The Costs of Heritage

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In the discussion of heritage, much of the debate has been framed: “here are the economists and there are the heritage people”, like those were two different sides. I would suggest that is absolutely a misunderstanding of the concepts of both economics and heritage. One of the simplest, most straight forward definitions of economy, is “The careful or thrifty use or management of resources.” Heritage conservation could easily be defined as “The careful thrifty use and management of heritage resources.” These are not two different things. They are in fact the same thing, in different venues.

In real estate there are two different perspectives when we look at returns. Private ownership of real estate gets its return from four sources. 1) Cash. At the end of the year, we have taken in more than we spent. 2) Returns from the appreciation of the property over time. 3) There may be a return from the amortization of debt; we use tenant’s money to reduce our loan at the bank. 4) And at least in the US, there is a return from tax savings.

But the public also looks for and receives return from real estate. Included in those public returns would be: property tax revenues catalytic impact that a property has on its surrounding area; job creation in the construction process and subsequent economic activity within the building; and the external impact of a property which can be both positive and negative.

There are also more difficult to measure but equally important returns: the image of the city, the quality of life contribution, and natural business incubation which is discussed below. I will come back to.

There is at least potentially, an inherent conflict between the private side perspective of these returns and values of real estate and the public side. It is not that one is right and one is wrong, it is just that there are two different perspectives looking at the same issue.

Here is where real estate economics at the building level and at the public level meet. From the building perspective there is the issue of investment. How is my investment returning? What is it requiring me to do? How much financing can I get? Are there incentives available? What are the opportunity costs of my having to do X, instead of Y or being precluded from doing Y? Is there an “economic hardship”, an American concept that is discussed below? These issues are at the centre of property rights debates and we have a very vociferous property rights movement in America usually focused on the issue of property values.

That is one side of the equation. The other side addresses issues of economic development. Economic development is about jobs, household income and wealth, communal wealth in the community. Additional public site issues include housing policies, environmental policies, tax revenues, creating jobs, and fiscal responsibility.

My assignment was to identify the “costs of heritage conservation.” It was made clear that the symposium from which these papers were taken was not supposed to focus on the Productivity Commission Report. But that report provides at least a good starting point in the four broad categories of costs it identified: 1) the cost of the heritage regulatory systems; 2) the incrementally greater cost for repair and maintenance for heritage buildings; 3) the cost of compromises to contemporary use and enjoyment; and 4) the opportunity costs for foregone development opportunities.

Starting with the last category – opportunity costs – there are some real rational reasons why someone might say, “Get rid of that heritage building.” Below is a hypothetical example from a real estate appraiser’s perspective, of how those numbers might be considered.

We have a four storey historic building that is being proposed to be demolished and replaced with a ten storey building. Here is our set of assumptions whether we rehabilitate the four storey heritage building or construct the ten story new building:

- 20,000 square foot floor plate
- 90% net to gross ratio (i.e. 90 percent of the square footage will generate rent)
- When completed both buildings will rent for $25 per square foot per year
- The cost of either rehabilitation or new construction is $120 per square foot
- Land value is defined as property value less building cost
- Effective property tax rate is two percent per year of the property value
- Stabilized vacancy for either property will be 10 percent
- Operating expenses are equal to 35 percent of effective gross income (gross income less vacancy)
- Appropriate capitalization rate is 9 percent.

