114664

REPORT BY THE

Comptroller General

OF THE UNITED STATES

How To House More People At Lower Costs Under The Section 8 New Construction Program

The Section 8 New Construction Program is producing very good quality rental housing; housing which is, in fact, often better than most other housing in the general market areas where it is located. GAO found that given the caliber of this housing, development and operating costs were generally reasonable. However, significant savings are possible, which could be used to extend housing assistance to a greater number of the needy.

114664

The Department of Housing and Urban Development should

--take steps to increase incentives for high-quality management and long-term ownership of new section 8 projects,

--build more modest-size section 8 housing with fewer amenities,

--get better use out of recently completed housing, and

--improve program administration.

Previous GAO reports related to the section 8 program have recommended various other actions which could reduce costs and improve program results.

UNITED STATES GENERAL ACCOUNTING OFFICE

CED-81-54
MARCH 6, 1981

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-199105

March 6, 1981

The Honorable Pete V. Domenici
Chairman, Committee on Budget
United States Senate

Dear Mr. Chairman:

This report was prepared pursuant to a March 17, 1980, request from the former chairman and the ranking minority member of the Senate Budget Committee. The report discusses (1) the nature and magnitude of financial benefits afforded to developers and investors in subsidized housing built under the Section 8 New Construction Program, (2) the reasonableness of development and operating costs for this housing, and (3) the possibilities for reducing costs and improving the results of this program.

The Department of Housing and Urban Development generally agreed with the findings and recommendations in the draft report and said that the report will be useful to program managers. The Department stated further that the scope of the draft report covers critical areas in its subsidized housing programs. However, because of the time required to properly study these issues, it does not expect to have a written response to the draft report until mid-March. In accordance with the request of your office to expedite the report, we are transmitting our report without these formal written comments. Depending on the nature of the Department's response, we will consider issuing a supplemental report evaluating its written comments on the recommendations contained in this report.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Secretary of Housing and Urban Development.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States

REPORT BY THE COMPTROLLER GENERAL OF THE UNITED STATES

HOW TO HOUSE MORE PEOPLE AT LOWER COSTS UNDER THE SECTION 8 NEW CONSTRUCTION PROGRAM

D I G E S T

Housing being built for the needy under the Section 8 New Construction Program is of very good quality and, considering the quality, costs are reasonable. However, actions are still possible to reduce the cost of subsidized housing units and achieve greater equity and a broader distribution of housing benefits. (See chs. 3 and 4.)

At the request of the Senate Budget Committee, GAO examined financial benefits afforded to developers and investors in subsidized housing under the program, the reasonableness of development and operating costs for the housing, and the possibilities for reducing costs and improving program results. (See p. 1.)

The housing GAO saw during this and prior reviews was better than most housing in the general market areas where it was located. (See ch. 4.) With the aid of independent fee appraisers, GAO found that for the caliber of housing being built, development costs were generally reasonable for a sampling of 31 new projects in California, Delaware, Ohio, Pennsylvania, and the District of Columbia.

The projects GAO reviewed represented a cross section of projects for families and the elderly built under the general supervision of the Department of Housing and Urban Development (HUD), the Farmers Home Administration, and State housing finance agencies. GAO made a limited evaluation of the reasonableness of first-year operating costs and these costs appeared to be reasonable. (See ch. 3.)

Although a considerable amount of entrepreneurial skill is required to develop section 8 projects and development involves some risks, substantial financial benefits are available for developers and investors, primarily from selling limited partnership interests and tax shelters. (See ch. 2.)

Some of GAO's recommendations involve lowering somewhat the caliber of housing being built under section 8. GAO recognizes that these recommendations may invite objections, but it believes the present policy of building section 8 housing that is better than most of the housing in the general area around it reduces both the number of housing units which can be built and the number of people who can be served with available funding. Such a policy also raises valid questions about the overall fairness and equity of federally subsidized housing programs. GAO in no way suggests, however, that section 8 housing be less than decent, safe, and sanitary. (See p. 43.)

PROGRAM COSTS AND PROGRESS

From its inception in 1974 through fiscal year 1980, the overall section 8 program has cost about $5.6 billion in direct appropriations and has incurred obligations totaling about $128 billion to pay future rental subsidies over the next 20 years, according to a Department of Housing and Urban Development estimate. The additional cost to the Government to date and for the future of the income tax writeoffs provided to owners and investors in the section 8 program is extremely difficult to estimate, but probably amounts to many billions of dollars.

Through fiscal year 1980, a total of 1,737,745 housing units have been planned or completed under the section 8 program. This total covers existing, newly constructed, and substantially rehabilitated housing units. Of this total, the new construction component of the program includes 712,181 units. (See pp. 3 and 4.)

FINANCIAL BENEFITS TO DEVELOPERS AND INVESTORS

Substantial financial incentives exist to attract developers and investors to the Section 8 New Construction Program:

--Projects can be undertaken with a fairly small cash investment in relation to total project development costs. (See p. 8.)

--Government-subsidized, below-market interest rates on project mortgages are provided to developers. (See p. 8.)

--Developers earn profits by syndicating (selling limited partnership interests in) projects they undertake. (See p. 11.)

--Significant tax shelters are provided to owners and investors in new projects through the highly accelerated depreciation allowed for the projects and the way losses can be distributed. (See p. 20.)

--Other benefits include profits from construction, management fees, anticipated gains from the future sale or conversion to condominiums, operating profits, cash distributions, and other types of tax savings. (See pp. 18, 23, and 27.)

While present inducements for the production of section 8 housing appear to be effective, inducements to ensure quality management and long-term ownership of section 8 housing are not nearly so strong. Some action seems needed to remove this imbalance between production incentives and operation and long-term ownership incentives. (See p. 29.)

Recommendations to the Secretary of HUD

The Secretary of HUD should increase the incentives for high-quality management and long-term ownership of section 8 new construction projects. One way of doing this would be to require developers to make higher equity investments and, in return, allow greater cash distributions during operations. This option should attract investors who are less motivated to seek profits from tax losses generated by production and more interested in yearly profits possible from operating section 8 projects and providing housing services. (See p. 31.)

The Secretary should also study a variety of methods, including economic incentives and contractual sanctions, to encourage present project owners under 5-year assistance contracts to continue in the section 8 program after their contracts expire. (See p. 31.)

REASONABLENESS OF DEVELOPMENT AND OPERATING COSTS

Independent fee appraisers employed by GAO concluded that development costs were reasonable, for the most part, for the 31 projects GAO selected for review, on the basis of "what was there." GAO did not ask them to pass judgment on other aspects of project cost, such as the size of the units, need for certain amenities, or occupant densities. GAO could not resolve some differences of opinion regarding cost reasonableness on certain projects between its fee appraisers and HUD. (See pp. 32 to 37.)

Using data published by the Institute of Real Estate Management, GAO was able to make a limited evaluation of the reasonableness of first-year operating costs for 14 of the 31 projects. For the most part, operating costs appeared reasonable, but GAO recognizes that first-year operating costs may not be representative of costs in later years. (See pp. 37 to 42.)

While procedures for controlling development costs appeared to be adequate, many cost determinations were not satisfactorily documented. Also, HUD's policy of granting annual automatic rent increases without evaluating the need for such increases based on reviews of financial statements of project owners precludes effective control by HUD over the reasonableness of section 8 operating costs. (See pp. 36 and 42.)

Recommendations to the Secretary of HUD

The Secretary of HUD should:

--Direct HUD area offices and delegate agencies involved in reviewing section 8 development costs to adequately document their cost determinations. (See p. 37.)

--Direct these same officials to survey the rental housing construction market and develop alternate approaches for evaluating section 8 development costs when appropriate comparable projects cannot be identified. (See p. 37.)

--Enforce the requirement that project owners submit annual, certified financial statements and use the statements to evaluate regularly the reasonableness of formula-based annual rent increases given to housing owners. (See p. 42.)

--Develop uniform procedures and train staff to properly and promptly review project financial statements. (See p. 42.)

OPPORTUNITIES TO REDUCE COSTS AND IMPROVE PROGRAM RESULTS

To reduce costs and improve program results, the Secretary should also:

--Develop an explicit definition of "modest housing" for use under the Section 8 New Construction Program which (1) limits the size of family units to dimensions closely approximating those suggested in HUD's minimum property standards and (2) reduces substantially the types and number of amenities permitted in new section 8 housing. (See p. 54.)

--House the single elderly in efficiency/studio type units instead of one-bedroom units. (See p. 54.)

--Develop definitive guidelines for section 8 projects which require that units be assigned and reassigned to achieve optimum use of all units. (See p. 60.)

--Direct HUD field offices to monitor the use of section 8 units more closely, especially during initial occupancy, and to invoke appropriate penalties when owners/managers consistently fail to comply with HUD occupancy guidelines. (See p. 60.)

