PAST MEETS FUTURE

SAVING AMERICA'S HISTORIC ENVIRONMENTS

NATIONAL TRUST FOR HISTORIC PRESERVATION

Edited by Antoinette J. Lee

THE PRESERVATION PRESS

1992

RETHINKING ECONOMIC VALUES

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IN 1966 *WITH HERITAGE SO RICH* SCARCELY MADE MENTION OF ANY ECONOMIC CONSIDERATIONS OF HISTORIC PRESERVATION. CERTAINLY PHRASES LIKE "DEPRECIATION SCHEDULE," "PASSIVE ACTIVITY LOSS LIMITATION," "DIFFERENTIATED ASSESSMENT PROVISION," AND "TAX CREDIT PASS-THROUGH" STIRRED FEW MEN'S (OR WOMEN'S) SOULS OUTSIDE OF THE HOUSE WAYS AND MEANS COMMITTEE AND THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS.

But over the last 25 years, the preservation movement has broadened and diversified, and the mention of historic preservation and dollars in the same sentence is no longer considered too crass for discussion in polite company. This sometimes grudging acceptance of the pecuniary possibilities of preservation is a result of four lessons that have been learned during this quarter century.

- There are far more important historic properties than can be used for museums
- There will never be sufficient public monies to undertake all of the historic preservation that ought to occur
- Historic preservation and economic development can be consistent and mutually beneficial public and private goals
- A historic preservation developer is not a contradiction in terms

Underlying these lessons is one basic axiom: historic preservation will not take place in the private sector on a sustained basis unless it makes economic sense. While that premise is accepted by most preservationists, it is not widely understood. Until there is a broadened understanding among preservationists and by developers (a point that will be returned to later), conflict between the two groups will persist and historic buildings will continue to be lost.

While there are certainly exceptions, capital is a fundamentally bias-free commodity. Capital moves to where there is money to be made. There is no better evidence of this economic principle than the federal rehabilitation tax credits. Beginning in 1981 when preservation was greatly tax advantaged, literally billions of dollars (a very small percentage of which, one supposes, came from "preservationists") were invested in historical rehabilitation. Even more quickly, when the tax code was changed in 1986, those sources of investment capital dried up virtually overnight. It was not that less money was available; the money simply went elsewhere. Even when the nature of the investment was significantly constrained (by compliance with the Secretary of the Interior's Standards for Rehabilitation), private capital moved to historic preservation when it made economic sense to do so and away when it did not. For preservationists to insist on such investment when it does *not* make economic sense is neither rational public policy nor a recipe for broad-based, long-term support of preservation goals.

MAKING PRESERVATION MAKE SENSE

The question, then, is simple: how do we make historic preservation make economic sense? There are short, intermediate, and long-term answers to that question. A prerequisite to formulating those answers, however, is the acceptance of a four-part syllogism.

1. Historic preservation primarily involves buildings
2. Historic buildings are real estate, and real estate is a commodity
3. For a commodity to attract investment capital, it must have economic value
4. Therefore, to attract private investment to historic preservation, it is necessary first to create and then to enhance economic value

Preservationists often talk about the "value" of historic properties: the social value, cultural value, aesthetic value, urban context value, architectural value, historical value, the value of sense of place. In fact, one of the strongest arguments for preservation ought to be that a historic building has multiple layers of "value" to its community. Each of those types of "values" has its own attributes, many of which are identified elsewhere in this book.

Likewise, "economic value" has its attributes. These include the elements of value that are necessary for economic value to exist at all and forces of value that operate to enhance (or reduce) economic value. Both the elements of value and the forces of value must be reckoned with if historic preservation is to have sustainable economic value.

