JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

X. COMMUNITY INVOLVEMENT - CITY, STATE, AND NATION

D. Examples of Involvement Outside of Madison

4. Correspondences between Graaskamp and the American Society of Planning Officials (ASPO) Regarding ASPO's Approach to Development Rights, November, 1972

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American Society of Planning Officials

November 8, 1972

Prof. T. Graaskamp
University of Wisconsin
School of Business
Madison, Wisconsin 53706

Dear Prof. Graaskamp:

In the course of a conference on teaching planning law held last week in Cincinnati, I met and talked briefly with Richard Lehman, Director of the Bureau of Research and Information for the State of Wisconsin. I related to Richard that ASPO had recently completed for the New Jersey Department of Community Affairs an analysis of a proposal for a statewide development rights transfer scheme introduced in the Maryland Senate in January, 1972. I had approached the analysis of the bill primarily from the standpoint of its planning and legal implications. In my opinion, however, no analysis would be complete without at least some thought about the economic effects of the proposal.

Richard Lehman suggested that you might be interested in seeing the Maryland proposal and perhaps could be persuaded to communicate your reactions to it. Specifically, I'd like to know (1) are my pseudo-economic criticisms in the ballpark, and (2) what potential economic outcomes do you see resulting from implementation of the rights transfer technique?

I would appreciate receiving your comments on the bill and my analysis. I plan to do an article on the bill and the concept either in an appropriate Land-Use Controls Service publication or ASPO's Planning magazine, and I want to integrate as much thoughful comment on the potential of the proposal as possible. Feel free to call me collect on extension 259.

Sincerely,

Frank Bangs
Editor, Land-Use Controls Service

FB/lz

39th Annual ASPO National Planning Conference — Biltmore Hotel — Los Angeles, April 7-12, 1973

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Encl: (1) SB 254
(2) Md. flier
(3) N.J. Analysis
(4) ASPO analysis

Graduate School of Business 1155 Observatory Drive, The University of Wisconsin, Madison 53706

November 16, 1972

Mr. Frank Bangs
Editor, Land -Use Controls Service
American Society of Planning Officials
1313 E. 60th Street
Chciago, Illinois 60637

Dear Mr. Bangs:

There is always a certain satisfaction in having one's opinion sought by those who have some stature in a common area of expertise such as Dick Lehman and yourself. While your inquiry comes during the final crescendo of the semester, this note represents the musing of an evening's study on the Maryland proposal SB 254 and your critique. My area of specialty is the business of development rather than land economics although I consider myself an analyst rather than an advocate of the development business. The best economist I have met relative to development economics is Claude Gruen of Gruen & Gruen, Ferry Building, San Francisco 94111, and I would urge you to seek his opinion. Perhaps you are familiar with his work relative to theeconomics of the California Coastal Zoning Plan or the San Francisco Bay Land Use Commission.

The critical economic assumption and basic concept of SB 254, as you pointed out, is not the separation of current and future use but rather the premise "that all land within a district is equal in use value and all benefits from planning should be shared equally by all land owners within the plan." If that is so, then development rights are a fungible good and it therefore follows that economic institutions that characterize such goods would spring up. Most of these possibilities suggest undesirable by-products of a marketplace for the proposed development rights:

1. A futures market would exist for development rights for residential, commercial, and industrial units. Assuming development rights cannot float from one planning district to another, the size of the planning district would determine the number of development rights which would be available on the market. Just as stock must be qualified for an exchange listing, there would need to be a minimum number of shares and shareholders to assure a reasonable statistical probability of transactions every day or every week. There would be specialists on the development rights "exchange" who would know the supply and demand balance on any given day. If construction volume varies with interest rate and economic activity, these development rights would be fantastically volatile, in the nature of warrants or options on development opportunity.

2. Of course the planning district for which futures in development rights could be bought and sold might not be large enough to provide an orderly market and therefore little information for buyers and sellers to know what these rights were worth. Indeed how would a farmer in the hinterland know the marginal value of a development right to an apartment developer at a preferred urban location in order to make a knowledgeable decision?

3. While the uninformed seller would have little ability to estimate marginal value of development rights to the buyer, he would be painfully aware of the marginal cost of holding a development right which would be taxed as any other real estate interest. A farmer in the hinterland who sees no reasonable hope for immediate urban appreciation would dump his development rights to avoid the marginal cost since the least productive land would be taxed on its development rights at the same rate as a development right with the most present value. He would do so with as little care as he sells posthole easements to the electric company or transmission routes to big utilities.

