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Role of Tax Policy in Preserving the Stock of Low-Income Rental Housing

Statement of
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Subcommittee on Select Revenue Measures
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to assist your subcommittee in considering how the federal government might best respond to the potential loss of a significant number of privately owned and federally subsidized low-income rental housing units. The potential loss of low-income housing is a subject which we have previously reported on and one which we consider to be critical in designing future federal housing policy.

In the last 2 decades, approximately 2.0 million low-income housing units have been constructed through assistance provided by various federal programs. These programs include the Department of Housing and Urban Development's (HUD) section 8 new construction program, section 221(d)(3) program, and section 236 program; and the Farmer Home Administration's (FmHA) section 515 rural rental housing program. Over the next decade, many of the federally subsidized units are at risk of being lost from the low-income stock because of the expiration of restrictions requiring that projects serve low-income persons. My remarks today,

-- provide an overview of our findings from two reports we issued regarding the potential loss of federally assisted rental housing units, and

-- provide some observations on H.R. 3663 that the subcommittee may wish to consider concerning the

use of tax policy as a means of encouraging the preservation of low-income rental housing.

OVERVIEW OF POTENTIAL REDUCTION IN THE PRIVATELY OWNED AND FEDERALLY ASSISTED INVENTORY

On June 16, 1986, we issued a report on the 1985 inventory of privately owned and federally assisted rental housing administered by HUD and FmHA and the potential impact of expiring section 8 contracts and mortgage prepayment restrictions on this inventory.[1] Just recently, we issued another report dated February 11, 1988, which provides an update on the potential loss of low-income rental housing units from the section 515 rural rental housing program administered by FmHA.[2] Collectively, the two reports show that almost half of the approximately 2.0-million-unit inventory is vulnerable to loss by the end of fiscal year 1995 through owners' voluntary withdrawal from federal housing programs.

Since our first study, other public and private groups have conducted more in-depth evaluations. As a result, the Congress has found that

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[1] Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory (GAO/RCED-86-176FS).

[2] Rural Rental Housing: Impact of Section 515 Loan Prepayments on Tenants and Housing Availability (GAO/RCED-88-15BR).

-- in the next decade, more than 465,000 low-income housing units produced with assistance under section 8 of the United States Housing Act of 1937 could be lost as a result of the expiration of the rental assistance contracts;

-- in the next 15 years, more than 330,000 low-income housing units insured or assisted under sections 221(d)(3) and 236 of the National Housing Act could be lost as a result of the termination of low-income affordability restrictions; and

-- some 150,000 units of rural low-income housing financed under section 515 of the Housing Act of 1949 are threatened with loss as a result of the prepayment of mortgages by owners.

GAO'S OBSERVATIONS ON RECENT PRESERVATION INITIATIVES

During the 1980's, the reduction and elimination of direct and indirect federal assistance gave private owners incentives to withdraw from federal housing programs and has created an environment for future losses. Recognizing this problem, the Congress is pursuing a dual approach to preserve low-income housing. The Housing and Community Development Act of 1987

provides interim measures aimed at minimizing losses from the federally assisted inventory. Specifically, they include incentives designed to increase owners' rates of return, restraints on prepayment of mortgages by owners, and provisions supporting the purchase of projects by nonprofit or public agencies. In addition, H.R. 3663 not only proposes to strengthen the tax incentives that cover these federal housing programs but would also extend benefits to state and local housing programs as well.

Mr. Chairman, the following question comes to mind immediately: What amount of incentives is necessary to retain private investment in low-income housing, but prevent private investors in low-income housing from taking advantage of opportunities for extra cash and returns? Unfortunately, differences in market areas preclude a simple answer.

The current inventory of privately owned, federally assisted housing has been characterized as representing three different market areas. Generally, projects located in strong market areas have a high potential to be lost from the inventory. The economies of these housing markets offer owners the possibility of profitable returns through market-rate rentals or conversion to condominiums or some alternative use, such as office space. Therefore, a very deep subsidy may be required to induce their continued participation.

At the other end of the spectrum are units that have no better economic use or potential than as low-income housing. The markets in which they are located will not support higher rents or alternative uses for the property. The lack of these units' marketability will discourage owners from disposing of them in the private sector. Consequently, little or no incentive, tax or otherwise, may be required to induce their continued participation.

Other units probably have a borderline position in the market and have the potential to move either way. They may be located in markets which are stable but not showing signs of increased rent or gentrification. The owners can only realize a limited gain by converting to market rentals or other uses. The incentives needed to induce these owners to retain their projects as low-income housing would fall somewhere between the other two extremes.

The incentives provided in the Housing and Community Development Act of 1987 are aimed at increasing owners' rates of return. They include greater cash distribution allowances, reduced loan interest rates, increased rents under existing section 8 contracts, and provisions for insuring second mortgage equity loans and financing capital improvements.

