

The Politics of Real Estate Cycles

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Fluctuations in real estate market activity--economic cycles of boom and bust--have been a recurrent phenomenon in American history. Two centuries ago George Washington, Thomas Jefferson, and James Madison were speculating in land for the District of Columbia and got caught short by a downturn in the market. Robert Morris, the legendary Revolutionary War financier, even went to debtors' prison for defaulting on payments owed on thousands of vacant lots he had purchased in the new Federal City. Since land was widely available and frequently bought and sold, it was often subject to periods of wild speculation and excess supply in which the inflationary bubbles eventually burst. The subsequent rapid decline in property prices and real estate activity has served as both cause and effect of financial panics and economic depressions during the past two hundred years [16, 21].

While the boom-bust behavior of realty investment has been noted by writers and commentators on the American scene from the Duke de la Rochefoucauld in the eighteenth century to Charles Dickens in the nineteenth, it was only during the Great Depression of the 1930s that scholars began to systematically examine the historical pattern of real estate cycles. Inspired particularly by the business cycle studies of the National Bureau of Economic Research, economists began to chart the duration of national cycles and the variations across cities and regions. They compiled and analyzed data on transactions, values, construction volume, land subdividing, mortgage loans, and other statistics drawn from a wide variety of government and private industry sources. In books, monographs, and articles including such classics as Homer Hoyt's *One Hundred Years of Land Values in Chicago* (1933), and Clarence Long's *Building Cycles and the Theory of Investment* (1940), economists searched for historical explanations and research methods that could help predict the timing and impact of future fluctuations. Much of this analytical work was prompted by increasingly favorable attitudes toward industry-wide restructuring encouraged by the growing number of private trade associations and by advocates of government intervention and regulation. These ideas, which became popular during the Progressive Era and World War I, reached maturity with the economic crisis of the 1930s. Industry and government leaders responded to the national emergency by attempting to turn economic theories of business cycles into policies designed to reverse the long downward spiral and to maintain upward momentum by applying new forms of control [2, 4-5, 7-13, 15-21, 23-30].

These economic studies represent a rich source of information and ideas on real estate cycles. However, most of them do not address issues of industry or government organizational and political dynamics. This paper presents some of what I have discovered about the relationship of cyclical economic activity in the real estate sector to industrial restructuring and public policy reform. My essential argument is that most government initiatives to regulate or reorganize the real estate industry take place either during the downward slide after a boom, during the trough of the bust period, or in the early stages of an economic recovery. Few substantive public policy changes are made at the high point of the cycle when the real estate business is booming. There are three reasons that account for this common pattern of behavior: 1) public opinion; 2) real estate industry politics; 3) the flow of financing.

Public Opinion

Politicians and government officials generally respond to highly mobilized public opinion as expressed through lobbying by citizen groups and various other means of communication. During the peak of a real estate boom, many ill effects of the frenzied activity become apparent, ranging from outright business fraud to abuse of the urban and rural environment. The chorus of dissatisfaction during the boom is partially muted by the enormous profits, employment, and investment being generated. Once things begin to slow down, however, these pent-up frustrations take the form of widespread public support for more stringent government and industry regulations. An example is the current response to the savings and loan crisis, part of which is really "closing the barn door after the horse is gone," with the rest being an attempt to ensure that the new horse will stay inside the barn in the years ahead.

At the bottom of the cycle, public concerns shift from retribution, correcting abuses, and cleaning up the mess, to actively trying to revive the stagnant market. The policy framework becomes one of economic incentives and stimulus. The federal deregulation of the savings and loan industry in 1980 and 1982, for example, was motivated partly by a desire to boost real estate during a severe recession.

Finally, in the early stages of an upswing two types of public responses emerge. First, many actions are taken to further the process of economic revival. Second, new regulations are established to prevent or ameliorate certain problems before too much development is initiated. Once the boom is going strong, however, the first response becomes obsolete, and the second is no longer politically viable. Too many people have a vested interest in letting development and sales proceed without any further encumbrances, and thus significant reforms are temporarily blocked.

Real Estate Industry Politics

An important factor in the changing nature of public opinion toward real estate is the volatility and fluctuating size of the industry itself. Real

estate is a game played primarily with borrowed money, and it is relatively easy for a large segment of the population to participate. Especially when times are good and real estate prices are rapidly increasing, vast numbers of people get involved in buying, selling, leasing, building, renovating, and additional aspects of property investment and development. These new entrepreneurs can quickly become an obstacle to any kind of meaningful reform or regulation. Many of them are small-scale operators who have only recently succeeded under the existing rules and fear that proposed changes might be economically harmful to them.

