

## **The Biggest Problem Facing Real Estate Today**

PETER LINNEMAN

I am frequently asked "What is the biggest problem facing U.S. real estate today?" The questioner usually assumes one of several answers: the collapse of the European financial system; the continued weakness of the U.S. economic recovery; a double dip recession; the continued struggle of the CMBS market; fiscal imbalances at the state, local and federal levels; capricious and inconsistent government regulations; global warming; or further terrorist attacks by Al Qaeda. While some of these answers present serious challenges to the health of real estate values, each will resolve itself in due course.

Take, for example, the Euro crisis and the potential defaults of the PIGI government sovereign debt. The collapse of the Euro and government defaults would certainly cause turbulence in real estate capital markets, triggering a temporary flight to quality that would reduce the values of all but the highest quality U.S. real estate cash streams. But as was the case with the 2008 financial crisis, within a year or two new real estate capital sources would evolve, while the associated economic disruptions would prove to be cyclical, rather than secular. In fact, the highest quality U.S. real estate might even see value increases associated with the flight of capital from Europe.

Similarly, a weak U.S. economy has significantly delayed the rebound in real estate cash flows in all but a few markets and property categories (most notably "gateway" multifamily properties) due to weak job formation rates increasing the time it is taking to fill the empty desks created by the loss of 8.8 million jobs in the 2008/2009 recession. But real GDP is higher today than prior to the recession and job formation continues, though more slowly than almost everyone anticipated. But cash flows for U.S. real estate slowly improve as the U.S. economy adds jobs.

The resiliency of real estate capital markets is underscored by the surprisingly swift recovery of the CMBS market in late 2010 through late July 2011. It took the complete withdrawal of S&P from the rating of new CMBS issues to a halt this capital source at the end of July 2011. Slowly, this capital gap is again being filled, and debt capital will flow to U.S. real estate via securitization over the coming years. And while debt may not be as cheap and plentiful as highly leveraged borrowers would prefer, this does not threaten U.S. real estate but rather specific U.S. real estate owners. In fact, many new investors are ready to swoop in and replace current owners if insufficient refinancing debt exists.

While government budgets have careened out of control at all levels, this will ultimately rebalance. Whether this is through spending cuts or tax increases remains to be seen, but history shows that the economy can survive both higher taxes and lower spending. And while capricious and unpredictable government interventions have seriously reduced risk taking by American businesses, bad governments will ultimately be replaced by better (if not good) governments.

The threats raised by global warming alarmists are of slight relevance for the future of U.S. real estate. Not only are the possible economic impacts small and far in the future, but the predicted temperature increases leave temperatures well within the ranges where economies have prospered in the past, and prosper today. In addition, the ingenuity of solving such problems has repeatedly saved us from similar disaster scenarios in the past. For example, Malthus worried about a world of starvation and overpopulation, but because of increased agricultural productivity the biggest health problem in the developed world today is obesity, while advances in birth control have made shrinking—not

growing—population today's concern. And while terrorist threats remain, their economic impact is small and transitory. After all, people who live in caves cannot undermine the U.S. economy.

## **The Biggest Problem**

So what is the biggest threat facing U.S. real estate? Simply stated, it is the dramatic erosion of the U.S. education system. From 1900 to 1970, American education displayed a continued improvement in the depth and breadth of quality of students, who fueled unimaginable economic and technological growth. This economic growth has created living standards that even in recessionary times are beyond comparison with those of a half a century ago. For example, education drove advances in worker skills that allowed automobile and phone service to become ubiquitous, while extended leisure time and recreational shopping are part of everyday life for all but our most severely disadvantaged. Meanwhile, improvements in technology have reduced the real cost of providing safe and comfortable environments in which to work, shop, live, and play.

The U.S. education system, which once was the envy of the world, fueled both extraordinary economic growth and economic mobility, which drove long-term real estate cash flows and values. But without a vibrant educational system, the long-term growth of U.S. real estate demand is in serious jeopardy. And sadly, there is no doubt that the U.S. education system is in serious trouble.

In the early and mid 1900s, 90 percent of U.S. K-12 teachers came from the top third of their graduating university classes; today it is estimated that only 23 percent of teachers come from the top third. The suggestion that a top graduate should enter high school teaching would be considered absurd today, since no talented individual wants to work in a unionized system where mediocrity, not performance, is rewarded. Add to this that young teachers are the first to be fired when budgets are cut. Time in service, as a rationing device to reduce labor counts, makes some sense for assembly line workers where workers are relatively interchangeable parts, but not in a system where service delivery quality varies enormously across workers. Nevertheless, American public schools use a system where everyone with comparable job tenure and credentials receives the same pay, with time in service as the sole determinant of who is let go, irrespective of individual ability. Such an outdated model of personnel management is ill-suited for the ultimate service business—the creation of great minds.

