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RESEARCH REPORT

Linking Tax Law and Sustainable Urban Development:

The Taxpayer Relief Act of 1997

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LINKING TAX LAW AND SUSTAINABLE URBAN DEVELOPMENT:
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Linking Tax Law and Sustainable Urban Development: the Taxpayer Relief Act of 1997
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Executive Summary

Changes in tax laws can have a significant effect on sustainable development. In enacting the Taxpayer Relief Act of 1997, Congress and the Administration removed a tax provision that has, since 1951, tended to encourage exurban sprawl and the decline of central city and older suburban neighborhoods. The key change was the replacement of former Internal Revenue Code § 1034 with a new § 121, changing the treatment of capital gains on home sales.

Former § 1034 provided that taxes on capital gains resulting from the sale of a homeowner's principal residence would be deferred if the seller purchased another replacement home of equal or greater value within two years. The law was originally intended to avoid taxing homeowners on the incidental appreciation of their homes, allowing them to move and replace their homes without incurring tax liability. However, the law also had the perverse effect of requiring virtually all homesellers to keep "trading up" with each home purchase simply in order to avoid triggering a taxable event.

As a result, the tax code discouraged most homesellers from moving inward toward central cities and inner suburbs, where housing prices were generally lower. In addition, homesellers moving from higher cost areas of the country to lower cost areas were effectively compelled to purchase larger, newer, more expensive homes on larger parcels of land, rather than existing homes closer to older neighborhoods and urban centers, simply in order to avoid incurring tax liability. The tax code thus indirectly encouraged increased consumption of land for new housing, hastened declines in the viability of urban neighborhoods by locking out many prior homeowners, and increased the trends toward loss of agricultural land to exurban development.

The Taxpayer Relief Act eliminated tax liability entirely for the vast majority of capital gains on home sales. It now allows a married couple filing jointly to exclude up to $500,000 and a single person to exclude up to $250,000 in gains on *each* sale of a principal residence -- figures that exempt all but a tiny proportion of home sales from any tax consequences. Indeed, the change in the law affects nearly 4 million sales of existing homes each year, many of which involve capital gains. At the same time, the 1997 Act has created new opportunities for urban revitalization by making housing rehabilitation by owner-occupants an opportunity to generate tax-free income.

This study examines the effects of former § 1034 and projects the likely effects of the new law on residential migration and urban development. Beneficial effects will occur in two areas. First, the repeal of former § 1034 will lead to greater retention of homeowners in urban centers and older suburbs and will encourage inward rather than outward migration by homebuyers moving within and between metropolitan areas. Second, new § 121 will provide incentives for the rehabilitation of older urban housing stock by owner-occupants, leading to opportunities for revitalization of urban neighborhoods. These effects, in combination, will encourage sustainable urban development.

Effects on Housing Choices and Migration Patterns

- The change in the tax law will increase the *retention* of current homeowners in urban centers and older communities. Homesellers with capital gains who want to remain in or near the city will not be forced to move outward by the tax consequences of their home sales as under prior law. This will strengthen the economic viability and tax base of these urban areas.

- For moves occurring within a metropolitan area, the tax change presents the possibility of a substantial increase in the migration of homesellers with accrued capital gains toward the urban core. Nationally, this could amount to as many as 140,000 *additional* homeseller households per year moving inward rather than outward in local moves, even without construction of more high-value urban housing or provision of other incentives to locate in urban centers.

- Among homesellers moving from one metropolitan area to another, the tax change is likely to lead to an increase in homeowner moves closer to central cities. Among these movers, an *additional* 100,000 or more homeseller households per year may move closer to central cities. This effect may be even larger in the long run.

- The change in the tax law presents an opportunity for central cities to adopt programs to *attract* middle- and upper-income households previously locked out of the city by their need to avoid capital gains taxes. The tax change makes it more economically viable to construct, retain, and maintain housing of mixed values in urban areas, rather than simply low-value housing. In turn, this will strengthen urban neighborhoods and improve real estate tax bases.

- The change in the tax law presents an opportunity for lower-cost urban areas in states with high net domestic inmigration to attract more movers to their urban centers.

Opportunities for Urban Housing Rehabilitation

• The Taxpayer Relief Act will lead to the rehabilitation of urban and older suburban housing stock by owner-occupants through the opportunity the law creates for tax-free income. A rapid way to generate a capital gain in housing is to rehabilitate run-down and older homes, particularly in neighborhoods where surrounding homes retain value. Under new § 121, homeowners may live in and successively rehabilitate older urban homes in order to reap tax-free capital gains. Because the seller no longer needs to purchase a more expensive home in order to avoid taxation, owners can successively (but not more often than every two years) purchase low cost homes for rehabilitation, rehabilitate and sell them, pocket the entire gain, and repeat the process (the "serial seller" strategy). Thus, a larger portion of the nation's existing urban housing stock will be rehabilitated by owner-occupants, even without any additional incentives.

• The change in the tax law presents a substantial opportunity for existing public, private, and lender-based urban rehabilitation programs to spur the increased revitalization of neighborhoods by owner-occupants. Because of the new treatment of capital gains, programs such as the Federal Housing Administration's 203(k) loan program, can provide rehabilitation financing to owner-occupants on an even more attractive basis. And the tax-free nature of the gain makes community lending and other efforts less risky and more attractive.

• Coupled with the migration effects noted above, lending and incentive programs can help harness the effects of the tax law. Attraction of homeowners and retention of owner-occupied housing are both factors that add value to housing stock in neighborhoods. This, then, makes the rehabilitation of other housing in the same neighborhoods a better prospect for generation of a capital gain by owner-occupants, resulting in more urban revitalization.

The Taxpayer Relief Act's effect on urban migration, development, and neighborhood rehabilitation shows that sustainable development is directly connected with law. Changes in tax law can remove perverse incentives that drive development in unsustainable directions, and can create new opportunities to place urban development on a sustainable path.

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Chapter One:

Taxation and Development Patterns

Sustainable development requires the coordination of policy signals so that desirable environmental outcomes are reinforced, rather than undermined, by laws and governmental policies. Specifically, it requires attention to many areas of law and public policy that are not typically identified as environmental in character. Indeed, the critical first step in the transition to the practice of sustainable development is "the identification of inconsistent and conflicting legal institutions, doctrines, and programs that cancel out ecological protection and community development."[1]

Taxation is a key area of law and policy that profoundly affects development choices. Taxes can promote or reinforce either sustainable or unsustainable decisions. In general, other things being equal, taxpayers will make decisions so that they can minimize taxes and take advantage of tax preferences. A tax law that tended to drive housing and residential development decisions in a direction adverse to urban sustainability was former § 1034 of the Internal Revenue Code. Section 1034 concerned the manner in which capital gains resulting from appreciation of a taxpayer's principal residence were recognized and taxed. It was repealed by Congress in § 312 of the Taxpayer Relief Act of 1997.[2]

This repeal may be fairly described as the most significant environmental legislation enacted by Congress in recent years. Section 312 of the Taxpayer Relief Act, now codified at § 121 of the Internal Revenue Code, appears to be an instance in which Congress, by changing the tax code, managed in one stroke to cut taxes, protect the environment, and provide an incentive to rehabilitate older central city housing.

This report discusses the consequences of the prior tax law for previous development decisions and home ownership choices. Then it projects the new law's potential effects on residential development and home owner migration patterns - particularly with reference to the distribution of housing choices between exurban areas and older central cities and inner ring suburbs. The report also examines opportunities created by the new law that may be used to increase its positive effect on urban revitalization and sustainable development.

FORMER LAW

Former Internal Revenue Code § 1034 was first enacted in 1951.[3] Designed to shield homeowners from unintended taxable consequences of home ownership, it provided that taxes on capital gains resulting from the sale of a homeowner's principal residence would be deferred if the seller purchased another home of equal or greater value within two years. (The purchase of the replacement residence could occur either before or after the sale of the principal residence). The law allowed the same tax deferral where the seller purchased a lower cost replacement home but made capital improvements during the same two-year period to bring the total cost of the replacement home (as improved) to more than or equal to the value of the previous property.

Because recognition of a taxable gain was deferred, rather than forgiven, the homeowner's cost basis in the prior home was rolled over into the new home. For example, if a person purchased a home for $100,000 and sold it for $120,000, taxes on the $20,000 gain would not be owed if the homeowner purchased a replacement home for $120,000 or more within two years. If the homeowner thereafter sold the replacement home for $150,000 and did not defer the gain again (by purchasing a higher cost home), the taxable capital gain would be figured on the difference between the sale price of the last home and the original cost basis of the first home ($150,000 minus $100,000 = capital gain of $50,000). The cost of any capital improvements made to any of the homes in the sequence also became part of the cost basis. In the above example, if the homeowner had spent $20,000 in capital improvements to the second home, the cost basis would be $120,000 ($100,000 plus $20,000) and the accumulated taxable gain would be $30,000 ($150,000 minus $120,000). The § 1034 deferral could be used an unlimited number of times.

