CUT TO INVEST

Create New Bond and Tax Credit Programs to Restore Market Vitality to America's Distressed Cities and Neighborhoods

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Summary

To promote market recovery and revitalization of cities and neighborhoods destabilized by recession, job loss, and foreclosures, Congress should authorize the creation of a new, multifaceted Strategic Neighborhood Investment Program that includes bonding authority, tax credits, and a special mortgage program. These programs, each of which tackles a different aspect of the problem, would together make possible the reuse or demolition of thousands of now-vacant or substandard properties, stabilize distressed neighborhoods, create new homeownership opportunities for young families, foster sustained increases in market value and private investment, and ultimately improve the fiscal and economic health of the nation's metropolitan areas.

Background

The ability of cities, towns, and metros to compete in the "next economy" is inextricably linked to their being healthy, attractive, and desirable places to live and work. In fact, the relationship between a city's economy and its neighborhoods is a reciprocal one: Without a thriving economy, a city will have few strong neighborhoods, and without thriving neighborhoods, a city's economy will be fragile.

Unfortunately, the short-term vitality and long-term survival of many American communities is seriously at risk. Five years of elevated mortgage foreclosures, coupled with sustained high unemployment and municipal fiscal stress, have destabilized neighborhoods in cities and suburbs throughout the country. Vacant, abandoned properties in these neighborhoods act as a drag on market recovery, devaluing property values, deterring developers and prospective homebuyers from investing, and discouraging existing owners from improving their homes. Market distress is exacerbated by neglected vacant lots and public spaces, occupied but deteriorated housing, crime and safety concerns, and inadequate infrastructure.

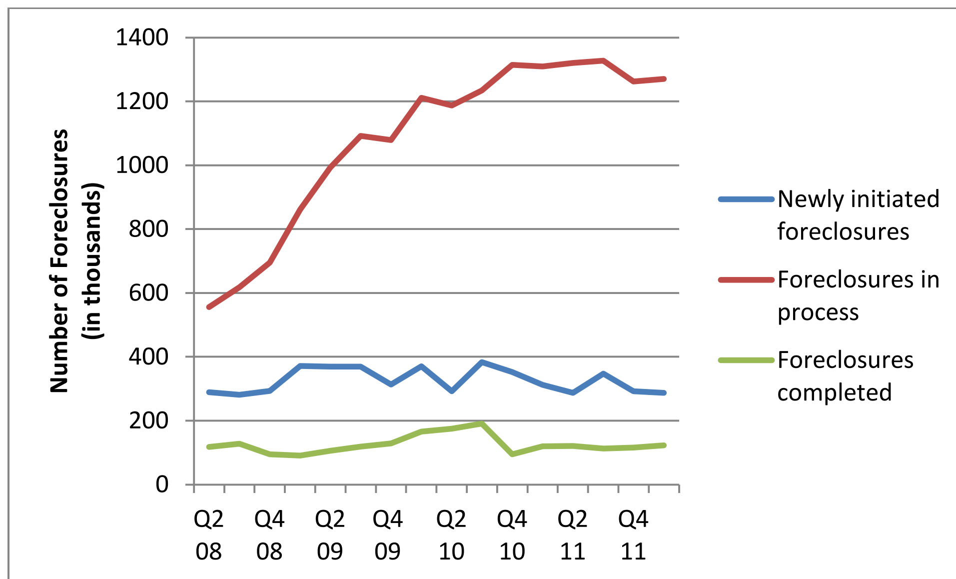
Efforts to rebuild the economies of these communities are unlikely to be successful unless we also restore the overall health of their residential neighborhoods.

