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Using public real estate to fuel a postpandemic recovery

As deficits mount, governments can use their real estate holdings to create breathing room.

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The public sector has responded to the COVID-19 crisis with staggering outlays, in some cases up to 40 percent of GDP, to save lives and livelihoods. On balance, the spending seems likely to serve its purpose—by keeping economies going until a vaccine and therapeutics can be developed and distributed. But it will also likely produce a $30 trillion deficit by 2023, which will put pressure on operational budgets and result in service cuts. In the United States, for example, 66 percent of counties have cut or delayed infrastructure maintenance and 54 percent have cut or delayed new infrastructure projects.[1] Many states are facing a future in which spending on important everyday services—mass transit, adult and elderly care, mental health support, substance-abuse programs, school programs like special education, children's health insurance, and more—will become more difficult.

Governments are borrowing to plug the gaps. Public debt is set to expand dramatically this year, by 16 percent in advanced economies, and 17 percent in emerging middle-income countries.[2] The new obligations come at a time when public-debt levels in many nations are already at their historical peak. A high debt burden limits a government's ability to raise the financing required to fund growth; many have debt thresholds they cannot breach. Today, many governments are unable to raise more debt. Further, such a burden makes default more likely if operating cashflows shrink. Three countries have already defaulted in 2020, and more are likely.[3]

How will governments maneuver between the rock of service requirements and the hard place of financial default? One possible passageway is through financing mechanisms that remain largely untapped. Governments have an opportunity to reimagine their finances by focusing on one of the most underappreciated public assets—their real estate holdings and operations. In this article, we will outline the possibilities and discuss three structures that allow governments to manage and invest their real estate assets. Each of these have proved effective in different settings around the world. They are not, however, recommendations, as every public context has its own requirements. Moreover real estate is only one aspect of the broader question of public wealth, which we will address in upcoming research.

The opportunity of public real estate

Government is a huge holder of real estate, as well as a tenant. For example, the US federal government owns about 885 million square feet of building space, and it leases another 254 million square feet.[4] For cities, some estimates suggest that the entire public portfolio of real estate within a city has the same value as the city's GDP and could represent a quarter of the total market value of real estate.[5]

Governments can realize the value of public real estate in two ways—earning their passage through a modern-day version of the Greek legend of Scylla and Charybdis. First and most important, they can increase the value of the asset through better management or rethinking its use. For example, in Rio de Janeiro, Brazil, Escola Municipal Doutor Cícero Penna is an ordinary public school in an extraordinary setting. It's located on Avenida Atlântica, the famous stretch facing Copacabana Beach, surrounded by luxury high-rises on perhaps the most expensive land in the country. Education is of course vital, but it could be conducted a couple of blocks away on much cheaper land, in an environment that might also be more conducive to students' learning. The city could realize the highest value of the beachfront property, while still retaining ownership. It could build an equivalent or better school with part of the revenue from developing the more valuable property; the remainder would flow into the general account. Cities around the world have thousands of similarly overlooked opportunities.

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[1] *Comprehensive analysis of COVID-19's impact on county finances and implications for the U.S. economy*, National Association of Counties, July 2020, naco.org.
[2] *World economic outlook update, June 2020: A crisis like no other, an uncertain recovery*, International Monetary Fund, June 2020, imf.org.
[3] "Sovereign defaults set to hit record in 2020," Fitch Ratings, May 12, 2020, fitchratings.com.
[4] Federal Real Property Profile Summary Report Library, US General Services Administration, October 4, 2019, gsa.gov.
[5] Dag Detter and Stefan Fölster, "Unlocking public wealth: Governments could do a better job managing their assets," *Finance and Development*, March 2018, Volume 55, Number 1, pp. 44–7, imf.org.

Despite the benefits, governments have not been able to tap into the hidden goldmine of their real estate portfolios for several reasons.

A second kind of fiscal space is created if governments are able to issue debt secured by their real estate portfolios and held in special-purpose vehicles (SPVs), which may be more appetizing to investors than sovereign debt or general-obligation bonds, as well as to governments, as both of these can affect a government's credit rating. For example, assume that an issuer can raise 30 percent of the portfolio's value in debt, as is typical for investment-grade bonds in the United States. If the portfolio is equivalent to about 50 percent of a city's GDP, and provided they can create sufficient SPVs as discussed below, cities can raise additional debt of about 15 percent of GDP. Both levers create additional cashflow that in turn could pay for the services that governments must continue to provide.