Thus, throughout a taxpayer's lifetime, the purchase prices of each succeeding home and the investments in capital improvements to these homes had to be tracked, in order to calculate the amount of taxable capital gain potentially subject to tax if the taxpayer eventually were unable to defer the tax.

The prior law also provided that a homeowner over age 55 could, on a one-time basis, exclude up to $125,000 in accumulated gain from the sale of a principal residence.[4] This provision was enacted in order to help older homeowners who might have accumulated gains over their lifetimes, but who did not then choose to purchase a more

expensive home (because, for example, they moved to a smaller home, rental apartment, or assisted living situation, or went to live with relatives).

EFFECT OF FORMER § 1034 ON HOUSING DECISIONS

The original purpose behind § 1034 was highly desirable. It was intended to avoid taxing people on the incidental appreciation of their homes, and it protected them from taxation based solely on their need to relocate and purchase another residence. Making such events taxable might have had the effect of depriving people of sufficient assets to replace their homes with comparable living quarters.

However, the law also had the perverse effect of requiring home buyers to keep "trading up" until at least age 55, whether or not they needed or wanted a larger or more expensive house, simply in order to avoid the tax. This feature of the law had several consequences for the evolution of real estate markets and the pattern of development.

Homeowners moving from high cost metropolitan areas to lower cost areas were, in effect, required by § 1034 to buy larger homes, newer homes, and homes on much larger parcels of land, simply in order to avoid being taxed on their accumulated appreciation.[5] The House Committee Report on the Taxpayer Relief Act described some of the negative consequences of § 1034:

> To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision of present law encourages some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas. This promotes an inefficient use of taxpayer's financial resources.[6]

In the same way, § 1034 discouraged homeowners from moving into urban cores where housing prices had become depressed, because such a move would make it almost impossible to avoid the tax. For example, a homeseller moving from the relatively high-cost Washington, D.C. metropolitan area to a city such as Indianapolis could not buy a home in the downtown area without investing several times the home's value in upgrades in order to avoid triggering a taxable event. This, however, would in many areas require a purchaser to overinvest in improvements to a degree that the expenditures could never be recouped on resale. In effect, a move to a central city could

be prohibitively expensive. A 1994 study by seven universities in Ohio strongly suggested that § 1034 impeded movement by homeowners into urban centers in that state.[7]

At the same time as § 1034 was influencing virtually every housing choice by America's homeowners, it produced little revenue to the treasury. In effect, the provision produced nearly universal "compliance." Indeed, although approximately 4 million sales of existing homes occurred each year,[8] only 150,000 to 200,000 taxpayers were required to pay capital gains tax on these sales.[9]

But the law influenced these individual choices in ways that, at least in some instances, were socially damaging. Section 1034 effectively encouraged increased per capita consumption of land for new housing, and greater investment in new exurban construction than in rehabilitation of existing lower cost housing stock. It apparently reinforced, and accelerated, declines in the viability of urban tax bases and trends toward loss of agricultural land.

Indeed, the tax code specifically made it harder for certain economic classes of people to move inward toward the central city and inner ring suburbs. Specifically, § 1034 affected homeowners -- those persons who, by definition, have accumulated economic assets and who typically have relatively stable or rising incomes. Moreover, it affected precisely those homeowners who had experienced gains in their net worth (at least as reflected in their housing).

By forcing those with rising economic fortunes to look elsewhere for housing, and erecting barriers to their entry into the market for urban housing, the tax code exacerbated trends leading to economic and social abandonment of the cities. These trends have had profoundly adverse consequences. As urban scholars have noted:

> [T]he outmigration of upper-income households has had a double impact on inner-city residents: fiscal and social. Fiscally, the loss of middle- and upper-income households has affected central cities in two ways. It has decreased the demand for housing, thus reducing its value and the city's tax base. Also, this loss has left inner-city residents with weakened political power to attract public resources from state legislatures to their neighborhoods. Socially, the loss...weakened basic institutions [in the central cities] and left...residents with no middle-class role models to emulate and with few means of learning about employment opportunities often located in the metropolitan periphery.[10]

At the same time, by creating a tax preference for more expensive housing (potentially favoring newer homes, larger homes, and/or larger parcels of land), the tax law hastened the loss of agricultural lands to exurban sprawl. The American Farmland Trust has detailed the loss of agricultural lands in the U.S. to development during the last decade.[11] Over one million acres of farmland are lost each year to development. Current findings show that much of the development threat to prime and high quality farmlands is no longer confined to the edges of the nation's major metropolitan areas, but is now being hastened by the dispersal of the population into the nation's smaller and medium-sized cities and towns. This migration is supported by better telecommunications, the decline in industrial manufacturing jobs, and the accessibility of more lands by interstate highways and major roads.[12] But the new migration has been less to the smaller towns and cities themselves than to their outskirts. This has produced sprawl effects on adjacent farmland, a trend consistent with the tax preference expressed in former § 1034.

THE TAXPAYER RELIEF ACT

In December 1996 the Sustainable Communities Task Force of the President's Council on Sustainable Development made the reform of § 1034 the first of its recommended actions for reducing sprawl and promoting smarter growth:

> The federal government should redirect federal policies that encourage low-density sprawl to foster investment in existing communities.... It should...change the capital gain provision in section 1034 of the Internal Revenue Service code to allow homesellers to defer tax liability even if they purchase a new home of lesser value. Currently the code allows deferred tax liability on capital gain realized during ownership only if homesellers purchase another home priced at least equal to the one sold.[13]

This recommendation was carried out by the President and Congress through enactment of § 312 of the Taxpayer Relief Act of 1997. Section 312 eliminated the tax liability entirely for the vast majority of capital gains on home sales. As amended, the law now allows a married couple filing jointly to exclude up to $500,000 and a single person to exclude up to $250,000 in gains on *each* sale of a principal residence -- figures that exempt all but a tiny proportion of home sales from any tax consequences. Both the residence replacement tax deferral provision of § 1034 and the over-55 exclusion were repealed.

The law now provides:

> Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.....The amount of gain excluded...with respect to any sale or exchange shall not exceed $250,00....[or $500,000 if] a husband and wife make a joint return for the taxable year of the sale or exchange of the property [and either spouse meets the ownership requirement and both meet the use requirement].[14]

The new exclusion cannot be used more than once every two years, unless "such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances," in which case the excludable gain is prorated against the length of actual ownership and use compared to two years.[15] The new law applies to home sales or exchanges after May 6, 1997; however, a taxpayer may elect to treat sales and exchanges made after May 6 and before August 5, 1997 under the prior § 1034 provisions.[16]

The taxpayer can use the non-taxed accumulated gain in any manner -- for example, to purchase a larger home as before, or to purchase a less expensive home, to rent an apartment, to save and invest, to pay for college education, to make charitable contributions, to provide income for living expenses or retirement, to purchase consumer goods, or for any other purpose. While this is a substantial boon to the taxpayer, the new law is also likely to have effects on patterns of homeownership and development.

These effects are reviewed in the next two chapters. They include the likely retention of more current homeowners in urban centers and older communities, and the opportunity to encourage movement by other homeowners toward these areas in greater numbers than under previous tax law conditions. Additional effects include increased rehabilitation of older urban housing by owner-occupants based on the incentives created by the law's favorable tax treatment of appreciation in housing. These effects will be significant because of the broad applicability of the tax provisions, which affect millions of home sales each year.

Chapter Two:

Potential Effects of the Taxpayer Relief Act on Housing Choices and Development Patterns

Eliminating the § 1034 requirement, as Congress noted, increases individual freedom by removing a pervasive artificial constraint on Americans' housing choices.[17] Congress removed a significant financial obstacle to home owners moving into lower cost urban centers, while ending a significant financial inducement for home owners to buy larger and more expensive homes -- often in newer suburbs and the exurban fringe.[18] The Taxpayer Relief Act's provisions on residential capital gains take tax law, at least in part, out of the business of driving urban abandonment and exurban sprawl development.

Simultaneously, as discussed in the next chapter, the new law creates an incentive that may encourage revitalization of the nation's older urban housing stock by owner occupants. The incentive is provided by the nonrecognition of taxable gain on the appreciation of principal residences (up to $500,000 on each house; and on successive houses as often as every two years) -- making most gains on owner-occupied homes completely tax-free. In general, a rapid way to generate a capital gain in housing is to rehabilitate run-down and older houses (particularly in neighborhoods where surrounding homes retain some value). With elimination of the § 1034 requirement to replace homes with more expensive homes, some enterprising home owners may elect to live in and successively rehabilitate older urban homes in order to reap tax-free gains (the "serial seller" strategy).

