Washington MONTHLY

Respond to this Article

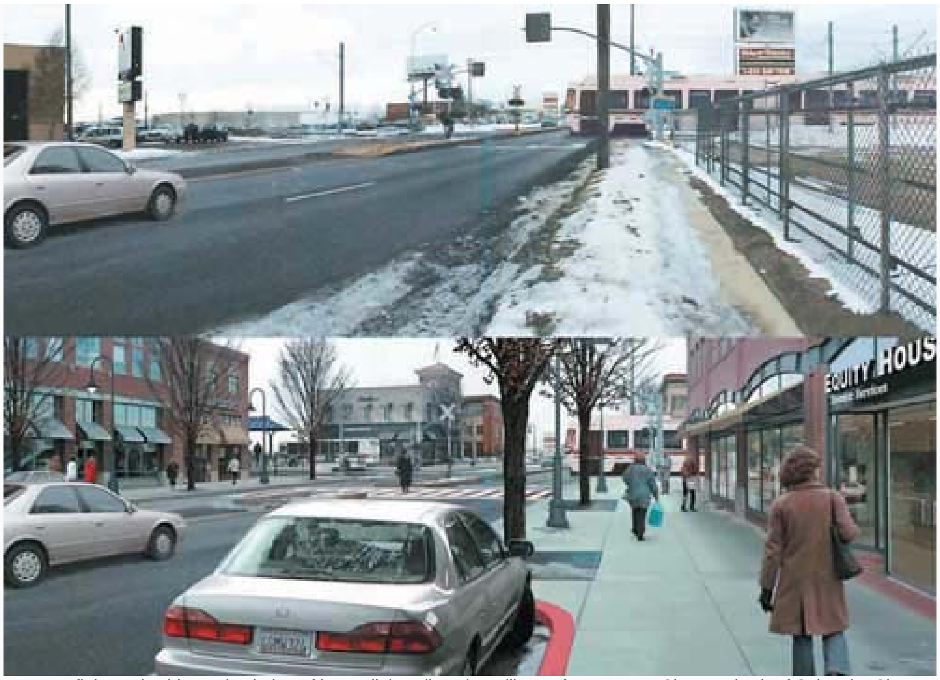
Washington Monthly, November/December 2010

The Next Real Estate Boom

How housing (yes, housing) can turn the economy around.

By Patrick C. Doherty and Christopher B. Leinberger

SHARE



Retrofitting suburbia: A simulation of how a light rail station will transform Murray City, a suburb of Salt Lake City.
Photos: Calthorpe Associates and Urban Advantage

What if there were a new economic engine for the United States that would put our people back to work without putting the government deeper in debt? What if that economic engine also improved our international competitiveness, reduced greenhouse gases, and made the American people healthier?

At a minimum, it would sound a lot better than any of the current offers on the table: stimulus from the liberals, austerity from the conservatives, and the president's less-than-convincing plan for a little stimulus, a little austerity, and a little bit of a clean-energy economy.

The potential for just such an economic renaissance is a lot more plausible than many would imagine. At the heart of this opportunity are the underappreciated implications of a massive demographic convergence. In short, the two largest demographic groups in the country, the baby boomers and their children—together comprising half the population—want homes and commercial space in neighborhoods that do not exist in anywhere near sufficient quantity. Fixing this market failure, unleashing this latent demand, and using it to put America back to work could be accomplished without resorting to debt-building stimulus or layoff-inducing austerity. At least for the moment, Washington has an opportunity to speed up private investment for public good and launch what could be a period of long-lasting prosperity. It is a market-driven way to make the economic recovery sustainable while addressing many of the most serious problems of our time: the health care crisis, climate change, over-reliance on oil from countries with terrorist ties, and an overextended military.

Real estate has caused two of the last three recessions, including the Great Recession we've just gone through. That is because real estate (housing, commercial, and industrial) and the infrastructure that supports real estate (transportation, sewer, electricity, and so on) represent 35 percent of the economy's asset base. When real estate crashes, the economy goes into a tailspin. To speed up the economic recovery now slowly underway, the real estate sector *must* get back into the game, just as it played a central role in the economic recoveries of past recessions. (Real estate also kept the high-tech recession in the early 2000s from being as serious as it might have been.) The United States will be condemned to high unemployment and sluggish growth if 35 percent of our asset base is not engaged. And hundreds of billions of dollars in potential investment capital is on the sidelines, waiting for the right market signals to be deployed.