<u>10 story building</u>

Cost = 10 x 20,000 x $120
$24,000,000

Value:	18,000 s.f. x $25 x 10 =	$4,500,000
	Less Vacancy (10%)	450,000
		$4,050,000
	Less Expenses (35%)	1,417,500
	Net Operating Income (NOI)	$2,632,500

Value = NOI / *Capitalization Rate*
Value = $2,632,500 / .09 = <u>$29,250,000</u>

Property Value – Building Cost = Land Value
$29,250,000 - $24,000,000 = $5,250,000

<u>4 story building</u>

Cost = 4 x 20,000 x $120			$9,600,000
Value:	18,000 s.f. x $25 x 4 =	$1,800,000	
	Less Vacancy (10%)	180,000	
		$1,620,000	
	Less Expenses (35%)	567,000	

Net Operating Income (NOI) $1,053,000

Value = NOI / *Capitalization Rate*
Value = $1,053,000 / .09 = $11,770,000

Property Value – Building Cost = Land Value
$11,770,000 - $9,600,000 = $2,170,000

Here is how a local government will look at the difference:

	10 Storey Building	4 Storey Building	Difference
Value	$29,250,000	$11,770,000	($17,480, 000)
Tax Rate	2%	2%	2%
Taxes	$585,000	$235,400	($349,600)
Const jobs	799	342	(457)
Permanent jobs	800	320	(480)
Land value	$ 5,250,000	$ 2,170,000	($ 3,080,000)

So the city makes a tough decision – let the developer tear down that four storey building – there is reason to say that makes sense. That is the opportunity cost. What would we forego by keeping four stories, instead of allowing ten stories?

But it is important to point out, that this has to do with any land use regulation, this isn't heritage designation – this is zoning or building codes or any land use regulation.

It is more than disingenuous to start pretending, that preservation ordinances are something other than land use controls. If we say there is a public right to regulate how land is used then heritage limitations are no different.

If, on the other hand the opportunity cost argument is given highest weight, then the same set of arguments about forgone opportunity costs can be used to get rid of those zoning laws, building codes, subdivision ordinances or environmental statutes – the very same set of arguments.

A second argument related to the costs of heritage in the Productivity Commission report was the cost of Heritage Regulatory System. If this discussion were being held in the United States, this particular issue probably wouldn't be at the top of the agenda. Certainly in the US one hears developers say "it takes too long", "you have to go through too many hoops" and "there are too many regulations." Real estate developers say that all the time. But the three most heavily regulated cities in America are New York, San Francisco and Washington, yet none of them are being starved for investment capital. To try and create a kind of cause and effect between amount of regulation and aversion of capital is just sheer nonsense. There may be an issue in Australia on this, but it wouldn't be the top of the list of priorities in the US.

The next category of costs if heritage it is a good one to be at the core of the discussion. In many cases, there is an argument to be made that maintenance costs, and repair costs for Heritage buildings are incrementally higher than with have a new buildings But even here it shouldn't be accepted as a prima facie truth. It may be true, but caution should be exercised before simply accepting that assumption.

And the example I want to cite is a submission to the Productivity Commission. A property owner wrote, "They are trying to make me put on a stupid slate roof and it is going to cost me $70,000 or $80,000. I could put an asphalt roof on there for $30,000 or $40,000." There is $40,000, twice as much and he is probably correct. I don't dispute those numbers whatsoever. But here's what's missing from the equation. The asphalt shingle roof has a life span of 15 to 20 years; a slate roof has a lifespan of 100 years. Furthermore, when a slate tile goes bad, you can replace it tile by tile. You can't do that with asphalt shingle roofs.

So the "cost" answer changes when you look beyond only what the dollars have to be spent today. What is the life cycle cost? What is the contributory value to the building? So be cautious when you hear "It is going to cost me twice as much" what does that mean? And the answer is not necessarily as easy as it seems.

Related is the claim of incrementally higher operating expenses. Perhaps, but that too deserves systematic analysis. In the United States, the federal agency that is essentially the government's landlord is called the General Services Administration. They are the ones that both own all the Federal Government buildings and lease private buildings for Government Agency use. A couple of years ago, they took a look at the historic buildings in their portfolio – 400 or 500 of them – and compared the operating cost of those buildings, to the cost of the industry as a whole. Here are some of the results that they found:

- The overall operating cost, per rental square foot of the historic buildings, in their inventory, was 10% less, than the industry average for non historic buildings.
- Cleaning costs, 9% less,
- Maintenance costs, 10% less,
- Utility costs, 27% less
- The highest operating costs of all the buildings were buildings built in the 70s
- The highest customer satisfaction was in their oldest buildings.

