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STAFF PAPER



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COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

A Comparative Analysis Of
Subsidized Housing Costs

By
The Program Analysis Division
Of The
U.S. General Accounting Office

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ABBREVIATIONS

CRS	Congressional Research Service
FHA	Federal Housing Administration
FMR	fair market rent
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HUD	Department of Housing and Urban Development
MIP	mortgage insurance premium
PILOT	payment in lieu of taxes
TDC	total development cost

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D I G E S T

This paper presents a comprehensive discussion of the subsidy costs involved in the three major multifamily housing programs administered by the Department of Housing and Urban Development (HUD) for low- and moderate-income families. These programs are:

1. The conventional public housing program, which has been in existence since 1937 and serves exclusively low-income tenants.
2. The section 236 rental assistance program enacted in 1968, which serves predominately moderate-income tenants.
3. The section 8 rental assistance program created in 1974, which can serve both low- and moderate-income tenants.

Housing subsidies are provided through a variety of mechanisms. The most obvious are direct payments by the Federal Government, which result in lower rents for the occupants. Each of these programs utilizes such a payment although the methods differ. There are also indirect subsidies, such as tax savings for private housing developers or public housing bond holders. In order to exhibit the full cost associated with a specific housing program, both the direct and indirect costs must be considered. In addition, the long-term costs of various subsidy strategies may differ markedly so that comparisons based on first-year costs alone may be misleading. Thus, carefully estimating the future costs of a particular strategy and expressing these costs in terms

of present value provide a basis for legitimate comparison.

A number of basic questions about these subsidy programs are addressed in this report.

1. Are there real differences in the total cost of subsidizing newly constructed housing units under these programs? To answer this, the total subsidy costs of providing equal services to low- and/or moderate-income tenants for 20 years under these programs are compared. (See pp. 7 to 22.) Based upon assumptions about financing costs, mortgage failures, and other important factors, which tend to understate the cost differences among the three programs, GAO provided sample calculations showing that:

--For a low-income tenant, the long-term yearly subsidy cost for newly constructed units would be \$2,068 per unit for public housing, \$2,181 per unit for section 236, and \$2,164 per unit for section 8, when a two-bedroom unit costing \$27,125 is provided to a four-person household with annual income of \$4,250. These estimates include both direct and indirect subsidies for 20 years of operation. (See p. 20.)

--For a moderate-income household earning \$9,000 a year, which would make them ineligible for conventional public housing, the direct subsidy would be \$1,531 per year under section 236 and \$1,800 under section 8 for identical newly constructed units costing \$27,125 per unit. Indirect subsidies would be virtually the same. The moderate-income tenant in these calculations would pay about 30 percent of adjusted income under section 236, as opposed to 25 percent of income under section 8, due to different program rules. (See p. 12.)

2. Are there any savings in subsidy cost when housing is provided utilizing rehabilitation rather than new construction? To answer this GAO compared the long-term subsidy cost of providing rehabilitated housing under section 236 to new construction under section 236. (See pp. 23 to 26.)

--Although the rehabilitation of housing under section 236 probably results in a lower development cost and hence a lower direct subsidy than under new construction, the special tax provisions for rehabilitation result in higher indirect subsidies and consequently a larger total subsidy. Assuming that rehabilitation expenses would be extensive, resulting in development costs within 15 percent of new construction, which is consistent with past experience, GAO calculated a discounted long-term yearly subsidy cost of \$2,367 per unit to serve a low-income household earning \$4,250 a year. The comparable figure for a newly constructed unit was \$2,181 per year. (See p. 25.)

3. Does subsidy cost under nonprofit sponsorship of housing by churches, fraternal groups, or other philanthropic organizations differ substantially from the subsidy cost under limited dividend (profit-motivated) sponsorship by a partnership or syndication? GAO compared the cost of providing similar section 236 housing under each method of sponsorship and provided estimates showing that:

--The long-term cost of providing a two-bedroom apartment costing \$27,125 to a lower income family earning \$4,250 a year would be \$2,507 per year under nonprofit sponsorship of section 236 compared to \$2,181 per year under limited dividend sponsorship. (See p. 19.)

--The difference in cost is attributable to (1) the fact that section 236 nonprofit sponsors borrow 100 percent of development cost, resulting in higher mortgage payments and consequently a higher direct subsidy (limited dividend sponsors must provide 10 percent of the development cost as equity), and (2) much higher default rates for nonprofit sponsors than for limited dividend sponsors, causing large losses to the Federal Housing Administration insurance fund. (See pp. 10 and 18.)

4. How costly are mortgage defaults under the section 236 rental assistance program? GAO made estimates of the expected cost due to mortgage failures associated with providing one unit of housing costing \$27,125 for 20 years of service. These estimates indicate that:

--Under limited dividend sponsorship with a cumulative failure rate of 10 to 15 percent of all units over 20 years, the average yearly cost of failures could be negligible, ranging from a profit of \$15 per unit, if a 10-percent failure rate occurs, to a loss of \$23 per unit, if a 15-percent rate occurs. (See p. 19.)

--Under nonprofit sponsorship with a cumulative failure rate of 40 percent over 20 years, the average yearly cost of failures would be \$323 per unit. (See p. 20.)

5. What are the short-range direct subsidy savings available through the leasing of existing housing under the section 8 rental program and will this approach be more economical than new construction under all circumstances over the long term? To address these questions, GAO estimated (1) the short-term direct subsidy costs of leasing and new construction in three different housing

markets, Pittsburgh, Pennsylvania; Durham, North Carolina; and San Bernardino, California; (2) the indirect costs of leasing in these markets; and (3) the long-term subsidy costs of leasing in Durham, North Carolina, where existing fair market rents are relatively close to new construction fair market rents. The GAO calculations showed that, based on HUD's published fair market rents:

--Potential savings due to the utilization of existing leasing were substantial for all three housing markets in the short run. (See pp. 30 and 31.)

--When long-term costs were considered for Durham, where the fair market rents for new and existing housing were \$2,484 per year and \$2,028, respectively, the average yearly discounted cost for providing a two-bedroom unit to a low-income household earning \$5,500 a year is calculated as \$1,057 per year for a newly constructed section 236 unit, \$1,007 per year for an existing unit leased under section 8, and \$965 per year for a newly constructed public housing unit. These calculations are based on the assumptions that (exclusive of operating cost increases) rents and indirect subsidies can be fixed to the original mortgage payments under the new construction alternatives for at least 20 years. But existing fair market rents will be raised periodically to keep pace with inflation in rents, necessitating an increase in direct subsidy for leased units, and indirect costs will also rise, since real estate investors re-finance, sell, or trade property periodically in order to increase the depreciable base of their holdings and, consequently, their tax savings. (See pp. 33 to 35.)

GAO CONCLUSIONS

Housing subsidies should be considered as long-term investments. Once entered into, such subsidies are difficult to curtail, regardless of the subsidy method or the contractual arrangement the Government has with the suppliers of housing, since HUD also has an obligation to the housing recipients which cannot easily be dismissed. The costs involved in housing programs do differ, depending upon subsidy method, and it is in the best interest of the Government to pick alternatives that most economically accomplish housing goals. In the past much of the cost information reaching the Congress has not clearly identified the differences between programs and has not considered the long-term nature of housing subsidies. GAO believes that housing costs should be analyzed like any other long-term investment, considering the total long-term costs of the program and not just the initial investment or first-year subsidy. Unless this is done, it is impossible to make informed judgments of whether one alternative is likely to result in a lower cost than another. While this paper neither compares all possible program alternatives nor purports to answer the important cost-related questions once and for all, GAO believes that it calls into question many of the answers supplied in the past and proposes a method for comparing costs which the Congress may want to require that the Department of Housing and Urban Development use when analyzing new programs or changes to existing programs.

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CHAPTER 1

INTRODUCTION

The costs involved in a subsidized housing program are difficult to comprehend. The absolute magnitude of the cost of a program like the section 236 rental assistance program, which has provided roughly a half million housing units, must be measured in billions of dollars. Housing subsidy costs are incurred through a variety of mechanisms, from direct monthly or yearly subsidies to foregone tax revenue resulting from housing investors' deducting accelerated depreciation from their tax returns. The direct subsidy can clearly be attributed to the program, whereas foregone tax revenue cannot easily be attributed to a specific program and investors could be expected to seek alternate tax shelter through some other means if the housing alternative were not available. The bulk of housing subsidy costs under most housing programs are delayed to future years. Payments run as long as forty years; thus the changing value of money and the way in which delayed expenditures tend to be discounted in the minds of decision-makers become very important considerations. Certain costs are impossible to accurately estimate, such as the ultimate cost of mortgage defaults under a program like section 236, which involves Federal Housing Administration (FHA) insurance. The cost of the housing unit provided varies with locality, type of construction, and many other factors.

Very often the housing cost information presented to the Congress is sketchy, including only first-year direct subsidies or only a portion of the indirect subsidies. Cost comparisons are often made on the basis of first-year costs, which can be misleading since the current housing programs have different expenditure patterns over time. For example, section 236 has relatively high initial costs which taper off rapidly during the first 10 years. For a similar unit under public housing, the initial subsidy is lower but decreases slowly over the 40-year financing period.

PURPOSE

This work was undertaken to demonstrate a method for presenting the long-term costs of housing policy alternatives which can facilitate rational decisionmaking and to attempt to give better answers to questions about the realistic costs of various housing programs and subsidy methods. Although housing programs have generally been tailored to serve a particular purpose or specific income group, their goals may

sensibly result in overlaps, such as the section 236 rent supplement combination, which can serve tenants who would also be eligible for public housing. In such cases it is reasonable to compare such alternatives to see which method results in a lower subsidy, even though there may be other considerations which would result in the choice of the higher cost alternative. When one program is proposed as a replacement for another, such comparisons should be mandatory.

