State of the Market 63-64:
Blue islands in a red ocean

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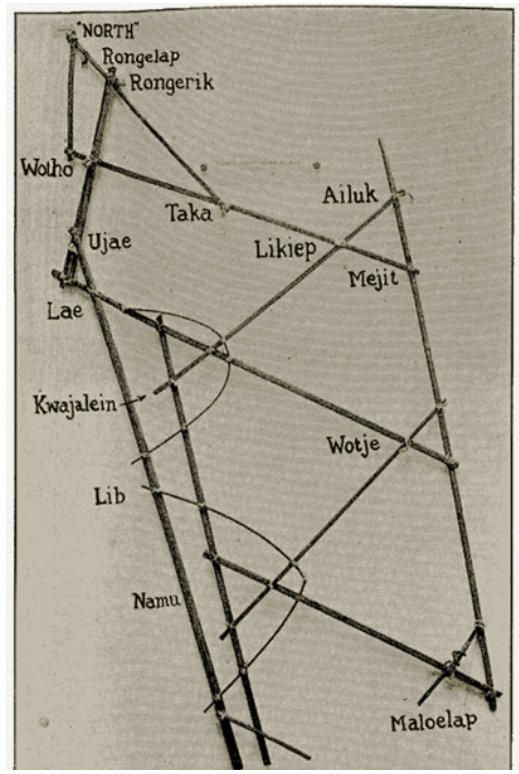

Connect the dots and plot your course

Blue islands in an ocean of red

So quickly have we passed from the information age to the networked age that our residential market dynamics are being upended, in ways that are right before our eyes, if we have the wit to see them.

Find any map of recent American voting showing the familiar blue-red political coloration and it'll usually show an archipelago of blue islands in an ocean of red. The blue archipelago appears fractally at every level of granularity – national, state, local, even sublocal.

This isn't coincidence, it's causation – from land-use decisions of policy and economics. Bottom-up political clustering is causing suburbs and cities increasingly to adopt divergent modalities of land use, economic development, modes of government, and voting patterns. These dual modalities (see inset box in ¶3 below) self-reinforce in unhelpful ways: our metropolitan economies are becoming increasingly more complex and interpenetrated,[1] setting up a tension between economic flexibility (job creation, mutation, and migration) versus spatial rigidity (planning, development, use and reuse):

- ***Job-generating cities*** aren't building housing they need for growth-enabling jobs.
- ***Amply-built-out suburbs*** aren't attracting the growth jobs they need to support the tax base.

Many suburbs need what the cities have; many cities need what the suburbs have; and the blue-red governance divide is inhibiting the emergence of new Networked-Age suburbs and Networked-Age urban affordable housing forms. The frontier of affordable housing innovation for decades to come will be in solving the spatial-economic mismatch[2].

Every issue of *State of the Market* is predicated on bringing you *insight you can use*. This issue is

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[1] Zoning, a hundred-year-old invention, is being decisively disrupted by telecommuting, live-work spaces, and Airbnb.

[2] Some parts of the country are 'structurally overbuilt', with more homes than they need. For no-growth formerly industrial cities, or techno-agriculture heartland where it's wise to plow the homes under and grow crops, not people, future success depends on shrinking the built-environment footprint, and cutting the public spending budget to match.

double length because the big thesis it presents is useful not for itself in tactical execution but rather for its consequences in your company's, city's, or state's long-term strategy.

If you don't perceive this widening divide between two different ecosystems of economic urbanization, you can't make sense of American housing and American politics, the interactive feedback-loop connection between them, and where each is going. Once you *do* see it, the pattern will inform every decision you and your company will make, from capitalization to risk tolerance and risk selection to property location and apartment configuration.

Knowing the coloration of your company's or portfolio's investment or management market – how much red ocean, how many blue islands, and how connected – enables you to think for the future, so that your acquisitions and dispositions become a portfolio rather than just a collection of oddball properties that 'seemed like a good deal at the time.'

1. America's suburbanization, and its reversal

Halfway through the twentieth century, America reached peak suburbanization, where today's Boomers retain childhood memories of morning doorstep Dads kissing aproned Moms goodbye and driving off to the Big City (noteworthy for its horizon-hazed skyscrapers), only to wheel back into the garage in time for family-style dinner and appointment television.