It is possible that in some instances operating costs for heritage buildings are higher. But that conclusion should be based on systematic analysis, not argument by anecdote.

And then there is the argument from the Productivity Commission report that is my favourite – the cost of compromises to contemporary use and enjoyment. I love this argument, because I lived in New York City, in the mid 1980s and almost verbatim, this was the claim being made by developers, a bunch of architects, and many in the city Government. "We have got to get rid of those Class B and Class C, 1920s and 1930s office buildings in Lower Manhattan. We have got to tear those things down, because they don't allow the contemporary use and enjoyment that is expected in today's market" – virtually the same words as in the report. Well those 28 year old MBA's on Wall Street, making $800,000 a year, ought to be making big contributions to the conversation groups, because it was the preservationists, who stood up and said, “Like hell, you are going to tear down these 1920s buildings.” That opposition from the preservation community is the only reason those buildings are there today.

Even though demolition proponents argued, “Well they don’t meet current needs” that claim has proven itself sheer, utter nonsense. I challenge you to identify a single use in the world, the most cutting edge 21st century use, that somewhere, is not being met in historic buildings. One of the most under recognised characteristics of heritage buildings is their extraordinary adaptability to modern uses.

In the appraisal terminology it is called ‘functional obsolescence’ and it is a real thing. Functional obsolescence comes about from about three or four ways. It comes about when the use for which the building was built, no longer exists. The buggy whip factory -- we don’t need buggy whips anymore, so that factory doesn’t perform the function for which it was designed and built and, therefore, is functionally obsolete. Sometimes the use still exists, but in a different form, railroad hotels, for example. Railroad Hotels, which I am sure you had in Australia, like we had in America and Canada, were built next to the railroad tracks and they were small narrow rooms, with the bathroom down the hall. We still need hotels, but not in that form and that would be another example of functional obsolescence.

Systems – heating, cooling, air conditioning, plumbing -- can be antiquated and in need of replacement. That too is functional obsolescence. As can the situation when the physical space is configured so that it is inefficient for current operations.

So functional obsolescence is real, but what are our choices, when we have a functionally obsolete building?

- We can do nothing. That gives us a redundant building just sitting there and nothing happening to it.
- We can tear it down and that is the most frequent response. It is functionally obsolete, so demolish it.
- We can reinsert the old use. We could put in the buggy whip factory, but then we need a permanent subsidy for buggy whips.
- We can make a museum. I am not against museums, but there is a finite demand in the market place for more museums.
- We can manage it is a ruin. Maybe a dozen places around the world are appropriate for that.
- Or we can adaptively reuse the building.

There are some preservationists, perhaps in Australia, certainly in the international realm, who claim it is not enough to save the building, we have got to save the use as well. But then you are going to have to do it out of the public coffers, because private capital is not going to do that.

If we want to attract private capital into these buildings we have got to figure out how to adaptively use those buildings.

So there are the claims of the costs of heritage conservation – some legitimate, some less so. But we should also look at some of the costs of not protecting and using our historic buildings. If we are going to be serious about the cost benefit analysis, than we ought to be measuring the cost of not acting as well. Here are some examples of the forgone costs when we don't pay attention to our heritage resources: property values, sustainable development, economic integration, affordable housing, small business incubation and jobs. I just want to give you some of the factoids of some of the research that has been done in the last decade or so in the US.

Local designation is often a contentious issue, because there is frequently a claim, often coming from the real estate community saying, "We have got to go through more hoops. We have got to get more regulation. People are going to tell us what to do. It is going to prima facie reduce the value of the properties."

