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MARCH/APRIL 1983

THE CONDOMINIUM TREND: RESPONSE TO INFLATION
Theodore Crane

Social factors, such as smaller families, only partially explain the trend toward condominiums and cooperatives. Home-ownership itself, whether of a traditional single-family house, or of a unit in a multi-family building, continues to offer significant returns as an investment, and particularly so in times of inflation.

REMOVING DEPOSIT RATE CEILINGS: HOW WILL BANK PROFITS FAIR?
Mark J. Flannery

Deregulation ignores the complex indirect forms of competition that have evolved in response to Regulation Q, and that have rendered it less effective than is sometimes assumed. Data on aggregate bank profitability and stock market reactions following other recent deposit rate deregulations provide further evidence to counter the gloomy forecasts.

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The Federal Reserve Bank of Philadelphia is part of the Federal Reserve System—a System which includes twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation’s monetary affairs. Supruining functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self-supporting and regularly makes payments to the United States Treasury from its operating surpluses.
The Condominium Trend: 
Response to Inflation

by Theodore Crane

The Dorchester, Hopkinson House, The Philadelphia—three familiar center city Philadelphia addresses with a common trait: each was a large rental apartment complex converted to condominiums in the late 1970s. Philadelphia has not been alone in seeing many of its higher quality rental units “go condo” or become cooperatives. Nationwide, about 350,000 units were converted in the 1970s; in several U.S. cities, this amounted to a significant proportion of the rental housing stock.

The increased availability of condominiums has broadened the range of housing options for many American households. Apartment living no longer implies renting; the apartment-dweller now must decide whether to rent or buy a unit. And in many condominium developments almost identical units are being offered for sale and for rent.

Recent demographic trends explain why more people want to live in apartment-sized units, but they do not explain the increased demand by households to own the units. At first glance, the increased demand to own these units seems anomalous during a decade when rents were rising at an annual rate of only 5.4 percent and new home prices at a rate of 8.6 percent. Rather than dampen the demand for homeownership, however, this relatively rapid rise in housing prices actually
encouraged home purchases. Buying a home was viewed as a wise investment which provided a hedge against inflation. In fact, the structure of the U.S. tax system makes homeownership less expensive than renting for large numbers of households during periods of high inflation.

CONDOMINIUMS ACCOUNT FOR AN INCREASING PERCENTAGE OF OWNER-occupied HOUSING

The condominium form of ownership is a relatively recent development in the United States; the first was established in 1947 in New York City where cooperatives were already well known (see CONDOMINIUMS AND COOPERATIVES). The so-called condo-craze, however, did not erupt until the 1970s. Fewer than 400,000 owner-occupied condominiums and cooperatives existed in the U.S. in 1970; by 1980 the number had more than tripled to 1.4 million.1 Condominiums and cooperatives rose from 6.9 percent of all owner-occupied housing in 1970 to 2.7 percent in 1980.

Many of these new condos and co-ops were converted rental units. The Department of Housing and Urban Development (HUD) estimates that 346,505 units, or about 1.4 percent of the 1970 rental housing stock, were converted in the seventies.2 In the largest metropolitan areas, conversions ranged from almost 8 percent of the 1970 rental housing stock to less than 1 percent (Figure 1). Despite considerable controversy over conversions, these new forms of ownership introduced many Americans to the homeownership market (see LAWS REGULATING CONDOMINIUM CONVERSIONS page 12).

Some analysts have attributed the increased demand for condominiums to changes in lifestyles and family structure. But the demand for these new types of housing cannot be

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FIGURE 1
CONDOMINIUM AND COOPERATIVE CONVERSIONS
TEN LARGEST METROPOLITAN AREAS.

