Issue Analysis

The Limitations of Public-Private Partnerships

Recent Lessons from the Surface Transportation and Real Estate Sectors

By Marc Scribner

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Executive Summary

Government at all levels in the United States has been slowly moving away from grand central planning schemes and toward markets. One result has been the rise of public-private partnerships (PPPs). Proponents of these arrangements argue that many of the information and transaction cost problems inherent in government institutions can be mitigated by sharing construction, maintenance, and operational responsibilities with profit-motivated private firms. When the status quo is a government monopoly, PPPs should be viewed as preferable in nearly every case.

Unfortunately, PPPs can also drive rent-seeking behavior, and create significant risk of improper collusion between political actors and politically preferred firms and industries. This harms not only taxpayers, but the economy at large, as critical investment decisions are distorted by political considerations. Such shady dealings also serve to delegitimize and discourage privatization efforts and commercial infrastructure investment in general. Worse still, the errors of the public sector component are often blamed on private parties.

This paper examines public-private partnerships and their relation to surface transportation and real estate development, two areas where their use has grown substantially in recent years. These sectors also tend to be intertwined, with investment in transportation infrastructure often coinciding with real estate development or redevelopment. This relationship tends to grow stronger as project size increases, as large-scale developments such as shopping centers and stadiums significantly alter local land-use patterns and demand for transportation.

But these sectors are hardly similar, as the paper's case studies bear out: One has long been dominated by government monopolies and the other has been largely free of political forces. In the case of surface transportation infrastructure, innovative new private-sector financing, management, and ownership regimes have much to offer in terms of minimizing taxpayer exposure to risk, capturing user revenues, and creating an efficient transport network. In contrast, government's recently expanded role in real estate development has increased taxpayer exposure to risk, socialized costs, and concentrated the benefits into the hands of select private developers and special interests.

The popularity of PPPs should not blind policy makers to the fact that these sectors suffer from problems that are markedly different. Outside of limited instances such as the Department of Defense's Base Realignment and Closure (BRAC) program, PPPs in the real estate sector offer very little in terms of social benefits. These arrangements should be avoided.

A responsible path forward would be to utilize PPPs in surface transportation infrastructure development and management, while cutting bureaucratic impediments such as land-use regulations and business licensing to promote redevelopment. In essence, both require reducing political intervention and expanding market opportunities. Only when policy makers realize their own limitations will these sectors be free to maximize wealth creation that could potentially bring about a new era of American prosperity.

Introduction

In recent years, government at all levels in the United States has been gradually moving away from grand central planning schemes and toward markets. One result has been the rise of public-private partnerships (PPPs). Proponents of these arrangements argue that many of the information and transaction-cost problems inherent in government institutions can be mitigated by sharing construction, maintenance, and operational responsibilities with profit-motivated private firms. This is true to some extent; PPPs are certainly preferable to government monopolies.

Unfortunately, PPPs can also drive rent-seeking behavior, and create significant risk of improper collusion between political actors and politically preferred firms and industries. This harms not only taxpayers, but the economy at large, as political considerations distort critical investment decisions. Such shady dealings also serve to delegitimize and discourage privatization efforts and commercial infrastructure investment in general.

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This paper examines public-private partnerships and their relation to surface transportation and real estate development, two areas where their use has grown substantially in recent years. These sectors tend to be intertwined, with investment in transportation infrastructure often coinciding with real estate development or redevelopment. However, there is a crucial distinction that must be taken into consideration. While transportation PPPs inject market forces into a sector previously dominated by government monopolies, PPPs in real estate tend to inject politics into the market.

Defining Public-Private Partnerships

The term "public-private partnership" is used to describe a wide variety of arrangements between government and the private sector. These include everything from military contracting to infrastructure management and development. PPPs concerned with the latter have seen growing support among policy makers in recent years, with for-profit private firms taking over traditional infrastructure management of roads, bridges, and tunnels. These arrangements can be broken down broadly into four categories:[1]

1. ***Management and lease contracts***. Contracts that transfer management of a public infrastructure project to a private company for a fixed period of time, while the state retains control over revenues and investment.

2. ***Concessions***. Long-term leases that transfer control of revenues and development investment to a private entity for a fixed period of time.
3. ***Greenfields***. Newly constructed infrastructure projects where ownership is either retained to some degree by private investors upon completion, or transferred to the state after a fixed period of time.
4. ***Divestitures***. Ownership transfers of existing public infrastructure to private firms, either fully or partially.

Private sector involvement in surface transportation infrastructure is not new. Public and private turnpikes—roads that require the payment of a toll for passage—have existed for hundreds, if not thousands, of years.

While not all PPPs are created equal—and those that promote private ownership of infrastructure in the long-run should certainly be preferred over those that merely lease public infrastructure to private managers—they should be seen as a step in the right direction. However, this only holds when market forces are introduced into the workings of public monopolies. The danger of PPPs is that one can just as easily use the same language to justify the introduction of harmful *political forces* into thriving competitive sectors.

Public versus Private Surface Transportation Infrastructure in U.S. History

Passenger rail and, to a greater extent, roads are often sloppily categorized as "public goods"—goods and services which the market will theoretically underprovide or not provide at all. This is a textbook mislabeling that ignores the historical significance of privately provided surface transportation infrastructure, as well as current private-sector involvement in transportation.

