THE ECONOMICS OF PLANNED NEW COMMUNITIES: WILL THEY SELL?

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Introduction

During this celebration of Reston's 20th Anniversary, it is appropriate to consider the economic viability of planned new communities, as well as their obvious aesthetic and social benefits. The committee planning this occasion has placed this topic under the short and provocative title, "Will it sell?" They have taken the equally provocative step of asking me to answer that question.

However, I wish to confine my analysis to only one type of planned new community: the type exemplified by Reston. That type is built on the edges of an existing metropolitan area by a private developer. It is large enough to include several different types of land use, including residential, commercial, industrial, and governmental; hence it initially encompasses at least 5,000 acres. Each such community is developed according to a single cohesive plan that "internalizes" relationships among different land uses considered "external" to most smaller-scale developments. It can be considered either a peripheral or a satellite new community, but it is definitely not an in-city community. Yet it depends heavily upon the economy of the rest of its metropolitan area; so it is definitely not an autonomous new community either.

Concerning such a planned new community, the correct and decisive answer to the question "Will it sell?" is: "Yes and no." That sounds ambiguous, but it is not. This question is really two very different questions in disguise. One is: once such a new community has been created, will many consumers purchase homes

* The views in this article are solely those of the author, and not necessarily those of the Brookings Institution, its trustees, or its other staff members.

there, and will many industries and commercial firms locate there? The second question is: will developers and investors have sufficient economic incentives to create such communities in the first place? The answers are "Yes" to the first question and "No" to the second.

I could stop right there, but I presume the committee wants some further explanation of why these answers are the correct ones. The remainder of this article provides such an explanation.

The General Economic Theory of Real Estate Development

Planned new communities are special kinds of real estate developments, and therefore conform to the general economic theory underlying such developments. The basic idea is the same as that for all investment: to make profits on invested capital. In real estate development, the initially-invested capital is used to buy land or other properties at one cost, to create additional values by adding amenities to those properties, and to sell or rent the enhanced properties to final users at another, higher cost. The amenities consist of new structures and environments created on land that is either initially vacant -- the usual case -- or added to improvements already there.

The profitability of this value-creation process depends upon (1) the spread between the initial cost of acquisition and the final disposition price, (2) the costs of creating the added amenities involved, and (3) the time between initial purchase and final disposition.

The price spread can be increased by purchasing land at a very low price. One way to accomplish this is to buy land far out on the periphery of the market being served. That is why downtown office developers often build on the outer fringes of the existing office market, and why suburban housing developers often build on parcels far beyond areas that are already solidly built up.

The cost of enhancing the land purchased can be kept down by restricting the added amenities to relatively simple ones that are easily mass-produced. This is one reason most residential developers build one subdivision at a time, filling it with homes that are quite similar to each other -- whether they are huge single-family mansions or small multi-family apartment units.

Nearly all value creation -- including manufacturing as well as real estate development -- takes time, since the initial inputs must be substantially modified. But time always costs money because of the interest that must be paid on the capital invested. Usually the developer borrows the capital and thus must pay the interest as a cash expense. But even if it is his or her own capital, interest must be foregone on it as long as it is tied up in development. Therefore, <u>all real estate development involves a race against the clock</u>. The developer must be able to create and sell or rent the amenities involved fast enough, and for high enough prices, to beat the ever-rising cost of interest charged against the capital required. The higher are prevailing interest rates, the faster this race must be run by the developer.

<u>Basic Principles of Profitable Development Derivable from the General Theory</u>

Certain principles of successful real estate development can be derived from the above analysis. They are:

---<u>The smaller the initial capital investment required, the better the chances of completing any project profitably</u>. Small initial investments run up either actual or imputed interest costs more slowly than large ones, other things equal. Moreover, any given absolute size of profit produces a higher profit <u>rate</u> against a smaller equity base than a larger one. This principle encourages developers both to attempt relatively small projects, and to borrow most of the initial capital required if they can do so feasibly. It also encourages them to acquire land through "take-down" contracts. Such contracts permit them to pay for each parcel right before they actually develop it, rather than having to pay immediately for all the land they will use only over a relatively long time.

