THE HIGH COST OF DISINVESTMENT

Stanley J. Hallett

About the Author

Stanley J. Hallett represents a unique combination of academic background and practical experience in dealing with neighborhood disinvestment.

Under joint appointment at Northwestern University, Dr. Hallett is a lecturer at the Graduate School of Management, and an associate of the University's Center for Urban Affairs. His research and teaching areas cover inner city banking, urban planning and management, and health action programs. His educational background includes a Ph.D. from Boston University.

Dr. Hallett is President of the Woodstock Institute, a not-for-profit corporation which does policy research and development, conducts public education and provides technical assistance to the public, private and voluntary sectors.

Dr. Hallett has worked extensively in the revitalization of the South Shore area of Chicago. He is a Vice-President of the South Shore National Bank. He serves also as a member of the Board of Director of the Illinois Neighborhood Development Corporation, a bank holding company that owns the bank.

THE HIGH COSTS OF DISINVESTMENT

The budgets of our city and state governments are stretched tight, some to the breaking point. The pressures created by this fiscal strain are prompting a new look at the relationships between our public and private economies, and the ways in which they interact in urban regions. This new look is calling into question some of our traditional ways of doing business, and assumptions on which those ways are based. The purpose of this paper is to probe some of the public policies and private practices and developments which shape the flows of money in urban regions, and to stimulate the inquiry into alternatives for our cities and states.

The paper will look at: 1) the flows of funds in the neighborhood economies; 2) the flows of funds in urban regions; and 3) the costs of the current patterns of investment and disinvestment.[1] The constructive task of exploring alternative policies and programs will be addressed in other papers.

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[1] "Disinvestment" is discussed in work paper 2 on page 31. It includes actions by individual property owners, financial intermediaries and public officials which result in the reduction in or refusal to extend capital investment in facilities and services within a fairly well defined area of a city.

The Flow of Funds in Neighborhoods

Banks, and other financial institutions, can be viewed as the financial plumbing system of neighborhoods and regions. They are like the sewer and water system needed by every community. For the most part, they are invisible. While used by almost everyone, they are generally out of sight and out of mind, except when they don't work!

Credit, like the water system, is essential. "Credit" implies belief in the future. To "discredit" is to shut off the funds which is the equivalent of shutting off the water in a house. Banks and Savings and Loans continue to receive deposits from neighborhoods, even when they have shut off the credit. The sewer system still works, and it is not surprising to see neighborhoods going down the drain.

The economy of a neighborhood begins with people, and the activities in which they participate (see figure 1, page 7)*. The private economy includes houses, churches or other associations, convenience shopping such as food, drug, or hardware stores, and comparison shopping such as appliance, clothing, or department stores, and a range of services. The public or quasi-public economy includes institutions such as hospitals, schools, libraries, public offices, parks,

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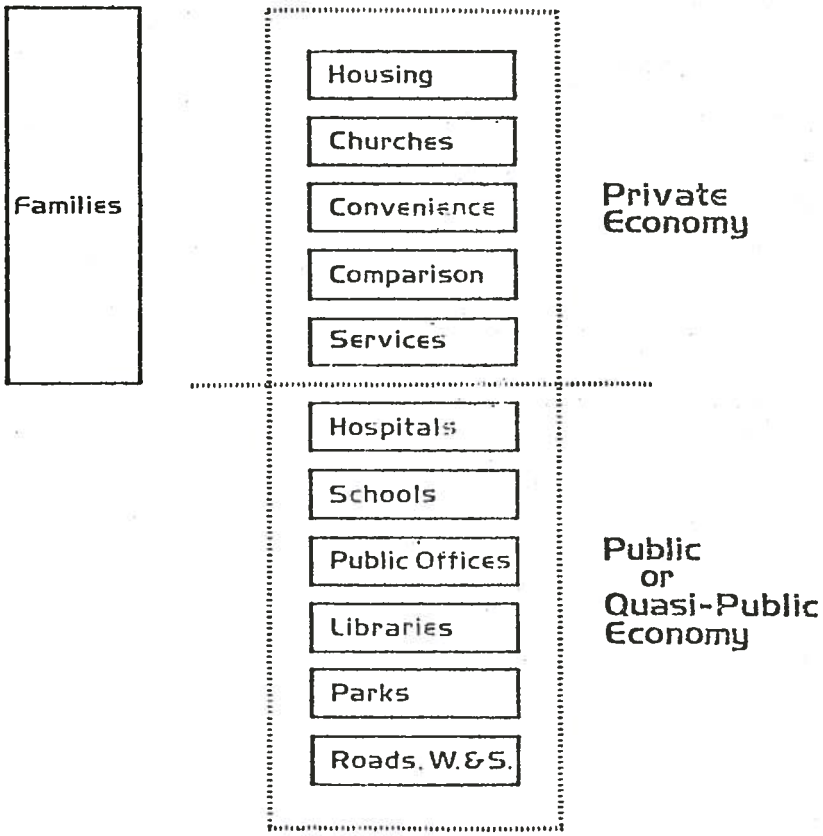
FIGURE 1
Families and Neighborhood Activities



and physical infra-structure including sewer, water, and roads.

