

# ORER LETTER

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## Fairness in Condominium Assessment

Roger E. Cannaday

Condominium assessment procedures used in many jurisdictions may result in unfair distribution of property taxes among condominium unit owners, leaving some over-taxed and others under-taxed. Since appeals are not likely to be symmetrical (the over-taxed may appeal, whereas the under-taxed probably will not), taxing jurisdictions may even be collecting less tax revenue than they would if assessments were more accurate.

The practice of assessing a condominium complex as a whole, rather than valuing each unit individually in the manner followed for detached homes, is a key aspect of the assessment procedure used in such cities as Chicago. Under this type of system, each unit owner pays a share of the total tax for the complex. A unit owner's share is based on the owner's declared percentage of ownership. Such a system does not necessarily lead to unfair assessments. However, a question of fairness arises when owners' declared percentages do not accurately reflect their units' current market values.

The method used to estimate ownership percentages varies. One method is based on prices at which units originally sold, while another simply measures unit square footage as a percentage of total size of the complex. Such methods are obviously based on assumptions that units with equivalent interior amenities are equivalent in value and that factors influencing value are unchanging over time.

Yet recent research has shown that units in a complex may vary significantly in market value due to a variety of factors that were not necessarily taken into account when the units first sold. This variation holds even for units with equal size and identical layout, located on the same floor of a particular condominium complex. A key factor causing the values of such units to vary is view. For example, two units

on the same floor of a high rise building on Chicago's lakefront may differ in value by tens of thousands of dollars, depending on the particular views of Lake Michigan. In other locations, golf course or ocean views have influenced condo values in a like manner.

If declared percentages of ownership do not reflect unit market values, then assessing a complex as a whole guarantees unfair tax distribution among owners. Assume, for example, that annual re-assessment of a complex is based on values indicated by a few recent sales, as may typically be the case. Three possible scenarios would be: 1) the set of recent sales is reasonably representative; 2) mostly lower priced units have sold recently; and 3) mostly higher priced units have sold recently. Further assume that declared percentages of ownership are higher than would be dictated by current market values for lower priced units, while declared percentages are lower than the market would indicate for higher priced units. (Perhaps the more desirable units sold first, at relatively low prices, before the complex gained favor and all unit values rose accordingly.)

Under the first scenario, with representative sales, total tax collected would be approximately correct, but owners of lower priced units would pay more tax than their fair share, while more expensive units would be under-taxed. Under the second scenario, in which mostly lower priced units have sold, the total tax levy would be less than it should be. Owners of higher priced units would pay even less than under the first scenario. Owners of lower priced units would pay less than under the first scenario, but would possibly still pay more than they should because of the distortion in declared ownership percentages. Under the final scenario, in which units that have sold are

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### ORER News

#### IBR SUBSCRIPTION

Because ORER now has a regular publication, short versions of ORER Papers will not generally be published in future editions of the *Illinois Business Review* (IBR). Further, Illinois residents on the ORER mailing list will no longer automatically receive IBR. IBR is available free of charge to anyone who sends a written request to the publisher. *ORER Letter* readers who wish to continue receiving the IBR should contact: Bureau of Economic and Business Research, 428 Commerce West, 1206 S. Sixth Street, University of Illinois, Champaign, IL 61820.

#### ALUMNI LUNCHEON

There will be a luncheon in Chicago for U of I real estate alumni on Friday, Nov. 4. Yukio Ohshima of Rubloff will speak on "The Japanese Perspective on Investment in U.S. Real Estate." The presentation should be an interesting follow up to Charles Palmer's spring talk. A cash bar will be available; socializing and networking are encouraged. A special page inserted in *Letters* addressed to U of I alumni contains details and reservation information.

## Condo Assessment

*(continued from the first page)*

in the higher price range, the total tax collected would be more than it should be (unless a sufficient number of appeals were upheld). Owners of lower priced units would pay even more than under the first scenario. Owners of higher priced units would pay more than under either of the other scenarios, but would still possibly pay less than their fair share. Of course, an example could be constructed that causes owners of higher priced units to be treated more unfairly than owners of lower priced units.

