For at least thirty years we have heard complaints about suburban "sprawl" from some in the ranks of urban planners, environmentalists, and public transit advocates, among others. These observers have urged government actions to reverse, stop, or at least slow suburban growth. Much of their literature and rhetoric has been provocative; the very use of the term "sprawl" casts the idea of growing suburbs in an unfavorable light. (The non-pejorative term "suburbanization" is used in this discussion.)

Academic economists have weighed in on issues relating to suburbanization. Their most important contributions have been in the areas of metropolitan location and spatial analysis, local government tax and expenditure analysis, and the analysis of interactions between metropolitan transportation and spatial issues. Yet, remarkably, academic economists have written almost nothing on the general government policy issue of allegedly excessive metropolitan suburbanization. This article presents the case for suburbanization from an academic redoubt. The fact that much of the literature opposing suburbanization is written within the Washington beltway is suggestive, but does not make the claims either correct or incorrect. Many DC-based organizations have issued negative reports and pamphlets on suburbanization. Typically vituperative is the Surface Transportation Policy Project. Beyond doubt, Anthony Downs is the intellectual leader of the anti-suburbanization group; for his views see his Brookings Institution publications cited in the references on page 7.

What Should Concern Us
In the outdated traditional view, central cities serve as our major population and employment centers, with suburbs playing a minor supporting role. An economic definition of suburbanization is a reduction in the fraction of a metropolitan area's population or employment that is located in the central city (corresponding to increased activity in surrounding suburbs). Many such relationships have been estimated for large numbers of historical years and metropolitan areas throughout the world. (Occasional corrections made when central city boundaries change do not alter the important conclusions.) There is no question that recent decades in our country have been characterized by higher population and employment growth in the suburbs than in the central cities. The substantive issue is whether this growth has been excessive. Suburban growth would be excessive if it imposed higher costs on society than would corresponding central city growth – that is, if the growth were occurring in the wrong places. If so, then our efforts should be directed toward identifying the excess costs that suburbanization creates, and the appropriate government response, with appropriate economic tools.

It is unfortunate, therefore, that today's anti-suburbanization literature is hardly ever written in the context of modern welfare economics. We have learned how to analyze the social efficiency of resource allocation in competitive markets through half a century of extremely careful studies, and private suburban land markets in US metropolitan areas are certainly competitive. I have presumed, in writing this article, that any suburban land misallocation is the result of a mispricing of resources. This mispricing, in turn, results from the ineffective regulation of externalities, or from other failed government policies.

A Brief History
Suburbanization is not the shocking new development that its opponents seem to profess. This growth has been occurring in metropolitan areas the world over for at least 40 years; it has proceeded in the US for 75 or 100 years. I have never seen a careful study that reported findings to the contrary among the dozens that have appeared on the subject. This article presents the case for suburbanization from an academic redoubt. The fact that much of the literature opposing suburbanization is written within the Washington beltway is suggestive, but does not make the claims either correct or incorrect. Many DC-based organizations have issued negative reports and pamphlets on suburbanization. Typically vituperative is the Surface Transportation Policy Project. Beyond doubt, Anthony Downs is the intellectual leader of the anti-suburbanization group; for his views see his Brookings Institution publications cited in the references on page 7.

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Reasons for Suburbanization

While serious scholars may dispute the relative importance of factors that cause suburbanization, there is general agreement as to reasons why we suburbanize. One important reason is size; large cities are more suburbanized than small ones the world over. It would, of course, be almost impossible, and certainly expensive, to locate most of a large metropolitan area’s employment in or near its CBD. Think of the time and money cost of providing housing and the transportation infrastructure to move workers between residences and jobs. Even in a midsized (1-5 million people) metropolitan area, several small subcenters are more efficient than one large CBD. (Garreau’s term “edge cities” is not quite synonymous with subcenters; many subcenters are not cities and many are not at the edges of metropolitan areas. However, his dramatic case studies are instructive.)

A second reason for suburbanization is high income. High income metropolitan areas are more suburbanized than low income ones, a result that can be documented within the US, but more dramatically by international comparisons. The easy explanation is that high income residents demand large quantities of housing, and cheap land for large houses is available away from central cities. (The correlation between family income and the home’s distance from the CBD is strong within most US metropolitan areas. This relationship is less certain for areas outside the US, since few other countries report incomes in census data.)

The suburbanization of employment and housing reinforce each other. Firms suburbanize if their workers and customers suburbanize, and residents suburbanize if jobs (and shopping centers) are predominantly in the suburbs. Evidence indicates that jobs follow people to the suburbs more than people follow jobs.

Manufacturing is a separate case. US manufacturing has been moving from CBDs to outer parts of central cities, then to suburbs, and then to small metropolitan areas or even non-metropolitan areas for at least half a century. The primary driving force has been the shift in freight movement from rail and water to road and, to a minor extent so far, air transportation. The revolutionary cause was the development of internal combustion and diesel engines, refrigeration, and modern highways. These innovations made it economical to produce in suburban locations – free from high land prices, congestion, strong unions, high taxes, and burdensome regulations – while shipping inputs directly from, and outputs directly to, distant areas. There can be no doubt that the result has been enormously beneficial. Manufacturing dispersal has been little influenced by, but probably has promoted, population suburbanization.

Chicago’s Mayor Daley, and other large city mayors (and their planning organizations), have been loath to shed the fantasy that they can attract manufacturing back to the central cities. Although manufacturing is a thriving and crucial sector of the American economy, it has not been a source of substantial job growth, either nationally or in the Midwest region, for several decades. It will certainly not be a source of job growth in central cities during the careers of people currently serving as government officials.

Irrelevance of Inner City Problems

Suburbanization’s pervasiveness indicates that it does not result mainly from parochial post-World War II US central...
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city problems, such as race. Indeed, our metropolitan areas were suburbanizing long before the massive postwar migration of minorities to the cities. It is beyond dispute that racial minorities, poverty, and crime are concentrated in central cities; and some evidence indicates that the fraction of jobs and residents located in suburbs has grown as minorities, poverty, and crime have become more concentrated in central cities. Yet it is almost certain that social issues affecting the central cities have had a greater effect on who lives and works in suburbs than on how many live and work there. 7

Indeed, during the 1980s and 1990s African Americans and Latinos have been moving to suburbs in record numbers, in Chicago and elsewhere (despite the fraction of jobs and residents located in suburbs has grown as minorities, poverty, and crime have become more concentrated in central cities. Yet it is almost certain that social issues affecting the central cities have had a greater effect on who lives and works in suburbs than on how many live and work there. 7

The pervasiveness of suburbanization over long time periods and among countries with very different government and private institutions indicates that suburbanization is deeply embedded in the urban growth process.

some suburban governments' efforts to keep minorities - and the poverty and crime feared to accompany them - in the central cities). The migrants are mostly not poor; their socio-economic characteristics are much like those of whites who moved to the suburbs in droves starting about forty years ago. 8 It is ironic that more housing has been built and rehabilitated in Chicago (and some other cities) during the prosperous years since 1993 than was built over many previous years. Some housing professionals feel that growing numbers of the large cohort born between 1950 and 1965 are becoming "empty nesters" and moving to increasingly safe and leisure-oriented central cities, some from suburbs they had seen as attractive places to raise their children.

Transportation's Important Role

Modern economic activity requires specialization, and specialization requires the movement of people, goods, and information. People and goods are most efficiently moved within a metropolitan area, mainly because proximity between origins and destinations permits travel distances to be short, and high activity densities enable the transportation system to be used at close to design capacity. But a truly socially useful metropolitan area requires a transportation system that not only serves the intra-metropolitan area well but also connects with other places. One reason that economic activity in many Asian and African metropolitan areas is so concentrated is that transportation to other areas is poor, so firms and workers crowd into countries' few (or sometimes only) fine port cities despite astronomical rents and massive crowding.