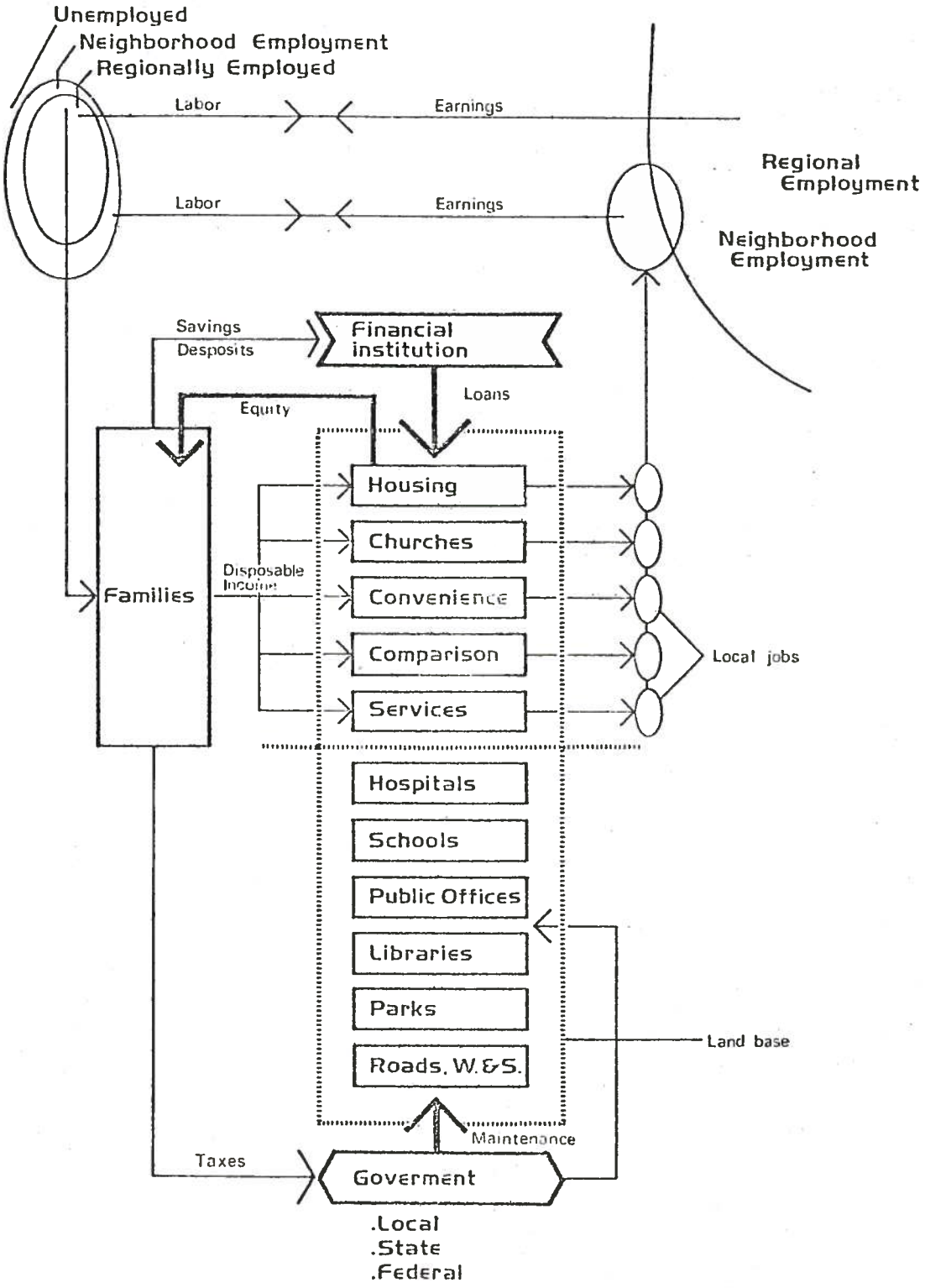
These elements of a neighborhood are linked into a set of relationships which control how much money is going to flow through the piping system of a community (see figure 2, page 5). Members of the households provide the work force, some of whom work at regional jobs, others of whom work in the neighborhood jobs, and the remainder are unemployed, or not part of the work force. It is important to note that consumer-oriented, neighborhood jobs have been increasing rapidly in our economy. Factory employment in actual numbers is about where it was in 1954.