H.R. 3663, like the Housing and Community Development Act, is designed to increase investor returns. The major provisions include (1) allowing property owners additional depreciation

deductions by restoring the depreciable basis of their property, if they maintain their property as low-income housing for at least 20 additional years, (2) excluding from taxation the noncash gain on the sale of a building to a subsequent owner who agrees to maintain the property as low- or moderate-income housing for 15 years, and (3) allowing greater opportunities for use of the low-income housing tax credit.

Both legislative initiatives should facilitate the retention of low-income housing units. We believe, however, that H.R. 3663 could be more effective in achieving this objective if the subcommittee considered such options as:

-- strengthening certain targeting provisions to ensure that housing projects provide the maximum possible assistance to low- and moderate-income households,

-- enhancing cost-control provisions aimed at maximizing the number of units assisted while minimizing costs, and

-- strengthening accountability and oversight by requiring a program evaluation mechanism.

I will discuss each of these areas along with our rationale for the needed changes.

Maximizing Assistance to
Low-Income Households

While the Housing and Community Development Act and H.R. 3663 express the same objective of preventing the loss of "low-income housing," there are substantial differences in the two initiatives. Specifically, the housing act limits its incentives to specific HUD and FmHA housing programs which have very similar definitions of low-income households. Generally these programs give a greater priority to assisting very low-income households (those with incomes no greater than 50 percent of the area median income), who often have the most critical housing needs. Conversely, H.R. 3663 covers a broad base of federal, state, and local housing programs whose definitions of low-income may differ from HUD and FmHA program definitions.

H.R. 3663 offers tax incentives to owners of "qualified" low-income housing which, as defined in the bill, is housing "which is substantially assisted, financed, or operated under a federal, state, or a local housing program and subject to restrictions on rents or income with respect to at least 20 percent of the tenants." Any differences in the low-income definitions among the federal, state, and local housing programs, would not ensure that

the tax incentives offered will be directed toward the most critical housing needs. This would not conform with current national housing policies which define low-income in the context of those most in need. We raised this issue in a previous report on tax-exempt bond financing[3] where we found that above-average income renters could qualify as "low- and moderate-income" renters because program income ceilings were set at 80 percent of the areas' median income and did not include adjustments for family size until after 1985. The Congress reaffirmed its commitment to helping the most needy in the Tax Reform Act of 1986 when it defined low-income for purposes of obtaining the low-income housing tax credit as households with incomes not exceeding 50 or 60 percent of the area median income and included household size adjustments.

H.R. 3663 also extends its tax benefits to projects which partially serve low-income families. Specifically, the bill allows projects to receive the full tax benefits even though as few as 20 percent of the units serve low-income families. We have expressed concern in the past as to whether tax subsidies are most efficiently directed when as many as 80 percent of a project's units may not be serving low-income households. Accordingly, we would favor a higher low-income occupancy requirement than presently contained in H.R. 3663.

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[3]Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds (GAO/RCED-86-2).

Enhancing Cost-Control Provisions

Cost controls are necessary for any program if it is to successfully encourage the minimization of costs and the optimization of benefits. We have repeatedly advocated strengthened controls for direct subsidy programs such as section 8 and we strongly believe that cost controls should be a major emphasis in any tax reform proposal. In this regard, an excellent feature of H.R. 3663 is that it requires recapture of additional depreciation if the owner does not hold the property as low-income housing for 20 years as prescribed in the bill.

The more specific targeting of H.R. 3663, as I previously mentioned, would further control costs by limiting the tax incentives to those projects serving the most needy. For example, the 1987 housing act does this by requiring HUD and FmHA to determine, on the basis of market conditions, that (1) owners need an incentive to retain their projects in the low-income housing stock, (2) the incentive provides the owners with a fair return on their investments, and (3) the incentive is the least costly alternative for the federal government to pursue.

As a complement to this targeting, the subcommittee may wish to consider, for federally assisted projects, linking the tax incentives to the incentives provided for in the Housing and

Community Development Act of 1987 and limiting their use to only those situations where HUD or FmHA would determine they are necessary to retain a particular project in the low-income rental stock. Likewise, we believe that for state and local housing programs, tax incentives should only be provided when either HUD or FmHA determines that they are necessary and/or appropriate to retain a project in the low-income stock. I recognize, Mr. Chairman, that this is a substantive departure from the present bill, but we believe it is an option worth exploring. This check goes to the heart of an earlier issue that I raised, namely the need to ensure that project owners are provided with a fair return on investment without providing windfall profits.

Strengthening Accountability and Oversight

H.R. 3663 does not specifically provide a mechanism for evaluating the degree to which the incentives enumerated in the bill are effective and efficient in preserving the stock. Program evaluation is one of the key tools in assuring the effective allocation of scarce resources and should be an integral component of any housing preservation initiative. Again, one means to achieve this oversight would be to tie the tax incentives to the preservation provisions of the Housing and Community Development Act. In this regard, since HUD and FmHA are required at the outset to determine a project owner's need for incentives and the

appropriate incentives to provide, it is logical that they also be required to report to the Congress on a periodic basis which incentives have been used, their cost, and their degree of effectiveness in retaining low-income housing.

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Mr. Chairman, this concludes my prepared statement, and I welcome the opportunity to answer any questions that you may have.