The US has intra- and inter-metropolitan area transportation systems as fine as any in the world. In analyzing a transportation system we emphasize people's trips to work, which constitute a minority of intra-metropolitan trips but create the greatest stress for the system. A system that can handle work trips can handle any other demands placed upon it, at least if it has a large road-based component. About 90% of Chicago and other US metropolitan area work trips are made in private vehicles (mostly cars, but also motor cycles, bicycles, and taxis). 9 An even greater percentage of non-work trips is by private motor vehicle, since most are either social (with enormous origin-destination diversity) or freight hauling (shopping trips, business goods delivery, etc.), for which private motor vehicles are the only practical modes.

The basic reasons for US reliance on auto-based commuting are high incomes; inexpensive land, vehicles, and fuels; and good roads. As noted, high incomes and low cost land are major reasons for metropolitan residents' moves into low density suburbs. Add to these factors the dispersion of jobs into low density sub-centers, cheap gasoline, and a fine metropolitan road system, and the story is complete. Because work trips' origins and destinations are highly diverse, and the densities of suburban residential and employment centers are low, fixed rail mass transit tends to be uneconomical. A high quality modern highway with two lanes in each direction can handle about 16,000 vehicles (8,000 in each direction) during a two-hour commuting period. (10,000 vehicles is more typical use in US metropolitan areas, since lanes are not used to capacity and travel is typically greater in one direction than in the other. 10 A fixed rail transit line's capacity is at least 20,000-50,000 passengers per hour in each direction. (In Tokyo, up to 75,000 passengers travel in one direction during a rush hour on busy subway lines.)

US metropolitan areas can not provide requisite densities for fixed rail commuting without massive and artificial restructuring. In our country, almost no fixed rail commuter lines cover operating costs, let alone the much larger capital costs. At low intensity use, a fixed rail system is prohibitively expensive. No careful study has indicated that social benefits exceed costs for any of the fixed rail commuter lines built in US metropolitan areas during the last 35 years.

Buses are another matter. A nearly full express bus traveling at highway speed can compete with private cars in both money cost and travel time, if the driver can pick up and discharge passengers without making many stops. In contrast, a local bus making 4-6 stops per mile can not compete with cars in terms of speed or time and money costs, no matter how nearly full it travels. Most passengers on such buses either can not afford cars, place low value on travel time, or make short trips to CBD work places where parking is expensive.

Express buses can be economical because service is divisible and rights-of-way can be shared with private motor vehicles. Filling a bus in only a few stops at residential origins requires frequent service, to keep waiting times short. An important issue is whether suburban residential areas can provide enough passengers to fill buses with few stops at 5-10 minute intervals without requiring more than about 10-minute walks and waits, for two morning hours. An express bus that must share crowded highways can not travel faster than cars; advocates thus suggest reserved lanes. Efficient use of a reserved bus lane requires more than 200 buses during the two-hour commuting.
period. If use of the reserved lane is light, other lanes are even more crowded, and car users complain bitterly. Reserved bus lanes have been used with some success, notably in southern California. To compete with cars, express bus service must be well planned, and must operate in an environment favorable to bus commuting.

Benefits and Costs of Suburbanization
The benefits of suburbanization are great; tens of millions of people have been able to acquire inexpensive housing in pleasant, low density communities with fine schools, low crime rates, and recreation areas for children. Widespread car ownership provides great flexibility in choice of home and work locations without high commuting costs, and has provided flexibility in travel for shopping and social trips. In addition, suburbanization of both people and jobs has enabled large metropolitan areas to function efficiently, with no more than modest road congestion.

Why is there so much concern about the suburban pattern of US metropolitan areas? Most of the concern appears to relate to auto use, specifically regarding:
- Subsidy – People grouse that governments subsidize auto travel through road construction, maintenance, and operation outlays. While this claim is correct, there are misconceptions. Spending on roads is about equal to revenues raised from vehicle taxes (mostly fuel tax, but also excise taxes, registration fees, import duties, bridge and road tolls, etc.). We can not be sure, because so many diverse taxes and spending programs exist. Only the federal highway trust fund is dedicated to road expenditures. An irony is that, for a couple of decades, much of that fund has been used to subsidize fixed rail construction. Far from being free, road use is taxed at levels that approximately repay government spending on roads.
- Congestion – Though we causally view congested as synonymous with crowded, a crowded public facility is congested in the economist’s view only if the marginal, or extra, cost imposed on society by an added user exceeds the average cost. Average cost is the time and money cost that each user bears. Marginal social cost includes not only the cost that each individual user bears, but also the cost imposed on others by slowing their trips. While this explanation may sound paradoxical, it follows from the fact that travel speeds drop as traffic increases on a crowded road. The total added cost imposed on other users by each additional user may be several times the cost the added user bears. While each extra user slows traffic only slightly, that slight burden affects hundreds of other users.

The existence of congestion implies inadequate supply and/or pricing of travel facilities. If marginal social cost exceeds average cost, then the average cost to society rises with each new user. Much research has been devoted to ascertaining how to charge appropriate congestion tolls. The issue is not easily resolved; for example, a congestion toll that equates the price each user faces to the added cost imposed on society is optimum only in the short run, when transportation infrastructure remains fixed.

In private markets, an implied excess profit would induce capacity expansion. Governments should imitate the competitive response; transportation infrastructure should be augmented until average and marginal cost are equal, and the price of using a facility should be set equal to that cost. At that point, there is no congestion: the facility may seem crowded, but there is no excess of marginal over average social cost. The appropriate investment may be more roads, fixed rail systems, reserved bus lanes, or better traffic control. Only benefit/cost analysis of alternative plans can settle the issue.

As an example, road building is quite costly in built-up areas. Chicago’s road system capacity could probably grow by about a third with the expenditure of a few tens of millions of dollars to improve traffic control (reverse direction and one way streets and lanes, timed traffic lights, enforcement of traffic rules, higher on-street parking fees, and abandonment of restrictions on private off-street parking). The benefit/cost ratio would be large.

Spending billions to acquire land and build new roads would not be justified.
- Environmental Costs – Motor vehicles are often accused of being polluters. Yet new autos emit only about 15% as much waste gas per vehicle mile as the last uncontrolled cars, produced in the late 1960s. Cars with internal combustion engines do not discharge the two air pollutants known to have substantial health effects: sulfur and particulates. With existing technology, new car emissions could be reduced somewhat more, but the benefits would be modest relative to the costs. On the horizon for the next decade are technologies that will have much bigger benefits (fuel cells, dual engines, gas turbines, electric cars).

Old cars raise more serious problems. The oldest 20 or 25% of cars emit most of the auto pollutants. Federal law requires states to compel old cars to adhere to high standards, but they have not done so, presumably because old cars are driven primarily by low income residents. Diesel engines are even worse; they emit particulates, and emission standards are low. Everyone is aware of malodorous truck and bus emissions. Again, the need is for states to enforce reasonable standards.
- Oil imports – Some people complain that our dependence on cars and imported oil worsens our international balance of payments. But exchange rates today are mostly set by markets; these markets equilibrate international supplies of and demands for goods, services, and money assets. Our balance of payment deficits on current account mean that foreigners find the US a good place to invest. There is no merit to proposals to control oil imports for balance of payment reasons.

More worthy of our fear is unreliable foreign petroleum sources. We have had two interruptions of foreign oil supplies, 1973-74 and 1980-81. A third politically motivated major reduction in foreign oil supplies seems unlikely. OPEC is weaker, foreign sources are more diverse, and we have an emergency reserve; but I can not judge the adequacy of such protections.
- Farmland – Some observers worry that suburbanization absorbs land that we will need to grow food and fiber in the future. That problem is unlikely to arise; we now have about as much land in crop production as we had 50 to 75 years ago.
and irrigated land has replaced land absorbed by metropolitan areas. We grow much more food than in the past, far more than we consume; indeed, agriculture is a major export sector. We could produce even more by abandoning federal restrictions, and by farming more intensively to achieve the rapid increases in output per acre of which our farmers are capable. There has been no prediction of a US food shortage in any responsible study, at least since the early 1970s.

**Government Policy Toward Car Use**

Our federal government has made intermittent attempts to reduce car use in metropolitan areas. Subsidies for rail transit, buses, and carpooling experiments are the most common federal actions. Attempts at physical control have included restrictions on parking facilities at workplaces. Yet most government policies have wasted money, imposing minor inconvenience on workers while having no measurable effect on auto commuting. It would indeed be unforgivable to impose severe controls on commuting by car without accompanying massive improvements in metropolitan public transit systems.