The Problem

Unfortunately, the scale of the foreclosure and abandonment problem is too large, and the market failures too deep, for distressed neighborhoods to recover on their own—nor can cities and states alone fill the gap:

- **Foreclosures are still at a crisis point.** Although home prices may have hit bottom and new defaults have started to decline, between 11 and 15 million homeowners are still "underwater," the volume of new foreclosures is largely unchanged, and the "shadow inventory" of properties in foreclosure remains at near-record highs (Figure 1). Foreclosures continue to wreak havoc not only on individual families, but on entire neighborhoods, particularly those occupied by low-income and minority households

Figure 1. Foreclosure Trends, 2008–2012



Source: Office of the Controller of the Currency, Mortgage Metrics Report
Note: Data based on a sample of approximately 62 percent of all mortgages

- **Since 2000, the number of vacant properties in the United States has skyrocketed.** While the number of housing units in the nation increased by less than 14 percent between 2000 and 2010, the number of *vacant* units rose by 44 percent. During this period, the number of units classified by the Census as "other vacant"—a rough surrogate for long-term vacant or abandoned units—rose by 59 percent, from 2.3 million to 3.65 million units. These units are disproportionately located in central cities and in urban and suburban areas hard-hit by foreclosures

- **Long-term economic decline, exacerbated by the foreclosure crisis, has triggered widespread neighborhood destabilization.** At-risk neighborhoods fall on a destabilization continuum. At one end of the spectrum, there are areas in distressed cities like Detroit and Cleveland where disinvestment is far advanced, the market has effectively ceased to function, and the neighborhood fabric has largely been eroded by vacancy and abandonment. In these areas, large-scale demolition is needed both to remove blighted properties for which no market exists, and create vacant land that can be reused or turned into green space.

At the other end of this spectrum are neighborhoods that are still vital, yet are steadily being eroded by foreclosures and abandonment. Many of these neighborhoods have strong assets, including historic or architecturally valuable houses; proximity to major universities, hospitals, downtowns, and transit routes; strong neighborhood organizations and community development corporations; and dedicated homeowners. In these neighborhoods, most vacant buildings can and should be preserved and restored for new occupants, before they become a blighting, value-draining, and ultimately wealth-stripping influence on surrounding properties and homeowners.

Even in asset-rich communities, however, weak market demand often keeps values too low to make rehabilitation economically feasible without public sector assistance. A house in Cleveland that may cost $80,000 or more to restore to sustainable occupancy may be worth only $40,000 after restoration; the same house in Detroit may be worth only $25,000. With financially-strapped cities and states hard-pressed to provide their citizens with even basic services, this issue calls for a federal response

- **The Federal Neighborhood Stabilization Program (NSP) has helped improve conditions in some communities, but its impact has been limited.** First authorized in 2008, the Neighborhood Stabilization Program ultimately provided three rounds of funding to help stabilize communities that have suffered from foreclosures and abandonment. The amount provided, however, was minute compared to the sheer scale of the problem, and in many parts of the country devastated by foreclosures the capacity to strategically spend even that small amount was inadequate. In many communities, moreover, limited funds were scattered too thinly to have a significant impact, and they were rarely used as part of a larger market-driven strategy to stabilize neighborhoods. With these funds largely spent, and no more on the horizon, many still-viable American neighborhoods remain at imminent risk of further deterioration and market collapse

It is unrealistic to believe that the housing market will improve at the scale and pace needed to turn these neighborhoods around. Without focused federal support, many are likely to deteriorate further, resulting in the loss of billions of dollars in home values and millions in tax revenues.

Proposal

To address these challenges, the Metropolitan Policy Program at Brookings proposes the **creation of a multifaceted Strategic Neighborhood Investment Program that includes both a Qualified Neighborhood Investment Bond program, and a multi-part Neighborhood Investment Tax Credit program**. While the qualified neighborhood investment bonds could be used by states and localities in a variety of different locations, the tax credits and the associated mortgage program would be limited to specified designated neighborhoods, as described below.

1. Qualified Neighborhood Investment Bond program (QNIB)

This proposed bond program represents an adaptation of the Restore our Neighborhoods Act of 2012 (HR 4210), introduced in March 2012 by a bipartisan group of representatives led by Stephen LaTourette of Ohio. That bill would have authorized $4 billion in Qualified Urban Demolition Bonds to fund the demolition of vacant and abandoned housing in hard-hit communities across the country.

