Economic Methods in Historic Preservation
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Good Afternoon. I'm John Kilpatrick, from Seattle, Washington. As you may (or may not) be able to tell, I'm not a native of the Pacific north-west. Until just a few months ago, I taught Real Estate and Corporate Finance in the University of South Carolina's Darla Moore School of Business. I also ran the South Carolina Center for Applied Real Estate Education and Research, which I help to start-up in 1996. While at USC, I held a variety of administrative posts, such as Administrator of the South Carolina Supercomputer Network.

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I wanted to tell you all of this to give you a "heads up" early in this talk to two important matters. First, we'll be dealing with some highly technical issues over the next few minutes. Second, though, I have been a teacher for a fairly long time, and hopefully I've learned a few things about translating technical matters into a format easily understood by the lay-person. We'll all find out together over the next few minutes.

Since the summer, I've been a Senior Analyst at Mundy and Associates of Seattle. My new firm – which has been in business for quite a few years – is in the real estate economics consulting and valuation business. Specifically, we work on a variety of special situations, such as natural resource and wetlands matters, contamination problems, and historic property. For example, our firm was a principal consultant to the State of Alaska in the Exxon Valdez matter, measuring the damages to the real estate surrounding the crash site. As you know, this was a huge and complex problem, and required some "cutting edge" measurement techniques, many of which are applicable to historic preservation. I will come back to this specific issue near the end of my talk.

Economic Methodology

- Four South Carolina Studies
- New Jersey Study

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The driving force for this talk – and this portion of the presentation today – is a series

of economic studies, which I will briefly outline for you, although not necessarily in chronological order. The first study I want to outline was finished in May of last year. General research oversight for this study was provided by the New Jersey Historic Trust, with involvement by too many individuals to list here. However, they included representatives of the Center for Urban Policy Research at Rutgers, the Regional Science Research Corporation of New Jersey, Longwoods International of Toronto, Canada, and the National Center for Preservation Technology and Training. The purpose of this study was to measure "total" economic effects of historic preservation in New Jersey, both direct and indirect. The direct effects include construction and rehabilitation expenses as well as tourism and other measurable impacts. Indirect impacts are conceptually a bit more difficult, but every bit as real. They include secondary and tertiary jobs created in the economy as a result of the historic preservation effort but not necessarily directly tied to the historic preservation effort. Let me give you an example. Here in Savannah, there are measurable "direct" dollars spend each day on historic preservation – rehabilitation expenses, tourism dollars, etc. We could run an adding machine tape and like good accountants come up with a total to the penny. Somebody in the Georgia Department of Revenue – the local income taxing folks – most certainly have all of those numbers. However, think of the folks who work in the local grocery stores, pharmacies, and retail outlets. Think about the local physicians, nurses, and dentists, the barbers, beauticians, and dry cleaners, the school teachers, traffic cops, and, yes, even college professors. Don't they also derive a portion of their income from the historic preservation and tourism effort?

Imagine, if you will, a scenario in which historic preservation and history related dollars in Savannah completely disappeared. Starting tomorrow, the locals quit spending money on historic rehabilitation. Tourists quit showing up. What would happen to the local economy? In a heavily "history" dependent economy like Savannah, the impact would be immediate and devastating. This would be true even in a less history-dependent economy like Seattle, where I now call "home", where Boeing (for example) employs 106,000 people, and Microsoft employs over 3,000 millionaires. (By the way, measured in terms of total revenue, Microsoft is <u>barely</u> the third largest firm in the Seattle area. Barely.) While the impact of a "history shutdown" in Seattle wouldn't be immediately devastating, it would be significant, even on the shopkeepers and traffic cops and cardiac surgeons. These secondary impacts are measurable and important for telling the whole story, and we'll talk about some of the techniques in just a bit.

The other four studies are ones I did. I will use them for two reasons. First, collectively they tell as story about the variety of methodologies used when measuring the impacts of historic preservation. Second, they are methodologically consistent – in other words, even though I use a variety of methods, these methods all tell the stories in the same way. It is possible, and in fact all too frequent, that we see studies which are methodologically inconsistent. The study, when subjected to critical examination, falls apart because the methods used are in conflict with one another or incongruent with the data.