4. A development right would be a frozen asset which could be liquidated by the small property owner with no immediate development prospects so that initially the supply of development rights would exceed demand with the logical consequence of an extremely low value for long term benefits. Gradually development rights would be concentrated in the control of those with less need for liquidity and more concern for futures. What a fantastic estate transfer device as land control would have a low cost to acquire, relatively low taxes or holding cost, a low value for estate taxes, and eventually monopoly value as the market value for a fixed supply of floating development rights is cornered for a small development district by a combine of local home builders and developers! Talking about analogy to oil and mineral rights, how about analogy to:

   a. The sale of savings and loan passbooks for pennies on a dollar when the S & L's went on call to cash rich investors who then traded the passbooks at par value for foreclosed property held by the same S & L.
   b. Timber stripping in northern Wisconsin when stumpage value exceeds purchase price.
   c. The distribution of commercial interests in the land of the Indian reservation to members of the tribe when the tribe loses reservation status.
   d. Conversion of a mutual insurance company to a stock insurance company when policy holders have right to a fraction of a share or a guaranteed purchase price of X dollars from the directors who end up owning the company at a fraction of its growth potential. Who better understands the potential of the company particularly if they have been doing the accounting for several years prior to the distribution?

e. The problems of crop allotments for government supported crops like tobacco, cotton, etc.
f. From the developers viewpoint access to development rights would be as critical as access to water rights to a rancher or gallonage allotments in an irrigation district!

All of these situations involve fungible claims on productivity in the future and invariably have led to concentration of wealth through monopoly for the savvy as a result of exploitation of the unwise or temporarily illiquid sellers. Whole crops would represent an annuity. The price of the crop operates in a national market while development rights could be easily cornered as the total supply of "float" (i.e. rights which would relocate to other sites) would be finite in a planning district, only a percentage of the total since many people might refuse to sell, and constantly shrinking in supply. For example, could you buy an option (call) on a development right? Could you buy a put to the local zoning board if they changed their building codes? Talk about leverage benefits from planning for a few at the expense of the many - wow!

While the short term value of cash relative to future development rights is very high for the seller who is not in the development business, the utility of cash to the developer is very low relative to the utility value of controlling development rights.

1. The long term investment profitability of residential real estate is very low in terms of after tax cash for the developer because of the real estate tax, continuing change in the income tax, growing political pressure for rent controls, and an accelerating rate of style and location obsolescence. Increasing amounts of mortgage capital are necessary and the long term prognosis is for gradually rising interest rates. While the productivity of residential capital is falling, the cost to construct is rising so that the land residual value in constant dollars will also decline. However, a real estate enterprise with a very low net profit margin nevertheless turns over a large volume of dollars. The developer is interested in diverting these dollars through his land, construction, insurance, brokerage, mortgage banking, and property management companies. Equity is defined as the power to control disbursements of the real estate investment enterprise as each discretionary expense or outlay represents a sales dollar to some other organization. This explains why developers are happy to build in a soft market and then to sell to a limited partner since thay retain all of the discretion to divert expenditures as a general partner while the limited partner remains in the position of a contingent revenue bond investor. The development profit centers are in front end load on the total cost.

2. In that light the cash cycle which the developer controls begins with the production process of land development. Those who control

the development rights have the bargaining power for tie-in contracts to secure a portion of the cash cycle created by a development. In the early years of legislation purchase of the development rights on the most marginal land creates a trading commodity of tremendous monopolistic power with which to control construction contract awards, mortgage banking, and all of the rest.

3. Recognizing that potential in terms of the sophistication imbalance between early sellers and buyers the government might step in to regulate and control the tempo and traffic in development rights, which raises a variety of regulatory complications:

   a. Does everyone get a coupon book as in food rationing where different colored stamps become saleable at different times?
   b. Is there a half-life on development rights once they are detached from the land so that a stock pile of accumulated development rights would evaporate if they were not used to construct actual developments?
   c. Would the planners periodically announce special bonus coupons for the rehabilitation or destruction of slum areas or old style industrial plants?
   d. Would the vacillations of the futures market lead to government support of price levels or land banking of development rights?
   e. Would there be inter-planning district pooling at the government level to avoid short term shock impact on an individual district supply of floating development rights just as there is pooling and reinsurance between actuarial classifications for fire or earthquake premiums which failed to anticipate losses beyond a certain level of probability?
   f. Will there be counseling of sellers to protect against exploitation of those in need of cash?