Nevertheless, motor vehicle use in metropolitan areas is vastly underpriced. The argument is quite simple, and it has little to do with congestion. Congestion is limited to a small percentage of metropolitan driving, and is very difficult to price in a precise way. The appropriate price to charge for road use is the long run marginal cost of providing roads, which would be about equal to average cost if capacity were expanded appropriately. This price is the long run competitive equilibrium that government policy should imitate, as discussed in the prior section. Both optimum pricing and optimum capacity expansion are required.

The appropriate price is the opportunity cost of using the land, plus the replacement cost of the produced assets (roads, bridges, tunnels, etc.); plus the costs of maintaining, repairing, and operating the roads. These costs must be annualized and put on a vehicle-mile basis.

But there is no perfect way to collect such a fee. Electronic metering of road use is the favorite of technologically-minded commentators; its advantage is that the charge can be varied by detailed vehicle characteristics (e.g., weight), by location, and by traffic volume. It is costly to set up and operate, however, and is subject to evasion, avoidance, and sabotage. Each vehicle would need an electronic device so that a charge could be recorded (possibly on the owner's debit card) by contact with devices in roads in the system. Such charge systems might be practical on major limited access commuter highways, but they would not likely be feasible on ordinary city streets.

**Let's Talk About “Smart Tax”**

Much simpler would be a fuel tax. A uniform tax per gallon (different for diesel) would yield revenues very nearly proportionate to road use and vehicle weight. At-the-pump levies are extremely cheap to collect (less than for any other important tax) and almost impossible to evade. In principle, we can differentiate by where fuel is purchased, but not by when and where it is used. Whereas electronic pricing might be appropriate on major roads where vehicle congestion varies by time and location, an optimum fuel tax and optimum capacity expansion would eliminate most congestion (and any advantages of electronic metering).

How much would an appropriate fuel tax be? Gasoline taxes (federal + state) now average about 20¢ per gallon, or 1¢ per car mile driven. A rough calculation indicates that a proper fuel tax would be ten times the present level: about $2.00 per gallon, or 10¢ per car mile. In the early 1990s, the fuel cost of gasoline was about $1.00 per gallon; tax made the retail price average about $1.20. Raising the tax by $1.80 would bring gasoline's retail price to about $3.00 per gallon (still 50¢ to $1.00 less than the price in almost every other industrialized country). This price would represent a 150% increase, but the total cost of travel would rise by considerably less; there would be less driving, so speed would increase and the time cost of travel would fall. (The time cost of travel is now about half of auto-based commuting cost.)

It might seem justified to make the fuel tax less for those who use less costly roads; it is much less expensive to build rural than metropolitan roads, since rural land has less opportunity cost. Yet the usage cost per vehicle mile is not much less, since rural roads are used much less intensively. In fact, a lower tax on fuel sold in rural areas would counterproductively induce urbanites to drive to rural areas to buy their fuel, and differentiating by state would be dangerous since many metropolitan areas are in or near two or more states. But it might be feasible to return part of the fuel tax through federal income tax refunds to those who neither live nor work in metropolitan areas.

What would be the effect of a dramatic rise in fuel taxes? A few people would walk, cycle, or take public transit. More people would gradually replace large cars with more fuel-efficient ones, as they did after the two fuel crises. A crude estimate is that my proposed fuel tax increase would reduce metropolitan driving by 15-25%. I doubt that a higher fuel tax would induce much return of metropolitan area residents to central cities or inner suburbs; most of the reduced driving would be in suburb-to-suburb commuting. At present, thousands of Chicago area workers are in this situation: worker 1 lives in suburb A and works in suburb B, while worker 2 lives in B and works in A (note that many suburban circumferential roads are about equally crowded in both directions during commuting hours). Not all suburbs or suburban work centers are alike, but many have good schools, similar homes, low crime rates, and good shopping centers. Driving is so cheap that housing choices are made on the basis of secondary considerations, which people would rethink if commuting and other car trips became much more expensive.
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My 15-25% estimate of reduced metropolitan car travel is based on the assumption of fixed numbers of jobs and dwellings at all locations. Effectively, some people would just swap houses to locate closer to work. Of course, over a long period, there would be some increases in the densities of suburban employment centers, and of housing near employment centers. At present, local government land use controls are barriers to both effects. They should be relaxed anyway, but would have to be relaxed if we were to get the full benefit of reduced metropolitan driving. A further advantage of a more realistic fuel tax is that it might encourage the federal government to abandon its motor vehicle fuel economy standards. I feel that this proposed large increase in fuel taxes, along with better traffic control and modest physical road system improvements, would practically eliminate congestion for the foreseeable future, and the changes could be carried out in just a few years.

The most important problem with my proposal (or with proposals for any significant electronic congestion charges) is political. Americans dislike tax increases, and no elected official or government can guarantee that the higher fuel tax would be offset by a permanent reduction in any other tax. My proposed fuel tax increase would yield about as much revenue as local property taxes. Property taxes lead to inefficient investment decisions, and they are administered arbitrarily in Chicago and elsewhere, whereas higher fuel taxes would improve resource allocation. But it would be politically difficult to persuade voters that the abolition of property tax would be permanent.

Expanding road capacity is another means of reducing car travel cost that is technically easy but politically difficult. Some road systems should be built or expanded, mostly in suburbs. In built-up parts of urban areas, road capacity is best improved by traffic management. Evidence here and abroad also indicates that existing fixed rail commuter systems could be efficiently operated through private management. Bus systems should simply be opened to private competition.

Although my proposals might slow suburbanization somewhat, their effects would not please the anti-suburbanization forces. Nor should they; governments’ duty should be to get the prices right. Any effect on suburbanization would be incidental, and would probably be minor.

Smart Growth Controls

In recent months, “smart” growth has become popular with government and private groups, in Illinois and elsewhere. Despite much circumlocution, “smart” growth means physical controls on suburban expansion. My arguments against direct controls on suburban expansion are stated above. Suburban land use controls and federal methods controls should have shown people the results to expect from pervasive controls on suburban expansion. Governments invariably prefer direct controls to appropriate pricing policies, and much is known about effects of controls. But since stringent direct controls on suburbanization are relatively rare in the US, we must learn from other countries that have more experience.

The preface is that major parameters of housing demand equations are similar worldwide. (Detailed parameters, such as demand for air conditioning, vary from country to country.) Numerous careful studies of housing demand have been carried out during the last two decades, many of them by or for the World Bank. Invariably, the income elasticity of housing demand is estimated to be between 0.75 and 1.0; in other words, people increase their housing consumption a little less than proportionately as their incomes rise. Housing demand is invariably estimated to be price inelastic; a 10% increase in cost per unit (a combination of size and quality characteristics) of housing leads to a 4 or 5% decrease in housing demand. US studies, which are the most numerous and the most reliable, fit this pattern.

Nevertheless, housing expenditure varies enormously among metropolitan areas around the world. Home value relative to the owner’s annual income is the most telling statistic, varying roughly from 2.5 to 3.5 in most US metropolitan areas, from 3 to 6 in Europe, and from 4 to 10 or more in some Asian metropolitan areas. For example, home prices are about 4 times owners’ annual incomes in Bangkok, Helsinki, and Toronto; 5 times in Amsterdam; 7 times in Cairo; 8 times in Delhi; 9 times in Seoul; 10 times in Munich; 11 times in Warsaw; and 15 times in Beijing.

What accounts for these dramatic disparities? Many things, of course, including population density, the adequacy of real estate property rights, the quality of the construction sector, and the stability and honesty of governments. But the most important explanation is government interferences with housing supply. Interferences include restrictions on housing location, design, and density. The most important restriction, however, is that most governments require legal permission to convert land from rural to urban uses. The most severe restrictions are in moderate income countries, whose urban populations are growing most rapidly. Some restrictions are in the form of “greenbelts,” where urban development is illegal on any terms. More common is severe limits placed on what we would call rezoning from rural to urban uses. Seoul and other Korean cities have greenbelts, but rezoning is severely rationed even outside these areas. Delhi and Bombay represent cases in which government simply permits rezoning of very little land. In Toronto and other Canadian cities, rezoning is severely rationed. Moderately severe controls exist in nearly all European countries.