This paper examines housing subsidy costs using section 236 as a base case to demonstrate the various cost elements of a major housing subsidy program. Section 236 is then compared to the conventional public housing program and the new section 8 rental assistance program. The comparisons which we present in this paper are based primarily upon costs and assumptions which have been used before by the Department of Housing and Urban Development (HUD) or other researchers, but we have consciously attempted to understate the cost differences between the various programs. This was done because our initial calculations indicated that, if we based our analysis on identical development costs, which is customary, the public housing alternative appeared to be the cheapest method of providing new housing to low-income tenants. This seemed contrary to conventional wisdom, and we chose to be cautious in our approach. Had we used less conservative assumptions, we could probably have shown substantially greater differences in total subsidy among the programs compared. This same principal was observed when comparing section 8 leased existing housing to newly constructed housing under section 236 and public housing.

BACKGROUND

The section 236 program was established by the Housing and Urban Development Act of 1968. This act included a number of major housing programs which, in combination, provided a phenomenal amount of housing in only a few years--more multifamily housing, in fact, than had been provided by direct Government action throughout the 40-year history of Federal housing programs. Only once before did housing production under Federal programs even approach this scale. This was after the Second World War when nearly half a million rental housing units were produced under the section 608 Veterans Emergency Housing program. That program was the first large-scale Government effort to encourage private production of multifamily rental housing. Federal insurance for low downpayment mortgages was provided without

further subsidy. The section 608 program was quite successful, although it did receive initial criticism for providing windfalls to developers.

The section 236 rental assistance program also relies on FHA mortgage insurance for private financing of private ownership, but it adds additional subsidies which in effect lower the monthly rents charged to tenants. It was enacted as a replacement for the section 221(d)(3) program, which was based on either market interest rate or 3-percent direct loans from the Federal Government. The section 236 program was structured to overcome problems which undercut the effectiveness of section 221(d)(3). Both section 236 and its predecessor were aimed at moderate-income tenants or, more precisely, those households whose incomes were too high to qualify for public housing yet too low to obtain adequate housing in the market at affordable rents. Both programs were capable of reaching low-income tenants when combined with the rent supplement program, which provides assistance payments to private owners (or nonprofit sponsors) of housing insured under a variety of Government programs. Rent supplements were used extensively with the section 221(d)(3) market rate and section 236 programs. The rent supplement program was enacted to serve a subgroup of the households eligible for public housing and was intended as a private enterprise alternative to the public housing program. This deeper subsidy was limited to a minority of the units in any one project and consequently section 236 and its predecessor were still predominately moderate-income programs.

A primary reason for enacting section 236 was that the 3-percent direct loans featured under section 221(d)(3) were not providing a sufficient number of multifamily units to keep pace with the housing needs identified in testimony preceding passage of the 1968 act. There were probably a number of reasons for this, but two major problems with section 221(d)(3) were (1) the direct-loan approach required the Congress to provide the entire cost of new housing in a single year, so producing a large number of units would have a huge impact on the budget, and (2) increases in building costs were making it difficult to produce section 221(d)(3) units that eligible tenants could afford. Thus, a switch to insuring loans by private lenders and providing a yearly subsidy, which would effectively lower the developers' interest rate from 3 percent to 1 percent, looked like a promising alternative. Only the yearly subsidy payments would appear in the budget, and the further reduction of the interest rate would allow lower rents.

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The section 236 rental assistance program was characteristically utilized by profit-motivated builders and developers who sold interests in housing projects to passive investors, but there was also a large number of nonprofit organizations who sponsored projects. These nonprofit organizations were very often inexperienced in the housing business. It is frequently said that neither of these types of entities had both the skill and motivation needed to be successful in the long-term management of subsidized housing.

3 In addition to the direct subsidy provided to section 236 projects, there are indirect subsidies, such as accelerated depreciation (available to all rental housing), and special subsidies, such as the Government National Mortgage Association (GNMA) tandem plan under which mortgages are purchased by GNMA and resold at a loss, which makes possible lower interest rates and increases the availability of mortgage money. This combination of subsidies is costly, and critics have maintained that it is too costly. 3LA 01142

The section 236 rental assistance program has also been criticized as having an inordinate number of projects that experience financial difficulty and as having default and foreclosure rates that are much too high (and costly) to warrant continuation of the program.

The new section 8 leasing program, which is favored by HUD, has been developed to capitalize on the strengths of past programs while avoiding the pitfalls of older programs. It also provides a flexible subsidy formula which is not tied to the debt service as in section 236 and public housing. This allows HUD to provide much deeper subsidies where necessary and allows subsidies to be increased by administrative action, should inflation require it, without congressional action. Section 8 can serve all the income groups served by the suspended subsidy programs and can utilize several different housing strategies. Section 8 can provide newly constructed housing through (1) FHA-insured loans and private or nonprofit sponsorship, (2) private financing, (3) State housing finance agencies, or (4) public housing authorities. Existing housing can also be utilized with a local housing authority or other intermediary acting as a leasing agent. In all cases, the subsidy is based on established fair market rents which HUD publishes for each type and size of housing by local jurisdiction for the entire country. We examined only two of the section 8 program options, FHA insured limited dividend sponsorship and existing leasing through local housing authorities. Development through State

housing finance agencies is clearly more expensive; and the other alternatives are less likely to be widely used, for a variety of reasons.

The low-rent public housing program utilizes local housing authorities to provide predominately newly constructed housing. There are a variety of methods available to do this, but the one most frequently utilized was for the local authority to plan and contract for the housing and to float tax-exempt mortgage bonds to pay for the project. The debt service on these bonds is then paid by the Federal Government, and the rents collected must defray all operating expenses. In recent years additional operating subsidies have been provided to housing authorities where necessary.

Specific questions addressed

A number of basic questions about housing subsidy cost are addressed in this report.

- First, are there real differences in the cost of subsidizing new housing units under the section 236 program and the other major multifamily housing programs for low- and moderate-income families, namely public housing and the new section 8 program? To give insight into this question, we compare the total cost for each program of subsidizing a low- or moderate-income family in a newly constructed two-bedroom unit for an extended period of time.
- Are there any savings in subsidy cost as a result of using rehabilitation as opposed to new construction. To examine this we calculated the total cost of providing similar section 236 housing under the rehabilitation method and compared this to our new construction estimate under various assumptions about sponsor type and relative magnitude of development cost.
- One important cost difference between section 236 and other programs is that it has used predominantly new and rehabilitated housing, whereas public housing and the new section 8 program may make extensive use of existing housing which has not been rehabilitated. To analyze the cost implications of this, we compare new section 236 development to existing leasing under section 8. This comparison is based upon fair market rents for three U.S. cities and is not generalized to

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the country as a whole. Rather, the analysis demonstrates the impact of local market conditions such as growth rate and size of the housing stock on leasing cost. Also discussed is the possible inflationary impact of extensive leasing and its long-term cost implications in various types of housing markets.

--Another question which arises is whether subsidy cost under nonprofit sponsorship of housing by churches, fraternal groups, or other philanthropic organizations differs substantially from the subsidy cost under limited dividend sponsorship by a partnership or syndication. This question could be asked in regard to a number of HUD programs, such as 221(d)(3) or the new section 8, where these alternatives exist, but is addressed here in terms of section 236 only. The results of this comparison apply equally well to other programs and highlight the essential differences resulting from the tax-exempt status of nonprofit organizations and their historical tendency toward financial difficulty.

Finally, in presenting the various elements of subsidized housing cost, we try to explain how each cost arises, how much variation there might be in each subsidy cost, and how such variation would affect the relative position of the alternatives compared here.

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CHAPTER 2

NEWLY CONSTRUCTED HOUSING

SECTION 236, SECTION 8, AND PUBLIC HOUSING

Early HUD comparisons of the section 236 program to a revised leasing approach, essentially section 8, which were furnished to Congress during the fiscal year 1975 appropriation hearings, indicated that total subsidy costs for the two alternatives were virtually the same for newly constructed units. These estimates assumed identical development costs for each program and developed direct subsidy costs based upon identical tenant contributions of 25 percent of gross income. Indirect costs were estimated on a discounted basis and added to the undiscounted direct subsidy. Though this approach did not particularly favor either of these two alternatives, it did greatly blur any comparison made between these alternatives and public housing for which indirect costs were not discounted. It also had the effect of making certain of the indirect costs appear insignificant, although they are not.

The Library of Congress, Congressional Research Service (CRS), reviewed the HUD estimates and argued that the development cost for section 8 would likely be greater than for section 236, since the general guidelines for section 8 indicated that preference would be given to projects where no more than 20 percent of the units would receive assistance payments. CRS reasoned that this requirement would probably force developers to build market-competitive units with more amenities and larger floor plans, necessitating higher development costs. This argument is buttressed by the fact that nonsubsidized multifamily housing under section 207 (another FHA-insured program) is considerably more expensive than section 236 housing per unit.

It is also true that public housing is probably built to higher standards than section 236 and that the inspection to these standards is probably more rigorous, but this generally results in a higher quality unit. Based on discussions with housing experts and considering the wide variety of housing provided under each of the programs compared here, it is our feeling that differences in quality (and construction cost) are not integral to housing programs or subsidy methods and that they could be controlled up or down by careful program administration.

It also seems unlikely that profit-motivated sponsors will be willing to participate in constructing new units under section 8 without receiving subsidies for all or most of the units in a given project. If section 8 is to be successful, the program will probably result in new construction projects with 100 percent of the units receiving subsidies, and early program experience seems to bear this out. Our estimates are therefore based on the assumption that 100 percent of the units in section 8 projects will receive subsidy and that the total development cost per unit will be the same under each program or alternative (except for rehabilitation). This allows us to compare the same type of structure and the same benefit to the tenant. If fewer than 100 percent of the units in a project are assisted under section 8, the indirect subsidies for section 8 units are going to be higher per subsidized unit, since items like the tandem subsidy must be incurred for the unsubsidized units as well as the subsidized units in any given project.

