal government for help with urban renewal programs. For many this was considered ironic since it was the combined Washington-backed interstate construction and FHA/VA housing programs that had fueled suburban growth in the first place.

Downtowns Re-emergence As The Office Hub

Though falling short of many original goals, downtown revitalization efforts seemed to finally pay off in the early 1980s. Developers responded aggressively to pent up demand for office space and hotel rooms, and with the availability of liberal financing, the city center's economic vitality seemed to be reaffirmed. Again, the federal government played a major role, primarily through Urban Development Action Grants (UDAG) and favorable tax laws.

Planners and city leaders weren't the only ones pleased with the revitalization efforts. The new buildings commanded higher leases and, in turn, prompted increased land prices. Property owners raised their expectations, each anticipating that their site was a prime location for the next new high rise.

The only bothersome issue was an occasional complaint that downtowns were becoming large office parks, dead during nights and weekends. Non commercial activities that couldn't compete for land on a cost basis had to find more affordable sites in outlying areas. The remaining retail frontages were ripe for demolition to make way for the more dense development justified by the higher land prices.

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What initially were welcomed incentives often turned out to terribly skew the normal balance between market and production. The saga of "see through buildings" which began in the suburbs, soon impacted downtown areas in a massive way.

The Outlook For The Downtown Office
Today, despite some signs of stability, lingering real estate doldrums still affect large segments of the office sector. Many cities which now boast of low vacancy rates for Class A space carry large inventories of unoccupied older buildings. The outlook is aggravated by corporate downsizing and decentralization. Trends such as telecommuting and office "hoteling" may further reduce the ratio of space required per employee.

With 70 percent preleasing requirements now the standard before new construction can be financed, the task of aggregating sufficient firm commitments from small tenants has become almost impossible for larger buildings. Thus, as the office market slowly recovers, it is doubtful that more than a handful of million square foot structures will be built in the foreseeable future. It is even more doubtful that they will be built downtown. Corporations which might be candidates for a single-tenant, build-to-suit are likely to have a large percentage of clerical or back office personnel, a situation that in most localities suggests a suburban campus-type layout.

New Roles For Downtowns
As America's cities prepare to enter the 21st century, the measures of success for downtowns are ripe for change. If, for the most part, the great retail giants have indeed abandoned the city center for good and if new office structures will be of more modest scale, a new realism must make its way into the expectations of both community leaders and ambitious property owners.

Invariably, people want their downtown or city center to be the community focal point, the hub of commerce but also of culture and entertainment. They look for it to be the seat of local government and education. They want it to contain restaurants and specialty one-of-a-kind shops. It's where they look for the opportunity to come together for great celebrations.

This article advocates that well-founded downtown development will take a different form. New office and retail structures will be built but at a more modest scale.

Those cities which are enjoying a city center resurgence—and there are a fair number of them—are emphasizing such markets as the arts, tourism, sports and entertainment. New retail ventures are frequently oriented to these directions.

Entertainment Centers
The latest trend to catch the imagination of developers and planners is entertainment centers. The entertainment complexes often feature interactive arcades, virtual reality attractions, large theme stores and multi-screen movie theaters. They build on the understanding that the appeal of the retail mall, especially for younger people, is only coincidentally for shopping. For many it is primarily a place for entertainment.

Sports
Reversing an outward movement that began in the 1950s, new sports facilities now are returning to the inner city. New basketball arenas in Orlando and Phoenix and new baseball stadiums in Cleveland and Baltimore are credited with spurring ancillary development in the surrounding downtown district. Evidence that sports venues could serve as an economic redevelopment stimulus prompted the decision in Tampa to build a new NHL arena near the downtown waterfront. Buffalo, San Jose, Denver, Charlotte, St. Louis and Washington, D.C. are among other cities where downtown sports facilities have recently opened, are under construction or are planned.

The Arts
Surprising to some, the cultural arts are reported to attract an even larger annual attendance than sports. Here, too, there is a growing recognition of the potential economic impact on a downtown. Almost immediately after relocating from a previous site almost two miles away, the Dallas Museum of Art began to thrive on the higher visibility of its new location which provides easier accessibility and proximity to downtown office workers and hotel guests.

In several cities, both new and existing museums, theaters and performance halls have joined together to form arts districts. The most successful districts are often marked by cooperative ventures among the affected institutions for efforts such as design compatibility, joint programming and marketing, common signage and banners and shared parking arrangements. Together, they form a larger presence, with the district itself becoming a destination and precursor of new restaurants, galleries and complementary retail shops. Tucson, Denver, Dallas, Cleveland and Tampa illustrate this pattern of development.

Tourism In Downtown
Tourism has emerged as an effective revitalization focus and with good reason. As noted, downtowns are becoming the home for more cultural, sports and entertainment attractions. Restored waterfronts and historic districts, normally found in or near the city center, are growing in popularity.

Tourists are a good market for downtown business hotels, and many provide favorable weekend rates. Numerous places of interest are often available within walking distance or a short ride by taxi or public transit. In turn, tourism provides an additional market for restaurants and shops otherwise dependent solely on the nine to five work force.

Baltimore, Norfolk, New Orleans and Seattle are among the cities that exhibit the economic impact of revitalized waterfronts. The Main Street program of the National Trust for Historic Preservation helped demonstrate the drawing power of restored older buildings, particularly in smaller towns. Old Town in Alexandria, Virginia is a wonderful example of a successful historic district with a waterfront setting.

Managing Downtown's Assets

Attracting tourists requires a new way of thinking for downtowns, particularly in Florida where Disney, Busch Gardens, Universal Studios and others offer experienced, sophisticated and well-funded competition. On the other hand, a good theme park can actually be a model rather than an impediment.

What shapes the experience for the tourist, prompting them to make a repeat visit or give a favorable recommendation, is similar to what makes downtown an attractive place for business. The customer experience is favorably influenced by cleanliness, timely repairs, user-friendly design, good directional signage, a sense of security and personal attention. These are among the factors that allow downtown Orlando, for instance, to hold its own in a market that is also served by some of the world's premier tourist attractions only a few miles away.

Providing a higher level of services is difficult in downtown areas where the infrastructure generally is older and more intensely used. With federal cutbacks, local governments are strapped to fund services as well as development. Civic organizations are well-organized and articulate; their demands for improved neighborhood security and other residential-based programs take priority in leaner times.

In many cities, public-private partnership is traditional and typically applied to the development of critical community projects. The privatization of services, however, is a more recent trend. The concept had its roots in a variety of specific programs such as those initiated by Downtown Tulsa Unlimited. DTU is a private, nonprofit that in the early 1970s contracted with the Tulsa Urban Renewal Authority to manage parking operations on cleared predevelopment land parcels, providing shuttle bus service for transport workers from peripheral lots to the office core. In addition, DTU offered sidewalk cleaning services to subscribing downtown businesses.

The concept was popularized with the development of the 16th Street Mall in Denver. From the outset, it was acknowledged that the dollars spent on this marvelous civic improvement would be wasted if not accompanied by an intensive program of cleanliness, maintenance, marketing and promotion. The creation of a Mall Management District, funded by assessments against affected properties, provided the financial resources to insure an effective, dependable program of services. Recently, the district concept was expanded to include a larger area of the downtown.

The advantage of these programs is that they provide a consistent funding source, spreading the burden over all benefitting properties. Typically the programs are administered by existing downtown organizations or newly created quasi-public or nonprofit entities whose sole focus is the city center district.

There are now reported to be over 1,000 such districts throughout the United States and Canada. Similar programs are emerging overseas, particularly in England. Initial resistance normally includes concern that the proposed services should be provided by the municipality and that city government may use the existence of the assessment district as an excuse to further reduce downtown expenditures.

It is crucial to get beyond philosophical objections and to obtain binding commitments that funds will go for services beyond the level already provided. Once implemented, successful programs pay constant attention to feedback from property owners through newsletters, meetings and other forums. Though most districts have a sunset provision, it is rare that one is not recertified.

The management programs are the latest trend as cities take charge of their own future. Dependence on the federal government has often led communities in the wrong direction or prompted ill-founded expectations. As financial support becomes more limited, the successful downtowns of the future will once more reflect those qualities that initially gave them strength.

Their function again will be as the community gathering place, the focal point for civic and social life that binds the various neighborhoods together. To do so will require local acceptance of a new vision which is rooted in realistic but ambitious expectations, persistence to overcome setbacks along the way and, above all, an entrepreneurial spirit and cooperation.

MEXICO AFTER THE TUMBLE

by John C. Melaniphy, CRE

On December 20, 1994, Mexico once again stumbled. The peso lost its value and plummeted against the dollar and other world currencies. Most Counselors of Real Estate (CREs) who had been advising both Mexican and American clients in Mexico knew the peso was overvalued. However, no one expected it would be a free-fall. This was not the first time the peso had plummeted in Mexico. The 1982 devaluation was far more dramatic in Mexico than the current problem. This time the difference was how the global money markets reacted. With significantly better electronics, money roared out of Mexico at warp speed, and with it went the hopes and dreams of Mexico's rising middle class for the next three to five years. "If you are in business in Mexico, you must prepare for something like this occurring every eight to ten years," said a Mexican retailer. "It is a fact of life!"

This article will examine the situation which preceded the fall, the major influencing issues that brought it about and where I see the Mexican economy headed in the near future.

Prior To Devaluation

Demographics

During most of 1994, Mexico was considered by many as the crown jewel of opportunity. Located on the southern border of the United States, Mexico was, by American standards, an underdeveloped country. With a population of approximately 87 million, projected at 97 million by the year 2000, Mexico's population is about 37 percent of the United States',[1] but about three times larger than Canada's. However, in Mexico about half the people are under the age of 18 which makes its population much younger than either the United States' or Canada's. Population growth in most Mexican cities ranges between two and three percent annually. Contrary to almost anywhere in the U.S., the children's department in the major Mexican department stores usually covers an entire floor. Mexico City, considered by many as the fastest growing major city in the world, has a population of between 15 million and 23 million depending on whom one believes. The Mexican census is not known for accuracy. In reality, Mexico City's population is closer to 19 million people, which nevertheless represents about 21 percent of the nation's population.

Retail Sales

Mexico's total retail sales grew from an estimated $66 billion in 1990 to $83 billion[2] in 1992, an increase of 25.7 percent. In 1993, the growth slowed somewhat due to the influence of the U.S. recession.

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Nevertheless, retail sales rose to an estimated $102 billion, or $19 billion over the previous year. This rise in growth continued up until the devaluation. In contrast, while the U.S. is enormously larger in retail sales, its sales growth has been about $18 to $25 billion annually. Mexico's growth was in the same league, even though the overall U.S. retail sales amount is over $1,900 billion.[3]

Economic Growth

Before the devaluation, household income in Mexico was rising, the middle class was growing and the demand for just about everything was expanding. Conditions were reminiscent of the U.S. in 1947 following World War II when the country was poised for an explosive growth in population, jobs and income. In Mexico, the expansion generated purchasing power which, in turn, created a demand for housing, cars, shopping centers and other indications of the *good life*. As the middle-class Mexican looked at the economy, he or she saw inflation decline below 10 percent (from 150 percent in 1982-1983), interest rates down to 20 percent,[4] a stabilized and predictable peso (devalued at one peso per day) and credit availability from banks and retailers. Demand for well-educated people was strong and overall expectations for the economy were high.