What’s So Smart About Paying More?
The result of controls on housing supply is high prices. In extreme cases, such as Delhi and Bombay, only the very rich can afford decent housing. Seoul’s upper
middle class residents must save for years to accumulate down payments on modest houses. Closer to home, Boulder, CO has established its own greenbelt around parts of the city; housing there is increasingly the preserve of the rich. Portland, OR is trying to do the same. An axiom is that when governmental limits on housing supply result in especially high home prices, governments blame "speculators," sometimes even putting a few large property owners in jail.

None of the foregoing proves that growth controls are a bad idea, although I believe that they are. Relatively stringent growth controls certainly make metropolitan areas more compact than they otherwise would be. The result is that metropolitan areas are more crowded and, in extreme cases, so congested that activity threatens to come to a standstill; Seoul, Bombay, and Bangkok are examples.

It is important to emphasize that controls inevitably make housing expensive. Canada is a persuasive example: Toronto and Vancouver are surrounded by unlimited amounts of cheap land, yet housing prices are 50% greater relative to residents' incomes than across the border in the US. The reason is simply controls on land use conversion. Seoul is a second persuasive case; in about 1990 Korea's government began to rezone land for development near Seoul much more rapidly than previously. The result has been a drop in the housing price/income ratio from 9 to about 5 within six years (until shortly before the Asian financial crises).

Land use controls contribute to home prices that are not only high, but unstable as well. Real estate prices in Tokyo have fallen about 75% during the 1990s; those in Seoul may have fallen about 50% during 1997, according to press reports in the two capitals. Vancouver's real housing prices rose, fell, and rose again by a factor of two from 1979 to 1990. Prices were especially unstable in Southern California and Boston from the early 1980s until the mid-1990s. These areas have notoriously stringent land use controls. In Chicago, where the controls are much less stringent, housing prices changed little relative to the price level.

Land use controls make housing prices high by limiting supply. They foster price instability because the lengthy permit process slows builders' responses to demand increases in booms. Additional dwellings thus tend to come on the market at the end of a boom or early in the subsequent downturn, thus exacerbating price decreases.

Who Gets Hurt the Most?

Advocates of growth and compactness controls may believe that the benefits of such controls outweigh the costs. I have no idea what such benefits might be (and am unable to find a coherent argument that substantial benefits even exist). But advocates of controls should face the fact that an inevitable implication of the government actions they espouse is much more expensive and unstable metropolitan area housing. I worry about housing costs for everyone, but especially for low income families. It seems doubtful that any advocates of "smart" growth controls have considered what their proposals' inevitable effects on housing costs would do to people with low incomes.

Truly smart growth would require governments to "get the prices right" for the services they provide. It would also require them to permit people maximum freedom as to where and how they live and create jobs.

Notes

1. The only careful discussion of which I am aware is now two decades old; see Altshuler (1979).
2. See, for example, Dittmar (1995).
3. Among these studies have been a half dozen of my own; see Miszkowski and Mills (1993).
7. At the same time, there is evidence that minority children find it harder to escape poverty, crime, and family breakdown as these problems become more concentrated in their neighborhoods.
10. See Small (1992) for a superb recent account.
12. The calculations that follow are from Mills (1998): they pertain to the early 1990s. Most of the underlying data are from Small (1992).
13. The substance of this section depends very much on Malpezzi and Mayo (1997), and on the fuller presentation in Angel and Mayo (undated).
14. These data, from Malpezzi and Mayo (1997), pertain to years near 1990.
15. Evidence is provided in Clayton (1996).

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Viewpoint

The Brawl Over So-Called Sprawl
Thomas Sowell

Urban sprawl has been a topic of interest among scholars, political analysts, and legislators. "Smart growth" initiatives have been undertaken in many jurisdictions, including our state, whose Illinois Smart Growth Task Force has been organized by the General Assembly. We are, therefore, pleased to offer the following article, containing a prominent conservative commentator's views, as a supplement to Dr. Mills's introductory piece.

The latest scare phrase that is supposed to set off a political stampede is "urban sprawl." But, before we go thundering off in all directions, just what is this urban sprawl? How can you tell whether there is urban sprawl where you live? If someone says there is and someone else says there isn't, what can you look for to tell you who is right?

Those who want to lead a government-sponsored crusade against urban sprawl have no time for such questions. Just as some restaurants have a soup du jour, politicians who want to "do something" and "make a difference" must have a crisis du jour. Urban sprawl is today's contrived crisis.

In so far as there is any coherent meaning to the term, urban sprawl is a name given to the fact that metropolitan areas are spreading out, with people living in lower densities in the suburbs than in the central cities. What is so terrible about that?

The real objection may be that all this is going on without the guiding hand of Big Brother. But the alarm that is being sounded is that farm land is disappearing under concrete as suburbanization spreads. Images are conjured up of a growing population needing more food while the land available on which to grow it is getting smaller and smaller.

Another way of saying the same thing is that agricultural advances over the past century have drastically reduced both the amount of land and the number of farmers needed to grow food, even in places where the population is several times as large as before. Far from being something to be alarmed about, this is one of the key factors in rising standards of living around the world.

Where have all the people come from who produce all the abundance of goods and services that make our standard of living so much higher than that of people living just a couple of generations ago? Those people have come largely from the farms, where they were no longer needed. Neither is so much land needed. That is why farmers are selling it to those who build homes and communities that relieve urban crowding.

This is not rocket science. It is basic economics. Resources tend to move from where they are valued less to where they are valued more, because those who value these resources more will make their current owners an offer they can't refuse.

Objections to this common process come largely from people who either have no conception of economics or who imagine that their own superior wisdom and virtue can determine what is "really" more valuable, regardless of what other people want. It is no coincidence that shrill cries about urban sprawl are coming from people with a long history of big government politics on all sorts of other issues.

The most prominent of these critics of urban sprawl is Vice President Al Gore. When he was a Senator, Al Gore twice beat out Ted Kennedy for the title of the biggest spender in Congress. His book Earth in the Balance is a classic of hysterical environmental extremism. The Unabomber had a copy in his cabin.

The head of the Sierra Club is also frothing at the mouth against urban sprawl because more space for people means less space for animals. Using land for what the Sierra Clubbers like is called "saving" it, while using it for what other people like is called "spoiling" it. Demanding that the government prevent other citizens from doing what they want, in order that the environmentalists can do what they want, is depicted as something noble, instead of something selfish beyond words.

Portland, Oregon is held up by the Sierra Club as a good example of a place with restrictions on growth that have "helped make Portland one of the world's most livable cities." There is not the slightest sign of embarrassment at the incredible ego of determining for other people what is a "livable" city. Obviously millions of other people prefer to live in Los Angeles, the very epitome of urban sprawl.

At the heart of the liberal-left vision is the idea that the self-appointed saviors should be telling the rest of us, through the power of government, what we ought to do, what we can do, and what we cannot do. They will define for us what is good and what is bad, remaking us in their image.

Urban sprawl is only the latest battleground in that crusade. This is a culture war -- and the only thing worse than being in a war is being in a war and not knowing it, while the other side is carrying on a Jihad.

Dr. Sowell is a noted economist, author, and university faculty member. He is a senior fellow at Stanford University's Hoover Institute. The foregoing article appeared in late July of this year in Dr. Sowell's widely syndicated newspaper column. It is reprinted here with the permission of Creators Syndicate, which the Office of Real Estate Research thanks for its helpful cooperation.
The so-called “urban sprawl” question is fundamentally one of whether a metropolitan area’s real estate has been allocated to the most appropriate uses. One technique that has been proposed for directing real estate to needed uses is taxing land value while leaving improvements untaxed. The supporting argument is that an improvements tax causes a developer to improve land less intensively than society might wish, whereas unimproved land exists without anyone’s having put forth effort, so taxing it does not reduce economic incentives for optimal use.