The QNIB program uses the same fiscal structure, but provides greater funding flexibility. It would authorize $8 billion dollars in state and local bonding authority, the purpose of which would be to provide a flexible resource for addressing property issues that are hindering the revitalization of distressed cities and towns. Funds could be used for demolition, which is likely to be a priority for many

Midwestern states and cities; for property acquisition and rehabilitation; and for related uses, such as improvements to vacant lots. States and cities would have five years to spend their allocation, with any unused authority rescinded.

Following a model established for qualified school construction bonds in the American Recovery and Reinvestment Act, the interest on these bonds would be replaced by a federal tax credit to the bond buyers, so that issuers could borrow the funds at zero percent interest.

The cost to the issuer would be the cost of repaying the principal amount when the bonds become due, in 20 or 30 years. The issuer would create a sinking fund today, which by earning interest over that period grows to the full amount of the principal by the bond due date.

Of the $8 billion in bonding authority, one-quarter would be allocated in equal shares to all of the states, while the balance would be allocated state-by-state on the basis of a formula that took into account vacant housing, foreclosures, and economic distress. Bonding authority would be allocated to state governments, which would be required to share their authority with local jurisdictions that meet certain criteria and want the ability to issue bonds directly.

2. Neighborhood Investment Tax Credit program (NITC)

The Neighborhood Investment Tax Credit program (NITC) is designed to be a realistic, cost-effective, market-based vehicle for generating targeted investment in still-vital but severely destabilized neighborhoods. The NITC would foster housing rehabilitation and increased homeownership, help preserve homeowners' equity, and restore sound, healthy housing market conditions so that today's distressed neighborhoods once again become self-sustaining.

The NITC program would have three elements:

- **neighborhood investment pools**, funded by passive investors who would receive a tax credit for their investments
- a **tax credit for households** that buy and restore houses for owner-occupancy
- a **special FHA mortgage program** for homebuyers

These three elements complement one another, with each playing a clear and critical role in the process of neighborhood revitalization.

Designated NITC neighborhoods would be determined by HUD through a competitive process, which would be based on each neighborhood's (1) assets and market-building potential; (2) demonstrated level of need, as reflected in such measures as high foreclosures, low property values, and high vacancies; and, (3) presence of one or more public sector, nonprofit, or neighborhood-based entities with the capacity to carry out a strategic revitalization and market-building program. In each neighborhood, one public or private entity would be designated as the lead entity to administer the program. The number of neighborhoods that HUD could designate would be limited to make sure that each neighborhood received enough investment to have a significant impact, while keeping the total federal outlay within bounds. Designated NITC neighborhoods would likely vary widely in size, and could be located in both large and small cities.

The investment pool tax credit would work much like the Low-Income Housing Tax Credit. Investors would receive a tax credit that they could take over 10 years equal to the amount that they invest in the neighborhood investment pool. Since there would be no recapture risk associated with these tax credits—unlike with the LIHTC—they are likely to lead to investments equal to 85 to 90 percent of the amount of the credit. Investment pool proceeds could be used for a wide variety of purposes designed to stabilize targeted neighborhoods, but at least 50 percent of the proceeds would have to be used for

housing acquisition and rehabilitation. The balance could be used for public improvements such as streetscape or park improvements; commercial district improvements or business assistance; and marketing and community-building activities. Three hundred million dollars per year in tax credits would be available to investors. Based on the experience of a similar state tax credit program in New Jersey, these funds are likely to leverage $6 or more in private, philanthropic, or other public funds for every $1 of tax credit proceeds.

Once a neighborhood is designated by HUD as NITC-eligible, it would receive a five-year allocation of investment pool tax credits, the amount of which would be determined by a formula based on neighborhood size (either population or number of residences); market conditions; and the scope of potential revitalization activity needed. Each neighborhood's lead entity would be responsible for marketing the investment pool tax credits to investors and would have broad discretion to use investment pool funds as needed to further their local strategies. Twenty-five percent of the housing rehabilitation assistance funded by the investment pool tax credits, however, would have to go to either low-income households or units renting at levels affordable by low- income households.