The Chiapas uprising in Mexico received a great deal of media attention as a major problem. However, it was a non-event and did not play a role in the governmental or economic problems. The area where the uprising occurred is so far removed physically from 99 percent of the Mexican population, that it had virtually no impact on the country. If it wasn't that the international media forced the Mexican government to take action, nothing would have happened.

In 1994 NAFTA, the North American Free Trade Agreement between the United States, Mexico and Canada, established a free trade zone between the three countries. Expectations were high that each country would benefit from the other's economies. For Mexico the agreement represented jobs, capital, new plants and equipment and most of all, a higher standard of living. Outsiders saw it as virgin territory, cheap labor, explosive growth, rising demand for foreign products, rising income for housing, cars, shopping centers, office buildings, hotels, industrial parks, road construction and all forms of infrastructure. Unfortunately, most development and expansion were being financed with short term debt in hopes of attracting long term foreign capital.

Politics/Government

Prior to his election and even afterward, President Ernesto Zedillo was virtually unknown throughout Mexico. While many higher-ups in the PRI party (Party Revolutionary Institutional) were aware of him, the general population was not. He was selected following the assassination of the candidate identified by the former President Salinas. Being an unknown has created some confusion regarding what Zedillo stands for and how he will govern Mexico. The presidential elections in which he was elected were perhaps the freest of political corruption in recent times. Moreover, as president he appears to lean toward an open government and judicial system totally different from the past 50 years under PRI rule. This is all very new to the Mexicans. The two state governorships being elected this summer should provide an indication of where this government is headed.

Unfortunately, the first true test of Zedillo's capability occurred just three weeks after his inauguration when the country's financial reserves came under pressure to meet short term governmental borrowing payments. As word leaked out, concern mounted that Mexico might not be able to meet its short term debt obligations. Without notifying the financial community, the new president waffled.

Instead of going to New York and explaining the problem to world money managers, he chose to let the peso float against the U.S. dollar and announced a 15 percent devaluation. The global money markets reacted almost instantly by dumping the peso, selling Mexican stocks and cutting off investment funds. Consequently, the value of the peso was driven down from about 3.4 to the dollar on December 19th, to a new low on March 9th of 7.45 pesos to the dollar. It has since recovered to between 6 and 6.5 pesos to the dollar. The impact, from the Mexican standpoint, has been to make dollar-denominated-debt twice as costly.

Moreover, with crisis abounding, President Zedillo waited two weeks before presenting an austerity plan to improve the situation. During those two weeks, the country's financial markets were ravaged. Between $15 and $20 billion in investment capital fled the country. Under the much-awaited Zedillo Plan, interest rates on existing loans were adjusted causing rates to rise between 80 to 100 percent.[5] Imagine, if you owned a home or a new automobile and the interest rate climbed to this level. The Mexican banks, which had borrowed dollars extensively from other foreign currencies, now found themselves almost insolvent. They began to call loans or foreclose on defaults. Unfortunately, the Mexican middle class is losing its homes and cars because its income has not risen sufficiently to cover the higher cost of debt.

Virtually, all planned income-producing real estate projects have been stopped, along with most construction. None will be able to restart until foreign capital is encouraged to return to Mexico. My firm had been consulting on the two biggest new malls in Mexico, both of which were under construction in December 1994. They were being financed with short term borrowings from Mexican banks. They now sit with naked steel and construction stopped until long term capital can be found to complete the projects.

After The Fall

President Clinton moved quickly to promote financial relief for Mexico. A loan guarantee program was designed whereby Mexico could pay off short term debt and float new borrowings. Without adequate loan reserves, Mexico would have experienced an even worse situation, and recovery would have taken ten or more years. Mexico is the U.S.'s biggest trading partner thus, any problem there certainly affects our exports. Even with the merits and benefits of U.S. assistance, the impact upon Mexicans can clearly be seen:

- The inflation rate had risen from an annual rate of about 10 percent in 1994 to approximately 50 percent today.
- Retail sales have declined between 30 and 50 percent, depending upon the type of retail store. Automobiles, furniture, appliances and other durable goods are down over 50 percent in sales, while supermarkets and pharmacies are down about 30 percent.
- Interest rates are now in the 80 to 100 percent range for short term funds. There basically are no long term funds available or being sought at these rates.
- Imported goods now cost double what they were before devaluation.
- Dollar-denominated-debt now costs twice the amount borrowed in repayment.
- Gasoline prices have been raised as part of the austerity plan.
- A value-added tax of between 10 and 15 percent has been imposed on most merchandise.
- Income taxes have been raised.
- Wages and salaries have been permitted to increase by 15 percent to offset the rising costs and taxes. The increase is inadequate to cover the rising costs.
- The Mexican economy will probably shrink by about four percent in 1995.
- Many Mexican banks are close to if not insolvent because of dollar or Eurodollar borrowings from foreign sources that must be repaid in kind. Also, defaults on loans to small businesses and individuals for homes and automobiles have compounded the problem.
- Mexican banks, in conjunction with the Mexican government, held an RTC type auction of non-performing and under-performing assets. The value of properties auctioned was valued at over $100 million. Buyers needed deep pockets and had to buy at significant discounts to cover the long holding periods likely to be required.
- Office buildings are being offered for sale with a wide range of prices. Class AAA (our A) buildings are selling at about a 15 to 20 percent discount. Class AA (our B) buildings are being offered at discounts ranging from 25 to 35 percent to raise needed capital for debt ridden owners. Class A (our C) buildings are going begging.
- Most major shopping centers are condominiums and therefore, with some exceptions, the rental markets are generally for small stores. Nevertheless, since devaluation, rents for existing well located space are off 10 to 15 percent. Vacancies have risen as small retailers fail or liquidate. The substantial decline in retail sales will continue to increase vacancies even in the best centers and business districts. Community based shopping centers have experienced even higher failures and vacancy. Rents in these types of centers are off as much as 30 percent. The bigger problem is finding retail tenants for store space. Recently, a real estate consultant called to discuss a major new mixed use project in downtown Mexico City. He has been engaged, since devaluation, to advise a large Mexican bank on the status of its retail investment. Rents in the development were projected at an average of $50 to $60 per square meter per month (about $55 to $67 per square foot annually). Today, the only interest in the property has come from one retailer who offered approximately $40 per square meter per month (roughly $45 per square foot annually). Beyond that there is no current demand. My experience in Mexico tells me that for the next two to three years it will be very difficult to average rents above $35 to $40 per square foot per month for any new developments. That is why most new retail projects are mothballed until the economy improves.
- There has been increasing interest from U.S. based investors who recognize that the current economic situation will not last forever. I see them moving to acquire or invest in well-located but unfinished mall projects where major Mexican and U.S. department stores are likely to be the primary anchors. Because debt capital is so scarce, U. S. investors who can generate capital to finish the projects are in an excellent position to invest at a substantial discount. It is important however, to invest as equals and avoid putting in capital until all the approvals have been obtained, along with agreements from the major anchors.

- Industrial development near the U.S. border in the Maquiladora zones continues to expand as a result of devaluation. Industrial firms want to take advantage of the even lower peso wages in Mexico. Maquiladora zones are areas designated by the Mexican Government near the U.S./Mexican border. Foreign companies located within these zones are permitted to import duty free components for assembly. Also tariffs are paid only for the value added to the products. Therefore, it is much cheaper to manufacture components elsewhere, ship them to a Maquiladora zone, assemble the components and ship them back to the U. S. According to existing Mexican law, the Maquiladora zones will lose their special tax status in 2001. Another reason for the increased interest in these areas is the cheaper construction costs that are available since devaluation. Construction savings today can range between 20 and 30 percent.
- Housing is a mixed bag. Demand for new middle-class housing has drastically declined because of the pressure on middle-class income. Living expenses for the middle-class have risen dramatically, while their income growth is restricted under the president's austerity program. The demand for government guaranteed housing continues because of the housing shortage in Mexico. Even so, the total volume of government guaranteed housing is down because of the austerity program. For those wealthy Mexicans who protected their assets during the recent devaluation, now is the time to expand their existing homes or build new ones.
- Probably the greatest impact of devaluation and the austerity program will be the loss of between 1.2 and 2.0 million jobs, which will further depress the Mexican economy.

The Immediate Future—Issues To Be Resolved

The first major issue to consider for anyone investing in Mexico is its political stability. Unfortunately, both Mexicans and foreigners alike are concerned with the lack of leadership provided by the current administration. There does not appear to be any clear economic plan or direction. Until the government is perceived as working toward a stable economy and currency, it will be difficult to obtain the needed foreign investment capital. Among retailers, there is a minority school of thought that this is a great time to develop in Mexico since so many retailers are financially strapped. Regardless, those who decide to proceed will need considerable capital and be willing to wait a very long time to recover their investments.

If stability comes to the government and the peso stabilizes at about 5.5 pesos to the dollar, the Mexican economy would be able to slowly emerge from this economic and financial mess. Furthermore, NAFTA regulations are not being applied as expected. United Parcel Service (UPS) has experienced the problem first hand. Mexican regulators will not permit UPS to use the same size trucks it uses in the United States, even though this size is used by Mexican competitors. Furthermore, President Zedillo's government appears to be much more pro-union than previously thought.

Both Mexican and U.S. department stores have experienced considerable problems with the Certificates of Origin required to import goods from outside the country. Many Mexican department stores did not receive their Christmas goods in time for the holidays because the items were held at the border by Mexican Customs. J.C. Penney recently opened two stores in May, one in Monterey and another in Leon, without all their goods because of the problem. The U.S. department stores or discount department stores involved are very concerned about receiving shipments and have scaled back their expansion plans partly because of this problem.

With construction stopped on almost all new income-producing projects, the need for foreign capital will become increasingly desperate as time passes. This may be further complicated because Mexican and U.S. retailers will be reluctant to pay rents in dollars. Thus, it will be even more difficult to lure foreign capital into Mexico.

Mexican Real Estate Over The Next Five Years

There are several answers to the question "What is the future of Mexican real estate over the next five years?" The first part of the answer depends upon political stability. If government reflects strong leadership and consistency, the world community will once again view Mexico as a place to invest capital. Another part of the answer lies in the attitude and perceptions of the Mexican people regarding their government. The general feeling now is that the government has failed the average Mexican by eroding his assets and security. Next, the Mexican economy must stabilize and grow so the average worker can begin to afford more than the necessities of life. Finally, the consumer must perceive improvement in his or her buying power.

The Mexican people have previously experienced similar economic situations and therefore, know how to protect themselves. This time however, they will be more wary, since the present free-fall came with almost no warning. Also, the middle class has lost many of its hard won assets. Many lost cars and some lost or will lose homes. Their caution will affect existing shopping centers and other commercial developments. While they had a taste of credit cards, Mexicans will be slow to accumulate the large debt which existed in 1994. The value of existing shopping centers and retailers will remain below 1994 levels but will gradually improve over the next three to four years. Most new developments will revert back to condominium projects which the retailers know and understand.

Office Market

The office market should be one of the first to return to some level of stability. While there was overbuilding in some cities, the office market generally is sound. There are over 70 million square feet of office space in Mexico City. First class space accounts for about 11,000,000 square feet, by our standards. Another 10 to 11 million is classified as first class by Mexican standards. Business failures and downsizing have increased office vacancies. Nevertheless, current vacancies will, in my opinion, begin to decline in 1996 if political stability is achieved. The new office building condominium with the highest rents and sale prices will be the slowest to improve occupancy. Many of these buildings were occupied by foreign companies who have either fled or downsized. However, they will return slowly.