Private sector involvement in surface transportation infrastructure is not new. Public and private turnpikes—roads that require the payment of a toll for passage—have existed for hundreds, if not thousands, of years.[2] In the United States, turnpikes enjoyed limited success in the 18th and 19th centuries, before being virtually eliminated early in the 20th century.[3] Renewed interest in tolls occurred just prior to the Second World War and continued until the passage of the National Interstate and Defense Highways Act in 1956.[4] Only in the last couple decades have toll roads again become politically palatable, with many taxpayers now preferring tolls to increases in fuel taxes as means to fund road construction and upkeep.[5] This is important not only in terms of getting road financing right, but also because tolls are the most efficient cost-recovery mechanism for private firms.[6]

Private roads serving residential areas also have enjoyed limited historical and contemporary success in the U.S. These are typically financed and managed by local property developers and owners' associations, many of which allow public traffic. The advantage of these private roads is that investment and use decisions are made in close consultation with the affected stakeholders—the abutting property owners.[7] Roads controlled by private developers and owners' associations can accommodate owners' preferences, which may be at odds with one-size-fits-all government regulation, such as narrower roads and smaller building setbacks.[8]

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During the 19th century, private streets were constructed in St. Louis. The "private-place model" was successful for several decades, until new municipal ordinances granted the city the exclusive right to install and maintain "sewers, sewer inlets, water mains, gas mains, underground conduits for electric wires, fire plugs, lamp posts and other conveniences."[9] Essentially, owners of private streets lost the ability to control their properties. Many gave up and lobbied the city to take over ownership and management. But with the recent rise of common interest housing developments (often referred to as "gated communities" or "private communities"), private streets have been making a modest comeback.[10]

Private involvement in surface transportation was not limited to roads. Prior to the middle of the 20th century, passenger rail infrastructure in the United States—including track used for intercity service, commuter service, and urban mass transit—had been privately built, owned, and operated. In the past, private firms owned and managed New York City's subway and commuter rail systems, Chicago's El, and the nation's cross-country intercity passenger rail network.[11]

The poor state of private rail transit following World War II was in part a consequence of the massive economic distortions and dislocations caused by the federal government's heavy intervention into industry to support the war effort.[12] However, rail transit had been losing market share for years following the first auto-driven suburban expansion after World War I. The streetcar industry, for example, was in a financial death spiral long before the outbreak of World War II.[13] Unfortunately, these inefficient and unpopular (at least in terms of ridership) transit networks were put on government-funded life support for decades—and many continue to limp along to this day.

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If the surface transportation sector is going to keep up with the demands of the 21st century economy, it is crucial for policy makers to address the inefficiencies of the current government-dominated system. A growing body of scholarly literature suggests that the private sector's role in the surface transportation sector should be significantly increased.[14] Public-private partnerships are one plausible means to achieving this end.

Surface Transportation Infrastructure and PPPs

Following shocks to the transportation system during the 1970s fuel crisis, public officials began looking to alternative transportation models, including introducing the private sector and market forces into the building and maintenance of infrastructure. While outright privatization is still rare, duties formerly performed by public transportation authorities have been transferred to private firms in the form of public-private partnerships.

Before discussing transportation PPPs in the United States, it is useful to briefly survey the international scene. PPP involvement in transportation infrastructure has become quite popular in many developing nations. These countries typically lack sound political and legal institutions, face heavy public debt loads, and their governments have not developed the sophisticated financing tools that would enable them to tap into private capital. As a result, many have turned to private developers for assistance in constructing, maintaining, and improving transport infrastructure.

During the 1990s, private firms invested more than $60 billion on 279 turnpike projects in 26 developing countries.[15] These investments were allocated to more than 21,000 miles of toll roads, bridges, and tunnels.[16] This period also saw a rise in private sector involvement in rail infrastructure investment. During 1990-1997, private investors committed over $14 billion to rehabilitate, manage, and/or build 37 rail projects in developing countries.[17] The majority of this was invested in greenfield and divestiture projects.[18] Greenfields, at least in the surface transport sector, are almost exclusively build-operate-and-transfer projects, in which the government eventually takes possession of the rail or road infrastructure after a fixed period of time. Divestiture projects tend to stop short of outright privatization, with most only being partially turned over to private owners.

While $14 billion is a drop in the bucket in terms of overall global rail expenditures, it indicates a willingness by private firms to invest in high-risk surface transportation infrastructure projects. This is especially the case for those projects that have at least a partial long-term private ownership component.

Global governmental interest in transport PPPs has continued into the 21st century. Investment in PPP transportation projects during 2001-2007 increased by 32.4 percent compared to investment during 1994-2000.[19] Although private transportation infrastructure development suffered a slump in the early 2000s, the market recovered quickly and private activity remained relatively robust until the latest downturn.[20] It is unclear how long a PPP recovery might take, but divestitures in particular may benefit from the recession as public funding for transportation infrastructure projects becomes scarcer and officials are forced to become more creative in their financing methods.

Increasing private sector involvement in transportation is a positive development, but there are right ways to involve private firms, and then there are wrong ones.

Increasing private sector involvement in transportation is a positive development, but there are right ways to involve private firms, and then there are wrong ones. Many of the problems associated with transport PPPs concern concession projects[21]—those where private firms hold management and construction responsibilities, but not ownership, and those rights are transferred back to the state after a fixed period of time. For the most part, the problems stem from the fact that merely transferring management fails to shift risk to the appropriate parties. Feasibility studies and traffic forecasts are often overly optimistic, and political factors—such as opposition to tolls *out of principle*, shifting regulatory frameworks, and cronyism and a lack of competition in procurement and contracting—exacerbate the risk-sharing problems.[22]

Unfortunately, concession projects remain the most popular form of public-private partnership in transportation. Government officials are more likely to agree to a PPP project if they are able to retain ownership in the long run without taking on the financial and construction risks. This is a serious problem. If government is going to engage in concession partnerships with private industry, it must accept that transferring *all* associated project risk—including inflation and exchange rate risk to financing—to private firms will increase the total cost of the project.[23] Likewise, if government retains too much risk (particularly in the construction phase), the resulting moral hazard to the firm significantly diminishes the project's chances of success and greatly increases the likelihood of cost overruns and construction delays.

