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How private development can fund public infrastructure

by Christopher B. Leinberger

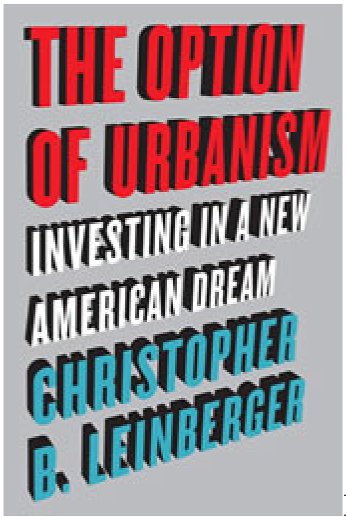
Real estate has caused two of the last three recessions. That is because real estate and the infrastructure that supports it—transportation, sewer, broadband, etc.—represent 35 percent of the asset base of the economy. When real estate crashes, the economy goes into a tailspin.

To speed up the recovery now slowly underway, the real estate sector must get back into the game. If over a third of our asset base is not engaged, the U.S. will be condemned to high unemployment and sluggish growth.

But the real estate recovery will not just be a continuation of the type of development of the past two generations—low density, drivable development. The Great Recession highlighted that there has been a structural shift in what the market wants. The bulk of the collapse in the housing market has been on the metropolitan fringe, exactly where the focus of drivable suburban housing growth has been. Fringe housing in most metro areas has lost twice the value the metro area as a whole has shed from the mid-decade peak. But the value of the opposite type of housing, known as "walkable urban," where most daily needs can be met by walking or public transit, only experienced about half the decline from the housing peak.

In fact, some metro areas have seen the highest housing values per square foot shift from drivable suburban neighborhoods in 2000, like Great Falls in the Washington suburbs or Highland Ranch south of Denver, to walkable urban neighborhoods, like Dupont Circle in Washington or LODO in downtown Denver, in 2010. The lines crossed in the decade. The last time the lines crossed was in the 1960s, and they were heading the opposite direction.

But housing may not play the same catalytic role during this recovery unless fundamental changes in transportation policy are adopted.



Most observers recognize that drivable suburban infrastructure has been massively subsidized. Some studies show that a drivable suburban home would have to pay 22 times what it currently pays for publicly and government-regulated private infrastructure. Suppose a city government, in its infinite wisdom, mandated that all restaurants must charge the same price for whatever customers ate or drank. That would mean patrons on a diet who do not drink alcohol would be massively subsidizing people who are stuffing themselves and getting drunk. This is not a free market at work.

This subsidized system has resulted in an oversupply of the wrong kind of house in the wrong location for what the market now wants. Federal, state, and local governments subsidize this type of product by building roads to nowhere while existing roads are left to deteriorate. The American Association of Civil Engineers recently gave American roads a near failing D- grade. Meanwhile, the Federal Highway Trust Fund is bankrupt, getting continuous federal cash infusions to subsidize the system.

The market wants the walkable urban alternative, which explains the 40-200 percent per-square-foot price premiums this type of housing commands and the hue and cry (or shouts of joy) about gentrification in urban neighborhoods. What is missing is an adjustment to this new market reality by investing in infrastructure, particularly transportation infrastructure, which will spark the type of housing and development the market wants.

Why transportation infrastructure? Because transportation drives development. For the 6,000 years that we have been building cities, the transportation system a society chose dictated what real estate developers could build. Starting in Sumer (present-day Iraq) through Pompeii, from Pepys's London to Franklin's Philadelphia, and from Henry Ford's Detroit to the Beach Boys' Los Angeles, the transportation system is the rudder that steers the investment of a large portion of a society's wealth.

So how do we pay for the transit, especially rail transit, that will allow developers to give the market what it wants: walkable urban development? The answer can be found in the past. In the early 20th century, every American town over 5,000 people was served by a streetcar system—this at a time when the real per capita household income was one-third what it is today. By 1945, metropolitan Los Angeles had the longest passenger rail system in the world. Atlanta's rail system was accessible to nearly all residents. Until 1950, our grandparents did not need cars to get around because they could rely upon various forms of rail transit. The average household only spent 5 percent of its income on transportation 100 years ago, versus 24 percent for drivable households today.