Several ironies of the planners logic intrigued me. Back in 1947 Professor Ratcliff wrote that in the ideal sense the function of the planner is to reduce the cost of friction and other marginal surpluses that give rise to differential values to zero so that all land in a region would be equally valuable. Having failed to do that, the planner now wishes to declare by statute that all land within a district is equally in use and therefore in value. On another point planners have always longed to tax the incremental value of land on the theory that it was an unearned return due to the propensity of people to multiply and of government to provide services not fairly costed to the beneficiaries. Since no one yet has discovered an accounting method which would measure the incremental value to be taken from a land tax, why not have the developer set the tax on himself by making him bid for his degvlopment features, just as he now bids for mortgage futures in the Fannie May auction? Not only will that distribute the present incremental value but it will provide a base for an immediate ad valorem tax on the development right long before the community could expect to tax the land at highest and best use. Until now the planner has felt impotent because voters did not perceive

any immediate vested interest in what the planner had to say. If the planner could create his own pseudo currency called development rights, a very large constituency of non-developers would have a vested interest in supporting the value judgments of the planner at the expense of the developer and consumers who come later. What an interesting way to buy voting power!

All of the premises that planner have made relative to the desirability of such drastic legislation are subject to considerable skepticism, to wit:

1. That land is a fungible commodity when in fact value lies in the uniqueness of every parcel relative to static physical properties and its dynamic interfacing with consumer behavior.

2. That planners at the state level are incorruptible or infallible when establishing the boundaries of districts or the quantity of development for all time within those districts.

3. That the politics of land use will be simplified because of the mutual sharing of incremental value when there will be land owners with development rights, without rights previously sold, and in addition, a new class of development right owners who would wish to see public cost for services resting on those presently using the land and who will experience tremendous leverage from their uncommitted pool of development rights.

4. That density zoning by district will not create indirect development costs which must either reduce quality of development or increase price with the result that the consumer surplus produced from pooling of the incremental value will be more than offset by the incremental cost to the consumer.

5. That the planner having created the artificial currency of development rights to manipulate the developer won't decide to later manipulate the currency through inflationary techniques to conceal erosion of the consumer surplus or to reward favorite schemes of the planner.

6. That the use of police powers will never succeed in achieving land use balance.

7. That the land owner or the developer are profiting unfairly (windfall) by the fortuitous location of their property and the slavish catering to the consumer. (After all, the country makes life and death decisions by means of a draft lottery and protects the right of the cigarette smoker to kill himself in the long run).

8. That additional fragmentation of the planning process by district will not have the same undesirable consequences that present political fragmentation has produced for regional planning.

Most of these thoughts above are suggested by your essay but perhaps your dispassionate presentation might gain emphasis through organization under topics relating to the implicit premises above. These implicit premises are smoothly or naively overlooked by both Senator Goodman and the New Jersey planners memo.

However, there are a couple of items in your presentation which are unclear to me since the proposed legislation is also unclear. The community infra-structure of which you speak on page 4 is generally financed from the bonding power of the real estate tax. To what degree will the carrying costs be assigned to existing users when it is the future users who will be pushing the consequences of development beyond the capacity of the existing infra-structure of the tolerance of the good earth to forgive abuse? The more rights which are sold and relocated to other parts of the district, the more remaining existing uses would need to carry their own service costs unless the real estate tax district were the same as the planning district. What would establish the ad valorem base for development rights taxation when these net values would be the averaged present values of speculative futures after hedging and dollar averaging? I suspect that the real estate tax would be more regressive than you suggested on page 5. Again you have covered these points but you have not been explicit as to their impact as to operational problems with which all citizens can identify. In short, you have structured your criticism on the explicit claims of the preamble while I would challenge the implicit and counterproductive premises of the planners logic. As you may notice I think best by analogy to similar institutional frameworks which is a business viewpoint, I suppose rather than pure economic dissertation. The problem with argument by analogy is that the perceived image of the comparable institution imputes a value judgment to the development rights proposal which may or may not be fair. However, in any event your review should expose that which has not been said in the preamble and the law as well as that which has been written in its support.

While this correspondence represents a rambling first draft of impressions, I would like to exact a small favor in return. Enclosed is a synopsis outline of a small modification of land planning law as it relates to a counterproductive aspects of real estate taxation. The State of Wisconsin Planning Department is now considering financing a test of this rather simple minded proposal and I would value any suggestions or analogies which you might provide. Note that the tax burden on land would be decided indirectly by the planners while the tax on improvements would be derived from cost to acquire in the market.

I am reminded of a conversation I had with a nationally known analyst in which he expressed some concern over the objectivity and ability of planners with whom he worked a good deal. I, in turn, expressed grave doubt on the ability and the wisdom of the appraiser (my specialty) in valuing undeveloped land by attempting to interpret market value from

a few presumed comparable sales. He carried the day with a reply that "I would prefer to trust the consequences of interpreting a half-assed market rather than live with the consequences of half-assed planning!" Perhaps my tax plan is a political compromise based on the above postulate. Thank you for the opportunity to comment.

Sincerely yours,

James A. Graaskamp
Associate Professor in Real Estate

JAG/db