A look at the history of real estate cycles provides clues to the pattern of regulatory activities affecting development and real estate.

The Politics of Real Estate Cycles

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While the recurrent boom-bust behavior of realty investment in America was noted by commentators as early as the 18th and 19th centuries, it was only during the Great Depression of the 1930s that scholars systematically began to 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.

These economists searched for historical explanations and research methods that could help predict the timing and impact of future fluctuations. Prompting much of this analytical work were new ideas for industrywide restructuring, ideas encouraged by the growing number of private trade associations and advocates of government intervention and regulation. These ideas became popular during World War I and reached maturity with the economic crisis of the 1930s. Industry and government leaders attempted to turn economic theories of business cycles into policies designed to reverse the downward spiral.

The relationship of cyclical economic activity in the real estate sector to industry restructuring and public policy reform is a subject ignored by most economic studies. That a direct relationship exists between the stages of the cycle and real estate industry regulatory activity is made clear by historical research. Most government initiatives to regulate or reorganize the real estate industry take place during the downward slide after a boom, during the low point 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 real estate is booming. This pattern is the result of three factors: public opinion, real estate industry politics, and the flow of financing.

Public Opinion

In boom times, dissatisfaction with whatever ill effects frenzied development activity may have is partially muted by the enormous profits, employment, and investment that development generates. Once things begin to slow down, however, pent-up frustrations take the form of widespread public support for more stringent regulation. The current response to the S&L crisis, for example, is, in part, closing the barn door after the horse is gone.

At the bottom of the cycle, public concerns shift to the stagnant market and how to revive it. The policy framework becomes one of providing economic incentives. The federal deregulation of the

S&L industry during the severe recession at the start of the 1980s, for example, was motivated partly by a desire to boost real estate.

Finally, in the early stages of an upswing, many actions are taken to further the process of economic revival at the same time that new regulations are established to prevent or ameliorate certain problems that could arise with a new round of development activity. Once the boom is going strong, however, economic incentives become obsolete and the adoption of new strict regulations becomes politically impossible—too many people have a vested interest in letting development and sales proceed without additional encumbrance.

In market upturns, development incentives and new regulations are the rule.

Real Estate Industry Politics

The size of the real estate industry varies through the cycle. When times are good, vast numbers of people get involved in buying, selling, leasing, building, renovating, and otherwise carrying out property investment and development activities. Newly established entrepreneurs, many of whom are small-scale operators with a large stake in the status quo, can quickly become obstacles to meaningful reform or regulation.

Large-scale entrepreneurs, on the whole, tend to view public policy initiatives more positively. For one thing, they are more likely to play influential roles—for their own ends—in the policymaking process. Even so, during boom times industry leaders, besides being outnumbered, are also loath to tamper with a status quo that spells profits for them.

Once the downturn arrives, however, larger developers become more willing to engage in public policy reform, in order to placate an increasingly hostile public opinion and improve the image of the industry. Real estate leaders often support new regulations as a means of avoiding more drastic measures. Many of these executives are anxious to differentiate their respectable business endeavors from the unscrupulous and scandalous activities of some boom-time entrepreneurs. In this atmosphere, trade associations may even support public or self-imposed steps to purge certain types of fraud and abuse from the industry.

Surviving entrepreneurs may welcome regulations that reduce competition and avoid overbuilding, but they are generally wary of restrictions that could inhibit their own future activities. Real estate leaders in favor of reform have more political power in a recession, and the advantage in political legitimacy at a time when public image is important. The real estate executives who emerge during a downturn to engage in public-private reform are professionals who managed to avoid the scandals that tainted many of their cohorts during the previous boom.

In a recession and the early phases of an upturn, the industry generally supports new government investment and production incentives. Real estate leaders become more willing to lobby for legislation and public intervention in order to strengthen their private economic positions. But once the boom is in full swing, serious governmental reforms generally are absent from the real estate industry's political agenda.

When the boom is in full swing, the status quo prevails.

The Flow of Financing

Financial institutions and intermediaries exert considerable power over the investment and construction process. More than most businesses, real estate operates with other people's money. Property financing is highly leveraged through mortgage loans and a myriad of other debt instruments. The dynamics of capital markets contribute heavily to the overall pattern of real estate cycles.

During boom periods, financial institutions compete vigorously to make loans and perhaps also to take a percentage of the equity in projects. At such times, many 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, questionable business practices, and numerous other abuses resulting in poor quality development. Most important for the theory of regulatory cycles, at the height of the boom, real estate lenders tend not to push for public policy reforms or regulation.