Designated NITC neighborhoods could have their credit allocations renewed for additional five-year periods subject to evidence of both measurable progress and continued need. As market conditions improved in a neighborhood, however, its allocation would be gradually reduced, and eventually it would be removed from the program, at which time other neighborhoods would be designated in its place. Once a neighborhood loses its credit allocation, it would also lose its eligibility for the homebuyer tax credit and its access to the special mortgage program. Investment pool tax credits not used in one neighborhood would be re-allocated to other areas where demand exceeds the available tax credits.

The homebuyer tax credit would go directly to any household that either buys a house in a designated neighborhood that is in need of major repair, restores it, and lives in it as an owner-occupant; or buys a house or condominium unit from a developer who has taken a structure in need of major repair and restored it. When a family moves into the home, it would be eligible for a federal income tax credit equal to one-third of rehab costs incurred up to a maximum of $40,000, taken over five years, provided that they continued to own and live in the house or condominium. Eligibility for the homebuyer tax credit would not be restricted on the basis of income.

Five hundred million dollars per year in tax credits would be budgeted for the program (see Budget Implications, below). However, *no formal statutory cap should be imposed on the program budget or on the amount of credits available per designated neighborhood*. The program is unlikely to achieve its potential unless prospective homebuyers know with certainty that the credit will be available to them if they buy an eligible unit, a certainty that is likely to be a critical element in motivating them to invest in a designated neighborhood. Not having a formal cap also significantly reduces the administrative burdens of the program, both for the agency that might otherwise need to pick and choose which eligible homeowners would receive the credit, and for the IRS. Instead of a statutory cap, HUD would be required to ensure that the $500 million targeted amount was met by carefully estimating the number of likely homebuyers that would take advantage of the program, based on the number and size of the designated neighborhoods and the characteristics of their housing stock.

In addition to benefiting homebuyers directly, the program would encourage developers to acquire and rehabilitate properties in designated neighborhoods, because the tax credit would enable them to sell houses or condominiums at a higher price, thus reducing—or eliminating—the market gap between the cost of rehabilitation and the sales price.

The FHA special mortgage program would be designed to ensure that an adequate flow of mortgage capital was available to qualified families buying houses in the designated neighborhoods. While homebuyers would have to meet standard FHA credit and down payment requirements, the mortgages would offer more flexible appraisal and loan-to-value ratios, reflecting both the value of the tax credit and the market-building focus of the initiative.

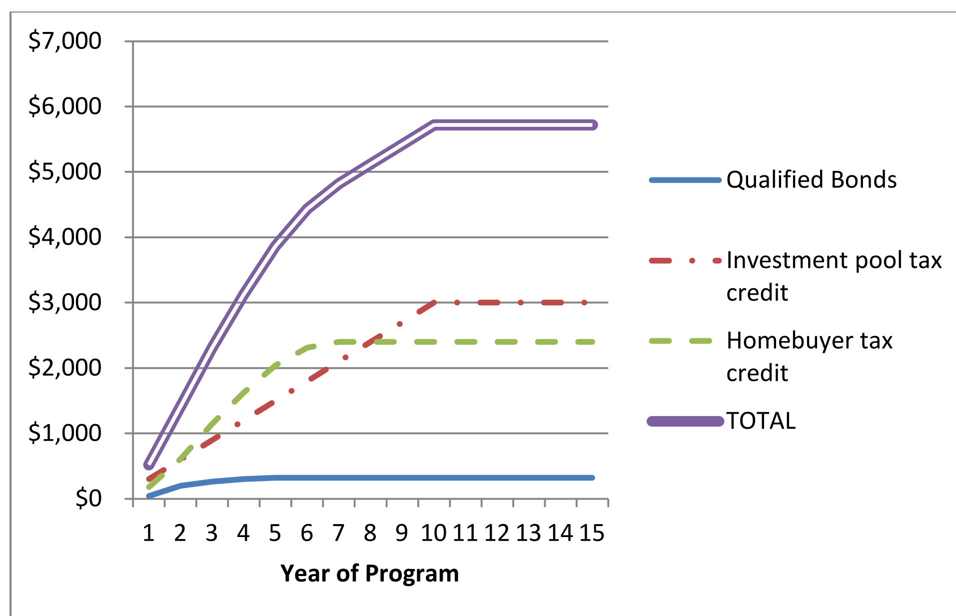
The impact of the NITC program would be far more substantial than the relatively modest outlay might suggest, because of the anticipated leveraging effect of the investment. The $500 million in homebuyer tax credits, for example, is anticipated to lead to rehabilitation of 20,000 vacant units per year, or 181,000 over ten years (assuming that the program will not be fully subscribed until year 3, as shown in appendix). Assuming that HUD would designate neighborhoods containing a total of 1.5 million households, that would result in roughly 1.33 percent of the units (i.e., 1.5 million divided by 20,000) being rehabilitated each year; thus, in a neighborhood with 15,000 units, approximately 200 units would be rehabilitated in the first year, and 1000 after five years. This, in turn—particularly when combined with the additional funds from qualified bond proceeds and the neighborhood investment pool—is likely to catalyze substantial other investment. In the meantime, assuming half of the qualified bonds are used for demolition, 400,000 substandard, blighting vacant houses will be removed from the nation's distressed neighborhoods, opening up future opportunities for redevelopment or greening in these communities.