Large-scale real estate entrepreneurs also are reticent about endorsing too much governmental power, but on the whole they are more favorable toward public policy initiatives than their smaller-scale colleagues. Big investors and developers are better able to shape legislation and regulation for their own ends and consequently are more likely to play influential roles in the policymaking process. During boom times these larger actors are politically outnumbered by their smaller competitors, and in any case are reluctant to tamper with the status quo while profits are still rising.

Once the downturn arrives, however, the attitude of the larger business leaders changes quickly. First, they become more willing to engage in public policy reform in order to placate an increasingly hostile public opinion and improve the image of the real estate industry which has been tarnished by the excesses of the boom. Such a response often becomes a compromise strategy, whereby industry leaders agree to new regulations as a means of avoiding more drastic measures. The concern for real estate's public image is important to these executives, many of whom are anxious to differentiate what they regard as their respectable business endeavors from unscrupulous and scandalous behavior by some of their rivals. In the post-boom atmosphere, trade associations may even support public and private methods designed to purge certain types of fraud and abuse from the industry. Such prohibitions can have the beneficial effect for the survivors of reducing competition, though even the largest entrepreneurs often fear that any new government restrictions could inhibit their own future activities.

During a real estate recession and in the early phases of an upturn the industry may be in conflict over the issue of stricter regulations, but generally supports new government subsidies and programs designed to stimulate investment and increase production. The larger actors in the industry become more willing to lobby for legislation and public intervention in order to strengthen their private economic position. In addition to cleaning up the public image of the industry and reducing competition and overbuilding, at the bottom of the cycle the main motivation for industry involvement in public policy reform is to shorten or reverse the downturn and to hasten the arrival and lengthen the duration of the upturn. This is another reason why once the boom is in full swing and appears to be self-sustaining, serious governmental reforms generally leave the real estate industry's short-term political agenda.

Executives of large real estate firms are not only more willing to support political action and public policy changes in recessionary periods, they are also better able to do so. Even though most businesses are weakened by a collapse of a real estate boom, many of the small entrepreneurs go bankrupt

and disappear from the industry. By contrast, most of the big firms find ways to survive through the tough times. Pro-reform real estate leaders have more political power in a recession, through greater intra-industry economic resources, and they have the advantage in political legitimacy at a time when public image becomes an important factor. The real estate executives that emerge during a downturn to form a "public-private partnership" with government officials are generally those who manage to avoid the scandals that have tainted many in their profession during the previous boom.

The Flow of Financing

More than most businesses, real estate operates with other people's money. Property financing is highly leveraged through mortgage loans and a myriad of additional debt instruments. The fluctuating dynamics of capital markets are crucial both to the rise and fall of individual fortunes and to the overall pattern of real estate cycles.

Financial institutions and intermediaries provide much of the short-term and long-term funds that realty entrepreneurs and consumers borrow for property development and acquisition. Real estate lenders exert considerable power over the investment and construction process. During boom periods they compete vigorously over which institution can loan the most money the fastest for the highest return of interest and fee income. Sometimes they also take a percentage of the equity in a project as part of the loan transaction. At such historical moments many real estate lenders ignore prudent underwriting standards and give credence to overly optimistic property appraisals and market analyses. "Easy money" helps fuel speculation, turnover, inflation, excessive land subdividing, overbuilding, and numerous other abuses resulting in poor quality development and questionable business ethics. Most importantly for our purposes, at the height of the boom the principal real estate lenders do not exert political leadership to support public policy reforms or regulations.

One of the main reasons that booms eventually crash is the withdrawal of previously available financing. During these periods of "tight money" or "credit crunch," borrowers are generally either unable to get new loans to finance building or buying, or the loans are too expensive. In such circumstances lenders often force borrowers to repay existing loans and refuse to extend or renegotiate loan terms, particularly when the cash flow from the property is insufficient to cover the debt service. If the borrowers cannot find other lenders to refinance their properties, then defaults, foreclosures, and bankruptcies will soon follow. Sales, construction, and property values will sharply decline during this downward spiral, and the lack of capital becomes a vital factor in precipitating and prolonging the real estate bust.