Concession agreements serve an important role as first steps toward privatization. Concessionaires are in many ways better suited to promote the long-term interests of building and maintaining an efficient transportation system. Concession agreements offer more certainty to future toll rates than public transportation authorities. Firms are more

aggressive in keeping costs low and in attracting motorists—they can take capital depreciation tax write-offs, and can tap into private capital in ways that government agencies cannot.[24]

In the United States, policy makers began to seriously examine PPPs as solutions to a variety of hardships faced by the existing public monopoly model of surface transportation in the 1990s.

In the United States, policy makers began to seriously examine PPPs as solutions to a variety of hardships faced by the existing public monopoly model of surface transportation in the 1990s. The following examples focus on PPP roads. In the United States, intercity passenger rail is controlled by quasi-governmental monopoly Amtrak, and, save a few very limited examples, regional and urban rail transit authorities do not seem willing to experiment with PPPs beyond the design and building phases.

California. Successful transportation public-private partnerships face many government hurdles in California. In the early 1990s, the California Department of Transportation (Caltrans) initiated three pilot PPP projects in Southern California and one in Northern California.[25] Only two of the four were ever implemented: State Route (SR) 91 Express Lanes in Orange County and SR-125 in San Diego County.[26]

The SR-91 toll lanes in Orange County were built in just over a year, with Caltrans estimating that they would have taken at least until 2001 to compete were the private sector not involved.[27] A consortium of private investors secured a 35-year concession to operate the tollway, and financed the entire $135 million project.[28] However, the agreement between Caltrans and the consortium mandated a three-mile "protection zone" adjacent to the lanes. This protectionist move prohibited Caltrans from adding competing lanes within the zone—either publicly or privately funded—and specified a bizarre series of restrictions on investment rate of return, maintenance, and infrastructure improvements.[29]

In less than a decade, these contract provisions and the resulting practices had led to a rapidly deteriorating situation, with confusion and panic on all sides. The consortium was facing internal pressure from investors and became involved in several protracted legal battles with Caltrans and other interests.[30] In 2002, the California Assembly passed legislation that authorized the Orange County Transportation Authority (OCTA) to buy out the concessionaire, shut down the protection zone, and eliminate tolls at the end of the 35-year period.[31] The legislation also prohibited OCTA from entering into new PPP agreements with potential SR-91 concessionaires, and required that all future franchise agreements be approved by the legislature.

The story of SR-125 is equally absurd, albeit in different ways. SR-125 involved building a new 12.5-mile $650-million road between SR-905 and SR-54 in San Diego County.[32] The project was also a 35-year build-operate-and transfer concession, but it took *nine years* for the project to receive final approval from state and federal environmental authorities.[33] In 2002, the original private investment consortium sold its interest to Macquarie Group, an Australian infrastructure development, financing, and management firm, before construction had even begun.[34] The southern tolled portion, since renamed the South Bay Expressway, eventually opened in 2007. Macquarie was optimistic about the project's future profitability,[35] but in early 2010, Macquarie's subsidiary, South Bay Expressway, Ltd., and its partner, California Transportation Ventures, Inc., filed for Chapter 11 bankruptcy protection.[36]

Illinois. In 1958, Chicago opened the 7.8-mile Chicago Skyway, an elevated tollway linking the downtown Chicago Loop with the Indiana Toll Road. Due to poor transportation planning and fiscal mismanagement, the city was unable to repay construction revenue bonds into the 1990s. After years of heated debate, the city finalized a $1.83 billion, 99-year concession agreement in 2005 with a consortium consisting of Macquarie and Cintra, a Spanish infrastructure developer.[37]

The concession agreement stipulated that in exchange for granting Macquarie-Cintra the exclusive right to all toll revenue over the 99-year lease, the consortium agreed to complete specific infrastructure improvements, install an electronic toll-collection system, improve throughput, and numerous other city government demands detailed in 300 pages of compliance requirements.[38] Within six months of operation, the newly managed Skyway implemented electronic tolls—now fully compatible with the multistate E-ZPass toll-collection network—which helped increase average toll plaza throughput from 300 to nearly 800 transactions per hour. This increased toll revenues and decreased congestion.[39]

The $1.83-billion infusion allowed the City of Chicago to repay $855 million in debt, fill a $375 million budget shortfall, and improve its debt rating to save millions annually in interest payments.[40] It also funded a $500-million long-term reserve and a $375-million medium-term reserve for the city.[41]

Indiana. Opened in 1956, the Indiana Toll Road (ITR) spans the 157-mile width of the state, from the Ohio to the Illinois state line.[42] After his election in 2004, Governor Mitch Daniels (R) ordered the Indiana Finance Authority (IFA) to investigate the feasibility of leasing the ITR to a private concessionaire.[43] Macquarie and Cintra formed the consortium ITR Concession Company and made the winning bid, agreeing to pay the state $3.8 billion in exchange for a 75-year concession.[44]

Unlike the Chicago Skyway, however, the ITR concession required the approval of the state legislature, which took around six months.[45] Also unlike the Chicago Skyway, the concession agreement establishes a protection zone with a 10-mile radius, prohibiting the state from investing in any limited access highway for the term of the lease.[46]

The authorizing legislation also mandates that the $3.8 billion generated from the ITR concession be used almost entirely for transportation-related funding.[47] It is difficult to determine the effect of this. On one hand, the City of Chicago dedicated a significant amount of its $1.83 billion on arguably wasteful discretionary spending. On the other, committing $3.8 billion to future transportation expenditures will likely incentivize the development of more poorly planned public transportation projects.