Budget Implications

The Strategic Neighborhood Investment Program will require new public resources. Assuming a tax credit equal to a 4 percent annual return, the annual cost to the Treasury for the $8 billion in qualified bonds would be $320 million per year. Since the bonds will be issued over a five-year period, the cost of the program would be less during the first four years, after which time it would level off at that total until all of the bonds have come due.

The impact of the NITC program on the federal budget would also be gradual. The first-year cost is estimated to be $480 million, with this cost projected to increase to $3.5 billion by the fifth year as the program grows and the cumulative effect of multi-year tax credits on the federal budget is felt. It would then level off at $5.4 billion per year in the tenth and all subsequent years of the program, as shown in Figure 2, or $5.72 billion if the qualified bond cost is included. Over ten years, the cumulative cost of the entire program, including both the qualified bonds and the NITC, is projected to be $35.7 billion. (See appendix for a detailed cost projection.)

Figure 2. Projected Neighborhood Investment Tax Credit Outlay by Year (in millions)



These programs could be paid for through the imposition of a phased-in reduction or elimination of the mortgage interest deduction (MID). Experts have suggested numerous ways the MID could be reformed, several of which are discussed in a companion brief in this series. One solution, for example, would be to reduce the deductible percentage of home mortgage interest for households earning over $200,000. While these households account for only 11 percent of households taking the MID (and roughly 3 percent of all households), they account for one-third of the total amount of the deduction. As such, even a modest 20 percent reduction in the deductible percentage would therefore be adequate to cover the cost of the proposed tax credit program. Nearly any reasonable MID reform, however, would raise tens of billions in income tax revenue annually that could be reallocated toward deficit reduction and innovative public investments such as those suggested here and elsewhere in this series.

State of Play

Enactment of the Strategic Neighborhood Investment Program would help restore healthy housing markets in many of the nation's at-risk neighborhoods and distressed cities, improving the quality of life for millions of Americans and enhancing the economic vitality of the metros in which those neighborhoods and cities are located. These benefits can be quantified in terms of increased homeownership, increased investment in urban areas, increased property values, and increased municipal tax revenues—as well as decreased municipal costs to maintain vacant properties and provide police, firefighting, and code enforcement services. They could also yield environmental benefits by increasing active and passive green space, redevelopment, and investment in transit-friendly, walkable urban areas. Research on Richmond's Neighborhoods in Bloom program and other targeted revitalization strategies, although still limited, offers substantial evidence that an effort of this nature would be successful.