NEW CONSTRUCTION DEVELOPMENT COST ESTIMATES

Our development cost estimates are based upon (1) a 1975 HUD estimate of national average fair market rent for section 8, (2) a HUD estimate of multifamily operating costs based on public housing data, and (3) a national average property tax rate. We made adjustments for inflation, where necessary. The national average fair market rent of \$3,900 for a two-bedroom unit was capitalized using an interest rate of 8.5 percent (plus 0.5 percent for mortgage insurance) and a 10-percent downpayment to arrive at a total development cost of \$27,125 for a two-bedroom unit completed in 1975. The 8.5-percent rate was used to maintain a conservative differential of 2.5 percent between the FHA rate and the public housing bond rate of 6 percent, although this differential is usually greater, and also because we felt the FHA rate was probably about 8.5 percent when the new construction fair market rents were established.

PROPERTY TAXES

Property tax rates vary drastically from area to area and from one part of a single jurisdiction to another. Taxing policies toward multifamily properties in general and subsidized properties in particular are quite unpredictable. We have used a national average tax rate of 2.5 percent of total development cost based on 1970 census data

for multifamily rental properties. This rate has been used by HUD and other researchers. When applied to the total development cost estimate of \$27,125, this results in a rather high (\$678 a year) tax estimate. Property taxes for the projects in the three cities which are discussed later in this report were uniformly lower than indicated by a 2.5-percent rate. Had we assumed a lower tax rate of 1.5 percent, it would favor public housing, since lowering the tax rate while holding the gross rent constant at \$900 increases the debt service for section 8 and section 236 more than for public housing.

OPERATING COST

The operating cost used here is a 1975 national average figure for public housing developed by HUD. This figure (\$950 a unit each year) is adequate for the nationwide comparison; but when we look at local housing markets, we will use local figures. If the \$950 figure is seriously in error, it will not affect the relative position of alternatives from our calculations. The estimate includes maintenance, management, utilities, and all other expenses not included elsewhere.

PROFIT

We have not explicitly analyzed the impact of profit under the limited dividend alternatives. The variation in total subsidy cost that it introduces due to changes in direct costs is slight, and it would result in higher but nearly identical costs for the two FHA limited-dividend cases which will in turn be shown to be more expensive than public housing but much less expensive than the nonprofit case.

DIRECT SUBSIDY UNDER NEW CONSTRUCTION

The direct costs involved in the alternatives considered here consist primarily of monthly subsidy payments. In the case of public housing, the subsidy payment is made to a local housing authority to cover debt service on nontaxable bonds, but our estimates also include an additional subsidy to defray a portion of the operating cost, without which these projects would not be feasible. Under section 236 the payments are an interest subsidy paid to the lender on

behalf of the sponsor (and a rent supplement for lower income tenants). The section 8 payment is the difference between fair market rent and tenant contribution (limited to 25 percent of adjusted income) which is paid to the landlord.

The following table shows our direct subsidy calculations for a newly constructed two-bedroom unit servicing low- and moderate-income four-person households.

Direct Subsidy

(Family of Four, Gross Annual Income of \$4,250)

	Section 236 (rent supplement)		Section 8 limited dividend	Conventional public housing
	Limited dividend	Nonprofit		
Total development cost	\$27,125	\$27,125	\$27,125	\$27,125
Loan amount	24,410	27,125	24,410	27,125
Term (years)	40	40	40	40
Interest rate (MIP) a/	8.5(+0.5)	8.5(+0.5)	8.5(+0.5)	6.0
Annual debt service	2,272	2,525	2,272	1,793
Operating expenses	950	950	950	950
Property taxes/PILOT b/	678	678	678	51
Gross rent	3,900	4,153	3,900	2,794
Tenant contribution	-859	-859	-912	-806
Direct subsidy	<u>\$3,041</u>	<u>\$3,294</u>	<u>\$2,988</u>	<u>\$1,988</u>

(Family of Four, Gross Annual Income of \$9,000)

	Section 236 (with rent supplement)		Section 8 limited dividend	Conventional public housing
	Limited dividend	Nonprofit		
Gross rent	\$3,900	\$4,153	\$3,900	(not
Tenant contribution	-2,369	-2,452	-2,100	eligible)
Direct subsidy	<u>\$1,531</u>	<u>\$1,701</u>	<u>\$1,800</u>	

a/ Mortgage insurance premium.

b/ PILOT stands for "payment in lieu of taxes," which is paid by local housing authorities to local governments. It is usually calculated as 10 percent of shelter rent, which is the rent paid by tenants less utilities.

Section 236 with rent supplement
versus section 8

The annual direct subsidies under limited dividend sponsorship of section 8 and section 236 with rent supplement are virtually the same for the lower income household. The slight difference (\$53 per year) is caused by different income adjustment rules for the two programs. In both instances tenants pay 25 percent of adjusted gross income. Nonprofit sponsorship, which is shown only for section 236, exhibits a higher subsidy, since no downpayment or equity is required, causing a higher debt service. Nonprofit sponsorship of section 8 would also result in a proportionately higher annual subsidy. For new construction the only potential for lower subsidy cost under section 8 than under section 236 seems to be the possibility of lower development cost, which seems unlikely.

Direct subsidy under public
housing is much lower

Public housing direct subsidies are substantially lower than the other alternatives for lower income households. It is more than \$1,000 less per unit under our calculations than with section 236 or section 8. This is in spite of the fact that tenant contribution is about \$50 or \$100 more, respectively, than under public housing, due to different income adjustment rules. This substantial difference in the direct subsidy arises because of the lower debt service and the local property tax relief granted public housing. Local housing authorities pay a percentage (in practice less than 10 percent) of tenant rent to the local government in lieu of property taxes, which generally results in a great reduction in their expenses and, hence, in the subsidy. In this case it is the difference between \$678 for section 8 or section 236 and \$51 for public housing. This is a very real saving which we offset as foregone local tax revenue when we look at indirect subsidy costs; but this offsetting effect may only exist when comparing public housing to section 236 or section 8, since there is no guarantee that this lost property tax revenue would actually be available if public housing were not created. For example, the land might have remained vacant. If this foregone property tax is not counted when computing the total cost of public housing and if the cost of providing municipal services to the public housing units is less than the \$678 per year, then public housing is even more attractive than shown to be in our calculations as compared to the other alternatives.

In our cost estimates, the assumption of a 6-percent tax-free bond rate for public housing probably overestimates the subsidy cost for public housing. As of March 1976, the bond rate for public housing had never exceeded 6 percent (although it could), and the construction period is financed with short-term notes at much lower interest rates (frequently in the neighborhood of 3 to 5 percent). This has two effects: (1) lower construction financing lowers the development cost for public housing and (2) HUD, who arranges the sale of housing authority securities, often rolls over (resells) the short-term lower interest rate notes several times in order to arrange permanent financing when long-term bond rates are down. So during this waiting period, substantial additional interest savings may be realized. Thus, our direct subsidy estimates overstate the direct cost of public housing and still show public housing to be much cheaper.

Direct subsidy for
moderate-income tenants

For higher income tenants (\$9,000 per year) who are not eligible for public housing, the direct subsidy per unit which we calculated for limited dividend sponsorship under section 8 is considerably higher than for section 236 (\$1,800 versus \$1,531) by virtue of the fact that the subsidy for section 236 is limited to the excess of debt service above what would be paid for a 1-percent mortgage, which in this example means a limit of \$1,531. Thus, the section 236 tenant pays about 30 percent of his adjusted gross income while the section 8 tenant pays 25 percent.

Deeper subsidy under
section 8

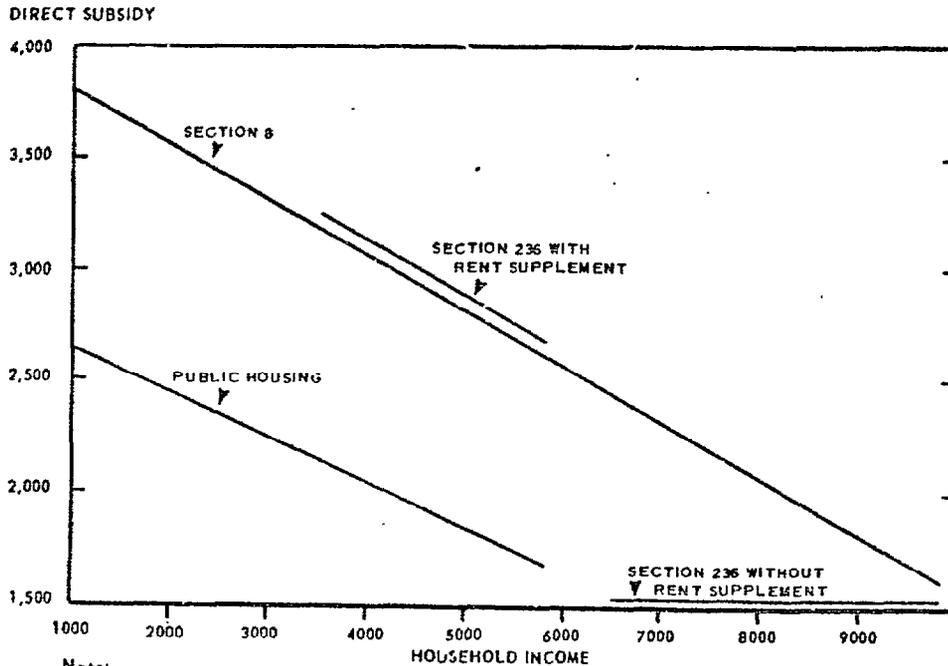
Under section 236 a large percentage of tenants have paid rents in excess of 30 percent of their gross income before adjustments. Thus, with the 25-percent limit under section 8, the subsidy will be proportionally higher than it was under section 236. For example, under section 236 the average yearly income of section 236 tenants was about \$5,500 during 1973 and 1974, and the average rent of these tenants was roughly \$133 a month or about \$1,600 a year. This was 29 percent of gross income or 32 percent of their adjusted gross income. Under the section 8 adjustment rules and by limiting rent to 25 percent of adjusted income, the average tenant rent would have been \$1,300 a year,

which is \$300 a year less than it was under section 236. Thus, if the section 8 method had been used, the subsidy for each unit of the approximately 439,000 section 236 units subsidized during fiscal year 1975 would have been an average of \$300 a year higher. This would have amounted to an additional \$132 million expenditure above the \$375 million spent. With greater construction and operating costs in the future, this difference would be even greater. In addition, section 8 may pay an even greater subsidy for some tenants, since the legislation authorized HUD to reduce tenant payments to as little as 15 percent of their adjusted gross income.