One of the main reasons that booms eventually crash is that financing is withdrawn. With money tight, borrowers are generally either unable to get new loans to finance building or buying, or the loans are too expensive. Moreover, lenders often force borrowers to repay existing loans and refuse to extend loans or renegotiate their terms, particularly when the cash flow from the property is insufficient to cover the debt service.

If borrowers cannot find other lenders to refinance their properties, then defaults, foreclosures, and bankruptcies will soon follow. Sales, construction, and property values sharply decline and the lack of capital becomes a key factor in prolonging the real estate bust.

In financial panics, lenders can get into serious trouble when the asset value of their real estate portfolio rapidly diminishes. A large number of credit providers have failed over the past two centuries due to real estate losses. Indeed, many have succumbed to the current real estate recession—first S&Ls, then commercial banks, and now life insurance companies.

In these periods, lenders and other financial intermediaries come under increasing criticism and scrutiny that lead to more conservative underwriting practices and new regulatory initiatives.[1] In response, the financial services sector becomes an

active participant in public policy debates and contributes to the formulation and implementation of reforms in the real estate industry.

Companies that insure real estate—property, title, and mortgage insurance firms—also exercise considerable authority during cyclical downturns to control and reorganize real estate business activities and promote government intervention. During booms, however, both insurers and their financial counterparts tend to relax their standards and become less enamored with public regulation.

When the slowdown starts, regulation picks up.

Two Histories

The Rise of the Community Builders[2] examines the real estate industry—residential development and brokerage in particular—in the first half of the 20th century. It analyzes the role of real estate politics in the creation of government planning agencies and land use regulations. The book also examines private regulatory and planning activity, including deed restrictions and trade association actions to impose industry standards.

A deep conflict existed between the large developers, or community builders, and the smaller operators or curbstoners, whom the community builders tried to exclude or upgrade. Big developers generally favored private regulation and most were also inclined to support some type of government regulatory and coordinating role.

Interestingly, the positions and efforts of the different actors varied over time. The single most important variable in explaining the variations was the real estate cycle.

Zoning laws were initiated in many cities in the slow real estate years during and after World War I. When development began to accelerate in the early 1920s, industry leaders still supported land use restrictions to promote growth. At the height of the mid-1920s boom, however, most of this support had evaporated. New laws were put on hold and existing ordinances were frequently weakened. Only during the late 1920s and the long depression of the 1930s were new zoning laws passed and old ones strengthened, with the backing of the community builders who survived the 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 Rise of the Community Builders*.

Own Your Own Home,[3] an analysis of the evolution of the residential development and finance sectors over the past 100 years, reveals similar patterns of political behavior and outcomes in terms of the real estate industry and economic cycles. The first federal homeownership policy initiatives came during and immediately after World War I, a period of housing shortages and real estate market recession.

A major reorganization of housing finance and development occurred in the depths of the 1930s depression. Real estate industry leaders, especially land developers, homebuilders, residential realtors, and home mortgage lenders, lobbied strenuously for government intervention ranging from subsidies to regulations.

At the end of World War II and in the immediate postwar years when housing shortages and fear of another depression were foremost among the concerns of the real estate industry, the Veterans Administration home loan guarantee program was created, and the FHA and Fannie Mae were greatly expanded. Mortgage financing subsidies provided in the 1949 Housing Act helped housing construction reach record levels. When homebuilding and sales began to fall in 1953, 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. Housing legislation has been justified frequently by its anti-recessionary effects.

Future and Prospects

In 1992, with a recession in full force everywhere, real estate industry trade associations are uniting to fight for new federal income tax subsidies to encourage residential, commercial, and industrial development. The industry argues that incentives are needed to stimulate property investment, which will help get the economy out of the recession.

At the bottom, policymakers support incentives to revive markets.

Where does all this lead? Historical lessons can offer considerable insight into the future. We should 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 these prospects 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. ❖

Notes

[1] Anthony Downs, *How the Current "Credit Crunch" is Excessively Depressing Real Estate Values* (Washington, D.C.: ULI–the Urban Land Institute, 1991).

[2] Marc A. Weiss, *The Rise of the Community Builders* (New York: Columbia University Press, 1987).

[3] Marc A. Weiss, *Own Your Own Home* (New York: Columbia University Press, forthcoming).

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