<table>
<thead>
<tr>
<th>Metropolitan Statistical Area</th>
<th>1970 Rental Housing</th>
<th>Percent of 1970 Rental Housing</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>0.9%</td>
<td></td>
</tr>
<tr>
<td>Los Angeles-Long Beach</td>
<td>0.6%</td>
<td></td>
</tr>
<tr>
<td>Chicago</td>
<td>7.2%</td>
<td></td>
</tr>
<tr>
<td>Philadelphia</td>
<td>1.6%</td>
<td></td>
</tr>
<tr>
<td>Detroit</td>
<td>0.4%</td>
<td></td>
</tr>
<tr>
<td>San Francisco-Oakland</td>
<td>1.4%</td>
<td></td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>7.8%</td>
<td></td>
</tr>
<tr>
<td>Dallas-Fort Worth</td>
<td>2.2%</td>
<td></td>
</tr>
<tr>
<td>Houston</td>
<td>5.8%</td>
<td></td>
</tr>
<tr>
<td>Boston</td>
<td>2.3%</td>
<td></td>
</tr>
</tbody>
</table>


The baby boom generation entered the 25 to 34 year old age group, fewer families followed the traditional pattern. On average they married later, and after they married, many postponed having children while both spouses pursued careers. From 1970 to 1980 the labor force participation rate for women rose from 43.4 percent to 51.6 percent. Also many of those who married were subsequently divorced, and the divorce rate more than doubled from 1970 to 1980. All of these trends resulted in a large increase in smaller, young households within the population. The number of persons under 35 and living alone increased threefold between 1970 and 1980, and the national percentage of one- and two-person households rose from 47.2 percent in 1970 to 53.4 percent in 1980.

These smaller, younger, professional households have several reasons for preferring the type of housing traditionally offered by rental units. They have no need for a larger, single-family, detached home. They also may value highly the neighborhood amenities more frequently available in areas where multi-family buildings are located (restaurants, shops, entertainment). And they probably enjoy the freedom from time-consuming maintenance. Moreover, they are the most mobile group in our society, a fact which in normal times would militate against their investing in owner-occupied housing.

Many in this group continued to rent apartments in the seventies. An increasing number, however, opted to buy apartment-sized units as condominiums or cooperatives. In December 1979 and January 1980, HUD conducted a survey of residents of recently converted buildings including both renters and buyers. The vast majority of both renters and buyers were members of one- or two-person households. Approximately one-half of each group was under 35 years old. More than
one-half of each group held a professional or managerial position. And, of those who were married, over 60 percent of both renters and buyers had working spouses. These household, age, and job characteristics did not distinguish the buyers from the renters. Changing demographic trends only explain the increased demand to live in apartment-sized units; they do not explain the demand to buy rather than rent.

To understand why more people are choosing to buy condominiums and cooperatives, it helps to view homeownership as an investment. The higher the return on that investment, the greater will be the demand for owner-occupied housing.

**The Owner-Occupied Home is Both a Residence and an Investment**

A family which rents its home is concerned only about the enjoyment it will receive from living there and the monthly rent it will have to pay. Housing will be treated like any other consumption item, and the last dollar spent on housing should provide as much enjoyment as the last dollar spent on any other good. For homeowners, however, a house serves not only as a shelter but also as an investment. For many U.S. households the major part of their savings is invested in their home; approximately 10.4 percent of the net worth of all U.S. households is in the form of equity in owner-occupied real estate.

Once a household has acquired a sufficient level of wealth, the decision to buy a home will depend upon the return on owner-occupied housing relative to the return on other available forms of investment. The gross dollar return on a house, excluding any capital gains, is equal to the rent the household would have to pay for a comparable dwelling, or the so-called imputed rent. We can think of the household as paying rent to itself instead of a landlord. The net return before taxes is equal to this imputed rent minus the costs of acquiring and maintaining the house.

The costs associated with homeownership will vary from household to household, and they are generally higher for young families. For example, if a homeowner's downpayment is less than twenty percent of the value of the house, his mortgage interest rate will generally be higher than the rate for borrowers with a larger downpayment. This will raise the cost of acquiring the house and lower the net return. The lack of sufficient savings is a primary reason why many young households find it more advantageous to rent than to buy a home. Again, if a household places a higher value on leisure time, the value of the time devoted to maintenance will be greater, and the net return on the housing investment will decrease. This may be a factor in the decision by some two-wage-earner households to rent rather than buy.