Texas. Two developers, Cintra and Zachry American Infrastructure of Houston, partnered under Texas' comprehensive development agreement (CDA) statutes—PPPs are officially known as CDAs in Texas—to form the SH 130 Concession Company for the purpose of completing SH-130's segments 5 and 6, which make up the 40-mile extension of the Central Texas Turnpike south of Austin to San Antonio. Cintra-Zachry paid the state a $25 million up-front concession fee and will finance the $1.3 billion project.[48] This arrangement allowed the Texas state Department of Transportation to shift the risk of designing and building the highway to the concessionaire, and indicators suggest that the project will come in well under budget.[49]

New turnpikes faced opposition from interest groups and the state legislature, with some politicians going so far as to suggest a two-year moratorium on CDAs. As the Reason Foundation's Robert Poole pointed out in 2007, a moratorium would have disastrous long-term consequences: "It is naïve to think that today's flurry of private-sector activity in Texas would freeze-frame, to resume business-as-usual 28 months later."[50] Thankfully, policy makers recognized the potential harm and opted to continue CDA activities. SH-130—which will become the first privately

designed, constructed, and operated open tollway in Texas—is scheduled to be completed in November 2012.[51]

Cintra-Zachry is also involved in a far broader and more innovative project, the Trans-Texas Corridor (TTC). The TTC is accurately described as "visionary" not just in its scope,[52] but in its guiding principles: "The Trans-Texas Corridor must be built with public/private partnerships in order to minimize costs to taxpayers," and, "Government does not have all the answers to the transportation challenges facing Texas and needs the innovation of the private sector."[53] This should be a breath of fresh air for anyone interested in challenging the government-monopoly model of transportation management and infrastructure development. The Texas Department of Transportation estimates the TTC will take 50 years to complete, but has prioritized a new 600-mile toll road that will extend from Oklahoma to Mexico.[54] Preliminary analysis by Cintra-Zachry concludes that seven major turnpike segments could be completed in the near term, and the consortium offered to invest $6 billion to design, build, and operate a 316-mile toll road between Dallas and San Antonio as part of the TTC-35 project.[55]

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In late 2009 after strong public opposition over various aspects of the proposed project became apparent, the Texas Department of Transportation announced it was rescinding the concession rights from Cintra-Zachry and canceling TTC-35 and the state legislature also failed to reauthorize the use of CDAs.[56] In 2010, the Federal Highway Administration formally ended the project.[57] While many cheered the sunset of CDAs, some industry experts remain cautiously optimistic about long-term PPP prospects in Texas.[58]

Virginia. Pocahontas Parkway in the Greater Richmond area was the first transportation PPP project completed since passage of the state's Public-Private Transportation Act of 1995.[59] Pocahontas Parkway is an 8.8-mile four-lane toll road linking I-95 with I-295 just south of the Richmond International Airport.[60] While the initial contract suffered from severe revenue shortfalls,[61] Australian toll operator Transurban took over the project in 2007 and secured a 99-year concession to exclusively maintain and improve Pocahontas Parkway.[62] Since then, Transurban has been able to dig out of the earlier debt it had assumed as part of the concession agreement and resolved the previous problems with revenue shortfalls.[63] It is estimated that without the PPP project, a traditional public road connecting I-95 and I-295 would have taken at least 15 years just to secure financing.[64]

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Virginia is also home to the Dulles Greenway, a 14-mile, six-lane PPP toll road that connects the state-owned Dulles Toll Road to Leesburg in Loudoun County.[65] The project was completed in 1995, but the original owner defaulted after revenue and traffic were far lower than predicted. However, the concession was taken over by Australia's Macquarie Group, which has since introduced a number of efficiency-enhancing measures, such as variable pricing and subscribing to the E-ZPass electronic toll-collection network.[66]

Recently, the Dulles Greenway had been the target of misleading, politicized attacks over scheduled toll increases. Virginia Congressman Frank Wolf (R) denounced the Greenway toll increases as "highway robbery. It's a disgrace."[67] Wolf also implied that the increases were unscheduled. The truth is that the toll schedule is and has always been set by the Virginia State Corporation Commission, and that it in part uses an inflation index to determine permissible toll increases.[68] He also failed to mention that there are "free," taxpayer-funded alternative routes—of course, those suffer from serious congestion problems, which is why the Dulles Greenway was built in the first place.

As shortfalls in government revenue since the recent economic downturn have made many of the more ambitious surface transportation projects more difficult, PPPs offer alternative financing solutions. States such as Texas and Virginia—the leaders of innovative PPPs in the United States—still face ideological opposition, but the trend seems to be against the government monopolists.

Real Estate Development and PPPs

Another sector that has seen a rise in public-private partnerships in recent years is real estate. Moreover, transportation and real estate are deeply intertwined. Many of the PPPs involving comprehensive property development or redevelopment have large transportation infrastructure components.