In past financial "panics" many lenders got into serious trouble when the asset value of their real estate portfolios rapidly diminished, and a large number of credit providers have failed over the past two centuries due to real estate losses. We are witnessing this situation again in the 1980s and 90s, first with savings and loans, then commercial banks, and now with life insurance companies. At such times, these lenders and other financial intermediaries

have come under increasing criticism and scrutiny, leading to more conservative underwriting practices and new regulatory initiatives¹. In response, the financial services sector participates actively in public policy debates and contributes to the formulation and implementation of reforms in the real estate industry. Insurance companies that deal with real estate not as lenders and investors but as insurers, such as property, title, and mortgage insurance firms, also exercise extensive authority during cyclical downturns to control and reorganize real estate business activities and promote government intervention. During booms, however, these real estate insurers, like their financial counterparts, tend to relax their standards and become less enamored with public regulation.

The Rise of the Community Builders

In *The Rise of the Community Builders* [28], I examine the changing structure of the real estate industry in the first half of the twentieth century, focusing particularly on the residential development and brokerage sectors. The purpose is to determine the role of real estate politics in the creation of government planning agencies and land-use regulations. I also analyze private forms of regulation and planning, including deed restrictions in property development and sales, as well as a wide range of trade association actions to impose industry standards. The latter includes private lobbying for public regulation through state licensing of brokers and sales personnel.

Through dissecting the economic and political divisions within the real estate industry, I describe a deep conflict between the large developers, or community builders, and the smaller operators, or curbstoners, whom the community builders were trying to exclude or upgrade. Big developers generally favored private regulation, and most of them also were inclined to support some type of government regulatory and coordinating role. A similar conflict existed among brokers over the issue of sales licensing.

The key to understanding these issues is that the positions of the different actors and the outcomes of their efforts varied over time. The single most important variable in explaining the chronological and geographic differences was the real estate business cycle. One example is zoning. Los Angeles introduced citywide zoning in 1908, in the midst of a deep recession following the Panic of 1907. New York City passed its landmark zoning law in 1916, after several years of debate in which many property owners, investors, developers, and lenders opposed the idea. What changed their minds in 1916 was the severe downturn in the market and their hope that the new zoning ordinance would help stabilize property values and encourage investment. Many other urban zoning laws were initiated during the slow real estate years of World War I and the depression of 1920-21. Some of these laws finally passed in the early 1920s when development was beginning to accelerate while land-use restrictions still retained industry support. At the

¹For elaboration of this theme, see Anthony Downs, *How the Current "Credit Crunch" is Excessively Depressing Real Estate Values* (Washington, DC, 1991).

height of the mid-1920s boom, however, most of this support had evaporated. New laws were put on hold and existing city zoning ordinances were frequently amended and seriously weakened.

Only in the late 1920s and especially during the long depression of the 1930s were new zoning laws passed and old ones strengthened, again with the backing of the community builders who survived the economic collapse. The story is very much the same for subdivision controls and real estate sales regulation, two of the other public policy reforms discussed in the book.

Own Your Own Home

In *Own Your Own Home* [25] I analyze the evolution of the residential development and finance sectors over the past 100 years. Key patterns of political behavior and outcomes in terms of the real estate industry and economic cycles are similar to the community builders story. The first national initiatives for federal homeownership policy came during and immediately after World War I, a period of housing shortages and real estate market recession. The major reorganization of housing finance and development came in the depths of the 1930s depression and was viewed mainly as a series of emergency measures to save the economic and financial system from completely failing. Real estate industry leaders, especially land developers, home builders, residential realtors, and home mortgage lenders, all lobbied strenuously for government intervention ranging from subsidies to regulations. These included such institutions and programs as the Federal Home Loan Bank System which saved the savings and loan industry, the Federal Housing Administration (FHA) with its revolutionary mortgage insurance program, the Home Owners' Loan Corporation that bailed out one million homeowners and their lenders, and the Federal National Mortgage Association (Fannie Mae) which created the modern secondary mortgage market. Even public housing was started at this time, which initially had lukewarm support from at least some of the community builders who later strongly opposed it.

