JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

I. MANUSCRIPTS

A. Published Books

10. Concepts and Precepts for Policy Decision Making in the 1980:s: The Richard B. Andrews Symposium on Institutional Land Economics: Compiled by James A. Graaskamp with preface and Chapter 4 also by James A. Graaskamp and published by Landmark Research, (1981)

Index

SYMPOSIUM ON INSTITUTIONAL LAND ECONOMICS

To Honor
Professor Richard B. Andrews,
University of Wisconsin

Compiled by
James A. Graaskamp

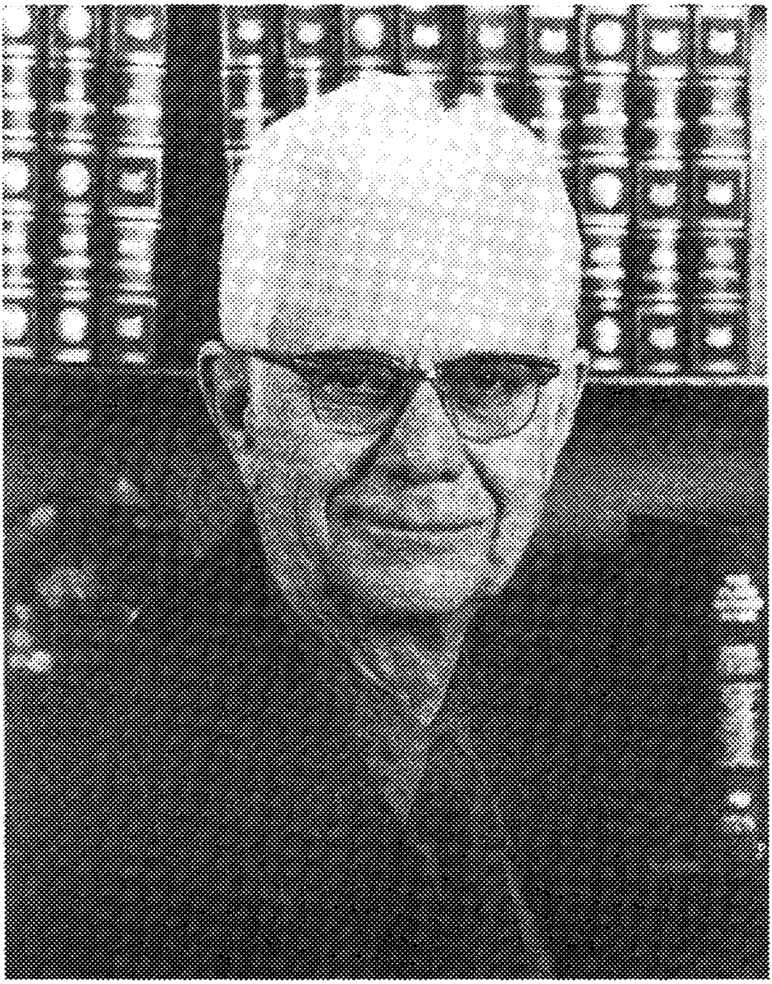
CONCEPTS AND PROSPECTS FOR POLICY MAKING IN THE 1980s:

The Richard B. Andrews Symposium on Institutional Land Economics

A collection of concept pieces by the proteges and doctoral students of Richard B. Andrews, Professor of Urban Land Economics, University of Wisconsin

Thursday, May 21, 1981
Wisconsin Center
Madison, Wisconsin

TABLE OF CONTENTS



PREFACE

Richard B. Andrews, born December 1, 1910 in Buffalo, New York, was the second son of Andrew Andrews, a printer and publisher, and of Lillian, his mother, a teacher. Thus fated to be a writer, edtior and teacher, urban land economics became the platform and the droll Spartan wit of Scotch ancestry his style. Richard Andrews became a man who delighted in words, language, and the Socratic methods of instruction, but when interviewed for some bibliographical notes, he delighted in feigning the taciturn Scotch banker. Thus the official record can only indicate that he progressed with honor through the elementary and high school system of East Aurora to achieve eminence as president of the senior class and editor of the school paper. He also served his Scottish birthright as manager of the golf team although conveniently no photographs survive of his spare 6' 3" frame in knickers and tam.

His undergraduate college days began at the University of Buffalo in 1929-30, but then it became necessary to search for work at the bottom of the Depression, a base point always lower in Buffalo. His corporate career began as office boy at the headquarters of City Service Corporation, a local gas utility and holding company, which later consolidated by releasing him as office boy with the least seniority and replacing him by demoting the previous office boy. Here lie the roots of the Andrew's skepticism about large organizations, corporate or public, roots that later bloomed into a metaphysical axiom as a result of his work for the government including the U.S. Army. In 1933 he traveled to Madison, Wisconsin, initially to pursue a career in journalism, but after one semester he zeroed in on his college objectives, graduating in 1936 with a Bachelor of Arts degree with majors in English literature, political science, and economics including agricultural economics. When asked what brought him to Madison, he could remember only that the Ag School dairy provided free buttermilk from a spigot all day long and that a hundred pounds of oats for oatmeal cost $1.50. He also remembered the communal soup pot at the co-op where he lived, through which passed much of the lab material from agriculture, a squirrel or two from Bascom Hill, and possibly a duck still reported missing from Lake Mendota. (To this day he feeds the ducks at Spring Harbor.) This hobo goulash prompted Dick Andrews in later years to gain renown as the chef at the Andrew's residence and to prefer evening seminars at local campus restaurants.