Industrial Market

The industrial market will continue to grow if political stability occurs. The lower labor costs, the benefits of NAFTA and the Mexican government will encourage industrial investment. It will be necessary for the government to overcome its pro-union stance to inspire a continuing flow of new manufacturing plants in Mexico. Motorola is an example. The company has announced plans to invest $72 million in Mexico. A new plant will be built near Chihuahua, and an existing plant in Guadalajara will be modernized. The company indicated that it planned the investment before devaluation. After reviewing the current situation, it decided to proceed because of the cheaper manufacturing wages and the lower construction costs.

Housing

The housing market will return slowly. The sale of existing homes has slowed to a trickle from lack of mortgage funds. Limited development capital, few end loans and buyers will keep the housing market way below the 1994 level. In my opinion, it will be at least four to five years before housing demand returns to the 1994 levels.

In summary, Mexico has once again experienced what many thought would not happen. Remember, the Mexican zest for life will once again enable this economic crisis to reach a successful conclusion.

NOTES

1. Instituto Nacional de Estadistica Geografia e Informatica (I.N.E.G.I.) and Melaniphy & Associates, Inc., 1994.
2. Banco de Mexico, Nacional Financiera, and Melaniphy & Associates, Inc., 1994.
3. U.S. Department of Commerce, Bureau of the Census, Census of Retail Trade, 1994.
4. Banco de Mexico
5. Banco de Mexico

PUBLIC/PRIVATE JOINT VENTURES: THE GOVERNMENT AS PARTNER—BANE OR BENEFIT?

by M.J. Brodie

The concept of public/private joint ventures is a very recent phenomenon in the long history of real estate development. But over the past three decades, the success of projects, ranging from Baltimore's Inner Harbor and Washington, D.C.'s Pennsylvania Avenue, to San Francisco's Yerba Buena and New York's Battery Park City, has demonstrated the potential of the public and private sectors joining forces. Certainly, the traditional public sector role was far removed from any vision of partnership. In the United States, the public sector's role represented regulation through law and administrative techniques. This stemmed from several sources and goals, such as the need to impose at least a minimum degree of order to the generally chaotic development in cities and in the undeveloped countryside. Governments hired surveyors to lay out streets, roads, farm dimensions and building lots, sometimes with a further design element, such as William Penn's "greene countrie towne" of Philadelphia or Pierre L'Enfant's Parisian-influenced forms for Washington, D.C.

Another factor for public sector involvement came from 19th- and early 20th-century concerns for public health and safety. Responding to high population densities, the lack of adequate air and light in tenement buildings, medical research on communicable diseases and a history of destructive fires, the 20th-century American concept of zoning evolved. This system is unconsciously but powerfully anti-urban in its too rigid segregation of uses.

A third more recent factor, usually inclusive of the previous two, was public sector planning through a department and/or commission. Typically involved was a set of detailed subdivision regulations and often a capital improvement program that quantified needs, identified sites and proposed financing methods for schools, parks, streets, bridges and water and sewer systems. The capital improvement program related to the public sector's historic role with infrastructure; this function was usually performed by a department of public works which, in addition to its own staff, employed private engineers, architects and contractors to assist in carrying out its responsibilities. All of these factors were useful, all relatively standard and all clearly within the American economic and

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political system which maximizes private initiative, decisions and financing of real estate development.

The Advent Of Suburbia And Urban Plight

In reaction to the post-World War II exodus of business and families from many of America's older cities to the suburbs, urban renewal provided the foundation for a more pro-active public sector role. Employing a variety of legal powers, e.g., eminent domain and combined federal and local funding, the public sector acquired large areas typically in the center of older cities where it often would demolish existing buildings, create new disposition lots and sell or occasionally lease the sites to private developers. The private development was often regulated with more detail than before with uses, locations of buildings and sometimes three-dimensional architectural concepts to be specified.

Nearly always a new public sector vehicle, the urban renewal agency, was created to implement the program. Sometimes it was part of local government and sometimes it was a more independent entity. The public sector role was also extended in terms of time. Use covenants, often for 40 years, were imposed on private development. Architectural changes beyond the originally approved design required a formal public review process. The basis of this additional public involvement in real estate was in the benefits the public actions provided to the private sector—almost a partnership or joint venture but not quite.

Increasing Demands On Public/Private Sector Partnerships

For many local jurisdictions, perhaps the decisive catalyst in creating public/private ventures, as defined today, was the federal government's passage in 1976 of the Urban Development Action Grant (UDAG). The concept, while built on the urban renewal experience, was significantly different. It outlined a set of criteria—ratio of public-to-private financing, job retention and/or creation, estimated increase in property tax revenues—that when taken together allowed a locality to compete for federal funds on a regular basis. The funds were intended to bridge the project's demonstrated economic gap in order to create financial feasibility. The idea of public/private venture now had a financial incentive and a set of official, nationwide rules. Localities deemed eligible on the basis of a need formula could compete for federal funding. At about the same period, based on a pragmatic reflection on past experience, some localities concluded that the traditional public/private sector relationship was inadequate to address a lengthening list of public goals and objectives within a declining pool of traditional public financial resources. While desirable, none of the following goals and objectives was easy to achieve or without cost:

- mixed-use developments, usually with such uses as housing or art space that produced lower economic returns, particularly in the short term;
- historic preservation;
- higher quality in both architecture and landscape design and construction;
- high-quality, long-term operation and maintenance of buildings and public open spaces; and
- additional public income, particularly in the creation of an ongoing revenue stream if the projects were profitable.

If the public sector expected to realize the goals and objectives, it needed to:

- develop a deep and clear understanding of the economics of the private and public sides of the development process, the costs and benefits and the risks and rewards for each party;
- develop fair, open and professional methods to select private partners;
- create the conditions for a relationship based on understanding and mutual trust that would survive the vicissitudes of time;
- identify and, if possible, quantify what it would bring to the partnership in the way of land or public improvements; financial incentives such as grants, loans, tax abatements, and mechanisms, e.g., Transfer of Development Rights; expedited processing of required approvals; or neighborhood relationships;
- provide an organizational entity staffed with knowledgeable and creative individuals prepared to operate in a business-like environment with the appropriate combination of authority and responsibility to make timely decisions and deliver on the public sector commitments.

The private developer also was expected to hold to a set of clearly articulated standards. For example, the private partner had to protect the public interest by allowing its books to be audited and often by sharing with the public sector its profits above a negotiated amount.

Although meeting these aspirations is difficult and, to a large extent, non-traditional, they have been achieved in many projects by the public and private sectors. What is critical is to establish a process and a structure that allows all partners to be dealt with fairly and professionally and where the product meets both public policy goals and the test of the marketplace. The following illuminates some of the challenges and the opportunities I experienced as director of two public agencies, one municipal and one federal, in administering revitalization programs through public/private partnerships.

The Baltimore Experience

The Development Of Inner Harbor

The rebirth of downtown Baltimore began in 1959 when the plan for the 33-acre urban renewal project for the Charles Center first brought private business and the city government into a cooperative relationship. By the early 1960s, with the Charles Center's $200 million effort well on its way to success, the city turned to redevelopment of the adjacent 240-acre Inner Harbor area. By the end of World War II, the once thriving port had fallen into disuse becoming a badly decaying assemblage of piers, warehouses, wholesale produce markets and railroad yards. Yet, the harbor's human scale and shorelines on three sides offered potential for new activity and a strong sense of identity for the city.

Framed by new office towers, Baltimore's rejuvenated Inner Harbor draws millions of visitors annually to the Harborplace retail pavillions, National Aquarium in Baltimore and Maryland Science Center. *photo credit: David Whitcomb/ RTKL*

Early in the renewal effort, the city began an important idea of administrative methodology, organizing a non-profit corporation (initially Charles Center Management and later Charles Center-Inner Harbor Management, Inc.) to manage the downtown projects on its behalf. The corporation, reporting to the mayor through the city's Department of Housing and Community Development, was created as a special entity with significantly greater flexibility than the typical public agency. The city, which provides the corporation's operating funds, retains ultimate control and therefore maintains its responsibility for the use of public powers.

In 1963 the mayor of Baltimore identified the renewal of the Inner Harbor as his top priority. The next year, voters approved the first $2 million city bond issue for the development of Inner Harbor. Soon, more than $14 million in city bond issues and $47 million in federal grants were approved for the acquisition and clearing of land surrounding the harbor basin. By 1966, an urban renewal plan for the first 110-acre phase of the Inner Harbor program was approved. A key element of the plan was to establish the harbor as a public amenity, bringing all the property around the water's edge into public ownership or public control. The demolition and clearing of land began in 1968. Subsequently, the city built a bulkhead and a 35-foot-wide brick promenade around the water which connected a variety of new public spaces such as playgrounds, playing fields and picnic areas.

Following these years of infrastructure improvements, including some new buildings, e.g., the Maryland Science Center, and with market studies identifying a population of three million people within a 45-minute drive of the Inner Harbor, the city of Baltimore nationally advertised its sites for commercial development on the harbor's west shore. There was no response until the summer of 1977 when the Rouse Company of Columbia, Maryland, a nationally known retail developer, submitted a proposal to develop the sites. As commissioner of the Department of Housing and Community Development and in accordance with city policies, I announced that the proposal had been received and other developers were invited to submit alternative proposals by a specified date. No other proposals were received.

Controversy Mounts Over Land Use

When the elements of the Rouse Company's proposal were made public, reaction was mixed. The proposal included about 150,000 square feet of special retail uses in two low-rise buildings. Some noted that the project could be the key to the Inner Harbor's long hoped-for vitality. Notwithstanding that the Inner Harbor Urban Renewal Plan called for commercial use, others concluded that no private development was desirable and that the sites should be used exclusively for a public park. Nearby restauranteurs in Little Italy and merchants in the South Baltimore commercial areas felt threatened by future Inner Harbor competition, and they voiced their opposition.

In a short time, enough signatures were obtained to place a referendum on the ballot for the upcoming election. The referendum called for the creation of a public park and no private development. In response, the city administration proposed, on the same ballot, a charter provision limiting private commercial development to two specific sites totaling 3.1 acres and committing approximately 29 acres around the Inner Harbor to public park use. If accepted, the provision would be placed in the city charter and could be changed only with a future vote by the electorate and not by actions of either the mayor or city council.

As a result of cooperative City of Baltimore/ Rouse Company studies, the proposed commercial sites were replanned to create a larger contiguous park area along the west shore. Citizens groups were formed for and against the two propositions, and extensive public debate, well-reported by the media, took place. The private developer, the Rouse Company, was placed in a difficult position. It would have been understandable if, as a prudent developer, it had ceased work until after the election. However, it seemed clear that the project had a better chance of voter approval if there were commitments to an exciting architectural design and to definite business terms between the city and the company. Negotiations were accelerated, and both the design (within strict city guidelines) and basic business terms were made public several months before the November election. On election day, the city's ballot proposition was approved, and the all-public park proposition was defeated.

By the following February, groundbreaking took place on a fast track basis. Detailed negotiations were completed, including considerable public discussion on affirmative action policy. This resulted in the city's commitment to apply Community Development Block Grant (CDBG) funds to assist minority businesses. Construction was carefully coordinated between adjacent public and private work. The Harborplace project opened on July 2, 1980.