We're unlikely, however, to see a real estate recovery based on a continuation of the type of development that has driven the industry for the past few generations: low-density, car-dependent suburbs growing out of cornfields at the edge of metropolitan areas. That's because there is now a massive oversupply of such suburban fringe development, brought on by decades of policy favoring it—including heavy government subsidies for extending roads, sewers, and utilities into undeveloped land. Houses on the exurban fringe of several large metro areas have typically lost more than twice as much value as metro areas as a whole since the mid-decade peak. Many of those homes are now priced below the cost of the materials that went into building them, which means that their owners have no financial incentive to invest in their upkeep. Under such conditions, whole neighborhoods swiftly decline and turn into slums. This happened in many inner-city neighborhoods in the 1960s, and we're seeing evidence of it in many exurban neighborhoods today. The *Los Angeles Times* reports that in one gated community in Hemet, east of L.A., McMansions with granite countertops and vaulted ceilings are being rented to poor families on Section 8 vouchers; according to the *Washington Examiner*, similar homes in Germantown, Maryland, outside Washington, D.C., are being converted to boarding houses.

Many hope that when the economy recovers, demand will pick up, inventories of empty homes will be whittled down, and the traditional suburban development machine will lumber back to life. But don't bet on it. Demand for standard-issue suburban housing is going down, not up, a trend that was apparent even before the crash. In 2006, Arthur C. Nelson, now at the University of Utah, estimated in the *Journal of the American Planning Association* that there will be 22 million unwanted large-lot suburban homes by 2025.

Meanwhile, the Great Recession has highlighted a fundamental change in what consumers *do* want: homes in central cities and closer-in suburbs where one can walk to stores and mass transit. Such "walkable urban" real estate has experienced less than half the average decline in price from the housing peak. Ten years ago, the highest property values per square foot in the Washington, D.C., metro area were in car-dependent suburbs like Great Falls, Virginia. Today, walkable city neighborhoods like Dupont Circle command the highest per-square-foot prices, followed by dense suburban neighborhoods near subway stops in places like Bethesda, Maryland, and Arlington, Virginia. Similarly, in Denver, property values in the high-end car-dependent suburb of Highland Ranch are now lower than those in the redeveloped LoDo neighborhood near downtown. These trend lines have been evident in many cities for a number of years; at some point during the last decade, the lines crossed. The last time the lines crossed was in the 1960s—and they were heading the opposite direction.

There are some obvious reasons for the growing demand for walkable neighborhoods: ever-worsening traffic congestion, memories of the 2008 spike in gasoline prices, and the fact that many cities have become more attractive places to live thanks to falling crime rates and the replacement of heavy industries with cleaner, higher-end service and professional economies.

But the biggest factor, one that will quickly pick up speed in the next few years, is demographic. The baby boomers and their children, the millennial generation, are looking for places to live and work that reflect their current desires and life needs. Boomers are downsizing as their children leave home while the millennials, or generation Y, are setting out on their careers with far different housing needs and preferences. Both of these huge demographic groups want something that the U.S. housing market is not currently providing: small one- to three-bedroom homes in walkable, transit-oriented, economically dynamic, and job-rich neighborhoods.

The baby boom generation, defined as those born between 1946 and 1964, remains the largest demographic bloc in the United States. At approximately 77 million Americans, they are fully one-quarter of the population. With the leading edge of the boomers now approaching sixty-five years old, the group is finding that their suburban houses are too big. Their child-rearing days are ending, and all those empty rooms have to be heated, cooled, and cleaned, and the unused backyard maintained. Suburban houses can be socially isolating, especially as aging eyes and slower reflexes make driving everywhere less comfortable. Freedom for many in this generation means living in walkable, accessible communities with convenient transit linkages and good public services like libraries, cultural activities, and health care. Some boomers are drawn to cities. Others prefer to stay in the suburbs but want to trade in their large-lot single-family detached homes on cul-de-sacs for smaller-lot single-family homes, townhouses, and condos in or near burgeoning suburban town centers.