He returned to Buffalo in 1937 to join the William Hengerer Company, a local department store, where his older brother was to become an executive in the marketing division, if the Andrews vita is to be trusted. Further investigation elicited a job description as service manager, but when pressed on this point, Andrews revealed his job was "floor walker." This experience in monitoring a cross section of humanity served him well as a teaching assistant when he returned to Madison in 1938 for a Master's degree in political science, which he received in 1940. It was during this time that his powers of observation led him to Ruth Pilger, a French and music major from Ripon, Wisconsin. Since the Scotch tradition required a man to have $1000 in the bank before he married, the politically astute Andrews became director in Madison of the Rural Urban Fringe Survey Project of the Work Progress Administration, a federal effort better recalled by some as WPA. To the anguish of his Scotch forefathers, he gave up trying to save $1000, and he and Ruth married September 20, 1941, an important start on his publication career as well, since most of his future books were dedicated on the front page "To Ruth." Perhaps the economics of maintaining the household then led him to be a rent inspector for the U.S. Office of Price Administration, Control Division, in Madison from 1941 to 1943. He has since observed that rent control does not lend itself to price administration, obviously an empirical conclusion. From 1943 to 1945 he moved up in the federal system as a private in the U.S. Army, assigned to France in a replacement depot with a nominal title as statistician, more specifically in the grisly role of graves registration. In the summer of 1945, the army gave him an opportunity to attend the Sorbonne, University of Paris, in order to polish his French to maintain parity with his wife's talents.

In 1946 he returned to Madison to pursue a Ph.D. degree in Economics, supporting himself in various teaching and research assistantships and in a major consulting role to develop a statistical reporting system with the City of Madison Housing Authority. His Ph.D. in 1951 included both urban economics and rural land economics, and his dissertation represented a major advance in the perception and techniques of measuring economic base for both urban and rural analysis. By 1948 he was already on the teaching faculty in the School of Business as an associate of Professor Richard U. Ratcliff, and by 1957, he had won great community regard as chairman of the City of Madison's Central Rehabilitation Committee, a group responsible for the Urban Redevelopment Program. In 1961 when the State of Wisconsin first initiated a program for economic planning, Professor Andrews was the architect and implementer of an economic analysis of each county for the State Department of Resource Development resulting in the first comprehensive state economic development plan and resource inventory by the end of 1967.

At the national level he became the chairman of the editorial board with the prestigious *Journal of Land Economics*,a position he held from 1969 to 1975. Much of the quality and balance of the *Journal* during that era can be attributed to the critical wit and editorial touch of Dick Andrews. His access to his peers in urban economics was further enhanced by his dual appointment in the School of Business, Department of Real Estate and Land Economics and the independent of Urban & Regional Planning on the Madison campus. He chaired the research committee in Urban and Regional Planning from 1979 until his retirement in 1981.

At one time or another, Dick Andrews taught virtually all of the real estate courses and many of the Urban & Regional Planning courses that appear in the extensive catalog listing. However, he excelled in the graduate seminar in which the format was to provide a broad selection of readings structured around such general subject areas as "Situs and Structure," "Location and Land Use Succession" or "Research Methods in Urban Land Economics." The student was drilled on the readings as Professor Andrews skillfully engineered active student debate with one another, pitting the real estate student against his foe, the public planner, the normative land economist against the pragmatic politician, and the democratic liberals against the more autocratic decision-makers and doers. All the time that he skillfully provoked the inarticulate to stating a forceful commitment, the canny Scot avoided revealing his own view with droll parry, arch exaggeration, or oblique claims of ignorance on the topic. Even on a few occasions of imminent violence between students on opposing views he maintained a calm detachment and objectivity as to the choice of restaurant in which to hold the seminar. Sardonic wit and false detachment are nevertheless the flimsy shields of the wistfully sad observer, and almost certainly these defensive mechanisms characterize Richard Andrews.

There is a thread of melancholy in his writings about the consequences of the urban growth that went largely unchecked through the 60s and 70s. As a trained analyst he could see the indirect costs, the waste of resources that undoubtedly appalled Dick Andrews' Spartan and humanitarian instincts when counting casualties on the beaches of Normandy or the corridors of urbanity.

After his return from Europe, he avoided travel throughout the U.S. for pleasure, and like Thoreau he traveled much in Madison. In his early 1962 book, *Urban Growth and Development,* he maintained a journalistic reporting style, an objectivity about the complexity of urban growth:

> One of the major objectives of this book is to present two or more conflicting views on each of eight major areas of controversy in the field of urban growth. In a more general sense it is the author's belief that controversial discussion rather specifically focused on small segments of this larger problem area will stimulate interest and subsequent thought to the high level which is necessary if we are to face up effectively to the challenge of the urban revolution that is upon us. It is the writer's further hope that thought sharpened in exchange will make us begin to think more deeply of what we want our cities to become—no longer the products of imponderable biologic and social forces but the handiwork of hard thinking human beings with a stern desire to control their environment rather than be ruled by it.
>
> In those parts of the text where a rather strict pro and con approach is employed, no attempt is made to counter each point raised. This is done for the rather obvious purpose of stimulating original rebuttals from the general reader and from the student in particular. No attempt is made at the end of each chapter to support one view over another—answers must be those of the reader and the group.[1]

By 1971 the preface of his next book, *Urban Land Economics and Urban Policy,* clearly stated his impatience, despairing, and pessimism as to the inability of an urban society to control the characteristics of a developing environment:

> The fact that each year more of our population is living under urban conditions than the year before is well known; the fact that rapid physical and social change is taking place within each of our urban areas is also familiar. Most of us are also probably aware of the fact that the fundamental meaning and social impact of these changes remains a mystery.

[1]Richard B. Andrews, *Urban Growth and Development* (New York: Simmons-Boardman, 1962), pp. vii, viii.

Such a mystery might remain no more than an intriquing phenomenon to a few if it were not for the fact that the urban way of life along with its blessings is now generating an appalling product of unhappiness, ill health, neuroticism, economic pressure, and civil disturbance. Although many of these social dislocations are the consequence of national and world-wide cultural malaise they nonetheless focus in the city.