American students fare poorly, and increasingly so, on global standardized tests (Table I). While these tests are imperfect measures of achievements, it is impossible to believe that the steady decline of American students' rankings over the last 30 years is not indicative of the decline of our educational system. For example, while 100 percent of Korea, Singapore, and Finland's teachers come from the top third of their university graduates, American K-12 students are generally taught by the bottom third. And even though we spend far more per student than any country in the world, we have fallen to 31st place (behind Latvia!) in PISA (Program for International Assessment) math scores for 15-year-olds. While Shanghai scores an average of 600 on this test, and Singapore 562, we score 487. Globally, we rank 17th in reading and 23rd in science.

**Table I:** Comparative global K-12 student assessments

2009 PISA Scores by Country						
	Reading		Math		Science	
	Rank	Score	Rank	Score	Rank	Score
Shanghai, China	1	556	1	600	1	575
South Korea	2	539	4	546	6	538
Finland	3	536	6	541	2	554
Hong Kong, China	4	533	3	555	3	549
Singapore	5	526	2	562	4	542
Canada	6	524	10	527	8	529
New Zealand	7	521	13	519	7	532
Japan	8	520	9	529	5	539
Australia	9	515	15	514	10	527
Netherlands	10	508	11	526	11	522
Belgium	11	506	14	515	21	507
Estonia	13	501	17	512	9	528
Poland	15	500	25	495	19	508
United States	17	500	31	487	23	502
Sweden	19	497	26	494	29	495
Germany	20	497	16	513	13	520
France	22	496	22	497	27	498
Britain	25	494	28	492	16	514

Sadly, there is one category in which our students rank highest: the belief that they are the best in the world. Surveys consistently show that U.S. students believe that their knowledge notably exceeds that of young people elsewhere around the globe, even as their performance lags far behind. Our "feel good and self-esteem" approach to education has succeeded in convincing our children that they are special, even as the facts show the contrary.

## The Universities

The well-documented failure of U.S. K-12 education has affected universities. American universities, which were the marvel of education worldwide for the two decades following Sputnik, have rapidly declined into little more than year-round—and very expensive—summer camps. Even as real tuition has risen 333 percent over the past 30 years (versus a "mere" 145 percent increase for healthcare), the quality of university education has drifted downward. Professors teach less and to fewer students, while indentured graduate students teach the undergraduate masses.

The rise in tuition does not reflect a rise in the educational experience. From 1920 to 1960, surveys of U.S. students showed that the typical full-time university student spent roughly 42 hours a week on classes and class assignments. Today, this number has plummeted to just 22 hours a week. In my experience, the idea of reading assignments prior to class, for example, has gone the way of the 8-track tape. In short, while university education was once a full-time effort, today, for most students, it has become a part-time activity. The decline in time has taken place both inside and outside the classroom. In 1961, full-time university students reported spending an average of 17 hours a week in class and an additional 25 hours a week reading and studying; the latter number fell to 20 hours by 1981, 13 hours in 2003,

and today it stands at just 10 hours a week. As for class-time, that has been reduced to only 12 hours a week. And fewer students devote themselves fully to their studies. In 1961, 67 percent of all full-time university students reported spending *more* than 20 hours a week outside of class studying; In 1981, this hard-working group represented 44 percent of all students; and today it stands at a pitiful 20 percent. Moreover, today's "hard-working" students (those who study 30 hours a week, or three times the average) are "slackers" by the standards of the past; and today's "slackers" are complete no-shows. It is little wonder that students complain about the cost of their books. After all, why pay good money for books that are not read? This absence of study time explains so many textbooks listed for sale on Amazon are advertised as "never used."

Meanwhile, the classes offered at universities have become ever more frivolous. Students at major U.S. universities merrily take courses in such critical topics as "The Lord of the Rings," "The Matrix," "Star Trek," and "Star Wars." There is an endless array of courses on sex (including alien sex), pornography, pornography on the Internet, and sexuality. Other popular courses focus on such pressing global issues as massages, walking, vibration, and beer and wine tasting. And there are innumerable courses on comic books, UFOs, zombies, vampires, ghosts, and television shows such as "Gilligan's Island." Among recent additions to this low-brow list are courses about pop-star Lady Gaga and her impact on society. The student association at Rutgers University recently paid a \$32,000 speaker fee to Snooki of the reality show "Jersey Shore." This self-proclaimed queen of ignorance advised a packed audience to "study hard, but party harder." One month later, Nobel laureate Toni Morrison was the keynote speaker at Rutgers' commencement ceremony; she was paid \$2,000 less than Snooki.