A taxing authority could improve assessment procedures, without drastically changing the practice of valuing a complex as a whole, through the use of a price index. Such an index would allow the number of sales used as the basis for re-assessment to be increased, by allowing for the adjustment of sales prices for time, so that all dollar figures would reflect market conditions on the same date (the "as-of" date of the re-assessment, such as January 1 each year in Illinois). Sales over a period of even several years could be used, thereby increasing the probability that data utilized in estimating the value of the complex would be representative of the values of all units.

Of course, improved estimates of declared ownership percentages would make for even fairer assessments. For example, if declared percentages actually reflect current market values of units, there will be a fair allocation of taxes among unit owners regardless of whether sales used to estimate the complex value are representative. The question arises as to who is responsible for improving estimates of declared percentages. If a taxing jurisdiction leaves it to owners of individual units to see that their complex fairly computes percentages of ownership, then each complex must take initiative to develop improved methods of estimation. Appropriate action could include the use of a price index.

Alternatively, local taxing authorities could adopt procedures for estimating unit values individually, just as they do for single family detached homes. These procedures might in-

*Roger E. Cannaday is an Associate Professor of Finance at the University of Illinois, specializing in real estate, and a Research Associate with the Office of Real Estate Research.*

## New ORER Advisors

Dean John Hogan of the University's College of Commerce and Business Administration has named two new members to the ORER Advisory Committee. They are Jerry Perlow, a Realtor® from Evanston who was instrumental in the creation of ORER; and Don Ursin, an Oak Brook Realtor® who serves as President of the Illinois Real Estate Educational Foundation. Their three-year appointments will begin on October 6, 1988.

## New Fee Instituted

As in the past, an individual request for one copy of a single ORER Paper will be filled without charge. However, because of the high costs of copying and mailing, the Office of Real Estate Research must institute a new policy of charging a fee for multiple copies of papers. If an individual or organization writes or phones ORER requesting multiple copies of a particular paper, or single copies of more than one paper, the Office will charge \$3 for each additional copy or each ad-

## U of I Real Estate Program History

Professor Roger Cannaday is writing a history of the real estate program at the U of I. He requests assistance in the form of information from any reader with material to contribute. In particular, there is a need for better coverage of the period from the mid 1950's, when Professor Bob Harvey first established a major in real estate, until the late 1970's, when Professors Colwell and Cannaday joined the faculty.

Of particular interest would be information on officers and activities of the initial Rho Epsilon chapter. The chapter was chartered in the mid 1950's; later the charter was dropped and the organization was inactive prior to gaining a new charter in 1977. Also of interest are anecdotes involving past or current real estate faculty members or teaching assistants. Former faculty and doctoral students will be contacted for information on the program itself, though former undergraduate and masters students are encouraged to provide such information as well. Anyone with material to submit should contact Professor Cannaday.

## ORER News

### SCHOLARSHIPS AWARDED

Three students from the University of Illinois real estate program have been awarded scholarships for the 1988 - 1989 academic year by the Illinois Real Estate Educational Foundation. All are finance majors with a concentration of studies in the real estate area. Two are continuing students, while the third is a recent graduate who plans to pursue further studies.

The Morgan L. Fitch Scholarship was awarded to Robert Koys. Koys, a senior from Riverside, Illinois, will serve as vice president of the campus chapter of Rho Epsilon in the coming Fall semester.

The Thomas F. Seay Scholarship was awarded to Alissa Schneider. Schneider is a Spring 1988 graduate from Skokie, Illinois, who served as president of Rho Epsilon. She will be working toward a master's degree in real estate at the University of Wisconsin at Madison.

A Real Estate Educational Foundation Academic Scholarship was awarded to Sean Cannaday. Cannaday is a senior from Champaign, Illinois.

The Office of Real Estate Research commends these students for their academic excellence.

## New Papers Added to ORER Series

Summer is traditionally the slow time in the academic world. Those who complete papers in the spring and fall may spend summer pursuing research, attending conferences, holding visiting professorships, and taking vacations. Nevertheless, five papers have been added to the ORER Paper Series since publication of the Spring *ORER Letter*. These additions bring the total number in the Series to 68.