GAO has issued a number of reports related to the section 8 program since its inception. Recommendations in more recent reports directed toward reducing costs and improving program results are summarized in this report. (See pp. 60 to 63 and app. I.)

AGENCY COMMENTS

HUD generally agreed with the findings and recommendations in the draft report and said that the report will be useful to its program managers. HUD stated further that the scope of the draft report covers critical areas in its subsidized housing programs. However, because of the time required to properly study these issues, HUD does not expect to have a written response to the draft report until mid-March. It stated that it expects the response to the recommendations to be positive. (See p. 6.)

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ABBREVIATIONS

CPA	certified public accountant
FHA	Federal Housing Administration
FmHA	Farmers Home Administration
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HUD	Department of Housing and Urban Development
SHFA	State housing finance agencies

CHAPTER 1

INTRODUCTION

On March 17, 1980, the Chairman and Ranking Minority Member of the Senate Budget Committee asked us to explore the following questions concerning the Section 8 New Construction Program:

1. What is the nature and magnitude of the financial benefits afforded to owners and investors in section 8 newly constructed housing?

2. How reasonable are the development costs and operating costs of newly constructed section 8 housing?

3. What changes do you recommend to reduce costs and improve program results?

NEED FOR RENTAL HOUSING

About 35 percent of all American families depend on rental housing. Many of these families, however, do not have the financial means to obtain suitable housing. Today's rental housing market is typified by a sharp decline in the production of rental units affordable by a large segment of the renter population, an increasing number of condominium conversions, and relatively low vacancies.

The Department of Housing and Urban Development (HUD)--which administers the principal Federal housing and community development programs--estimated not long ago that over 18 million families in this country needed some form of housing assistance. Six million of these families were living in substandard housing; 10 million were spending a disproportionate share of their income for housing; and the remaining 2 million were living in overcrowed housing.

SECTION 8 PROGRAM DESCRIPTION

The section 8 program is currently the major means of providing federally subsidized housing to low-income families and households. This program was established by the Housing and Community Development act of 1974 (Public Law 93-383). According to the act, the purposes of the program were to (1) help lower income families obtain a decent place to live and (2) promote economically mixed housing. From its inception in 1974, the program has made use of existing housing units, newly constructed units, and substantially rehabilitated units. More recently, moderately rehabilitated units have also been made a part of the program.

Section 8 provided for the continuation, on a modified basis, of the Leased Housing Assistance Program set forth in section 23 of the United States Housing Act enacted in 1965. Under this program, public housing agencies leased privately owned accommodations and, in turn, subleased the units to low-income families. About 150,000 units were leased under this arrangement.

Under the new construction portion of the section 8 program, HUD either directly or through State housing finance agencies (SHFA) or the Farmers Home Administration (FmHA) makes assistance payments to owners or prospective owners, who agree to construct housing in which some or all of the units are made available for occupancy by lower income families. HUD enters into 20-year housing assistance payment contracts with project owners to subsidize the rent of units rented to low-income people. Before January 1980, contracts allowed project owners to cancel or renew the contracts after 5 years. Project owners are responsible for operating and maintaining their units.

Program eligibility

Eligibility for assistance under section 8 is generally limited to families with incomes which do not exceed 80 percent of the median income for the particular area of residence. An eligible family's contribution toward rent is determined by formula and may vary between 15 and 25 percent of income depending upon such factors as income level; family size; and extraordinary expenses, such as high medical costs, which the family must support. At least 30 percent of the program's newly constructed units are to be occupied by families with incomes which are below 50 percent of the median area income, and to the extent possible, this ratio is to be maintained in subsequent leasing. A Federal subsidy is paid to the project owner equal to the difference between the contract rent--based on the market rent of comparable standard units in the area--and the amount of rent paid by the eligible family.

Fair market rents

The section 8 new construction program and its costs are tied very closely to fair market rents, which have been defined as the rents, including utilities (except telephone); ranges and refrigerators; and all maintenance, management, and other services, which would be required to be paid to obtain privately developed and owned, newly constructed rental housing of a modest (nonluxury) nature with suitable amenities and sound architectural design meeting the objectives of the HUD minimum property standards. Separate fair market rents are established for dwelling units of varying size (number of bedrooms) and types (e.g., elevator, non-elevator, detached, semidetached) and for different market areas. HUD is required to determine fair market rents at least annually.

Program activities

As of September 30, 1980, HUD's section 8 management information system showed the following program activity:

Section 8 program	Projects	Total units	Elderly units
New construction:			
Completed	4,109	294,835	210,517
Started--not completed	2,735	197,865	109,998
Reserved--not started	4,336	219,481	91,218
Total reservations	11,180	712,181	411,733
Substantial rehabilitation:			
Completed	499	39,486	18,110
Started--not completed	624	49,062	17,815
Reserved--not started	1,075	49,544	15,273
Total reservations	2,198	138,092	51,198
Existing housing:			
Completed	9,270	818,990	244,702
Reserved--not completed	1,054	68,482	13,653
Total reservations	10,324	887,472	258,355
Total section 8 program:			
Completed	13,878	1,153,311	473,329
Started--not completed	3,359	246,927	127,813
Reserved--not started	6,465	337,507	120,144
Total reservations	23,702	1,737,745	721,286

About 42 percent of the 1,737,745 total units reserved under all section 8 program segments were designated for the elderly. The remaining units, about 58 percent, are available for the elderly and for families. Of the 1,153,311 units completed under the section 8 program, about 41 percent were designated for the elderly and 59 percent for families. For the new construction segment of the program, however, about 58 percent of the 712,181 total units reserved and about 71 percent of the 294,835 units completed were designated for the elderly.

Also about 81 percent of the total units completed under the section 8 program were occupied as of September 30, 1980. The occupancy rate for units completed under the new construction segment was the same as for the entire section 8 program. The following table shows the section 8 occupancy for each segment of the program as of September 30, 1980.

Section 8 program	Projects	Total units occupied
New construction	3,568	238,783
Substantial rehabilitation	401	28,516
Existing housing	8,051	661,838
Total section 8 program	12,020	929,137

From program inception through fiscal year 1980, HUD estimated that contract authority approved by the Congress for the section 8 program was about $5.6 billion. Budget authority, which is to cover the costs of the units throughout their respective contracts, was estimated in fiscal year 1980 to be about $128.2 billion. The additional cost to the Government to date and for the future of the income tax writeoffs provided to owners and investors in the section 8 program is extremely difficult to estimate, but probably amounts to many billions of dollars.

For fiscal year 1980 the section 8 program contract authority was about $930 million and the budget authority was about $18 billion. The following table shows the contract and budget authorities for fiscal year 1980.

Section 8 program	Contract authority	Budget authority
	-------(millions)-------	
New construction	$507	$10,599
Substantial rehabilitation	140	3,166
Existing housing	283	4,234
Total section 8 program	$930	$17,999

GAO has issued a number of reports on the section 8 program. A list of these reports is shown in appendix I.

OBJECTIVES, SCOPE, AND METHODOLOGY

The basic objective of this review was to respond to the questions asked by the Senate Budget Committee on March 17, 1980. The request called for both descriptive and evaluative information on the nature and magnitude of financial benefits accruing to owners and investors in new section 8 housing, the reasonableness of development and operating costs for such projects, and the potential for reducing costs and improving program results.

We focused our review on the geographical areas served by the HUD area offices in Columbus, Ohio; Los Angeles, California; Philadelphia, Pennsylvania; and Washington, D.C. When we started our review, about 10 percent of the newly completed section 8 projects nationwide were in communities served by these four offices. We selected 31 projects recently completed in California, Delaware, Ohio, Pennsylvania, and the District of Columbia, which represented 21 percent of the 147 projects placed under rental contracts in the four HUD area offices in calendar year 1979 (tenants began to occupy the selected projects in the last half of 1978).

We did not select these 31 projects statistically and, therefore, make no claim that these projects are representative of the universe of projects in these area offices or the Nation. Our selection was designed to include

--the various types of financing used for construction,

--both large and small projects but none with less than 20 units, and

--a range of monthly rents within the spectrum of the universe of projects.

We collected data on each of the 31 projects, such as development and operating costs and the characteristics of the units. We collected this data from the financing agencies (HUD, FmHA, and the States of California and Pennsylvania); from the developers, management agencies, and resident managers of the projects; and from observations and photographs made during visits to the projects. A detailed description, with selected pictures, of each of the 31 projects included in our review is presented in a supplement to this report.

To assist us in our study of the reasonableness of development costs, we employed professional fee appraisers--a further explanation of their selection and their scope of work can be found in chapter 3. We used the statistical data published by the Institute of Real Estate Management, Chicago, Illinois, to help us evaluate the projects' operating costs.