When looked at systematically that argument is demonstrated not only to be mistaken, but outright silly. In the US there must be nearly 50 studies on the impact of local historic districts on property values. Most remarkable is the consistency of the findings. An overwhelming majority of those studies show that the rates of appreciation of properties within regulated local historic districts significantly out paces the comparisons. Sometimes the historic district is measured against the local market as a whole; sometimes to similar non designated neighbourhoods. Regardless of comparison, part of the country, or methodology, the rates of appreciation are consistently higher.

Nobody is paying a premium for the right to go and appear before the Preservation Commission. They are paying the premium for saying, "The lunatic across the street is not going to be able to do something to his house that adversely affects the value of mine." It is an investment decision. There is that old cliché which even showed up in the Productivity Report about the three most important things in real estate being location, location, location. But what does that mean? It doesn't say rough walls and ceiling, but location, location, location. That means that the value of real estate as an asset does not emerge from inside the property boundaries. The value of real estate, unlike most other assets, is largely generated externally. It comes as a result of what other people invest in, mostly tax payer investment through the public sector in road, street, police protection, etc. but from other property owner investment as well.

Real estate value comes from its context and the economic role of land use, regulations in general and historic districts in particular, is to protect the context in which the individual property exists. So this idea that the sheer existence of regulations, reduced property value is silly, just silly.

However in the studies I've done, when local historic districts had the greatest positive impact on value four things were true:

- The local historic commission had staff, had a human being whom a property owner could talk to.
- There were clear written and illustrated guidelines so property owners knew what was expected of them.
- There were firm, but consistent decisions.
- There was educational outreach on a ongoing basis not just to the property owners, but to the real estate community and the accountants and bankers, so there is a broad understanding of what it meant to be in an historic district.

The next area of the costs of not protecting heritage buildings is the environment. We don't often think about the demolition of buildings as an environmental issue, as having anything to do with historic buildings. But about a third of everything at the landfill in the US is from construction debris. In the US, as I assume here in Australia, we recycle our aluminium cans. A big pain in the neck, but we do it because it is good for the environment. A typical North American commercial building is twenty five feet wide and 100 or 110 or 120 feet deep. Tear down that two storey insignificant building, and we will have wiped out the entire environmental benefit from the last 1,344,000 that we recycled. We've not only wasted an historic building, we wasted months of diligent recycling those pop cans.

Sustainable development is the next cost; related to but not exactly the same as the environmental issues. There is the whole issue of embodied energy; one frequently over looked, although there is some great Australian analysis of embodied energy. The so called "green architects" always talk about the annual operating costs, whether we had solar panels or extra insulation or whatever. But the cost of building the building is 15 to 30 times the annual operating costs. That is often missed in the sustainability equation.

What are most heritage buildings built from? Brick, plaster, concrete and timber. What are among the least energy consumptive of materials? Brick, plaster, concrete and timber. What are major components of new buildings? Plastic, steel, vinyl and aluminium. What are among the most energy consumptive of materials? Plastic, steel, vinyl and aluminium. You're a fool or a fraud if you say you are environmentally conscious and yet are throwing away historic buildings, and their components.

We don't have a sustainability movement in America. The closest thing we have is called the 'Smart Growth Movement'. There is no movement in America that has broader support, across geographical, political, ideological ways than Smart Growth. The Democrats are for it for environmental reasons; the Republicans for fiscal reasons; small town County Commissioners, big city Mayors, there are Smart Growth proponents everywhere.

Smart Growth has a clear statement of principles:

- Range of housing opportunity and choices
- Walkable neighbourhoods
- Stakeholder collaboration
- Foster distinctive sense of place
- Development decision predictable
- Mixed land uses
- Preserve open space
- Strengthen and direct development towards existing communities
- Provide variety of transportation choices
- Take advantage of compact building design.

Great list, but if we did nothing but protect our historic neighbourhoods, every one of those Smart Growth goals are advanced.