Because the seller no longer needs to purchase a more expensive replacement home in order to avoid taxation, owners can successively (but not more often than every two years) purchase low cost homes for rehabilitation, rehabilitate and sell them, pocket the entire gain, and repeat the process. A potentially significant portion of the nation's existing urban housing can be rehabilitated by owner-occupants. This, in turn, may help to revive the urban tax base for municipal infrastructure, and prevent the stranding of existing public investments in schools, roads, and water and sewer facilities. The new tax provisions may also encourage other homeowners (who are not serial sellers) to engage in greater investment in home improvements. These upgrades may produce gains which the owners can realize upon sale without owing taxes.

The positive effects of the tax change on urban housing and on home buyer residential choices are not expected to be accompanied by concomitant adverse effects on the building trades. Although the repeal of the residence replacement provision may reduce some demand for new home construction -- particularly construction previously targeted at the higher end of the market in lower cost regions[19] -- builders may benefit in two other respects. First, business may be generated from the likely increase in rehabilitation opportunities; and second, the fact that the tax code now places construction of new homes of *all* values on an equal footing allows builders to build for a wider array of possible home purchasers (buy-downs as well as buy-ups).

The effects of the Taxpayer Relief Act on housing choices and migration patterns are discussed in detail below. While the law is too new to provide a track record, homeseller behavior under the old law provides a basis to project likely effects.

HOUSING CHOICES AND MIGRATION PATTERNS UNDER FORMER § 1034

It is necessary to understand the scale of the distortionary effect of former § 1034 on home ownership patterns and decisionmaking in order to assess future changes in housing decisions and development patterns as a result of the change in the tax law.

Housing Stock and Transactions

Tax laws that affect home ownership have a profound affect on the U.S. economy and on patterns of development and land use. Home ownership is substantial, comprising 65.7 percent of households. The total U.S. housing stock is approximately 115,722,000 units. Of these, at any one time 67,094,000 units are owner occupied; 34,952,000 are renter occupied; and 13,676,000 are vacant.[20]

About 5 million single family homes (both new and existing) change hands each year.[21] Sales of single family homes in 1997 were projected at 785,000 for new houses and 4,150,000 for existing houses.[22] Thus a substantial quantity of owner-occupied housing goes on the market each year. Approximately 4 million existing homes, many of which have accrued appreciation (capital gains) are sold every year.

The median sales price for a new single family home is $144,700, while the median sales price for an existing single family home is $123,700.[23] Thus, in general, although more existing homes are for sale at any time than are new homes, new homes

present a proportionally larger opportunity for homesellers with capital gains to buy up in value. (For comparison with 1990 census information, the median sales prices for new and existing single family homes in 1990 were $122,900 and $95,500, respectively.[24] The census reported the median home "value" in 1990 as $78,500.[25] "Values" and "prices" differ as most homes are not for sale at any given time).

Domestic Migration

Migration of individuals and households within the United States is substantial. Between March 1996 and March 1997, over 43.3 million persons moved into different residences in the United States. Of these, 27.7 million moved within the same county (64 percent), 7.9 million moved from elsewhere in the same state (18 percent), 6.4 million moved from another state (15 percent), and 1.3 million moved from abroad (3 percent).[26] This distribution is typical of the annual figures throughout the 1980s and 1990s.[27]

Only about 1/3 of total annual movers moved to owner-occupied housing.[28] The data are for individuals, rather than households. Approximately 14.5 million persons move to owner-occupied housing each year, while there are approximately 5 million new and existing home sales per year. Based on 1995-1996 mobility results (the most recent data which break out owners and renters), of those movers occupying owner-occupied units at the end of the move, 63 percent moved within the same county; 22 percent moved from elsewhere in the same state; 13 percent moved from another state; and 2 percent moved from abroad.[29] In comparison, of those occupying rental units, 63 percent moved within the same county; 17 percent moved from elsewhere in the state; 16 percent moved from another state; and 4 percent moved from abroad.[30]

Although movers move within cities, within suburbs, or between and among any combination of cities, suburbs, and non-metropolitan areas, net domestic migration has been unmistakably away from the central cities for several decades.[31] Table 1 shows net domestic migration during the last decade.

Table 1: Net domestic migration

	Central cities	Suburbs	Nonmetro Areas
1995-96	(2,436,000)	2,160,000	275,000
1994-95	**********	**********	*********
1993-94	(2,936,000)	2,850,000	86,000
1992-93	(2,493,000)	2,175,000	317,000
1991-92	(2,412,000)	2,495,000	(73,000)
1990-91	(2,459,000)	2,575,000	(117,000)
1989-90	(2,780,000)	2,908,000	(128,000)
1988-89	(2,955,000)	3,165,000	(211,000)
1987-88	(2,623,000)	2,792,000	(169,000)
1986-87	(1,680,000)	2,167,000	(488,000)
1985-86	(1,580,000)	1,883,000	(303,000)

Source: US Bureau of the Census. December 1996. *Table A-3 -- Annual Inmigration, Outmigration, and Net Migration for Metropolitan Areas: 1985-1994.* (Data based on metro areas as defined in 1984). 1995-96 Data from US Bureau of the Census. December 1997. *Table A-3 -- Annual Inmigration, Outmigration, and Net Migration for Metropolitan Areas: 1985-1996.* (1995-96 data based on metro areas as defined in 1993). The Census Bureau did not compile 1994-95 figures.

The data presented in Table 1 show that in moves occurring within the United States during the last eleven years, the central cities have lost over 26.8 million residents (assuming consistent results for 1994-95) to net outmigration. The suburbs absorbed virtually all of this total during most of this period, also drawing population from nonmetropolitan rural areas. In the years since 1992, however, rural areas have also been net gainers. This probably reflects further outmigration from both cities and suburbs to the exurban fringe. While not all of these movers were homeowners, many of them were, given the concentration of owner-occupied housing stock in the suburbs and nonmetropolitan areas.

Research on twelve of the nation's largest metropolitan areas has shown, moreover, that the net migration of *upper* income households from central cities to suburbs is quite high in comparison with migration of *lower* income households.[32] Indeed, the income relationship for the metropolitan areas studied was linear, with higher rates of net outmigration at each succeeding higher income class (quintile). Moreover, the same data show that:

(1) Most householders who decide to leave a central city move to that city's suburbs, whereas most of those who decide to leave the suburbs leave the metropolitan area, and

(2) this trend is most pronounced at the higher household-income levels.[33]

These findings reinforce the importance of assuring that tax and other policies do not result in hastening the abandonment of central cities for the suburbs by homeowners. They also suggest that impediments to homeowner moves from the suburbs to the central city have been substantial.

Housing Values and Net Migration

By comparing *median housing values* for a central city and its corresponding metropolitan statistical area (MSA) with *net migration* into and out of the central city (among movers who stay within an MSA), it is possible to discern a linear relationship between housing values and levels of outmigration from the central city. Levels of outmigration from the central city tend to be greatest in areas where median housing values in the MSA are significantly higher than those in the central city. Conversely, where the disparity between housing values in the MSA and central city is smaller, or where values in the central city are greater than those in the surrounding metropolitan area, fewer movers tend to move out of the city relative to those moving in.

Methodology

From Census data enumerating the changes in residence between 1985 and 1990 for movers within a given metropolitan area, one can calculate the number of outmigrants from the city to the suburbs and inmigrants from the suburbs to the city.[34] Because these numbers are not reported directly, it is necessary to derive them from the data collected, which are separately reported for central cities and for entire MSAs. Outmigrants from the city to the suburbs can be determined by subtracting the number of 1990 central city residents who lived in a different house in the central city in 1985, from the number of 1990 residents of the *entire* MSA who lived in a different house in the central city in 1985. The difference between these two numbers corresponds to the number of outmigrants from the central city to the suburbs. The inmigrants are the number of 1990 central city residents who in 1985 lived in the (non-central city) remainder of the MSA.

The Census data also provide the median value of owner-occupied housing units for central cities and metropolitan areas.[35] Because the MSA median housing value *includes* the central city housing value, it is a conservative measure of the disparity between city and suburb; using the MSA median for comparison dampens the potentially distorting effect of particularly high cost suburbs on the comparison.

By comparing the difference between median housing values in the MSA and the central city with the ratio of outmigrants to inmigrants for a central city, a relationship can be determined.

For purposes of this study, those MSAs for which the Census recognizes a single central city were separated from those that include more than one central city. (For example, using this approach, the Tulsa, Oklahoma MSA would be selected; the Albany-Schenectady-Troy, New York MSA would not). These single-city MSAs were selected in order to avoid the need to blend potentially different central city median house values from multiple-city MSAs to obtain a single value. Such a blended value or average of medians would not accurately reflect housing values in any of the cities, and would obscure moves from city to city within the MSA. From the list of MSAs with single central cities, we then randomly selected thirty-eight and calculated both the ratio of outmigrants to inmigrants and the disparity between MSA and central city median housing values for each city. These results are displayed in the Appendix.