From where does economic value originate? For any commodity, including real estate, to have economic value, four characteristics must be in place: scarcity, utility, desire, and purchasing power. These are known as the elements of value. All four must be present (although likely in differing degrees) for any economic value to exist. Consider a historic building in this context. It certainly has scarcity. That is one of the primary reasons preservationists want the building saved. And at least in America the purchasing power exists. Capital is available—it is just being invested elsewhere. What will most often be lacking in historic structures are utility and desire. Occasionally, the use for which the building was constructed (its utility) simply no longer exists. Unless and until a substitute use can be created, the building will not have economic value. Again, the absence of *any one* of the elements of value will preclude the existence of economic value for the property. More often there is a (perceived or real) diminished utility because the design, configuration, equipment, or amenities of an older structure differ from those of a contemporary building.

However, a major benefit of the amount of historic preservation activity over the past 25 years has been the demonstration that there is, in fact, an alternate use for virtually every kind of structure. Furthermore, good architects around the country have devised innovative ways to mitigate or overcome what might otherwise be defined as utility-diminishing design deficiencies of old buildings. Because these adaptive use success stories are so numerous and so widely dispersed geographically, preservationists often assume that this lesson has already been learned, at least by the design professionals. Unfortunately, that is not sufficiently the case. A recent letter opposing historic district designation written by an architect illustrates this point. The letter says that a structure's " . . . small rentable area and less than optimum conditions in the interior spaces (low ceilings, numerous posts and columns, few windows) does not bode well for the future of the building as a long-term investment." This statement says less about the historic building than about the lack of imagination of the architect. But it does not much matter if the lack of utility is real or imagined; if utility is perceived to be absent, the building will not have economic value.

There is an old saying in real estate that "more buildings are torn down than fell down." That has to be true to the magnitude of 1,000. Whenever a building is razed (whether or not it is a historic structure), that act is the manifestation of the owners' judgment that the land vacant is worth more than the land and building combined. The owner has concluded that the contributory economic value of the building is less than zero, at least to the extent of the demolition costs. In other words, the value of the vacant land plus the cost of demolition was calculated to be greater than the value of the property when it included the building.

Along with utility, desire is the element of value deemed absent from many historic structures. It is not sufficient that preservationists "desire" that the building be saved. That desire has to come from a broad segment of users of real estate in the marketplace. And this desire cannot be in the metaphysical abstract. It has to be expressed with a checkbook. When sufficient numbers of tenants declare a *preference* for restored historic structures as opposed to new buildings, and when that declaration is reinforced with rental dollars, capital will flow from new buildings to old. By extension, when customers and clients vote for historic buildings with their purchases of goods and services, building owners and occupants will get the message.

In brief, then, scarcity already exists and purchasing power is available. For historic buildings to have economic value into the next century, it will be necessary for us to advance up the learning curve of building utility and to better communicate the lessons learned to design professionals, contractors, and developers. And it will be essential to spread the desire for rehabilitated historic structures beyond preservationists to building owners, owner-occupants, customers, and tenants.

ENHANCING THE RELATIVE VALUE

But it is rarely argued that historic buildings have no utility or that there is no desire in the marketplace for their use. Rather, the contention is that the economic value of these structures is less than the alternative. Sometimes that alternative is a new building; sometimes it is nothing at all. Thus the challenge is less the creation of some modicum of value than the enhancement of the relative economic value of historic properties so that they are economically competitive in the marketplace. This requires the application of the forces of value. In economics, the four forces that affect the value of a property are social, economic, political, and physical. If preservationists are going to methodically approach the economic value enhancement of historic properties, it has to be through the systematic application of these forces.

Existing incentives for historical rehabilitation investment can be categorized by these four forces. Federal tax credits and local low-interest loan pools are both uses of the economic force to affect value. Historic districts and local limitations on demolition represent the use of the political force of value. Educational outreach by preservationists to explain to the community the importance of historic structures is a use of the social force of value. Public improvements and updated infrastructure in historic districts are uses of the physical force to enhance the value of individual historic buildings.

But important historic structures continue to be lost. By definition, this means that the existing incentives for preservation are inadequate to raise the economic value of a historic structure to a competitive level with the alternative. New approaches must be tried. Here are some modest proposals, both short-term and long-term, that might be considered.