Direct subsidy varies with income

The graph below shows how direct subsidy under these programs varies with income for our hypothetical two-bedroom unit.

NEW CONSTRUCTION
DIRECT SUBSIDY (DOLLARS)
TWO BEDROOM APARTMENT, FOUR-PERSON HOUSEHOLD
TOTAL DEVELOPMENT COST = \$27,123



Note: Public Housing eligibility would probably lapse somewhere between \$5,000 and \$6,000. Section 236 rent supplement payments would be dropped at about the point that public housing eligibility lapses.

For lower income tenants, the cost of the direct subsidy is about the same under section 8 and section 236 with rent supplement. But section 236 could not serve those households below about \$3,600 gross annual income even with rent supplement, since by statute the tenant must pay at least 30 percent of the basic rent of \$2,369. Basic rent is the sum of taxes, operating cost, and debt service at an interest rate of 1 percent. Public housing has a much lower direct subsidy for lower income tenants than either section 8 or section 236 but does not serve moderate-income tenants. For moderate-income tenants the direct subsidy for section 236 without rent supplement would be much lower than section 8, since there is an upper limit on the section 236 subsidy and section 236 tenants would pay higher rents. These moderate-income tenants were the primary target group under the section 236 program, and, indeed, most of the households served in the past were in this group. Thus, section 8 will probably result in a uniformly higher direct subsidy than the other two programs, which it has replaced at all household incomes, except where rent supplement is used in conjunction with section 236.

One difference between section 8 and section 236 is that section 236 holds out the possibility that, if tenant income increases faster than operating costs, the average per unit subsidy will decrease, since rents in excess of the basic rent set by HUD must be returned to HUD. Excess rents have thus far amounted to only a few dollars per unit, and recent HUD administrative decisions allowing excess rents to be applied to operating losses may further reduce these payments. Average tenant rents have been rather stable despite inflation, and even large increases in tenant rent in the distant future would be modulated by operating cost increases and the time value of money. Thus, it seems unlikely that the excess rent provision will have any appreciable effect.

INDIRECT SUBSIDY COSTS

Indirect subsidy costs range from about 20 percent of direct cost for section 236 with limited dividend sponsorship to about 70 percent of the direct cost in the case of public housing. These indirect costs are more difficult to estimate and are incurred irregularly over time. To clearly show the significance of these costs, we must make careful assumptions about alternatives, estimate the longevity of the units, discount future costs, and amortize the total unit cost over the expected life.

Discounting the value of money expended in the distant future to reflect present value is a common technique in cost and economic analysis and is important for comparative purposes here, since the rate at which costs are insured under public housing is quite different from the rate under section 236 or section 8. Discounting allows us to view all expenses as if they were being incurred today at the same value of money as opposed to showing disbursement over the next 20 or 30 years at varying values of money.

The indirect costs are those which are not explicitly charged against a program but which nonetheless are incurred as a result of creating units under the program. For section 236 these costs are program administration costs, losses to the insurance fund in excess of mortgage insurance premiums, Federal and local taxes foregone, and Government National Mortgage Association tandem subsidies. Some of these costs are great in magnitude and differ drastically from program to program. Administrative costs are slight compared to the other cost elements and have been given little attention. Our estimate is taken from an estimate prepared by HUD for the 1976 HUD budget hearings.

Indirect costs for section 236 and section 8 are assumed to be identical. We can find no reasons why they would differ greatly if the development cost were the same.

Federal taxes foregone

These costs are significant and varied. Undiscounted 5-year averages are shown in the next table.

Yearly Average

Federal Taxes Foregone, Two-bedroom Unit

(Total Development Cost of \$27,125)

<u>Years</u>	<u>Section 8 and section 236 limited dividend</u>	<u>Section 8 and section 236 nonprofit</u>	<u>Public housing</u>
1 to 5	a/\$839	-	\$800
6 to 10	270	-	767
11 to 15	121	-	730
16 to 20	18	-	662

a/ Includes construction period tax savings.

Section 8 and section 236 taxes foregone under limited dividend sponsorship are based on Touche Ross estimates of tax savings for a 50-percent tax bracket taxpayer. These estimates are considered to be quite good and would be in error only to the extent that we have guessed wrong about the income tax bracket of the investor.

Our estimate of the Federal tax foregone for public housing is straightforward. We assume that the debt will be financed using 6-percent tax-free bonds and that the bond holder would have paid tax on this interest at 50 percent without the tax-free feature. We also estimated this cost using a number of other methods, the most convincing of which yielded a lower estimate, which would make public housing even less expensive. Under nonprofit sponsorship no taxes are due; thus sponsors do not use losses to offset income from other sources.

The 20-year average discounted costs are \$272 a unit each year for section 8 and section 236 with limited dividend sponsorship and \$459 a unit each year for public housing. The discount rate used is 6 percent, which is considered to be conservative. A higher rate would favor public housing.

Local taxes foregone

This indirect cost applies only to public housing and reflects the special treatment accorded public housing by local governments. This cost is balanced by property taxes paid by developers of section 236 (or section 8) and is then counted in the direct subsidy.

Tandem plan costs for section 236

The Government National Mortgage Association (GNMA), a corporate entity within the Department of Housing and Urban Development, intervenes in the secondary mortgage market on behalf of lenders to subsidized housing projects. GNMA buys federally insured mortgages at a price equal to the unpaid balance on the mortgage (with certain adjustments) and sells such mortgages to the Federal National Mortgage Association or other investors. This encourages mortgage bankers to lend for subsidized housing, since they know that the mortgage can always be sold without a loss.

It is difficult to predict what tandem costs will be in the future since "tandem points" absorbed by GNMA have

in the future since "tandem points" absorbed by GNMA have varied widely and depend on the interest rates of the mortgages being sold and their current market value. GNMA sells mortgages at a price which allows the buyer to get the same yield as if the mortgage bore an interest rate at or near the current interest rate for mortgages saleable without GNMA intervention. GNMA issued many commitments to purchase 7-percent mortgages for projects which would be completed 2 or 3 years later. GNMA then purchased and held such mortgages for a year or more before disposing of them at auction (there are several other methods of disposal). At the time of disposal the market interest rate might have been 9 percent or more on conventional mortgages, making the market price for 7-percent mortgages particularly low. If the market rate were closer to the rate of interest on the mortgage, the selling price would be higher. For example, during 1974 section 236 mortgages at 7 percent were purchased by GNMA at 100 percent of the outstanding balance and sold at auction at prices near 90 percent of the balance, which means that GNMA absorbed about 10 percent of the mortgage amounts on that transaction. Prior to June 1973 the subsidy was only about 2.75 percent. In fiscal year 1973, when GNMA sold \$1.1 billion in mortgages, its losses were about 6 percent or \$65 million. According to HUD, GNMA sold \$70.7 million in 7-percent section 236 mortgages during the second quarter of 1975 at prices of 81 to 82 percent of the face amount, which indicates a subsidy of 18 to 19 percent of the mortgage amounts.

The tandem subsidy is a significant one-time payment which will probably be paid on the vast majority of section 236 units. Whether this subsidy will continue to be paid on units started in the future (for section 236 or section 8) is a matter of policy; but for units already started or in the pipeline, there are still a large number of outstanding commitments which will result in large subsidies. Our tandem plan estimate for this comparative analysis is 8 percent of the mortgage amount, which may be low compared to recent experience; but this percentage results in a total discounted cost figure which is close to that for public housing. When a higher percentage is used, public housing looks even more attractive. At 8 percent the cost of the tandem plan for providing a two-bedroom unit with total development cost of \$27,125 is roughly \$2,100 under limited dividend sponsorship and \$2,940 under nonprofit sponsorship. 1/

1/ These estimates include an adjustment for units lost through foreclosure and sale that do not complete a full 20 years of service.

The cost of FHA insurance failures

The Department of Housing and Urban Development issues mortgage insurance for privately built housing under a number of programs. In exchange for monthly insurance premiums and other fees, HUD enters into contracts to pay off loans in the case of default by the borrower. In the case of nonpayment by the borrower, the lender, which is usually a mortgage company or commercial bank, can either (1) assign the mortgage to HUD, which then becomes the lender, or (2) foreclose upon the mortgage and sell the property with HUD paying any loss. When either of these things happens, there is said to be a failure. Each failure will very likely result in a loss to the insurance fund.

The insurance losses are extremely difficult to predict; and the costs shown by HUD in the past for section 236 insurance costs have probably been somewhat misleading, since they were often exhibited on a discounted basis adjacent to undiscounted first-year direct subsidy costs, causing the discounted losses to appear insignificant. HUD also used a single figure for limited dividend and nonprofit sponsorship, although the failure rates are drastically different. We will make an order-of-magnitude estimate of these losses and sufficiently warn the reader about probable error so as to avoid misunderstanding. It is necessary to do this, since the foreclosure rates for different subsets of section 236 projects are dramatically different. These differences will be treated in more depth in subsequent reports and are presented briefly here with the presentation of costs. Nonprofit sponsors have experienced much larger termination rates than limited dividend sponsors so that expected losses to the fund for nonprofits are much greater. As noted earlier, there are no tax losses for nonprofits. Indeed, one reason that nonprofits fail could be the fact that they cannot rely on tax savings through depreciation to absorb operating losses. Thus, one cannot necessarily conclude that greater nonprofit termination losses should lead to a policy of avoiding nonprofit sponsorship.