We reviewed the legislation and appropriate regulations and procedures of HUD, FmHA, and the States of California and Pennsylvania. We used information from HUD's statistical reports relating to the section 8 program. We reviewed literature and publications on housing, concentrating on rental, subsidized, and section 8 material.

We interviewed personnel from the HUD and Department of Agriculture Offices of Inspector General during the review, obtained copies of their reports and, where appropriate, considered their findings in our study.

We discussed the section 8 program and the results of our review with numerous HUD, FmHA, and State officials. In addition, we discussed issues with people in and outside the Government whom we considered knowledgeable about housing problems and possible solutions.

We performed our review primarily at HUD headquarters and its area offices in Columbus, Los Angeles, Philadelphia, and Washington, D.C.; at FmHA headquarters and its State and district offices in Ohio and Pennsylvania; and at offices of the California and Pennsylvania State housing finance agencies.

Over the past year HUD has made several changes to contain the cost of the Section 8 New Construction Program. Since some of these changes are not completely implemented, we could not evaluate their impact on the program. Consequently, our review of some changes was limited to determining their status and potential for success.

AGENCY COMMENTS

HUD generally agreed with the findings and recommendations in the draft report and said that the report will be useful to its program managers. HUD stated further that the scope of the draft report covers critical areas in its subsidized housing programs. However, because of the time required to properly study these issues, HUD does not expect to have a written response to the draft report until mid-March. It stated that it expects the response to the recommendations to be positive.

CHAPTER 2

NATURE AND MAGNITUDE OF FINANCIAL BENEFITS

TO DEVELOPERS AND INVESTORS IN

SECTION 8 NEWLY CONSTRUCTED HOUSING

The Section 8 New Construction Program provides substantial inducements for developers and investors to produce rental housing. These inducements include

--small cash investment in relation to total project development costs;

--Government-subsidized, below-market interest rates on project mortgages;

--profits to developers from syndicating project ownership to investors;

--significant tax shelters for project owners; and

--construction profits for builders/developers.

To a lesser extent, inducements may also include project operating profits, small yearly cash distributions, anticipated gains from the eventual sale or condominium conversion of the projects, and management fees.

Present inducements for the production of section 8 housing appear to be effective. Inducements to ensure quality management and long-term ownership of section 8 housing, however, are not nearly so strong. We believe HUD should seek a better balance between production and project operation incentives. One possible way of doing this would be to require developers to make higher equity investments and, in return, to allow greater cash distributions during operations. This should attract a group of investors less motivated to seek shelters from the potential tax losses generated by production and more interested in the yearly profits possible from operating section 8 projects and providing housing services.

In this chapter we examine the nature and magnitude of the financial benefits to the producers of section 8 new construction housing. Our examination is based largely on information obtained at 31 selected projects in California, Delaware, Ohio, Pennsylvania, and the District of Columbia. We also developed hypothetical project data to illustrate the nature and magnitude of these financial benefits. The data was obtained from prior research by GAO and others and from discussions with developers and HUD officials. Appendix II shows these calculations and the assumptions used to develop them.

SMALL CASH INVESTMENT AND LOW-INTEREST MORTGAGES ARE A MAJOR IMPETUS TO PRODUCTION

A major reason why developers are attracted to the section 8 program is because the cash investment required to produce these projects is relatively small when compared to the investment required to produce unsubsidized housing projects or other large real estate developments. Further, project financing is provided by Government-subsidized, below-market mortgage interest rates.

Developers must certify project costs to HUD. The cash invested by a developer is the difference between the total project cost and the mortgage amount. For profit-motivated developers, however, there may be additional cash expenditures which HUD will not include in certified costs. For example, developers must pay any financing points not covered by the Federal Housing Administration- (FHA-) insured mortgage and for any builders' fees in excess of the amounts allowed by HUD. For nonprofit developers, the mortgage amount generally covers all the project costs and no equity investment is required of the project sponsor.

For our sample projects, we found that the cash investments varied depending on the type of developer and the type of financing used. In estimating the total project costs, we adjusted the certified project costs where appropriate to reflect any additional expenditures reported to us by developers. The following table compares the average cash investments, by type of developer, expressed as a percentage of total project costs, for each financing method.

Average Cash Investment as a Percentage of Total Project Costs

Financing method	Type of developer: Private profit	Private nonprofit	Public	Total by financing method
FHA-insured mortgage:				
Number of projects	17	1	-	18
Average investment (note a)	11.9	0.04	-	11.3
SHFA tax-exempt bonds:				
Number of projects	3	1	1	5
Average investment (note a)	6.0	6.9	11.7	7.3
Section 202 loans:				
Number of projects	-	3	-	3
Average investment (note a)	-	4.4	-	4.4
FmHA 515 loans:				
Number of projects	2	2	-	4
Average investment (note a)	7.6	b/0.2	-	3.8
Total by type of developer:				
Number of projects	22	7	1	c/30
Average investment (note a)	10.7	2.9	11.7	8.9

a/As a percentage of total project costs.

b/One of the projects was 100 percent financed by the loan.

c/One section 11(b) project in our sample, but sufficient data was not available.

Developers' cash investments are significantly below that traditionally required for unsubsidized projects. Commercial lenders have typically required as much as 25 to 30 percent or more equity investments by developers of unsubsidized residential construction.

Financing subsidies are also available to developers. These subsidies include mortgage-interest subsidies for privately financed projects and forgone revenues from tax-exempt bonds used to pay the development costs of publicly financed projects. These subsidies do not involve a direct cash transfer to project developers, but they reduce the financing costs and hence the direct rental subsidy.

Many privately sponsored section 8 new construction projects are financed through reduced-interest, federally insured (FHA) mortgages that are written by private lenders and sold to the Government National Mortgage Association (GNMA), an agency of HUD, which then resells the loans as market-rate-yield investments. Under this arrangement, GNMA absorbs the difference in interest rates as a financing subsidy, with the full cost borne by GNMA at the time that the mortgage is sold. This tandem financing assistance is funded through a special fund which also supports other types of mortgage assistance. The mortgage-subsidy costs directly attributable to the section 8 program, therefore, are not clearly identifiable.

Projects which are insured by FHA and financed through GNMA's tandem plan carry an administratively set 7.5-percent interest rate. Added to this is a one-half of 1 percent mortgage insurance premium which is paid to FHA to cover potential failures. Projects financed in this fashion therefore actually carry a mortgage interest rate of 8.0 percent. This rate allows the debt service, and consequently the project's rent, to be lower than if the projects were financed by a conventional lender. In early 1978, the time when most of our sample projects were financed, the interest rate on a conventional loan was about 9 percent or 9.5 percent. This difference in financing costs would result in a per unit tandem cost of about $3,000 per unit, when the total unit development cost is $30,000, including a $27,000 mortgage. Actual subsidies for specific projects could be somewhat lower or much higher based upon the timing of the sale. For example, 7.5 percent section 8 project loans sold in January 1980 resulted in per unit tandem subsidies approaching $7,000, for a unit development cost of $30,000.

Many other section 8 new construction projects, including all those sponsored by SHFA are financed by State or local housing revenue bonds. Both State agency and 11(b) financed projects take advantage of tax-exempt financing to provide low-interest rate mortgage loans. Because the interest paid to the purchasers of these revenue bonds is exempt from Federal taxation, the interest rate may be set at a lower level than the prevailing rate for similarly rated taxable bonds. This reduces the financing costs that must be carried in project rents. This financing technique results in forgone Federal revenues because of the tax exemption.

In our report to the Congress entitled "Evaluation of Alternatives for Financing Low and Moderate Income Rental Housing" (PAD-80-13, Sept. 30, 1980), we found that SHFA-financed projects were, on average, being financed with long-term bonds at about a 6.75-percent interest rate. This rate was the average interest paid to bond buyers for a number of issues in early 1978. However, the interest rate which is charged to an apartment project developer is somewhat higher than the bond interest rate because State agencies typically add a charge of three-fourths of 1 percent interest to cover their cost of operations. Section 11(b) projects financed by public housing authorities using tax-exempt bonds typically do not include this service charge.

Section 8 new construction projects are also financed by direct loan programs, such as HUD's section 202 and FmHA's section 515 programs. The section 202 program provides funds to nonprofit developers at rates equal to the average Government borrowing rate, plus an allowance to cover administrative costs and potential failures. FmHA's section 515 program provides funds to either profit or nonprofit developers at the prevailing Government borrowing rate. The Federal long-term bond rate for the first quarter of 1978 averaged about 8.2 percent.