Next we divided the cities into three groups: 1) Cities for which median housing values in the MSA were at least $10,000 greater than those of the central city; 2) Cities for which the difference between median housing values in the MSA and the central city were between $0 and $10,000; and 3) Cities in which median housing values in the central city were greater than those in the MSA. For each of these groups, we determined an average ratio of outmigrants to inmigrants.

Results

Table 2 shows the results of the comparison between disparities in housing values and net migration within metropolitan areas. A linear relationship emerges from the data. In aggregate terms, the number of outmigrants relative to the number of inmigrants is greatest in those MSAs with median housing values that are at least $10,000 more than corresponding values in the central city. Where the difference between housing values is less, or where housing values in the central city are greater than those in the MSA, there are fewer outmigrants relative to the number of

inmigrants. Thus, there appears to be a correlation between the disparity in median housing values between the MSA and central city, and the ratio of outmigrants to inmigrants. The greater the disparity, the greater is the ratio of outmigrants to inmigrants.

Table 2: Relationship Between Housing Value and Migration Within MSA

Difference in Median Housing Value (MSA - Central City)	Ratio of Central City Outmigrants to Inmigrants
Over $10,000	3.10
$0 - $10,000	2.40
Higher $ in city	1.62

Based on 1990 Census Data. MSAs with a single central city.

These results suggest that, in metropolitan areas where suburban housing is on average considerably more expensive than city housing, a greater percentage of movers within the MSA will move out of the central city than in MSAs where urban and suburban housing are closer in price. Several factors limit the utility of the results. First, although the aggregate numbers illustrate a linear relationship, exceptions exist within the groups. Particular demographic and socioeconomic factors may be applicable to specific geographical areas. Second, the data used to calculate the number of outmigrants and inmigrants are for persons over the age of 5, rather than the number of homeowners or households, and are not limited to homeowners. Nevertheless, the relationship is striking.

Observed spatially, distributions of median housing values in many metropolitan areas support the connection with outward migration. According to one theory of sprawl, many central cities are surrounded by a suburban "golden ring" of highest priced home prices. Analyzed over time, this ring can serve as a means of measuring sprawl. For example, a recent study of sprawl in the Kansas City area found that, in the span of three decades, the ring of highest housing values shifted farther away from the city core with each Census from 1970 to 1990, leaving behind rings of lower priced housing.[36] These findings not only illustrate the process of accumulating sprawl, but also indicate that sprawl followed the line of highest priced housing.

Implications of the housing value-migration relationship

The fact that high rates of migration from the central city to the suburbs are associated with higher median house values in the suburbs cannot, of course, demonstrate that the higher values (given former § 1034) have any significant responsibility for the net outmigration. Indeed, numerous other factors -- including concerns with crime, schools, and jobs -- are likely at work.

It is also not clear whether the generally higher home values available in the suburbs are in part responsible for the migration out of the cities (as homeowners sought opportunities to buy up in order to shelter their capital gains), *or* whether the higher values themselves chiefly reflect an increased demand for suburban homes. It is a well-understood principle of economics that -- other things being equal -- increasing demand for a good will lead to an increase in prices, while falling demand will tend to depress prices. Thus, if demand (for whatever reason) increased for suburban homes, we would expect to see higher prices (as well as more production of new homes to meet the demand). Conversely, a falling demand for central city homes would depress the prices of those homes. In sum, whether demand for suburban homes (driven by social factors and § 1034) led to increased home prices in the suburbs, or the higher home prices available in the suburbs led to increasing demand (through the effect of former § 1034), the observed effect would be similar.

However, the perverse nature of § 1034 necessarily made the trend toward disparity in housing prices self-reinforcing, regardless of how it had been initiated. This is because once demand shifted to the suburbs (whether for tax reasons or other preference reasons), central city housing prices in general would fall (or at least rise less quickly than suburban prices) because of reduced demand. A significant number of potential buyers (those with accrued gains) would then be excluded from the market for the lower priced homes by the operation of § 1034.

In an unfettered and undistorted market, the falling prices in the central city would soon create some "bargains" and demand would rise. Prices would then follow. But because of § 1034, lower priced homes in the central city were not "bargains" to any purchaser with accrued capital gains on the purchaser's previous homes. Purchasing such a property would have resulted in the immediate recognition of capital gains tax liability, offsetting much of the price differential by requiring a substantial tax payment to the federal government in the same year as the purchase of the central city residence. Thus the recognition of capital gains imposed a variable (but significant) surcharge on

purchasers of lower priced homes -- in effect raising their price differentially to those with accrued gains.

Some of the transactional consequences of the tax also militated against purchases of lower priced homes. Specifically, because the federal income tax on recognized capital gains had to be paid in cash, the recognition of accumulated appreciation effectively increased the homeowner's need for cash in order to close the transaction. In effect this required a purchaser to make a larger "down payment" in order to buy a home not eligible for deferral of the gain.[37]

Even worse, the tax payment (required of a purchaser "buying down") did not go into the cost basis of the purchased home. This meant that the purchaser was subject to yet a further tax exposure in future years if the home appreciated. For example, suppose a homeowner purchased a central city home for $60,000, and needed to pay non-deferred capital gains tax of $3,000 because of accumulated gains on prior homes.[38] The cost basis of the new home (for calculation of any future capital gain) would be only the purchase price of $60,000, even though the actual cost to the purchaser (the effective purchase price) was $63,000. If the home appreciated in later years to $70,000, upon sale of that home the homeowner would be exposed to tax on a capital gain of $10,000 -- unless the tax were then deferred by buying up or excluded by use of the former over-55 exclusion. The taxpayer would receive no credit for the taxpayer's actual investment of $63,000 rather than $60,000. Instead, the taxpayer would be taxed on a gain of $10,000 even though his or her effective gain was only $7,000. This effect stands in stark contrast to a home buyer's purchase of a more expensive home -- in which case the higher purchase price (as the cost basis) actually reduced the purchaser's exposure to future capital gains taxation upon resale.

In sum, the effect of § 1034 was to distort the market correction that would normally be expected to occur as a result of falling prices in the cities and rising prices in the suburbs. It continued to promote demand for goods (homes) with rising prices by providing a tax deferral (in effect, a subsidy) for such purchases, and artificially depressed demand for goods (homes) with falling prices by requiring a tax payment (in effect, a penalty). Thus, even if the exodus to the suburbs and the construction of newer and larger homes were caused by factors completely exogenous to the tax effect, the tax code reinforced and accelerated the phenomenon.

POTENTIAL EFFECTS OF THE TAXPAYER RELIEF ACT ON THE LOCATION OF HOMEOWNER HOUSING CHOICES

About 4 million homesellers each year are faced with decisions about their future residences. Many of these homesellers have accrued capital gains on housing over their lifetimes. The change in the tax treatment of home sales will affect many of these housing choices. This report examines the potential magnitude of the law's effects on the location of housing choices.

Assessing the scale of the likely effects is complicated by two factors. First, many interdependent reasons influence housing choices. The housing choices fostered by former § 1034 are reinforced by social factors (such as fear of crime, concern for education, and consumer desire for large yards, two-car garages, and other amenities); by infrastructure subsidies (such as highway construction, public works, sewerage); and by other elements of the tax code (such as the home mortgage interest deduction). Factors such as these may drive housing choices in the same direction as the now-eliminated § 1034. Thus, homesellers may continue to choose to purchase more expensive replacement homes -- rather than to invest in other goods, services, or savings.

Second, it is difficult to gauge the effect of the inducement provided by the new law to engage in purchase and rehabilitation of central city housing (discussed in Chapter Three). Prior state and local tax abatement programs, low-interest loans, and other incentives, provide little basis for comparison with the sweeping effect of the elimination of capital gains taxation on home sales. This is because most prior tax breaks or inducements were often (1) limited in scope - viz. to particular geographic areas where other factors may have been at work, (2) targeted to providers of low-income housing for first time homeowners rather than to existing homeowners looking to relocate, (3) targeted in depressed areas rather than toward protecting stable areas or reviving moderately declining areas, and (4) typically involved incremental relief (property tax abatements, etc.) rather than a lump-sum subsidy like capital gains forgiveness.

Nevertheless, it is possible to predict at least initial effects resulting from the repeal of former § 1034. These effects will be observed in a least two arenas – the effect on housing decisions by homesellers moving within metropolitan areas, and the effect on housing decision by homesellers moving from one metropolitan area to another.

Migration Effects Within Metropolitan Areas

A detailed study of the potential effect of former § 1034 in seven Ohio metropolitan areas suggests possible outcomes with respect to housing choices by homesellers moving within a metropolitan area.[39] That study found first that, based simply on the availability of housing (numbers of houses) in each ring around a central city area, 37 percent of available homes were inward of a homeowner (that is, closer to, or in the central city) and 63 percent were outward. Without regard to price or any other factor, then, one would expect approximately 37 percent of homesellers moving within the region to move inward rather than outward. And indeed, of those buying down in price, 36 percent did move inward. With respect to those needing to buy up in price (as required by former § 1034 to defer recognition of capital gains), however, the study found that the distribution of available homes of equal or higher price was 23 percent inward and 77 percent outward. Now, consider the effect of the Taxpayer Relief Act. By removing the barrier to buying down, the Act allows homesellers with capital gains access to the full 37 percent of the entire universe of homes inward of them -- not just to the 23 percent of the higher priced universe they had access to before.