The first new entry is Paper # 64, Eldred's discussion of costly yet avoidable mistakes that real estate investors and developers have made. Paper # 65 is Oltmans, Chicoine, and Scott's review of indexes used in monitoring farm land values in Illinois. The next manuscript is Paper # 66, Brueckner and Follain's study of the effects that borrower preferences and expectations regarding variable rate mortgages have on housing demand. Paper #67 is Taylor's study of minority housing in Chicago. The last of the new entries in the series is Paper #68, Cannaday's systematic framework for analyzing the income approach to valuation. The Cannaday paper is reviewed below. A shortened version of the Eldred paper appears on the following page as the first entry in the *ORER Letter Series*. Abbreviated versions of the work by Oltmans, Chicoine, and Scott; and that produced by Brueckner and Follain; will appear in upcoming editions of *ORER Letter*.

### A Systematic Look at the Income Approach

For many decades, the present value of future returns has been accepted by investors as a basis for valuation, and such an income-based approach has been considered an appropriate way to value real estate. Yet the income approach to property valuation can be confusing to appraisal clients, students of valuation, and even appraisal professionals. One problem is, of course, that the more advanced applications involve sophisticated financial concepts.

Another problem, though, is that the numerous income valuation techniques are typically presented in a manner that lacks consistency and organization. For example, the most recent texts of the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers in some instances classify equivalent techniques in very different general categories. Professor Roger Cannaday of the Uni-

versity of Illinois Department of Finance presents a possible remedy for the latter problem in ORER Paper #68, "A Systematic Framework for Alternative Methods of the Income Approach." The classification scheme presented is based on the author's observation that while some income approach techniques presented in appraisal texts are based directly on a discounting of expected future returns, not all are. The techniques that are discussed in the appraisal literature can be classified into three general categories.

Cannaday looks first at discounted cash flow based methods, those which follow explicitly from the economic rationale for the income approach. These methods involve direct computation of the present value of expected future income. Theoretical models generally utilize after-tax income, whereas techniques used by practitioners often rely on before-tax income. A defensible estimate of market value can be based on the marginal investor's before-tax or after-tax income; the discount rate used in capitalizing the higher pre-tax income is simply set at an appropriately higher level.

The methods that Cannaday classifies under the discounted cash flow heading may appear on the surface to differ considerably from one another and from the basic present value equation. Yet he shows that such techniques as the various Ellwood methods, a Band of Investment method, Capitalization in Perpetuity, and the various Physical Residual methods are simply refinements of the more general model. The refinements consist of incorporating additional simplifying assumptions beyond the simplifying assumptions of the basic model, which include end-of-year cash flows and a constant discount rate. For instance, the income stream can be permitted to remain level or to change by a constant rate or dollar amount; the property's value can be assumed to remain constant over time or to change by a targeted amount; transaction costs can be included or omitted; debt can be included or omitted; and the holding period assumed can be finite or infinite. The various methods discussed are presented in both narrative and equation form. The equations serve to highlight the effects that successive changes in assumptions have on the various models.

The second grouping involves definitional methods. The author shows that the equation supporting such a method must by definition be true, because algebraic simplification results in identical single terms remaining on both sides of the equation: value = value. Three general techniques classified in this group are the several Financial Component Methods, the Debt Coverage Method (which utilizes only lender-based criteria), and the Steele Method (which incorporates both lender and equity investor criteria). Though the origins of these methods are definitional, the justification for their practical application may be empirical.

The final grouping encompasses the Empirical Methods. These techniques, such as the well-known Gross Rent Multiplier method, are based on an assumption of simple linear relationships between gross or net income and value, based on past observed transactions. Though both conceptually and computationally simple, Empirical Methods are defensible only if the observed relationships on which they are based have been found consistently to predict arm's length sales prices.