PPPs in the real estate sector can play a positive, albeit very limited role. Since the Base Realignment and Closure (BRAC) program's inception, the Pentagon has faced the difficult task of deciding what to do with property formerly occupied by military installations. One solution—provided the land is not severely contaminated by military waste—is redeveloping the parcels into commercial properties.[69] A 2002 RAND

Corporation study found that real estate PPPs will be crucial in the Army's efforts to reduce excess real property holdings and property upkeep costs.[70] BRAC PPPs are one example of where government can trim its real estate holdings and management responsibilities. Numerous others exist across the country, ranging from private developer LCOR's lease of the U.S. Patent and Trademark Office Headquarters Campus[71] to the redevelopment of the James A. Farley Post Office in New York City.[72]

However, while these are welcome instances of government reducing its real estate footprint, most real property PPPs in the United States involve government asserting power that it had not exercised in the past—generally under the guise of "economic development."

Since the U.S. Supreme Court's 2005 *Kelo v. New London* decision, significant public attention has come to focus on government intervention in property development.[73] The case centered on a comprehensive redevelopment plan meant to augment pharmaceutical giant Pfizer's new research and development campus in New London, Connecticut (Pfizer announced construction in 1998 and decided to close the facility in 2009).[74] The city devised a plan, financed in part by $15 million in bonds, that included financing for the Fort Trumbull State Park and a mixed-use development adjacent to the Pfizer campus.[75] City planners estimated that the project would create 1,000 jobs and bring in new tax revenue.[76]

After several homeowners refused to sell, the City of New London initiated eminent domain condemnations through a public development corporation set up to complete the plan. The private developer of the mixed-use property was to receive a 99-year lease at $1 annually in exchange for developing the property in a manner consistent with the city's plan.[77]

The U.S. Supreme Court, in an unfortunate 5-4 decision, upheld the Connecticut Supreme Court's ruling that private property takings for redevelopment purposes are constitutionally sound.[78] The lower court found that projected increased tax revenues and job creation resulting from potential economic development satisfied the requirements of the Fifth Amendment's Takings Clause, which restricts private property condemnations by government only when the land is taken for "public use" and the owner is given "just compensation."[79] This ruling, many legal scholars fear, has essentially rendered the Takings Clause meaningless in terms of its ability to actually protect individual property owners from

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unnecessary and unjust seizures. Justice Sandra Day O'Connor went as far to write in her dissent that the *Kelo* decision's effect was "to wash out any distinction between private and public use of property—and thereby to effectively delete the words 'for public use' from the Takings Clause."[80]

Land-use restrictions such as zoning distort real estate markets and are often used to justify public-sector involvement in real estate, under the argument that the private sector is incapable of fighting city hall—or so the story goes.

Fundamentally, property development is an area where government has very little positive to contribute. Government cannot accurately forecast future economic conditions, as the New London-Pfizer situation demonstrates. Public officials have far less expertise in real estate development than private sector investors. Moreover, land-use restrictions such as zoning distort real estate markets and are often used to justify public-sector involvement in real estate, under the argument that the private sector is incapable of fighting city hall—or so the story goes.

A March 2010 study on New York City rezoning, by New York University's Furman Center for Real Estate and Urban Policy, found that upzoned areas—those where zoning restrictions were eased to allow more types of development—were predominately populated by lower-income minorities outside of "high growth areas."[81] While upzoning will have beneficial effects on the neighborhood and the city as a whole, eliminating burdensome land-use restrictions such as zoning altogether would be preferable. Removing these restrictions would also neutralize the red-tape cutting argument for *more* government involvement in real estate development.

Real estate development policy nationwide has also become beholden to ideologically motivated planners. The so-called "smart growth" and "New Urbanism" movements, which aim to promote high-density "sustainable" and "livable" urban development, dominate urban development policy discussions across the country. These advocates have also received support from government entities such as the Environmental Protection Agency.[82] Proponents desire to limit "suburban sprawl" and attempt to create denser developments closer to the urban cores, supported by expensive public "livability" projects and transit systems. A new method of promoting and enforcing this ideology is the form-based code.

Form-based codes, which have become popular as zoning alternatives in the southeastern United States, go far beyond the government invasiveness of Euclidian zoning regulation.[83] In essence, form-based codes further undermine the spontaneous order that characterized the real estate market prior to the U.S. Supreme Court's seminal 1926 *Euclid* v. *Ambler Realty* decision, which held that separation-

of-uses zoning was constitutional, by greatly enhancing the ability of central planners to dictate the terms of development.[84] Unlike traditional zoning, form-based codes specify regulatory compliance and land-use requirements that go beyond broad separation of uses restrictions. While they are touted as an improvement over zoning, form-based codes are in reality considerably worse. Public-sector meddling is increased across the board—as are the resulting distortions. This includes new requirements on green space (*e.g.*, shade trees on private property and public parks), accessibility to public transit, and construction guidelines.[85]

Government in recent years has grown more interested in "aiding" the private sector in real estate development through PPPs. The justifications generally given are that markets alone cannot bring about redevelopment in certain areas—although, if true, policy makers rarely try to understand why that is the case—and the existing public institutions are inadequate or counterproductive. Most often, this entails either a comprehensive redevelopment plan as was seen in *Kelo* or the development of large single-purpose structures such as stadiums and indoor shopping malls. The following examples highlight the problems inherent in this sort of activity.

The Twin Cities have a long history of expensive, poorly planned development projects.

Minnesota. The Twin Cities have a long history of expensive, poorly planned development projects. Notable cases include the Hubert H. Humphrey Metrodome in Minneapolis' Downtown East neighborhood, St. Paul's downtown revitalization efforts, and various aborted urban renewal projects in impoverished north Minneapolis. The Minneapolis-St. Paul metro area is home to approximately 2.87 million people, with less than a quarter of them residing in Minneapolis and St. Paul proper.[86] City officials see this as a problem, and have launched several development PPPs designed to attract new residents, businesses, and retail customers from the suburbs as well as from other regions.