The Ohio study also suggests some limits on the potential magnitude of the local migration effect of the repeal of former § 1034. The researchers found that inward homes of equal or higher price did not capture 23 percent of the § 1034-compliant movers. Rather, of those homesellers who bought up in price, only 15.8 percent moved inward. Thus, only 2/3 as many homesellers (15.8/23) moved inward as could have moved inward *consistent* with the need to shelter capital gains from taxation. This result demonstrates that factors other than former § 1034 influenced homesellers' decisions to purchase homes farther out. It shows that at least 1/3 of the former buy-up homesellers wanted to move outward regardless of the availability of § 1034-compliant homes inward of them. If we apply this relationship to the entire universe of available homes inward of homesellers, it suggests that in the metropolitan areas studied, no more than 25 percent (37% x 2/3) of those with capital gains might be expected to move inward based on repeal of § 1034 alone.

This is not insignificant, however. The difference between the 15.8 percent of inward movers among those complying with former § 1034 and the 25 percent potential is 9.2 percentage points. This represents the potential incremental increase in inward movers among those who formerly needed to buy up. These results suggest that the repeal of § 1034 presents the possibility of up to a *60 percent increase* in inward

migrations of homesellers with capital gains in moves within a metropolitan area -- viz. 25/15.8 = 1.6. On a national basis this kind of increase would be substantial.

While such results will be affected by whether housing availability in central cities and their surrounding suburban rings is comparable in other metropolitan areas around the country, the linear relationship shown in Table 1 suggests that this is a reasonable proposition. Although there is no guarantee that an increase in inward migrations will result from the repeal of § 1034, the Ohio study's finding that, of those buying down in price, fully 36% moved inward, suggests that there is an opportunity to capture more than the previous 15.8% of those with gains who moved inward without the repeal.

In broad terms, the Taxpayer Relief Act may affect the direction of several hundred thousand household moves within metropolitan areas each year. For example, of the 4 million annual sellers of existing homes nationally, approximately 85 percent have capital gains.[40] Of those with capital gains, approximately 25 percent claimed the over-55 exclusion.[41] So those homesellers potentially affected by the repeal of § 1034 comprise about 2.55 million (4M x .85 x .75). Looking at moves within a single county or metropolitan area, which account for 60 percent of all moves by homeowners,[42] then approximately 1.53 million moves each year may be subject to the Ohio analysis. If moves inward among those with capital gains increase by 9.2 percentage points, then the repeal of § 1034 creates the potential nationally for up to 140,000 more household moves per year to be inward rather than outward, for moves within the same area.

This result is without taking into account the effect of any other inducements or tax effects on housing stock discussed in Chapter 3. These should increase availability of housing stock for inward movers.

Effects on Moves Between Metropolitan Areas

The effect on longer distance movers may be even more significant, particularly in the long run. The Ohio study looked at movers within individual metropolitan areas. However, as noted above, and identified in the legislative history of the Taxpayer Relief Act, the larger effect may well be with respect to moves from one metropolitan area to another, and particularly from high-cost metropolitan areas to lower-cost cities, towns, and villages. If 40 percent of homesellers move outside their counties -- and using the same estimates noted above for capital gains and over-55 -- about 1 million additional

homeseller households are potentially affected by the new tax provisions each year. If these homesellers behave similarly to movers within metropolitan areas, a substantial additional number may purchase homes closer to city and municipal centers than would have done so prior to the tax change.

If the increase amounts to only 10 percent of the total out-of-county movers (comparable with assumptions about in-county movers), then over 100,000 annual moves inward may occur as a result of the change in tax treatment of homeowner capital gains. And the potential is far higher than this both because of regional disparities in housing costs, and increasing regional migration nationally from higher cost to lower cost areas.

While central cities and older suburbs in all areas of the country may experience some positive effects from the change in tax law, these effects should be most evident in those metropolitan areas where housing values are below the national median. Under the former § 1034, homesellers migrating to these areas from higher value areas typically had fewer houses from which to choose -- having to buy homes well above the local median value for the destination area in order to avoid recognition of capital gains on their prior home sales. And these more expensive houses were less often found in the central city than in the surrounding exurban areas. Thus, household migration made possible by the information economy and improved travel opportunities, has led less to the recovery of older towns and cities than to additional sprawl in these less costly communities. The repeal of § 1034 removes the bar to purchasing and living in older, more centrally located, less costly homes.

While net domestic migration statistics are not readily available on a metropolitan statistical area basis, one way to get at this issue is to look at states that are experiencing positive net domestic migration (viz. movement within the United States). Since 1990, ten states have been the biggest gainers, with over 200,000 in net domestic migration (Table 3).

Table 3: Gainers in Net Domestic Migration (1990-1996)

FL 770,300	WA 316,200
TX 428,300	NV 293,800
GA 437,000	CO 283,000
AZ 382,500	OR 221,300
NC 367,600	TN 271,000

Source: U.S. Bureau of the Census, Population Estimates Program, Population Division, Dec. 30, 1996. ST-96-3 "Demographic Components of Population Change, Annual Time Series, July 1, 1990 to July 1, 1996 (includes revised April 1, 1990 census population counts): Block 6 (Net Domestic Migration).

Metropolitan areas in these states could expect to share in some of this demographic growth. But urban areas in these states with housing values below the national median clearly labored under a disadvantage prior to 1997 in terms of the availability of housing that would enable in-migrants to defer taxes under former § 1034. These areas should experience benefits from the effect of the new § 121. The ten high net domestic migration states identified in Table 3 encompass 44 MSAs with housing valued below the national median: including 22 in Texas (including San Antonio, and Houston-Galveston), 1 in Colorado (Pueblo), 5 in Tennessee (including Chattanooga and Knoxville), 2 in Washington (including Spokane), 5 in Georgia (including Savannah and Augusta), 3 in North Carolina, 4 in Florida (including Pensacola and Lakeland-Winter Haven), 1 in Oregon (Salem), and 1 in Arizona (Yuma).[43] To the extent to which these are destination states for those moving from higher cost areas within the United States, these lower cost MSAs should now have a greater opportunity to attract some of the migration and to attract such movers closer to the central cities rather than only to the exurban periphery.

Projected Effects Generally

The effect of the new § 121 and the repeal of former § 1034 on migration and housing choices suggest that central cities and older suburbs could achieve up to a 60 percent increase in the inward migration rate of local homesellers with capital gains; and that lower cost cities and older suburbs in states with substantial net migration from other states could attract a more substantial share of the interstate movers to existing housing stock. The direction of nearly a quarter of a million homeseller

household moves should be affected each year, using conservative assumptions about the tax law's effects.[44]

These modest projections of annual migration effects in the near term do not take into account any other effects of the tax law, urban initiatives, or synergistic effects that may result from the increasing viability and attractiveness of central city and older suburb housing that may be produced by improvements in housing and enhanced neighborhood stability in the future. Such additional improvements may result from the greater retention of owner-occupants, the addition of new homeowner households, and from the housing rehabilitation opportunities discussed in the next chapter.

The effect of the Taxpayer Relief Act on a large portion of 4 million housing choices every year will be significant. It should become even more significant as awareness of the new tax implications of home sales and purchase decisions becomes more widespread.

Chapter Three:

Opportunities for Sustainable Urban Development and Housing Rehabilitation

In addition to repealing the § 1034 incentive for exurban sprawl and greater land consumption, the Taxpayer Relief Act created a new opportunity for greater rehabilitation and redevelopment of older existing housing stock. This opportunity arises because the profits on such an activity are now tax-free when performed on the owner's principal residence. The former requirement to buy up upon sale of the improved residence, which in the past severely limited homeowners' opportunity to do this kind of rehabilitation more than once, has been eliminated. As noted in the introduction to Chapter Two, an owner-occupant who generates a capital gain through investment in rehabilitation of a home, may realize the gain tax free, and may repeat the process as a "serial seller." While the serial seller strategy may appeal to a relatively small number of owner-occupants, the tax-free treatment of gains can be used to encourage rehabilitation of housing by a variety of homeowners, and to enhance interest in rehabilitation by lenders and community development organizations.

HOUSING REHABILITATION BY SERIAL SELLERS

The serial seller strategy is likely to attract at least some persons seeking to increase tax-free income. For example, a person with knowledge of construction may purchase and live in a "fixer-upper" house. By rehabilitating the house, the owner may produce a real capital gain. The gain is calculated on the purchase price plus the out-of-pocket costs for materials and labor -- not including the taxpayer's own labor. Upon sale of the house, the gain is tax-free income to the taxpayer. The taxpayer may then purchase another fixer-upper and repeat the process. This strategy may be used an indefinite number of times, so long as at least two years pass between transactions and the ownership and residency requirements are met.