That Fifties comfort was unsettled by the Sixties' disruptive social medium, live television, that brought Asian wars and urban riots into our living rooms, and confronted us with the dichotomy between the suburbs (green, horizontal, placid, familial, *My Three Sons, Father Knows Best*) and the cities (gritty, hip, mysterious, dangerous, *Blackboard Jungle, Naked City, Hill Street Blues*), each instantly identifiable by its establishing-shot built environment.

The cities' nadir arrived in 1975, when New York City teetered in the verge of bankruptcy. Since that dark moment, America has experienced an uninterrupted four decades of urban revival, as the industrial city gave way first to the information city, and now to the global-internet city where we accept without thought that our on-line tech support comes from halfway around the world.

2. The six ages of urbanization

Humanity's value has always been created in cities, and throughout history, waves of urbanization have begun each time a new business model and value proposition is created for having large groups of people living together in close proximity:

1. ***Defense****. Protect valuables and loved ones*. The world's first cities were defined by and bounded walls[3], behind which we citizens could retreat when threatened, triggering innovation in architecture and engineering: the masonry arch, the flying buttress.
2. ***Market****. Eficiently trade goods for mutual benefit*. The fortified city naturally became the safe place to exchange manufactured or imported goods for money, and the world's first commutes were day-long journeys to

[3] In the last five years, the world has experienced a resurgence of wall-building on epic scales to keep out foreigners and enemies: http://www.bloomberg.com/news/articles/2015-07-22/fences-rise-across-middle-east-as-jihadi-threat-rattles-leaders.

town to sell, from town home with purchases.

3. ***Manufacturing****. Combine things for added value*. With people coming to and from town selling goods and bringing money, towns became the place of innovation for manufacturing: textiles, metal, ceramics, and machinery.
4. ***Industrial****. Harness energy at replicable scale*. Artisanal piecework gave way to harnessed natural forces: wind, water, yoked animals, later steam and electricity. From the Jacquard loom to Henry Ford's assembly line, cities became powerhouses.
5. ***Information****. Speedily connect people and ideas and invent things*. Beginning with the inventions of telephone, electrical grid, and elevator, work left the ground and moved into the sky. It did so because three dimensional connectivity is orders of magnitude faster and cheaper than two-dimensional. The result was so much value gain from upzoning and building up that the manufacturing city was economically evicted outward: to the suburbs, the underpopulated areas, and now overseas.
6. ***Global-networked****. Connect global-best information hubs anytime, anywhere*. With handheld devices and infinite cheap broadband, each information-node city now interacts with the others in the global blue-city archipelago.

Of these waves of urbanization, each has come faster than the one before, and now even before we've integrated the information city the networked city is upon us.

The first five waves of urbanization all had scale economies: the larger the city, the greater its value proposition.

The sixth wave, the networked city, upends that.

3. America is in Network-age urbanization

The last two decades' worth of American urbanization have been driven by the dematerialized internet-based economy, where the information age gives way to its successor, the networked age.

Blue islands and red oceans

	Blue island	*Red ocean*
Zoning modality	Up (mixed-use)	Down (green)
Commute via	Public transit	Personal vehicle
Home innovation	Quality rental	'Smart-home'
Local vibe	Variety; newness	Familiar; safety
People magnet	Flexible work	Reliable schools
Disruptive tech	Uber, Airbnb	Amazon drone
Urgent need	Workforce rental	Elder homecare

Today's growing job categories are information and knowledge-based, and they are global. Meanwhile, capital investment in physical plant is worth something only when located in a particular place. The result is a paradox: capital and ideas move faster than ever, while localized place – personal touch among neighbors and communities – has more value than ever. The result is a paradox of development, where the highest property values lie at extreme visions[4] of residential land use density:

- *Spacious horizontal exclusivity* (multi-acre mansions).
- *Inclusive vertical density* (CBD skyscrapers)

These modalities of development are diverging, as illustrated in the box above.