PROFIT INCENTIVES DURING DEVELOPMENT

Developers and investors are attracted to the section 8 program largely because of the benefits derived from the syndication process. Profit-motivated developers can realize immediate profits on section 8 projects by selling ownership interest (syndication) in them to passive investors. Investors are passive since they do not develop or manage the projects but merely buy the investments from developers and turn the management over to a general partner. Proceeds from these sales provide funds for the developers to use for legal and syndication fees, for cash requirements during the construction phase, and as profit for developing the project. These profits could be reduced or eliminated by cost overruns that require developers to increase their cash investments. Profit-motivated developers that do not syndicate their projects retain the ownership interest and are entitled to the income tax shelters and cash distributions from the project operations. Nonprofit developers cannot realize any profits for developing section 8 projects, nor do they receive cash distributions.

While builders may realize profits from constructing section 8 projects, cost overruns can reduce or eliminate profits. In certain instances, builders' financial returns may depend on their special relationships with the developers. Builders may be the same entity or in the same organization as the developers or they may be totally independent of the developers which will affect their contractural arrangements and the profits which they accept for a given project.

The syndication process

The form of ownership which allows "passthrough" of tax shelter and other benefits to passive investors is typically the limited partnership. Ownership interest in a project may be sold to passive investors directly by the developer or through a syndicator or underwriter for a syndication fee.

In a limited partnership syndication, the project developer and maybe a few others are the general partners and the passive investors are the limited partners. Most developers syndicate their projects at the start of construction. It is not feasible to syndicate earlier because there are no tax shelter benefits to attract the passive investors.

Tax losses and the income of the partnership accrue directly to the partners. The limited partners' liability for the legitimate business debts of the partnership is limited to the amount of capital contributed, or agreed to be contributed, to the partnership. Additional liabilities are generally assumed by the general partners according to the partnership agreement. The limited partnership does not pay income taxes. Partners, however, must report their distributable share of the limited partnership's net income or loss, whether actually received or not, on their individual income tax returns. In other words, for income tax purposes, the annual net income or loss of the partnership is passed directly through to the individual partner. Tax losses (losses are the general rule for syndicated projects in the first several years) can be used to offset or shelter owners' income from other sources.

Syndicators, a firm or individual or in some cases the project developer, identify prospective passive investors and negotiate with them to obtain funds. Some syndicators purchase equity interest in projects for later resale to passive investors, while others act either as agents for the developer or as agents for investors seeking projects.

Syndicators receive a fee for their services from developers and/or from passive investors.

Developers in 13 of 31 projects in our sample syndicated their projects. We were able to obtain data describing the details of the syndications for eight of these. The syndication fees for the eight projects ranged from 1.2 to 30.7 percent of gross syndication proceeds and averaged 12.3 percent of gross syndication proceeds. Expressed as a percentage of the mortgages, the syndication fees ranged from 0.3 to 8.3 percent and averaged 2.6 percent. Other studies indicate somewhat higher syndication fees. A 1977 study 1/ indicated that syndicators usually charged fees from 15 to 20 percent of the syndication proceeds raised. A 1980 study 2/ indicated that syndicators' fees and expenses average 5 to 6 percent of the mortgage and that after expenses, syndicators usually net 3 to 4 percent of the mortgage.

An investor's decision to invest, and the amount to invest in a syndicated project, depends on various factors, including the potential risks and the potential return on investment. One of the main risks is that the project will go into foreclosure before the tax savings are fully realized. Investors are interested primarily in getting as large and as early a return on their investment as they can.

Usually, passive investors as a group are willing to pay from 15 to 20 percent of the mortgage amount for a 95-percent project ownership interest. Investments in our sample projects averaged 20.1 percent of the mortgage and 17.5 percent of the total project costs, while the passive investors received ownership interests averaging 90.4 percent. Excluding one project where only 50 percent of the ownership interest was syndicated, the average increased to 96.1 percent.

In three of eight syndicated projects in our sample, we found that developers were selling investors two types of ownership interests. For these three projects the investors' interests in the projects' annual operations were 95, 95, and 97 percent and the interests at time of sale were 50, 50, and

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1/"Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," Congressional Budget Office, May 1977.

2/"The Department of Housing and Urban Development (HUD) Section 8 Program," Surveys and Investigations Staff, House Appropriations Committee, Apr. 1980.

49.9 percent, respectively. This arrangement would greatly enhance the general partners' profit at the time of sale. Also, the investments for these projects were generally lower than for those projects where the ownership interests for annual operations and residual value were the same. Thus, it appears that the developers of the three projects were willing to accept less money from passive investors in return for an increased potential profit at the time of sale of the projects.

Developers' profit incentives from syndication

Developers can realize immediate profits on section 8 projects by syndicating them to passive investors. While developers' gross profits from syndicating projects appear high, the returns on their investments could be significantly lower depending on the timing of payments by passive investors. Further, cost overruns may require some developers to increase their cash investments, thereby reducing or even eliminating profits or resulting in a loss from syndication. On the other hand, profit-motivated developers retain ownership interests in the projects and are entitled to the tax shelters and cash distributions from project operations proportional to the ownership interests retained.

Developers handle the planning, organize other participants, and oversee most phases of the development process. Developers package or organize all the services and skills necessary from initiation to completion of a section 8 project. They perform such functions as obtaining the land and local clearances, negotiating for construction and permanent financing, and obtaining approvals from HUD and other sources.

From the developers' point of view, their cash investment in a section 8 project involves a high risk. If delays occur, development and construction costs rise, thus requiring additional cash investment in the project. For FHA-insured projects, HUD provides for a builder's and sponsor's profit and risk allowance in computing a project's replacement costs. The allowance is not paid to the developer in cash but is credited against the amount of private investment the developer is expected to provide. In essence, the developer substitutes expected profit for a part of the required cash equity.

Developers of section 8 projects may not have sufficient income to take advantage of the tax shelter that will be generated. Therefore, many developers syndicate the project to get investors' commitments of funds before proceeding with construction. With these commitments and a fast payment schedule from passive investors, the developers can limit their initial investment to a 2- to 5-year period and realize a portion of their profits well in advance of the usual holding period for real estate investments. In practice, passive investors make payments to the developer over a period of several years.

We were able to estimate the developers' gross profit (loss) for 8 of the 13 syndicated projects in our sample. In estimating the developer's gross profit (loss), we subtracted the mortgage amount from the total project cost to determine the developers' cash investment, or ownership interest. Only the portion of the ownership interest sold to investors was applied to net syndication proceeds (gross syndication proceeds less syndication fees and expenses) to determine the developer's gross profit (loss). In our analysis, the developer's gross profit (loss) is expressed as a percentage of the ownership interest sold and the mortgage amount.

In six of the eight projects, the developers realized a gross profit ranging from 21 percent to 140 percent of the ownership interest sold and ranged from 4 percent to 12 percent of the mortgage amount. The average developer's gross profit was 82 percent of the ownership interest sold and 8 percent of the mortgage amount. In two projects, the developers sustained losses of 23 percent and 48 percent of the ownership interest sold and 4 percent and 14 percent of the mortgage amount, respectively.

The following table shows the estimated developer's gross profit (loss), both as a percentage of ownership interest sold and as a percentage of the mortgage amount, for the syndicated projects in our sample.

Estimated Developer's Gross Profit (Loss) From Syndicating Projects

Project	Percent of project syndicated	Developer's gross profit (loss): Amount	As a percentage of: Ownership interest sold	As a percentage of: Mortgage amount
		(000 omitted)		
A	50	$216	120	5
B	95	677	140	12
C	95	147	21	4
D (note a)	95	31	38	5
E (note a)	95	297	93	10
F (note a)	97	(192)	(48)	(14)
G	98	(86)	(23)	(4)
H	98	233	81	8

a/These developers retained about 50 percent residual interests in the projects.

Similar findings were contained in the previously mentioned April 1980 study prepared by the House Appropriations Committee's Surveys and Investigations staff. In this study, profit calculations were made on six section 8 new construction projects. The study showed that developers realized profits from syndication ranging from 4.2 to 12.1 percent of the mortgage.

While developers' gross profits from syndication appear high, the actual rate of return on their investments is influenced by the timing of the investments and of the payments by passive investors. Developers' cash investments generally are made before and during project construction. Most syndications require an initial payment when the partnership is formed with additional payments at certain predesignated intervals during construction and operation of the project. Developers start recovering their investment when syndication takes place, but it generally takes several years before they recover their full investment and realize a profit.

The cash flow between investments and syndication proceeds over a period of several years could significantly affect a developer's return. For example, in our hypothetical project illustration (see app. II) the developer's investment syndicated was $403,200 and net syndication proceeds were $541,200. The developer's gross profit was

$138,000, or 34 percent of the ownership interest sold. The annual rate of return from syndication would be significantly lower, however, assuming that 75 percent of the developer's investment was made in the year prior to construction and that 25 percent of the developer's investment was made during construction, and further assuming that net syndication proceeds were received in three yearly payments, beginning with construction. Based on this cash flow, we estimated that the developer's annual rate of return 1/ would be about 17 percent. The following table shows the net cash flow and annual rate of return from syndication under the above assumptions.