The neighborhood jobs are particularly important for families on the lower rungs of the ladder, where the second or third income counts heavily. Whether or not there is employment for the teen-ager, mother, or grandmother is very important for a family in the $4,000.00 - $8,000.00 a year level trying to move from a status of subsistence to a status of economic growth.

The ways in which the economics of neighborhoods work are keys both to family budgets and to governmental budgets--local, state, and federal. A new neighborhood under construction, or an older neighborhood caught in a downward spiral of deterioration, each make unusual demands on public funds and create

FIGURE 2

Neighborhood Econmic Relationship



Stable Neighborhood

quite different contexts of opportunities or constraints for families.

One way to begin the inquiry is to ask: are we managing city neighborhoods in ways which create opportunities for individuals and families to improve themselves economically, or are we managing them in a way which breeds or creates a welfare trap? Do residents--individuals and families--have a reasonable opportunity to move up the ladder, from survival subsistence where they are dependent on welfare or unemployment, to marginal-independence where they can make it on their own unless there is serious illness or periodic high unemployment? Can they move from there to being initial accumulators, where they have a down-payment on a house or car; or to moderate accumulators with savings, investments, and reserves enough for example, to send children to college? Or, move to rapid accumulators where money is multiplying itself? It is important to keep this ladder of human economic development in mind as we look at the economics of neighborhoods.

People work, generate earnings, and provide a base of disposable income which sustains the activity centers and provides taxes which are channeled by government into facilities and activities. And the neighborhood activity centers provide jobs, which

in turn provide income, to keep the cycle working.

Under normal circumstances, the financial institutions make it possible to aggregate some of the funds, and to extend credit so that people can buy homes. The institutions thereby facilitate the people-family stake in the neighborhood. Institutions also extend credit to the activity centers each of which at times in their history need additional resources to change, adapt, and develop new lines of activity in the face of changing circumstances, values, or opportunities.

The financial institutions, however, may decide to turn off the credit faucet,[2] and instead of pumping money back into the neighborhood, may channel it out (see figure 3, page 8). The reasons given for this decision vary widely. It may be racial or ethnic change in the population, aging of the facilities, a decline in population with a weakening of the market, or something quite idiosyncratic, like new owners of a financial institution who have other uses for the funds.

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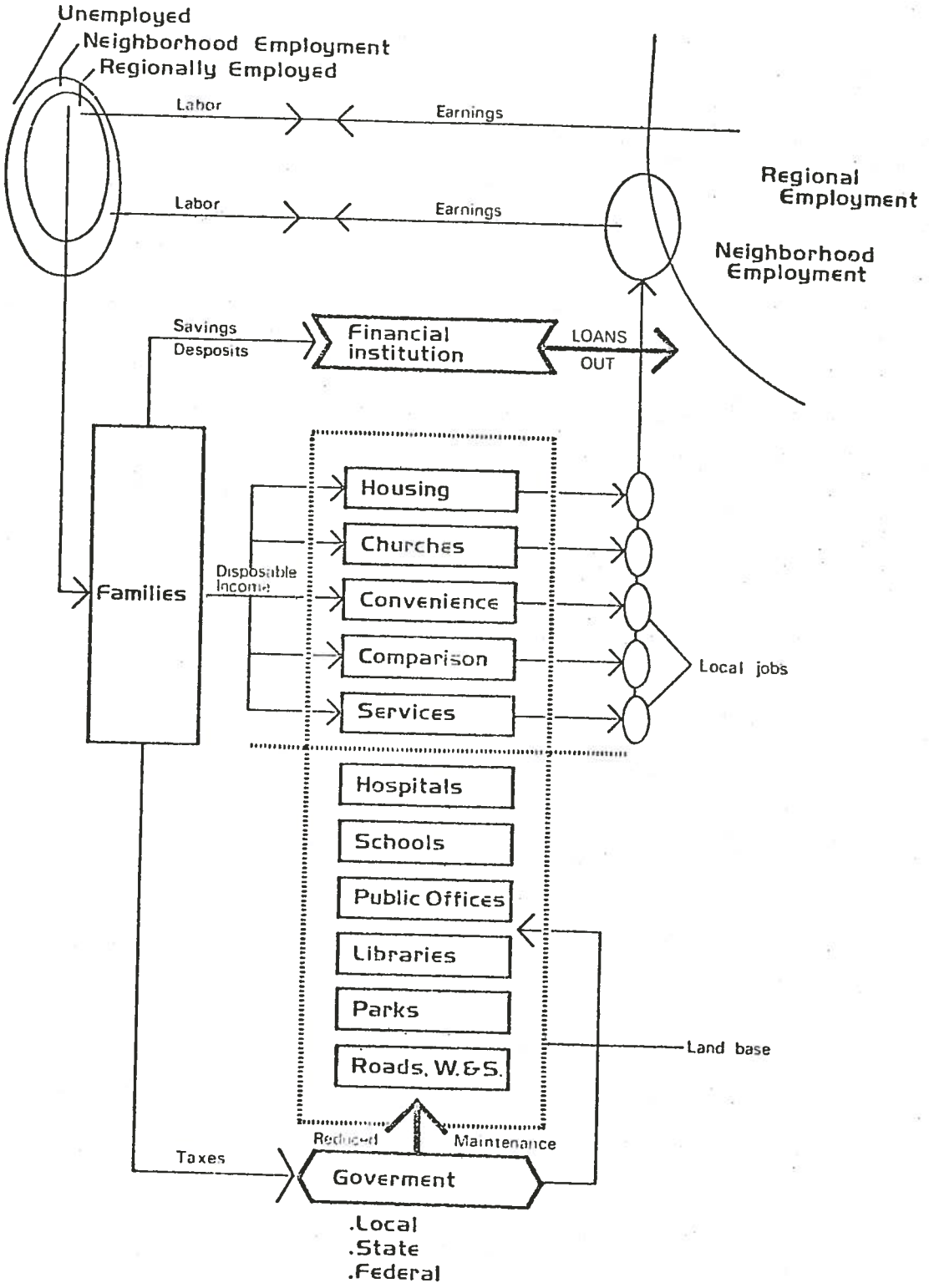
[2]Denying or limiting credit in specified neighborhoods without regard to the credit worthiness of the individual mortgage applicant or the quality of the specific property has come to be known as "Redlining."