At present the system which is our way of life appears to many to lack goals and consistent guidance. This is particularly true of the city which increasingly lives day by day, year to year, from emergency to emergency. It is thought that the accelerating pace of change and the growing complexity of the system are the reasons for this exigent existence. It well may be the truth that the modern city as we know it is beyond our comprehension and control in a long term sense. Despite this somewhat pessimistic view of the urban future, it is true that man continually tries to control his environment, even though he may lack a pattern or a vision of what he is trying to accomplish. So it has been, particularly within the past fifty years in the United States. Legal systems of control and restraint have been fashioned in ever more sophisticated though not necessarily effective form to guide the city. A subarea of this control system is that associated with legal devices, mostly public or governmental, for managing the development and use of land and buildings. The components of this subsystem include zoning, building and housing codes, subdivision regulations, extension practices, etc. Supplementing this legal system are general policy and administrative systems that by example include the comprehensive plan, housing and renewal authorities, and special service districts."[2]

And journalism had given way to criticism and advocacy:

To date our understanding of and concern with ramifications of local public policy relating to land have been minimal. There is no doubt that the inadequacy of this understanding and concern has contributed more than proportionately to the urban social and economic dislocations of our times.

A secondary theme is that, where such a complex cul-

[2]Richard B. Andrews, *Urban Land Economics and Public Policy* (New York: The Free Press, Collier Macmillan Ltd., 1971), pp. v-vi.

tural phenomenon as the modern city is concerned, single-discipline analysis of a land policy or policies is futile. Hence examples and guideposts are provided on how the only effective approach, the multidisciplinary, might function.

Finally, much is made, particularly in the last two chapters, of the question of *process*. The point of view here is that the viability of a particular land policy or system of policies is largely dependent on the degree to which such policies fit with what is actually going on.[3]

In more recent years his writings concentrated on definition of the elements of the urban land economics process as he saw it in a series of seven monographs published by the Urban Land Economics Research Institute on the Madison campus. These essays summarize the core and thrust of his many seminars to structure a process description that is adaptive and evolutionary and certainly multidisciplinary. The approach is generally to establish broad operating hypotheses of basic elements in the urban system and then to extend these toward policy implications. These essays suggest more detachment, reveal less frustration "with what is actually going on," and parallel his retrenchment from active participation in the redevelopment of the city center. He was heard to say wryly that his last great crusade was the ill-fated Frank Lloyd Wright design for a performing arts center, a project oversized in terms of its suggested Madison lakefront site, budget, and urban idealism. No greater counterpoint in style and substance can be imagined than Wright and Andrews on the same crusade.

If he was resigned to the irrationality of macro forces and organization, he nevertheless rejoiced in the micro details of his immediate circle of friends and environment with an affirmation of his own principles. Because he believed the car was the enemy of urban form and citizens' safety, he did not drive or own a car. He was a great patron of the Middleton Bus Company, a single bus utility available after a brisk walk across the hills of Blackhawk Country Club. He and Ruth hiked the Madison west side for mundane

[3]Richard B. Andrews, Theory Discussion Papers:
1. *A Real Estate Investment, Its Meaning and Role in Urban Development*, 1979
2. *Urban Land Economics and the Urban System*, 1979
3. *The Nature of Urban Land Economics and Its Relation to Urban Land Use*, 1979
4. *Urban Land Use Succession Theory*, Part 1 (1980), and Part 2 (1981)
5. *Situs Theory*, Part 1 (1980), and Part 2 (1981)

Published by Center for Urban Land Economics Research, University of Wisconsin School of Business, Madison, WI 53706.

shopping chores, for nature walks including winter support of Spring Harbor ducks, stray cats and dogs, and Ruth's many young pupils of piano and adult students of the pipe organ. Two focus elements in their lives, the Unitarian church and the University, represented daily hikes of one and a half and three miles, respectively, and to this day Dick Andrews, of Scotch pedestrian persuasion, has a stride and the stamina of the Puritan. One of his friends at a European university noted that Dick Andrews had the marvellous capacity to be *in* the Twentieth Century but not *of* the Twentieth Century. Certainly a quick chortle and Scotch fatalism together with fresh air are critical to survival as an urban land economist. While Ruth provided much of the music for the church, Dick Andrews did what he could for harmony on the faculty as his quiet, thoughtful, and urbane counsel was a unique and disarming approach to faculty squabbles. More than once he rescued this outspoken observer from the retribution of promotion and salary committees. In his oblique way he perhaps thought the urban scene was better off without a real estate developer trained to argue both sides of academic issues. There are many in the academic and planning arena who owe some part of their analytical talent, teaching style, and love of scholarship to the opportunity to study under Richard Andrews.

This collection of essays is a small statement by his proteges in teaching throughout the United States to mark the nominal retirement of Dick Andrews from the University of Wisconsin, where he will remain as resident scholar emeritus. Each piece was written for a symposium held at the Wisconsin Center on Thursday, May 21, 1981; once again there is no record that Dick Andrews might have thought that some have learned their lessons better than others over the years. The chore of compiler was naturally mine since my debt was greater because I owed him my tenure at the University of Wisconsin, as well as a conviction as to the need for a multidisciplinary perception of the urban process. Nonetheless the fatal flaws of the executive crept through, and all the real work was delegated to Fran Larson and the costs of publication shifted to the University of Wisconsin Real Estate Alumni Association of more than 500 real estate titans who had the opportunity to benefit from the Andrews' classroom interrogatories. This small book is inadequate appreciation for his gifts to all of us, and as a token depends heavily on Dick Andrews joy in the minutia of personal relationships and intellectual adventures shared. Somehow a set of suitcases and a tour of the world's great cities didn't seem appropriate.

—James A. Graaskamp, August, 1981

GUIDELINES FOR ATTRIBUTING PROJECT INCOME TO REAL ESTATE COMPONENTS

James A. Graaskamp

Since Ricardo, a major premise and concern of urban land economists has been the proper attribution of net income of economic surplus to the instruments of production. The sentimentalist may still prefer the 19th century equity and romance of land, labor, capital, and management, but accounting specialists prefer 20th century refinements of the pittance left to land and capital with allocations to land, structure, personality, tangible, and intangible assets. Intangible assets include entitlements such as permits to build a dam or operating agreements to create a unique joint marketing environment at a regional shopping center. Intangible assets might also include premiums paid for properties suitable for the business opportunity of condominium conversion or for syndication.