Generation Y has a different story. The second-largest generation in the country, born between 1977 and 1994 and numbering 76 million, millennials are leaving the nest. They may sometimes fall back into the nest, but eventually they find a place of their own for the first time. Following the lead of their older cousins, the much smaller generation X (those born between 1965 and 1976), a high proportion of millennials have a taste for vibrant, compact, and walkable communities full of economic, social, and recreational opportunities. Their aspirations have been informed by *Friends* and *Sex in the City*, shows set in walkable urban places, as opposed to their parents' mid-century imagery of *Leave It to Beaver* and *Brady Bunch*, set in the drivable suburbs. Not surprisingly, fully 77 percent of millennials plan to live in America's urban cores. The largest group of millennials began graduating from college in 2009, and if this group rents for the typical three years, from 2013 to 2018 there will be more aspiring first-time homebuyers in the American marketplace than ever before—and only half say they will be looking for drivable suburban homes. Reinforcing that trend, housing industry experts, like Todd Zimmerman of Zimmerman/Volk Associates, believe that this generation is more likely to plant roots in walkable urban areas and force local government to fix urban school districts rather than flee to the burbs for their schools.

The convergence of these two trends is the biggest demographic event since the baby boom itself. The first wave of boomers will be sixty-five in 2011. The largest number of millennials reaches age twenty-two in 2012. With the last of the boomers hitting sixty-five in 2029, this convergence is set to last decades. In addition to the generational convergence, the Census Bureau estimates that America is going to grow from 310 million people today to 440 million by 2050.

An epic amount of money will pour into the real estate market as a result of population growth and demographic confluence. To be sure, unemployment and stagnant wages have eroded people's buying power. Boomers have suffered steep declines in the value of their current homes and 401(k)s, and young people are leaving college with ever-larger student loan debts.

But Americans of all ages have saved and paid off debts since the recession began, and average household balance sheets should be significantly healthier five years from now. In addition, 85 percent of the new households formed between now and 2025 will be single individuals or couples with no children at home; unburdened by child-rearing expenses, they will have more income available for housing (and less desire to spend it tending big backyards).

Most importantly, the very act of moving to more walkable neighborhoods will free families from the expense of buying, fueling, and maintaining the two or more cars they typically need to get around in auto-dependent suburbs. Households in drivable suburban neighborhoods devote on average 24 percent of their income to transportation; those in walkable neighborhoods spend about 12 percent. The difference is equal to half of what a typical household spends on health care—nationally, that amounts to $700 billion a year in total, according to Scott Bernstein of the Center for Neighborhood Technology. Put another way, dropping one car out of the typical household budget can allow that family to afford a $100,000 larger mortgage.

The burgeoning demand for homes in walkable communities has the potential to reshape the American landscape and rejuvenate its economy as profoundly as the wave of suburbanization after World War II did. If anything, today's opportunity is larger. The returning veterans and their spouses represented approximately 20 percent of the American population at that time; the current demographic convergence—77 million boomers plus 76 million millennials—comprises nearly 50 percent.

In the postwar years, America pushed its built environment outward, beyond the central cities, creating millions of new construction jobs and new markets for cars and appliances—a virtuous cycle of commerce that helped power American prosperity for decades (until, of course, it went too far, leading to the oversupply of exurban development that is acting as deadweight on the current recovery). The coming demographic convergence will push construction inward, accelerating the rehabilitation of cities and forcing existing car-dependent suburbs to develop more compact, walkable, and transit-friendly neighborhoods if they want to keep property values up and attract tomorrow's homebuyers. All this rebuilding could spur millions of new construction jobs. But more importantly, if done right, with "smart growth" zoning codes that reward energy efficiency, it would create new markets for power-conserving materials and appliances, providing American designers and manufacturers with experience producing the kinds of green products world markets will increasingly want.

In addition to fueling long-term economic growth, the new demand for walkable neighborhoods could provide other benefits. One of the biggest drivers of rising health care costs is the expansion of chronic diseases like obesity, diabetes, and heart disease—conditions exacerbated by the sedentary lifestyles of our car-dependent age. All would be substantially reduced if Americans move into higher-density, transit-friendly neighborhoods in which more walking is built into their daily routine.

The potential environmental benefits are equally profound. A study conducted by the National Resources Defense Council concluded that simply conforming new construction to smart growth standards would reduce carbon emissions 10 percent within ten years, more than half the target set by the president and the stalled climate legislation. Similarly, the U.S. Green Building Council estimates that new sustainable developments could reduce water consumption by 40 percent, energy use by up to 50 percent, and solid waste by 70 percent.