Cannaday provides many interesting insights into appraisal theory and the manner in which it has developed. He notes, for example, that techniques dating from the 1930's were developed in computational form (easy to compute, but difficult to follow logically) rather than in more abstract conceptual form (intuitively appealing, but difficult to compute manually), to facilitate computations in the pre-electronic environment. Information is drawn from popular texts and major articles, including some of the author's own previous work. The paper serves as both a thought-provoking approach to new classification techniques and a solid review of the income property valuation methods currently in use.

# The Most Costly Mistakes in Real Estate

Gary W. Eldred

*In the past, a shortened version of a research paper in the ORER Paper Series has been published in each edition of the Illinois Business Review. However, because the Office of Real Estate Research now has its own more specialized publication, short versions of ORER Papers will henceforth appear in the ORER Letter. Copies of the short versions which appeared in the Illinois Business Review, known collectively as the ORER IBR Series, are still available through ORER. The following short version of a recent ORER Paper, and those that will appear in future issues of this publication, will be known as the ORER Letter Series.*

This past decade has been a busy time for promoters of real estate schemes promising quick riches with little or no risk and little or no money down. Unfortunately, countless naive followers of these promoters have spent countless dollars on books, tapes, and seminars without building fortunes. Yet not just the naive have suffered disappointment; even sophisticated institutional investors have suffered major real estate losses in recent years. During the recent past, aggregate losses in real estate development and investment have set new records. Leading banks, savings and loans, syndicators, and development companies, as well as thousands of smaller scale entrepreneurs, have lost tens of billions of dollars in a medium that the uninitiated often view as low-risk: real estate.

Many people explain these losses with reference to the "real estate cycle." But closer examination shows that losses were often caused by mistakes that could have been avoided through better planning and analysis. The following summary of ORER Paper #64 examines data obtained through interviews with more than 200 real estate practitioners working throughout the United States. The purpose of the paper is to classify and discuss the various types of mistakes encountered. The project that culminated with this paper was undertaken to help the reader who agrees that it is better to be wise by the misfortunes of others than by one's own.

*Mistake #1: Ill-Defined Purpose.* One popular writer has called real estate a "money machine." Yet real estate is best viewed as a prod-

uct or service, which can compete in the market only if it fills consumer needs. Greed can be an investor's downfall. Successful developers are usually people who approach their activities with vision and passion. Their concern is what they can achieve, rather than how much money they might make.

*Mistake #2: The "Investment" Fallacy.* Too many people have equated real estate investment with a more passive "buy low, sell high" investment in such assets as stocks, gold, or stamps. They have failed to recognize the time, talent, and work that must go into maintaining and enhancing a property's value. Such people may realize that their homes are investments, and they take care to devote proper attention to upkeep. Yet they fail to understand that income and value of "investment" properties are largely the fruits of imaginative and capable management.

*Mistake #3: Faulty Location Analysis.* Everyone knows the key to successful real estate development: select a good location. Yet developers sometimes assert that they have secured favorable location without considering the two basic factors that determine the attractiveness of a location. First is accessibility. The property must be close to neighborhoods or services that the targeted population, rather than the developer, wishes to be close to. Accessibility also relates to required time for travel to work or other destinations, at the relevant hour of the day.

The second aspect of location is environment. A location's desirability is greatly affected by such factors as crime rate, zoning, and quality of government services. A property may be too close to unpleasant or dangerous industrial activity, or may be served by one city's municipal services but another city's school district.

*Mistake #4: Faulty Site Analysis.* Topography, soil characteristics, and water runoff often cause serious problems. A group of investors in the Southwest spent more than a million dollars over several months to design and arrange financing for a development. Before closing the loan, the lender required a soil test. The inexpensive test showed that the site, a former railroad yard, was contaminated with a 90 year buildup of oil and hazardous chemicals, rendering it unsuitable for the proposed residential use. Another investor completed a "dream home" in a wooded location near a stream, only to find that the stream floods the site every spring.

*Mistake #5: Faulty Property Analysis.* Investors invite catastrophe by failing to thoroughly examine all physical aspects of property improvements, including size, structural stability, and mechanical systems. In one instance, lack of familiarity with a purchased building led an investor to believe that all space would be net rentable square footage, whereas the unusual floor plan resulted in a significant amount of unusable space. Other parties have suffered losses by relying on "ball-park" estimates of rehabilitation costs or by purchasing multi-unit buildings after seeing only "representative sample" units carefully selected by sellers. In addition, as with location analysis, an important aspect is to satisfy actual consumer needs rather than the developer's unsubstantiated guess as to what the market desires.