Since students are spending less and less time studying and going to classes, tests measuring their cognitive and reasoning skills indicate little improvement as they proceed through college. Yet university grade point averages are almost a full point higher today than they were four decades ago, rising from 2.5 to 3.4. Welcome to Lake Wobegon University, where half the students are on the Dean's list, and all the students are above average.

The U.S. university system has degenerated to an American version of that old Communist adage: "Faculty pretend to teach and students pretend to learn." Part of this pretense is the evaluation of a faculty member's ability by depending exclusively on the student evaluations. Recent research indicates that university students primarily evaluate their teachers on how easily they grade, how little time students are required to study, whether class attendance is mandatory, and the entertainment value of the class. On top of that, students who neither study nor attend classes are asked to evaluate whether the readings (which they have not read) are relevant, and whether the teacher "knows his or her subject." Weak and frightened faculty respond by adhering to the old Hollywood maxim: Give the people what they want. And what they want is to cut demanding courses, do no work, receive high grades, and party. Parenthetically, despite that peer review is the traditional method of evaluating faculty research, universities do not use peer review to evaluate teaching, and few faculty members have ever had another faculty member sit in their course.

The erosion of our universities is no surprise given the weak educational foundation provided by K-12 teaching. Yet, even an average student in our failing grade schools and high schools spends much more time in class and studying than do our university students! The absence of preparation, attendance, and study means university students know less and less and are losing critical thinking skills. Analytic thinking is rapidly being replaced by mere opinions. The truth is that students cannot apply themselves less and learn more. Just as athletic skills are honed by hours of tedious practice and conditioning, critical thinking is the outgrowth of hours of painstaking preparation, reading, listening, and writing.

## **Conclusion**

The decline of K-12 education partly reflects the fact that the system was created at a time when a large pool of bright and educated women had few career choices except to become teachers. These talented females taught well and for little pay, as they had few other options. However, as young women entered the professions and became doctors, lawyers, engineers, and businesswomen, the education system failed to adjust. Thus, while women's liberation improved society as a whole, it had an unforeseen side-effect by reducing the number of bright and energized teachers. The situation is worst in science and math subjects (the foundations of rigorous and logical thinking), which today attract the same number of bright young females as they have historically--that is, none.

Is it surprising that a knowledge-based industry—primary and secondary education—is failing, when it draws almost all of its teachers from the bottom quarter of a faltering university system? After all, if the average university student is spending only ten hours per week studying, those in the bottom quarter of their class (from which our K-12 teachers are drawn) are studying even less. High school students are too frequently being taught by people who majored in "partying" while at university, spending five or six years studying just two to five hours per week. That such K-12 teachers produce students who do not study when they go on to university is no surprise. A pernicious circle.

The United States is in danger of drifting back to a time, not so long ago, when an elite few were extremely well-educated, while the masses were very poorly educated. This was basically the state of U.S. education prior to World War II. The difference today is that many of the "poorly uneducated" now boast university degrees (in some cases advanced degrees), and have GPAs in excess of 3.0.

Our education system soaks up ever more money while generating ever fewer well-educated graduates. Fifty years ago, if a university student graduated with honors it meant that after 45 to 60 hours a week on their studies they had distinguished themselves by graduating among the top 15 percent of their class. Today, an honors student studies about 22 hours a week, and ranks in the upper half of her class. This is an extension of the K-12 culture, in which everyone gets a trophy for participating rather than achieving, and where "good enough" substitutes for excellence.

As the U.S. education system continues to erode, the rest of the world is creating ever more skilled workers. Too many U.S. university students waste four to six years partying and taking nonsense courses, while piling up tens of thousands of dollars in government subsidized loans. The majority of U.S. college grads are unprepared for jobs in an ever more globally competitive environment. They possess neither technical work skills nor critical thinking skills in spite of having spent the first quarter of their life in educational institutions. Yet, judging from the slogans of the Occupy Wall Street movement, these students feel entitled to great pay simply because they were born in the United States. Meanwhile hardworking young people across the world are scrambling for a limited number of workplaces in a competitive global economy. The result is that those with globally competitive skills have seen their real wages rise, while those who merely float by see their wages stagnate—or fall. This widening wage gap is inevitable in a globalizing world where high skills are in increasing demand and poorly skilled workers abound. Without well-educated young people who are prepared to create and innovate, real economic growth in the United States will slow—and without long-term economic growth, real estate demand and values will stagnate. And this is not a self-correcting problem. To the contrary, ignorance breeds bliss. As a result, as the problem grows larger the willingness to admit the emperor has disrobed diminishes: it is the absence of a self-correcting mechanism that makes the collapsing educational system by far the biggest problem confronting real estate today.

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