The serial seller strategy is a business opportunity for owner-occupants created by the change in tax law. Even without governmental or lender attention, it is likely to produce a higher level of rehabilitation of distressed properties in reasonably stable neighborhoods. However, with such attention, or coupled with other strategies aimed

at redevelopment and housing, a great deal more might be made of this opportunity for urban revitalization.

For example, assume a run-down central city house with a purchase price of $25,000. A nonprofit or public lender might make a loan to a low-income first-time home buyer of $25,000 for the purchase price, and a $20,000 construction and rehabilitation loan, both at a low interest 6% with a 5-year balloon note. Interest payments would be about $225 per month. Assuming that the $20,000 was expended for materials and labor (other than the homeowner's own labor), the homeowner's basis in the house would be $45,000. If it were sold for $55,000, the gain would be $10,000, providing the homeowner with a tax-free nest egg after payment of the note.

If the loan and purchase arrangement were part of an ongoing program, the homeowner might be given an option to purchase another house rehabilitated under the program with all or some portion of the $10,000 going toward the downpayment. With this kind of downpayment, commercial mortgage lenders could end up making the loans to the subsequent owners, as the nonprofit lender moves on to the next rehabilitation area.

A similar approach might seek to capture a portion of the nontaxable gain to support the loan program - for example, assigning the lender an interest in the gain on the sale. The result could be the production of a greater quantity of improved housing stock with, in effect, a federal subsidy requiring no federal outlay but deriving from the tax code.

THE FHA 203(k) PROGRAM

Greater attention to, and implementation of, existing programs for the rehabilitation of housing could produce substantial synergies with the housing rehabilitation opportunity presented by § 121. One program with particular utility for this purpose is the Section 203(k) program administered by the Federal Housing Administration (FHA).[45]

This mortgage insurance program is the primary Department of Housing and Urban Development (HUD) program for the rehabilitation and repair of single family properties. The program allows the lender to provide the borrower with a single mortgage loan, at a long-term fixed or adjustable mortgage rate, to finance both the purchase and rehabilitation of the property. By rolling purchase and rehabilitation

costs into one mortgage, 203(k) eliminates the need to acquire separate, more expensive mortgages for both the short-term acquisition of a property and construction.

The amount of the mortgage reflects both the projected value of the property upon completion of the work and the cost of the work. As a risk-minimizing incentive to the mortgage lender, the mortgage loan qualifies for endorsement by HUD as a fully-insured loan following the disbursement of mortgage proceeds and the establishment of a rehabilitation escrow account at closing.

To be eligible for FHA 203(k), a property must be a one- to four-family residence that has been completed for at least one year. With some restrictions, the loan also applies to condominium units and "mixed use" properties. The loan can be used for the purchase and rehabilitation, as well as the refinancing and rehabilitation, of a residence. For all properties, the program requires a minimum of $5000 in rehabilitation or improvements.[46] FHA 203(k) can be used by investors and commercial home renovators as well as by owner-occupants. The required downpayment for investors is 15 percent, rather than the 3 to 10 percent required of owner-occupants.

The loan process works in the following way: First, a homebuyer selects a house and determines the extent of renovations necessary to comply with all local housing codes. The homebuyer then chooses a mortgage company participating in the 203(k) program and hires a either a contractor or a plan reviewer as a consultant. At this point, the homebuyer must arrange for a property appraisal, after which the lender determines a "maximum insurable mortgage amount." This amount is the lesser of (1) the pre-rehabilitation value plus the cost of rehabilitation, or (2) 110 percent of the estimated market value after rehabilitation.[47] The loan limitation based on 110 percent of the estimated post-rehabilitation value is not applicable if a unit of local government satisfactorily demonstrates to the FHA that the property is located in an area subject to a "community-sponsored program of concentrated redevelopment or revitalization" and imposition of the limit would prevent the utilization of the program to accomplish rehabilitation in the area.[48] The maximum mortgage amount is also limited by the normal FHA mortgage insurance limits, which are adjusted periodically and which apply different limits to higher cost areas.[49]

FHA 203(k) has been in existence for over three decades and has been an official program since the Housing and Community Development Amendments of 1978; however, until recently, the program has been underutilized.[50] For example, from 1986-1990, the program averaged fewer than 450 loans per year nationwide.[51] The annual

average rose to nearly 3100 in 1991-1994.[52] The Clinton Administration attributed the program's lack of popularity to the complicated administrative procedures previously required by law and, in response, simplified the loan. The loan is now administratively less burdensome and less expensive for lenders to implement by no longer requiring lenders to oversee renovations and by limiting the number of required appraisals.[53]

The Clinton Administration named FHA 203(k) as a key element in its *National Homeownership Strategy* issued in 1995, and announced by the President in June of that year. The strategy recommends that partnership efforts:

> seek to expand the number of conventional lending institutions and other FHA-approved lenders actively participating in the FHA 203(k) program. Partnership efforts also should include increasing risk-sharing opportunities and more fully developing the secondary market for this product.[54]

According to HUD, the number of 203(k) loans has increased considerably in recent years.[55] In 1996, the FHA insured 17,000 loans under the 203(k) program, a remarkable increase in a short time.[56] Continued emphasis on opportunities to expand this program can, coupled with the tax benefits of § 121, lead to a substantial amount of revitalization of urban housing stock -- benefiting neighborhoods, first time homebuyers, and serial sellers. Even before the change in federal tax law, this program was increasing in usefulness and has been used by such organizations as the nonprofit Columbus Housing Partnership in Ohio to rehabilitate HUD-foreclosed homes and put them into the hands of low-income homeowners.[57]

The 203(k) program could significantly benefit prospective homeowners seeking to purchase and rehabilitate urban residences needing rehabilitation. The loan not only eases the burden of purchasing a property and making the desired improvements, but, under the new tax scheme, also preserves all capital gains resulting from the increase in the value of the residence. In addition, the loan can further contribute to the revitalization of urban housing by allowing homeowners to improve properties already in their possession by providing funds for refinancing and the desired rehabilitation.

OTHER INCENTIVE PROGRAMS FOR URBAN REVITALIZATION

A variety of other programs can also work together with § 121 of the Internal Revenue Code to improve prospects for owner-occupant rehabilitation of housing and central city neighborhoods. In addition, the boost to urban homeownership and retention of homeowners provided by the Taxpayer Relief Act can help make economic

development and residential initiatives more viable by assuring a more broad-based, stable socio-economic environment. The tax signals for private decisionmaking for the first time are not working at cross-purposes with many of the public and private programs designed to revive cities and urban neighborhoods.

Homeownership Zones: Homeownership Zones are large scale single-family housing developments designed to bring mixed income and more working households back to inner city neighborhoods in need of revitalization. The program finances infrastructure improvements and homeownership opportunities, allowing select communities (designated Empowerment Zones or Enterprise Communities) to construct new low- and middle-income housing units, rehabilitate blighted property and reclaim vacant land. In the past year, $30 million in Homeownership Zone grants funded revitalization projects in Baltimore, Philadelphia, Louisville, Sacramento, Buffalo and Cleveland. In June 1997, HUD Secretary Andrew Cuomo announced an additional $10 million in grants to fund new Homeownership Zones.

Ginnie Mae Targeted Lending Initiative: Officially launched in September 1996, this program provides up to 50% reductions in the guarantee fee charged to lenders that issue inner city mortgages in 72 eligible inner city communities designated Empowerment Zones and Enterprise Communities. The ultimate goal of the program is to stimulate at least $1 Billion in annual mortgage loans and bring 15,000 new homeowners to urban areas.

Urban Homestead Initiative: With cuts in HUD home mortgage insurance premiums, the Urban Homestead Initiative annually saves first-time homebuyers an average of $200 each in closing costs when they purchase homes in the inner city with a mortgage insured by the Federal Housing Administration.

Community Development Block Grants: A Community Development Block Grant (CDBG) is a federal entitlement program, designed to benefit low- and moderate-income individuals by providing suitable housing and expanding economic opportunities. CDBG funding, granted directly to states and large communities, is highly flexible and can be used to fund a variety of activities, including housing rehabilitation, construction of new housing and the purchase of land and buildings. The majority of CDBG funding goes to large cities.

HOME Investment Partnerships Program (Grants): As of September 30, 1997, this program provides funding, through grants, for the construction, rehabilitation, or purchase of affordable housing units for an estimated 280,000 families and individuals.

HOPE for Homeownership of Single Family Homes (HOPE 3): Through project grants, HOPE 3 aims to provide homeownership opportunities to lower-income families and individuals by financing the purchase and rehabilitation of single-family properties for occupancy or sale. The program is geared towards private nonprofit organizations, cooperative associations and public agencies (in cooperation with private nonprofit organizations).

Other programs and approaches include linkages to enterprise zones and brownfields, tax increment financing (using local real estate tax abatements to encourage rehabilitation of housing and neighborhoods), and city and nonprofit programs.