CHANGES IN PROPERTY ASSESSMENT PROCEDURES

This policy has been adopted in a few taxing jurisdictions. Local property taxes are a major cost of owning investment real estate. While there is a wide variation between one locale and another, annual property taxes generally run between 1.5 and 2.5 percent of the market value of a property. This typically represents somewhere between 10 and 18 percent of the gross annual revenues that a property generates.

In most jurisdictions, the methodology for tax assessment begins with the valuation of land "as if developed to its highest and best use." Here, highest and best use is defined as "the most profitable likely use to which a property may be placed." When there is strong demand and the zoning ordinance permits greater development intensity than is being used by an existing historic structure—for example, a two-story historic building sitting where a 10-story building would be permitted—the highest and best use value of the land will most likely be far greater than its existing use value. Without some financial mitigation, this means that the historic property will be significantly overtaxed in comparison to the alternative: a new building filling the zoning envelope. If, for example, property taxes on the land were $1 per square foot of permitted density, the historic structure might be paying five times the land taxes per square foot of building than a new structure.

Procedurally, a relatively simple change could be made by local taxing authorities. Land under historic buildings could be taxed based on how it *is* developed instead of how it *might be* developed. At least this would reduce the disincentive to maintain a lower development intensity than that permitted by the zoning ordinance.

DEMAND-SIDE INCENTIVES

Currently nearly every preservation incentive is directed to the supply side of the demand-supply equation. Federal tax credits, depreciation deductions, local tax abatements, rehabilitation grants, and low-interest loans are all geared to increasing and maintaining the supply of space in historic structures. Almost nothing is available to increase the demand for the space within those buildings. Yet it is the increase in the demand (or the reduction of competitive supply) that will ultimately increase the economic value of historic properties.

Perhaps it is time for Congress to consider tax credits for tenants of historic buildings. An annual tax credit of, say, 15 percent of the rent paid by a tenant in a historic building could substantially increase demand for that space.

Three incidental benefits would flow from this approach.

First, there are far more tenants than landlords. This incentive would spread tax advantages much more broadly. Second, this tax credit would compensate for any real or imagined reduced utility of the old building versus the new. Third, historic preservation as a public policy should not be narrowly defined only as saving old buildings. It ought to be used to encourage private reinvestment in areas appropriately targeted for public intervention: inner cities, small-town downtowns, old commercial neighborhoods. It is in these areas where the vast majority of America's nonresidential historic properties are located. But a rehabilitated empty building does not particularly add to an economic revitalization strategy in those areas; that building filled with tenants does. People and economic activity, not paint and plumbing fixtures, ultimately add economic value. Demand-side incentives would encourage *both* paint and economic activity.

CONSISTENT PUBLIC POLICY

The biggest success of preservationists in the last 25 years may be the fact that today every level of government pays at least lip service to the importance of historic preservation. Over the same period, but particularly in the past 10 years, the phrase "fiscal responsibility" has been the slogan not just of conservative Republicans but also of liberal Democrats and virtually everyone in between. And for good reason. In the next 25 years it is highly unlikely that any level of government—federal, state, or local—will have an excess of funds.

But there have been too few efforts to tie together historic preservation and fiscal responsibility. The federal government continues to build post offices at the edge of town, abandoning not only important historic structures but, equally important, the commercial neighborhoods of which the old post offices were important components. The Carter administration issued a directive that federal agencies give priority to historic structures when looking for additional office space. The evidence that any of them actually do that today is virtually nonexistent. Similarly, state governments continue to build new (and usually undistinguished) buildings to house public employees, when in the same communities important historic structures sit empty. Local governments are probably the worst offenders. Peripheral development is not only tolerated but often encouraged with significant public subsidies, all at the expense of historic buildings in the city's core. When municipal public agencies necessitate acquiring, by purchase or lease, additional real estate, rarely do local governments even consider historic buildings, let alone give them priority.

This countervailing public policy is fiscal irresponsibility at its greatest. No longer can any level of government afford to spend scarce public resources to serve only one purpose. When the public sector needs additional space, and historic buildings in the community are underused, these two needs should be addressed with one expenditure. The policy statement in favor of historic preservation is admirable, but unless it is followed with public occupancy of those same buildings, scarce tax dollars are being wasted.