We can reap these economic, health, and environmental benefits if the real estate market is allowed to follow the demand preferences of consumers. But that's easier said than done. Markets don't exist in a vacuum. They operate within rules and incentives set by governments. The rules and incentives that guide today's real estate market were designed, for the most part, more than a half century ago to fit the demands of the postwar-era Americans who were looking for new homes with yards outside overcrowded cities in which to raise their families. For many years the government-insured mortgages provided to millions of GIs were regulated in such a way that they could only be used to buy newly constructed homes, not to purchase or rehab existing homes—an incentive that strongly biased growth away from cities and toward the suburbs. Cheap rural land outside cities became accessible and valuable to developers thanks to the building of the interstate highway system, 90 percent funded by the federal government. Using federal matching grants, suburban municipalities extended water, sewer, and electric lines to new subdivisions, charging developers and homeowners a fraction of the real costs of those extensions. Municipalities also crafted zoning codes, often in response to federal regulations that essentially mandated low-density development.

Today, even though consumer preferences have changed, most of the old rules and subsidies remain in place. For instance, federal transportation funding formulas, combined with the old-school thinking of many state departments of transportation, continue to favor the building of new roads and widening of highways—infrastructure that supports low-density, car-dependent development—over public transit systems that are the foundation for most compact, walkable neighborhoods. When developers do propose to build denser projects, with narrower streets and apartments above retail space, they often run up against zoning codes that make such building illegal. Consequently, few compact, walkable neighborhoods have been built relative to demand, and real estate prices in them have often been bid up to astronomical heights. This gives the impression that such neighborhoods are only popular with the affluent, when in fact millions of middle-class Americans would likely jump at the opportunity to live in them.

To meet this broad new demand, however, requires that entire metropolitan regions work together to chart a common vision for their communities. When that happens, all kinds of Americans, and not just coastal elites, choose walkable, transit-based growth.

Consider the recent experience of Utah, a state that voted 63 percent for John McCain and Sarah Palin. In 1997, in anticipation of the 2002 Winter Olympics in Salt Lake City, a coalition of local CEOs, elected leaders, developers, farmers' associations, conservation advocates, and urban planners put together a process of public meetings to get citizens involved in developing a strategy to accommodate greater Salt Lake City's fast-paced growth in a fiscally and environmentally sustainable way. That process, dubbed "Envision Utah," led to a blueprint for development in the four-county region. The plan largely rejects further suburban sprawl in favor of a "quality growth strategy" of dense walkable neighborhoods built around transit stops.

The first step was the building of a seventeen-mile, twenty-three-station light rail line in Salt Lake City called TRAX. The line was highly controversial; many predicted it would be an underutilized boondoggle. But when the first phase opened in 1999, TRAX proved an immediate hit with the public—eventually some trains became so crowded with riders that their doors couldn't close. In 2000 and 2006, voters approved tax increases to expand the system, including increased reach to several outlying suburbs, twenty-six miles of new light rail track, forty additional station stops, and eighty-eight miles of heavier commuter rail, reaching as far as Provo. Meanwhile, mixed residential-commercial developments have been constructed around existing stations in places like the formerly industrial suburb of Murray City.

Locally financed transit expansions are also underway in such wide-ranging places as St. Louis, Denver, Los Angeles, Montgomery, Alabama, and Broward County, Florida. From 2004 to 2009, 67 percent of light rail ballot measures passed. In 2008, the election year defined by the financial crisis, 87 percent of transit measures passed. In Seattle, a 2008 measure saw sponsors actually eliminate road funding so that the thirty-four-mile extension of the light rail system would pass.

The public, then, has made its desire for transit-oriented growth quite clear, and governments at the local and metropolitan levels have begun to respond. At the federal level, however, the policy machinery remains on autopilot, supporting a sprawl-based growth model that is beyond broken. What we need to do should be obvious: replace old federal rules and incentives that hamper the market's ability to meet changing needs and preferences for housing with new ones that don't, thus helping to rejuvenate the American economy. But these new policies will have to be produced in a political environment that, unlike in the postwar years, is hostile to government actions that add considerably to the federal deficit. And they need to be written quickly: the peak of the convergence is only three years away, and the economy needs a sustainable base from which to grow more quickly now.