Downtown Minneapolis' Block E remains one of the most controversial projects ever undertaken by the city. In 1987, the city council voted to condemn the entire block, after years of threats of redevelopment.[87] Prior to its razing, the block was dominated by adult-oriented businesses, which attracted a clientele that city officials found undesirable. Nearly overnight, Block E went from a somewhat seedy business district to full-blown urban wasteland, complete with gang-controlled open-air drug markets. The neighborhood's astronomically

high crime rates (according to police statistics, about 25 percent of all downtown crime took place on Block E in the late 1980s[88]) led to local residents dubbing the city "Murderapolis."[89]

Over the past few decades, the city has undertaken some strange crime-fighting and urban development programs, including blasting Italian opera music over large speakers on the street corners to annoy drug-dealing gang members,[90] and the construction of a new $148 million shopping mall and a hotel—with $39 million in public support—when the entire downtown was watching its retail consumer base dry up.[91]

The retail and entertainment development formerly known as Xanadu Meadowlands—recently renamed The Meadowlands—has been plagued with problems since the planning stage.

Block E has been a complete failure. On December 31, 2009, the original developer of the retail complex, McCaffery Interests Inc., sold its stake to Union Labor Life Insurance Co. (ULLICO), the notoriously mismanaged union-owned financial services company.[92] The Minneapolis *Star Tribune*, whose editorial page ranks among the chief cheerleaders for public real estate investment in Minneapolis, was optimistic at this change in ownership:

> The new ownership arrangement at Block E should help the struggling entertainment and retail complex capitalize on two big changes in downtown Minneapolis: the new Twins ballpark opening in April, and a redesigned Hennepin Avenue that includes two-way auto traffic and pedestrian improvements.[93]

However, within four months, ULLICO announced it was selling Block E to Minneapolis condo developer Bob Lux.[94] The new Minnesota Twins stadium, Target Field, has since opened, but retailers continue to vacate their spaces or file for bankruptcy.[95]

New Jersey. The retail and entertainment development formerly known as Xanadu Meadowlands—recently renamed The Meadowlands[96]—has been plagued with problems since the planning stage. The East Rutherford megamall is located on the site of the Meadowlands Sports Complex, about seven miles west of Midtown Manhattan in Bergen County, and would be the largest retail and entertainment complex in the United States.[97] In addition to the shopping mall, Xanadu was to include an indoor ski jump, a basketball arena, a ballpark, a luxury hotel, and office towers.[98]

The 4.8-million square foot project was expected to cost $1.3 billion when developers Mills Corporation—which had originally proposed the

mall in 1998—and Mack-Cali Realty Corporation won the winning bid in February 2003.[99] In March 2003, losing developers Hartz Mountain and Westfield America Trust both sued the New Jersey Sports and Exposition Authority (NJSEA), the state agency that owns the Meadowlands property, in an attempt to halt the deal.[100] These lawsuits were ultimately unsuccessful, but the initial optimism over the project was already waning.

The NJSEA and Mills/Mack-Cali originally estimated an opening two years after groundbreaking, which occurred after the development consortium secured a 175-year lease from NJSEA in 2004.[101] In 2005, the New York Giants, a Meadowlands Sports Complex tenant, filed suit in New Jersey Superior Court in an attempt to halt construction of Xanadu.[102] The Giants claimed the project violated their lease agreement by obstructing views from the stadium, among other reasons.[103] This lawsuit was also unsuccessful, but Mills was already in deep financial trouble. In the spring of 2006, Mills had laid off 15 percent of its staff, shareholders had filed suit, and several state attorneys general and the Securities and Exchange Commission were investigating the company,[104] which soon announced it was looking for buyers.

Mills was eventually sold to Indianapolis-based Simon Property Group, which abandoned the project after financier Lehman Brothers collapsed and other lenders pulled out of what they believed was a doomed development.[105] Xanadu was then taken over by a new consortium led by Colony Capital, a real estate developer. The project continued to suffer from financing difficulties, which led to ongoing work stoppages. By this time, the budget ballooned to $2.3 billion.[106] Dan Fasulo, managing director of real estate analysis firm Real Capital Analytics, described the Xanadu project as “too big to fail,” citing extensive public liabilities.[107]

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In February 2010, billionaire Stephen M. Ross’s Related Companies, a major Manhattan developer, announced it was taking over the project.[108] This followed the release of a report authored by the transition team of Governor Chris Christie (R), which attacked Xanadu for its “failed business model” and which called on the state of New Jersey to tell the developers to “open or surrender the property” back to NJSEA.[109] The report concluded:

> There is no leasing plan making material on-site progress. The physical activities of construction are at a standstill, if not abandonment. The construction loan is out of balance. There are no monies readily available to finish construction

> of public areas or tenant improvements. Most, if not all, of announced major tenants have an "escape clause" solely dependent on leasing—or lack thereof.[110]

Atlantic Yards required extensive use of eminent domain—both the threat of condemnation and condemnation itself.