The land economist prefers working with a pristine landscape a la Thunen, and his poor second cousin, the appraiser, prefers things simple, if not pure. The appraisal world, then, is built on three concepts—fee-simple title, highest and best use, and fair market value. The gross momentum of change in the real estate world is leading to some difficulty in the application of fee-simple title, fair market value, and best use concepts that are consistent with the accounting elegance of intangible entitlements, tangible assets, and indirect benefits from the profit centers for services inherent in the real estate business. As a result the economist, planner, and tax assessor are misreading the marketplace to a degree that is counterproductive to public land-use policies and priorities.

Fee-Simple Title

Fee-simple title is a term surviving from the Middle Ages because of its elasticity in adapting to the definition of the moment, the residual left to the private sector after allowing for first claim on productivity via the real estate tax, public control of use via police power, and cash compensation for benefits perceived as vested in the individual by historical precedents via eminent domain. One exhaustive litany of the benefits in fee-simple title is provided in Exhibit 1. Nowhere in that list does it recognize the fleeting entitlements provided by density zoning, environmental impact permits, project approval, and the infinite variety of burdens and benefits created by political action at every level of government to create monopolies in time and place or potential responsibilities out of scale with potential values. Where does it recognize entitlement for septic tank capacity to serve 72 bedrooms, or access to the state highway for 16 traffic lanes adequate for a regional shopping center, or limitations on residential development a la Petaluma or Ramapo? Entitlement rather than title is the stuff from which value is generated. The economist and the appraiser today are more concerned with fee-simple title encumbered by entitlements or management burdens imposed by subsidized lending, joint private/public development agreements, and the like. If that is so, then we need to review the conventional use of the term "fair market value" that assumes purchase of fee-simple title.

EXHIBIT 1

Definitions of Fee Simple

FEE SIMPLE: An absolute fee; a fee without limitations to any regular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation. An inheritable estate.[a]

FEE SIMPLE: *Absolute.* A fee simple absolute is an estate limited ab-

[a]Byrl N. Boyce, *Real Estate Appraisal Terminology*, rev. ed. (Cambridge, Mass.: Ballinger Publishing Co., 1981), p. 102.

solutely to a man and his heirs and assigns forever without limitation or condition. An absolute or fee-simple estate is one in which the owner is entitled to the entire property, with unconditional power of disposition during his life, and descending to his heirs and legal representatives upon his death intestate. Such estate is inlimited as to duration, disposition, and descendibility. Slayden v. Hardin, 257 Ky. 685, 79 S. W. 2d 11, 12.

The estate which a man has where lands are given to him and to his heirs absolutely without any end or limit put to his estate. 2 Bl.Comm. 106. The word "fee," used alone, is a sufficient designation of this species of estate, and hence "simple" is not a necessary part of the title, but it is added as a means of clearly distinguishing this estate from a fee-tail or from any variety of conditional estates. Fee-simple signifies a pure fee; an absolute estate of inheritance clear of any condition or restriction to particular heirs, being descendible to the heirs general, whether male or female, lineal or collateral. It is the largest estate and most extensive interest that can be enjoyed in land.

Conditional. Type of transfer in which grantor conveys fee simply on condition that something be done or not done. A defeasible fee which leaves grantor with right of entry for condition broken, which right may be exercised by some action on part of grantor when condition is breached.

At common law an estate in fee simple conditional was a fee limited or restrained to some particular heirs, exclusive of others. But the statute "De donis" converted all such estates into estates tail. 2 Bl. Comm. 110.

Defeasible. Type of fee grant which may be defeated on the happening of an event. An estate which may last forever, but which may end upon the happening of a specified event, is a "fee simple defeasible". Newbern v. Barnes, 3 N.C.App. 521, 165 S.E.2d 526, 530.

Determinable. A "fee simple determinable" is created by conveyance which contains words effective to create a fee simple and, in addition, a provision for automatic expiration of estate on occurrence of stated event. Selectmen of Town of Nahant v. U. S., D.C.Mass., 293 F.Supp. 1076, 1978.[b]

[b]Henry Campbell Black, *Black's Law Dictionary*, 5th ed. (St. Paul, MN: West Publishing Co., 1979), p. 554.

Highest and Best Use

In recent years the lexicons for real estate have clarified the definition of highest and best use to be that use which is legal, technically feasible, and financially viable at a proven level of effective demand and financing terms. Moreover, best use has been qualified as one that is sensitive to community planning goals and fiscal limitation. Unfortunately the industry retains the subtle arrogance or ambiguity of the term in lieu of more contemporary substitutes, such as most probable use or the normative—most fitting use. Urban economics and appraisal presumes that best use refers to the real estate productivity, the economic surplus to be generated from allocation of receipts and outlays to the real estate. However, real estate has become recognized as a fungible commodity, square feet of Class A office space, room nights, apartment unit months, not to mention condominium convertible square footage. As a fungible commodity it has become a speculative commodity that permits the investor to go short or long in a specific market constrained by physical and regulatory phenomena as well as a proxy for a long-term monetary standard or interest trend speculation. Purchase of a building on a land contract with a minimum down payment has become virtually a perfect hedge or straddle in two commodity markets. The exculpatory clause in the mortgage or land contract permits the buyer to call the future appreciation by selling the property and paying off the loan; if the property does not appreciate, the buyer can default or put the property to the lender or seller. The straddle is purchased with a down payment recovered from tax shelter in a short period of time. Notice that, if the futures market for real estate improves, net income will rise and cause the property to appreciate. If interest rates fall in the money market, the opportunity to refinance from this money market speculation will also result in appreciation. And if the economy stagnates, investment opportunities will shrink relative to the supply of investable funds, the investor expectations will fall, and property will appreciate. Since money is defined only in terms of commodities and real estate is the only commodity that permits long-range speculation without spoilage or loss of income as opposed to wheat, sow bellies, and so on, real estate space-time units have become a significant commodity in the long-term futures market. Purchases for commodity speculation are significantly distorting current prices and creating a second market tier that is concerned with purchasing power rather than productivity in use and portfolio effects rather than productivity in use and portfolio effects rather than properties as single enterprises.