Business Terms Finalized For City And Developer

Apart from the Rouse Company's experience in Boston with the Faneuil Hall Marketplace (a historic building renovation in a city and region with a much larger market area and a higher income population than Baltimore), there was no precedent for the Harborplace development. The developer's risks, both financial and reputation-wise, were considerable. Based on market studies, the potentials seemed substantial but were unprovable. And, from the city's point of view, a failure of this key project could diminish the confidence of other developers for nearby sites which would slow or halt the momentum of renewal.

The basic business terms agreed to by the Rouse Company and the City of Baltimore were:

- A market-rate land lease covering the two parcels (with a total of 136,867 square feet or approximately 3.1 acres);
- An unsubordinated ground rent of $100,000 which the developer would pay the city, based on a single-phase development of 150,000 square feet of gross leasable floor area;
- Full real estate taxes estimated at $368,000 for the first full year of operation to be paid by the developer;
- The city would receive 25% of the net profits after payment of operating expenses, fixed costs such as ground rent, taxes and debt service and a return to the developer of 10% of gross revenues and cash equity;
- At the end of the 75-year lease term, the buildings would become the property of the city at no additional cost;
- The developer's plans and specifications for buildings, landscaping, lighting and signs were subject to city approval; and
- The developer would be required to operate the project at a standard of quality comparable to its Faneuil Hall Marketplace project in Boston.

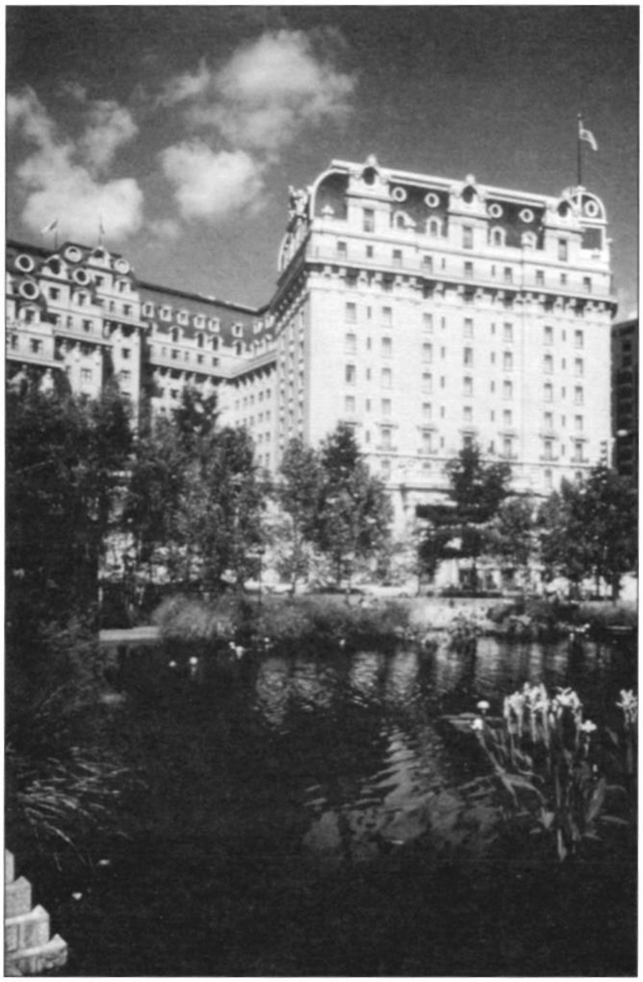
The total revenue to be received by the city in ground rent, profit sharing and real estate and personal property taxes was estimated at $628,000 in the first full year of operation, $868,000 in the fifth year and $1,167,000 in the tenth year. (These estimates did not include revenue to be received by the city from income, sales, utility and parking taxes.)

Reflecting 90% tenant ownership from the Baltimore/Washington area, Harborplace's 138 small shops, restaurants and other eating places were an immediate success. It's continued success accelerated the pace of the Inner Harbor effort, providing a major attraction and positive image for Baltimore and receiving national and international acclaim. Businesses in the adjacent neighborhoods have benefited from the expanded number of customers drawn to the Inner Harbor, and the new Oriole Park at Camden Yards provides an additional draw. Approximately 16 million tourists visit the Inner Harbor area annually, spending more than $500 million.

One billion dollars in private investment was leveraged from the city's $200 million investment. The success of the Inner Harbor development is due to several factors. First, its overall plan was strong and exciting in concept and design so it could be implemented in increments with public open space as a key integrating element. Second, the city took responsibility for providing top quality design to improve the infrastructure and public environment of the Inner Harbor—its walkways, public spaces and many parking areas. This demonstration of the city's commitment created an attractive framework for subsequent private investment. Third, the city became an innovative public partner, creating Charles Center-Inner Harbor Management Inc. as an effective, non-bureaucratic entity.

The Pennsylvania Avenue Development Corporation (PADC) Experience

As the seat of the federal government since the 1790s, Washington, D.C. has served as a magnet to those seeking to influence public policy. The presence of the federal government helped protect the city from the severity of economic downturns over the years. However, even post-World War II Washington was not immune to the suburban pressures that affected neighboring Baltimore, 35 miles to the north. By the 1960s, the mile-long stretch of Pennsylvania Avenue from the White House to the U.S. Capitol was a paradox. The stable southern side of Pennsylvania Avenue was lined with federal government buildings developed in the 1920s and 1930s, while the north side was a chaotic and dilapidated mixture of buildings and parking lots, hardly reflecting the image of America's Main Street.



Combining historic restoration with new construction, the Willard Inter-Continental Hotel and Office Building project was a milestone in the revitalization of Pennsylvania Avenue. *photo credit: Carol Highsmith/PADC*

In 1961, John F. Kennedy was dismayed at the condition of Pennsylvania Avenue as he rode from the Capitol to the White House following his presidential swearing-in ceremony. After many studies, but little action, legislation was enacted in 1972 creating the Pennsylvania Avenue Development Corporation (PADC) as an independent corporation of the federal government charged with rejuvenating the 110-acre Pennsylvania Avenue area. Under PADC's leadership, Pennsylvania Avenue has been almost totally revitalized, leveraging $1.5 billion in private development from a $150 million investment in public funds (in streets, sidewalks, public plazas and parks and historic preservation work).

Today, Pennsylvania Avenue is lined with new and renovated buildings of high design quality including, for example, the Willard Inter-Continental Hotel and Office Building, The Evening Star Building and the Canadian Embassy. Other significant projects—Market Square and The Pennsylvania, both residential/office/retail complexes, and The Lansburgh, a residential/retail project including The Shakespeare Theatre—are making major contributions to Washington's new 24-hour-a-day downtown living.

The Rehabilitation Success Of The Willard Hotel

The Willard Hotel, two blocks east of the White House and a grand and authentic part of both local and national history, was a key public/private partnership success story. The hotel was in decay and had been closed for more than a decade when it and the adjacent property was acquired in 1978 by PADC for slightly over $10 million. The team of Stuart Golding and the Fairmont Hotel with Hardy Holtzman Pfeiffer Associates, Architects, was selected in a national design and development team competition to develop the site. After several years of intense but unsuccessful efforts to finance the project, the Oliver Carr Company of Washington was added as general partner to the Willard Associates team. The mix of uses was refined to encompass a 395-room hotel, 222,000 square feet of office space, and 24,000 square feet of retail and underground parking for 218 cars.

By the beginning of negotiations with the developer, PADC's investment in the property totaled $11.4 million. The site, which consists of nearly 60,000 square feet and includes the shell of the old hotel, is leased by PADC to the developer on the basis of a fixed rent of $800,000 per year (this recognizes a $5 million write down as a result of PADC's historic preservation requirements). Based on a 25/75 percent ratio for PADC/developer, PADC also participates in the gross income (not to exceed $400,000 per year) and net rental income (after a 20% return to the developer on its equity). The base rent is subject to adjustment based on reappraisal at various times as specified in the lease. Financing for this $115 million project consisted of a $75 million construction loan which became a mini-permanent loan for a five-year term after the project's completion.

The developer, with the assistance of PADC, sought and obtained an Investment Tax Credit (ITC) of approximately $12 million for the historic restoration work. The quality and detail of the extensive restoration in the hotel's public areas were clearly enhanced by the ITC. After an extensive design review process by PADC and the Commission of Fine Arts, construction began in the summer of 1983. The hotel was officially opened on September 22, 1986. Permanent financing was secured by 1987 for $90 million at a 15-year term, interest-only for five years and then amortizing on a 35-year schedule. The balance of the financing was raised through private individuals, the hotel operators and the Oliver Carr Company.

Both the developer and PADC estimated that the revenue from the office space would carry the hotel through the expected slow early years; in point of fact, both the hotel and the office building have exceeded economic expectations. Just as the Willard's decline reflected the deterioration of the Pennsylvania Avenue area, its re-opening represented, both physically and symbolically, the revitalization of America's Main Street and subsequently assisted PADC in advancing many other developments.

Other PADC Projects

The Willard represents one of the three methods PADC employs to work with private developers: public assembly of a major site through negotiations and/or condemnations followed by a development/design team competition. Other projects developed by this method are:

- National Place—Completed in 1984, this mixed-use project consists of the 774-room, J.W. Marriott Hotel, 74,000 square feet of shops and 418,000 square feet of office space around the restored National Theatre. PADC's ground lease was purchased in an open-bid competition several years after project completion, for over $40 million.
- Market Square—Completed in 1990, these twin 13-story towers house 210 residential condominiums, 104,000 square feet of retail and 584,500 square feet of office built around Market Square Park, a major public open space featuring the Navy Memorial. PADC acquired the site for $21 million and sold it, in fee simple, for approximately $26 million.
- The Lansburgh—Completed in 1992, this complex of 385 rental apartments, 36,000 square feet of retail space and the 475-seat Shakespeare Theatre combines new construction with the preservation of the terra-cotta facades of the former Lansburgh department store. Recognizing that the housing use could not carry full land costs, PADC sold the site for $1.6 million, the estimated value of the retail uses, with a provision for sharing in future profits derived from sale and/or refinancing of the project.

Mixed-Use Jenifer Building

A second public/private relationship is based on private ownership of a site and/or building, with PADC working with the private owner and

With its 210 condominium units, ground-level retail and eight floors of office space, Market Square is a key element of the new Pennsylvania Quarter neighborhood. *photo credit: Carol Highsmith/PADC*

sometimes providing financial assistance for historic preservation. On the mixed-use Jenifer Building, PADC assistance enabled the owner to add a two-story rooftop addition, thus providing a total of 30,000 square feet of office, 2,500 square feet of retail and 10,900 square feet of space for the Washington Project for the Arts. PADC provided $300,000 in historic preservation funds; the District of Columbia provided $100,000 worth of streetscape improvements for the $8.5 million private investment.

Market Square North Project

A third public/private relationship is represented by the Market Square North project which will provide 201 condominium residential units in two towers and an office/retail building with 397,000 square feet of office space and 25,000 square feet of retail space. PADC had acquired several sites in the block where a single private developer owned more than 50% of the block, and the remainder was in several other private ownerships.

As permitted by PADC's enabling legislation, the more than 50% owner, unable to buy the remaining parcels, turned to PADC to purchase the PADC sites and to avail itself, if necessary, of PADC's eminent domain power to assemble the complete block by contracting to design and build a development in accord with the PADC plan.