Now, I'm not at all suggesting that we tailor the methods or the studies to the final outcome we desire. I'm not – and would not – suggest such a thing. While I have an

admitted bias in favor of historic preservation, anyone who has ever worked with me will tell you that I do not, and will not, start a project with a preconceived outcome. When someone does that, they violate the intellectual integrity that is so vitally important to being a valid advocate. However, it is entirely possible to be "in favor" of a particular issue and at the same time examine the issue critically. The truth is the truth is the truth, and you either have it working on your side, or you need to re-think which side you are on.

However, when designing a study – or more specifically, a study methodology – it is important that the study methods used fit the story you are trying to tell. For example, the New Jersey study is designed to demonstrate the broad economic impact of historic preservation on that state's economy. If they had chosen to use, say, some multiple regression (which we'll discuss in a minute) to measure the benefit of historic district designation on house prices, they would have wound up with a perfectly valid and perfectly useless set of results. Hence, an extraordinary amount of care has to be taken in the organization and formulation of the project, to determine if the methods used fit the story being told.

The first South Carolina study was conducted in 1995, using house prices in historic neighborhoods of Columbia (the state capital and largest city) over approximately a 14 year period. Specifically, I looked at houses in the historic neighborhoods which had sold twice (or, in one case, three times) so that I could create an index of house price rates-of-return over time. I then compared this with an index of house prices for the market as a whole, and found that houses in the historic district increased in price approximately 50% faster than did houses in the market as a whole.

It is important to note three key elements to this "repeat sales" study. First, as I discussed earlier, the methodology was chosen to tell a specific story – the value of the historic district designation to homes (or more specifically, homeowners) in the districts in question. Had we chosen to use some broad economic measures of "quality of life", such as employment, per-capita income, or tourism dollars, or some measure of indirect benefits as was done in the New Jersey study, we would have ended up with perfectly valid and perfectly useless information.

Second, in the Columbia study, the data and results were subjected to rigorous statistical testing, to insure that the story we were telling would withstand the inevitable criticisms. In an academic world, this sort of methodological validation is crucial to the process, which is often more pedagogical than practical. However, in the "real" world, where study findings will often influence public policy, taxation, property values, and public ordinances, it is equally important – perhaps even more important – that the "truth" is actually what we say it is.

Finally, using the repeat-sales technique "pushed the envelope" a bit, in terms of historic preservation methodology. I'm not sure just where the envelope is right now; perhaps a few of us need to sit down and figure that out.

Our second South Carolina study, which has become known as the "Beaufort" study, was really a replication of a prior study published in 1992 in the Appraisal Journal. The previous study, authored by Paul Asabere and Forrest Huffman of Temple University, used a multiple regression technique known as hedonic pricing to extract the "price premium" paid by homebuyers in the historic districts of Philadelphia. They found that Philadelphia historic district homes carried a price premium of approximately 27% over similar homes outside the districts. In Beaufort, in 1996, we used a similar methodology, but our model included variables more similar to those typically used by a real estate appraiser. We found a 21% premium for historic district homes in Beaufort. Note that both the Columbia study and the Beaufort study applied seasoned, well-defined economic methodologies to a field where here-to-fore these methods had not been used.

In 1997, we looked at two historic preservation ordinances in Greenville, South Carolina, with a specific eye to the impact of those ordinances on house prices. I wanted to know something a bit different here –were the ordinances themselves the vehicle for price impacts, or was something else at work. Thus, I was less interested in the magnitude of price change, but in the timing of the price change. To accomplish this, I used what is known as an "event study", sort of a before-and-after look at prices, again using rigorous statistical techniques to isolate just the impact under study. Event studies are commonplace in corporate finance, and are used to isolate the impact of certain "events" on stock prices, interest rates, bond prices, and such. To my knowledge, event studies had never been used in this field. The findings were profound – house prices in both historic districts of Greenville made a dramatic and statistically significant jump when the ordinances were proposed.