Fair Market Value

The basic definition of fair market value from the authoritative *Real Estate Appraisal Terminology* is provided below with certain elements italicized to anticipate argument in the monograph that follows:

> MARKET VALUE—The highest price in terms of money which a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus.
>
> Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
>
> 1. buyer and seller are typically motivated.
> 2. both parties are well informed or well advised and each acting in what he considers his own best interest.
> 3. a reasonable time is allowed for exposure in the open market.
> 4. *payment is made in cash* or its equivalent.
> 5. financing, if any, is on terms generally available in the community at the specified date and typical for the property type in its locale.
> 6. the price represents a normal consideration for the property sold *unaffected by special financing amounts and/or terms, services, fees, costs, or credits incurred in the transaction.*

Nothing is mentioned in terms of opportunity costs of capital for the foreign investor, the institutional pension fund, or the investor washing illegal funds. Financing presumes equal access to straight debt capital at a time when U.S. citizens do not have equal access to capital and the probability of more selective credit controls is increasing. Neither is anything said about special permits and entitlements, the encumbrance of political administration, or the normality of subjective financing in assumptions 5 and 6. As an alternative, consider the less normative most probable selling price. As an alternative consider the contemporary definition:

> MOST PROBABLE SELLING PRICE—The price at which a property would most probably sell if exposed to the mar-

ket for a reasonable time, under market conditions prevailing as of the date of appraisal.

This definition implies:

1. that the most probable use will govern the most probable buyer type and that the central tendency will reflect the relative bargaining position of buyer and seller as best can be known from public information. That means the appraiser must consider the buyer's access to capital, the buyer's emphasis on productivity versus commodity price-level speculation, or the necessity of seller financing.
2. that there is no cash equivalent rule but valuation price must always be conditioned by the terms of sale indicated from similar market transactions.
3. that the best way to predict price is to mimic or simulate the bargaining behavior and calculus of the most probable buyer rather than to measure the economic productivity as perceived by the normative methods of the economist or appraiser.

Fair market value assumes that the income anticipated from purchase of an income property is inherent in market level operations of the rental business. On the other hand, the most probable price requires an a priori description of most probable buyer so that it might reflect a syndicator or condominium converter who are expecting to capitalize for the spread between investment value and consumer retail value. Are the short-term prices paid by the condo converter or syndicator the fair market price or the most probable price?

Limitations on the Market Comparison Approach to Value

Not only is there a two-tiered market for real estate as a tool of production and as a commodity-money standard, but the market is further fragmented by financing terms offered, income tax considerations, and motivations for investment or arbitrage (conversion, syndication, trade). Major income properties of investment quality are bought and sold under the supervision of accountants, lawyers, security dealers, pension fund regulators, and institutional investment committee preferences. The result is prices and terms engineered to suit the bookkeeping of the parties at interest. While tax considerations are an immediate example, equally as often the corporation sells at a fake price to avoid a capital loss while providing a master lease to the buyer that will result in the conversion of the capital loss to an operating expense. Sometimes real estate is purchased at a high price to reduce the nondepreciable goodwill residual in the purchase of a business or is sold at a low price to facilitate a shift of value to personalty. Condominium converters and apartment syndicators may purchase desired properties at a discount from the retail price of individual investment units, sharing with the seller the spread between investment value of the project and retail value of the units. Developers may sell projects under the guise of convertible mortgages to take a development profit, management fee, and tax shelter and to avoid the trap of an expiring construction loan without permanent financing. Car dealership buildings may be sold subject to an encumberance that no future owner may sell cars on that site; land may be purchased to acquire easements, extinguish air rights, or complete assemblages despite holdouts. In short, verification of most major investment quality income-property prices is most difficult. Market-derived capitalization rates are therefore volatile, misleading, and likely to be undefined as to which market tier the buyer was in at the time of purchase. On the other hand, the cost approach, after adjustment for wear and functional obsolescence, must fall back on the income approach to explain the economic obsolescence or premium that is due for a particular project. One writer has called the spread between cost and market the entrepreneurial factor[1] and added it to the cost approach; however, it is not earned with construction nor is it even a tangible asset. It is the present value of income attributable to the ability of management to exploit market shortages in order to arbitrage opportunities between market tiers or to obtain nonmarket financing. Therefore, it is a return to management, a goodwill factor in defining intangible assets of the enterprise. If the market approach and the cost approach are increasingly unreliable, then the income approach might be necessary, which brings the essay face-to-face with the problem of attributing income to real estate.

The Income Approach

Properties purchased for income and appreciation due to improving productivity might logically emphasize some form of the income approach to value. It is a truism to say that the present value of an income property equals the present value of all private sector

---

[1]Sanders A. Kahn, "Kahn on the Entrepreneur," *The Appraisal Journal*, January 1973, pp. 113-18.

claims on periodic income plus the present value of the private sector interests in the reversion, discounted or converted to value by a formula representing or predicting the price to be paid, either under the cash-to-seller premises of fair market value or the more behavioralistic freedom of most probable price concepts. The application is a bit sticky because of conceptual accounting problems in attributing revenue and expenses correctly to land, improvements, personalty, intangible assets, working capital, management, labor, and ancillary public-vested interests. An additional problem lies in forecasting a reversion value that is consistent with nonspeculative canons of appraisal and the non-vested nature of the future without ignoring perceived futures affecting behavior of the investor.

Some general questions to be addressed[2] for real estate project revenues allocation or attribution to realty, personalty or management might be:

1. Is income attributable to entitlements that are point-specific and go with fee-simple title to the land or that are transportable permits separatable from the deed?