Indeed, the argument continues, extracting land’s full value through a tax forces the owner to develop it in a productive manner, in order to meet the tax. Proponents trumpet egalitarian ends as well; the price of land will fall to more affordable levels, we are told, since any increase in value accrues to the public through complete taxation. (The idea that the corresponding tax increase prevents the land owner from realizing any affordability benefit seems not to dampen the enthusiasm of land tax supporters.) Nineteenth century American economist Henry George is recognized as an early land taxation proponent. Among those to adopt George’s views have been governments, both in the US and overseas, that have actually enacted land-only tax regimes (or “graded” systems that tax land more heavily than improvements).

Faulty Logic
But we see many reasons to challenge the claims made by proponents of land value taxation. One problem with land taxation is that it discourages socially useful land speculation activity. If there were a 100% land value tax — that is, if a land owner had to pay an annual tax equal to the rent that the most willing tenant would pay to use the parcel in question for a year — then speculating in land would be completely eliminated. No person or private business would spend resources to locate an area’s most promising parcel, and then shell out hard cash to make a purchase, if any increase in the land’s value would be captured by the public sector. Even a less-than-100% land value tax would distort resource allocation by reducing, though not eliminating, land speculation.

Would reducing, or bringing an abrupt end to, all land speculation be good? Some people would answer affirmatively; they have a visceral reaction to the very term “speculation,” seemingly feeling that speculators do nothing to earn their rewards. But that view is definitely incorrect. It is a shame that there is so little appreciation for the good things speculators do for society. A problem may be that speculation sounds like “speculum,” a medical device sure to elicit unpleasant thoughts. We should find more neutral phrasing for the activity. “Land arbitrage” might be an appropriate term; every mother would love to brag that her offspring is an “arbitrageur,” whereas only a mother could love a “speculator.”

Defining the Process
What a land speculator does is to buy and hold it for sale at a later time. An important aspect of speculation therefore is forgoing returns on alternative investments. It follows that the speculator faces real costs. More importantly, waiting to develop a parcel is a service that has great social value, and society should want to reward the speculator’s service, which includes preventing spatially continuous development. Of course, some people do not see avoiding contiguous development as socially valuable. After all, “leapfrogging” is said to be an element of urban “sprawl.” (Obviously, many non-neutral terms have managed to sneak into the discussion.)

The speculator’s role may be clearer if we consider the value of waiting. Why should anyone extract non-renewable resources at less than an infinitely fast pace? Why wait, for example, before tapping a cask of wine, or go through a search process instead of simply taking the first job that comes along? By the same token, why should a society wait to exercise the option to develop a parcel of land? All these questions are part of the same issue. The answer is that there is value in waiting, which the old Austrian capital theorists recognized with their “point-input, point-output” models.

Think of a common form of speculative activity: retaining a corner of an agricultural tract that is otherwise developed for residential use. That corner ultimately may contain a church, school, shopping center, fire house, or other facility. The point is that a better use comes along later. Spatially continuous development would require that houses (and perhaps even infrastructure) eventually be demolished to make room for a more valued use that does not become evident until the later date. The speculator saves society from this waste of resources.

But land speculators do other good things. For example, they increase liquidity in the land market by reducing the bid-ask spread for available parcels. This spread is the difference between the price a knowledgeable investor would charge (ask) a buyer if he were to sell a parcel, and the lower price the investor would pay (bid) to buy an identical parcel himself. Such a “dealer’s markup” exists in every product market, from diamonds to mortgage loans, with higher markups for items with greater intra-category diversity. In a market such as land, with units characterized by unique features, the bid-ask spread would tend to be high; absent speculation, a seller needing quick turnover would expect to sell at a price far below the land’s intrinsic value.

Waiting to develop a parcel is a service that has great social value, and society should want to reward the speculator’s service, which includes preventing spatially continuous development.
Doing Well by Doing Good
Speculators try to predict (guess) the transaction, or spot, prices that will prevail at stated future dates. They enter the market in the present and bid for assets that they believe will rise in value. This activity raises current prices more in line with (although not equal to) what the speculators think future prices will be. Through their desire for profit, and their willingness to wait before reselling or developing, speculators decrease not only the bid-ask spread in today’s spot market, but also the difference between spot and expected future prices. Narrowing this spread is valuable to society, because it reduces price volatility and the associated tendency for people to avoid investing in a commodity as thinly traded as land.

What Speculation’s Critics Say
Speculators have so many critics that we who admire them sometimes wonder whether we are missing something. In many discussions and e-mails we have asked colleagues who would demonize speculation to explain the problem. Their arguments seem based more on emotion than on analysis; they are wholly unconvincing. For example, one correspondent expressed concern that communities suffer when private or public entities hold locations vacant for long periods, because of the attendant loss of tax revenue. The solution offered is a high land value tax to pay for public services, and to compensate others who can not use the sites when parcels sit vacant during the assembly phase of a large scale development.

Some critics blame speculators for dangerous, unkempt vacant lots that dot the urban landscape. The remedy offered, again, is a land tax that, its proponents hope, would bring prices down to a level at which the government could purchase such land for public use. This approach puts the public sector in the speculator’s role, and we do not disagree that government could provide the speculative function. The question is whether it is likely to do the job well, and at low cost. When private speculators make big mistakes they are punished; they suffer losses, and then go try something else. When government makes a big mistake, on the other hand, it usually decides that things would be better if it just did more of whatever has failed. Of course, some people seem to have faith that government has wisdom that private parties lack, and that the government will act on its wisdom to provide the appropriate amount of waiting.

And blaming speculators for garbage strewn lots is silly. The most dangerous, unsightly urban lots tend not to be owned by private speculators; problems are most severe on lots that have become public properties as a result of tax default.

The most dangerous and unsightly urban lots tend not to be those owned by private speculators; these problems are most pronounced on lots that have become public properties as a result of tax default.

Of course, the speculator is largely limited to the long (purchase) side of the market; it is tremendously difficult to “go short” in the land market the way stock market speculators sell corporate shares short. (Shorting land would involve selling borrowed acreage today in hopes of replacing it with land purchased at a lower price later.) But this inability to sell short is just a limitation of current institutions; it does not provide a basis for criticizing land market speculation, per se.

Some of the risk that speculators incur relates to the problem that the later, better use will not generate sufficient value to fully compensate for opportunity costs (the forgone investment); even the harshest critics concede that speculators do not always win. At the same time, risk does not disappear in the absence of speculation; it instead must be borne by some other entity. An area’s citizens would bear it in a land value taxation environment, though some might be oblivious to the fact. Alert taxpayers seem to see the problems that land-only taxation creates. The idea has been with us for more than a century, but has been put into practice in relatively few venues worldwide.

Notes
2. Land-only taxation’s underlying proposition—that owners do nothing to enhance value—is clearly false. For example, a land owning citizen may lobby and vote for higher taxes to support road improvements or economic development activity expected, net of tax expenditures, to increase area land values.
3. The idea of an optimal waiting or holding period is illustrated through a graphical analysis and numerical examples in “NPV, IRR, and the Optimal Holding Period,” Illinois Real Estate Letter, Summer/Fall 1994.
The name Cuba conjures, for many, images of a country hostile to private real estate ownership. But those of us who have been to the island recently know that opportunities for private land ownership do exist, although they are limited. As far as Cuba is concerned, American investments in certain kinds of real estate are welcome, as are those of citizens of other nations who are willing to follow Cuban law and enter into working partnerships with Cuba’s government.

Excuse Me; Did You Say Cuba?

Cuba has changed its foreign investment laws to make the island more hospitable to investment from abroad. The introduction to 1993’s Foreign Investment Law is a concise statement on the benefits of international business; it shows a softening of the socialist government’s stance on economic cooperation with capitalist economies. Addressing the National Assembly of People’s Power, Cuban president Ricardo Alarcon de Quesada said Cuba “…can benefit from foreign investment, on the basis of the strictest respect for national independence and sovereignty, given that such investment can be used in the introduction of innovative and advanced technology, the modernization of its industries, greater efficiency in production, the creation of new jobs, improvement in the quality of the products and services it offers, cost reduction, greater competitiveness abroad, and access to certain markets…”

Yet as far as our national government is concerned, until Congress lifts its longstanding trade embargo, American real estate ownership in Cuba will be limited to a select group of government and eleemosynary organizations carefully screened by the Treasury’s foreign asset control division. For example, anticipating greater trade and diplomatic activity, the State Department recently renovated its downtown Havana quarters. Only one of the six floors is occupied, but the building sits ready for other potential occupants, “sucking air,” as developers say.