Hypothetical Developer's Net Cash Flow and Annual Rate of Return from Syndication

Year	Ownership interest sold	Net syndication proceeds	Net cash flow
1	$302,400	-	($302,400)
2 (Construction period)	100,800	$131,200	30,400
3	-	205,000	205,000
4	-	205,000	205,000
Total	$403,200	$541,200	$138,000
Annual rate of return (percent)			17

In addition to the immediate profit incentives from syndication, profit-motivated developers can realize a later return on their investments in proportion to the ownership interests they retain. A return is realized from project operations in the form of tax shelters and yearly cash distributions and from proceeds on sale or refinancing of the project. For the eight syndicated projects in our sample, developers retained ownership interests ranging from 2 to 50 percent. Also, profit-motivated developers in nine projects retained the project ownership and are entitled to the benefits from the project operations. Developers in nine other projects were nonprofit and thus are not entitled to any profits or returns.

1/Annual rate of return is calculated by using the internal rate of return method. The internal rate of return is the periodic interest rate which will make the net present value of a series of cash flows equal to zero, which indicates the minimum interest rate before losses occur.

For our hypothetical project illustration, the developer retained a 4-percent ownership interest. We estimated that the developer's annual rate of return from operations and sale was 18 percent for sale after 10 years and was 16 percent for sale after 20 years. The details of our computations are shown on page 26.

Builders' profit incentives
from construction

Builders are directly responsible for construction. They may perform the major construction functions themselves or subcontract portions of their work to others. Initial construction cost estimates (contract price) and builders' profits (over and above costs) are generally negotiated with developers. Construction cost overruns may reduce these profits, however, and cost underruns may increase them.

In certain instances, builders' financial returns may depend on their special relationships with the developers. For example, project developers are often builders, but the builder's role is a separate one even when the builder and developer are identical.

Builders must certify actual construction costs to HUD. From the time that estimated construction costs are first submitted to HUD for approval until the project is completed, 1 or 2 years or even more may elapse. With a volatile, inflationary economy, actual cost increases are generally more than originally anticipated. Construction costs in excess of the initial contract price may be allowed by HUD, if justified, with commensurate increases granted in mortgage amounts and estimated rents. Cost increases not approved by HUD are generally borne by the builder out of profits. On the other hand, cost underruns could further enhance the builder's profits.

For our sample projects, 17 of 30 projects had cost overruns, ranging from 0.1 to 24.3 percent of the contract price and averaging 7.6 percent of the contract price. One project had a cost underrun totaling 1.3 percent of the contract price. Also, in 12 of 30 projects the construction costs were the same as the contract price.

The builder's profit is usually expressed as a percentage of the construction contract or as a specified dollar amount. If the developer also functions as the builder, however, or if the builder is otherwise related to the developer, such as by a joint venture arrangement, the payment and receipt of a profit is, in substance, an offset. In such cases the builder/developer may also decide not to segregate a profit for constructing the project, but to take its profit for the total development.

For our sample projects, the builders were independent of the developers in 12 of 29 projects. The builder and developer were identical or related in some fashion in 17 of 29 projects. In 7 of these 17 projects, builder/developers did not segregate a profit for constructing the projects.

We estimated the builders' profit (loss) for 27 of the 31 projects in our sample for which we had sufficient data. We assumed that cost overruns were absorbed by the builder and that the builder received the benefit of cost underruns. In 16 projects the builder realized a profit; in 8 projects the builder sustained a loss, and in 3 projects the builder broke even. In seven of the eight projects where the builder sustained a loss, there was an identity of interest with the developer, making it difficult to assess the meaning of the loss. The details of our analysis are shown in appendix III. The following table summarizes the estimated builders' profit (loss) as a percentage of both the certified construction cost and the contract price.

Estimated Builders' Profit (Loss) as a Percent of Certified Construction Cost and Contract Price

	Certified construction cost	Contract price
	- - - -(percent)- - - -	
Builders profit (16 projects):		
Low	0.1	0.1
High	13.1.	13.1
Average	5.5	5.5
Builders loss (8 projects):		
Low	0.4	0.5
High	16.9	20.3
Average	6.3	7.2

The House Appropriations Committee's Surveys and Investigations Staff study (see p. 13) analyzed the builders' profit (loss) in constructing six section 8 projects. The study showed that in four of the six projects the builder sustained a loss. The losses ranged from 0.5 to 6.1 percent of the construction cost and from 0.6 to 7.9 percent of the contract price. Builders' profits on the other two projects were 5.5 and 6.2 percent of the construction cost and 6.6 and 8.2 percent of the contract price.

TAX SHELTER ALLOWS SIGNIFICANT RETURNS TO INVESTORS

As mentioned earlier, the tax syndication process is the primary attraction for investors in section 8 projects and, in turn, acts as a stimulus for housing production. People who invest in subsidized housing are primarily interested in a tax shelter and the profit if the project appreciates in value.

Tax shelters have two main goals--to defer the payment of taxes for as long as possible and to convert ordinary income into capital gain income which is taxed at substantially lower rates. Tax payments on ordinary income are deferred primarily through deduction of certain construction period expenses and accelerated depreciation during project operation. Upon the sale of the project, ordinary income deferred in earlier years is, in effect, converted into a capital gain. Depending on the timing and manner of disposition, attractive tax benefits exist for lower-income housing from the recapture rules of excess depreciation. These benefits are defined and discussed below.

The discussions in this section rely mainly on the information contained in a prior GAO report entitled "Evaluation of Alternatives for Financing Low and Moderate Income Rental Housing," (PAD-80-13, Sept. 30, 1980).

Construction period deductions

During the construction period, the owners of residential construction projects have been able to deduct certain expenses immediately instead of capitalizing them and writing them off over the life of the projects. These expenses, such as interest payments on the construction loan, real estate taxes, and certain other fees and charges, were typically advanced by the lender and yet the owner still received the benefit of the deduction. Thus, these expenses were used for sheltering an investor's other income.

The Tax Reform Act of 1976 limited this benefit by requiring that such expenses for rental housing be capitalized and eventually amortized over a 10-year period. For low-income housing, such as under section 8, the time schedule is retarded with the requirement to amortize, beginning with a 4-year writeoff in 1982 and increasing to 10 years in 1988.

Accelerated depreciation

Depreciation of construction cost during the project's operating life is the primary tax benefit to section 8 investors. Depreciation, as an expense against project income, is not a cash expense. There are several allowable methods permitted by the Internal Revenue Code by which depreciation can be accelerated over the straight line method. The table on page 22 shows the methods that are permitted for different types of residential real estate.

Owners of all newly constructed residential housing can use the 200-percent declining balance method which, for tax purposes, allows projects to be depreciated at a rate that is in the first year twice that of the straight line method. The depreciation deductions, which are noncash expenses, are applied against the income generated by the project during the period of rental operations. Even though the project is generating a small cash flow (project income less cash expenses), the depreciation expense is much larger and provides a taxable loss to investors, at least during the early years of a project's life. This loss will shelter the cash flow generated by the property and, to the extent that it exceeds the cash flow, will also provide shelter against the investors' income from other sources.

Depreciation Methods Permitted by the Tax Reform Act of 1976

Type of real estate	Most accelerated method permitted	Rules of recapture of excess depreciation
New residential for low- and moderate-income families	200-percent declining balance and sum-of-the-years digits	Declines 1 percent per month after 100 months. No recapture after 16 years and 8 months.
All other new residential	200-percent declining balance and sum-of-the-years digits	All excess depreciation recaptured regardless of time of sale.
Used residential	125-percent declining balance if useful life of 20 years or more, otherwise straight line	All excess depreciation recaptured regardless of time of sale.
Section 167(k) rehabilitation for low- and moderate-income housing	Straight line with 5-year useful life	Declines 1 percent per month after 100 months. No recapture after 16 years and 8 months.
Commercial	150-percent declining balance	All excess depreciation recaptured regardless of time of sale.

Attractive recapture provisions

Other tax benefits provided to section 8 investors relate to the timing and manner of disposal of a project. Recapture refers to the tax provision under which accelerated depreciation claimed on tax returns in excess of that allowable under the straight line method is taxed at the time of sale as if it were ordinary income in the year of the sale. This provision has the effect of destroying the advantage of converting ordinary income to capital gains income when a property is held for too short a period.