*Mistake #6: Misjudging Demand.* Developers have faced costly setbacks by assuming that customers existed without undertaking adequate market analysis. A major development contained an exclusive retail area designed to attract shoppers from executive ranks in the adjoining commercial center. High-income executives, however, with demanding work schedules, tend to shop during leisure hours near their suburban homes. Clerical workers, who might shop during lunch or break periods, can not afford upscale store prices. The developer of a suburban condominium project learned the hard way that families in that locale wanted detached houses and singles preferred to rent. Others have faced losses by assuming that industrial growth would create an abundance of high-paying jobs and a result-

ing demand for expensive homes, or by failing to note employers' plant-closing plans.

*Mistake #7: Misjudging Supply.* When evaluating supply, an investor may take too narrow a view of a property's competition. Much can be lost if a developer or purchaser fails to consider that a commercial building's competition can be located in distant geographic areas, and can even be a different property type. One developer thought he had found a profitable market niche in providing lower cost office space in an otherwise up-scale market. Yet a surplus lowered rents of prestige office space to a point at which tenants shunned cheaper, more functional property. (See "Flight from Quality," *ORER Letter*, Spring 1988.) Another developer refused to pre-lease a building under construction, feeling assured that an office space shortage and escalating rents would continue. He failed to recognize that profit potential in an underbuilt market would attract competitors; by the time the building was completed, the shortage of space had become a shortage of tenants.

*Mistake #8: Faulty Financial Analysis.* Financial analysis involves financial statement analysis and analysis of costs. It is never wise to accept as factual an income statement prepared by a property seller or the seller's agent. Prepared income statements frequently omit or understate expenses, overstate potential rental income while understating likely vacancies, or match low prior year expenses with high future income projections. The prudent investor constructs a new income statement, using as input current market conditions, experience of similar properties, and common sense. Every aspect of a reconstructed statement should be checked and checked again; even computational errors have proven costly.

Faulty cost analysis is most frequently a problem with properties needing renovation or remodeling. Yet the investor faces a paradox: while sound cost estimation is essential, accuracy is difficult, if not impossible, to achieve. Reasons include hidden damage not found until work has begun; planning difficulty caused by the need to schedule work in the proper sequence; inflation during the project period; and strikes or materials shortages. Careful investors design contingency plans for handling the cash shortages that result from higher interest costs and delayed receipt of revenues.

*Mistake #9: Buying Cash Short.* Those who buy without adequate cash range from inexperienced attendees of "no money down"

seminars to experienced investors who fail to recognize the continuing need for cash after a transaction closes. Though not easy, it certainly is possible for someone with no down payment to buy a property. The problem is that a property for which a seller offers financing assistance may require extensive work, and therefore extensive cash, after purchase. In addition, if a seller is providing financing assistance, the property may be overpriced.

*Mistake #10: Capital Driven Development.* Projects should be market driven, not capital driven. Lenders, for example, can suffer losses in their quest to attract business from major developers. Developers, in turn, may come to believe that past successes assure future success. They can use profits and equity from earlier projects to arrange favorable financing and begin construction on new projects, even in overbuilt markets. To avoid problems of capital driven investment, both lenders and developers should ask such questions as: Can the market absorb the project proposed, and will it serve market needs? Have the developer's past successes actually been with property types different from that proposed? Does the developer's own capital base consist largely of other real estate projects? Could their values be overstated on financial statements? Are the projects geographically diversified and liquid? The problems caused by capital driven development can be seen in the overbuilding of multi-family buildings in the 1970's and the glut of urban office properties in the 1980's.

*Mistake #11: Faulty Deal Making.* No two deals are alike, and actions that prove favorable in some negotiations could prove disastrous in others. Still, there are two rules that should always be followed. One is to put first things first. Activities involving low costs and short turnaround times may provide critical information on the advisability of progressing to costlier project phases. An inexperienced developer bought a costly parcel, and *after* the expensive purchase commissioned an inexpensive engineering study which revealed site grading problems that made the planned development unfeasible.