Later in 1997, I began a study of six small towns in South Carolina, to isolate the impact of their small town historic preservation ordinances. There were a number of important aspects to this study, but I want to focus on just two today. First – and perhaps of lesser importance – was my preference to include as many towns as possible in the study. I didn't just choose the number "six" at random. While there are a number of towns in South Carolina which have historic preservation ordinances, we wanted to select those with certified local governments, and we wanted the towns to be as geographically dispersed as possible. Interestingly enough – and I didn't exactly plan it this way – there are six congressional districts in South Carolina, and I think we got one town in each of the six, or nearly so.

More importantly, though, I chose to use a variety of measurement methods, relying on standard appraisal approaches such as adjustment grids and paired sales techniques, relying less on more esoteric statistical methods.

The findings again were consistent, valid, and useful. In all six of the small towns, the local preservation ordinances had a positive effect on house prices. It is noteworthy that in some of these towns, the historic districts were the "pricy" parts of town, while in other towns, the historic districts were actually somewhat depressed economically. However, even in the "depressed" historic district, historically protected dwellings sold for more than similar homes not covered by preservation ordinances.

So, ignoring the methodological issues for a bit, what are the underlying, fundamental questions at hand? Consistently, I see two issues which drive public policy in this area:

- What does it cost?
- What are the benefits?

The general context within which these questions are addressed are two-fold:

- Community Values
- Intrinsic Values

Basic Issues

⌘What does it cost?
⌘What are the benefits?

⌘"Community Values"
versus
⌘"Intrinsic Values"

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The community values context – or approach, as I have called it in some previous talks – can be thought of as the traditional model by which economic costs and benefits are measured. The "community" contributes to the value of the historic structure or place, and the community should – and does – derive some economic benefits from that structure or place.

The intrinsic value context places the historic component within the property rights debate. It is well suited to deal with issues such as "takings" legislation, eminent domain arguments, and taxation issues. In some way, shape, or form, in a society which places great value on private property rights, the intrinsic value of those property rights – and the impact of potential diminution of those rights by historic preservation ordinances – must be addressed proactively.

So, with that in mind, let's walk through some of the more common methodologies used to put dollar signs in front of intrinsic value impacts. First, I will want to discuss traditional appraisal approaches, which include cost, income, and sales comparison and matched pairs. These are methodologies which are in the "toolbox" of ever real estate appraiser in your hometown.

Valuation Methodologies

Traditional Appraisal Approaches
⌘cost
⌘income
⌘sales comparison & matched pairs

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I will also want to look at some more academic methods of economic valuation. These include, but are not limited to:

- Macroeconomic assessment

Valuation Methodologies

Economic Assessment
⌘macroeconomic assessment
⌘time series
⌘cross sectional (hedonic regression)
⌘event studies (before-and-after)
⌘input-output models

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- Time series studies
- Cross-sectional studies
- Event studies, and
- Input-output models.

Traditional appraisal approaches have some key strengths which support their usage in historic preservation valuation. First, these methodologies are terrifically well developed, and have been with us for most of this century. The Appraisal Standards Board in Washington, with direct Congressional oversight, and the Appraisal Institute in Chicago, with which I am affiliated, expend an extraordinary amount of time, effort, and money to examine, validate, and hone these techniques. Further, if you choose to use appraisal techniques, you will find yourself blessed with plenty of help, right in your own town. As mentioned, nearly every appraiser – certainly every appraiser who is designated by the Appraisal Institute – can help you with and advise you on studies such as these. These methods work with relatively few data points, which is terrifically useful in historic preservation work, where we are often looking at just one unique property. Finally, these techniques are reasonably understandable by the business community, who will often ultimately sit in judgement of the costs and benefits of historic preservation proposals.