---The longer it takes to carry out any given project, the harder it is to do so profitably. Lengthening the time needed both runs up interest costs proportionally, and exposes the developer to greater uncertainties about future market conditions. Interest rates may rise, a recession may cut back on consumer demands for new housing, tax reforms may affect investor attitudes towards real estate, and all sorts of other adverse events may occur that were unforeseen -- and often unforeseeable -- at the time the project started.

---The more complex a project, the harder it is to complete profitably. Greater complexity requires the developer to orchestrate more different types of skills successfully, to overcome more different kinds of obstacles, and to promote sales in more different types of markets. Few developers have the breadth of experience and other capabilities to undertake really complex, multi-use projects successfully. More complex projects also take longer to complete, thereby making success harder for reasons stated above.

---The larger a project, the harder it is to complete profitably. Really big projects take longer to carry out than small ones, and usually involve much greater complexity because they encompass more different types of land uses. True, there may be positive synergy among the many land uses in a large project. For example, the presence of each may add to the market attraction of the others. Thus a regional shopping center in a project makes it easier to sell homes there, and the homes sold add to the center's sales. Nevertheless, in most cases, large size creates more problems than benefits for developers.

These principles help explain why most urban developments in the past have been relatively small and simple ones. Moreover, each developer leaves the creation of most supporting infrastructure -- such as streets, sewer and water systems, shopping centers, and schools -- to local governments or other developers specializing in some other type of land use. Even most shopping centers, though often quite large, have until very recently contained almost entirely retail establishments. There is a lot of talk about mixed-use development, but the vast majority of modern America has been created through relatively small-scale, single-use projects.

The Specific Economic Theory of Planned New Communities

Planned new communities like Reston appear to violate all the principles of general real estate development stated above. They cover huge land areas, involve many different land uses in complex patterns, and take decades to complete. How can their developers expect to carry them out profitably?

New community developers have formulated a whole theory in answer to that question. It is not always fully spelled out, but I will try to set it forth as clearly as I can. Their basic strategy involves three central ideas.

The first is to buy land cheaply, usually by purchasing it at the outer edges of a large existing metropolitan area. But they want to be close enough to that area to remain within reach of the housing, industrial, and commercial markets already present there.

The second idea -- and the heart of their strategy -- is to develop an entire quasi-self-contained community in accordance with a single cohesive plan. By integrating many types of land use together in such a plan, they can produce a much higher quality overall environment than traditional fragmented real estate development. Moreover, a large project often contains several types of housing, such as large and small detached single-family homes, townhouses, low-rise and high-rise rental apartments, and condominiums. Such diversity can appeal to several markets, thereby increasing potential sales per year. And synergy among different types of land uses increases the marketability of each, as noted earlier. However, in order to create a large, multi-use, quasi-self-contained new community, the developers must initially get control of a very large amount of land. And before they can start selling or renting homes or other properties, they must also install a lot of infrastructure not normally provided by developers

The third idea follows from the first two. It is that the final products of development -- improved land parcels -- can actually be sold or rented both faster and at higher final prices because of this integrated plan than would be possible through traditional fragmented development. These results are supposed to occur because of the superior attractiveness of the community and the synergy among its multiple land uses. True, it will take much longer than usual to get from the intial land purchases to the first sales of finished products in such a strategy. More land has to be purchased at first, and more amenities created initially to convince people the overall plan will actually become a reality.

But once the community has emerged enough to become credible, the higher quality of its environment will permit its developers to market land there much faster, and at higher prices, than would otherwise be possible. These advantages will more than make up for the higher initial investment, longer development period, and greater costs of creating planned new communities than of building traditional subdivisions.