At the end of World War II and in the immediate postwar years, when housing shortages and fear of another depression were foremost among policymakers' and real estate industry leaders' concerns, the Veterans Administration home loan guarantee program was created and the FHA and Fannie Mae were greatly expanded. When the 1949 Housing Act finally passed after a four-year struggle over the public housing provisions, the additional influx of federal mortgage financing subsidies helped private housing construction reach record levels, particularly for single-family homes. It was only when homebuilding and sales began to fall in 1953 that another major national housing act was introduced. This cyclical pattern of housing legislation, with the residential real estate industry lobbying for more government expenditures and new programs whenever housing markets falter, has persisted. Successive housing legislation has been frequently justified by the need to reverse downward cycles. Examples include the 1968 Housing Act that privatized Fannie Mae, established the Government National Mortgage Association (Ginnie Mae), and launched several ambitious new FHA

programs, and the Emergency Home Financing Act of 1970 that created the Federal Home Loan Mortgage Corporation (Freddie Mac).

In addition, major public policy reforms intended to curb abuse of government programs also have been adopted only in the aftermath of housing booms, never in the middle of one. For example, the three biggest postwar scandals involving government mortgage insurance for private housing development occurred during the height of housing booms in the early 1950s, early 1970s, and middle 1980s. The legislative reforms to clean up these messes were not adopted until 1954, 1974, and 1989, all post-boom recession years.

Conclusion--The 1980s and 1990s

I want to conclude by discussing two other cases: the savings and loan debacle, and federal income tax reform. The impetus for deregulating the thrift institutions was primarily in response to the high interest rates of the late 1970s that rendered the value of existing thrift assets and liabilities uncompetitive in the capital markets. Legislative actions to alter the regulatory framework were all taken during the severe real estate recession of the early 1980s, and then despite abundant evidence of impending crisis, the federal and state governments essentially sat back and let the disaster unfold until the boom had completely subsided in all regions of the country. Only then did Congress pass and President Bush sign the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) [3, 6, 14, 23].

Tax policies also fit within the cyclical framework. The original accelerated depreciation provisions of the federal tax code which helped stimulate investment in income property were passed by Congress in 1954 as the single-family housing boom was subsiding and the postwar apartment and office building booms had yet to begin. Subsequent changes that allowed for real estate investment trusts (REITs), condominiums, limited partnership syndication of tax losses, and other investment vehicles all came during or immediately following recession periods, not at the height of booms. This pattern was most pronounced with the 1981 Economic Recovery Tax Act, which passed during the depths of a severe downturn and created substantial benefits for real estate developers and investors. The new law offered lucrative financial incentives that helped stimulate the massive overbuilding and speculative activity of the 1980s property boom.

How then does one explain the 1986 Tax Reform Act [1], which passed while the boom was still in progress in the northeast and the Pacific coast and had the effect of killing the real estate syndication industry and considerably dampening investment in income properties, especially office buildings and multi-family housing? One key reason is that the real estate boom had already collapsed in southern and western energy states such as Texas, and the negative effects of overbuilding on the economy and the financial system in those regions were quite apparent. The real estate industry lobbied ferociously to retain their favorable 1981 tax treatment, forming for this purpose a new coalition called the National Realty Committee. However, because the industry had already lost favor with the general public in some

areas of the country, they did not have a broad enough coalition to ward off all of the proposed reforms. Another important factor is that the real estate coalition was divided since tax benefits for homeowners were not under attack and were preserved in the 1986 law. This was politically crucial because for the average person the 1980s real estate boom consisted mainly of rising values for single-family homes, townhouses, or condominiums that they owned.

In 1991, with a recession in full force everywhere but the Pacific northwest, real estate industry trade associations are uniting to fight for restoring federal income tax subsidies that were lost in 1986. The principal argument that the industry is making is that these incentives are needed to stimulate property investment which will help get the economy out of the recession. The political approach of the real estate trade associations and their lobbyists clearly fits within my cyclical analysis, though in this case it is too soon to predict the outcome of these efforts [22].

Where does all this lead? I have observed a very consistent and persistent political-economic phenomenon and offered a theoretical framework with which to explain collective patterns of behavior. In the case of real estate cycles, industry restructuring, and public policy reform, historical lessons can offer considerable insight into what may occur in the future. We will be aware that tighter regulations are most likely to be implemented in the early stages of a downturn, that economic incentives stand the best chance of being enacted during the latter phases of a bust, that either of them might prevail in the initial period of an upturn, and that significant new reforms probably will not be established during the height of a boom.

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