The net return to owner-occupied housing will also depend upon the frequency of a household's moves, since there are large costs associated with buying and selling a home. The younger, smaller households traditionally attracted to rental housing are also the most mobile households in our society. In the 1979-80 HUD survey of residents of converted buildings, mobility surfaced as a major factor in the decision to buy or rent. Of the former tenants who remained in the converted buildings, only 17 percent of those...

3 The exact results of the survey are as follows: members of one or two-person households (buyers, 82 percent; renters, 85 percent; under 30 years old (buyers, 48 percent; renters, 50 percent), holding a professional or managerial position (buyers, 65 percent; renters, 33 percent), percent of married who had working spouses (buyers, 80 percent; renters, 61 percent). See HUD, The Conversion of Rental Housing to Condominiums and Cooperatives.

4 Capital gains are also part of the total return on a house, but we will discuss them in the context of inflation.
who bought their units intended to move within two years, while 60 percent of those who continued to rent intended to move within two years. After controlling for such variables as income and family size, a study by Michael Lea and Michael Wasylenko found that mobility played a significant part in the decision to continue to rent rather than to buy. This was not unexpected, since households which move frequently may have little or nothing to gain from buying their home. But in an inflationary environment mobility plays a smaller role in the buy/rent decision, because buyers can recoup the costs of investing much more quickly.

The speed with which a household can recover the costs of buying and selling a home depends upon the rate of return to owner-occupied housing in the years of occupancy. Certain tax advantages raise the after-tax return on owner-occupied housing for all households; they also cause the rate of return to vary among households according to their marginal tax rates. And high rates of inflation actually increase these tax-based advantages to owner-occupied housing.

OWNER-OCUPIED HOUSING ENJOYS CERTAIN TAX ADVANTAGES

If owner-occupied housing were treated like any other investment, the net return on a house (imputed rent minus any costs incurred) would be taxed at the homeowner's marginal tax rate. The imputed rent, however, is not included in the homeowner's gross income for tax purposes, and yet some of the costs (mortgage interest payments and property taxes) are deductible from this other income. Furthermore, if owner-occupied housing were treated like any other investment, any capital gain on the house would be taxed at the capital gains rate upon sale of the house. Rollover provisions, however, permit the deferral of taxes on any capital gain as long as it is reinvested in owner-occupied housing. And a one-time exemption from the tax for individuals over fifty-five years of age means that the capital gains go untaxed for most people above this age.

The implications of these tax advantages can be appreciated if we compare the after-tax return earned by two otherwise identical couples, one investing its savings in owner-occupied housing and the other renting a comparable house and investing its savings in a financial asset earning the market rate of interest. If each couple has $18,000 to invest and the market rate of interest is 5 percent, the renter couple will earn $900 in taxable interest income in the first year. Their after-tax return will be one-half of the marginal tax rate times the market rate of interest. If this couple's marginal tax rate were 30 percent, their after-tax earnings would be $630. Each year the couple's accumulated wealth will increase by their after-tax return.

Because of the initial costs of investing in owner-occupied housing (which include mortgage origination fees, transfer taxes, and recording fees), the first year's return on the homeowner couple's $18,000 will actually be negative. Furthermore, when this couple decides to sell their home, they will incur still more costs in the form of brokerage fees, which the renters avoid. Therefore, the owners' after-tax return, during the years they are in the house must be considerably higher than the renters' if they are to be as well off as the renters. Much of that higher return is in the form of tax savings.

We can measure the advantages of homeownership by comparing the wealth positions of our two hypothetical couples after each year of residency. Figure 2 provides computations and comparisons of four cases, in each of which the following holds: The renters' wealth consists of their original $18,000 and the accumulated after-tax interest.