Traditional Appraisal Approaches

Strengths:

- well developed methodology
- "lotsa help"
- methods which work with few data points
- reasonably understandable by the business community

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Unfortunately, there is no such thing as a free lunch, and the use of traditional appraisal techniques in historic preservation situations is fraught with problems. First, attempts to value historic properties requires the use of specialized adjustments which are often beyond the experience of most appraisers. In fact, such specialized appraisals must often fall back on "non-traditional" techniques, such as multiple regression, to determine adjustment factors. Secondly, and perhaps more critically, the standard appraisal model relies on certain underlying assumptions, such as "fair market value" and "arms length transactions" which are typically violated in the historic preservation situation. While the appraisal can – and often is – adjusted to accommodate such violations of underlying assumptions, the result is usually problematic. Finally, the traditional appraisal model relies heavily on the "three legs" of the three approaches: cost, income, and sales comparison. However, in the historic preservation situation, cost and income are rarely useful. Thus, the appraiser is left with sales comparison, and within that the appraiser will probably use adjustments which came from a regression model. The question is then posed, why not just toss the appraisal model away, and go directly to the regression model? In fact, that is what we more often must do.

Traditional Appraisal Approaches

Weaknesses:

- specialized adjustments for historic property
- underlying assumptions may be violated
- cost and income approaches are rarely useful

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Relying on typical economic valuation methods, the first – and most common – is a simple assessment of the macroeconomic factors at work in a community. These include things like employment, income, and "quality of life" variables. These are fairly easy to gather and quantify, and usually tell a nice, broad story about the economy in a community. If, for example, a historically protected neighborhood exhibits positive "quality of life" measures, then this tells a meaningful story. However, in most situations, this sort of evaluation does not tell a complete or useful story. This is sort of like telling someone a broad story about the Atlantic Ocean, including the marine biology, the hydrological aspects, the underwater geological formations, and the geography of the coastline, when what they really wanted you to do was teach them to swim.

Economic Assessment

Macroeconomic Assessment

- relatively easy (quantitatively)
- provides a broad economic picture of the vitality of the district or property in question
- problem: doesn't really answer any questions

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Time series studies can involve either macrostatistics or repeat sales, such as I used in the Columbia study. In a time series study, we try to measure some changes over time, such as increases in house prices, changes in rents, or changes in property tax revenues. Please note that time series studies can be simple or complicated. The simple studies are much like the broad macroeconomic assessments we discussed a moment ago – they tell a pretty story, but often don't get to the heart of the matter. The more useful studies generally require some statistical interpretation and validity tests which are complex, to say the least.

Economic Assessment

Time Series

- Macrostatistics versus repeat sales
- Measures rate-of-change
- Can be difficult to interpret
- Subject to statistical interpretation

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Multiple regression studies are often referred to as cross-sectional studies, because we attempt to measure a specific impact across a "cross sectional" sample of the population. When applied to real estate pricing issues, these are often referred to as "hedonic" pricing models. Regression techniques do an excellent job of targeting in on a specific factor, such as the impact of a historic district. However, these models require a very large amount of data. In the Beaufort study, for example, we used several dozen sales in the historic district compared with over 200 sales outside the historic district. Additionally, hedonic studies almost always have a time-series component, since is rare that the sales all occur close to one another in time, and house prices are notorious for

Economic Assessment

Cross Sectional (hedonic regression)

- Does an excellent job of explaining target factors (historic district)
- Difficult for the lay person
- Requires a large amount of data
- A predictive component
- Useful in litigation

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changing over time. There are some serious and complex details needed when merging time series with cross-sectional components in a regression model. Also, there are other complex issues which are well beyond the scope of your basic college statistics book. I have used regression models in my studies, and so have many of my colleagues. However, like they say on the TV shows, please don't try this at home, folks!

One powerful benefit to regression models, however, is the usefulness in litigation and in public policy matters. The courts are generally well experienced in dealing with regression models. However, it is critical to make sure, in these matters, that the "expert" witness you hired is really an expert.

I'm probably the only person in the country who has done much in the way of well developed event-studies on historic preservation ordinances. There is a lot more to be done here, from an academic perspective, and I would certainly like to talk with folks who are interested in doing this sort of work.