FIGURE 3

Denial of Credit



Redlining

The decline in population seems to be an increasingly important factor. The national population shifts from East to West and from North to South, and the regional shifts from central city to suburban and small town mean that increasingly our city neighborhoods will be losing some population. If this triggers a shut off of credit, it will mean the decline in population, instead of being the opportunity for improving neighborhoods and making them more liveable with lower densities, will trigger a downward spiral of deterioration and decay.

As the shut off of credit, or redlining proceeds, several important changes start to occur in the neighborhood economy. Jobs disappear, and with them the income for families whose members held those jobs. An example of this phenomena occurred in the South Shore area of Chicago where it has been estimated that a loss of 300-400 jobs occurred in housing maintenance alone when the area was redlined. Jobs are lost from the commercial and service sectors. And the housing values start to drop, so that even those families who have an investment in a house find that the value of the house is declining faster than their equity is building up. They have been caught in double jeopardy. Taxes start to decline, and government is likely to cut back some of the normal maintenance.

However, government is caught in a peculiar position. As the neighborhood declines (see figure 4, page 11), governmental costs start to rise. Families, having lost their income base, become dependent on welfare or unemployment. Care and medicaid costs start to rise. Social service costs start to go up. And equally important, some of the standard services such as schools and police start to lose their effectiveness. Educating children for jobs which don't exist in their life experience is a frustrating and frequently hated exercise. And the transiency goes up, with educators frustrated at trying to teach a moving stream. Transiency and stakelessness are also critical factors in neighborhood security, and the police fight an expensive, losing battle when the community fabric breaks down. More public funds into family income maintenance and expanded social services does not have the effect of restoring the neighborhood economy. The public costs go up, but the downward spiral continues.

At the same time this process is going on in some neighborhoods, an upward spiral is present in new neighborhoods (see figure 5, page 12). Funds are flowing in through the credit institutions to developers who are generating jobs as they build