That is the theory underlying private development of planned new communities. But how well has this theory worked in practice, and how well can it be expected to work in the future? In other words, "Has it sold?" and "Will it sell?"

The Successful Aspects of Planned New Communities

Merely to raise these questions within the attractive boundaries of Reston itself seems almost impertinent. Obviously, Reston and its nearby cousin Columbia both exist and embody the kind of higher-quality environments that advocates of planned new communities proclaim as desirable. I do not dispute that these two planned communities, and several others across the nation, have generated environments that are both aesthetically more attractive, and functionally more efficient, than those resulting from traditional subdivision development.

In driving around these new communities, I have been particularly impressed by the absence of commercial strip development. It is delightful not be be exposed to the usual amazingly ugly parade of uncoordinated advertising signs and autonomously designed buildings, each totally unrelated to the others around it or to any overall environmental concept. In addition, planned new communities have physically located different land uses in relation to each other in more functionally efficient patterns than often occur in unplanned communities. This is clear from comparing either Reston or Columbia with two unplanned communities near my own home -- downtown McLean, Virginia, and the entire Tyson's Corner area. More chaotic jumbles of unrelated and uncoordinated land uses are hard to imagine.

Moreover, planned new communities have attracted many households, office firms, industrial firms, retail establishments, and other occupants over time -- enough so they do indeed constitute true multi-use communities. That is why I answered one of the two questions encompassed in the title of this paper -- "Will it sell?" -- with "Yes." Once a new community has been brought into being and equipped with many of its planned amenities, it can attract lots of households and business firms to locate there. Hence it can eventually become a full-fledged embodiment of the at least some of the virtues its developers initially promised.

The Economic Failure of Planned New Communities

Nevertheless, planned new communities suffer from one flaw that has been economically fatal to most developers who have tried to start them. That flaw has also prevented any widespread imitation of Reston or Columbia around the U.S. It is the inability of the initial developers to sell or rent their final products fast enough, or at high enough prices, to overcome the handicap of having to make huge initial capital investments. In short, planned new communities have not been profitable soon enough after their inception to justify investing private capital in starting them without major public subsidies.

Once a planned new community has been created, and its initial developer has suffered huge losses, subsequent investors can sometimes make its operation profitable, if two things happen. First, they must acquire it from the original developer at a relatively low price compared to what that developer has invested in it. Second, they must be lucky enough to experience an unlikely but not impossible combination of circumstances favorable to their venture.

Thus, most successful new communities need what Bill Nicoson has called a "sacrificial lamb" to get them started. That means an imaginative developer who conceives of the basic idea, raises a pool of venture capital, amasses a large initial plot of land, installs a lot of costly infrastructure, and then goes broke! Such pioneering makes its performers famous and revered, but not wealthy. Hence this is not a role that an economist can conscientiously recommend to potential investors or developers. Yet if no one performs it, few planned new communities would ever be created.

This division of labor between an initial "sacrificial lamb" and later economically more successful investors is illustrated by the history of Reston. Its original founder had to abandon his investment and turn it over to corporate investors. The first round of such investors may also have had an unhappy profit experience with this community. But a second round apparently has been more successful, although I do not have accurate data concerning the profits made by either group. The new community of Columbia also failed to produce high enough overall returns on the capital initially invested in it to justify any repetition of starting another such community elsewhere. One or two planned new communities -- such as Irvine, California -- have proved profitable. But dozens of others have failed economically -- certainly from the perspective of their founders, and often from that of a second round of investors too.

So the answer to the second basic question posed by the title of this article -- "Will developers and investors have sufficient economic incentives to start more such communities?" -- must be: "No!" -- at least under the kinds of economic and other conditions most likely to prevail in our economy.