Other than the cost, which is modest compared to the benefits it will trigger, there are few drawbacks to the creation of this program. There are uncertainties, however. The process of revitalization and market-building is as much an art as a science. It is all but inevitable that revitalization efforts in some of the targeted neighborhoods will fail to yield the market leveraging anticipated, and that the investments made in those areas will be less productive than in others, although even in those cases, investment will yield benefits in terms of better quality housing and environmental conditions. On the flip side, there is a risk that in some neighborhoods, strong market success could lead to displacement of low-income households; while this outcome is likely to be rare, safeguards to protect the interests of low-income residents will have to be built into the program.

Given its projected positive impact on cities and metros throughout the United States, the program should gain wide support. It will help diminish value-draining blight while increasing construction, development, green space, and real estate market activity in distressed neighborhoods—with spillover benefits likely to accrue to adjacent areas as well. Supporters are likely to include local officials, community development organizations, builders and contractors, realtors, and the financial sector, as well as residents of impacted communities and their organizations. However, since the problem is more acute in some states than others, the programs may not be seen as similarly beneficial by legislators from states in which relatively few if any neighborhoods are likely to be designated. Every state, however, will receive at least an absolute minimum of $40 million in qualified bond authority.

Implementation Requirements

Creation of the Strategic Neighborhood Investment Program will require legislative action.

Appendix. Detailed Cost Projection for Strategic Neighborhood Investment Program (units and cost in millions)[1]

	housing units	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
HTC Year 1	6,000	$180	$162	$144	$126	$108					
HTC Year 2	15,000		$450	$405	$360	$315	$270				
HTC Year 3	20,000			$600	$540	$480	$420	$360			
HTC Year 4	20,000				$600	$540	$480	$420	$360		
HTC Year 5	20,000					$600	$540	$480	$420	$360	
HTC Year 6	20,000						$600	$540	$480	$420	$360
HTC Year 7	20,000							$600	$540	$480	$420
HTC Year 8	20,000								$600	$540	$480
HTC Year 9	20,000									$600	$540
HTC Year 10	20,000										$600
HTC Total	181,000	$180	$612	$1,149	$1,626	$2,043	$2,310	$2,400	$2,400	$2,400	$2,400
Investment Pool[2]		$300	$600	$900	$1,200	$1,500	$1,800	$2,100	$2,400	$2,700	$3,000
Qualified Bonds[3]		$40	$200	$260	$300	$320	$320	$320	$320	$320	$320
TOTAL COST		$520	$1,411	$2,309	$3,126	$3,863	$4,430	$4,820	$5,120	$5,420	$5,720

[1] These figures are based on an average $30,000 homebuyer tax credit (HTC) per unit and an assumption that residential turnover will result in a 10 percent drop in the amount of the homebuyer tax credits taken each year after the first year. In other words, while 100 percent of eligible homeowners will take the first-year credit, 90 percent of the eligible homebuyers would still be owner-occupants of the same unit at the end of year 2, 80 percent at the end of year 3, 70 percent at the end of year 4, and 60 percent at the end of year 5.

[2] This assumes that all tax credit authority under the investment pool tax credit will be utilized from year 1 onward.

[3] This assumes that all of the bonds authorized will be issued on the following schedule: $1B in year 1, $4B in year 2, $1.5B in year 3, $1B in year 4 and $0.5B in year 5.

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Remaking Federalism | Renewing the Economy

This paper is part of the Brookings Metropolitan Policy Program's *Remaking Federalism | Renewing the Economy* series. This series frames the challenges facing Washington and advances a select number of actionable federal policy recommendations to support the nation's states and metropolitan areas as they move toward a new, more innovative, production-oriented economic model.

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- Establish a National PPP Unit to Support Bottom-up Infrastructure Investment
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- Make the Research & Experimentation (R&E) Tax Credit Permanent

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Acknowledgments

The Metropolitan Policy Program at Brookings would like to thank the John D. and Catherine T. MacArthur Foundation, the Heinz Endowments, the F.B. Heron Foundation, and the George Gund Foundation who provide general support for the Program's research and policy efforts. We would also like to thank the Metropolitan Leadership Council, a network of individual, corporate, and philanthropic investors that provide us financial support but, more importantly, are true intellectual and strategic partners.

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