   (A permit to build a dam or sewer plant is site-specific but assignable with the land; in some areas the liquor license goes with the building, but in most jurisdictions, it can be reassigned to new locations with the same operator. Sale of land with development entitlements is more than a fee-simple title; it significantly alters development risk potentials for the next buyer. Most appraisers would estimate the rental value of the bar space and assume that the surplus income was attributable to management and monopolistic licensing.)

2. Does the real estate income accrue from retailing of space or from wholesaling space?

   (Lease of a parking ramp is real estate income versus rental of a parking space by the hour, which is business income. Similarly, lease of the top floor of the John Hancock Building is a real estate transaction, but admissions from operation of the observation desk is show business.)

3. Is the income generated by extraordinary services or by intangible benefits rather than customary components of space?

   (Refrigerator-stove might be customary compared with maid service; joint merchandising and guarantees of the shopping

---

[2]Refined from discussions with Phil Adams, CPA, Touche Ross, Public Accountants, Chicago, IL.

center operating agreement create a rental premium for this intangible asset compared with rental of basic retail space.)

4. Is the income derived from ancillary functions rather than those that must be integral with the project?

   (Janitorial service could be contracted for off-premises or utilities purchased directly from utility company rather than purchased from developer, who receives a distributor's margin. Heat from a single boiler is integral with the project.)
5. Does the IRS classify the asset as real property or personal property, or tangible or intangible assets? Did the owners and tenants define personal property in their agreements?
6. Is income attributable to governmental agencies in exchange for contractual entitlements of control or use to the public interest for the term of the contract?

While accounting societies issue professional white papers directing their membership on the proper treatment of these matters as business issues evolve,the appraisal guilds wallow around in banal feuding about organizational matters or the adequacy of old techniques. Exhibit 2 suggests the need to match the definition of value to the purpose and benefits to be appraised.

Relevance of Valuation Issues to Urban Land Economics

Urban land economics has held that fair market value is central to the premises and models of land-use decisions and successions. A few of us have argued that cash flow is more relevant and that each land use establishment is purchased in view of its contribution to spendable cash and liquidating value of net worth after taxes, a going-concern view or at least purchase of access to profit-center opportunities in a development project. Nowhere is the problem of defining the economic surplus of the real estate more significant and more misunderstood than in the valuation of properties for tax assessment purposes. Four illustrations are provided below to illustrate topic areas where the economics and the appraiser should have some current rules and definitions to improve the efficiency of public policy and the equity of a major public activity (tax revenue generation) tied to fair market value concept.

Case 1.—Assume that a regional shopping center has been developed on land owned originally by two of the major department stores. These two stores select a developer who in turn leases pads to two additional majors and purchases a sandwich of land which he

EXHIBIT 2
CRITICAL ISSUES THAT DEFINE APPRAISAL PROCESS

FUNCTION OF THE APPRAISAL	PROPERTY RIGHTS	RELEVANT DEFINITION OF VALUE	ALLOCATION OF PRODUCTIVITY	BUYER MOTIVATION PRESUMED
Tax assessment	Fee simple private rights unencumbered	Cash market present value (As opposed to most probably selling price)	Present value income attributable to land and structures only	Purchase of economic productivity
Mortgage loan (nonparticipating)	Encumbered fee simple private rights plus additional right pledged	Regulations - market value Underwriting - solvency price or liquidating value	Fixed income pledged from all sources less costs of creative management	Share of econ economic productivity contributed by capital
Mortgage loan (participatory)	Encumbered title plus nonvested interest in selected future revenues	Present value of all future cash flows	Variable income pledged plus share of reversionary interest	Share of economic productivity contributed by capital plus share in selected management returns plus positioning against devaluation due to changing conditions
Sale of an investment)	Encumbered title plus vested entitlements plus going concern profit center opportunities	Most probable price above minimum acceptable alternative opportunity	Returns from land, structures, personalty, and selected entitlements	Increase in spendable cash increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Purchase of Investments	Encumbered title plus positioning for access to entitlements	Most probable price within perceived peril point limit	Land, structure, personalty, and intangible assets less profit centers for management	Increase in spendable cash increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Going concern purchase of a business	Encumbered title plus positioning for access to entitlements in risk for business start-up plus control of monopolistic market position controls	Most probable sales price within perceived costs of creating an alternative	Land, structure, personalty, and intangible assets and good will plus artifactual profit centers for management	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions

developed into 100 stores. At the outset the four major department stores and the developer enter into an elaborate operating agreement that guarantees that the majors will operate under their brand names for at least 30 years, participate in join merchandising of the center, abide by common operating rules, and maintain vast amounts of parking. The developer in turn agrees to build, operate, promote, and secure a synergistic mix of smaller tenants to optimize trade area penetration, etc. His selection by the department stores is, in effect, giving him a franchise to provide subfranchises to the tenants in a joint merchandising effort; at the same time, the small tenants receive guarantees about ongoing operations of their neighbors, parking, and security they could never find in a multiple landlord downtown where participation in a merchant association is both voluntary and democratic. These merchants are clearly paying a premium rent for the existence of the operating agreement, and that intangible agreement is a franchise under any state law.[3] Therefore, it is personal property, and income attributed to it should not be included in valuation for real estate tax assessment.

Shopping center development is a business, and sale of the developer's position is sale of an ongoing business management opportunity. The value of the opportunity is the present value of management fees and other profit centers plus the premium rent paid by tenants to be paid of the shopping center marketing and controlled business environment. Notice that the accountants, when allocating the purchase price of a business, first subtract the cost to replace all tangible assets and then divide the remaining intangible balance of the purchase price among patents, copyrights, franchises, and a catch-all called Goodwill or going-concern value. Accountants are trained in the problems of attribution of income, while appraisers and assessors avoid the discipline whenever possible. Assessors clearly have a vested interest in exaggerating real estate values; presumably, appraisers need oversimplification so that they do not overwhelm the simplicity of NOI/OAR for regional shopping centers.