FIGURE 4

Neighborhood Decline

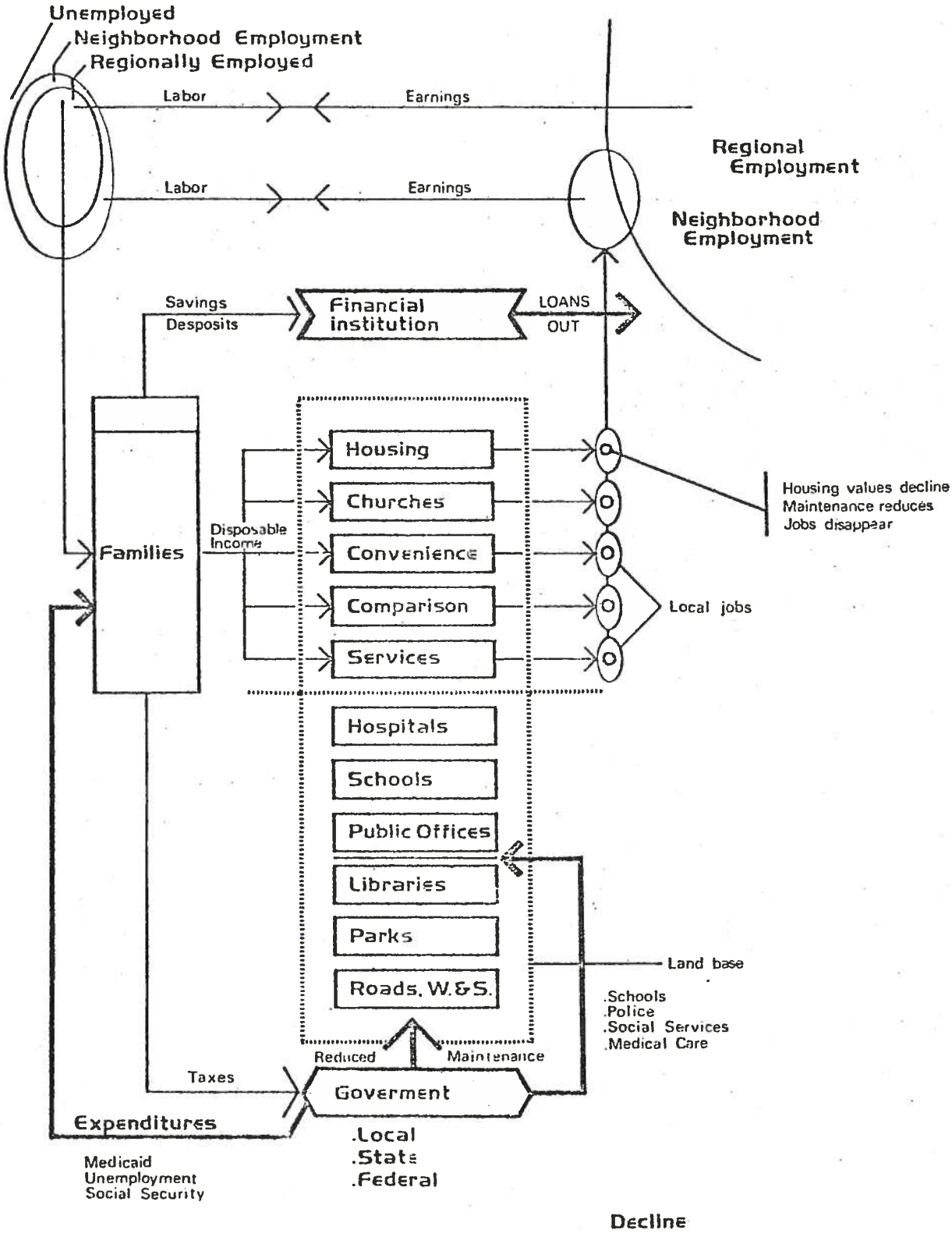
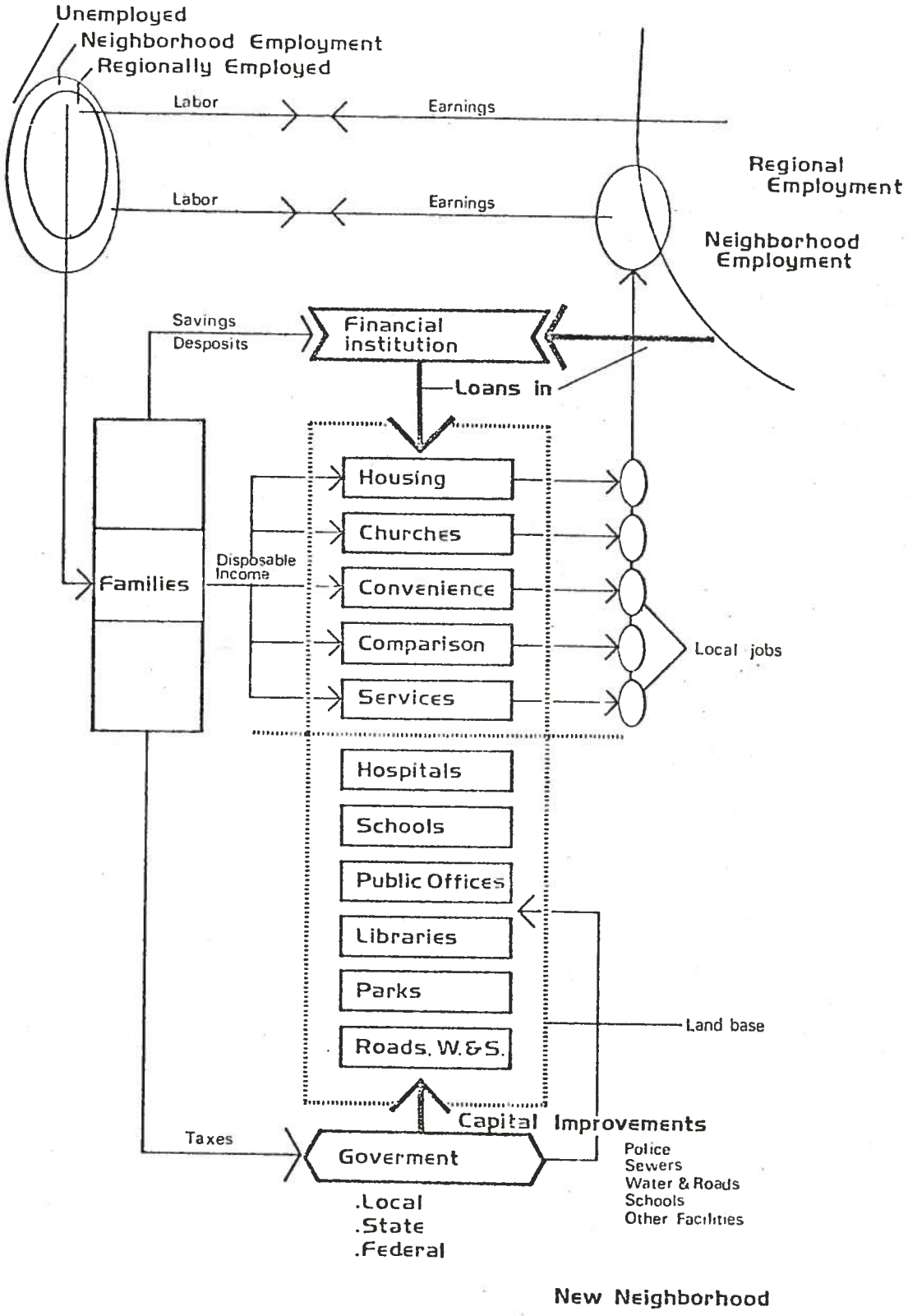