People with wealth want choice, comfort, lifestyle, and safety. If the urban market won't

[4] These competing visions were prefigured sixty years ago by science fiction writer Isaac Asimov, in novels entitled *The Caves of Steel* and *The Naked Sun*.

let them create that downtown, they'll use the wealth to buy private rural luxury.

4. Government needs a new 'urbanization control panel' for the networked age

In the twenty-first century's ear of network-age value creation, nearly all of the job creation (and hence the economic value creation) occurs in the urban context. As the cities go up and ever up, network-age-urbanization vertical development is progressively more complex. The physical buildings are a constellation of computerized and interconnected smart systems and the highest value structure arcologies are mixed-use: walk-in streetscape, commercial and retail around an interior courtyard, short-term residential (e.g. hotels) and long-term residential (apartments and condos) drawing from that same building backbone.

Inherently vertical, inherently mixed-use, inherently mixed-finance means this type of value-creating urban development is at least an order of magnitude more complex than it used to be, because every aspect of high physical and economic density has consequences:

- *Legacy property uses collapse in value almost instantly*. America currently has more shopping malls than we will ever need again, and it's by no means clear what use will take their place. A big stick-built house in a low-growth area can have negative value[5].
- *Zoning is obsolescent*. Invented a hundred years ago to keep the stockyard downwind of the schoolyard, zoning was predicated on two assumptions true in 1915 and false today: that land use is two-dimensional, and that manufacturing is tactile, dirty, and dangerous.
- *Eminent domain is essential, but contentious*. Redevelopment almost always requires parcel aggregation and that takes eminent domain, which is inherently governmental (exercise of police power to seize private property), thus contentious and susceptible to abuse, especially as a lever for the powerful to dispossess and displace the powerless.
- *Urban redevelopment must be strategic and democratic*. When space (or cubic) is at a premium, changes in zoning/ land-use create or destroy millions if not billions of dollars' worth of value. Strategy is essential, and it must be publicly legitimate.
- *Urban redevelopment is continuous, not transitory*. As long as technology evolves, cities as technological constructs must evolve with them. No use is granted perpetual economic vitality.
- *Urban redevelopment requires epicurean mixing of use, including affordable housing* because affordable housing *is* urban infrastructure.

The game developers are playing now won't be the game they'll need to play a decade from now. Urban greenfield development is dying as a business model: pretty soon, all development will be either brownfield, infill, or upzoning via demolition-rebuild.

Anyone trying to develop in the urban context today knows that as-of-right zoning is dead[6], few development processes are strategic, and approval consists of running a gauntlet of the

[5] When it costs more to secure the house, or prevent environmental leakage into the soil than the home is worth, or worth the land is more valuable vacant.

[6] See *State of the Market 37, More's the Laws (April, 2011).*

anti's until the property emerges smaller, pricier, and less affordable than the developer intended.

As this happens, blue cities become progressively *less* affordable, and they do, they become more anti-growth. In fact, the more these cities adopt measures designed to curtail development – progressive, smart-government approaches to land use, extensive review processes, neighborhood meetings, and remediation requirements (everything from small critters to traffic), the wider grows their affordability gap,[7] pricing out the very foundational workers they need to keep the city going[8]. So these growth-blessed (growth-cursed?) cities adopt new goals, new procedures, new payments, and an ever-more-intimidating development gauntlet to be run, so the cost of creating the housing needed for the new jobs the city attracts grows ever higher.

Eventually, some big businesses decide it's time to escape the megacity altogether, and meanwhile many other emerging businesses intending to create a new job colony – some of them, ironically, back in those obsolete suburbs.

5. Megacities versus job colonies

If, in April of this year, you wanted to rent a U-Haul van between Los Angeles and Austin, TX, it would cost you $586 to go west (Austin to LA), but nearly three times as much ($1,556) to take the identical van east (LA to Austin) – that's a measure of the job-growth disparity between the old information-age frontier and the new network-age frontier.