Case 2.—Subsidized housing for the elderly and low-income families is another area of confusion for lack of proper income attribution that reflects benefits to the private sector as opposed to the public sector. Notice that the shopping center case is concerned

---

[3]Few developers are arguing loudly for a franchise definition. Since sale of a franchise is operating income, not capital gain, sale of a shopping center would not entitle the seller to take capital gain on the sale of his interest in the operating agreement.

with allocation to tangible and intangible assets while subsidized housing is concerned with allocation of productivity from the private to the public sector. Appraisal is typically concerned with benefits to the private sector, as demonstrated by the traditional subtraction of sales taxes, real estate taxes, and even income taxes attributable to the real estate. Consider the appraisal of a Section 8 project, which includes elderly housing units and family housing units on separate sites under a single mortgage and under a single subsidy contract. Furthermore, assume that construction and permanent financing is provided by a state housing finance agency at nonmarket rates subject to a detailed management agreement defining tenant selection, rent controls, expense escalation, special services, special reporting and auditing requirements, and the maximum subsidy available over a five-year span. Assume further that failure to observe management covenants is a default on the mortgage and that, in the event of a default, the Housing Finance Authority will become general partner, at its option, without foreclosure and with automatic consent of the limited partners.

Given the gap between market rents and higher rents necessary to justify construction and the elaborate indirect costs of the subsidy process, the Federal government has thoughtfully provided a fictitious set of fair market rents (FMR) for the market area that is capable of justifying construction. To the degree, these FMRs favor elderly construction, and the elderly unit component of the project subsidizes adequate unit costs and operating budgets for the family housing. The developer is willing to submit to rent control, serious limitations on his right to resell, and major responsibilities to provide welfare type of services in exchange for the opportunity to make a development profit, a property management fee, and a sale of a participation in tax shelter to limited parters. The limited partners are not to receive more than 6% cash income on an artificially defined equity established at the outset of the project even though operating losses on the down side are unlimited; sale to another group other than a tenant co-op is discouraged by taxes on excess depreciation and the lack of tax incentive for the second owner.

There is no market comparison sales of Section 8 projects, and cost to replace is irrelevant because the costs are inflated by protracted negotiation with the government and Federal regulations relative to union labor, etc. Moreover, the project might have more or less space, amenities, or site density than is consistent with highest and best use in the private market. Functional and economic obsolescence relative to the private market is not easily measured.

With the cost approach distorted and the market nonapplicable, the appraiser is left with the income approach.

The present value of cash dividends to the equity position plus the present value of the reversion to equity 20, 30, or even 40 years in the future is minimal to the second owner without the tax shelter because there is no opportunity for an increase in cash dividends by rolling over the leases. Therefore, the net income to the project should be the actual rents paid by the tenants plus one fifth the actual subsidy dollars available per year less actual operating expenses; that net income discounted at the full market rate is the value of the economic product to the private sector. The difference between that number and the higher costs is a transfer of wealth to the public sector, which has purchased housing for a particular social group in this rather obtuse and oblique way. The premise that Section 8 is a cost-effective way to provide for public purposes by means of a wealth transfer through subsidized rents and subsidized interest rates is suspect. Nevertheless, a large portion of project value is encumbered by de facto land-use covenants in mortgage and management contract terms, which are, in effect, an easement-in-gross to the social body politic. Wherever there is subsidized demand, subsidized interest, or special tax benefits to ownership, it is necessary to think through the attribution of income and value among the private interests and the public interests.

Case 3.—A significant number of major income projects today involve the limited use of Urban Development Action Grants (UDAG). Sometimes, these grants are used to fund directly certain community infrastructure such as a parking ramp. Building it could not be justified by the ratio of market revenue to construction costs and operating costs but was, nevertheless, a pre-existing condition for other private capital efforts. Assume that a community wished to bring housing to the downtown area and that it was necessary to write down land costs from commercial expectations and provide underground parking for the housing residents. A UDAG grant is made to the city which, in turn, provides the loan to the developer at 3% interest and 50 years amortization so that the cost of underground parking and land will not increase the borrowing of conventional funds at a rate that would preclude acceptable rents or condominium prices with consequent monthly payments beyond the means of the market. If other uses could have justified a higher landprice and if effective demand could not have supported living units with indoor parking in a downtown area, considerable violation would have been done to the concept of highest and best use. What has occurred is a transfer of potential value from the private sector to the public sector, because the public was willing to buy encumbrances on the land that reduced fee simple title options in order to advance public purposes of returning residents downtown, of accelerating urban redevelopment, and perhaps of anticipating the need for urban compression as an energy conservation strategy. Again, the income approach for fair market value of the complete fee title, which has been reduced by assignment of certain rights and considerations of nonmarket financing, indicates that net income should be defined as the actual revenues of the project attributable to the real estate less all operating expenses. This net income should be capitalized at the appropriate cost of private capital. Similarly, fair market value of an industrial plant financed by an economic development bond at less than market interest rates would need to be appraised by taking actual market rents less full operating expenses and capitalizing it at the market rate for cost of capital.

Case 4.—All real estate investment enjoys some degree of special subsidy from Federal tax treatment of depreciation, a subsidy that tends to favor new residential as compared to old, subsidized housing relative to conventional, intensively renovated housing units relative to existing units, commercial renovation relative to commerical new, and farm development versus urban development.

Depreciation understates taxable income from the real estate and occasionally shelters other income as well, but the tax is postponed and the benefit is largely in the present value of deferring cash outlays for tax payments. Nevertheless, a significant segment of the development industry is devoted to the protection, marketing, and replacement of tax shelters to a degree that overprices the supply of certain types of real estate while contributing nothing to the production of economic surplus to which fair market value is related. Since the degree of tax shelters is inherent in the tax bracket of the investor and not directly related to fee simple title, it would seem that cash equivalency value would need to discount sales for the premium paid for tax shelters. Pricing of real estate income to be on an after-tax equivalency basis with other forms of investment income is consistent with the premises of most probably price but not inherent in fair market value. There is considerable doubt that the tax subsidy to real estate is an efficient and cost-effective policy relative to housing, rehabilitation of existing structures, or retrofitting for energy conservation.