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### Figure 2
**Comparison of Wealth Between Renters and Owners (After Sale)**

<table>
<thead>
<tr>
<th>End of year</th>
<th>Case 1</th>
<th></th>
<th>Case 2</th>
<th></th>
<th>Case 3</th>
<th></th>
<th>Case 4</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Renters</td>
<td>Owners</td>
<td>Renters</td>
<td>Owners</td>
<td>Renters</td>
<td>Owners</td>
<td>Renters</td>
<td>Owners</td>
</tr>
<tr>
<td>1</td>
<td>$18,913</td>
<td>$11,754</td>
<td>$19,282</td>
<td>$14,400</td>
<td>$19,282</td>
<td>$16,118</td>
<td>$19,206</td>
<td>$12,061</td>
</tr>
<tr>
<td>2</td>
<td>19,041</td>
<td>13,510</td>
<td>20,656</td>
<td>19,611</td>
<td>20,656</td>
<td>22,922</td>
<td>20,226</td>
<td>16,285</td>
</tr>
<tr>
<td>3</td>
<td>19,583</td>
<td>15,268</td>
<td>21,128</td>
<td>21,427</td>
<td>21,128</td>
<td>31,403</td>
<td>21,866</td>
<td>19,848</td>
</tr>
<tr>
<td>4</td>
<td>20,141</td>
<td>17,030</td>
<td>23,033</td>
<td>32,545</td>
<td>23,033</td>
<td>41,349</td>
<td>23,331</td>
<td>23,621</td>
</tr>
<tr>
<td>5</td>
<td>20,715</td>
<td>18,795</td>
<td>25,039</td>
<td>40,347</td>
<td>25,039</td>
<td>52,691</td>
<td>24,094</td>
<td>28,162</td>
</tr>
<tr>
<td>6</td>
<td>21,306</td>
<td>20,565</td>
<td>26,039</td>
<td>49,515</td>
<td>26,039</td>
<td>65,518</td>
<td>26,362</td>
<td>32,977</td>
</tr>
<tr>
<td>7</td>
<td>21,913</td>
<td>22,340</td>
<td>28,171</td>
<td>59,938</td>
<td>28,171</td>
<td>60,681</td>
<td>28,442</td>
<td>36,240</td>
</tr>
<tr>
<td>8</td>
<td>22,539</td>
<td>54,122</td>
<td>29,791</td>
<td>71,617</td>
<td>29,791</td>
<td>97,568</td>
<td>30,250</td>
<td>43,592</td>
</tr>
<tr>
<td>9</td>
<td>23,184</td>
<td>25,910</td>
<td>31,004</td>
<td>84,315</td>
<td>31,004</td>
<td>110,455</td>
<td>32,267</td>
<td>50,411</td>
</tr>
<tr>
<td>10</td>
<td>23,841</td>
<td>57,706</td>
<td>32,415</td>
<td>96,360</td>
<td>32,415</td>
<td>137,407</td>
<td>34,428</td>
<td>57,006</td>
</tr>
</tbody>
</table>

In this figure, the following is assumed to hold for all four cases: *Each couple earns $42,000 a year in salaries, and lives in an $80,000 home. Non-housing tax deductions are 5 percent of their salary income. The owners purchase their home with 20 percent down and a 25 year fixed rate mortgage.* Closing costs represent 2.5 percent of the initial value of the house, and yearly maintenance costs are 2.5 percent of the initial value. The house depreciates at an annual rate of 1.2 percent. Property taxes are 2 percent of the current value of the house. Selling costs are 7.5 percent of the sale price of the house. The annual rent is 10 percent of the current value of the house: the renters invest $18,000 in savings in a financial asset earning the market rate of interest. The shaded area indicates those years in which the owners' wealth exceeds that of the renters.

**Case 1:** General prices and housing prices are stable. Market interest rates, including mortgage rates, are 5 percent. Tax rates are calculated according to the 1980 tax law.

**Case 2:** All prices and incomes rise by 7.4 percent a year. Market interest rates, including mortgage rates, are 12.5 percent. Tax rates are calculated as in Case 1.

**Case 3:** The assumptions are the same as in Case 2 except that housing prices and maintenance costs rise at a rate of 9.5 percent a year.

**Case 4:** All prices, including housing prices and incomes, rise by 5 percent a year. Market interest rates, including mortgage rates, are 10 percent. Tax rates are calculated according to the law which will prevail in 1984.