A second rule is to avoid "tough guy" negotiating. Trying to wring every possible concession from the party on the other side of the transaction can be counterproductive. A condominium developer had sold the individual dwelling units and most of the common areas while retaining title to the recreational facilities, which he in turn leased to the homeowners' association for the residents' exclusive use. At lease renewal, the developer, certain that he had the upper hand, offered the association the choice of paying a four-fold rental increase or sharing the pool and tennis courts with the general public on a fee for use basis. However, the developer had forgotten that the association owned the land around the recreational area and could deny access to any outside user. The residents negotiated a new rental that was 50%, rather than 400%, of the prior year's level.

*Mistake #12: Misunderstanding the Government Approval Process.* Persons or groups with political influence can affect the value or use of a property. There are 3 areas in which investors can face unusual difficulty. First is the private lawsuit. A factory owner gained an injunction against construction of an upscale residential development; he feared that nearby affluent homeowners would eventually take steps to limit his firm's activity. Even parties without affected property have sued based on environmental impact to halt development.

Second is the degree of minute detail inherent in the approval process. Hostile outside parties may be able to stop development by locating a seemingly innocuous oversight on the developer's part.

Finally, though written laws apply, issues of politics and personality can have an impact. Those who enforce rulings possess some discretionary power, and by acting more slowly or quickly can delay or facilitate a project's approval.

Real estate entrepreneurs should not let the fear of making mistakes block

*At the time this paper was written, Gary W. Eldred was a Visiting Associate Professor of Finance at the University of Illinois. He is now a member of the finance faculty at the University of Virginia's McIntyre School.*

## Director William Bryan Discusses Economy, ORER

*Professor William R. Bryan assumed the duties of Director of the Office of Real Estate Research on August 15. He also continues to serve as Chairman of the University's Department of Finance. Bryan, a native of Muncie, Indiana, began his career in education as a public school teacher after earning a degree in English and history from Ball State University. He later served as a training officer in the United States Air Force. Following military service, Bryan began his doctoral studies in economics at the University of Wisconsin at Madison. Upon completing the Ph.D. in 1960, he joined the staff of the Federal Reserve Bank of St. Louis, serving eventually as senior economist. Bryan came to the University in 1966 as an Associate Professor of Finance, and has been with the Department of Finance since that time, though he took a leave to spend the 1970-71 academic year in Washington, D.C. as an assistant to the Treasury Department's Director of Debt Analysis. He was promoted to Professor in 1971.*

*In his capacity as Finance chair, Bryan played an active role in the creation of the Office of Real Estate Research, and he has served for many years on the ORER Advisory Committee. Bryan's research interests cover many areas. He has studied the value of human capital, and has served as a consultant on issues of personal injury and business losses. Another area is the measurement of fiscal policy, particularly through a measure Bryan calls the Balanced Budget GNP. Bryan, who also serves as editor of the Illinois Business Review, views himself as a business economist, who follows economic developments with an eye toward providing useful current information to decision makers. The following interview addresses his views on the current state of the economy and the role of ORER.*

*We're bombarded with talk of the federal budget deficit. Do you feel that members of the real estate community, as voters and market participants, should pay close attention to this measure?* I have not been overly concerned about the federal budget deficit. I'm not concerned either with its actual size or with the fact that it has been persistently large. The reason that these do not worry me is that

over the years I have become fascinated by opposites. Some of the first things you learn in economics relate ultimately to a host of truisms. One such truism is that deficits and surpluses across the economy always sum to zero. So an observation that one sector of the economy is in a deficit situation, is at the same time an observation that other sectors are experiencing surplus. Therefore, if there are persistent negative effects on the one hand, there must be just as persistent a set of positive effects on the other.