As shown in the table on page 22, there are different provisions for recapturing excess depreciation when a project is sold. When an accelerated depreciation method is used and the project is sold, the excess depreciation is taxed as ordinary income unless the project has been held for a certain period. While all excess depreciation is recaptured if the project is unsubsidized, no excess depreciation is recaptured if a section 8 project has been held for 16 years and 8 months. Also, excess depreciation declines 1 percent per month after 8 years and 4 months.

Expected gain upon sale

Capital gains taxes and the recapture of excess depreciation have long been considered important incentives for good management and long-term ownership of subsidized housing. Such considerations were based on the assumption that property would not appreciate in value. Because section 8 projects are considered more likely to appreciate in value than under past subsidized programs and capital gains laws are more favorable today than in the past, returns on investment from the sale of section 8 projects could be substantial.

Many section 8 projects are generally well located and will likely appreciate in value to the point where the owners can expect to make significant profit by selling or converting them to condominiums. Real estate values, in general, have grown rapidly and a housing shortage is predicted through the 1980s. In addition, section 8 projects should be worth more than past subsidized projects and, because they generally house the elderly, they will probably be in better condition.

Capital gains tax laws changed in 1978. Before that time only 50 percent of any gain was taxed at the ordinary income tax rate; after the 1978 tax law was passed, only 40 percent of the gain is taxed at the ordinary rate. This change further increases the potential for greater returns from the sale of section 8 projects.

For many section 8 projects in operation before January 1, 1980, early sale and conversion to unsubsidized housing is likely. Before January 1980, the housing assistance payment contract executed with section 8 project owners allowed cancellation or renewal of the contract at the owner's option after 5 years (or multiples of 5 years). After January 1980, minimum contract terms of 20 years are required on all section 8 contracts. All section 8 projects currently in operation, however, have 5-year contracts. The strong economic incentives would highly motivate many owners to dispose of their investments after only a few years because the return on investment would be substantial.

In our report on alternative financing for low- and moderate-income rental housing (see p. 20), we calculated the tax impacts and expected profits for owners of multifamily subsidized projects which appreciate at a rather moderate 5 percent per year. Even after recapture and capital gains taxes are paid, passive investors in relatively low marginal tax brackets (50 percent) could expect impressive yearly rates of return of about 28 percent and 32 percent if multifamily properties were sold after 5 or 10 years, respectively. Although these properties would continue to provide good returns after 10 years, the bulk of the tax shelter is exhausted in the first 10 years. And tax shelter is the primary motivation for investment in subsidized multifamily projects. Higher appreciation rates and higher investor tax brackets, which are the norm, would result in even greater incentive to dispose of such investments. This combination of factors makes it very likely that some portion of section 8 owners will choose to sell when housing assistance payment contracts come up for renewal.

Hypothetical project illustrates the rate of return to investors

We also developed a hypothetical project to illustrate the tax shelter effects and the expected rates of return for owners who retain ownership in section 8 projects for 10 years and 20 years. The assumptions used to develop the hypothetical project data are based on findings from our sample projects and from other studies of section 8 new construction projects. Therefore, we believe the data to be realistic and typical of a section 8 new construction project. The data should not however, be thought of as average or representative because individual syndication structures vary widely and data to calculate an average or representative figure would be very difficult to obtain. Appendix II shows the data we developed and the assumptions used to develop the data.

For our example the project owners consist of a developer and three passive investors. The developer invested \$420,000 in the project, retained a 4-percent ownership interest, and is in the 30-percent marginal tax bracket. The three limited partners each contribute \$68,333 a year for 3 years, receive 32 percent ownership interest, and are in different marginal tax brackets--50, 60, and 70 percent.

The developer paid a $73,800 syndication fee out of the syndication proceeds.

The annual rates of return on these investments, based on net cash flows over both a 10-year and 20-year period, are about the same. Operating losses due to the tax shelters (construction period deductions and accelerated depreciation) are significant, particularly during the first 10 years. Even after sizable recapture and capital gains taxes are paid for sale after 10 years, the annual rates of return were about the same as those returns for sale after 20 years, where no excess depreciation was recaptured. Further, the sales price, under both sales conditions, assumes a modest 2-percent per year appreciation rate. While the passive investors have the same investment and same ownership interest, their net cash flow from the project's operation and sale differ because of different tax brackets. The following table summarizes the net cash flow and annual rates of return from operations and sale after 10 years and after 20 years for each project owner.

Net Cash Flow and
Annual Rates of Return
from Operations and Sale
for Hypothetical Project Owners

	Developer	Investor A	Investor B	Investor C
Marginal tax bracket	30 percent	50 percent	60 percent	70 percent
Operations and sale (10 years):				
Investment	$16,800	$205,000	$205,000	$205,000
Cash flow from:				
Operations	$16,966	$226,040	$271,246	$316,454
Distributions	5,880	33,600	26,880	20,160
Sale	24,471	127,435	93,269	59,103
Total cash flow	$47,317	$387,075	$391,395	$395,717
Net cash flow	$30,517	$182,075	$186,395	$190,717
Annual rate of return (note a)	18	16	20	27
Operations and sale (20 years):				
Investment	$16,800	$205,000	$205,000	$205,000
Cash flow from:				
Operations	$19,928	$262,604	$314,249	$365,894
Distributions	11,760	67,200	53,760	40,320
Sale	66,770	446,056	398,009	349,962
Total cash flow	$98,458	$775,860	$766,018	$756,176
Net cash flow	$81,658	$570,860	$561,018	$551,176
Annual rate of return (note a)	16	16	20	27

a/Annual rate of return is calculated by using the internal rate of return method. (See p. 17.)

CASH DISTRIBUTIONS AND MANAGEMENT FEES DURING PROJECT OPERATIONS

Project owners have a vested interest in ensuring that their projects are well managed, at least until substantially all of the tax shelter benefits are fully utilized. To ensure that sufficient funds are retained by project managers to maintain operations, however, HUD limits the amount of cash distributions that can be made to owners. HUD also limits the amount of fees that management agents are allowed to receive.

Cash distributions from operations

Investors in section 8 rental housing are usually advised to expect little or no cash distributions from project operations. In fact, HUD limits the distribution of project funds for section 8 new construction projects to ensure that enough cash is available to meet operating expenses.

Cash distributions on unsubsidized housing projects decreased from 19 percent of owners' equity for properties constructed between 1966-69 to 7 percent for properties constructed between 1974-76. This was the finding of a HUD study prepared by Touche Ross and Company entitled "Study on Tax Considerations in Multifamily Housing Investments, 1976-1977." According to this study, the decrease in cash distributions was primarily attributed to (1) an increase in land and construction costs during the period and (2) increases in operating costs. The study concluded that in periods of relatively high inflation, the investor must commit greater amounts of equity in terms of current dollars in the hopes of achieving potentially diminished levels of cash distributions due to inflation in operating costs. Investors that participated in the HUD study also pointed out that in many cases the ability to raise rents in order to meet inflationary pressures has been hampered by market conditions, thereby not affording the opportunity to increase the return provided by cash distributions.

By contrast, owners of section 8 new construction projects are granted automatic annual rent increases meant to compensate them for increases in operating expenses. This benefit provides the potential for more predictable and perhaps more attractive cash distributions, but cash distributions are limited by HUD.

Before April 23, 1980, cash distributions to profit-motivated owners were unlimited. Since then, however, HUD regulations limit the distribution of funds to profit-motivated owners of section 8 projects. For the life of the housing assistance payment contract, project funds may only be distributed to profit-motivated owners at the end of each year, after all project expenses have been paid (or funds have been set aside for payment of such expenses) and all reserve requirements have been met. Nonprofit owners are not entitled to distributions of project funds.

HUD's limitation on distributions provides for a higher rate of return for family projects than for elderly projects. The higher rate of return is intended to provide additional incentives to develop family projects. For family projects, the distribution is limited to 10 percent on equity. For elderly projects, the distribution is limited to 6 percent on equity. Any shortfall in cash distributions for any year(s) may be made up from surplus funds in future years.

In determining the allowable distribution, an owner's equity investment in a project is deemed to be 10 percent of the replacement cost of the part of the project attributable to dwelling use accepted by HUD at the time of cost certification. The owner can justify a higher equity contribution by cost certification documentation.

At times, project funds may be more than the amount needed for project operations, reserve requirements, and permitted distribution. In such cases, HUD may require the excess project funds to be placed in an account to be used to reduce housing assistance payments or for other project purposes. Upon termination of the housing assistance payments contract, any excess project funds must be remitted to HUD.

Management fees

The project owner is responsible for all management functions and all repair and maintenance functions. Management functions include screening and selection of tenants, reexamination of tenant incomes, evictions and other terminations of tenancy, and collection of rents. Repair and maintenance functions include all ordinary and extraordinary maintenance and replacement of capital items.