Next cost of not saving heritage buildings – economic integration. I don't know how important this is in Australia but it is in my country. America is a very diverse country, racially, economically, occupationally. We have all kinds of laws to preclude segregation. But on the neighbourhood level, it is an extraordinarily segregated country. At the neighbourhood level, the vast majority of neighbourhoods are all black or are all white, are all poor or all Hispanic. There is not much real integration on the neighbourhood level, with this exception – historic districts.

We looked in Philadelphia, a city extraordinary diverse, particularly racially and we said, to be a diverse neighbourhood, it had to be less than 80% white and 80% black. If it was more than that, you couldn't call it diverse at all. At the block level, barely one in five neighbourhoods met the diversity test. Essentially 80% of them were either all black or all white. However in the historic districts almost 60% met the diversity test. Cleveland is another big city, racially, ethnically and culturally diverse. Again about a third of the neighbourhoods at the block level, met the diversity test in the city as a whole, but two thirds of the historic districts were diverse. This is a major public policy contribution that has been overlooked and is vitally important to keep those neighbourhoods diverse.

Next cost of not saving historic buildings – loss of affordable housing. Affordable housing is a major issue in the United States. There is a serious housing crisis. Over the next decade the problem is going to get worse instead of better. In the past affordable housing was about taking care of the poorest amongst us and has always been a social service issue. Today this issue of affordable housing has absolutely moved to being the critical economic development issue.

But what is often overlooked is that disproportionately, the need for housing people of modest means is being met by older and historic housing. It's there just because it still exists, it hasn't been torn down. The vast majority of this housing has no subsidy, no intervention, no public funds at all. It is being provided as affordable housing, just because it's there.

One might think that given these two situations: 1) an affordable housing crisis, and 2) older housing is meeting the need, there would be a national priority to save that older housing stock. Unfortunately that is not so. If one considers just the housing built before 1950 and occupied by people below the poverty line, it would cost the US taxpayers $335 Billion to replace that housing using the most cost effective Federal housing program available.

One would think a national effort would be made saving that housing stock. But every day, seven days a week, 52 weeks a year, over the last 30 years, we have lost 577 housing units, built before 1950, permanently from our national inventory, 80% of them single family dwellings. For our most historic houses, those build before 1920, in just the decade of the '90s we lost permanently from our inventory of older houses, 772,000 housing units.

So much of the discussion about heritage protection is about the real or imagined imposition of a "burden" for the public benefit, on a property owner. And certainly there might be examples of that. But here is an example the other way. I am tearing down this old building, so that I can build a mansion there. What I have done is take the benefit myself, of enhanced property value. But I have simultaneously passed the burden of replacing that affordable housing unit, onto the public. Most of the discussion of this flow of costs and benefits is represented as if it only flowed in one direction, “Private property owners are asked to carry this public burden.” But it certainly goes the other way as well.

When heritage commercial buildings aren’t protected we lose them as assets for small business incubation. In the US one hears about the fortune 500 and Wall Street and General Motors. But they are not who are creating the jobs in America. 85% of all net new jobs in America are created by firms of 20 people or fewer. One of the few costs that firms of that size can control is occupancy costs – rent. Where they are finding space small business can afford? Not at the shopping mall, or the industrial park or the suburban office campus. It is being found in older and historic neighbourhood business districts, in small towns, and in downtowns.

One of the great historic commercial districts in America is Pioneers Square in Seattle. A few years ago the business management association there did a survey of the businesses there and why they chose that neighbourhood. Number one on the list was that it was an historic district. Number two on the list – affordability. Those responses are not accidental.

What is another “cost” of not reusing heritage buildings? Jobs. In the economic development business there are two major measurables – numbers of jobs and the household income that those jobs generate. In the US as a rule of thumb new construction will be half labour and half materials. Rehabilitation, by contrasts, will be 60% to 70% labour with the balance being materials. This has ramifications, up and down the indicators in a local economy.

Many people think about economic development in terms of manufacturing, so I want to compare US averages for manufacturing, new construction, rehabilitation.