Why not? The answer is that planned new communities of this type must be so large, so complex, and take so long to complete that they cannot keep up with the interest charges required by their initial investments. The theory that the attractions of planned environments would speed up the marketing process enough to overcome this handicap does not work -- at least not for initial investors. The required development period is so long it exposes the initial developer to experiencing at least one, and as many as three, business cycles before the land can be sold off. Those cycles cause rising interest rates and recessions, each of which leads to temporary declines in the sale of homes and the disposal of non-residential property. Hence the econometric models of successful marketing that assumed ever-rising or even constant sales at high average levels have proved too optimistic. Even if second-round developers can make such projects profitable, they can do so only because of the economic sacrifices made by the initial investors. Hence no one has much incentive to initiate such projects. Obviously, without initiators, they will not be created, no matter how profitable they have been to second- and third-round investors.

In addition, longer-run changes in economic conditions not necessarily associated with business cycles have hurt developers of planned new communities. The most important has been the secular rise in nominal interest rates since the mid-1970s. Higher interest rates mean the whole development process must speed up to keep up with interest charges against initially-invested capital.

True, unexpectedly high inflation in the late 1970s through about 1981 did help developers of planned new communities. It raised the prices of their land and other improvements rapidly. This was especially beneficial if they had borrowed large amounts of fixed-rate debt at relatively low interest rates. But high inflation has not persisted through the mid-1980s, and cannot be counted on to "bail out" future planned new community developers.

Another difficulty has arisen from the tension between locating far enough out from already-developed areas to buy land at low prices, and being close enough to those areas to draw upon established housing and non-residential land markets there. Some new-community developers went too far out to get low-priced land, thereby weakening their final product markets. They were unable to sell housing or non-residential land fast enough because of that low demand. Others tried to stay in closer but had to pay so much for the land that they could never catch up with their initial investments.

True, a new community developer who buys really far-out land may be able to market it eventually if the site is in or near a fast-growing metropolitan area, such as Dallas or Orange County, California. But "eventually" may not be soon enough to beat the interest rate clock.

Therefore, large-scale planned new communities <u>viewed as private investments</u> have not succeeded enough to capture any significant share of total new urban development in the U.S. Nor are they likely to do so in the forseeable future without large public subsidies. Under our present budgetary situation, with huge federal deficits and an administration opposed to any increases in domestic spending, large public subsidies are very unlikely.

In other nations, such as Sweden, local governments sometimes provide the required subsidies. They can do so because they own much of the necessary land, and control all zoning so they can award themselves monopoly sites for large commercial centers. But such behavior by local governments would be considered too activist in the U.S. It would be seen as too competitive with private developers -- even though private developers cannot successfully start large new communities, as shown above.

The closest thing to this process that might occur in the U.S. would be a local government's tightly planning specific future land uses for all the sites within its boundaries, then doling out permission to develop each site in accordance with a comprehensively-planned schedule. But the private real estate community has fought such "growth limits" in most areas, partly because they tend to raise the prices of the land favored by selection for early development. So we are not likely to see anything resembling large planned new communities appear through this route either.

What Conditions Would Make Such Communities Economically Feasible Investments?

True, at least one large-scale planned new community (Irvine, California) has succeeded in establishing itself profitably, and perhaps a few others have too. Therefore, the answer to the second question could be "Yes" under certain circumstances, even if it is usually "No." What are those circumstances? A few clues can be derived from the Irvine experience.

The original developers of the Irvine community acquired the land decades ago from Spanish land grants. That land was then so far out on the fringe of developed areas that no one considered it urban land at all. Moreover, they paid virtually nothing for that land. But they also had to wait for decades before urban growth came close enough to make their land marketable for urban uses. True, these original developers eventually sold the land at extremely high prices to a second set of entrepreneurs, who in turn sold it again a few years later at even higher prices.

But by the time the entrepreneurs who bought the land from its original developers appeared on the scene, two favorable factors had enormously increased their ability to re-sell the land at higher prices. One was the extension of urban development much closer to their land -- in fact, all around it. The other was the creation on their site of an extensive community, including a campus of the University of California. So they were buying an already on-going and viable new community, not just a vacant site on which to create one. These entrepreneurs therefore cannot be considered "pioneering" new community developers in the same sense as Bob Simon, Jim Rouse, or the original developers of Irvine.