Economic Assessment

Event Studies

- A "before and after" test
- Measure impacts of changes
- Can apply a variety of statistical tests
  - t-tests, regression, anova, time series, macrostatistical analysis
- weaknesses: interpretation, regime shifts

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Note that I said "well developed" event studies. Anyone who wants can go out and measure house prices before and after the institution of a historic preservation ordinance. It's fairly easy to do, and the data is readily available. However, a well constructed examination will include necessary and sufficient statistical tests to validate the study, and to predict – with some confidence – that the topic under study (that is, the preservation ordinance) is really the cause of the noted effects.

There are some problems with event studies, which generally fall under a category we call "regime shifts". In simple terms, a neighborhood under study can be impacted by several events simultaneously. If historic preservation is just one of them, isolating that factor can be problematic. In two of the six "small towns" in South Carolina, we had the potential for a regime shift, due to extraordinary rehabilitation in the wake of a major hurricane. I had to be careful to design a study which would, in essence, "ignore" any impacts of the hurricane. As it turned out, the hurricane wasn't a big deal in the final study, although it could have been, had the methodology been chosen differently.

The New Jersey study relies heavily on what are called "input-output" models. This name stems from the method: direct economic expenditures (the "inputs") result in indirect economic benefits (the "outputs"). This is a fairly powerful story – this really links the "intrinsic value" issue with the "community values" context. There are three principal models being used in the U.S. today. While

Economic Assessment

- Input-Output Models (RIMS II, ULI, NAHB)
- Links "intrinsic value" with "community value"
- Used in conjunction with other methods
- Highly technical
- Powerful results

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there are other models, they are all basically an outgrowth of the grand-ma of them all, the RIMS-II model developed by the U.S. Bureau of Economic Analysis in the U.S. Department of Commerce back in the mid-1980's. Since this is called "RIMS-II" there must have been a "RIMS-I" somewhere back in time, but I'm not totally familiar with the origins.

RIMS stands for "Regional Input-Output Modeling System". It is one of the most complicated economic models I have ever seen or used. Period. I recently used it to model the impacts of a major real estate development near Charlotte, North Carolina, with economic impacts measured in the Billions of dollars. A colleague of mine at the University of South Carolina, Doug Woodward, recently used it to measure the impact of Coca Cola bottling on the economies of Poland and Romania. It is highly adaptable, and extremely useful. It is also very expensive to use, both in time and data sources.

There are other, simpler models which are also available. The Urban Land Institute has a model, which I have used, which is much less expensive to use and maintain. However, it is not directly adaptable to historic preservation, and is more focused on subdivision development. The National Association of Homebuilders also has a model, and in fact I will be discussing that one at their annual nationwide executive officers conference in St. Louis in two weeks. Again, this model is not widely useful for historic preservation measurement.

What is needed in this area is a model, similar to the Urban Land Institute's model, which is both user friendly and adapted to historic preservation impacts. I am presently working on a model which would adapt the RIMS-II factors and methods into something more useful for localized preservation efforts. However, don't look for it under <u>this year's</u> Christmas Tree, OK? Also, anyone who wants to help is welcomed to grab a shovel and help dig.

There is one technique which didn't make it to my slides. Sorry. In fact, it is probably the most interesting story in the box. There was a study published in <u>Public Finance Review</u> earlier this year on the use of Contingent Valuation in a historic preservation context. Now, my firm is one of the best known in the U.S. on the use of contingent valuation and related techniques in valuing contamination damages. Specifically, contingent valuation and its kid sister, conjoint analysis, were the principal techniques we used to measure the damage done in the Exxon Valdez accident. Just last week, I submitted the final draft on a multi-hundred-million-dollar contingent valuation based environmental damage evaluation stemming from a groundwater contamination problem. Survey based techniques has their roots in the real estate marketing profession, and were developed to estimate the "value" which potential buyers would put on certain components, such as a deck or a hot tub. In contamination issues, we use survey techniques to determine the perceived diminution resulting from proximate contamination, and the amount of compensation which property owners are willing to accept as a result of that perceived diminution. Conjoint measures are useful to validate the contingent valuation, and to create spatial components to the damage claims.