In most cases, the owner or an associated management firm manages section 8 projects. In other cases, with HUD approval, the owner may contract with a private or public entity to provide services or duties required to operate the project. Such an arrangement, however, does not relieve the owner of the responsibility for these services and duties.

Management fees are negotiated between owners and the management agents. These fees are usually expressed as some percentage of gross revenues collected each month. Linking management fees to monthly collections gives property managers an incentive to collect rents promptly.

According to developers and management agents, section 8 projects, compared with unsubsidized rental housing projects, may involve additional management expenses in selecting tenants and certifying their eligibility for subsidy payments and there may be additional difficulties in collecting rents. HUD recognizes this and for HUD-subsidized projects provides for a somewhat higher management fee rate. HUD also permits a 0.25-percent per year increase in the management fee rate, up to a total of 2 percent, after each year of superior management performance. Estimates on the management fee rate vary from 3 to 7 percent of revenue collected.

For 24 projects in our sample, management fees ranged from less than 1 percent to 11 percent of annual project income and averaged 5 percent. Also, the project owner was the manager in four other projects and no management fees were reported. Further, there was little difference in the average management fee rate between syndicated projects (5 percent) and nonsyndicated projects (5 percent) and between private, profit-motivated projects (5 percent) and private, nonprofit projects (6.5 percent).

CONCLUSIONS

The section 8 program, with its financing subsidies and its potential for syndication profits, provides exceptional inducements to developers to produce subsidized rental housing. The tax benefits, in turn, are very attractive to passive investors and stimulate demand for investment in subsidized housing. Thus, the only real limitation on the production of section 8 housing under the present program design appears to be the availability of money for the program.

The financial inducements for owners to ensure good management and provide quality housing services, however, are not nearly so strong. Section 8 will probably provide much greater opportunities for profits during the operating life of projects than did earlier subsidy programs because the subsidy is deeper and can be expected to provide adequate operating funds. Nevertheless, the major profit incentives are for production and tax avoidance, neither of which are strongly linked to good management or efficient operation. Owners are motivated to ensure survival of a project in order to maintain the tax shelter and avoid costly recapture in the event of foreclosure. This is hardly an incentive for either high quality or efficient project operation, but rather for minimal management with no cash contributions for operation beyond that generated by the subsidy and tenant rents. Also, management agents appear to have no obvious financial incentives to control operating costs. Their fees are directly related to project revenues collected which, in effect, are limited by the project rents set by HUD.

This imbalance between production inducements and operating inducements could motivate many section 8 owners to sell or convert their projects to condominiums after as little as 5 or 10 years for several reasons. First, the bulk of the tax shelters section 8 provides are exhausted during the first 10 years. Second, while projects can continue to provide good returns to investors after this period, the returns may be greater if the projects are sold or converted to condominiums, especially if the property has appreciated in value. These returns would have to be sufficient, however, to offset the recapture of excess depreciation for not holding the property for the required period. Third, project owners can sell all projects in operation today because they are under 5-year housing assistance payment contracts. Since the first projects are about 5 years old, project owners will be determining whether their projects are providing an adequate return and whether to continue operations or to dispose of their investments in favor of renewed tax shelters or other investment opportunities.

While financial incentives for housing production appear to be effective, some action seems needed to remove the imbalance between production incentives on one hand and operation and long-term ownership incentives on the other. It appears to us that a balance could be reached by requiring developers to make higher initial equity investments of perhaps 25 to 30 percent of total development costs and by allowing greater cash distributions during operations of perhaps 15 percent on their equity investment. The specific details of this alternative would have to be determined by financial analysis. This provision should also create a more traditional real estate investment, in which tax losses are applied against project income in order to provide tax-free cash flow. An experiment of this sort would give HUD the opportunity to compare different management incentives, since project owners would be primarily interested in project operations and much more likely to be active investors.

RECOMMENDATIONS TO THE SECRETARY OF HUD

We recommend that the Secretary of HUD take steps to increase the incentives for high-quality management and long-term ownership of section 8 new construction projects. One possible way of doing this would be to require developers to make higher equity investments and, in return, allow greater cash distribution during operations. This provision should attract investors who are less motivated to seek shelters from tax losses generated by production and more interested in yearly profits possible from operating section 8 projects and providing housing services.

We recommend also that the Secretary study a variety of methods, including economic incentives and contractual sanctions, to encourage project owners under 5-year assistance contracts to continue in the section 8 program after their present contracts expire.

CHAPTER 3

DEVELOPMENT AND OPERATING COSTS FOR

SECTION 8 NEW CONSTRUCTION PROJECTS

Development costs as discussed in this chapter represent the sum total of all expenditures associated with producing particular section 8 projects. Operating costs represent the expenditures required to sustain the projects in operation once they are built.

We assessed the "reasonableness" of development and operating costs for newly constructed section 8 projects from two different viewpoints. The first, which is the subject of this chapter, is whether costs were reasonable based on what was actually built. The second, which is the subject of chapter 4, is what should have been built in keeping with the concept that section 8 housing was intended to be "modest housing."

DEVELOPMENT COSTS

Independent, private fee appraisers, whom we employed to evaluate the reasonableness of development costs for selected newly constructed section 8 projects, concluded that development costs were reasonable for 24 of the 31 projects we selected for review. For 7 of these 31 projects, the appraisers questioned the reasonableness of certain costs such as for structural construction, land acquisition, land improvement, and financing. The total questioned cost amounted to $1,291,000, or 1.4 percent, of the total $95,171,474 development cost for the 31 projects. While not significant in total, their findings were significant with regard to certain individual projects.

Housing officials overseeing the construction of the seven questioned projects did not agree with our appraisers' findings. They contended that the costs were reasonable based on their cost analysis.

We could not fully resolve the differences of opinion between housing officials and our appraisers, since they had used different methodologies in arriving at their conclusions.

We asked our fee appraisers to make their appraisals on the basis of "what was there" and not to attempt to pass judgment on the need or the reasonableness of various features and amenities which might be included in the projects, such as unit size, equipment, and the like. These and other matters relating to the cost of newly constructed section 8 projects, as stated above, are discussed in chapter 4 of this report.

Our review of the policies and procedures for evaluating the reasonableness of development costs for section 8 projects disclosed two weaknesses: (1) the reliance on comparables in evaluating new construction proposals was severely limited by the lack of appropriate comparables from which to make such comparisons and (2) sufficient documentation was not maintained to show the basis on which the reasonableness of construction costs was evaluated.

Reasonableness of development costs

The professional fee appraisers we employed were selected primarily from a listing of HUD-recommended appraisers. Interested appraisers were advised that they must

--have experience in appraising multifamily rental housing in the geographic areas in which our sample projects were located;

--be knowledgeable of project development costs, rents, and land values in the geographic areas;

--be knowledgeable of HUD's project development procedures;

--neither presently be employed by HUD nor have worked in any capacity on the selected sample projects; and

--issue a final written product in accordance with our anticipated need date.

Ultimately, fee appraisers were selected on the basis of the appraisers' agreement to meet our anticipated report need date and on the lowest acceptable bid.

Appraisers were asked to evaluate the reasonableness of total project development costs as well as the major components of cost, including land, land improvements, construction, architect fees, interest and taxes during construction, property insurance, mortgage insurance premium, examination and inspection fees, title and recording fees, legal fees, and other costs. The evaluation was to be based upon a visual inspection of each project and a review of documents and records, including a schedule of project characteristics, rents, land appraisal, and development cost.

Given what was constructed, the appraisers generally found that total project development costs for the 31 selected newly constructed section 8 projects were reasonable, including the major component costs such as construction, land, and architect's fees. However, the appraisers did question various elements of cost associated with 7 of the 31 projects.

The appraisers believe that the costs of structural construction for three projects and the land values for three projects were about $715,000 and $64,470 too high, respectively. Our appraiser also concluded that land improvement costs totaling $189,000 for one project and financing costs totaling $322,000 for the project were excessive, but the appraiser did not make a judgment on the degree of excessiveness.

The difficulty of resolving or reconciling differing viewpoints on the reasonableness of development costs is illustrated by the following discussions we had with the parties involved for six of the seven projects.

For one project our appraiser questioned about $305,000 in structural construction costs and $322,000 in financing costs. City housing officials contended that the construction and financing costs on this project might have exceeded normal costs for the following reasons:

--The project was constructed on a very small and inaccessible building site; as a result, building materials had to be moved by hand, not by heavy equipment.

--The design of the exterior walls had to be altered to meet HUD's light and ventilation requirement as well as privacy requirements.

--The project had more fire walls than normal to meet city and HUD code requirements.

--The city code required the project to provide more parking than could be provided on the site; therefore, underground parking facilities had to be constructed.

--The use of bonds to finance the project resulted in higher financing costs than if some other form of financing, such as FHA-insured loans, had been used.