FIGURE 5

New Neighborhood



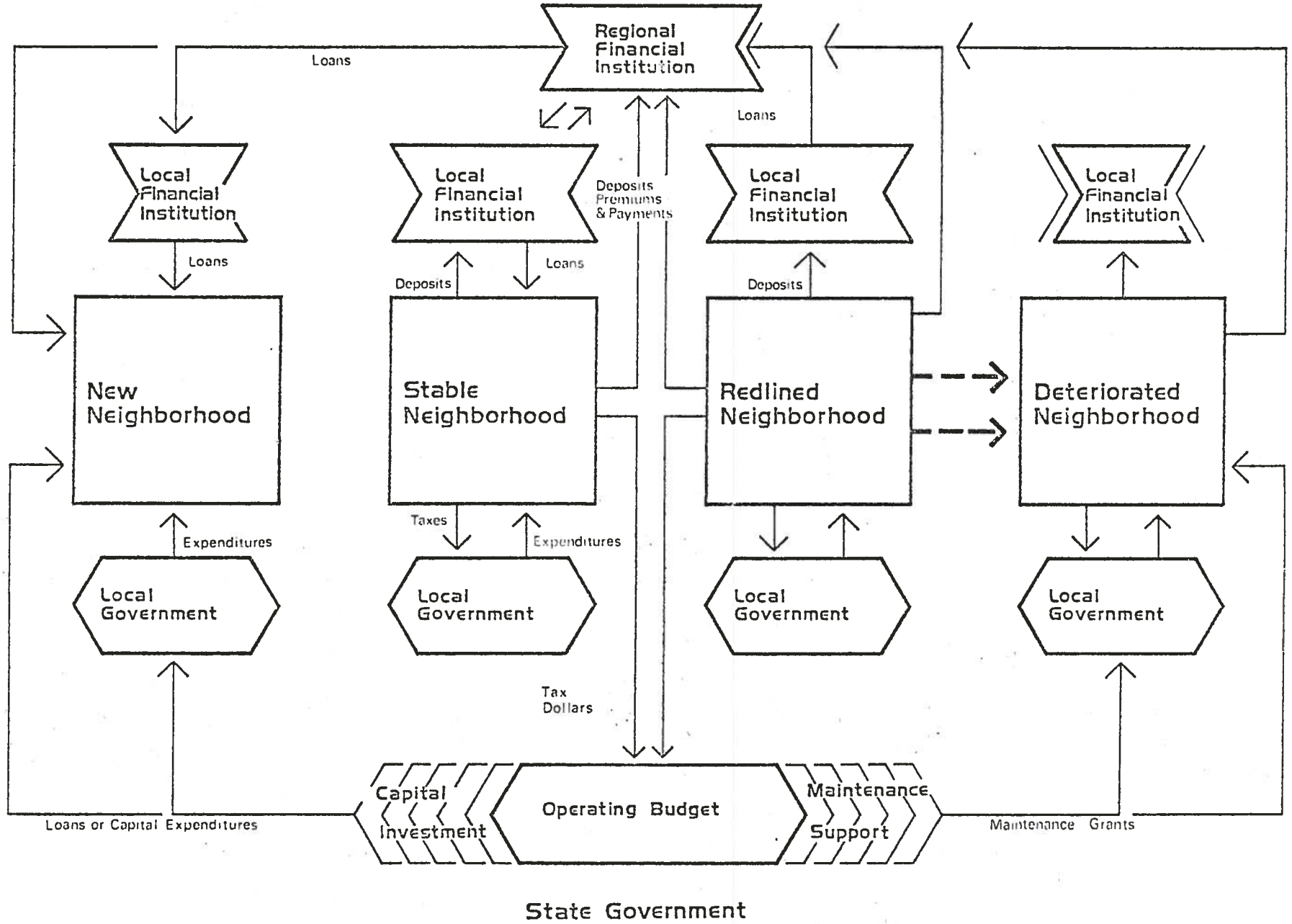
a new community. And large amounts of public funds are flowing into the capital improvements, the roads, sewer, water, and public facilities required for the new community. Values are rising, and those who invest early are in a good position, provided, of course, that development continues.