Another crucial factor related to Irvine was an unexpected surge of inflation in the late 1970s. It was combined with very strong population and economic growth in the particular area surrounding Irvine -- Orange County, California. These two factors created soaring demands for land, housing, and other real estate there that raised their prices much faster than the cost of living generally. But lenders who had put up much of the capital to develop Irvine had not expected that inflation; so they lent money for long periods at relatively low interest rates. The resulting equity build-up for borrowers was a windfall gain that is not likely to occur again.

Another hard-to-predict factor benefiting Irvine was the appearance of smog in Southern California because of the immense use of automotive vehicles there. Ocean breezes blow smog away, and the mountain barriers against which smog builds up are inland away from the coast. So coastal areas are less plagued by smog than inland areas. The founders of the Irvine Ranch could have forecast that coastal sites would be more desirable than inland sites because of lower temperatures and better views. But air pollution was hardly predictable at that time. Yet it is a key factor causing land values along the coast to exceed those inland by greater-than-usual margins.

What lessons can be drawn from this experience? It appears that a new community developer can greatly increase chances of completing his or her project profitably if some or all of the following conditions prevail:

---The site is on the fringes of an extremely fast-growing metropolitan area.

---Cash carrying costs for the land are extremely low because it was purchased for a nominal price, and is initially assessed as farmland.

---The site's geographic position gives it climatic and environmental benefits that increase its value relative to all other portions of that metropolitan area. Preferably, these benefits are not known to anyone else, and will become evident only after the developer has acquired the land at prices that do not reflect them.

---The developer can persuade some major government to locate a huge new publicly-financed facility in the middle of the new community site. This facility will attract thousands of patrons each year, and will create spin-off industries and activities that want to locate nearby. It will also have a staff of thousands, most of whom also want to live nearby. And it will constitute a regional amenity that causes other people to want to live near it, even if they never patronize it!

---An unexpected surge of inflation occurs right during the initial phases of new community development, after the developer has borrowed large amounts of money through long-term loans for low fixed interest rates.

---The central city of the nearby metropolitan area becomes innundated with relatively low-income in-migrants from abroad who overcrowd its neighborhoods and cause thousands of middle- and upper-income households to move farther out towards the developer's site.

Needless to say, not many sites have these traits. Moreover, it is impossible to know in advance which sites will have them. In fact, if possession of such traits could be forecast, the sites concerned would already have risen sharply in value. Those that even have a possibility of possessing such traits are probably already too expensive to make development of planned new communities on them economically feasible. Hence these lessons do not support the conclusion that large-scale planned new communities financed by private investors will soon -- or ever -- become major contributors to the nation's future growth.

What Practical Lessons about Future Land Development Can Be Learned?

Experience in land development across the U.S. since the late 1960s convinces me that nearly all future urban growth will be at much smaller scales than those embodied in planned new communities like Reston. Even so, some lessons about how to improve the quality of smaller-scale development can be derived from the experiences of Reston, Columbia, and other planned new communities.

For one thing, it is desirable to internalize several different types of land uses within a single plan controlled by a single developer. This makes it possible to place these uses in relation to each other so as to achieve greater functional efficiency, and more pleasing aesthetics, than if all such relationships are external to each development. However, internalizing multiple land uses requires fairly large sites compared to the small ones typical of most subdivisions. Sites of 750 to 1,500 acres are large enough to permit at least some multi-use development and high-quality functional planning. Yet they are small enough to protect developers from the basic flaw that has made Reston-like communities unprofitable.

Hence local governments should encourage new developments at this intermediate scale by awarding incentives to developers who choose that scale.

Such incentives could include allowing higher densities, greater freedom from detailed planning and building code regulations, and willingness to provide some infrastructures within each development through traditional local government bond financing instead of loading infrastructure costs entirely onto the developers (hence eventually onto the occupants).