Throughout human history, transportation has determined the pattern of real estate development, and so the place to begin is federal transportation policy. Fortunately, next year Congress will probably reauthorize the giant transportation law that determines most federal infrastructure spending—which, tellingly enough, is still commonly referred to in Washington as “the highway bill.” This will provide a golden opportunity to change federal policy in several fundamental ways. First, the biases in federal matching grants that favor roads and highways over every other type of infrastructure (sidewalks, bike paths, mass transit, and so on) must end. Second, the grants should be “scored” based on their economic, environmental, and social equity impacts—in particular, on the degree to which proposed transportation projects minimize travel times and distances for residents and enable compact, walkable, energy-efficient, and affordable development. Third, metro areas should be required, and given funding, to do what greater Salt Lake City did: create a blueprint for future growth. Those blueprints should then help guide which specific infrastructure projects get federal funding. In effect, this will shift the power to shape growth patterns away from congressional appropriators and state departments of transportation and to local citizens and local elected officials. And it will help ensure that actual consumer demand drives the process, rather than the current combination of antiquated federal funding formulas, congressional earmarks, and offstage machinations of conventional developers.

Many liberals might want Washington to cover most of the costs of this new infrastructure. That’s unlikely to happen in the current political and fiscal environment. Nor, frankly, is it necessary, or even healthy. Instead, scarce federal dollars should be used to attract private dollars, of which there are plenty. The Investment Company Institute reports that institutional investors are keeping a relatively stable $1.8 trillion in money market funds because money managers see no good long-term investment vehicles. A similar amount is sitting in the coffers of non-financial corporations.

The Obama administration has proposed one way to tap some of these private dollars: create an “infrastructure bank” that would leverage several private dollars for every federal dollar invested to build a project. In return, the bank and private investors would receive, say, a dedicated locally raised future tax revenue source.

Another approach would be to revive a practice from the past. A hundred years ago, virtually every city of 5,000 or more had an extensive network of streetcars. These systems were typically not publicly owned. Instead, real estate developers, often in partnership with electric utilities, built and ran them, even paying municipal governments to rent the right-of-way. The developers made their money not from fares, which barely covered operations, but from the increased land values that the trolley extensions made possible. There's no reason why similar deals can't be negotiated today to fund various kinds of mass transit. In fact, the process has already begun in a few places. Developers are helping to pay for the extension of the Washington, D.C., metro rail to Dulles airport, while Microsoft cofounder Paul Allen's real estate company and other property owners participated in the funding of the streetcar to his substantial property holdings just north of downtown Seattle. The federal government can help make such arrangements much more common by offering partial guarantees of the debt floated to build transit infrastructure.

Another way Washington can encourage walkable neighborhoods is through reforms of Fannie Mae and Freddie Mac. These two government-sponsored mortgage guarantors and underwriters went bankrupt and were taken over by the U.S. government—in large part because they overinvested in homes on the suburban fringe. But in recent years Fannie Mae has been experimenting with an interesting new product: "location efficient mortgages." Instead of relying solely on credit score and income to determine whether a borrower qualifies for a mortgage, these loans use electronic map systems to take into account how much homeowners will have to pay for transportation. Research by Scott Bernstein of the Center for Neighborhood Technology suggests that location efficient mortgages may have lower default rates than conventional Fannie Mae loans. If that finding proves true, then it makes sense to expand the program, and to apply the same concept to household energy savings: Fannie, Freddie, and HUD's Federal Housing Administration should factor in the savings from more energy-efficient homes and retrofits. And all these products should be available for more types of construction than just the single-family detached house.

In the past, big shifts in real estate patterns, from suburbanization to gentrification, have often made the lives of the poor considerably worse. To make sure that doesn't happen as we move toward more walkable communities, federal action will also be needed. The Obama administration took a first step earlier this year by announcing that location efficiency will be a criterion for $3.25 billion in competitive HUD housing grants. That means that at least some walkable developments will be built to include housing for lower-income families, and more can be done along these lines using existing federal housing programs such as the Low-Income Housing Tax Credit.

But the truth is that federal housing policy can make only a modest dent in the affordability problem. As we've seen, what really drives development is transportation policy, and so the real lever of change is, again, the upcoming transportation bill. The bill should offer state and local governments a clear choice: if they want federal dollars for light rail and other transit systems, they must ensure that citizens at all income levels reap the benefits. That means changing local zoning codes to mandate that a portion of the housing in transit-oriented developments—say, 15 percent—be reserved for lower-income families. It also means that local jurisdictions need to remove ordinances that act as barriers to affordable housing—an idea long championed by many conservatives, including the late Jack Kemp. For instance, empty nesters ought to have the right to rent out unused bedrooms or turn part of their homes into separate rental units. Doing so is illegal in most municipalities today.