How did the country afford that extensive rail system? Real estate developers, sometimes aided by electric utilities, not only built the systems but paid rent to cities for right of way. Henry Huntington built the Pacific Electric in Los Angeles; Robert Lowry in Minneapolis built the Twin City Rapid Transit; and Sen. Francis Newlands in Washington built the Rock Creek Railway going up Connecticut Avenue from Dupont Circle in the 1890s. Newlands did not get into the rail transit business because of the profit potential of streetcars. He was a real estate developer, buying 1,700 acres between Dupont Circle and suburban Chevy Chase, Maryland, served by his streetcar line. The Rock Creek Railway did not make any money, but it was essential to getting homebuyers to Newlands's developments. So he subsidized the railway out of the profits. Most other streetcar/development entrepreneurs did the same thing. They understood that transportation drives development and that development had to subsidize the transportation.

After World War II, the wealth of the country was so vast that the federal government, along with the states, disconnected transportation and development. We decided that "your tax dollars at work," as every highway construction sign would proclaim, did not require a financial payback. One Polish refugee turned real estate developer, Nathan Shapell, who owned a large tract of land outside Los Angeles, was approached in the 1960s by the California highway department about building a freeway through his property. His first reaction was to offer for free as much land as needed for the road and to pay for the interchange to get customers to his land. The state official said that would not be necessary; the state would buy his land for the road and completely pay for the interchange. His reaction was, "What a wonderful country!"

But now, our transportation funding system is clearly broke. As transportation specialist Rob Puentes, senior fellow at the Brookings Institution, has said, "We've run out of money. It's time to start thinking."

It is time to go back to the future and redirect some of the property appreciation caused by rail transit to fund its expansion. This approach, called "value capture," is best known in this country by its public version, tax-increment financing, which uses increased future tax revenues expected from an investment in public infrastructure to pay off the debt incurred to build it. It has been used extensively in Chicago by Mayor Daley to fund that city's remarkable turnaround.

At present, only a fraction of the value added to private property by public transportation is tapped to support infrastructure. Property taxes are around 1 percent per year in many parts of the country, so only 1 percent of the upside can be captured. Yet the increase in private property values could yield much more, and there are many of methods by which support for transportation can be linked to rising land values. Property owners along a proposed rail corridor could vote in a special election, for example, to decide whether they want to fund the project.

In a Brookings Institution analysis of a proposed $140 million streetcar line, just 17 percent of the increase in private property values would pay the effort's entire capital costs. This is what Senator Newlands found out over a century ago: development can help pay for transportation improvements. Using value capture to pay for rail transit and highways is charging those who benefit the most from these public investments, the property owners, for at least some of the cost of transportation improvements.

There is no reason all transportation project costs, not just those for rail, should not be paid for in part by the property owners who profit from the improvement. If property owners would benefit from any transportation project, rail or road, and they are willing to help pay for it, that is the market speaking and we should listen—and benefit by their financial contribution. Levy exemptions could be made for existing communities that are too poor to pay if the project's main purpose is to provide existing residents transit to work, though even road or rail projects to parts of a metropolitan area that are underserved may spark economic growth that could then be used as value-capture revenue.

A few metro areas are experimenting with how these value-capture mechanisms would be structured. A developer, along with his adjacent property owners, funded a third of a new $100 million Metrorail station in Washington, D.C. that serves their projects. He felt he got a 10-20 times return on his investment by bringing rail transit to his front door. And it is important to note that this is only partially about the redevelopment of American cities. My research shows the majority of the market demand will probably be satisfied by transforming suburbs into walkable urban places.

Investment in rail transit is essential if we want to get the 35 percent of the economy in real estate growing more substantially. No economic recovery will be sustainable without the growth of the largest asset class in the economy. And looking to the past to understand how to pay for that rail transit is not only good policy, it is one of the only options we have left.

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