The Pennsylvania Quarter Neighborhood Association

Beyond direct partnership in individual projects with private developers, PADC helped create a non-profit 501(c)(6) organization, the Pennsylvania Quarter Neighborhood Association, to enliven the new Pennsylvania Quarter neighborhood. Each of the private developers, whose mixed-use projects contain a residential component, joined PADC in founding an association whose activities include co-operative retail planning, joint marketing, promotion, events and activities sponsorship.

What It Takes For Public/Private Ventures

The experience of Baltimore's Inner Harbor and Washington's Pennsylvania Avenue redevelopment exemplify the characteristics critical to the success of these and other public/private ventures:

- A clear and comprehensive revitalization strategy and plan, in which the project is an integral part, with timely and visible infrastructure improvements;
- A strong public entity, well-organized and targeted to the accomplishment of particular tasks within a sensible time frame;
- A thorough and realistic assessment of the costs and benefits involved and the ability of the parties to articulate these elements to elected public leaders, the public and the media;
- A project concept that is both innovative and based on local conditions and characteristics; and
- A private developer who appreciates long-term asset development and value as more important than short-term profit and is willing and able to commit the necessary resources of time, energy and funds to overcome known (and often unknown) obstacles.

On the other hand, the most common mistakes that lead either to failure or to unsatisfactory results of public/private ventures are:

- An overly optimistic view of market demand most often predicated on a belief that success from one project can transfer to another location with different conditions;
- Inexperienced public-sector staff who lack understanding and negotiating experience with the public sector;
- An over dependence on public finance to compensate for weak private market economics;
- Public-sector demands for more benefits than the development economics can support; and
- Private-sector unwillingness to share fairly the rewards of a successful project with the public sector.

Conclusion

Not every real estate development requires a public/private joint venture. But in complex projects, particularly in urban situations, where land assembly, infrastructure and citizen participation complications exist, a properly structured and implemented public/private partnership can play an important and often decisive role. At a time when public confidence in government has perhaps never been more skeptical, the success of projects, such as those described in this article, demonstrate that public and private sectors can both benefit from working together to create developments of a scope and quality that neither, acting alone, could produce.

MIXED-INCOME HOUSING: A NEW DIRECTION IN STATE AND FEDERAL PROGRAMS

by Morton Hoffman, CRE

In the vast literature on housing, relatively little attention has been given to mixed-income, income-integrated housing. This article analyzes the experience of state housing finance agencies in Illinois, Maryland and Massachusetts and the Fair Share, an inclusionary housing program in New Jersey. The article cites Montgomery County, Maryland's Moderately Priced Dwelling Unit Program and the path breaking activities of the Housing Opportunities Commission.

A 1974 article by Jack Bryan in the *Journal of Housing* noted that "the conscious attempt to experiment in mixing different economic levels in the same housing area represents a new direction in the United States for both private and public marketing policy and has gradually expanded only in the past 10 years."[1] Bryan cited state and federal programs, such as New York State's Mitchell-Lama program of low-cost, long-term mortgages and tax abatement, federal laws for interest subsidies for moderate-income families in private developments (Section 221(d)(3) in 1961 and Section 236 in 1968), and rent supplement payments for lower-income families in these developments (first authorized in 1965). Similar to early writers/organizations in this field, Bryan emphasized projects and programs bringing low-income occupants into moderate-income housing.

The Massachusetts Housing Finance Agency (MHFA) program, initiated in 1970, was cited by Bryan as the most advanced and largest of the mixed-income state housing programs. In the late 1960s and early 1970s, the New York State Urban Development Corporation (UDC), under the direction of Edward L. Loge, promoted mixed-income developments, noting that the need for better housing is shared by both low-and middle-income families. Such balance would promote the development's long-range social and fiscal viability. The UDC established a policy of economic balance for its housing developments, using a "70-20-10" formula (70 percent for moderate-income families, 20 percent for low-income families and 10 percent for low-income elderly).

Based in part on the writer's experience in these areas and a review of the literature, this article draws upon data from the State Housing Finance Agency and other housing officials in the four states already identified and in Montgomery County, Maryland.[2]

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Montgomery County Maryland, Moderately Priced Dwelling Unit Program

Montgomery County, Maryland, a northern suburb of Washington, D.C., with a 1994 population of 803,000, is the most populous jurisdiction in the state, with more than 60 percent of the county's workers employed within its boundaries. The high cost of new and existing housing in Montgomery County has made it difficult for many low-and moderate-income employees to live near their jobs. A current estimate is that 29,000 low-income families are in need of affordable rental housing, and the county's Housing Opportunities Commission has 10,000 households on its waiting list for federal subsidies.

In 1973, Montgomery County developed an innovative, countywide inclusionary zoning/density allowance program known as the Moderately Priced Dwelling Unit (MPDU). The program requires builders to make available a share of the units at a below market rate sale price or rental rate which allows the builder to exceed the normal zoning density of the site.

The MPDU program facilitates the distribution of new low-and moderate-income housing throughout the county, thereby fostering the development of mixed-income communities. The county establishes affordable housing requirements and density allowances in its county code and zoning ordinance. The housing authority and housing finance agency, the Housing Opportunities Commission (HOC), may purchase up to one-third of the MPDUs, and it can provide below market-rate mortgage financing for qualified MPDU purchasers.

Density Allowance To Builders

The MPDU program is the country's first mandatory inclusionary zoning law that also provides a density allowance for builders to offset production costs. It requires that between 12.5 to 15 percent of every subdivision or building of 50 units or more (in zones with lot sizes of less than one acre) be made available as MPDU units. A density bonus allowance is given for up to 22 percent, which is linked with the production of MPDUs. A specific program goal is to fund additional affordable housing initiatives through contributions to the county's housing trust fund made by developers in lieu of producing moderately priced dwelling units.[3]

The MPDU program markets to renters and first-time home buyers with 1995 incomes ranging from under $16,000 to $39,900 for larger families. Units purchased by HOC are targeted for households with low-or very low-incomes. HOC also makes below market rate financing available to MPDU purchasers and works with non profit agencies who wish to participate in the purchase of up to seven percent of all ownership MPDUs. Financing for the acquisition of MPDUs by HOC comes from a variety of sources, including Federal Low Rent Public Housing acquisition funds, local tax exempt bonds, private sector contributions to Federal Low-Income Housing Tax Credit partnerships, non profit corporations, state housing finance agency funding (the Community Development Administration) and the Federal Housing Finance Board's Affordable Housing program.

Ironically, a significant obstacle to the MPDU program is the restriction imposed on all residential production by the county's Adequate Public Facility and Annual Growth Policy ordinances. The MPDU program's most significant limitation arises from its dependence on the level of market rate housing. Nearly 8,800 MPDUs were produced from 1976 to 1993, constituting about three percent of the county's total housing stock. The MPDU program has fostered economic and racial integration in a county which otherwise might have become exclusionary. Moreover, two surrounding jurisdictions, Fairfax County, Virginia and Prince George's County, Maryland, have enacted similar legislation.

Montgomery County, Maryland, Housing Opportunities Commission

The Housing Opportunities Commission (HOC), which benefits from the county's MPDU program, follows an extraordinarily careful and thorough preparation and planning for its mixed-income developments. It selects a site, often at a greatly reduced or marked down price, prepares a detailed physical plan and suggested architectural treatment, including unit size distribution, and retains an architect. It has an economic consultant perform an independent market analysis designed to evaluate the marketability of two to three categories of low-and moderate-income housing, usually totaling 50 percent of all units and market rate housing of 50 percent, carefully coordinates and monitors activities of all staff and consultants, considers the need for social and support services, involves the neighborhood in issues of design, access and possible neighborhood impact, holds public hearings and devises a financing plan and program.

Four Mixed-Income Developments

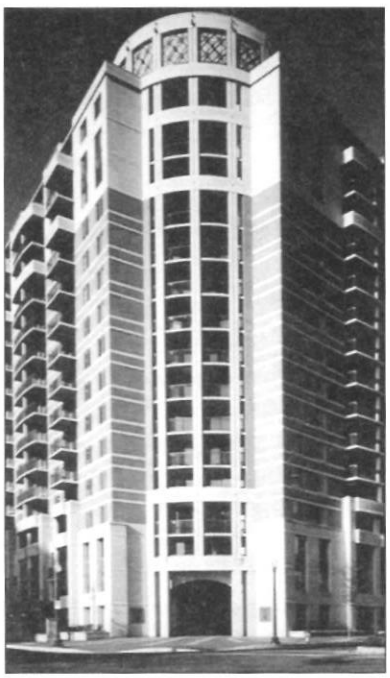
As of May 1995, HOC has four mixed-income developments completed or under construction, with a total of 681 units, including townhouses, low-rise, four-story elevator and high-rise, with the market rate share ranging from 22 to 70 percent.

In an article in *Urban Land* on Timberlawn Crescent, a mixed-income development in West Bethesda, the authors noted that development feasibility "depended on the low-cost land and on HOC's ability to issue $5.46 million of tax-exempt essential function bonds at an interest rate of 7.05

percent. Insurance provided by the Maryland Housing Fund... made this an AA-rated bond issue." Important in alleviating the fears of neighbors was "HOC's declared intention of building a community that met or exceeded neighborhood norms in terms of design."[4]

Five years after completion, Timberlawn Crescent had 99 percent occupancy and had added 20 assisted units in a second section, lowering the market rate proportion to 40 percent. The development has proven successful and has been completely accepted by the community association.

Alexander House, a 311-unit high rise in Silver Spring, has seven tiers of rent, ranging from affordable to very low-income households, to market rate rents of more than $1,000; 78 percent of the units are below market. Now under construction, Strathmore Court at White Flint, in North Bethesda, benefits from the donation of land by the nearby office space developer (arising from the county's growth plan requirements).



Alexander House, a 16-story high rise in Silver Spring, completed in 1988, has 311 apartments with tiered rents for low, moderate and market rate household. Financing included HOC tax exempt mortgage revenue bonds, a state loan of $1.5 million, a county loan of $2 million and $2 million from HOC's Opportunity Housing Reserve Fund. Amenities include a public park and ornamental iron sculpture.

Sunrise at Kensington Park is a 165-unit retirement community containing three buildings, two for assisted living and one for independent living. Thirty percent of the residents have incomes averaging 20 percent of the area median income; rent-assisted residents in the assisted-living component pay 75 percent of income for rent; rent-assisted tenants of the independent living component pay 65 percent.[5] The remaining 70 percent pay market level rents.

A second category of mixed-income developments monitored by HOC, arise from HOC-financed, privately owned developments. As of June 1993, there were 8,400 units, all rental, in 35 to 40 developments. Most are 80 percent market rate, and 20 percent are low-and moderate-income. Almost all were bond financed. The great bulk of the privately owned development was produced in 1984-1985.