Specialized tax programs like the new federally-authorized $5,000 tax credit for first-time home buyers in the District of Columbia, present opportunities that -- when coupled with a clear explanation and understanding of the effect of the Taxpayer Relief Act -- can provide a profound incentive for re-entry to the central city and rehabilitation of run-down housing by owner-occupants. Urban homesteading, and $1 tax-sale programs similarly have been given a potentially significant economic boost by the new law.

STRATEGIC PLANNING FOR SUSTAINABLE URBAN DEVELOPMENT

The new tax law does not only present a business opportunity for homeowners with construction skills, nor just a way to generate rehabilitation of housing for poorer residents. It also presents an opportunity to target the attraction of those middle and upper-income households who desire to live in the city but who have been previously locked out by the need to avoid taxation of their lifetime of accrued gains. It offers opportunities for synergies in targeting urban revitalization incentives -- such as encouragement of infill -- with positive spillover effects. For example, if urban development or lending programs focus on upgrading existing neighborhood housing or constructing new infill housing, these activities will increase the *potential* value of adjacent existing *unrehabilitated* housing. The existence of this potential value, in turn, creates the opportunity for others to rehabilitate these homes in order to reap the

benefits created by § 121. Thus, § 121 provides a means to amplify the effects of community investments and redevelopment on surrounding homes and neighborhoods. Programs that support owner-occupant investments, moreover, can help assure that these positive spillover effects of more direct programs are realized.

There is a profound need for attention to neighborhoods by cities and older suburbs hoping to harness the effects of § 121. Research has shown that coordination of housing investments and neighborhood revitalization efforts is critical because of the "threshold effects" of changes in demography on neighborhood investment and stability. This matters because "at the threshold, the marginal increase in an expected benefit resulting from a given increment [increase] in middle income residents will be noticeably greater because of the number of middle-income households *already* present in the relevant area."[58] Thus, although § 121 applies everywhere, targeting incentives to take advantage of its likely effects in *particular* neighborhoods will be important if it is to have a meaningful effect in reviving urban centers.

One of the most important of the threshold effects for central cities and older suburbs is the house upgrading threshold. This effect, which has been well-documented by both empirical and theoretical studies, is that investments by homeowners in upgrades (improvements and repairs) reinforce the tendency of others in the immediate vicinity to make similar investments:

> In contexts with high degrees of mutual reassurance . . . aggregate upgrading becomes probable when some exogenous factor (like public investments) encourages one individual to upgrade.[59]

In the new tax environment, § 121 will provide a modest incentive or reinforcement to upgrades of owner-occupied homes. If targeted loan, incentive, or other programs can be brought to bear in key neighborhoods, this tax incentive will be magnified and the threshold effect will produce desirable impacts on the surrounding area. For example, strategies that promote infill development and brownfields redevelopment are likely to encourage private owner-occupant investments in rehabilitation of homes in the same neighborhoods. This, in turn, should increase the viability of further efforts in the vicinity, as well as improve the local tax base. Strategic targeting of urban redevelopment strategies, loan programs, local tax incentives and other tools can help take advantage of the new tax-free status of increases in the value of homes.

CONCLUSION

Taxes matter. Changes in tax law can remove incentives that drive development in unsustainable directions, and can create new opportunities to place development on a sustainable path. Especially in areas such as housing and development, where millions of individual decisions affect the environment and social context, tax law can be far more influential than many other tools available to governments.

The Taxpayer Relief Act of 1997 presents an opportunity for the nation's central cities and older suburbs, while reducing some artificially induced pressures that threaten the nation's rural areas and farms. It is a first step toward sustainable urban development.

Appendix

Migration within MSAs with Single Central Cities
and Difference in Median Home Values

CITY	*# MOVED OUT*	*# MOVED IN*	**RATIO OUT:IN**	*MSA: MEDIAN VALUE ($)*	*CITY: MEDIAN VALUE ($)*	**DIFF.* MSA-CITY* ($)
Grand Forks, ND	781	1351	**0.58**	62,200	64,000	**(1800)**
Casper, WY	2066	2358	**0.87**	52,300	52,400	**(100)**
Enid, OK	999	1119	**0.89**	37,800	38,000	**(200)**
Wichita Falls, TX	2032	2092	**0.97**	45,800	47,200	**(1400)**
Florence, AL	3613	3323	**1.09**	49,200	52,500	**(3300)**
Montgomery. AL	7585	5884	**1.29**	60,600	61,000	**(400)**
Pascagoula, MS	2937	2269	**1.30**	49,900	47,800	**2100**
Pittsfield, MA	2110	1618	**1.30**	116,500	110,700	**5800**
Dubuque, IA	2088	1600	**1.31**	53,400	51,300	**2100**
Tulsa, OK	27,583	19,978	**1.38**	58,500	60,000	**(1500)**
Yuba City, CA	5368	3827	**1.40**	79,900	85,200	**(5300)**
Merced, CA	5551	3702	**1.50**	90,100	90,300	**(200)**
Altoona, PA	3797	2363	**1.61**	40,700	30,600	**10,100**
Jackson, MI	6114	3731	**1.64**	47,600	31,500	**16,100**
Hagerstown, MD	6002	3401	**1.76**	82,700	67,000	**15,700**
New Bedford, MA	6256	3531	**1.77**	131,100	114,900	**16,200**
Springfield, MO	12,573	6414	**1.96**	57,700	53,300	**4400**
Daytona Beach, FL	9157	4630	**1.98**	69,200	62,000	**7200**
Lima, OH	5888	2965	**1.99**	54,100	38,800	**15,300**
Olympia, WA	8043	3987	**2.02**	79.800	77,500	**2300**
Madison, WI	19,810	9655	**2.05**	77,900	74,400	**3200**
Fort Wayne, IN	17,397	8419	**2.07**	58,500	47,200	**11,300**
Chattanooga, TN	21,132	9640	**2.19**	56,900	53,900	**3000**
Binghamton, NY	9925	4532	**2.19**	77,800	70,400	**7400**
Santa Fe, NM	4999	2188	**2.28**	109,000	98,900	**10,100**
Laredo, TX	2105	845	**2.49**	48,800	51,400	**(2600)**
Tallahassee, FL	12,537	4991	**2.51**	70,000	71,800	**(1800)**
Reading, PA	11,072	4366	**2.54**	80.900	37,300	**43,600**
Knoxville, TN	29,752	11,119	**2.68**	60,000	49,800	**10,200**
Anniston, AL	3937	1404	**2.80**	51,300	49,700	**1600**
Columbia., SC	26,803	7388	**3.63**	72,300	72,100	**200**
Bradenton, FL	16,791	4415	**3.80**	79,000	71,300	**7700**
Baton Rouge, LA	33,776	8621	**3.92**	66,100	67,100	**(1000)**
Rochester, NY	64,603	15,073	**4.29**	86,200	64,700	**21,500**
Augusta, GA	17,248	3860	**4.47**	62,700	47,700	**15,000**
Shreveport, LA	22,905	4856	**4.72**	56,100	53,700	**2400**
Washington, DC	155,789	25,889	**6.02**	165,300	121,700	**43,600**
St. Louis, MO	170,692	27,941	**6.10**	69,500	49,700	**19,800**

Source: 1990 Census

Notes

1. James M. McElfish, Jr and J. William Futrell, "Sustainable Development Law: More Than a Planning Goal," in *Modernizing State Planning Statutes: The Growing Smart Working Papers (Vol. 1)*, American Planning Association, Planning Advisory Service Report Number 462/463. 1996. at p. 64.

2. Pub. L. 105-34 (Aug. 5, 1997), § 312, 111 Stat. 836-841, codified at 26 U.S.C. § 121.

3. Former 26 U.S.C. § 1034 (1996).

4. Former 26 U.S.C. § 121 (1996).

5. H. Rep. 105-148, June 24, 1997, 105th Cong., 1st Sess. 347, reprinted in 1997 U.S. Code Cong. & Admin. News 741. See also Gerald E. Auten and Andrew Reschovsky, "The New Exclusion for Capital Gains on Principal Residences," 90th Annual Conference on Taxation, National Tax Association, November 1997, at p. 4.

6. H. Rep. 105-148, 105th Cong., 1st Sess. 347 (June 24, 1997), reprinted in 1997 U.S. Code Cong. & Admin. News 741.

7. Ohio Housing Research Network, *The IRS Homeseller Capital Gains Provision: Contributor to Urban Decline* (1994).

8. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997).

9. U.S. Dept. of Treasury estimate. Tax revenues were about $400-500 million/year. See also Auten & Reschovsky, at p. 8, and Table 1 (tax revenues of $491 million, $884 million, and $682 million in 1993-95; but revenue losses to Treasury after enactment of § 312 of the Taxpayer Relief Act projected at $300-400 million).