- A million dollars of output from a manufacturing firm in the US creates 23.9 jobs.
- A million dollars of new construction, about 31 jobs.
- A million dollars of rehabilitating a historic building – 35.4 jobs.
- A million dollars of output from a manufacturing firm will result in $515,000 in additional household income
- A million dollars of new construction – $653,000 in household income
- A million dollars in historic rehabilitation – $762,000.

These ratios come from the US Department of Commerce which has created this econometric model, called RIMS II – Regional Input-Output Modelling System. They have taken 523 categories of business activities and calculated what a million dollars worth of output from that industry means – what does that mean in terms of jobs created, what does that mean in terms of household income, what does that mean in terms of impact on the other 522 industry types.

Among the very highest, in the combination of jobs and household income, is the rehabilitation of historic buildings. There are some that will have more numbers of jobs, in the same model output, like a restaurant, but those are not very well paid. There will be some that will have more household income, like a nuclear power plant, but it won’t be very many jobs. But in this combination of numbers of jobs and amount of household income, almost nothing exceeds cumulatively the rehabilitation of historic buildings.

Finally in the United States we have an issue called “takings”. In the US we have a concept of eminent domain. If government needs the property, they have to pay the market value of the property to its owner. I assume there is a similar system in Australia. We also have the principle of police power and that is right to regulate private property for the public good.

When regulation has reached a point that, in fact, exhausts the value of the property, it is called a taking. It is viewed as inverse condemnation and the person is entitled to compensation. One of the few Supreme Court cases related to historic preservation issues in the US was the Penn Central case in 1978 and addressed that very question. The Pennsylvania Railroad who owned Grand Central Station in Manhattan. They wanted to build a giant tower above Grand Station, but were denied the right to do so by the New York City Landmarks Commission. Penn Central said, “We have this huge opportunity that we are being denied. We have this building and we are being denied the opportunity to make millions of dollars if we were allowed to build up as high as the surrounding buildings.”

It went all the way to the Supreme Court and the Supreme Court said “nonsense.” What you are entitled to, the Court decided, is a “reasonable return”. Maybe that is the kind of other side of coin of “unreasonable cost” that the Productivity Commission frequently mentioned. In the US the concept of “reasonable return” has permeated, because of the Supreme Court decision, all of public policy and law regarding historic preservation.

If I am in a local historic district and want to tear down my building, the only way I can get that done, is to present a case for “economic hardship”. Economic hardship doesn’t mean it is going to cost me a little more. Economic hardship means that I cannot get a reasonable return on that investment. That to me is a prudent way to approach costs, incremental costs, and forgone opportunity.

Much discussion has been whether an economic evaluation should take place prior to a building being listed as a heritage property. In the United States listing and demonstrating economic hardship are two distinctly different processes. If you were ever to go to court in the US and say, “I don’t want to be listed, because it is going to be economic hardship, here is my evidence.” The court would say, “That is not ripe for our decision. Come back after you’ve been listed and then we will pass judgement on the economic hardship question.”

Listing processes make a judgement, “Is or is not this building appropriate to be included on a registry of historic properties?” If that question is answered “yes” and is subsequently listed, then I have the option to say, “I want to be able to tear down my building, because there is the evidence of economic hardship.” Then that decision will be yea or nay depending on the evidence. But the preservation decision of worthiness for listing does not consider economic consequences. If the property owner doesn’t like the preservation commission’s decision, they can nearly always go to the City Council who could overrule the commission and ultimately to the courts system. So, there is plenty of avenues for demonstrating economic hardship. But to make listing and economic hardship part of the same process is absolutely comparing apples and oranges issues.

Of course there are costs associated with heritage buildings. But there are also costs – foregone opportunities, jobs, affordable housing, quality of life, economic integration, tax revenues, property values, and others of not protecting the historic built environment.

So called "cost-benefit analysis" that doesn't consider these costs is short changing both the taxpayers and future generations.