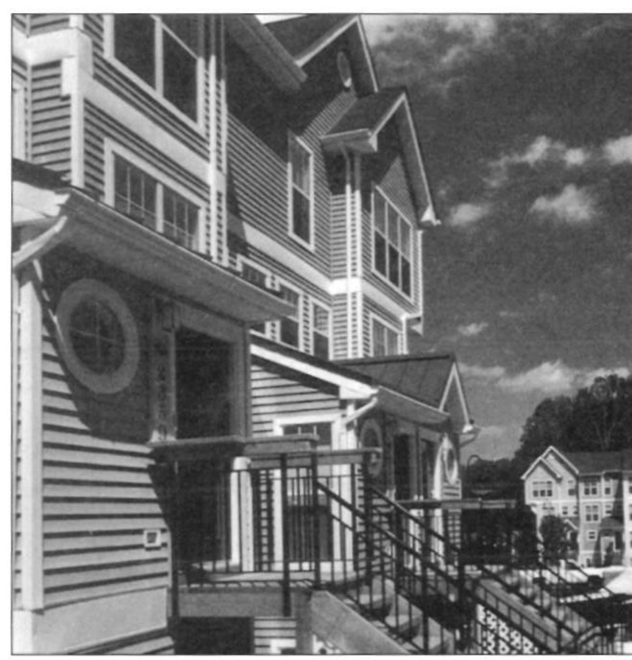
A third category of HOC economically-integrated projects are developments acquired by HOC as part of a conservation program to maintain and secure the existing affordable rental housing stock. These projects have no restrictions on income and the occupants represent those who are predominantly below 60 percent of median family income. The projects also include households who lived there before HOC acquisition, and they pay market rate rents. Of the five developments, four are for family occupancy. They are HOC managed, contain 483 units and range in size from 18 to 189 units.

The HOC Board and staff believe strongly that low-and moderate-income residents benefit in many ways from living in the same development with market rate, middle income residents. In varying degrees, several state housing finance agencies share this philosophy.

Maryland Community Development Administration

Data are available from three state housing finance agencies on the proportion of total housing financed by these agencies that are market rate or income-restricted units and the share of market rate and income-restricted units in mixed-income developments.

In Table 1, data on the Maryland Community Development Administration (CDA) portfolio, as of



The Glen, opened in Spring 1995, is a 90-unit townhome rental community in Wheaton, Maryland. Using Federal HOME funds, a Maryland state loan and tax exempt mortgage revenue bonds, the Housing Opportunities Commission is renting the property at rents ranging from $417 to $1,105. Thirty-five of the units rent for below market price.

TABLE 1

Maryland Community Development Administration—Mixed-Income Multifamily Developments

	All Developments				Mixed-Income Developments			
	Number of Developments	Income Restricted Units	Market Rate Units	Total Number of Units	Number of Developments	Income Restricted Units	Market Rate Units	Total Number of Units
Baltimore Area[a]	173	9,467	3,881	13,348	87	4,128	3,881	8,009
Suburban Maryland[b]	91	6,673	3,564	10,237	52	3,781	3,564	7,345
Remainder of State	85	2,965	519	3,484	34	596	519	1,115
Total *Maryland*								
Number	349	19,105	7,964	27,069	173	8,505	7,964	16,469
Percent		70.6%	29.4%	100.0%		51.6%	48.4%	100.0%

[a] Includes Baltimore City, and Anne Arundel, Baltimore, Carroll, Harford, and Howard Counties.
[b] Includes Charles, Frederick, Montgomery, and Prince George's Counties in the Washington, D.C. area.

Source: Maryland Community Development Administration, and Morton Hoffman and Company, Inc., May 1995.

May 1995, show 349 developments financed in Maryland containing 27,069 housing units. Of these 70.6 percent were income-restricted (i.e., low- and moderate-income), and 29.4 percent were market rate. However, of 173 mixed-income developments with 16,469 units, market rate units constituted 48.4 percent and income-restricted units constituted 51.6 percent.

Ninety-three percent of the market rate units were in the most populated Baltimore and Washington, D.C.- suburban Maryland areas, and only 6.5 percent were in the remainder of the state. Montgomery County is included in the total for suburban Maryland. The most frequent mixed-income developments are 80-20, with 80 percent market rate and 20 percent low income.

Research Findings On Mixed-Income Housing

In a May 1991 article in *Urban Land*, Elizabeth A. Mulroy summarized the comprehensive 1990 research by the Boston University School of Social Work on three mixed-income and three comparable market rate projects (in Laurel, Maryland; St. Louis, Missouri; and Fremont, California). The three mixed-income projects, all of the 80-20 type, had different below market income levels. Professor Mulroy concluded that, "When they offer attractive amenities, good quality housing, safe environments and housing value, mixed-income developments in a wide variety of locations are competitive with market rate developments in attracting tenants."[6]

Illinois Housing Development Authority

The Illinois Housing Development Authority (IHDA) was established in 1967, the fifth such state housing finance agency in the United States. In a fascinating book, *The Poorhouse, Subsidized Housing in Chicago, 1895-1976*, author Devereux Bowly, Jr., noted that "in its first seven years of active participation in housing financing, IHDA achieved a good record. In 1974 and 1975 one in every three new rental units in Illinois was financed by IHDA",[7] or 6,100 of 18,700 units were constructed.

Table 2 shows the current portfolio of 218 IHDA developments, consisting of 38,758 units, of which 24 percent are market rate and 76 percent are income-restricted. However, of 63 mixed-income developments, 63 percent of 14,789 units are market rate and 37 percent are income-restricted. Most of IHDA's mixed-income developments were in the form of 80-20 developments.

Massachusetts Housing Finance Agency

A far reaching study on the effect of mixed-income housing was commissioned in 1974 by the Massachusetts Housing Finance Agency (MHFA).[8] MHFA's original policy required a minimum of 25 percent of all units in the developments it finances to be available through subsidy programs to low-income tenants. The substantial degree of racial integration, also called for in the policy, was found to be less successfully implemented.

1974 Social Audit

A research group headed by Dr. William Ryan of Boston College and Allan Sloan studied a sample of 16 MHFA-financed developments with 3,200 tenants, including intensive interviews with 200 plus MHFA tenants and a control sample of 125 tenants

TABLE 2

Illinois Housing Development Authority—Mixed-Income Multifamily Developments[a]

	All Developments				Mixed-Income Developments			
	Number of Developments	Income Restricted Units[b]	Market Rate Units	Total Number of Units	Number of Developments	Income Restricted Units[b]	Market Rate Units	Total Number of Units
City of Chicago	79	12,022	4,189	16,311	24	1,944	4,289	6,233
Chicago Suburbs	70	8,428	4,582	13,010	33	2,953	4,582	7,535
Balance of State	69	9,012	425	9,437	6	596	425	1,021
Total *Illinois*								
Number	218	29,462	9,196	38,758	63	5,493	9,296	14,789
Percent		76.0%	24.0%	100.0%		37.1%	62.9%	100.0%

[a] This does not include production from either the Federal Home Program or the State's Affordable Housing Trust Fund Program.
[b] The Income Restricted Units include either Sec. 236, Sec. 8 or low-income units as required by Tax Exempt programs.

Source: Illinois Housing Development Authority, May 1995.

in similar nonmixed-income developments; held interviews with developers, managers, architects and town officials; and conducted design evaluations. The study also analyzed demographic variables of the towns. The households were chiefly in garden type apartments in smaller cities and 16 towns.

Eighty-nine percent of the MHFA residents were, of varying degrees, satisfied with their homes and the projects, compared with 78 percent of those in the nonmixed-income developments. Their satisfaction resulted not because the projects were economically integrated, but from the quality of the housing, the neighborhoods and the management.

The general conclusion of the Massachusetts study was that "income mix 'works'...principally because these developments are superior in design, construction and management. Income mix as such does not seem to be an important determinant of satisfaction and dissatisfaction."[9]

MHFA Mixed-Income Programs

As shown in Table 3, by May 1995, MHFA had financed a total of 52,321 units in 439 developments, of which market rate units equal 16 percent and income-restricted units, 84 percent. For 130 mixed-income developments, market rate units constituted 53 percent of the 16,177 units and income-restricted units constituted 47 percent.

According to its 1985 Annual Report, MHFA used a new shallow subsidy program, State Housing Assistance for Rental Production (SHARP), in conjunction with the HUD co-insurance program for its first 80-20 developments. "In these developments, rent skewing is used to make at least 20 percent of the units available for low-income households."[10]

Mixed-Income Housing In New Jersey

In 1975, the New Jersey Supreme Court in *Mt. Laurel I*, established the doctrine of a municipality's constitutional obligation to provide a realistic opportunity for the construction of its fair share of the regional need for low- and moderate-income housing.[11]

However, lack of vigorous enforcement of *Mt. Laurel I* led, to *Mt. Laurel II*, in which the New Jersey Supreme Court reaffirmed and strengthened the *Mt. Laurel* doctrine, broadening the obligation to include all municipalities in the state and providing for more specific and effective remedial devices. The court called for development of a numerical fair share formula, use of the State Development Guide Plan to allocate fair share responsibilities, approved general use of the "builder's remedy", and assigned three specially-designated trial judges to handle all *Mt. Laurel* litigation. (The "builder's remedy" permits builders to sue a township or municipality on a friendly basis and allows for four market rate units for each affordable unit. Theoretically, the market rate units subsidize the lower cost units.) A trained professional planner, called a court master, reports to the judge on the status and circumstances of a case.

The Fair Housing Act of July 2, 1985, provided a comprehensive planning and implementation process and established the Council On Affordable Housing (COAH). COAH was given the power to define moderate-income housing at the state and regional level and to establish criteria and guidelines for municipalities to determine their own fair share, to phase in their housing obligation and, if desired, to transfer some of that housing to a willing municipality through a regional contribution agreement (RCA). In *Mt. Laurel III*, 1986,

TABLE 3

Massachusetts Housing Finance Agency—Mixed-Income Rental Housing

	All Developments				Mixed-Income Developments			
	Number of Developments	Income Restricted Units	Market Rate Units	Total Number of Units	Number of Developments	Income Restricted Units	Market Rate Units	Total Number of Units
Total *Massachusetts*								
Number	439	43,761	8,560	52,321	130	7,617	8,560	16,177
Per Cent		83.6%	16.4%	100.0%		47.1%	52.9%	100.0%

Source: Massachusetts Housing Finance Agency, May 22, 1995.

the Supreme Court declared constitutional the Fair Housing Act and allowed transfer to COAH of virtually all litigation then pending before the courts.

A 1993 report prepared by the New Jersey Department of Community Affairs,[12] based on a 1992 survey, showed that during the first six-year cycle under COAH, 13,600 total dwelling units were built, rehabilitated or were under construction in 280 developments in 125 municipalities.

Types Of Subsidies, Mt. Laurel Housing

Subsidies for Mt. Laurel housing came from one of five main sources—Inclusionary Development, Regional Contribution Agreements, Balanced Housing Fund, Low-Income Housing Tax Credits and a handful of HUD programs.

According to Sidna Mitchell of COAH, and corroborated by a study of Professor Robert W. Burchell of Rutgers, about 13,500 units were constructed out of 54,174 approved affordable housing units in COAH's first round. Of these, *about 10,000 were probably mixed-income.*

According to Burchell, "COAH and the courts oversaw or influenced affordable housing at a rate of 11,000 land parcels per year, 25 percent of which was realized in the form of developed or rehabilitated housing."[13] The real estate recession was, of course, going on during this time.

In spite of this commendable showing, COAH estimated 1987-1999 affordable housing needs at about 83,000, including 42,700 to replace deteriorated housing and 40,600 for new housing.