10. Roberto G. Quercia and George C. Galster, "Threshold Effects and the Expected Benefits of Attracting Middle-Income Households to the Central City," in Housing Policy Debate, Vol. 8, Issue 2, 409, 410-411 (Fannie Mae Fdn. 1997) .

11. A. Ann Sorensen, Richard P. Greene, and Karen Russ, *Farming on the Edge*, American Farmland Trust (1997).

12. *Id.*

13. President's Council on Sustainable Development, *Sustainable Communities Task Force Report: Final Review Draft* (released December 1996), "Policy Recommendation 7: Reduce Sprawl and Promote Smarter Growth, Action 1," p. 27. The Task Force's final report was published as PCSD, *Sustainable Communities Task Force Report* (Fall 1997), "Policy Recommendation 7: Reduce Sprawl and Promote Smarter Growth, Action 1," pp. xii and 30.

14. 111 Stat. 836, codified at 26 U.S.C. § 121(a),(b).

15. 111 Stat. 837, codified at 26 U.S.C. § 121(c).

16. 111 Stat. 841.

17. H. Rep. 105-148, 105th Cong., 1st Sess. 347-348 (June 24, 1997), reprinted in 1997 U.S. Code Cong. & Admin. News 741-742.

18. Of course other tax incentives for purchase of expensive homes remain, including the home mortgage interest deduction and property tax deductions. See, e.g., Auten & Reschovsky, *supra* n.5 at 13, n.1 (giving Treasury's estimates of tax expenditures for these as $47.5 billion and $15.9 billion, respectively, for fiscal year 1998).

19. "[H]ome builders, particularly those who have catered to people pushed to build bigger houses in low-cost areas...'may be the only set of losers, and they don't lose that much'," Maryann Haggerty, "Candidates Peddle End to Capital Gains Tax," Washington Post, September 7, 1996, p. E2, quoting John A. Tuccillo, economist at the National Association of Realtors.

20. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997) (1997 projections based on 2d quarter seasonally adjusted rate). Compare total U.S. housing stock (1990): 102,264,000 units - 59,025,000 owner occupied; 32,923,000 renter occupied; 11,312,000 vacant.

21. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997). New single family housing completions in 1997 are projected at 1,107,000, a number consistent with annual completions throughout the 1990s which have run at approximately 1 million to 1.1 million per year. *Id.* (1997 projections based on 2d quarter seasonally adjusted rate). Total new housing completions (including single family and multiple unit) in 1997 are projected at 1,378,000. Total new housing completions in the 1990s have run at approximately 1.3 million to 1.4 million per year. *Id.*

22. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997) (1997 projections based on 2d quarter seasonally adjusted rate).

23. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997) (1997 projections based on 2d quarter seasonally adjusted rate).

24. US Dept of Housing and Urban Development. US Housing Market Conditions (Aug. 1997).

25. U.S. Bureau of the Census. 1990 Census.

26. U.S. Bureau of the Census, "Geographical Mobility of People 1 year and older, by sex, between March 1996 and March 1997", Current Population Survey, Preliminary Data. This survey does not count persons who moved from the United States to other countries, but is based on surveys of those currently living in the United States at the end of the survey period.

27. See U.S. Bureau of the Census. August 1995. Table A-1 Annual Geographical Mobility Rates, By Type of Movement: 1947-1994. However, the percentage of total movers was slightly

higher from 1984 to 1990, ranging from 17.9% to 20.2% annually. *Id.*

28. Bureau of the Census, Current Population Reports, Geographical Mobility: March 1995 to March 1996 (by Kristen A. Hansen), Table D. This report breaks down the statistics to show persons in owner-occupied and renter-occupied units at the end of the period, and where they moved from; but it does not enable one to discern where home owners (or renters) at the beginning of the period moved to.

29. Percentages based on Bureau of the Census, Current Population Reports, Geographical Mobility: March 1995 to March 1996 (by Kristen A. Hansen), Table D.

30. *Id.*

31. However, not all cities have lost population, or lost it at a high rate. In many cases this is due to births and to foreign immigration.

32. John Kasarda, Stephen Appold, Stuart Sweeney, and Elaine Sieff, "Central-City and Suburban Migration Patterns: Is a Turnaround on the Horizon?" in Housing Policy Debate, Vol. 8, Issue 2, pp. 307-358 (Fannie Mae Fdn. 1997). This study answers the question posed in its title in the negative.

33. Kasarda, Appold, Sweeney & Sieff, at p. 321.

34. U.S. Bureau of the Census, 1990 Census of Population and Housing.

35. U.S. Bureau of the Census. 1990 Census Data.

36. Chris Lester and Jeffrey Spivak, "Suburbs Can't Escape the Cost of Separation" Kansas City Star, December 17, 1995.

37. The tax liability could not readily be financed in the mortgage on the new property, because the appraised value of the purchased home, in many instances, might not support additional loan amounts.

38. The Treasury Department estimated that under § 1034 in recent years, only about 150,000 taxpayers were required to pay capital gains taxes on sale of their principal residence each year, generating total yearly revenues of $400-500 million. This suggests an average additional tax bill of $2,600 to $3,400 for those homeowners buying down.

39. Ohio Housing Research Network, *The IRS Homeseller Capital Gains Provision: Contributor to Urban Decline* (1994). This study, led by Prof. Thomas Bier, Director of the Housing Policy Research Program at Cleveland State University, compared deed records of home sales and purchases in the seven urban metropolitan areas in Ohio.

40. See Auten and Reschovsky, *supra* n. 5, at Table 1 (IRS Form 2119 data show 87 percent of homesellers with capital gains, based on sample of tax returns for 1993, 1994, and 1995).

41. *Id.* The percentage based on the sample return statistics was 24 percent (1993-1995 data). Our analysis excludes these over-55 claimants in part because they are likely to be less affected by the repeal of § 1034 (although some over-55 homesellers may still have had capital gains subject to taxation after use of the exclusion). More importantly, however, for purposes of the Ohio analysis they were already included in the "buy-down" group (36 percent of which moved inward) rather than the "buy-up" group (15.8 percent of which moved inward) which is the basis for the calculations that follow. It should be noted also that excluding 25 percent of all households with gains from the analysis to account for the former over-55 exclusion may be conservative as this percentage may overrepresent those affected by the former exclusion. Forms 2119 are filed by only about 40 percent of homesellers, for a variety of reasons including unfamiliarity with the law. Presumably older taxpayers claiming the exclusion were more likely to be aware of the law, to comply, and to file the necessary forms.

42. See mobility data, *supra*, notes 26-30.

43. U.S. Census Bureau, 1990 Data, Metropolitan Statistical Areas: Median Value - Specified Owner-Occupied Housing Units.

44. The results of this study are consistent with those reported in a detailed economic analysis of tax data. Leonard E. Burman, Sally Wallace, and David Weiner, "The Economic Effects of Taxing Capital Gains on Owner-Occupied Housing," unpublished paper, September 5, 1997. Burman *et al.* concluded that approximately 8.3 percent of filers of Form 2119 were induced to buy up rather than down in price due to § 1034. Applied to the 1.5 million filers, this analysis suggests that 125,000 households would change their behavior given the Taxpayer Relief Act; if applied to the full 4 million sellers of existing homes, this would represent as as many as 330,000 households.

45. 12 U.S.C. § 1709(k); see regulations at 24 CFR 203.50.

46. Department of Housing and Urban Development, "Rehab a Home with HUD's 203(k)" (1997).

47. 24 CFR 203.50(f).

48. 24 CFR 203.50(g). The local government must also show that the interests of the mortgagor and the FHA are adequately protected if the limit is not used. Id.

49. For example, the basic FHA limits for FHA-insured loans on single family homes are currently $86,317, unless the property is located in a high cost area -- which includes most urban and metropolitan areas. For example, the current FHA mortgage limit in the District of Columbia for a single family home is $170,362. See http://www.hud.gov/fha/sfh.

50. Matt Carroll, "Worthwhile US Program Ignored" Boston Globe (25 October 1992), A1.

51. *Mortgage Marketplace*, September 9, 1996.

52. *Mortgage Marketplace*, September 9, 1996.

53. Department of Housing and Urban Development, "The Clinton Administration's National Urban Policy Report," (Draft, July 25, 1995)

54. Department of Housing and Urban Development, *National Homeownership Strategy: Partners in the American Dream* (May 1995), Action 41.

55. Greg Thomas, "Renovation Loans Come to the Rescue: Federal 203(k) Program Provides Money to Buy, Fix Up Old Houses" Times-Picayune (1 March 1997), R1.

56. Jeff Testerman, "Scheme Threatens Housing Dreams," St. Petersburg Times, Jan. 18, 1998, p. 1B.

57. Department of Housing and Urban Development, *National Homeownership Strategy: Partners in the American Dream* (May 1995), Action 41.

58. Quercia and Galster, *supra* n. 10, at 418.

59. Quercia and Galster, *supra* n. n. 10, at 420, n. 12.