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on that money. The homeowners' wealth consists of their accumulated tax savings and the after-tax interest earned on that savings plus the equity they would receive from their home after selling it. Each couple earns $42,000 a year and files a joint income tax return under the 1980 tax law. The homeowners buy an $80,000 house, and the renters occupy a comparable house and pay $6,000 a year in rent.

For Case 1 suppose there is no inflation, no increase in housing prices, and an interest rate of 5 percent. Through savings in rent and taxes the owners will have recouped the costs of buying the house by the end of the second year, but they will not have accumulated enough equity to offset the cost of selling the house until the seventh year. The homeowners, then, must reside in their house approximately seven years if the housing investment is to be more profitable than renting. The picture changes dramatically, however, when we take inflation into consideration.

**INFLATION INCREASES THE TAX ADVANTAGE ENJOYED BY HOMEOWNERS**

Inflation increases the tax advantages of homeownership in two ways. First of all, as incomes increase to keep up with inflation, marginal tax rates increase because households are pushed into higher and higher tax brackets (bracket creep). Renters will pay this higher rate on all their income. Homeowners will avoid this higher tax on the imputed rent which they receive from their property. Inflation also helps homeowners in a second way. As housing prices rise along with other prices, the homeowner will receive nominal capital gains upon the sale of his house. Because of rollover provisions and the one-time exemption in the tax laws, these capital gains generally go untaxed. Capital gains on other assets, however, will be taxed at the capital gains rate.

Returning to the example of our two couples, the renters and the buyers, we can demonstrate the effect of inflation on investment in owner-occupied housing. In Case 2, we assume that all prices and incomes are rising at 7.4 percent a year (the average annual inflation rate for the 1970s) and that interest rates are 12.5 percent instead of 5 percent; now it takes the owners only three years instead of seven to recoup the costs of buying and selling their home (Figure 2). The after-tax return to owner-occupied housing has increased relative to the return on other assets, and now some households who move more frequently can profitably invest in owner-occupied housing.

**HOUSING PRICES ROSE FASTER THAN INFLATION IN THE SEVENTIES**

While the general price level as measured by the Consumer Price Index rose at an average annual rate of 7.4 percent in the 1970s, the price of a standardized new home rose at an annual rate of 9.6 percent (Figure 3, overlaid). In most areas of the country housing was experiencing real capital gains during the decade. These real gains accelerated the pace at which homeowners could recoup the costs of making their investment.

What happens to the wealth of the couple who rents and of the couple who buys when the general price level rises at 7.4 percent per year and housing at 9.6 percent per year? Under these conditions, Case 3, the owners would recover the costs of buying and selling their home in two years instead of three (Figure 2). Even more of those families who move relatively frequently will find it profil-
able to buy rather than to rent. This will increase the demand for homeownership of apartment-sized condos and co-ops. The increase in the relative price of housing may have furthered condominium development in another way. As housing costs absorb a larger share of income, households will tend to consume less housing by buying.

**FIGURE 3**

**CONSUMER PRICE INDEX AND HOUSE PRICE INDEX 1970-1981 (1967 = 100)**

*The House Price Index was rescaled.*

**Sources:** CPI-W (BLS, CPI Detailed Report) and "Price Index of New One-Family Houses Sold" (Department of Commerce, Construction Reports C363-82).
smaller units. In fact, as housing prices rose more rapidly than average prices in the seventies, the median size of new single-family homes peaked in 1978 and has fallen every year since then. Sharp increases in utility costs have the same effect, since these costs are related to the size of the dwelling. As households begin to consume less housing, condominiums and cooperatives offer the possibility of smaller, owner-occupied units.

To recap, demographic trends set the stage for strong condominium demand in the 1970s. The rise in the number of young professionals living alone or as couples without children increased the demand for apartment-sized units, and high inflation rates provided the incentive for these young professionals to buy their units. Inflation resulted in bracket creep which heightened the tax advantages for homeownership; it also produced nominal capital gains which go untaxed in the case of owner-occupied housing. Furthermore, increases in housing prices greater than the inflation rate not only resulted in real capital gains for homeowners but also shifted demand toward smaller dwelling units. These increased advantages to homeownership meant that highly mobile households could buy their unit, resell it in a few years, and still fare better than if they had rented. This possibility provided a large number of prospective buyers for condominiums and cooperatives in the seventies.