For our new construction cost estimates, we have chosen 20-year cumulative failure rates of 10 and 40 percent for limited dividend and nonprofit sponsors, respectively. These rates imply a total program failure of 19 percent if 30 percent of the sponsors are nonprofit and 70 percent

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limited dividend. This is roughly the current split if cooperatives (which also have a higher failure rate) are grouped with nonprofits. This 19-percent rate is slightly lower than, but roughly equivalent to, the 20-percent 10-year rate predicted in "Housing in the Seventies." It is extremely treacherous to make estimates of ultimate failure, but we are using such an estimate to show what the costs will be if the failure situation is roughly what HUD projected on the first 10 years and to distinguish in terms of cost between various program alternatives and show the relative cost of failures in a total cost framework. The HUD 40-year projection of 30-percent failures is considered even more tenuous and not considered there.

If the total losses in the limited dividend projects are fewer than assumed in these calculations, the relative cost of new construction under section 8 and section 236 would decrease as compared to public housing. The potential for such improvement among limited dividend projects is slight, since the failure experience thus far is 3.4 percent and the average age of 236 mortgages is still less than 3 years, leaving many risky years (most failures occur in the first 10 years). As for nonprofits, it is unlikely that enough improvement could take place in the failure rate to greatly change their cost relative to public housing or limited dividend sponsorship of section 8 or section 236. The nonprofit failure rate was already 15 percent at the end of 1974.

Projected losses

Losses were estimated by (1) calculating the expected insurance claims over the years, likely income from resale of projects, and expected revenues per unit from mortgage insurance premiums for 20 years; (2) discounting each amount back to the first operating year; (3) adjusting for lost units; and (4) dividing by 20 to get a yearly cost. Based upon a cumulative failure rate of 10 percent and a per unit insurance loss of approximately 54 percent of the outstanding mortgage, which is commensurate with historical evidence on similar programs, the insurance fund would actually make money on limited dividend units with an average yearly profit of about \$15 per unit. If the cumulative failure rate for limited dividends is increased to 15 percent, then the fund would incur an average yearly loss of \$23 per unit. For nonprofits the average annual discounted insurance loss associated with providing one two-bedroom unit for 20 years is

\$323 per year based upon a 40-percent cumulative failure rate. Much improvement could take place for nonprofits without changing their relative cost positions.

TOTAL SUBSIDY COST UNDER
NEW CONSTRUCTION

When we consider both the direct and indirect costs of these alternatives, the 20-year costs are rather close, given the diversity among the individual cost elements. The following table shows our calculation of the average discounted yearly cost of providing a two-bedroom unit of housing to a lower income tenant for a total of 20 years.

New Construction

Discounted Annual Subsidy Cost

For a Family of Four with \$4,250 Annual Income

(20-year Average)

	<u>Section 236 with</u>		<u>Section 8</u>	<u>Public</u>
	<u>rent supplement</u>	<u>Non-</u>	<u>Limited</u>	<u>housing</u>
	<u>Limited</u>	<u>profit</u>	<u>dividend</u>	
	<u>dividend</u>			
Direct subsidy	\$1848	\$2002	\$1816	\$1208
Federal tax foregone	272	-	272	459
Tax revenue on sale (after 20 years)	-49	-	-49	-
Insurance losses	-15	323	-15	-
Tandem plan subsidy	105	158	105	-
Local tax foregone	-	-	-	318
HUD administration	20	20	20	20
Total	\$2181	\$2503	\$2149	\$ 368

These figures indicate that under reasonable assumptions about mortgage failures, the insurance losses for nonprofit sponsorship are nearly balanced by the taxes foregone for limited dividend sponsorship. The remaining cost difference between nonprofit and limited dividend sponsorship is caused by the higher mortgage amount which increases the potential insurance losses and the tandem subsidy as well as debt service.

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The yearly average public housing subsidy is somewhat less than the section 8 and section 236 figures. This is in spite of the fact that we purposely overstated the cost of public housing wherever possible and understated the cost of the other alternatives. In addition the discount rate used was considered low but used since it favors section 236 and section 8 rather than public housing which would benefit from a higher rate of 8 or 10 percent. There are no insurance losses or adjustments for lost units of public housing since based upon HUD data roughly 99% of all public housing units constructed since 1937 are still in existence. Even in cases where financial difficulties are encountered, the housing generally continues to serve the intended tenants.

As noted, these comparisons utilize a 20-year time period, even though housing units can be expected to last much longer. The reason for this choice is that limited-dividend sponsors will probably liquidate their investment after 20 years or refinance the property without Federal subsidy, so that it is unlikely that it will continue to serve subsidy tenants.

The bulk of the tax shelter for investment in new rental housing expires after 8 or 10 years, and it is common for investors to sell or refinance residential properties in order to get their equity out and/or convert to better tax shelters. In the case of section 236, the limited dividend investor is bound by his agreement with HUD to hold the section 236 project for 20 years or to get HUD's permission to sell.

Public housing and nonprofit
rental assistance housing
may serve longer

Public housing and nonprofit-sponsored section 8 and section 236 projects that survive a full 20 years can be expected to go on providing low- and moderate-income tenants with housing for many additional years. This will have the effect of greatly diminishing the yearly subsidy costs of these alternatives. If we compare the cost of these alternatives amortized over 30 years to the limited dividend alternatives for a 20-year period, both public housing and section 236 nonprofits are much less expensive than limited dividends.

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Discounted Annual Subsidy Cost
(Family of Four, \$4,250 Annual Income)

	<u>20 years</u>		<u>30 years</u>	
	<u>Section 236 (rent supplement) limited dividend</u>	<u>Section 8 limited dividend</u>	<u>Section 236 (rent supple- ment) non- profit</u>	<u>Conven- tional public housing</u>
Direct Subsidy	\$1848	\$1816	\$1602	\$ 967
Indirect Subsidy				
Federal tax foregone	272	272	-	350
Less revenue on sale	-49	-49	-	-
Insurance losses	-15	-15	205	-
Tandem Plan subsidy	105	105	106	-
Local tax foregone	-	-	-	305
HUD administration	20	20	20	20
	<u>\$2181</u>	<u>\$2149</u>	<u>\$1933</u>	<u>\$1622</u>

In addition to the lower subsidy under public housing, the building is still owned by the housing authority after it is paid off at the end of 40 years. If it has been adequately maintained and modernized, it can continue to provide housing. Other analyses have shown that public housing is more expensive and sometimes conclude that, since the buildings and land are retained and have residual value, perhaps it is worth the expense. Our calculations indicate that public housing is the cheaper alternative even before the residual value is considered. We have not tried to estimate this value, since the real value is the continuation of housing services and the freedom from starting new units at the end of 20 years. Another method for making this comparison would have been to assume that new section 236 housing would again be provided at the end of 20 years and that the public housing would continue to serve for a total of 40 years. This would result in much higher costs for section 236 as compared to public housing.

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CHAPTER 3
REHABILITATION
VERSUS
NEW CONSTRUCTION

There are significant cost-related differences between the provision of section 236 housing through new construction and provision by rehabilitation of existing units. First of all, the total development cost (TDC) of the two alternatives differs. Estimates of TDC for rehabilitation as a percent on new construction TDC vary widely. The best estimate which we could locate is about 86 percent, which is the figure used here. Secondly, the mortgage failure rate among all section 236 rehabilitation projects is much higher than new construction under limited-dividend sponsorship.

The cost comparison below uses roughly the same methodology as the nationwide new construction comparison of section 236, section 8, and public housing. An ultimate mortgage failure rate of 40 percent of rehabilitated units over 20 years is used, which is the same rate used for new nonprofit section 236 development. This is done to reflect a much greater likelihood of failure. The current failure rate for nonprofit new construction is very close to the current rate for rehabilitated projects. Rehabilitation projects for lower income housing qualify for a rapid writeoff of rehabilitation expenses during the first 5 years of operation. To qualify, the developer must expend at least \$3,000 per unit for renovation over 2 consecutive years up to a maximum of \$15,000. The cost of renovating dwellings under section 236 was usually quite high, since most section 236 rehabilitation projects were of the "gut rehabilitation" variety. One study of rehabilitation tax incentives found that a sample of rehabilitation tax incentives found that for a sample of rehabilitation projects, the median amounts expended for renovation was 67 percent of the total rehabilitation development cost. Consequently, the bulk of depreciation is on rehabilitation expenses, which implies that tax savings for developers are completely exhausted in the first 5 years of operation and projects develop taxable income in the sixth year. The rehabilitation expense used in this comparison is slightly higher than the \$15,000 maximum but it has been included to show how these alternatives compared in the past and would compare in the future if the rapid writeoff provision were extended with a higher ceiling on eligible rehabilitation costs.

DIRECT SUBSIDY LESS COSTLY
UNDER REHABILITATION

Rehabilitation looks attractive at first glance since it results in lower development costs and, hence, a lower direct subsidy cost. Our standard two-bedroom unit serving a lower income family of four has an undiscounted direct subsidy cost of \$3,040, whereas servicing the same family with a comparable rehabilitated unit requires a direct subsidy of \$2,525 per year.

INDIRECT COST FOR REHABILITATED
HOUSING IS HIGHER

Higher tax losses under rehabilitation, however, cancel out the savings in direct subsidy. Average tax savings in the first 5 years for an investor in the 50-percent tax bracket are shown below with the direct subsidy for these alternatives.

Average Yearly Cost (First 5 Years)
Two-bedroom Unit, Family Income of \$4,250

	<u>New construction</u>	<u>Rehabilitation</u>
Development cost	\$27,125	\$23,463
Direct subsidy	\$3,040	\$2,525
Federal taxes foregone	<u>670</u>	<u>1,532</u>
Total subsidy	<u>\$3,710</u>	<u>\$4,057</u>

The rehabilitated unit in this example generates taxable income after the first 5 years, and the newly constructed unit costs an average of \$136 a year in taxes foregone over the next 15 years. When tandem points and other indirect costs are added and the costs are discounted and amortized over a 20-year period with adjustments for lost units, the rehabilitation option appears to be more expensive if TDC for the rehabilitated unit is calculated as 86.5 percent of new construction TDC.