*Which sectors are benefiting?* In the current accounts, surplus units are the household sector, which is always in surplus; the business sector, which is sometimes in surplus, sometimes in deficit, but is currently in surplus; and the state and local government sector, which over the past decade has moved heavily into the surplus category. Finally, the international sector has a current account deficit and a funds account surplus. Over the past 3 years or so it has accumulated a heavy surplus in the funds account, which it turns out is the mirror image of the current account deficit. Any time you look at the international sector's funds account position, which is to say its position as a borrower or a lender, you're seeing the mirror image of its current account position, its position as a net importer from, or net exporter to, the U.S.

It's quite another matter to talk about politics. There is the issue of government entities, whether their powers be local, state, or federal in nature, making spending decisions without at the same time considering taxes. That issue is a political matter and not an economic matter. My feeling is that spending and taxation decisions should not be separate. It is necessary for state and local spending decisions to be closely tied to decisions on how projects are going to be paid for. At the federal level, the coordination of spending and taxes is less critical, but it is nonetheless important as a political matter over reasonably long periods, perhaps ten years. We should be concerned if ten years pass and the Administration and Congress continue to undertake expenditures that bear little relationship to the underlying set of receipts.

*What about trade deficits?* Those concerned with trade as a general issue should actually be asking a different question. I feel we should ask whether people in various countries are doing what they are most capable of doing. If they are, then consumers as a group, worldwide, get the highest amount of output for the given resource use. The world has to allocate its limited productive resources effectively. Since I believe that, I favor trade policies that are based, to the degree possible, on relative efficiency in production. Therefore, I'm willing to accept any resulting deficit or surplus as a natural consequence of optimal policies. But I also believe that nations have to compete on a level playing field, and there are certainly charges that American firms face impediments in reaching markets in some countries, such as Japan. Foreign government intervention in various countries tilts the playing field in ways that encourage their exports and discourage imports of our goods. The U.S. should resist implementing any type of policy that would, in the end, result in a suboptimal allocation of goods, and we should discourage other countries from using such tactics.

I'm not particularly concerned about the current account deficit in the balance of trade, to which you referred. Recall that, in my view, the key to understanding is often to look at the opposite side, and that in this case the opposite is a capital account surplus. But something else is important here. In some sense there are not any real choices. If foreigners decide to build up their holdings of dollar denominated assets, and in the process shift real resources to this country, the mechanism by which that

shift occurs is that we import more than we export. It's just like when we shift real resources from the Rust Belt to the Sun Belt in our country; the mechanism by which that shift in real resources occurs is that the Sun Belt imports more than it exports. In a fundamental sense we cannot know what is cause and what is effect. We can't always know whether our deficit in the current account is caused by the surplus in the funds account, or whether the funds account surplus is caused by the current account deficit.

Foreigners are investing in productive capacity that will benefit us in future periods. When the foreigners shift real resources to our part of the world, or, more importantly in terms of the magnitudes involved, when U.S. citizens decide that they want to slow the rate at which they shift resources to other parts of the world, the result is expanded productivity here. It would be a completely different matter if the U.S. were simply profligate, if we were greedy in our use of current account resources. If that were the case the borrowing would represent a foreign bailout. If that were the case, then we might have reason to be concerned about the deficit. But even someone with this belief would be misplacing concern by focusing on the deficit. Of more concern should be our profligate ways.

*What should we be following with regard to the money supply and interest rates?* One historical issue to consider is how we ought to go about discussing monetary policy. Most of the talk about "monetary policy" is actually talk about interest rate developments. People look at the results, rather than the causes, of monetary policy. Yet even with interest rates, we ought to be looking at a more general question involving the cost of credit.

In my view, monetary policy involves what happens to a collection of financial instruments called "money." In evaluating monetary policy, I tend to pay a lot of attention to what's happening to something called the "monetary base." The monetary base is something the Federal Reserve can actually control over reasonably extended periods of time. The monetary base connects itself to the various M-1's and other monetary aggregates through the applicable multipliers. I'm very traditional in terms of monetary theory, in that I pay so much attention to the money supply. I look at quantities, rather than at interest rates, credit developments, or whether markets are easy, tight, resilient, or cautious.