The Flows of Funds in Urban Regions

If one looks at the flows of funds in a region, (see figure 6, page 14), what one sees is some stable neighborhoods in which the funds are being recycled. Money goes into banks, and flows back as credit. Money is paid as taxes, and comes back as job-generating services. But there are some redlined neighborhoods, where the money is flowing out through the financical institutions. Local banks lend to the regional or money center banks, and they in turn lend the funds in other parts of the region. As the redlining effects proceed, the neighborhood deteriorates. The financial institutions shrink, or may even abandon the area. The maintenance costs of government start to rise.

In the new community funds are flowing in, creating jobs which in turn strengthen the demand for housing and other facilities. Public capital expenditures rise accompanied by increased bonded

FIGURE 6 Regional Flow of Funds



indebtedness. New communities are likely to be mortgaged to the hilt, both in terms of family and public budgets. Failure of a new neighborhood to grow at the projected rate creates serious problems. The very large losses which banks took on Real Estate Investment Trusts in recent years are in large measure a result of the failure of population growth in suburban areas to meet the projections on which their lending had been based.

The regional pattern of new community construction in the suburbs and a demolition derby among city neighborhoods can be viewed as a simultaneous boom-bust cycle, and the faster it goes, the higher the costs to the taxpayer.

The Costs of Disinvestment

The costs of managing a neighborhood from redlining to demolition are enormous. In one Chicago neighborhood, South Shore, calculations were made of the subsidies which were poured into the neighborhood in effort to sustain families after the private economy had collapsed.[3] This neighborhood is one of about

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[3] This paper develops a concept showing the ways in which disinvestment costs occur. The South Shore data illustrate the process. Other data are being collected and analyzed to estimate disinvestment costs and to trace those costs to sectors of the public and private economies. These data will be presented in subsequent papers.

80,000 people. The estimated cost of welfare was approximately $38 million, the cost of Medicaid about $17 million, and unemployment compensation about $9 million. In addition, it was estimated that about one-half the school expenses, $10 million, were wasted because of transiency and teenage frustration. The expense of added police and criminal justice costs increased by about $8 million as a result of the continued decline of community conditions. One could add other cost categories, such as special programs in alcohol and drug abuse, housing subsidies, etc., but the total is already up to $82 million per year. Overall, it seems reasonable to suggest that the cost to the public budgets of managing a neighborhood of this size from redlining to abandonment is well in excess of $500 million.