Illinois interests also await an open Cuba. Recognizing the potential impact of Cuban trade on the Illinois business community, in 1995 the Chicagoland Chamber of Commerce held a non-political business conference focusing on the role of Illinois business in Cuba’s post-embargo future. The conference was attended by sixty-five business professionals. “We don’t often see that many people,” noted Bob Lahey, director of the Chamber’s World Trade Division.

When Cuba opens up, the real estate investment opportunities could equal those of Florida, California, the Colorado highlands, South Texas, and other 20th century boom locations. During the next decade, Illinois investors could easily be operating real estate developments in Cuba, designed by Illinois architects, built by Illinois engineers, and funded by Illinois lenders. Illinois Realtors® could be listing condominium units overlooking any of the more than 1,000 miles of Cuban beaches.

This article provides an analysis of the business environment for real estate investments in Cuba, moving from the US blockade to discussions of property rights, the growing tourist trade, the growth in foreign investment, and some unexpected sources of competition (such as the Cuban military, which is actively engaged in real estate development).

Cuba’s Development Environment

The US blockade is the overriding influence on business development in Cuba. Initiated in 1961, after several rounds of back and forth hostilities between the US and the Castro government, then strengthened by the Helms-Burton Act of 1996, the embargo makes it illegal for Americans to spend money in Cuba. It effectively blocks direct investments, although our countrymen can invest in foreign companies that do business in Cuba.

The Illinois business community is playing a key role in efforts to eliminate the blockade. Dwayne Andreas, the long-time CEO of Decatur agribusiness conglomerate Archer Daniels Midland, is a major figure in a US Chamber of Commerce advisory committee working to ease the embargo by permitting sales of food and medicine to the Cuban people.

Many observers believe that once restrictions on the sale of food and medicine to Cuba are lifted, the mere problems of defining food and medicinal products will lead to a quick termination of the entire embargo. Once it is lifted, Americans will be able to own property within the limits imposed by the Cuban government.

Property Rights

Even though Cuba has a socialist government, its citizens own land, houses, and automobiles; and they have bank accounts. Moreover, many Cubans own their own businesses, under the provisions of a law that permits entrepreneurs to work “on their own account.” Lands have titles that are recorded in a Registry of Properties, maintained by the Cuban government in the Ministry of Justice.

Under Cuba’s post-revolution constitution, real estate can be owned by: small farmers; private citizens; cooperatives; the government; and political and social groups, such as labor unions, churches, and other non-governmental organizations dedicated to nonprofit activities. In terms of numbers, small farmers are the largest category of land owner, as a result of a strong agrarian reform movement following the revolution. Between June 1959 and February 1961, a total of 32,823 land titles were given to small farmers. In terms of total acreage, this group owns about 15% of all Cuban land; cooperatives own another 50%, and the rest belongs mostly to the state.

Certain kinds of real estate can be owned by foreigners under provisions of the Foreign Investment Law of 1993. As set forth in Article 16, paragraph 1, foreign investors can “acquire ownership and other property rights over that real estate.” But these investments are limited to particular uses; as paragraph 2 of Article 16 specifies, “the investments in real estate discussed in the previous paragraph can be utilized for: a) housing and other structures destined for private residence or tourism activities of persons who are not residents in Cuba, b) housing or offices of foreign companies, and c) real estate development for use in tourism.”
Most notably, foreign firms can not purchase land for agricultural production, extractive industries, or any other business not related to tourism. Further, foreign firms are prohibited from practicing law or medicine, or owning internal communications media. Moreover, all investments by foreign firms are subject to government approval. However, that approval is usually forthcoming when a project can be shown to be profitable, and to generate jobs. Available evidence shows that in dealing with foreign investors, Cuba’s government is generally fair and honest.

In fact, Cuban laws are probably less restrictive, and certainly less complicated, than US regulations on foreign investment, simply because the Cubans have had only a decade of experience in this

Pernuta has developed into a flourishing but clandestine housing market centered on a boulevard in Old Havana. Prices run from $10,000 for small flats to $50,000 for elegant mansions in Havana suburbs.

But while Pernuta works for Cubans, it would work less well for foreigners, who are subject to constant surveillance. Foreigners attempting to subvert Cuban law can easily find themselves charged with “Economic Crimes Against the State,” as was Robert Vesco, the fugitive American financier, who is now held in a Cuban prison hospital. Basically, under this law, it is illegal to trick the Cuban government. Most foreign real estate investors find it more convenient to build facilities for the tourist trade, which the government encourages and appreciates.

At a 1998 press conference, Cuba’s Minister of Tourism voiced concern about the social impact of America’s “spring breakers” on Cuban society.

activity. Indeed, over the 1982-1992 decade, out of 76 capital associations with Brazilian, Canadian, French, Mexican, and Spanish corporations, there were no major legal disputes, and only one business was terminated: a Spanish-operated downtown discotheque. Yet while the legal problems are not as severe as some might expect, foreign investors complain about business practices: inertia, poor workmanship, poor communications, misunderstandings, personnel problems, and Cubans’ inability to meet deadlines.

Tourist-Driven Growth
Tourism is the fastest growing sector of the Cuban economy, recently overtaking sugar as the major foreign exchange earner. Cuban statistics show that the number of visitors tripled from 340,000 to 1,004,000 between 1990 and 1996. As many as 2,000,000 visitors are hoped for by the end of the year 2000, although government tourism officials regularly issue overly optimistic projections. Even with two million visitors, Cuba would be far below the number enjoyed by the Bahamas, where ten million people come each year to bask in the sun, but the growth has garnered attention. Worried about an open Cuba’s impact, Florida’s state legislature commissioned a 1998 study, which found that the post embargo Cuban tourist industry will cannibalize Florida’s tourist trade. Expressing a different fear based on the same underlying belief, Cuba’s Minister of Tourism (at a May 1998 press conference at the Annual Tourism Convention) voiced concern about the social impact of America’s “spring breakers” on Cuban society. Preparing for large numbers of boat borne tourists, Cuban planners and their consultants have already conceptualized a “Pista de Piratas” (Pirate’s Trail) that will take boaters around the island, stopping at small historic sugar ports (still functioning but largely abandoned, like small town ports in the riverine system of the American Midwest). Similarly, a “Pista de Pescadores” (Angler’s Trail) will take boats through Cuba’s archipelago of cays on the south coast, a string of islands larger than the Florida Keys. Intriguingly, in a post-embargo Cuba, large outboard boats will be able to travel from Miami to Central America with a three hour run through open ocean. American waterfront developers continue to monitor the political climate, hoping to build marinas and thereby join the growing foreign business community engaged in Cuban activities.

Increases in the number of foreign businesses operating in Cuba will drive the demand for improved real estate. Cuba now has 340 joint ventures with overseas companies. Foreigners have invested $2 billion on the island in the last few years, with most of the money coming from Canada, France, Great Britain, Italy, Mexico, Netherlands, and Spain. Another 120 joint ventures are under review by Cuban officials, indicating accelerated future growth and an increased need both for commercial space and for housing to shelter foreign managers.

Yet the international private sector has not been alone in responding. In a manner quite unfamiliar to most Americans, military establishments in Latin America often own and operate businesses completely outside the realm of defense activities. Cuba’s military is no exception; it is heavily involved in real estate development. Among the military’s companies owning and operating real estate are Gaviota, which owns tourist facilities; Contrucciones ANTEX SA, a construction company that also owns real estate; and Agribusiness Sector, which owns a huge rural development project and agricultural holdings. The military establishment is no small player in Cuba’s real estate development industry.