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Discounted Annual Subsidy Cost (note a)
(Family of Four, \$4,250 Annual Income)
(20-Year Average)

	Section 236 new construction	Section 236 rehabilitation	
		86.5% of new TDC	75% of new TDC
Total development cost	\$27,125	\$23,463	\$20,344
Direct subsidy	1,848	1,535	1,339
Federal taxes foregone	272	474	411
Revenue on sale after 20 years	-49	-58	-51
Insurance losses	-15	252	218
Tandem plan costs	105	123	107
HUD administration	20	20	20
Total subsidy	\$ 2,181	\$ 2,346	\$ 2,044

a/Both alternatives are with rent supplements and limited dividend sponsorship.

The total subsidy cost under rehabilitation is quite sensitive to development cost and, as noted in the table, would be less than for new construction if development cost for the rehabilitation unit were 75 percent of the development cost for new construction. The breakeven point under our assumptions seems to be about 82 percent of new construction development cost.

NONPROFIT REHABILITATION COSTS
LESS THAN LIMITED DIVIDEND

The calculations shown thus far have considered only rehabilitation under limited dividend sponsorship. A major rehabilitation cost is foregone Federal tax revenue, which is not incurred under nonprofit sponsorship.

If we assume the same mortgage failure rate (40 percent over 20 years), the cost of a two-bedroom unit serving the same lower income family using nonprofits is considerably lower. Direct subsidy is slightly higher, due to the higher mortgage (100 percent versus 90 percent), but this is outweighed by the tax situation.

The discounted annual subsidy to serve a family with income of \$4,250 under nonprofit rehabilitation would be \$2,104.

This is much less than the limited dividend rehabilitation subsidy of \$2,346 a year and also less than the limited dividend new construction subsidy, which was \$2,181 per year. As noted, there are indications that the failure rate for nonprofit rehabilitations may be greater than that for limited dividend rehabilitations; but the failure rate could be much higher than assumed for this calculation, and the cost would still be lower than the limited dividend alternatives.

EXTERNAL FACTORS NOT CONSIDERED

There is a good possibility that newly constructed units will have a longer life than rehabilitated units, which would further lower the cost of new construction as compared to rehabilitation. On the other hand, there may be cost savings under the rehabilitation approach that are not easily estimated. Community and neighborhood services that may already be in place need not be provided. Some examples are sewer lines, streets, curbs, gutters, and traffic signals. Under new construction the local government surely incurs such costs. We were unable to locate this type of cost information, but field studies could certainly establish a range for such costs.

Secondly, rehabilitation may have salutary ripple effects on the neighborhood that contains the project. It may contribute to the preservation of established neighborhoods and greatly improve the environment for individuals not directly benefiting from the housing. It may directly replace substandard housing with adequate housing.

Finally, rehabilitation probably adds fewer units to the low-rent housing stock than new construction, because it replaces units which may have already been providing minimal housing services to poor households.

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CHAPTER 4

LEASED EXISTING HOUSING UNDER SECTION 8

VERSUS

NEWLY CONSTRUCTED HOUSING

IN LOCAL HOUSING MARKETS

To this point we have dealt only with new construction or rehabilitation alternatives and have shown little cost difference between section 8 and section 236 when tenants pay identical rents under each. But section 8 will also replace leased housing under the public housing program, and this is where section 8 shows a real potential for cost savings.

It should be kept in mind that the housing services provided under the leased housing approach may differ considerably from the services provided under new construction in a number of ways. We will point out the likely differences as cost estimates are presented for new construction and leasing in three American cities. These cities have distinctly different housing markets due to demographic and housing stock characteristics and will allow us to demonstrate a range of possible cost savings as a function of market conditions.

These estimates represent the per unit savings associated with providing a limited number of units in each city, but we make no attempt to estimate the impact of full-scale implementation of the leasing approach within these cities. We will, however, report some previous research indicating that heavy utilization of leasing might have a considerable inflationary effect on general rent levels.

Another consideration is the long-term costs likely under the leasing approach as compared to the short-term cost advantage. Long-term costs of leasing versus new construction were calculated using a reasonable scenario for property ownership and appreciation. Leasing under section 8 is compared to new construction under section 236 and public housing.

The three cities used for this analysis are Pittsburgh, Pennsylvania; Durham, North Carolina; and San Bernardino, California; the counties containing these cities were used in a previous General Accounting Office (GAO) study on the

relative costs of section 236 and section 8 which projected total first-year direct subsidies for serving eligible households. GAO found that the subsidy cost of new construction under the two programs was about the same and that existing leased housing would provide substantial savings. Our analysis utilizes some of the cost data developed by GAO for that study, augmented by actual operating costs for projects in these cities and fair market rents for 1975. We also looked at the possible indirect costs for the two alternatives and projected the costs of these alternatives into future years.

DIRECT SUBSIDY: NEW CONSTRUCTION

The estimating methodology for new construction in the three cities is roughly the same as for the nationwide estimates. Fair market rents are capitalized using an 8.5-percent interest rate, a 40-year mortgage, local tax factors, and operating expenses to arrive at total development costs.

Section 236
Total Development Cost for a Typical Two-bedroom Walkup
and Resulting
First-year Direct Subsidy for a Family of Four

	<u>Pittsburgh</u>	<u>Durham</u>	<u>San Bernardino</u>
Fair market rent	\$3,756	\$2,484	\$2,952
Total Development Cost	\$26,309	\$18,668	\$21,190
Debt service	\$2,204	\$1,564	\$1,775
Operating cost	1,235	712	52
Property taxes	<u>317</u>	<u>208</u>	<u>325</u>
Gross rent	<u>\$3,756</u>	<u>\$2,484</u>	<u>\$ 952</u>
Direct subsidies:			
Very low income (45% of area median)	a/\$2,508	a/\$1,328	a/\$1,828
Moderate income (70% of area median)	a/1,746 b/1,485	615	1,133

a/Indicates that rent supplement is necessary if tenant pays only 25 percent of adjusted gross income.

b/without rent supplement.

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These total development costs are very close to estimates prepared by HUD for actual projects in these cities for the earlier GAO comparison of section 236 and section 8 costs. Operating costs were based upon the most recent operating statements for these projects that we could obtain. Costs used are not meant to be averages for the three cities but are considered to be quite realistic. The margin of error in these costs is considered small enough to allow us to distinguish between cities and between new construction and existing leasing within each city.

The median family incomes for these cities do not differ markedly, yet the subsidies necessary to serve the households shown vary greatly, due to large differences in construction and operating costs from city to city. The costs in Pittsburgh are so much higher that, despite a higher median income than the other cities, the moderate-income family of four in our example requires a rent supplement to keep their rent at 25 percent of their adjusted income. If they were to pay the normal basic rent (which is more likely), their subsidy would be \$1,485 a year and their tenant contribution (rent) would be \$2,271 or 28 percent of their adjusted gross income. This again points out the fact that actual subsidies under section 8 may be considerably higher than they would have been under section 236, since section 236 tenants have characteristically paid much more than 25 percent of their adjusted incomes in rent.

EXISTING HOUSING IN THE THREE CITIES

Cost and resulting rents are generally lower in older existing units than in newly constructed units of comparable quality and type. This is true of all types of housing and, hence, for existing housing under section 8 as compared to newly constructed subsidized housing. Some warnings need to be made, however. If little or no new rental housing were being provided (as is currently the case) and there were a shortage of housing (as there is in some parts of the country), then provision of subsidies to existing housing on a large scale might very likely have the effect of bidding up the price of housing in general and redistributing the current supply among income groups. Many supporters of a housing allowance approach (which has much in common with the section 8 existing provision) agree that this is likely. Their contention is that increasing the demand for housing services will result in the provision (construction, rehabilitation or improved maintenance) of additional housing

services. Although this increased demand will probably raise the price of all existing housing, the allowance advocates feel that eventually enough new housing services will be efficiently provided to justify a general increase in the cost of housing. This argument is far from conclusive. While increased demand can be expected to increase prices, it does not assure that additional housing will be provided, since there are other factors, such as the availability of credit, that affect supply. This is a judgmental area where the phenomenon is not clearly predictable.

The 1975 fair market rent (FMR) limitations for existing two-bedroom walkup apartments in the three cities are shown below. New construction FMRs are shown again to allow comparison.

	<u>Pittsburgh</u>	<u>Durham</u>	<u>San Bernardino</u>
Existing FMR	\$1,788	\$2,028	\$1,872
New construction FMR	3,756	2,484	2,952
Difference between existing and new	+110%	+22%	+58%

These fair market rents seem reasonable in light of available information on local housing markets. For example, Pittsburgh is an area which had little or no population growth between 1960 and 1970. It has a large stock of older existing housing. Pittsburgh experiences reasonably high operating and construction costs, due to its temperate climate and high labor and material costs. Thus, the difference between the rents for older existing buildings and those rents necessary for units in newly constructed apartment buildings would be expected to be significant. In Durham the population has grown rapidly, the housing stock is much newer, housing production probably trails demand, and construction and operating costs are lower. Thus, the difference between new and existing fair market rents in Durham, which is much lower than in Pittsburgh, seems reasonable.

FIRST-YEAR DIRECT SUBSIDY
FOR EXISTING UNITS IS MUCH LOWER

The first-year direct subsidies for existing units under section 3 are shown below for low- and moderate-incomes comparable to those used for new construction. The new construction subsidies are included to allow easy comparison.