WILL THE CONDO TREND CONTINUE?

In the weak housing market of the early 1980s, the pace of condominium conversions has slowed considerably. Recently, the demand for owner-occupied housing has been dampened by high interest rates and a sluggish economy; but what are the prospects for condominiums and cooperatives as the economy recovers?

Certain economic facts and demographic trends will act to encourage condominium development and conversions. First, the housing market adjusts with a lag. And the fact that housing prices and utility costs have already risen relative to other prices will favor the ownership of smaller housing units as the market continues to adjust. Second, as the final phase of the baby boom generation enters the household formation years in the 1980s, the number of young households will continue to rise. This increase should bolster demand for housing in general; and if the trend toward more one- and two-person households continues, it also should spur condominium development.

A period of lower inflation rates and lower tax rates, on the other hand, could provide less incentive to purchase a condominium. The CPI inflation rate has fallen from a high of 13.3 percent in 1979 to an annual rate of 3.9 percent 1982. Moreover, the prices of new homes increased less rapidly than average prices in 1980 and 1981. These developments mean less bracket creep for taxpayers and less need to shelter their income. They also foreshadow lower capital gains for owner-occupied housing and a decrease in the investment demand for housing.

Besides the indirect effect of disinflation, the tax advantages afforded homeowners have been affected directly by the tax cuts contained in the Economic Recovery Tax Act of 1981. By 1984, marginal tax rates will have been reduced by more than twenty percent from their 1980 levels. If the renter and owner couples described earlier lived in a world of 5 percent inflation and were subject to the tax rates which will prevail in 1984, Case 4, it would take the homeowners four years to recover the cost of investing in their home (Figure 2). This compares with two years under the conditions which prevailed in the 1970s; Case 3. A household which did not intend to remain in the house those extra two years would fare better by renting.

In sum, condominium development and condominium conversions are not a thing of the past. Their future is assured by the trend toward smaller households and smaller housing units. The rate of condominium
Laws Regulating Condominium Conversions

In the wake of the large number of conversions in the late 1960s, complaints have been voiced about sharp reductions in the supply of rental housing, homelessness of older tenants, and misrepresentation to prospective buyers. Following the pattern of these complaints, state laws have been enacted to protect tenants and buyers.

The effect of conversions on the rental housing market is difficult to assess. They certainly do not reduce the supply of rental units on the market and the demand for such units will remain constant. However, demand for rental units will be reduced by conversions if someone who previously lived in the converted building becomes a landlord. The net effect of all these forces is probably a slight reduction in rental vacancies in the rental market. In some communities condominium conversions have a large impact on small rental units in certain neighborhoods and on rental units in older buildings. In a nationwide study, HBD estimated that over one hundred units were converted to condominiums in each of the cities studied. The most radical form of anti-conversion legislation was the moratorium. In Chicago, Philadelphia, San Francisco, San Jose, Seattle, and Washington, D.C., the cities which have the largest number of conversions at any one time in the 1970s, the moratorium was enacted by state legislation. Other cities such as the states and cities which have not enacted such legislation have enacted such legislation. Other cities such as the states and cities which have not enacted such legislation have adopted similar legislation. Some cities such as the states and cities which have not enacted such legislation have adopted similar legislation.

The more immediate problems associated with conversions are the displacement of the elderly and the handicapped and misrepresentation to prospective buyers. The most common form of tenant protection is a notice provision creating a period of minimum occupancy before the tenant must move. Other forms of tenant protection include an exclusive option to buy the unit in which the tenant lives and relocation assistance for those tenants who do not choose to purchase. The elderly and the handicapped are often provided special protection. In some cities, such as New York, New York, and Washington, D.C., the state has adopted similar legislation.

Twenty-three of the fifty states provide some form of buyer protection.

*The Conversion of Rental Housing to Condominiums and Cooperatives, 1980.
†Condominium Cooperative Conversion Housing Study, City of Philadelphia, 1981.