Like much of Texas, Austin is booming, its skyline dotted with a settled flock of construction cranes. So is Verona, Wisconsin, to which Epic Systems decamped when Madison got too congested for the growing campus it needed. While the *ideas* for jobs may be invented in megacities, increasingly the growth in *jobs themselves* may be migrating to the post-suburban nodes, anchored by a place-based and immovable amenity – lake, river, national park, university[9], teaching hospital, state government – acting as a relocation magnet.

A suburb that flourished a century ago before losing its mojo can add connectedness much faster than cities can carve out green space. As it does, it can have another big advantage over its blue-island competitor: the flexibility and cost of workforce housing.

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[7] *Economist* (July 19, 2015), *How cheaper housing can boost productivity*, http://www.economist.com/blogs/economist-explains/2015/07/economist-explains-12: "Work by Paul Cheshire and Christian Hilber, of the London School of Economics, estimated that in the early 2000s regulations acted as a tax worth roughly 300% in Milan and Paris, 450% in the City of London, and 800% in its West End."

[8] *Business Insider,* August 4, 2015: "Housing in San Francisco is … so expensive, in fact, the city's schools can't hire enough teachers because the cost of living is so onerous." http://www.businessinsider.com/san-francisco-teachers-cant-afford-to-live-2015-8

[9] For this purpose, the ideal innovation beacon is a university that is national-class (even better, world-class) in at least one important discipline, because the built-environment costs of universities make them too expensive to move. Hence the growing economies in Ann Arbor, Austin, Knoxville, Madison, Nashville, and Provo.

6. Mobility, zoning, and workforce housing

"If your city's so great, why can't you afford to live there?"

A network-age entrepreneurial town that reaches the point of scalability needs to hire people, talented people with mobility and choice, and because housing is urban infrastructure,[10] the company's host city or town needs a flexible housing market: flexible in size, configuration, price, and tenure model. The best economies thus have high mobility and high optionality (many choices, low search and transaction costs), usually clustered around a particular knowledge dominance that attracts new bright minds to keep investing in the city's entrepreneurial comparative advantage.

Because every new job brings with it new demands for affordable commuting and affordable housing, you would think that politically rational governments of states and cities with growing economies should also be doing everything they can to expand the supply of housing – and yet time and again we observe the reverse:

- *Red-ocean towns with affordable housing embrace growth* because they like newcomers who promise to bring jobs, retail sales, and new real estate taxes.
- *Blue-island cities where the economy is hot* seemingly do everything they can to expel the entrepreneurs.

Whether it's San Francisco, New York, or Boston, the zoning review is tortuous; the NIMBYs are always out in force; approval process is protracted, torturous, and random; and the expansive entity[11] (seeking to add jobs, offices, hotels, or housing) is treated with suspicion or hostility and endlessly peppered with new fees and requirements. That's precisely backwards in terms of municipal strategy.

It's also both shortsighted and inequitable:

- *Shortsighted* because a city whose economy stops growing will decline economically, become physically obsolescent, have to cut services, and fall hard – for proof, look no farther than Detroit, San Bernardino, or (soon) Chicago.
- *Inequitable* because choking off new supply makes a city into an incumbent's club, where if you own a home, you get rich merely by living in it; and if you don't, you can't move here. A remarkable new Brooking-published study[12] by economist Matthew Rognlie shows that nearly all of Thomas Piketty's ballyhooed premium return on capital resides in the housing sector.

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[10] See *State of the Market 61, Housing is Infrastructure, April, 2015.*

[11] The expansive entity is any business, for-profit or non-profit, that is significantly growing its employee base, customer base, or real estate footprint. Hospitals, universities, tourism industries, are all as fair game as R&D hubs, bioscience labs, or techster WeWorks.

[12] "The fall and rise of capital income outside the housing sector in the US [] is not paralleled by fluctuations in the measured value of non-housing capital." http://www.brookings.edu/~/media/projects/bpea/spring-2015/2015a_rognlie.pdf. This observation — combined with the theory of factor substitution, and simulation results from a multisector model — casts doubt on explanations of changes in the net capital share that rely on changes in the value of capital. "If housing wealth is the biggest source of rising wealth then [] policy-makers should deal with the planning regulations and NIMBYism that inhibit housebuilding and which allow homeowners to capture super-normal returns on their investments." http://www.economist.com/blogs/freeexchange/2015/03/wealth-inequality.