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Direct Subsidy (note a)

	<u>Pitts-</u> <u>burgh</u>	<u>Dur-</u> <u>ham</u>	<u>San</u> <u>Bernardino</u>
Very-low-income tenant (45% of area median):			
Section 236 new	\$2,508	\$1,328	\$1,828
Section 8 existing	<u>-467</u>	<u>-803</u>	<u>-681</u>
Potential sav- ings	<u>\$2,041</u>	<u>\$ 525</u>	<u>\$1,147</u>
Moderate-income tenant (70% of area median income):			
Section 236 new	\$1,746	\$ 615	\$1,133
Section 8 existing	(not needed)	(not needed)	(not needed)
Potential sav- ings	\$1,746	\$ 615	\$1,133

a/Existing leasing estimates do not include an amount for local housing authorities who act as the leasing agent for HUD.

The rent subsidy is not needed for four-person households making 70 percent of median income in these cities. This is because at this income level the tenant rent, which is calculated as 25 percent of adjusted gross income, exceeds or nearly meets the existing housing fair market rent limitations in these cities. This results in a great potential for savings if such families can indeed locate adequate housing at rents near or below these fair market rents. For the lower income families, there is an even greater potential saving under the leasing approach as compared to new construction, but the savings vary greatly from place to place. In Pittsburgh the direct subsidy savings for our example would be more than \$2,000 for a family of four in a two-bedroom walkup apartment; whereas in Durham the calculated saving in direct subsidy is only about \$500 per year.

These differences in subsidy probably arise from the market factors mentioned earlier, namely an older housing stock and surplus in Pittsburgh as opposed to a much newer housing stock and a tight market in Durham.

INDIRECT SUBSIDIES FOR LEASING IN
THE THREE CITIES ALSO LOWER

Indirect subsidies in these cities are also lower for

existing housing than for new housing. They are much harder to estimate than for new housing. HUD administrative costs, which are slight, are assumed to be the same as for new housing but could be somewhat greater. Tandem points and insurance losses do not occur under existing leasing. The only indirect costs then are Federal tax expenditures that landlords receive as a result of depreciation and other expenses. Under new construction where the development cost and, hence, the depreciable base are known and where debt service and operating expenses usually offset income, the tax loss is easier to estimate. With existing leasing, apartments that can rent at or below the fair market rents must necessarily be in buildings at least several years old. Consequently, there may or may not be a loan on the property, and the property may or may not be fully depreciated. We can, however, use a maximum tax savings figure for existing housing to, in effect, estimate the minimum subsidy reduction available under existing leasing. Tax savings are greatest when a residential project generates no net income yet has a significant depreciation expense. Thus, if we assume that all of the rental income in excess of utilities and property taxes is used to service a debt, it has the effect of fixing the debt service at the highest level, which would allow the project to operate without net cash loss. Investments that actually lose cash are undesirable to investors; and cash loss is less likely after the mortgage is a few years old, since rents rise with inflation. Using this maximum-debt service and the normal-depreciation rules, we are able to estimate maximum tax savings for each city. These estimates are shown below along with the direct subsidy for the lower-income family of four. New construction tax savings are estimated in a manner similar to the nationwide calculations. All costs represent averages for the first 5 operating years. A HUD estimate of local program administration is also included.

First-5-year Average
Yearly Direct and Indirect Costs (note a)
(Very-low-income Family of Four, 4-Bedroom Walkup)

	Pittsburgh		Durham		San Bernardino	
	New section 236	Existing section 8	New section 236	Existing section 8	New section 236	Existing section 8
Direct subsidy	\$2,508	\$467	\$1,328	\$ 803	\$1,828	\$ 681
Indirect subsidies:						
Federal tax foregone	650	106	461	271	523	185
HUD administration	20	20	20	20	20	20
Local housing authority administration	---	179	---	179	---	179
Yearly subsidy	<u>\$3,178</u>	<u>\$772</u>	<u>\$1,809</u>	<u>\$1,273</u>	<u>\$2,371</u>	<u>\$1,065</u>

a/Family income equal to 45 percent of the area median income. These costs are not discounted.

The minimal potential savings through leasing are quite significant, ranging from an approximate 80-percent saving compared to the new construction subsidy in Pittsburgh to a 40-percent saving in Durham.

No general conclusions can be drawn for the Nation as a whole from these calculations, since each locality has a unique set of characteristics just as do these three cities. Savings will however be somewhat proportional to the difference between new and existing fair market rents if the FMRs are realistic.

LEASING COSTS IN A DYNAMIC FRAMEWORK

The cost relationships between the various programs for newly constructed housing would be expected to hold, regardless of the degree to which these approaches were applied within a given area, since our calculations are based on equal development costs. Hence, if the price of land, construction, or financing increased, the cost of new units under all programs or subsidy types would increase accordingly.

The relationships between rents for newly constructed units and existing units leased concurrently cannot be expected to remain the same. Under leasing with new construction, HUD can be expected to have control over rents for 20 years, just as it does under section 236. But under the existing leasing approach, agreements between landlords and local authorities can be expected to be much shorter in duration and the stated fair market rents will need to be increased periodically to keep pace with increases in private rents.

The Urban Institute compared leased public housing to conventional public housing and, using cost data on years prior to 1969, concluded that inflation in the monthly rent of a leased unit would be roughly \$1 greater per year than for a conventional public housing unit. This was equivalent to a 0.8-percent increase in the leasing rent per year. This is probably a very conservative estimate, in view of recent inflation in property values, local taxes, and interest; and it considers only the direct costs.

The cost of leasing will increase with time

We have prepared a sample calculation based on Durham to show how subsidy cost under existing leasing might

increase, as compared to new construction under section 236, as a result of property appreciation alone.

In this analysis, as previously, we do not account for inflation in operating cost and utilities, since these could be presumed to increase equally for both newly constructed and leased housing. The only factors that we consider are property appreciation and the tendency of investors to turn over their property (or refinance) every few years. Also not considered here is the possibility that rents might rise even faster than necessitated by appreciation or that property taxes are more likely to rise when property is sold. Durham was used because the new and existing subsidy costs were closest there and because the housing services are probably similar for both alternatives. In the first few years, the likely savings through leasing in Durham are great; but, since the existing housing is probably relatively new (or equivalently desirable), it will probably appreciate and be saleable unless it is poorly located. Our scenario is that the building was originally built around 1972 (because the \$2,028 fair market rent for a two-bedroom unit will support a building constructed in that year) and that the project is resold twice in 1980 and 1988, which is realistic. If multifamily property appreciates at 4 percent per year (which is probably a conservative rate based on recent experience), then the existing fair market rents in the years 1980 and 1988 would have to be about \$2,600 and \$3,300, respectively, in order to carry the debt, without increases in operating costs.

The indirect cost due to depreciation would also increase for the existing alternative since with each sale the new owner starts depreciating the building again from a higher basis. Tax revenue on sales and local housing authority administrative costs are included for the existing leasing alternative. The following table shows the total yearly subsidy for our two-bedroom walkup apartment serving low- and moderate-income families of four.

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Hypothetical Calculation of
Total Direct and Indirect Subsidy
New Section 236 Versus Section 8 Leasing
Durham, Two-bedroom Walkup

	<u>New section 236</u>	<u>Existing section 8</u>	<u>Public housing</u>
Very low income (\$5,500 a year):			
First year	a/\$1,862	\$1,302	\$1,625
Twentieth year	1,586	2,793	1,503
Average yearly (20-year discounted)	1,057	1,007	965

a/Includes a prorated share of tandem plan costs.

First-year subsidy is lower for the existing unit, but in the 20th year the existing unit has a much greater cost than the new construction unit. When the costs are discounted, the yearly subsidy costs for leasing are slightly lower than newly constructed section 236. Public housing, however, is cheaper than both the other alternatives. This example does not prove that leasing will in general be more expensive than new construction under section 236 or public housing. It merely shows that in this situation, where new and existing fair market rents are only a few hundred dollars apart, it is quite possible that existing leasing might result in higher total subsidy cost than new housing development, even when several factors that could further increase the cost of existing housing are not considered.

Extensive leasing may have an
inflationary impact

Another important consideration is that the use of the leasing approach on a large scale might have its own inflationary impact on rents beyond that of the normal escalation that could be expected in its absence. The Urban Institute has done housing market simulations to determine the long-term effects of a housing allowance; these simulations indicate that full-scale subsidies to existing housing might cause a significant long-term increase in rents. The housing allowance approach subsidizes the tenant directly, who then locates his own housing. The existing leasing provision of section 8 is similar to the housing allowance approach, although section 8 utilizes local housing authorities as intermediaries. In the six cities simulated, which

included Durham and Pittsburgh, the average percentage of increased housing expenditures that went to higher prices (not better services) was 23 percent. They also found that, although slower growing cities such as Pittsburgh had a greater initial price discount than faster growing cities, the amount of increased housing expenditures lost to higher prices was, oddly enough, greater in the simulations for cities having initially high discounts; furthermore, the cost increase was greatest in the lowest third (lowest rents) of the housing market. Thus, they concluded that the inflationary impact is greatest in the cities where the leasing approach is initially the best bargain and that concentrating allowances on poorer households may concentrate demand pressures on the most inflationary segment of the market.

Housing scarcity and leasing costs

Increased scarcity of housing due to the current housing recession may drive up the cost of existing housing and decrease the savings possible, compared to new construction subsidies. Large savings presently possible are, to a certain extent, due to the rapid building during the last decade. The national housing boom is now over, and adjustments in the price differential between new and used housing will probably speed up. Just as the cost of rent in existing buildings is now generally a good buy, due to rapid building in the late sixties and early seventies, existing rents could be driven up rapidly in the last part of the decade as a result of the continued demand for housing and the dearth of multi-family construction in the last few years.

Leasing economy and interest rates

Existing rental housing is also a bargain compared to new construction, because of the rapid increase in financing charges since the mid-sixties. Much of this advantage will disappear as housing is refinanced at current interest rates, unless interest rates continue to rise, which would certainly not give any relief to the low- and moderate-income housing situation.