In a historic preservation context, these techniques offer powerful tools for measuring the added value of historic preservation ordinances, for historic registry listing, or other target components. However, much, much more needs to be done in this field, and I have every intention of being out in front in this area in the coming months.

Some danger zones. First, all-too-often I see studies – authored by folks who ought to know better – which rely on tax assessment data. This is really a problem. Tax assessors use what are known as "mass appraisal" techniques to do what they do. Let's recall for a moment what tax assessors do for a living – they attempt to measure the value of all of the property in a taxing jurisdiction for tax purposes. This means some sort of equity issues are at work. However, they are also using broad statistical measures which often do not pick up on the subtleties of historic preservation. For example, historic residences are old. Old residences are, all things being equal, worth less than new residences. Hence, assessors use "age" as a proxy for "depreciation" and ignore the historic preservation issues. In reality, the age-value function probably declines to a point, and then turns around as the historic quality overcomes the age factor. However, this point of inflection is way too subtle to be reflected in tax assessment statistics. Thus, if you use tax assessment data to measure the impact of historic district designation, your results will be horribly skewed and generally worthless.

Danger Zones

- Reliance on tax assessment data
- "Fair market value" versus "tax bill"
- Gentrification issues
- Value versus rent

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A couple of other danger zones are worth noting. First, there are gentrification issues. Specifically, Dennis Gale of the University of Maine dealt with this in a study of Washington, DC, historic preservation covered in a paper published in 1992. The problem, unfortunately, is that he used tax assessment data. He finds that there is no crowding out of existing populations as a result of gentrification stimulated by historic preservation. However, his use of tax assessment data calls these findings into question.

I would argue – and unfortunately no one has asked me to do a study to back this up – that gentrification and crowding out resulting from historic preservation is a flawed argument to begin with. Owners of properties which are covered by some historic designation are, in my findings, handed a valuable economic gift. The intrinsic value of their properties increase. The value continues to increase over time, rewarding not only the owner at the time of the designation but also the subsequent owners. Now reflect on just why someone would want to own rental property. First, the income from rents. Second, the capital gains. If the capital gains increase as a result of the historic designation, then the reliance on rents

Thoughts for the future

- Increasing reliance on market solutions
- Declining marginal cost of assessment technology
- "The Internet"

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for economic returns actually diminishes. Now, I'm not suggesting that gentrification does not occur in historically preserved neighborhoods, but placing the blame on historic preservation ordinances is spurious, and violates the underlying economic concepts of property ownership and financial returns.

A few thoughts for the future. I don't know if you have noticed it or not, but the world today seems to be run by people who are increasingly relying on market solutions to social problems. This is a powerful two-edged sword for historic preservation. The clear challenge for this audience is to place historic preservation in this market solution context. This isn't nearly as hard as it sounds. While there are broader implications outside of the topic of today's session, the clear message for you and for today is that economic assessments – based on the same techniques and methods used in other business contexts – are and will continue to be an important component of historic preservation.

Two pieces of good news. First, assessment technology is becoming cheaper, literally by the day. For example, ten years ago, to do even a simple multiple regression, I needed a mainframe computer and an expensive and time-consuming software package. Today, simple regression models can be run on a lap-top or desk-top PC using a software routine which Microsoft Excel throws in as a "free-bee". When I bought a new computer for my office last month, the marginal cost of adding regression technology was exactly zero, although to be fair, it did take nearly 3 minutes of my precious time to install the package. (However, I'm sure my 10 year old son could have done it faster).

One other great piece of news. The internet. It is becoming extraordinarily fast to share data across the office, across town, and around the world. I do a fair amount of work with low income housing. To accomplish a current project, I needed a huge file of economic data from the U.S. Department of Housing and Urban Development. I downloaded it at home last weekend. It took 30 minutes. It was free. And, I watch TV while I was doing it. This kind of data availability was inconceivable just a few years ago. Yet, this is the type of tool needed to make economic assessment handy and available in every historic preservation problem.

Thank you, and I am now open to questions.