Blue island cities generally respond to skyrocketing housing prices by raising taxes even as they adopt tighter policies over land and property development. As they become politically bluer[13], they also become less affordable. This first exposes and then widens the workforce housing gap – housing for people who earn too little to rent market apartments, and too much to qualify for LIHTC (60% of area median income). In the red ocean, there is no workforce housing gap; in the bluest cities, it swallows a third to one-half of the working population. The need is particularly acute for young singles, families, and foundational jobs (those that make daily life work).

In America, we have rapidly growing economies, and we have places with plenty of workforce housing choice. The twain seldom meet. The commuting distances between them are lengthening.

7. Place-basing versus people-basing?

To closing the gap between cost and affordability, either lower the cost or raise the affordability, and that puts policy makers on the horns of a political dilemma: place-based, or people-based?

- ***Supply side: place-based***. Lower the net delivery cost of housing: Government-provided land, density bonuses, waived permitting fees, fast-tracked approvals, and development subsidies like LIHTC, soft second loans, and HOME/ CDBG funds.
- ***Demand side: people-based.*** Raise households' ability to pay with targeted subsidies: Mortgage Interest Deduction, first-time homebuyer tax credits, down payment assistance, portable rent subsidy (like Housing Choice Vouchers).

Neither solution is perfect. Place-based subsidies work fantastic in the red ocean (unless there's overt discrimination), where the housing can be built[14] if the numbers work; people-based subsidies can be targeted precisely to the households one wants, but fails if the subsidy key can find no door to open, which happens frequently in the blue islands.

8. Where does this leave affordable housing?

Uniformity in housing policy nationwide works only if the country is uniformly developable – a land of infinite greenfield, standard building codes, and consistent zoning. That vision reached its apex in the 1950s – coincidentally, the heyday of the great developers and the greatest housing affordability in the modern era. Since then, with periodic disruptions like stagflation or the Great Recession, the march of housing cost has been ever upward, as both development land and per-square-foot development costs have steadily risen in real terms. They've done so because in today's America, the new jobs created have their offices in the air, in new buildings that arise on the footprint of older, shorter buildings demolished to make way for them.

[13] The political dynamics are complicated. People moving from blue often redden. Conversely, a red town that booms can attract bluer people and itself more blue, reversing the pro-growth policies that created the jobs that attracted the newcomers that removed the pro-growth policies.

[14] Innovations in live-work space and the gig economy (Airbnb, Uber) place a further premium on the home, because the office *per se* is discorporating into a broadband connection to a room in one's home.

While the American frontier hasn't closed, increasingly it's vertical, and that third dimension takes us out of the realm of national spatial planning; it becomes a problem for states and cities. Verticality boosts the premium on development land, and so its emergence boosts the cost of housing.

What works on land doesn't work at sea, and vice versa; once we see America's property and housing markets as blue islands in a red ocean it becomes apparent that there can be no uniform national housing policy. National policy can apply to monetary policy, tax, defense, entitlements, possibly environmental housing – but in terms of housing, national policy can be only the basics. National programs worked in a development-homogenous purple suburbanized America (Truman, Eisenhower, even Kennedy), but as soon as the cities' fate diverged from the suburbs it was going to be impossible. In an irony of timing, the same 1967-68 urban riots that spawned Lyndon Johnson's creation of HUD also made HUD's success an impossibility, because it could never simultaneously facilitate both the blue islands and the red ocean.

The blue island/ red ocean dichotomy explains both HUD's decline and LIHTC's rise; though the yield element is national (uniform credits against *Federal* taxes), the resource allocation decision are market-specific, and states with big affordability gaps can design their own state or local resources – state tax credits, soft financing, tax abatements – to top-up the LIHTC baseline.

If program participants, the question is simple: *What colors are your markets?* Do you work in blue islands, the red ocean, or the boundary between? How have the colors changed and how will they change in the coming decade?

Knowing that will tell you much about what strategy to adopt – what role in the value chain, what housing typologies, what value proposition for your company, and how to shape your company and portfolio for growth and profitability.

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