Why this hasn't happened so far

Despite the benefits, governments have not been able to tap into the hidden goldmine of their real estate portfolios for several reasons. First, there are the technical problems of accountancy. Many national governments don't produce true financial statements that would recognize assets or amortize investments, among other features. Instead they rely on annual budgets and the deficits and surpluses they produce. That kind of short-term thinking hampers the development of debt policy or a true capital investment program.

City and state governments do produce financial statements, but they have their own accounting problems. In the United States, subnational governments follow Governmental Accounting Standards Board (GASB) guidelines in preparing their financial statements. The guidelines hold vast sway, since creditworthy debt cannot be issued without financial statements that adhere to them. GASB guidelines presume that the main purpose of government assets is to provide services as opposed to generating cashflow. This approach overlooks the ways that service needs change over time, and it does not recognize the value of the asset based on its potential to generate cash. Most cities record real estate at its book value rather than at market value. The difference can be enormous: in the city of Boston, indicative market value was shown to be almost 40 times[6] book value and in Pittsburgh, 70 times.[7]

A second problem is multiple and overlapping layers of government. Real estate assets are governed and managed by hundreds or even thousands of discrete agencies and authorities. Many local governments do not have a consolidated list of their assets. It's no accident that Singapore is so often cited for its sound public-sector management. The absence of multiple layers of government along with its geographic concentration result in unitary management, which alone would allow for much stronger financial thinking.

[6] *World Bank Blogs*, "Paying for development—Governments are sitting on a 'goldmine,'" blog entry by Dag Detter and Marco Scuriatti, April 10, 2019, blogs. worldbank.org.
[7] Hanan Amin-Salem, Ian Ball, Dag Detter, and David Walker, "How smart public assets management can drive the post-COVID-19 recovery," Citi, October 15, 2020, publicwealth.se.

Two other challenges stand out in some parts of the world. Unlike Singapore—where an apolitical, professional cadre of civil servants is considered a norm and highly valued—other countries suffer from a politicization of government that deprives them of access to the best minds. Historical norms around government compensation and incentivization may also make it difficult to recruit and retain financial talent. Finally, privatization, though it provides that access, must bear in mind the crucial differences between public and private context. Defining and maintaining the mandate to provide public goods is a critical challenge that when ignored has left citizens justly suspicious of privatization efforts.

Three structures to realize public real estate value

Creating dedicated organizations that will professionalize the management of governments' real estate assets will create value and fiscal space. Three distinct structures—a centralized government unit, an SPV governed by a public entity, and an arm's-length institution—offer one or more of three benefits (exhibit).

The three structures represent a progression in the rewards from and potential impact of public real estate. Each also incurs setup costs including the need for talent, market-based information, and regulatory change.

The centralized unit offers the promise of enhanced accountability for operating assets, which could be sufficient for property management. The SPV adds the benefit of an independent balance sheet—which may be needed to raise new debt that sits on a separate balance sheet, thus minimizing the impact on the government's credit rating and enhancing its debt-raising capacity. An SPV also has potential to attract top talent through performance-linked incentives and agility in procurement of subdevelopers and contractors. Finally, the arm's-length institution provides both accountability and an independent balance sheet, as well as the third benefit of creating a truly sustainable and

Exhibit

Governments can choose among three institutional options.

	Centralized government unit	Special-purpose vehicle	Arm's-length institution
Relevant use	Property management	Land development	Financing and development of real estate and infrastructure
Benefits			
Enhanced accountability	●	●	●
Independent balance sheet		●	●
Autonomous governance			●
Implementation requirements	Access to top talent; empowered mandate; budgetary support	Access to top talent; ownership of income-generating assets; independent accounting (financial statements)	Access to top talent; independent board; access to capital markets for funding; independent accounting (financial statements)

autonomous model for real estate asset management. Private-capital mobilization may even require arm's-length institutions to assure private markets that project selection is done on a commercial basis and is not subject to political influence.

Centralized government unit

Centralizing management of the government property portfolio in a single unit can unlock value by reducing the misuse of real estate assets, such as schools on beachfront property.

The centralized unit needs adequate authority to influence the ministries that own real estate and other government entities that use public property. That authority can be derived either from direct sponsorship by the highest political office or through ownership of the property titles in the unit-managed portfolio.

In 2011, New Zealand centralized public property management in the newly created Government Property Group (GPG), which covers property owned or leased by 62 government agencies, including all office accommodation and public-facing areas. Between 2011 and 2017, GPG saved $275 million in rental and facilities management. Some was hard savings, and some was cost avoidance achieved by reducing the size of the government's office requirements by 207,121 square meters, which is equivalent to 30 football fields. The unit also lowered the average rental cost per employee to $5,066, versus a comparable private-sector average of $7,328.