CONTINUED ADAPTIVE USE LEARNING CURVE

Not every incentive for preservation requires the expenditure of public dollars. The marketplace usually responds creatively when given an opportunity. Among the most valuable economic incentives to historic preservation over the last two decades are the lessons learned by architects, structural engineers, contractors, and manufacturers about building rehabilitation. Examples include windows that are both consistent with the Secretary of the Interior's Standards and energy efficient; retrofitted heating, ventilation, and air-conditioning systems that do not adversely affect the architectural integrity of historic buildings; appropriate handicapped-access accommodation; and building insulation systems. Once developed, innovations in these and other areas have quickly become cost-effective alternatives to new construction.

But for design and construction innovations to occur, historic preservation has to occur. The mere existence of rehabilitation activity provides the marketplace the opportunity to develop its own incentives—cost-effective technologies—thereby enhancing the economic value of preservation.

As far as long-term proposals are concerned, the word "proposals" is probably a misnomer. What follows is not so much a list of suggestions for statutory amendments as it is a framework for altering the fundamental perspective from which we view real estate in general and historic property in particular.

UNDERSTANDING REAL ESTATE'S REAL VALUES

Consider first how most building owners' perceptions of the value of their property diverge from reality. Most property owners believe that it is the four walls and the roof that give their building value. The ego of ownership has created the

Opposite: Slender papyrus columns announce the entrance to the rehabilitated Barney Ford Building in Denver.

myth that the value of the asset somehow emerges from within the property boundaries. Nothing could be further from the truth. The value of real estate comes primarily from the investments others have made: taxpayers, other property owners, employers. Take away a community's sidewalks, streets, sewage disposal system, water plant, police protection, jobs, and people, and what is the value of any building? Virtually zero. The generation of economic value in real estate is largely external to the lot lines.

The owner is certainly entitled to a return on his or her investment. But the investment that others have made, allowing the building to have value at all, also merits a return. This is the economic justification for land use controls: zoning, subdivision ordinances, and historic districts. It is not an issue of property rights; it is a question of equity, fairness, and return on *everybody's* investment.

Another misguided view shared by many landowners is that land use controls represent the public sector's clash with the private sector. Wrong. The economic, physical, social, and political context within which a building exists gives it value. The economic purpose of land use controls is to create and maintain a context that sustains and reinforces the *composite* value of the area. While a well-drawn historic district ordinance, for example, may diminish the maximum value of any single property, it will enhance the cumulative sum of values within the area. The ordinance is not a case of the public versus the private sector; it is the communal economic benefit of *all* of the owners versus the economic windfall of a single owner.

This is a crucial concept to grasp because, unlike most other investments, buildings are interdependent assets. The quality, condition, maintenance, and management of nearby properties will have a direct effect on the value of a given building. And still most owners are afflicted with lot-line myopia. This viewpoint is bolstered by real estate appraisals that deal only with the quantification of the deed holder's share of the property's value. The return on the individual owner's investment comes from cash flow and proceeds when the property is sold. It is partly through land use controls that other investors—other building owners, the city, taxpayers—get their share of the return.

One other characteristic distinguishes real estate. Unlike other types of investments, real estate is imposed on others 24 hours a day, 365 days a year. Simple fairness demands that the public have some control over the nature of that imposition.

Until property owners—and bankers, appraisers, real estate brokers, and city officials—broaden their understanding of the source of the economic value of real estate and its interdependence as an asset, these inane and spurious debates about "what gives you the right to tell me what I can do with my property" will continue. Enlightenment in the near term is unlikely.

FEDERAL TAX TREATMENT

A second broad area to be addressed in the long term is the treatment of real estate in the federal tax code. For tax purposes, real estate is assigned a "depreciable life" (the period over which a building is presumed to have economic value) of 31.5 years at present. What a patently absurd assumption! And yet that begins to mold one's thinking; it makes the asset disposable. Depreciation is justified based on real estate's definition as a "wasting asset." Thus it becomes a wasted asset, razed generations before its physical life is over. Buildings are torn down not because their physical life is over but because their remaining economic life is deemed to be limited. The rebirth of economic life is reinvestment, not demolition.