Analysis Of Griggs Farm

The case of Griggs Farm, in Princeton Township, New Jersey, is an example of a well-intentioned development that went wrong. In 1988, Princeton Township and the Princeton Regional Planning Board approved a 280-unit, 50-50 mixed-income and mixed-tenure development. Two years later, Princeton Township contracted with a consulting firm to evaluate the marketability and financial feasibility of this severely troubled project. In its 1990 report to Princeton Township, the consulting firm stated:

> "We regard this laudable aim of Griggs Farm to be one of the reasons for its present financial predicament. That is, it is difficult but achievable to obtain economic integration and financial viability in an individual housing development if land planning, unit mix, architectural considerations and site location are all in tune. However, when different tenures, sales and rental, are added to a combination of low-, moderate-, and market-rate income housing, it becomes very difficult to get expeditious occupancy for the highest priced or market rate units. Many factors have contributed to Griggs Farm's problems, including unit mix; design of units; size of units; lack of storage; apparent high density in appearance; lack of phasing of units which could have brought about earlier FNMA approval on a first section and would have resulted in availability of FHA and VA financing and lower down payments; inadequate marketing; and insufficient awareness of the characteristics of competitive developments in the broader market area. The severe real estate downturn exacerbated all these weaknesses. However, the mix of 50 percent affordable units—25 percent rental and 25 percent sales—and 50 percent market rate sales is a crucial part of the problem."[14] This was apparently the only COAH project in New Jersey with this mix.

Income Integrated Housing Provides Broader Living Environment

For a long period, conventional real estate analysis held that most families seek identified one-class developments. Many state housing finance agencies, such as those in Illinois, Maryland, Massachusetts and New Jersey, have successfully fostered housing for low-,moderate and middle-income families, and encouraged mixed-income or income integrated developments.

In recent years, there has been increasing recognition that creating excessive concentrations of low-income families is an unwise public policy that should be avoided. However, achieving a mixed-income housing development cannot be undertaken lightly. Research previously cited by the MHFA Ryan/Sloan team and Mulroy, and the experience of the Montgomery County, Maryland Housing Opportunities Commission confirms that mixing income levels is not a deterrent to people seeking better housing and neighborhoods, as long as the development itself is well designed, built and managed. Careful tenant selection is also advisable.

Professor Elizabeth Mulroy found that "the most important determinants are the overall quality of the development and the neighborhood, the monthly rent and accessibility to services such as stores, public facilities, and public transportation."[15]

NOTES

1. Jack Bryan, Major Feature Writer, *Journal of Housing*, 8:74 "Can 'economic mix' in housing work?", pp. 367-374.
2. Appreciation is noted for the cooperation of: John Greiner, Housing Policy Officer, Maryland Department of Housing and Community Development; Dan DeLong, Assistant Director, Marketing Research, Illinois Housing Development Authority; and Rufus Phillips, Research and Program Development Officer, Massachusetts Housing Finance Agency.
3. Division of Housing, Montgomery County, Maryland, Department of Housing and Community Development, May 27, 1993 Statement on the *MPDU Program*.
4. See Tom Doerr and Joyce Siegel "Mixing Incomes at Timberlawn Crescent", *Urban Land*, April 1990, pp. 8-11.
5. See Daniel Sachs and Joyce Siegel, "Assisted Living With a Twist--Mixed Income Residents", *Urban Land*, February 1994, pp. 21-23.
6. Elizabeth A. Mulroy, "Mixed-Income Housing in Action," *Urban Land*, pp. 2-7.
7. Devereaux Bowly, Jr., *The Poorhouse, Subsidized Housing in Chicago, 1895-1976*, 254 pages, pp. 219-220.
8. William Ryan, Allan Sloan, Mania Seferi, Elaine Werby, *All In Together: An Evaluation of Mixed-Income Multi-Family Housing*, A summary report of the Massachusetts Housing Finance Agency Social Audit, January 24, 1974, 24 pages.
9. *Ibid*, page 24.
10. Massachusetts Housing Finance Agency. *Annual Report for the year ended June 30, 1985*, page 2.
11. Low-income housing—housing which is affordable to people earning 50 percent or less of area median income, and moderate-income, between 50 and 80 percent of area median income.
12. Bob Fitzpatrick, *The Math of Mt. Laurel*, March 1993, 40 pages; see also a five-page summary of this report in COSCDA (Council Of State Community Development Agencies), *The State Line*, Jan/Feb 1993.
13. *Center for Urban Policy Research (CUPR) Report*, Rutgers University, Spring 1993, Vol. 4, No. 2, page 5.
14. Morton Hoffman and Company, Inc., *Marketability and Financial Analysis of the Griggs Farm Development*, Princeton Township, New Jersey, November 1990, page II-7.
15. Mulroy, *op. cit.*, page 5.

PUBLIC INCENTIVES FOR DEVELOPMENT: RESPONDING TO FISCAL CONSTRAINTS

by Stephen B. Friedman, CRE

While state and federal governments seek to drastically cut back spending on community and economic development, local governments continue to have a responsibility to foster economic activity. Curtailed federal and state aid, in fact, exacerbates the pressure on local governments to foster development. When the state and federal governments were more generous with development programs (e.g., Community Development Block Grants, CDBG, school aid formulas based on tax effort and general aid such as the former general revenue sharing program), local governments had some help in meeting their needs by tapping broadly based taxes of higher levels of government. As federal and state resources decline, individual communities are forced to seek development to maintain their own fiscal stability. Ironically, in some states there are also efforts to curtail local government incentives.

The overall impact of this reality may not minimize overall governmental spending, encourage efficient location of development or otherwise contribute to an overall public good, but commercial and industrial development become essential to survival. In localities without commercial and industrial development, and with heavy reliance on property taxes, there is virtually no way to meet responsibilities for schools, police, fire and other basic services within a reasonable tax rate. Little wonder then that communities compete with each other for commercial development.

The tools communities use vary from state to state but generally include tax incremental financing, special service taxing districts and tax abatement for some period. Larger communities continue to have CDBG funds available and smaller communities can obtain these funds from county or state agencies. Transportation-related funds may also be used for transit-oriented developments. In addition, many localities have surplus real estate which can sometimes generate greater returns if the locality is a development participant rather than just a seller.

In the current climate, it is very important that the government make good business decisions that minimize the investment of public incentives and maximize the returns to the public sector. For the taxpayer, it should no longer be acceptable to assist private development projects without careful

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evaluation of the need for help and without knowing if the funds can be recovered in the future. For the developer seeking assistance, more judicious use of incentives may help preserve their availability for when they are really needed. The following key issues should be considered in evaluating public financial participation in public development projects:

- What is the public purpose being served and will the project occur anyway?
- Is the project fundamentally viable?
- What is the competitive incentive situation regarding such a development?
- What is the financial gap that needs to be filled to achieve economic feasibility and attract private financing?
- How can assistance be structured to maximize public benefit?

What Is The Public Purpose Served And Will The Project Occur Anyway?

Commercial development not only enhances the tax base of a community, but it balances residential development which is more costly in direct demands for public services, such as schools. While this is an important reason to seek commercial development, it is not a sufficient reason to justify public investment. Public investment should be considered when a project provides overwhelming benefits and achieves important public policy objectives. A project should be reviewed in terms of such objectives, costs and benefits and whether it would occur without assistance (the *but for* test).

Public Revitalization Objectives. Assisted developments should contribute to achieving objectives established by the community. These may include enhancing the local tax base, job creation, efficient use of public facilities or other measurable benefits. More intangible benefits should also be considered such as historic preservation, deconcentration of low income housing, enhancement of transit/air quality improvement, esthetic contributions, etc.

Cost Benefit Analysis. The benefits of projects can be partially quantified. Direct revenue generation from taxes and fees can be readily estimated. Broader economic impacts from job creation and attendant secondary fiscal benefits can also be quantified. Averted public service costs from use of an infill location can also be considered, among other measurable benefits. The overall benefits serve as a probable upper limit of assistance, but not a budget. Similarly costs can be considered. These include extraordinary project costs, such as environmental remediation of an infill site, infrastructure, required services and the direct costs of incentives offered.

The "But For" Test. Even if the project provides overwhelming benefits, assistance is justified only if the project would otherwise not proceed. This is partially measured by evaluating the financing gap including both structural and return on investment issues. It may also be the result of competitive pressures created by business climate and incentives offered in other locations.

Is The Project Fundamentally Viable?

If a project appears to provide positive long term benefits and is unlikely to occur without assistance, it is important to review whether the project is fundamentally viable. A number of interrelated issues are involved, which are critical in determining the level of assistance needed. These include market factors for commercial real estate type projects, site location fundamentals for single user facilities, environmental issues and construction costs.

Market Factors. While financial assistance, such as a low interest loan, may help overcome a soft market, the market fundamentals must still be present. Whatever the land use, are the rents sufficient and market occupancy levels strong enough that the project has some fundamental strength? Can an anchor lease be complemented by enough market driven smaller leases? Is the competitive position of the site reasonably strong, and is there a market niche in the face of competition? Market factors for each land use and specific project are, of course, unique, but they need to be carefully reviewed. The assumptions derived from the market will drive the financial analysis. If occupancy and rents are understated, the need for public assistance will be improperly overstated. If occupancy and rents are overly optimistic, the project may not be able to survive at all and, at the very least, will end up undercapitalized and result in either further demands for public assistance or a workout situation.

Site Location Fundamentals. Particularly for single user and industrial facilities, what are the site fundamentals? Are accessibility and visibility appropriate? Are the labor market and transportation conditions such that this is a good long-term location for a particular type of firm? Are educational and telecommunication requirements met? Some factors cannot be anticipated, and business conditions may change: deregulation of trucking and increased energy costs have rendered locations uncompetitive which previously were successful. Telecommunications and other technology are continually changing the competitive position of an area. Nonetheless, an honest competitive analysis can help identify both where to target incentives and whether the project has good long term prospects.

Environmental Issues. We have become increasingly aware of environmental issues at a site specific level. While they can be addressed and often are justification for public financial assistance, it is critical to understand their magnitude and cost prior to commiting to a project and agreeing to provide incentives. Typically this would require a Phase 1 Environmental Assessment followed by a Phase 2 study with reasonably complete cost estimates for remediation.

Construction Costs. Cost estimating for new projects is difficult. Even if the design is fairly straightforward there may be soil conditions or other issues to address, and often the project sponsor is seeking preliminary commitments before more than conceptual design is completed. In rehabilitation projects, cost estimating is very difficult. Few rehabilitation projects are planned with the building in such condition that behind-the-wall and under- floor situations can be fully assessed. A detailed assessment by specialists and a greater degree of preliminary architectural analysis is called for so that the magnitude of the project is fully known prior to initial commitments.

What Is The Competitive Incentive Situation Regarding Such A Development?

One of the most common circumstances in which incentives are sought is to match the competitive incentives from another locality. A community may face this issue in trying to retain a firm as well as in attracting new development. This is usually related to the move of a specific user, but can also occur if two communities are vying for the attention of developers in a small or tight market. Incentives may include free land, infrastructure, job training, financing, etc., the entire menu of whatever is available. However, in state-to-state and metro-to-metro competition, real estate costs, tax structures (business and personal), cost of living, costs of transportation, labor force quality, wage rates and quality of life factors may all play a role in the competition. Analysis should include both the specific incentives that might be available in the locality's tool kit and business climate/locational fundamentals. There may be issues on which one's geographic area simply is not competitive at the time. For example, certain levels of telecommunications needed to support telemarketing are not available in all rural areas. There may be other issues to immediately address including tailored training programs through vocational/technical systems to address labor issues; housing or transportation improvements to support labor availability, etc. Careful research of both financial and locational issues allows a community to focus on winable competitions and resources and sharply target assistance against the competitor's advantages. In community-to-community competitions, this is the most fundamental issue.