Development Markets in Cuba
Currently, there are three potential Cuban markets for US real estate developers and sellers in a post-embargo environment. They are: 1) developing tourist facilities
such as hotels, condominiums for foreign owners living outside Cuba, and recreational facilities such as marinas; 2) constructing commercial office space for foreign firms operating in Cuba; and 3) building housing for foreigners living in Cuba. Ultimately, in a restructured Cuba, US developers may be permitted to build housing for Cubans, although doing so is illegal under existing statutes. At this time, development of tourism facilities holds the most promise for US investors.

Developments Targeted for Tourists
Tourist facilities in Cuba tend to be seaside developments. Of course, no Cuban lives more than fifty miles from an ocean, and with more than 1,000 miles of beach, the island is certainly the least developed in the Caribbean. In the past decade a number of tourist facilities were built, beginning with hotel construction and culminating in raising timeshare units.

American firms are already poised to serve the tourist market in post-embargo Cuba. In 1995, Days Inns of America announced that it had located twelve Cuban hotels to carry the Days Inn logo once the embargo has ended. Meanwhile, European and Latin American firms have been busy. In 1994, just after the Foreign Investment Law of 1993 took effect, European hotelier Climent Guiart signed agreements to build 3,000 rooms, mostly on the north Cuba coast. Weeks later, Austrian investors agreed to build a 1,000 room hotel on Cayo Sabinal; the government gave them the entire island in return for investing a billion Austrian schillings.

Extensive development is planned at Varadero ("the Shipyard") Beach, which is the Miami Beach of Cuba. With four five-star hotels, nineteen four-star hotels, and fourteen three-star hotels, Varadero is by far Cuba's largest destination resort complex. The government plans to triple hotel capacity, early in the 21st century, from 10,000 to 30,000 rooms. At that capacity, Varadero will rival Cancun and Miami, neither of which has much space to expand. Even then, large stretches of Varadero will remain undeveloped.

Not to be left behind, Canadian company VanCuba Holdings, SA, plans to invest $400 million in 11 hotels, with a total of 4,200 rooms. Cubans will hold 50% interest in the company. Another Canadian company has entered into a joint venture with the Cuban government to build 2,000 resort units; it will offer timeshares for the first time in Cuba. A timeshare unit will cost $5,000 for a one week interval each year, while condos will start at $200,000 (a price considerably higher than the government charges for comparable units sold to foreigners taking up permanent residence in Cuba).

Commercial Development Opportunities
When Cuba shifted from an economy dominated by Soviet aid to an emerging market economy in the mid 1990s, there was virtually no commercial space available to house offices of companies seeking to do business there. Early on, executives converted hotel rooms to offices; indeed, the second floors of several hotels are still dedicated to commercial space.

Recognizing this shortage, the Cuban government retrofitted and renovated homes on thoroughfares west of Havana in the Miramar district. It rented them through the state real estate operation Cubalese, and then began to enter into joint ventures with foreign corporations.

In 1995, the first non-tourism related project in Cuba began with the construction of an adaptive re-use project in old Havana. A joint venture was formed between a subsidiary of the Spanish banking group Argentaria and the Cuban tourism enterprise Habaguanew. The $19 million project gutted the Lonja de Comercio building in Old Havana to accommodate new offices. Cuban government officials say that 250 such joint ventures with foreign entities are under negotiation, an indication of a sharply increased demand on the island for both housing and office space.

Housing Market for Foreigners in Cuba
In Cuba, all consumer real estate is overseen by the National Housing Institute. Moreover, Decree Law 171, published on May 16, 1997, prohibits apartment owners from renting to “representatives of organizations, firms, entities, or foreign countries accredited in the Republic of Cuba.” Apartment owners may rent to tourists, or to other Cubans, but not to foreigners living in Cuba on a permanent basis. The effect of this ruling has been to make all foreigners living permanently in Cuba customers of Cubalese, a state-owned company that leases houses for $1,000 to $5,000 per month, a price that very few Cubans could afford.

However, in 1998, faced with a housing shortage so severe that foreign managers were threatening to live in Cancun or the Bahamas and commute to Cuba, the government relaxed its restrictions.

In a news conference, Foreign Minister Ibrahim Ferradaz announced the creation of five joint real estate enterprises, with a sixth under negotiation and thirty more under consideration by the ministry. In August of 1998, Real Inmobiliaria started pre-selling apartments at its Monte Carlo Palace project, at prices ranging from $137.70 to $171.90 per square foot.

The Domestic Housing Market
The mass domestic housing market is theoretically off limits to foreign investors. Yet this market is so potentially lucrative, and the Cuban government has shown itself to be sufficiently flexible in meeting popular needs, that its dimensions should be explored. After nearly four decades of centralized planning that resulted in frequent delays and neglect, a lack of adequate housing has become one of Cuba’s most acute social dilemmas. Part of the problem lies with the government’s declared policy of giving priority to agricultural and industrial development at the expense of other economic sectors.

In the fourteen years preceding the revolution, the average construction rate was 3.5 dwellings per thousand inhabitants annually; between 1959 and 1982,
it was roughly half that level. As a result of the drop in construction, the housing supply declined dramatically. According to Cuba: Handbook of Historical Statistics (written by Susan Schroeder, Atlas Demographic, La Habana, 1995), dwelling units built annually per 1,000 in population numbered 2.84 in the 1921-1945 period, 3.50 in the 1946-1958 period, 1.09 in the 1959-1970 period, 1.83 in 1971-1982, and 0.14 in the years since for which information is available.

Although the population is growing slowly, it is still growing, at 1% per year. More importantly, shifts in Cuba’s population have added to the housing problem. Moreover, the economy’s deep slump in the past ten years has reduced the level of housing construction even further. From

1987 to 1995, the government built only 11.2% of its planned 123,500 units. On a per capita basis, housing construction is only 4% of its 1946-1958 level. Even the Cuban government’s own reports on housing reveal acute shortages, particularly in Havana. There in the capital, about 21,000 people live in sixty-eight government shelters, and another 210,000 live in “citadels” (buildings of one room apartments, whose occupants share community bathrooms and kitchens). With the large number of residences needing repair, three fourths of all Cubans live in substandard housing.

Indeed, housing conditions are equally poor in rural areas. In the countryside, more than 300,000 houses are “bohios,” thatch-roofed huts used as living units. In some areas, schools are being converted into housing units, while “low consumption” housing is being constructed with a minimum of cement, iron, and wood. Similarly, “ecological settlements” consisting of primitive adobe huts are being built in some rural areas. Clearly, Cuba’s masses could benefit from America’s vast expertise in building and marketing housing for the working class.

Conclusion
Whenever our country’s trade embargo is lifted, as it surely will be, Cuba will present a wide range of investment opportunities for American investors. The island’s economic opening may well be a regional real estate development opportunity to rival the most noteworthy booms in the history of American real estate markets. After the embargo ends, investors from the US will find a Cuban government reasonably hospitable to foreign investment, albeit very careful in its dealings with partners. Generally speaking, Cuba follows the rule of law, although the government has more authority than is true in most countries, particularly where matters of national economic security are concerned.

In the short run, the best development opportunities will be in destination resorts, followed by commercial office space for foreign companies doing business in Cuba, and then permanent residences for foreigners. In the longer run, the Cuban government may well open the mass housing market to foreign investors, to help stem the country’s critical shortage of decent places for its people to live. In fact, because the Cuban government’s attitudes have become increasingly flexible, the need for housing among Cuba’s masses represents what may well be the most dramatic development opportunity for outside investors since the 1970s’ resort construction boom. Still, caution is advised; some unknowns remain, and the knowns are not always reassuring. Furthermore, tight government control over real estate transactions dictates that an investor should expect to own a Cuban property for the very long haul.