Officials were confident that Ross would be able to secure $500 million to $700 million in new financing and that an opening date could be expected as soon as mid-2011. However, in early July 2010, the role of Related Companies was still unclear, and the state was mulling the option of providing $180 million in emergency financing in a last-ditch attempt to save the project.[111] Ultimately, the state was unable to reach an agreement with Ross. In August, senior lenders foreclosed. As of December 3, 2010, Xanadu's lenders had yet to find another developer.[112]

Officials are considering tax increment financing (TIF), a method of public financing in which construction debt is financed by expected future tax revenue increases (the increment) that occur as a result of the property included in TIF district being more productive in the future.[113] This, however, carries significant risk—public services may be overprovided, and the likely possibility of harmful real estate market distortions should concern local policy makers.[114]

New York. About 15 miles southeast of Xanadu, an equally troubled real estate PPP complex is currently under development. Atlantic Yards is a mixed-use residential and commercial project comprised of 17 high-rise buildings located on the border of the Fort Greene and Prospect Heights neighborhoods in Brooklyn.[115] The development also includes a sports arena, since named the Barclays Center, which will serve as the new home of the New Jersey Nets NBA franchise.[116]

Atlantic Yards is the brainchild of real estate developer Bruce Ratner, who heads Cleveland-based Forest City Enterprises' New York subsidiary and is also part-owner of the New Jersey Nets.[117] In 2003, Ratner partnered with the Empire State Development Corporation (ESDC), New York State's public development financing agency, to redevelop a 22-acre zone comprised of a rail yard used by the Metropolitan Transportation Authority's (MTA) Long Island Rail Road and several parcels of private property adjacent to it.[118]

Unlike Xanadu, however, which is being built on land wholly owned by the state of New Jersey, Ratner's Atlantic Yards required extensive use of eminent domain—both the threat of condemnation and condemnation itself. Forest City Ratner Companies (FCRC) lobbied

heavily for this power, and the ESDC and supportive local politicians were more than happy to comply.

FCRC and ESDC touted a study authored by Smith College economist Andrew Zimbalist, which claimed that Atlantic Yards would bring the city 10,000 permanent jobs and $812.7 million to city and state coffers.[119] Zimbalist is well-known as a hired gun for professional sports stadium promoters, rarely finding a potential public-financed stadium he doesn't like. His 2003 report for FCRC was immediately criticized by a variety of economists and urban planning scholars for serious methodological flaws and overly optimistic revenue projections.[120] This has become quite common for Zimbalist. In fact, three separate courts tossed out or disallowed his testimony in 2008, citing concerns with Zimbalist's credibility as an expert.[121]

Rather than focusing on easing the public sector's burden on the private sector, city officials have chosen to inject politics even further into the local economy.

The negative reports didn't stop Ratner. FCRC and ESDC have moved forward with the project, which will put taxpayers on the hook for at least $1.6 billion.[122] Moreover, the residents and business owners fighting to save their neighborhood from the wrecking ball faced opposition from "community activists" Al Sharpton[123] and Bertha Lewis, CEO of the now-defunct Association of Community Organizations for Reform Now (ACORN).[124] It was later discovered that Ratner promised ACORN the control of low-income housing projects and quietly funneled millions of dollars into the organization, in exchange for Lewis's and ACORN's support.[125] Ratner got it. Lewis went to the press and staged demonstrations, and went so far as to claim that property owners opposed to condemnation harbored racial biases.[126]

Landowners fighting ESDC's eminent domain condemnations were largely defeated in early 2010, with the courts finding no wrongdoing in Ratner and company's private property seizures.[127] It should be noted that New York's eminent domain statute ranks among the worst in the nation in terms of the ability of owners to defend their property holdings from government condemnation.[128] The court challenges continue, but there seems to be little hope for Fort Greene and Prospect Heights residents and business owners.

Pennsylvania. Pittsburgh's population has declined by about 50 percent since 1950.[129] As is the case with many declining industrial cities, civic leaders are seemingly offended by this trend—as if they somehow are entitled to residents, jobs, and economic growth. Rather than focusing on easing the public sector's burden on the private sector, city officials have

The District of Columbia has struggled with redevelopment for the past several decades.

chosen to inject politics even further into the local economy. Beginning in the mid-1990s, the city—through its Urban Redevelopment Authority (URA)—began purchasing large parcels of property for the purposes of redevelopment.[130]

Then-Mayor Tom Murphy (D) proposed that the city redevelop downtown's Fifth and Forbes corridor.[131] Murphy courted Chicago developer Urban Retail Properties and signed an option agreement with the company in 1997.[132] The proposed $400-million redevelopment plan focused on creating 400,000 square feet of new retail space. In 1999, Urban Retail Properties obtained approval from the city for a 500,000-square-foot mixed-use development and began actively promoting it, with the promise of $53.5 million in public funds.[133]

Former City Councilman Sala Udin and the Pittsburgh Downtown Partnership formed the Downtown Planning Collaborative in early 2000.[134] The goal of this organization was to create planning recommendations for government and developers. Some sample recommendations include: Organic food stores, street performers, folk music clubs, a potential SmithKline Beecham "concept store," and expanded light rail.[135]

Thankfully, the Collaborative also explicitly opposed the city using eminent domain to condemn private property,[136] although this was largely moot given that much of the property was already owned by the URA. Following an outcry from residents and business owners, Murphy declared eminent domain condemnations for Fifth and Forbes redevelopment off the table.[137]

This turned out to be a wise decision. When one of the major retailers decided against opening a downtown Pittsburgh location in late 2000, Urban Retail Properties pulled out of the project.[138] The city had essentially wasted three years on a project that would never materialize. A series of developers and failed projects followed. During the next 10 years, no fewer than four redevelopment proposals were floated.[139] Eventually, local developer Millcraft Industries began considering more surgical redevelopment opportunities.