Defining the Problem of Net Reversion to Equity Investment

As the net cash available for the equity position from operations has been squeezed even thinner by rising costs, rising interest expense, and elastic demand, real estate investors have made a fetish of gambling on the resale price as developed earlier. The resale price is seen as a hedge for devaluation of money, falling interest rates, or even changing supply/demand relationships. As if the predictability of the resale price ten years in the future were not sufficiently in doubt, a number of definitional problems in attributing the increase in value to real estate or personalty remains. At this point, we can raise the question in general better than we can state a solution in the form of a set of rules appropriate to every case. Pesumably the equity reversion attributable to resale would be the net proceeds from sale less total dollars due and payable to lenders, to the tax authorities, and to the costs of transfer including fees to professionals involved. However, measuring these components raises several interesting questions:

1. Does the syndicator's share of the net reversion represent deferred payment for his management, which created the value because he invested his time rather than his own money and which was subordinated to cash returns to the investors from operations? This could be a sizable 10%-20%.
2. Were the variable rate mortgages negotiated to use an index that reflected the cost of money? If not, the share of sale or refinancing proceeds might provide the lender with more than an acceptable return on capital invested at the expense of land and management.
3. Is the premium paid for real estate suitable for syndication or condominium conversion? Is the payment attributable to the real estate or the business opportunity of retailing market shares or market units?
4. In subsidized housing is there any reason to believe that the resale price will increase for 20 years or more? Rents are allowed to increase only enough to cover increased operating costs and subsidized loan agreements, and rental contracts place a variety of penalties on conversion to conventional market use. Prices paid for the unit represent primarily the present value of tax shelter plus a small cash dividend, the resale values and profit centers for the limited partners attributable to anything but tax shelter are virtually dis-

carded in the investor calculus.

5. Many leases today feature full pass-through of increasing expenses to the tenant, and so the cost of occupancy can become unreasonably high. Is it the terms of the lease or the cost of occupancy that represents fair market rent? Just as property is appraised on the basis of market rent rather than contract rent, should not the appraiser reduce income by an amount attributable to income derived due to insensitive negotiation of escalator clauses? For example, in California Proposition 13 reduced taxes, but many tenants received no benefits because their leases passed through the increases from the status quo.
6. The issue of whether to lease or buy is a function of current cash needs, salvage value of the asset, and the opportunity cost of money. As interest rates fluctuate, a bank could find ownership or leasing more attractive, depending on a net bank earning power rates and rates assumed by lessors providing building space. Should a bank own half and lease half to average the loss of the rental position versus the short-term straddle?
7. How does one define equity when the mortgage lender decides to take that portion of resale value necessary to modify its yield on the financing to an internal rate of 18%, given a 12% interest only mortgage?

Each of these seven scenarios requires a handcrafting of the reversion from the circumstance, and the result will seldom be neatly correlated with net income or some other defined residual. Still, that is what is being taught when income property appraisals are done with overall capitalization rates and resale prices are unadjusted to cash equivalencies in order to reflect assignable financing, deferred fees, or entitlements and monopolistic advantages from a going concern, intangibles included in the purchase price. Recent awards for appraisal essays defended the overall rate method when discounted cash flows is the only workable process for irregular return. Indeed, given the uncertainties of the forecasting process, the logical priority for appraisal would be development of Bayesian models or density models that could assign probabilities to alternative outcomes. That development must be postponed until the appraisal fraternity adapts to the silicone chip for work processing and arithmetic. In the meantime, the problems of investment valuation are having their impact on land-use patterns of use and reuse, and that is the theme to which we wish to return in the final section of the essay.

Distorted Values and Policy Issues

The difficulties in coordinating public incentives for priority real estate needs with institutionalized definitions of fair market value lead to unfortunate misallocations by those who regulated capital flows toward these priorities. Tax incentives for the production of new housing lead to syndication profits on existing projects, which increase the real estate tax burden on all apartment buildings if the few sales for syndication are used as comparables for the remaining properties used as investments. The result is to raise the tax cost and rent of the residents as much as $10-$15 a month. Given the increasing shortage of rental housing units at reasonable prices, the tax assessor is working at cross purposes to housing policy. The assessor has misunderstood and exaggerated the market value on subsidized housing to produce a regressive real estate tax by requiring the private sector to pay a tax on fee-simple prerogatives that have been transferred for the term of the subsidized financing to the public. The assessor stands on traditional definitions of an encumberance by means of an easement for the benefit of the public, failing to recognize that a mortgage is also a transfer of property rights, particularly when the defeasance clause is tied to performance on a management contract as well as the conditions for eligibility for subsidized mortgage interest rates.

The need to fund private pension programs with investment opportunities sensitive to inflationary trends has led to reorganization of the development investment and investment banking industry into alliances intended to produce product for the institutional investor who provides 100% of the funds. At the same time, the deals are structured to provide entrepreneurial incentives for long-term management by the developer; to what degree does this represent a return for management that should not be capitalized into the real estate value even if the full charge for management does not appear above the net income line. If compensation is contingent on earnings, must we redefine economic surplus to be that amount of cash throw off that remains after interest is paid on capital and contingent compensation is paid to management? If the developer sells his position, is he selling a real estate interest or a business opportunity to earn the contingent compensation? The pressure to maintain some equitable title in a real estate project for all those who want the benefit of tax shelter leaves the appraisal process confused as to allocation of income among land, improvements, personalty, and the capitalized value of services performed by those who take a nominal equitable title and convert payment for services to a capital gain. The lack of direction to appraisal practitioners from their own professional societies means that fair market values are exaggerated, often undermining the equity in real estate taxation, the safety of regulated securities, and the auditing controls on institutional real estate investment portfolios. The cumulative result must be distortion in the rate of land development, redevelopment, and cost efficiency of land-use decisions.