Are Your Tickets Refundable?
Dr. Norvell warns in the accompanying article that, despite progress, investing in Cuba is not yet like committing funds in our domestic markets. In a June 28 front page piece, Wall Street Journal reporters Jose de Cordoba, Carita Vitzhun, and Julian Beltrame tell of FirstKey, a Canadian engineering firm that lost $9 million after committing to a $500 million electricity project, on which Cuba’s government later reneged, handing the Canadians’ plans to a European rival. This reversal occurred despite involvement by Canada’s government, which had itself committed seed money to the project. Canadian officials and business people apparently had seen the 1993 opening as a way to trump US companies restrained by the embargo

The move to lure outside money to the island may have slowed in 1996, when Castro decided to discontinue liberalization beyond 1993’s enactments. Yet many problems, cultural and physical, face those bold enough to undertake Cuban ventures. The country has high foreign debt, some already in default, and it lacks access to the IMF and World Bank. Reports tell of petty bureaucratic interference, of government spies in business offices, and of Cuban officials’ refusal to respond to phone calls and faxes. The need to sustain relationships with people close to Castro necessitates picking up the tab for officials’ costly travel and entertainment. And a nagging physical problem, not surprisingly, is a lack of reliable electrical power.

As in Norvell’s report, the Journal tells of success stories: Canadian, Dutch, and Spanish investors speak favorably of past and current opportunities (though a major planned Canadian real estate investment has been scaled back considerably). A Spanish source surmised that FirstKey had hastily agreed to conditions that were impossible to meet, giving Cuba an excuse to back out, while a Dutch response was that the risks should have been understood. At least the risk side of the risk/return tradeoff seems to be alive and well in Castro’s paradise.
Reader Responds on Zoning Article

While I enjoyed "The Price of Zoning Revisited" (Winter 1999, pp. 1-3), I had a few problems with the article. First, while the word "pre-emption" is not used, Dr. Carol McDonough asserts that the FCC has "express regulatory power over wire­less facilities' radio frequency emissions when concerns arise over possible en­viron­mental impacts." While it is a subject of debate, most observers agree that the FCC sets guidelines or standards only; it does not monitor or enforce them. Local government is free to monitor and enforce and, if a violation is perceived, can report the carrier to the FCC. This so-called "health issue" is a murky one, and most municipalities stay away from it.

Second, the author implies that federal courts mostly side with carriers and thwart local attempts to regulate wireless. Yet of the five federal appellate cases I know about, four supported local government. The one that went for the carrier involved a town that depended entirely on RF emissions (FCC did not intervene, and never will). Four of the five were decided before your article appeared.

Third, using federal auctions to sell zoning rights is troubling. The auctions continue, but have been called into seri­ous question. So far, three carriers that failed to meet their bids have emerged from bankruptcy courts with their licenses (or some of them) for pennies on the dollar. The auctions are imperfect.

What Dr. McDonough would sell at local auctions involves external costs of "health issues" and aesthetics. We have enough trouble defining these terms; can you imagine a consensus on their external cost impacts? Other zoning "issues" that the author ignores include safety from ice fall, aircraft collision, and collapse; and the presence of hazardous materials. The issues are not simple, and "selling zoning" is hardly a workable answer.

Finally, Dr. McDonough assumes that wireless services must be deployed by "cellular towers." We who advise cities on the issue know better; antenna mounts are coming down in height. Once cell sites are on street lights and municip­al poles, we can use her idea to charge carriers lease rates for using the public right-of-way. Once cell sites are on street lights and municipal poles, we can use her idea to charge carriers lease rates for using the public right-of-way. This is more than a zoning issue, to be sure, but it will happen, and "externalities" will no longer be a factor.

Dr. McDonough is on the right track, and she and the Illinois Real Estate Letter perform a needed service by bringing this argument to the professional community.

Ted Kreines

The writer is president of Kreines & Kreines, Inc., a Tiburon, CA consultant to cities and counties on wireless planning.

The Author Replies

I thank Mr. Kreines for taking time to share his perspective. As he notes, FCC’s role, when there are environmental concerns, is the subject of much debate, and the issue ultimately will be defined by the courts, and perhaps by further legislation. Section 704 of the Telecommunications Act of 1996 “expressly preempts state and local government regulation of … wireless service on the basis of environ­mental effects … to the extent that such facilities comply …” with FCC rules, and lets parties “ … seek relief from the FCC if they are adversely affected by a state or local government’s final action …”

The assertion that the federal auction process is imperfect is an understatement, especially regarding the entrepreneurial blocks set aside for small business. I do not advocate auctioning municipal zoning permits for telecommunication structures. I suggest that municipalities charge wireless providers for these permits. As Mr. Kreines asserts, it would be difficult to reach consensus on telecommunications devices’ external costs, and these costs may fall as technology advances. Still, external costs exist, and economic theory suggests that zoning rights should be sold to compensate those who are affected.

While the price of permits may be an imperfect estimate of the negative externalities, the process would be helpful from the point of resource allocation by tagging these externalities with a price.

Dr. McDonough is an economics profes­sor and zoning official in Massachusetts.

Author Viewpoints

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**Thought for the Day**

**Hey – How About a Little Credit?**

*Joseph W. Trefzger*

Our federal income tax has taken it on the chin in recent years – and rightfully so. Americans grow increasingly frustrated with a system some view as sufficiently loopholed to be unfair to the poor, yet others view as sufficiently graduated to be unfair to high earners. Many feel that the tax’s legal and administrative features spawn inefficiencies in our economy, and vast numbers feel that the IRS forms are incomprehensible. Especially galling is federal lawmakers’ repeated passing of tax “simplification” legislation that results in lives made simpler only for the purveyors of headache remedies.

Issues of fairness in spreading the nation’s tax burden will probably never be settled, though advocates of controversial flat(ter) taxes argue that their plans enhance fairness through fewer breaks for the rich. Flat taxers also provide the interesting efficiency-based justification that less of citizens’ time and resources would be spent on tax avoidance strategies, while very little productive time would be lost in filling out postcard sized 1040s. Many among us took cheer in a letter to the *Wall Street Journal* calling for members of Congress to be required to fill out their own federal tax returns, though the efficiency enhancing aspects of such a plan are unclear, and compliance would be impossible to police.

**A More Practical Approach**

Under current law, anyone lacking the ability to complete the 1040 and supporting schedules typically bears the entire cost of professional advice, books, or software. Tax preparation help is a fairly toothless miscellaneous itemized deduction that applies only if its cost, along with some job-related and other outlays, exceeds 2% of the filer’s adjusted gross income, with added phaseouts for higher earners. Because even those who pass the 2% test gain only to the extent of their marginal rates, many citizens muddle through complex returns by themselves, risking errors and potential penalties.

Yet there is a solution to the burdens of tax compliance that would be simple to implement and could promote a degree of efficiency: replace the deduction with a credit, which directly reduces the tax owed. To spur frugality, Congress could limit the tax preparation credit to 90% of the sum spent (thus we would still fill out truly simple returns ourselves). The benefits could be enormous: taxpayers’ time freed for productive use, fewer errors for IRS to correct, and a partial offset to the credits’ revenue reduction through more income to tax in the law and accounting sectors. And to prevent even that small revenue drain, Congress would merely have to enact real tax simplification.

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**Inside Summer 1999...**

“Truly Smart ‘Smart Growth’” (page 1) discusses suburbanization, in which economic activity moves from central cities to suburban areas. While critics decry “sprawl,” this movement is shown to be the most efficient type of growth for large, prosperous metropolitan areas. Lessons from other countries, and some US areas, show that stringent growth controls cause housing prices to be high and unstable. The author cites replacing property tax with a motor fuel tax as a superior method for directing metropolitan growth appropriately.

“The Brawl Over So-Called Sprawl!” (page 8) explains why “smart” growth leads to undesirable outcomes. Suburbs’ popularity among firms and families actually represents a movement of resources to their most valued uses.

“Land Speculators: Urban Sprawl’s Unsung Heroes” (page 9) examines the role that speculators play in providing liquidity, and conserving resources, by holding land for development at a later time.

“Cuban Real Estate: The Next Boom?” (page 11) outlines the opportunities, and the dangers, that face real estate investors as the nearby communist island nation opens the doors for foreigners to help solve its commerce, housing, and other economic problems.

“Hey – How About a Little Credit?” (page 16) urges that 1040 filers be permitted to treat the cost of help in completing income tax returns as credits, rather than as less valuable deductions.