This concept of real estate as Kleenex affects not only historic structures. It also reduces the quality of new buildings being built. Why spend the time and money to design and erect a structure to enable it to last 100 years, when its anticipated life is 31 ("and anyway, my accountant says I should sell it seven years from now")?

Capital-gains taxes likewise do a disservice to both historic structures and quality new buildings. If a developer builds a quality building with a long economic life, maintains it well, and therefore is able to sell it at a profit (and remember, if a given property has increased in value, its neighbors are economic beneficiaries), he or she is penalized with taxes. On the other hand, if the owner builds a cheap building and lets it decline through lack of maintenance, all at the expense of surrounding properties, he or she is rewarded by being permitted to deduct the losses. Furthermore, if the owner chooses to tear down a building, even though it may have considerable remaining value, both to the community and as an income-producing asset, he or she is entitled to take a tax deduction in the amount of the building's book value. The whole thing is backwards.

If Congress and the public are serious about fiscal responsibility, serious about the conservation of scarce resources, serious about inner-city revitalization, and serious about historic preservation, the tax code could be adjusted to more effectively support these goals:

- Eliminate depreciation altogether so that real estate becomes a renewable capital asset, not a "wasting" one
- Eliminate capital-gains taxes on the sale of real estate. This would encourage reinvestment and reward owners who erect and maintain quality buildings

- Eliminate the deductibility of capital losses on the sale of real estate. Again, reinvestment and maintenance would be encouraged, while vacancy, abandonment, and demolition by neglect would be discouraged. This would also stimulate building owners to have more concern for the context within which their building exists—that is, the neighborhood—and to take actions to reduce negative impacts on the area that could adversely affect their property's value
- Provide a reinvestment tax credit equal to the owner's ordinary tax rate. For example, an individual in the 28 percent tax bracket would receive a 28 percent tax credit for every dollar reinvested in an existing property. The rationale would be as follows: if, rather than spend your earnings, you reinvest them in a building, thereby extending its economic life and conserving resources, that portion of your income will not be taxed. For historic buildings, the Secretary of the Interior's Standards could be applied to this credit, as is now the case
- Eliminate all income taxes on earnings from buildings of, say, 100 years old or older. The basis of this policy would be that, after a century, the property has "paid its dues" and is entitled to a tax-free retirement. This last provision could be mirrored for property taxes on the local level

What would be the consequences of these actions? The incentive to tear down quality old buildings and replace them with cheap new ones would be greatly reduced. A strong motivation would be provided both to reinvest in existing buildings and to maintain them. Wider acknowledgment would be given to building interdependence, leading to greater cooperation among property owners for their mutual benefit. Private investment would take place where it is in the greatest public interest for it to occur: in central cities, in declining commercial neighborhoods, and in downtowns. Historic preservation would occur, not because of the granting of a specific tax-favored status, but because the entire tax code changed its focus.

What would be the cost of these actions to the federal treasury? That is a question that is certainly worthy of investigation. With the elimination of depreciation and the deductibility of capital losses, the effect could well be tax neutral. But the overall cost to society would certainly be less than it is currently.

AWARENESS OF PRESERVATION'S VALUE

The last of the long-term "proposals" is merely for heightened awareness on the part of city officials, bankers, investors, economic development advocates, real estate brokers, and others of another basic economic principle. In economics, it is the differentiation of a product that commands a monetary premium. Real estate is a commodity; our communities are also commodities. Our built environment and, particularly, our historic structures express better than anything else our diversity, our identity, our individuality, our differentiation. To homogenize our cities by demolishing historic buildings and replacing them with derivative architectural eunuchs is to sacrifice the economic premium our community and its investors are seeking. The economic value of historic preservation will be a foregone opportunity.