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CHAPTER 5

AGENCY COMMENTS

In a July 23, 1976, letter the Deputy Assistant Secretary for Economic Affairs, HUD, commented on a draft of this report. These comments were preliminary and were based upon a rapid reading of the report. The major items in HUD's response are summarized below with our point-by-point discussion.

HUD said our conclusion that public housing would be favored by a lower effective property tax rate of 1.5 percent (rather than the 2.5 percent rate which was used) was incorrect. They noted correctly that the taxes are the same for each program when both direct and indirect costs are considered.

However, the estimates of total development cost which we used were derived from the national average fair market rent of \$3,900 and assumptions about the property tax rate, operating costs, and interest rate, thus assuming a lower property tax rate would increase the total development cost for all alternatives. Since the debt service is higher for section 236 and section 8 than for public housing as discussed in Chapter 2, the gross rent and hence total subsidy would increase more for section 8 and section 236 than for public housing.

HUD noted that one comparison presented in the report indicated that the subsidy under section 236 would very likely be less than section 8, since the direct subsidy was limited by the debt service under section 236, resulting in average section 236 tenant rents above 30 percent of adjusted gross income; whereas the section 8 program allows a deeper subsidy, limiting tenant rent to from 15 percent to 25 percent of adjusted gross income. HUD noted that it was the intent of Congress to lower the rent burden on lower income families and that this comparison was therefore unfair.

The comparison which we included using different rent burdens for the two programs was a minor one used to show what the actual difference in direct subsidy might be regardless of tenant benefit. All major comparisons used the same tenant rent of 25 percent of adjusted gross income for all alternatives. The comparison in question

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does, however, illustrate quite clearly that the direct subsidy under section 8 will probably be uniformly higher at all incomes than the two programs which it is replacing.

HUD also suggested that the deeper subsidy under section 8 might result in lower FHA mortgage failures for section 8 than for section 236.

This is possible although there are other factors under section 8 which could increase failures under the program. Some examples are: (1) under section 236 the subsidy was paid for vacant units, but under section 8 the subsidy will be withdrawn after 2 months of vacancy; (2) under section 236 many of the failures occurred during construction or prior to full occupancy, but under section 8 this period will be made increasingly risky since once the rents are fixed for a new section 8 project they cannot be increased even if the developer experiences much higher costs due to inflation or other factors beyond his control; (3) according to HUD, rent increases under section 8 will be much harder to get than under section 236 except for standard yearly increases; (4) if rents established for section 8 are unrealistically low and cannot be exceeded except for standard 10- or 20-percent exceptions, developers may attempt to build projects which are not economically feasible; (5) HUD has been reducing the underwriting standards for section 8, such as vacancy ratios, which FHA uses in making determinations as to the insurability of projects. If these standards resulted in high failures for section 236, lowering them should not be expected to decrease the defaults or failures involved in section 8. Therefore, any assertions made by HUD to the effect that mortgage failures will be lower under section 8 should be viewed with skepticism.

HUD stated that the method which GAO used to calculate foregone tax revenue for public housing results in a low estimate of the costs.

We calculated this indirect cost by assuming that the public housing bond holder would ordinarily pay taxes at a 50-percent marginal rate and that the foregone taxes or tax saving to the bond holder would be 50 percent of the interest on the 6-percent tax-exempt mortgage bond. HUD contends that the proper method is to base this estimate of lost revenue on the tax that the bond holder would have paid had the tax-exempt bond not been available. They further stated that in the absence of the tax-exempt bond the investor

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would buy 8-percent taxable bonds. We chose our method of calculation in order to show what tax was not paid by the taxpayer on the income earned on the tax-exempt bond. This is consistent with our treatment of section 236 in which no alternate investment is assumed. HUD assumes an alternate investment for public housing but no alternate for FHA-financed new construction. Furthermore, HUD counts only a portion of the tax savings related to section 236--that associated with accelerated depreciation. Thus, HUD suggests a rather low estimate for new construction under FHA financing while at the same time suggesting a high estimate for public housing.

Although we are not completely satisfied with our estimates for a number of reasons, we find HUD's most recent estimates even less convincing. Asserting that the public housing bond holder would go to a taxable yield rather than searching for another means of sheltering income, while tacitly assuming that the profit-motivated housing investor would still avoid some taxes, treats the two alternatives unequally.

As noted in chapter 2, we also estimated the public housing taxes foregone in a number of other ways which yielded lower estimates. There is also evidence, which is not conclusive, indicating that public housing bond holders are in lower tax brackets than multifamily housing sponsors. If this is true, the taxes foregone would be lower for public housing and higher for subsidized private production.

If it is impossible to clearly identify the relative magnitude of these indirect costs, it might be advisable to completely ignore them; but we feel that HUD can do a better job of estimating these costs than they have in the past.

HUD indicated an inconsistency in our use of the GNMA tandem plan costs which we calculated as an additional cost associated with an 8.5-percent mortgage. They implied that no tandem subsidy would be needed unless the mortgage were at 7.5 percent and, therefore, that we are double counting.

The tandem plan estimate which we include is based-upon the likelihood that, if GNMA purchases mortgages at 8.5 percent these will carry a large discount when sold which GNMA must absorb, because the market interest rate will be more like 9.25 to 9.5 percent. HUD's most recent cost comparison showed a 9.75-percent interest rate. Had we used the 7.5-percent rate, the tandem subsidy would have been estimated

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as more than twice as large as we included in our estimates. Even if we had used 9.5 percent, which is probably closer to a market rate, we would have included some higher costs in development cost and gross rent, since HUD's guidelines for section 8 indicate that when a developer uses conventional financing the fair market rent may be increased up to 5 percent to cover loan discount costs. Thus, under any assumption which places the interest rate below the current market rate, we would expect an additional tandem subsidy to cover loan discounts when such mortgages are sold.

HUD suggested that our estimates of costs to the FHA insurance fund for sections 8 and 236 present a one-sided comparison since there must be some analogous problem under conventional public housing which would be translated into higher operating costs.

HUD has frequently spoken publicly about losses to the FHA insurance funds but has not mentioned similar problems for public housing. Our research could not uncover any such costs, and we feel that they do not exist. If operating costs are slightly higher, they do not result in the curtailment of the housing services, nor does a slight shortage in operating funds for public housing bring about failure as occurs in FHA-insured housing where the lender can assign the mortgage to HUD with little provocation. If such costs do indeed exist, they should be estimated and included in any further cost comparisons by HUD.

HUD described our inclusion of Federal taxes foregone under existing section 8 housing as erroneous, because the landlord would claim accelerated depreciation and thus avoid income taxes regardless of whether the housing is section 8 or is purely private housing. HUD contrasted this to the case in which new construction is carried out in response to the subsidy.

This same argument could be applied to the new construction case by saying that the 200-percent accelerated depreciation method is available to all owners of newly constructed rental housing regardless of whether the housing is subsidized or not. One might even say that the investor in rental housing would have found some other means to shelter his income had he not chosen housing and, therefore, that the taxes foregone are not a real

cost and should never be counted. Actually, these taxes are foregone for the particular housing being considered, and this particular tax expenditure is incurred by the Government to encourage investment in rental housing. It is therefore a housing subsidy. If the indirect subsidies are counted for new section 236 they should be counted for existing section 8.

HUD stated that our estimates seem to ignore taxes recaptured by the Federal Government on subsidies it pays to profit-motivated landlords and that no such tax recaptures are associated with conventional public housing.

In our estimates for newly constructed housing under section 8 and section 236 we did include an estimate of capital gains paid by housing investors when the housing is sold after 20 years. HUD apparently overlooked this. In addition, our estimate of taxes foregone included some years in which taxes were actually paid. These taxes were subtracted from the total taxes foregone.

With regard to our comparison between newly constructed section 236 and public housing, and the section 8 leasing program for similar housing in Durham, HUD had a number of criticisms which focused on the following three points.

1. Applying the 4-percent appreciation rate to section 8 units when they are sold, while not applying inflation to other cost components is inconsistent.
2. The 4-percent yearly rate causes the fair market rent to go up yearly, which is unrealistic.
3. Sales are controlled by HUD for units under leases so that such sales cannot occur.

Our methodology throughout this report was to ignore inflation wherever it could be expected to be the same for each program being compared. When estimating the total cost of leasing, however, the fair market rents can be expected to go up to cover rises in property value in addition to increases in rent due to operating cost rises. Thus, we added an incremental cost above normal operating cost inflation for section 8 leasing since under Government-sponsored new

construction programs property appreciation does not enter into rent calculations. This is clearly a reasonable procedure which results in comparable costs.

HUD's contention that we increased rents each year due to appreciation is incorrect. We increased rents only in the years in which we assumed sales.

Finally, we are aware that HUD controls sales during active leases, but these leases are a maximum of 5 years in length, and an investor could easily time his sales to coincide with expiration of a lease or write the lease to coincide with his plans for selling.

With regard to a statement in the report suggesting that full-scale use of leasing might have an inflationary effect on rents, HUD cited its 1976 Experimental Housing Allowance Program report in which they conclude that there had been no inflationary impact in Greenbay, Wisconsin, during 18 months of operation of the housing allowance experiment.

Our remarks were based upon common sense buttressed by a considerable amount of economic theory and a very good group of reports by the Urban Institute which simulated the long-term (10 years) impact of direct cash assistance payments in several housing markets under a large variety of groups of assumptions. Under every set of assumptions inflation resulted from the experiment.

The Greenbay experiment which HUD cited has a variety of design and execution problems which have led critics to conclude that virtually nothing will be learned from the experiment. Only a fraction of the eligible recipients of the housing allowance have chosen to take payments; and, of those who accepted the subsidy, a large percentage were homeowners who were already in place and did not shop the market for housing but rather defrayed other expenses with the allowance. Thus, no inflationary impact could be expected and none was observed. To generalize these results to the Nation without mentioning these caveats is misleading.

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