A second lesson is the desirability of permitting many different kinds of housing within each community, including multi-family units, townhouses, and condominiums, as well as traditional single-family homes. Only through such diversity of housing types can units be made available to the wide variety of different types of households whose contributions are needed in the life of any modern community. This does not mean each developer must create several types of housing within his or her development. But it does mean that each local government should provide areas zoned for all these types of housing.

However, attractive planned communities cannot provide housing for low-income households without substantial federal subsidies. Even initially setting aside units for such households at low rents or prices will not work in the long run, unless those units are incorporated into a permanent subsidy program. When the initial low-income occupants move -- as they eventually will -- such units will command prices or rents too high for other low-income households to afford. I believe the best way to achieve economically-mixed communities is for the federal government to adopt an entitlement housing allowance program for low-income renters, paid for by small reductions in existing homeowneship tax benefits. However, there is no chance that such a program will be adopted under this administration or under current budgetary conditions.

Even if such a housing allowance were adopted, it would probably not permit much socio-economic integration in communities like Reston or smaller-scale new subdivisions. Land values in very attractive communities become so high that rents on units built there must be set above levels even households with housing allowances can afford. Only public housing of some type can cut rents low enough for occupancy by such households. But public housing is viewed as such a blight on the landscape by most Americans that they will not politically permit its construction in such areas. This creates a dilemma from which no easy escape seems possible.

As a result, I believe most relatively affluent new communities built in the future at whatever scale will probably exclude nearly all low-income households. Yet I regard that as an undesirable outcome. It is bad not because socio-economic mixture at the neighborhood level is necessarily desirable in itself. Rather, excluding all poor residents from new-growth areas denies them relatively easy access to the many new job opportunities being created there. Yet most new jobs are being created in suburbs or non-metropolitan areas, not in cities where most poor and unemployed people live.

Equally important, residential exclusion of the poor from most new suburbs prevents their children from experiencing the relatively high-quality schooling provided there. It condemns many of those children to much lower quality educations provided in big-city school systems, where drop-our rates are now soaring. I believe this denial of equal educational opportunity to the children who need it most is a national scandal and one of our society's greatest injustices. But I do not know how to overcome these deficiencies in our current political climate.

Another perhaps more debatable lesson is the undesirability of permitting strip commercial development along major streets. True, such development has the advantage of seemingly easier access to each facility along the street. It is also politically powerful because it benefits so many owners of land along the streets concerned. In contrast, forcing all commercial development into a few major centers or specific sites benefits just a few lucky landowners. Avoiding the creation of such monopolies is a key reason why most communities do not require such clustering of commercial development. But unregulated strip commercial development creates an aesthetic blight that notably reduces the quality of life in the communities concerned, compared to that in places like Reston and Columbia. At least imposing some aesthetic and signing controls on commercial streets, as in Carmel, California, would improve the appearance of these developments.

Conclusion

Living or working in planned new communities like Reston or Columbia is a privilege that most Americans will never enjoy. Many would want to if they could. That is because the first answer to the question "Will it sell?" is "Yes." Yes, people and firms will move into large-scale planned new communities, once those communities have been created. But few Americans will have the opportunity of living in such places. That is because the second answer to the question "Will it sell?" is "No." No, investing in the creation of such communities is not economically feasible. Although a few such communities have proven profitable, the particular combination of circumstances that made them so is too improbable for investors to bet on.

In the face of such risks, nearly all developers will opt for smaller-scale activities. Hence nearly all future developments will be too small to enjoy the main benefits of comprehensive planning. They will be unable to internalize key relationships among many different types of land uses, as occurs in Reston and Columbia. Large-scale planned new communities will be built in the future only if some future federal administration decides the advantages of such communities justify big public subsidies in their creation. At present, that seems highly unlikely.

Meanwhile, I advise the residents of the few existing large-scale planned new communities to enjoy their privileged position as much as they can.