GPG strives to achieve efficiency in property management, typically by promoting collaboration between agencies and thus a more effective public service. Co-locations are one way agencies can share resources, work more closely together, and deliver more cohesive public services. In 2020, GPG opened four new office buildings in Christchurch; three have several agencies co-located in them. These modern buildings are showing other agencies how they can share facilities, help reinvigorate the central city, and provide seamless services to the public.

Many countries have succeeded with centralized government property-management units. Australia's Property and Construction Division (PCD), part of the department of finance, manages the nondefense portfolio of government properties, including commercial office buildings, law courts and other special-purpose properties, public-interest properties, heritage buildings, residential properties, and vacant land. In 2008, Dubai established wasl as part of the government's Dubai Real Estate Corporation (DREC) to manage and expand its real estate portfolio. The unit's main objective is to establish Dubai's position as a premier location to live and work and an attractive destination for tourists.

The special-purpose vehicle

Federal, state, and local governments can set up corporatized entities—with their own balance sheets, profit and loss, transparency, and professional management—to develop real estate, manage assets, and raise financing. The corporate entity can then use its property assets, booked at market value, as collateral to raise debt. The proceeds can be used to provide services, invest in new infrastructure development, or for other suitable ventures. By placing some or all of its real estate portfolio in an SPV under a publicly owned and professionally managed entity, the government can raise capital and also create visibility into its real estate assets and the value those assets can create.

Many governments have set up SPVs over the years. For example, the city of Copenhagen was able to monetize some unused land at Ørestad by transferring it to the Copenhagen (CPH) City & Port Development Corporation (the Corporation). Following the transfer, the local government rezoned the land for residential and commercial use. By borrowing against the value of this newly acquired land, the Corporation was able to make a one-time payment of $2 billion to Metro Construction Company to fund the expansion of a transport system.[8]

Today, the Corporation continues to use funds borrowed at low cost against its balance sheet of

[8] Bruce Katz and Luise Noring, *The Copenhagen City and Port Development Corporation: A model for regenerating cities*, The Brookings Institution, June 2017, brookings.edu.

assets and enabled by the city's AAA credit rating and a central bank guarantee to achieve greater leverage than comparable private-sector entities. In its 2019 annual report, the Corporation reported debt of $2.3 billion against a total asset base of $2.4 billion (a 95 percent debt-to-asset ratio; most investment-grade companies' leverage is less than 50 percent[9]). However, because the Corporation's financing is guaranteed by the central bank, it still burdens the government with higher costs and potentially affects the sovereign credit rating, which would not be the case if the guarantees were issued by an arm's-length financial institution. Moreover, while its corporate status allows it to make decisions independent of electoral and political concerns, the Corporation is still subject to state oversight.

The arm's-length financial institution

Governments can finance development of new real estate assets and associated infrastructure through an autonomous financing institution that unlocks private-sector financing by either finding ways to share risks with private investors, such as guarantees, or cofinancing along with the private sector. Some of the new assets in which the arm's-length institution invests may be built on land the government owns and sells to the institution, creating fiscal space for the government. Such an institution requires the highest level of accountability and talent but also promises the greatest return for governments.

To ensure that financing decisions are based on a robust appraisal of the project and assessment of its risks, rather than political considerations, three critical success factors need to be in place:

— *A clear mandate.* Institutions need to have a clearly defined mandate to be able to balance often-competing objectives (for example, creating "additionality" [that is, incremental financing that does not simply crowd out the private sector] versus maximizing financial return).

— *Operational autonomy.* The institution needs an independent board that appoints professional managers.

— *Talent attraction.* The institution must offer a compelling proposition to top talent. The ability to structure commercially viable deals and underwrite credit risk is a key differentiator between high-performing institutions and others.

The Canada Infrastructure Bank (CIB) was set up in 2017 as a Crown corporation with an independent and professional board that reports to the parliament through the minister of infrastructure and communities. Its mandate is infrastructure, not real estate. The ownership structure and governance of the CIB was designed to ensure the three critical success factors above. As of March 2020, the CIB is participating in nine transformational projects that are in the public interest, linked to national economic priorities, and delivered in partnership with public-sector sponsors and private and institutional investors. All projects will generate revenue, and all are commercially viable, having satisfied commercial due diligence requirements including private-sector investment.

In the wake of the COVID-19-induced shortfall, governments need to create fiscal space in coming years. Public real estate is a notable opportunity to meet this requirement and to enhance accountability and fiscal performance of the public sector.

[9] Richard Cantor and Albert Metz, *Moody's Special Comment: The distribution of common financial ratios by rating and industry for North American non-financial corporations: July 2006*, Report Number 98551, Moody's Investors Service, August 2006, moodys.com.

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