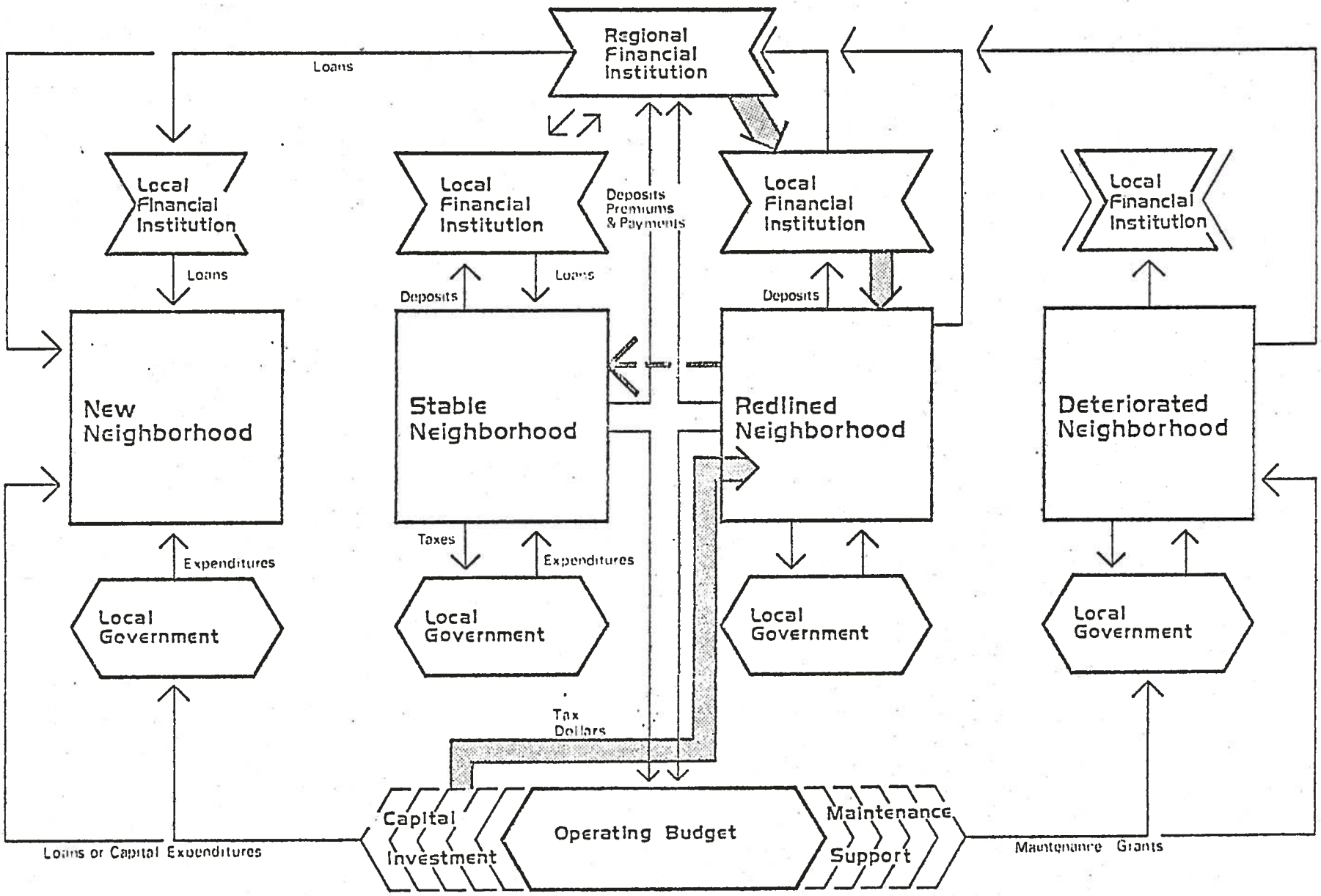
At the same time, the public is footing the bill for many of the costs of new suburban construction. The public costs of new development for a community of 100,000 people is well in excess of another $500 million. An investment of approximately $2 billion of private funds is also required to build the new community, and these costs are rising rapidly.

What does this mean in terms of the actual dollar costs of disinvestment? In one Chicago neighborhood which was totally redlined by financial institutions

five years ago, the South Shore area, these costs were checked. South Shore is a neighborhood which had changed from white to black in the previous decade. To manage that neighborhood to demolition would cost the taxpayers in excess of $½ billion. To rebuild a comparable neighborhood in the suburbs would cost $½ billion in tax monies and $2 billion in private investment and credit. A laundry list was made of everything which one could think of to bring that neighborhood up to snuff, to put it in first class shape, and the total list came to about $120 million. And that, as it turns out, is exactly what the present residents of South Shore have on deposit in banks. All they need is to be able to recycle their own money!

What is needed, then, are ways in which to channel public investment, rather than maintenance dollars, into city neighborhoods (and some suburban communities as well) in ways which will leverage the flow of private dollars (see figure 7, page 18). Private financial institutions need to do a re-assessment of their risk analysis, and develop the creative lending patterns which stimulate the flows of funds in improving and upgrading existing communities. The management resources to channel the flows of funds into existing communities are also needed.

FIGURE 7 Investment Strategy



Instead of a pattern of divergence, in which public policies and private practices contribute to upward spirals of development in some neighborhoods, and to downward spirals of deterioration in others, policies and practices are needed which tend to move neighborhoods and towns toward an equilibrium in which their economies stay balanced and working.

The alternative is to allow a continuation of state governments which are caught between maintenance costs on the one side and capital expenditures on the other, with one foot on either side of the fence, neither foot touching the ground, and wondering why it hurts!