By the end of the decade, the city had largely abandoned the idea of centrally planned comprehensive redevelopment. Millcraft has been slowly redeveloping parts of the downtown piece by piece, and has been quite successful with new commercial and residential properties.[140] Some neighborhood activists, however, still question the long-term viability of these projects.[141]

Washington, D.C. The District of Columbia has struggled with redevelopment for the past several decades. Following the assassination of Martin Luther King, Jr., in 1968, the city was literally set ablaze. The rioting destroyed many commercial corridors and working- to middle-class residential neighborhoods.[142] Much of the city remains scarred by the riots to this day.

In 1995, notorious D.C. Mayor Marion Barry had been reelected and the city's finances were placed under control of a federally appointed financial control board.[143] The federal receivership lasted for six years. During this period, reformers on the city council began examining redevelopment options for some of the areas destroyed in 1968. Much of this involved property along the Washington Metrorail, a rail transit system built in the 1970s that has been gradually expanded.[144] One interesting example of redevelopment planning centered around the Navy Yard neighborhood in Southeast Washington, on the west banks of the Anacostia River.

As cost estimates became public, the massive ballpark project attracted opposition from across the ideological spectrum.

Historically, the neighborhood was dominated by the Washington Navy Yard, a facility that saw continuous operation from the birth of the capital in the late 18th century until the years following World War II, when it was drastically scaled back.[145] Already in decline, the neighborhood was dealt a death blow when a portion of Interstate 395 cut through it.[146] This separated the Anacostia riverfront portion from Capitol Hill, and the neighborhood—particularly the residential and industrial zones closest to the river—became overrun with crime.[147] From the middle of the 20th century until the early 2000s, very little economic development took place around the Navy Yard. From the 1960s until the early 2000s, the area was home to several bars and nightclubs, most of which catered to D.C.'s gay community.[148]

Following a BRAC decision to consolidate Naval Sea Systems Command (NAVSEA) to Washington Navy Yard in 1995 and—a few years later—the decision to build a new 1.35-million-square-foot Department of Transportation facility, city officials began to lead a coordinated push for comprehensive redevelopment PPPs in the neighborhood.[149]

Many local officials and community activists had long sought to bring a Major League Baseball (MLB) franchise to the district, which had lacked a major league team since the Washington Senators relocated to Arlington, Texas, after the 1971 season, and were renamed the Texas Rangers.[150] City officials and their allies in the business community (such as large developers Forest City and Lerner) lobbied MLB for an expansion

team. In 2004, they got their wish when MLB and the city reached an agreement to move the Montreal Expos to D.C.[151] The team was renamed the Washington Nationals. Following this, the city's development agents began aggressively acquiring property in the neighborhood.

The elements of these five real estate PPPs vary greatly, but all share some key characteristics: fiscal mismanagement, handouts to business or labor interests (or both), and top-down central planning.

As cost estimates became public, the massive ballpark project attracted opposition from across the ideological spectrum. The city often highlighted the $611 million price tag on the stadium itself, of which $535 million was to be financed through the sale of municipal bonds.[152] Unfortunately, given several missteps—including requiring Project Labor Agreements (PLAs) that turned the project into a make-work union giveaway—the actual cost to the city was approximately $700 million.[153]

The city's decision to finance a major league ballpark was concurrent with broader redevelopment goals. Unfortunately for District taxpayers, much of this planning occurred at the height of the real estate bubble. To give some idea of the extent of Navy Yard real estate malinvestment, 12 million square feet of office space was planned.[154] As of the second quarter of 2010, only about 6.5 million square feet of office space had been built.[155] Of the current office space, the vacancy rate is approximately on par with the city-wide average[156]—hardly indicative of a neighborhood renaissance.

The city's administration has since changed and top-down planning involvement from City Hall seems to have been wound down. Neighborhood planning is now coordinated by the Capital Riverfront Business Improvement District (Capital Riverfront BID), which has taken a more cautious and realistic approach to future development. With much of the revitalization effort still in the planning stage or mothballed due to private financing difficulties, it remains to be seen if the ambitious redevelopment plan as presently conceived will ever become more than just expensive wishful thinking.

The elements of these five real estate PPPs profiled above vary greatly, but all share some key characteristics: fiscal mismanagement, handouts to business or labor interests (or both), and top-down central planning. The extent of social harm created through public sector subsidies also varies—ranging from New Jersey's Xanadu project facing imminent collapse to Pittsburgh's recent shift toward more humble (though still pernicious) planning. But make no mistake: All of these projects have misdirected investment to projects that the private sector, absent public subsidies, would never have developed.

Conclusion

The purpose of this paper is to draw a bright-line distinction between two common forms of PPPs: those in the surface transportation and real estate sectors. The goal of development policy should be to allocate resources in the most efficient manner possible, and market discipline is critically important in this respect. In other words, the market should guide development decisions.

But these sectors are hardly similar, as the case studies bear out: One has long been dominated by government monopolies and the other has been largely free of political forces. In the case of surface transportation infrastructure, innovative new private-sector financing, management, and ownership regimes have much to offer in terms of minimizing taxpayer exposure, capturing user revenues, and creating an efficient transport network. In contrast, government's recent expanded role in real estate development has increased taxpayer exposure to risk, socialized costs, and concentrated the benefits into the hands of select private developers and special interests.

The popularity of PPPs should not blind policy makers to the fact that these sectors suffer from problems that are markedly different. A responsible path forward would be to utilize PPPs in surface transportation infrastructure development and management, while cutting bureaucratic impediments such as land-use regulations and business licensing to promote redevelopment. In essence, both require reducing political forces and expanding market forces. Only when policy makers realize their own limitations will these sectors be free to maximize wealth creation that could potentially bring about a new era of American prosperity.

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