Real estate people, in the broadest sense, have major concerns about one type of resource use. That involves, of course, the physical building of dwelling structures and workplace structures. This type of resource allocation is a central issue in any economic system. Attached to that important allocative decision are some institutions, some markets, some marketing procedures, and some government regulations. So those of us who are interested in real estate must also have an interest in that whole range of activities: the marketing of final products; the markets within which the allocative decisions are permitted to occur; and the government institutions, laws, and regulations within which activity proceeds; as well as the technical side and the imaginative side of the real resource allocation itself. Real estate market participants qualify as having a pretty broad range of interests.

*What general plans do you have in your new role as ORER Director?* First, it's important to look at the past. The Office of Real Estate Research has fostered some important real estate research over the past few years, and it's important that the research thrust be continued. However, my chief focus will be, at least initially, on the public information and public service side of our mission. I want to develop ways to communicate with our constituency through such means as conferences, news releases, and increased real estate data development activity, in addition to the type of research conducted in the past. It's important for us to know, for example, the level of housing starts in the state's major metropolitan areas, and the mortgage lending terms available. We should strive for widespread dissemination of our output, with a view toward improving public understanding of real estate issues and developments. We can provide news agencies around Illinois with information such as graphs, charts, and short news stories that they can report locally.

Communities need objective information on what is happening in their real estate markets, and I feel that we can play an important role in providing it. In doing so we can also heighten the public's awareness of the existence of ORER. When any real estate issue arises in Illinois, whether it affects one community only or involves a broader issue such as government regulation of financial institutions, we want people to think of the Office of Real Estate Research as a source of information.

#### ORER Letter

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Office of Real Estate Research  
at the University of Illinois  
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William R. Bryan, Director  
Peter F. Colwell, Editor  
Joseph Trefzger, Associate Editor

Address correspondence to:  
Brenda Brooks  
304 David Kinley Hall  
1407 W. Gregory  
Urbana, IL 61801

#### ORER Advisory Committee

William R. Bryan  
ORER Director;  
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Peter F. Colwell  
ORER Professor of Real Estate  
Professor of Finance  
University of Illinois

Lydia Franz  
Senior Vice President  
Koenig & Strey

Charles Hill  
Executive Vice President  
Federal Home Loan Bank  
of Chicago

Jane Leuthold  
Associate Dean  
College of Commerce and  
Business Administration  
University of Illinois

Gerald Perlow  
Treasurer  
Illinois Association of Realtors®;  
President  
Gerald Perlow Realtors®

David Rittmiller  
Sales Associate  
Traders Realty Corporation

Ronald See  
Real Estate Commissioner  
State of Illinois

Donald Ursin  
President  
Illinois Real Estate  
Educational Foundation;  
President  
Coldwell Banker Residential Real  
Estate Services of Illinois

## Peoria Rebounds

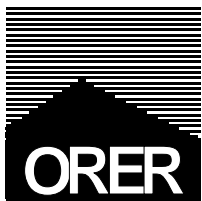
The Peoria Metropolitan Statistical Area appears to be maintaining its recent construction growth after many years of unusually low activity. The area has also been unusual in that for 14 of the last 18 years, total non-residential construction value exceeded that of single-family home construction. Perhaps 8 of the 18 years would be more typical for the state.

The accompanying graph includes actual data through 1987 and projections for 1988 (actual current year data are available only through July). An analysis by ORER Professor Peter Colwell in the February, 1988 *Illinois Business Review*, using incomplete 1987 figures then available, indicated a recovery underway. The 1987 totals and 1988 projections reflected in the graph show recent home and non-residential property construction greatly exceeding the 1986 totals, reaching the highest levels of recent years. An improved picture for such property types is not surprising in a "Rust Belt" community with a manufacturing-based economy, given that recent exchange rates have favored exports by American firms.

Multi-family permit values, however, fell in 1987 to levels even below the low 1986 figures, and appear to be headed even lower in 1988. This pattern, which appears to hold for the entire state as well, was a predicted outcome of changes in the treatment of income-producing property under 1986 tax legislation.

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University of Illinois  
304 David Kinley Hall  
1407 W. Gregory Drive  
Urbana, Illinois 61801