Ultimately, the biggest barrier to affordability is insufficient supply: homes in walkable, transit-oriented neighborhoods cost too much because there are not enough of them to satisfy the growing market demand. What's needed, then, is a supply-side solution: build more such neighborhoods.

Can a set of policies like these ever get through Congress? After all, Republicans have long been ideologically hostile to mass transit. With their base now predominantly in exurban and rural America, most GOP lawmakers will look with skepticism, even disdain, at proposals to use government in ways that benefit cities and closer-in suburbs that tend to elect Democrats. And many Americans who live in rural or exurban areas feel the scorn that too many educated urbanites express for their lifestyle, and reflect that scorn right back.

Yet, as Utah shows, conservative Americans can rally behind mass transit when all the advantages are pointed out and the hidden costs of sprawl made clear. The threats to family life posed by long commutes and auto dependency are a building issue among evangelical Christians. Conservatives are often among the most acute critics of federal highway subsidies and the way they insulate consumers from the real cost of driving. The late Paul Weyrich, cofounder of the Heritage Foundation, served on Amtrak's board and was an outspoken champion of passenger rail. As William Lind recently argued in the *American Conservative* magazine, it was hardly a triumph of free enterprise that America's convenient and affordable streetcar and passenger rail systems, most of them privately owned, were put out of business by government-subsidized and -owned highways.

In the wake of the Great Recession there is also another huge pocketbook force at work: however they might lean ideologically, the best hope suburbanites have for reversing their depressed home values is for mass transit lines to be extended in their communities. Though not every suburb can be saved in this way, for many it represents the most practical long-term solution to their dilemma.

Ultimately, the strongest argument for these policies—one conservatives and liberals ought to be able to agree on—is that they would allow the moribund real estate market to function again, and in so doing would give the economy a dose of healthy growth. Indeed, assuming that a decisive package like the one above is passed, the private sector, awash in capital, may anticipate the demand about to be unleashed in our markets and start investing in real estate again. That is what happened in downtown Portland, Oregon, when a proposed $50 million streetcar led to $3.5 billion of private-sector development, much of it *before* the streetcar was built. America will be back in business. And good business is good politics.

But leading the transition to sustainability is also a strategic imperative for the United States. China and India need to figure out how to accommodate 700 million of their countrymen who will leave the villages and enter the cities over the next forty years. That's more than twice the total American population. China is already building at a pace that will allow it to have 221 cities with more than 1 million residents—the U.S. has nine. The competition for energy and raw materials like copper, lumber, and steel under a business-as-usual scenario is extraordinary and will result only in increased levels of strategic conflict in the decades ahead, as recent congressional hearings on "strategic minerals" attests. By making a decisive shift and embracing sustainable communities, innovative American firms will have the domestic markets they need to develop and deliver the super-efficient products and services that will keep America secure and, through increased exports, help build our economy while reducing our trade imbalance.

Admittedly, the road to sustainability only begins with how we build and rebuild our communities. In addition to the ideas discussed here, there is much more we need to do to address the energy and material intensity of our economy in ways that will lead to better jobs, higher wages, reduced deficits, and greater national security. But at a time when the American people need a plan for long-term prosperity, and because real estate absorbs so much of our wealth, it is essential that we focus on pushing on the door unlocked by our demographic inheritance: the two largest population groups, half of our population, want communities that the market is not delivering due to out-of-date subsidies and policies.

The bottom line is this: despite the protests of orthodox adherents to liberal and conservative fiscal policy, it is now possible to unleash latent private-sector demand by implementing reforms that will end our subsidies to sprawl and focus our nation on sustainability. Neither stimulus nor austerity, this approach would provide a new economic engine for America that can set us on a secure and prosperous path for years to come.

Patrick C. Doherty is the director of the Smart Strategy Initiative at the New America Foundation in Washington, D.C.

Christopher B. Leinberger is a visiting fellow at the Brookings Institution in Washington, D.C., a professor at the University of Michigan, and an author and real estate developer.