What Is The Financial Gap That Needs To Be Filled To Achieve Economic Feasibility And Attract Private Financing?

In real estate development projects, including shopping centers, hotels, office buildings, business parks and residential projects, the most critical basis for public financial assistance is the financing gap. This is the amount of capital required after all the possible private debt and equity have been raised in private markets. Based on the cash flow of the project and the current underwriting standards for debt and equity, the supportable private financing can be estimated. This is illustrated in Figures 1 and 2.

In this example, a downtown inn is to be rehabilitated to historic rehabilitation standards. Because of the perceived level of risk associated with a hotel and restaurant, a relatively high debt coverage ratio would be applied by the primary lender. To attract equity, relatively high returns are required. The result is a capital shortfall of 15 percent to 20 percent of estimated costs. A participating second mortgage structured to be paid from 50 percent of cash flow is used to fill the gap. Weak initial cash flow improves over time with ultimate return to the second mortgage at a rate well in excess of the public sector's cost of funds.

There are many reasons why an otherwise viable project may present a financing gap, including:

- redevelopment land costs/site assembly
- weak market conditions
- construction costs/special site conditions
- special public facilities (e.g., public meeting facilities)
- rehabilitation/historic building restoration costs
- unusually high market interest rates
- financing market structural issues (e.g., high equity requirements)

Assistance can be provided by the public sector paying directly for costs that would otherwise be incurred by the developer, such as relief from infrastructure or impact fee requirements. Assistance can also be provided by further reducing project costs through land acquisition and write-down. There are a number of sources for such funds, including tax incremental financing, general obligation capital funds (for infrastructure), and revolving funds created from paybacks of past loans.

FIGURE 1

Hypothetical Historic Rehabilitation—
Downtown 25 Room Inn & Restaurant
Development Cost Summary

Uses Of Funds	1995
Land/Building Acquisition	
Building	$ 360,000
Other Acquisition Costs	4,000
Other Acquisition Costs (Legal, etc.)	2,000
Taxes During Holding Period	10,000
Subtotal, Acquisition	$ 376,000
Building Rehabilitation	
Construction Costs	$1,500,000
Contingency	150,000
Subtotal	$1,650,000
Equipment and Supplies, Including Restaurant	
Subtotal	$ 330,000
Soft-Costs	
Architecture and Design Fees	$ 178,200
Other Professional Fees, Insurance, etc.	20,000
Soft-cost Contingency	19,820
Subtotal, Soft Costs	$ 218,020
Financing Costs	
Loan Fees	$ 40,120
Syndication Fees	38,500
Other Financing Cost	5,000
Construction Period Interest	129,031
Subtotal, Financing	$ 212,651
Pre-Opening Costs	
Advertising & Marketing	$ 25,000
Salaries and Management Fee	75,000
Working Capital	100,000
Subtotal, Pre-Opening	$ 200,000
Capitalized Operating Losses	$ 0
Total Development Costs	$2,986,671
SOURCES OF FUNDS	
Equity	$ 550,000
First Mortgage	2,006,000
GAP/TIF Loan Needed	430,671
Total Development Funds	$2,986,671
Construction Period Interest	
Acquisition Hard and Soft Costs	$2,244,020
1/2 Out Average, Months	$ 129,031
12 11.50%	

Source: S. B. Friedman & Company

How Can Assistance Be Structured To Maximize Public Benefit?

Once it is determined that assistance is justified and the sources are identified, the financing structure should be considered. In general, the form of assistance should address the fundamental problems of the project. In the example provided, the cash flow second mortgage responds to the weak cash flow in the early years but creates the potential to obtain a higher overall return in exchange. To the extent that provision of public facilities can be used to assist the project, tax exempt debt may be used to reduce interest costs. Often however, the levels of assistance will exceed public improvements and adjunct help such as training, transit, etc. In such cases direct financial assistance is needed. Depending on circumstances, two of the best methods of involvement are participating ground leases and loans.

If the public sector has the land or must acquire it by eminent domain, then an opportunity for a ground lease exists. Sale lease backs of land could also be used. Such situations also include potential joint ventures for reuse of surplus public facilities. Participating ground leases with escalations linked to changing conditions can be structured to enhance some projects and provide long term public benefit. Important provisions include the basis for participation (gross revenue, sales, inflation or reappraisal), subordination to allow financing of structures and rights to cure.

It is also critical to include provisions to prevent sandwich subleasing situations. Ground leasing has been used with such diverse sites as school board properties, airport hotels and research parks. Disadvantages of ground leasing include potential problems with financing structures since some lenders will not finance ground leases. Other problems include reduced property taxes from the development, end-user attitudes and limitations on condominium development in states requiring land to be owned for condominiums. In addition, there are often problems structuring the adjustment clauses and enforcing them.

Loans can be readily structured to respond to the project's cash flow. Typically structured as a second mortgage, cash flow above that required for minimal debt and equity returns can be directed to service the second mortgage. Low rates can be used which are linked to the public sector's costs of funds (taxable bonds). Often a tax incremental financing district is used to raise funds for such loans, and the tax increment secures the bonds. Repayment is still desirable however, and the loan can be structured with contingent interest based on performance. Such loan structures have been used on residential, office, retail and mixed use projects.

FIGURE 2

Hypothetical Historic Rehabilitation—
Downtown 25 Room Inn & Restaurant

OPERATING ESTIMATES			1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Net Operating Income			$250,000	$300,000	$309,000	$318,270	$327,818	$337,653	$347,782	$358,216	$368,962	$380,031
Debt Service												
First Mortgage (High Risk) DCR	1.30		230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769
Cash Available for Equity and Gap Debt Service			$ 19,231	$ 69,231	$ 78,231	$ 87,501	$ 97,049	$106,883	$117,013	$127,446	$138,193	$149,262
RETURN ON EQUITY												
Share of Cash Flow	50%		$ 9,615	$ 34,615	$ 39,115	$ 43,750	$ 48,524	$ 53,442	$ 58,506	$ 63,723	$ 69,096	$ 74,631
Tax Credit			$300,000									
Total Return on Equity	Equity	($550,000)	$309,615	$ 34,615	$ 39,115	$ 43,750	$ 48,524	$ 53,442	$ 58,506	$ 63,723	$ 69,096	$721,882
Cash-on-Cash Return	Cumulative	262.23%	56.29%	6.29%	7.11%	7.95%	8.82%	9.72%	10.64%	11.59%	12.56%	131.25%
Percentage of Residual	50%											
Internal Rate of Return		19%										
GAP FINANCING												
Debt Service—Share of Cash Flow	50%	($430,671)	$ 9,615	$ 34,615	$ 39,115	$ 43,750	$ 48,524	$ 53,442	$ 58,506	$ 63,723	$ 69,096	$721,882
Nominal Interest Rate	0.085											
Percentage of Residual	50%											
Overall Return (IRR)		13%										

Source: S. B. Friedman & Company

In one case, a residential and retail project benefiting a private university received such a loan with cash flow split between the loan and the university's patient equity in the project.

Conclusion

It is critical that the public sector structure as much assistance as possible on a repaying or ongoing return basis. Not all projects will succeed. If these were developments of ordinary risk there would be no justification for assistance. Future sources of funds for development purposes are uncertain. Recapturing investments through loan repayments or leases provide a future stream of economic development investment resources under the control of localities relatively safe from changes in state and federal legislation. The broad parameters underlying public financial assistance include:

- The project should make a significant contribution to the locality.
- The project will not proceed "but for" assistance.
- Financial assistance to the project will be based on financial need.
- Assistance should be structured to provide ongoing return to the locality.

Geographic Information Systems (GIS): The Location, Location, Location Technology

by Gil Castle

A geographic information system (GIS) is a set of computerized tools, including both hardware and software, for collecting, storing, retrieving, transforming and displaying spatial data.[1] GIS is essentially a marriage between computerized mapping and data base management systems. Anything that can appear on a map can be encoded into a computer and then compared to anything on any other map, using longitude-latitude coordinates.

Many people think of GIS as a presentation tool. It does, in fact, create high quality maps that communicate considerable amounts of information in an efficient and attention-getting manner. For example, when used to select the optimal site for a major retail facility in a certain sub market, a GIS can simultaneously display the following on the computer monitor in a few minutes:

- all the census tracts in the sub market, with the color of each tract reflecting the number of households and median household income;
- all the arterials, with the traffic volumes listed next to each street segment;
- the sites of all potential competitors, shown as dots, with the size of each dot drawn proportional to the square footage or gross sales of that competitor;
- the locations of any toxic waste sites, flood zones, earthquake faults or other environmental constraints.

The presentation benefits of a GIS notwithstanding, the technology's greatest power is in data assembly and analysis. Using the same example of a major retail facility in a certain sub market, GIS can draw maps identifying all places throughout the nation where the number of households and their incomes exceed a certain threshold, the number of competitors within a five minute driving time is below a certain number and no environmental constraints exist within a one-mile ring. Similarly, when valuing a property it is possible to

- download from a comps service all the recent transactions fulfilling certain criteria;
- have the GIS automatically locate the comps on a street map, listing next to each comp certain critical information (e.g., date and cap rate of the most recent sale);
- point to each comp with the computer's arrow keys or mouse to display a photograph or even a video of the comp; and
- statistically correlate the property-specific information to all the demographic, traffic, competitor and environmental information displayed previously.
- Real estate professionals who utilize the endless possibilities of GIS are retailers, brokers, institutional investment managers and property tax assessors. Other professionals who could realize potential from a GIS are real estate consultants, appraisers, corporate real estate executives, mortgage underwriters, asset and property managers.

The overall benefits of GIS include

- more credible decisions based on incorporating more comprehensive data in the analysis, visualizing the information in two or even three dimensions and rapidly testing numerous alternatives in ways not possible with other technologies;
- enhanced presentation of the analysis results.
- an increased competitive position, greater revenues and higher profits.

Concerning costs, the prices of software and data have fallen rapidly during the last two years. Initially one would most likely spend between $500 and $5,000 depending on the particular software functions and data needed; subsequently, smaller expenditures usually are needed, e.g., to upgrade the software. Consultants are beginning to emerge who truly understand both real estate and GIS; a competent consultant can save considerable time and money in identifying which software and data bases are more appropriate for a specific business.

The Bad News

Dozens of vendors offer GIS software and data. The differences between products are real and complex thus, novices frequently spend more money than is necessary, especially for data. No one should expect to learn GIS software by playing with it for a few hours, or even a few days. One needs to have a solid understanding of GIS tools to realize how its capabilities can be applied.

The Good News

An ever increasing number of publications, conferences and other educational forums are focusing on GIS in real estate. The Counselors of Real Estate recently co-sponsored a one-day workshop in Boston that sold-out, and similar workshops are being considered in other locations. The bottom line is sooner or later most real estate professionals will use a GIS, so the key question is to decide whether or not you want to be a leader or a follower.

NOTE

1. Dr. Michael L. Robbins, CRE, "GIS in Real Estate" (Presentation delivered at the 1994 Annual Fall Conference of the San Francisco Bay Area Chapter of the Apraisal Institute, San Francisco, California, October 14, 1994).

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