Our appraiser concluded on another project that structural construction costs exceeded his estimated replacement cost by approximately 22 percent. Specifically, the appraiser cited for analysis the cost of rough carpentry, lath and plaster, insulation, cabinets, plumbing and hot water, and heat and ventilation. HUD officials, as well as the project's developer, contended that the project's construction cost compared favorably with costs incurred in the area at the time the project was constructed. Additionally, the developer noted that the project's actual construction cost was within 1 percent of the HUD cost estimate.

For a third project our appraiser questioned why HUD allowed $84,000 in structural costs because of a reported 8-month delay caused by inclement weather and material and labor shortages. The HUD files on this project contained weather reports and other documents submitted by the developer to justify delays. Periodic (usually weekly) inspections at the site by a HUD representative confirmed the adverse conditions experienced by the developer. For example, prolonged rains and the resulting muddy conditions at the site substantially delayed the start of construction. The cause of the delay can be seen in the HUD inspection report prepared about 6 months after construction was scheduled to start. That report shows that construction should have been about 60 percent complete but was only 15 percent complete.

HUD appraisers told us they believed that land values on the three projects questioned by our fee appraisers were reasonable because the land costs compared favorably with comparable sales in the areas.

Because we were unable to resolve the differences of opinions between housing officials and our appraisers, we reviewed the contract rents for the seven questioned projects. Our review disclosed that the contract rents for the seven questioned projects were generally below fair market rent limitations. Our appraisers also concluded that the contract rents were reasonable for the seven projects in question.

Weaknesses in section 8 control procedures

Our review disclosed two basic weaknesses in the way section 8 new construction development costs are controlled by HUD. While these weaknesses may or may not translate into higher program costs, they nevertheless warrant attention.

The primary method for controlling development cost centers around the use of comparable projects. Comparables are used to develop project construction cost estimates and to establish land acquisition values. Frequently, however, there are very few comparables.

Three of the four HUD field offices we visited had difficulties in finding appropriate comparables to develop their project construction cost estimates. Given the country's present economic condition (i.e., rising interest rates and rising building costs), little rental housing is being constructed. As a result, to obtain a valid comparable it is increasingly necessary to look to older projects and ones greater distances away, making adjustment factors an increasingly large part of the determination process. Likewise, in evaluating land acquisition costs, few comparable sites offer similar elements of utility and desirability for the types and sizes of the sites under study. Therefore, adjustment factors once again play a significant role in the determination process.

We found insufficient documentation to support the propriety of many agency cost determinations. As a result, we were unable to trace or to recreate the financing office's thought processes on a number of specific costs which we questioned. At best, we could only identify lump-sum cost adjustments which, by themselves, offered little explanation of the reason for the adjustment. When we questioned housing officials why something was or was not done, we often received an "I don't recall" type of answer. They saw nothing wrong with the fact that various cost determinations were not adequately documented because present regulations do not require cost determinations to be thoroughly documented.

Conclusions

Based on our fee appraisers' findings, HUD's comments, and our review of contract rents, we believe that the development costs for the 31 newly constructed section 8 housing projects covered in our review were generally reasonable. However, we were not able to resolve certain differences of opinion about component costs of some projects. While those costs may have been high, they did not result in contract rents which exceeded fair market rent limitations.

HUD's, FmHA's, and the State agencies' procedures for controlling development costs appeared to be adequate. But we believe that the organizations did not adequately document the many cost determinations which form the basis for supporting the development costs. Further, we believe that a continuing lack of new rental housing construction will reduce the effectiveness of HUD's procedures for controlling development costs.

Recommendations to the Secretary of HUD

We recommend that the Secretary of HUD direct HUD area offices and delegate agency officials involved in reviewing section 8 development costs to adequately document their cost determinations. We also recommend that the Secretary direct these same officials to closely survey the new rental housing construction market and to develop alternate approaches for evaluating section 8 development costs when appropriate comparable projects cannot be identified.

OPERATING COSTS

Our review of first-year operating costs for selected section 8 new construction projects disclosed that, for the most part, costs fell within the range of cost data considered normal by the Institute of Real Estate Management. Our further review of operating cost control procedures of HUD and its delegate agencies (FmHA and SHFA showed that HUD's oversight was extremely limited.

HUD area office officials told us that they saw little benefit to be derived from reviewing the operating costs of ongoing section 8 projects in view of HUD's policy of granting automatic rent increases annually to section 8 owners. They told us further that HUD's field staff often lacks the accounting background needed to review the financial statements which project owners are required to send to HUD annually, that HUD has issued little guidance on how to make those reviews, and that other work has a higher priority. They added that reviews of financial statements should only be necessary when owners request more than the automatic rent increase, which seldom happens. For the projects we reviewed, certain owners had not submitted the required financial statements to HUD or had submitted them long after they were due, thereby further lessening the opportunity for review by HUD.

We believe HUD should enforce its requirements that section 8 project owners submit annual financial statements in a timely manner. We believe further that such statements should be carefully reviewed and that regular evaluations should be made of the validity of the formulas used to grant automatic rent increases. At present, HUD has no real assurance that its increases relate realistically to the actual needs of its client section 8 owners.

Rent increases

The congressional conference report on the act authorizing the section 8 program specified that rents would be adjusted at least annually to reflect changes in fair market rentals in the area and permits HUD to adjust rents on the basis of a reasonable formula. It also allows rents to be increased further to meet substantial general increases in property taxes, utility rates, or similar costs as long as rents are not materially different from rents of comparable unassisted units. HUD has interpreted this report as requiring a formula approach to annual rent adjustment on an area basis rather than adjusting rents on a cost-based approach for each project. In the past, rent increases have been automatically granted on the anniversary dates of section 8 contracts, and any request for a larger rent increase must be justified by the project owners.

HUD's headquarters annually calculates rent adjustment percentages based on changes in the consumer price index for rents and utilities. The adjustment percentages for four census regions and 24 standard metropolitan statistical areas are published in the Federal Register and are required to be used in those locations. For projects which include utilities in the rent, separate rent increase percentages are established depending upon number of bedrooms and amount of the present rent. For projects which do not include utilities in the rent, a single percentage increase applies to all projects in the area. Selected HUD section 8 rent increases, effective for the year beginning November 1980, for a two-bedroom unit renting at $350 are shown in the following schedule.

Metropolitan region	Amount of increase	
	Rent including utilities	Rent excluding utilities
Cincinnati, Ohio	$39	$37
Philadelphia, Pa.	34	22
Los Angeles, Calif.	46	41
Washington, D.C.	34	31

The Congressional Budget Office concluded in March 1979 1/ that the use of the index could be permitting rent increases which are higher than warranted by increases in operating costs. HUD has not changed its procedures to recognize that the index is influenced by the older multifamily projects (built prior to 1970) while the section 8 projects were built in the late 1970s. Because increases in the operating costs are in part a product of age and deterioration of a project, the automatic rent increase factors for section 8 are probably higher than necessary to meet the increases in the operating costs of section 8 projects.

Monitoring by HUD after projects are operating

HUD regulations require that project owners submit annual financial statements which include an income and operating expense analysis 60 days after the end of each project's fiscal year. Certified public accountants (CPAs) or licensed public accountants must audit and render an opinion on these statements.

In our study of selected projects in Ohio, we found that the required annual financial statements were neither received by HUD nor reviewed by its staff in a timely manner. Although regulations permit withholding of rent increases when an owner does not submit the required statements, HUD area officials believe such action would be counterproductive as it would place the project in financial difficulty and possible default.

To assist in reviewing and analyzing financial statements, HUD is installing a computer system known as the Office of Loan Management System for Computer Assisted Analysis of Annual Financial Statements (OLMS). The system will evaluate operating costs by comparing reported operating expenses with an office standard in eight categories, identify deviations, and indicate the level of required review. The system is not yet operational at all HUD field offices.

1/"The Long-Term Costs of Lower-Income Housing Assistance Programs," Congressional Budget Office, Mar. 1979.

Monitoring by other agencies after projects are operating

For those projects where HUD is not the financing agency, reliance is placed on the delegate agency to determine the reasonableness of the projects' operating costs. For projects of FmHA and the SHFA, HUD reviews the yearly audited financial statements only if the project requests more than the automatic annual rent increase. Otherwise, HUD lets these agencies deal with any financial problems which might arise.

FmHA requires monthly operating reports from subsidized projects within 15 days of the end of each month for at least 12 months after the project has been completed. These reports may be discontinued after the first year if FmHA determines that the project is being adequately maintained. FmHA reviews these reports to detect and help correct fiscal and operational problems.

Each FmHA project must also submit an annual budget of income and expenses. In addition, all projects with 21 or more units must submit a CPA or licensed public accountant audit report of its financial statements. FmHA relies heavily on the audited report in determining the project's financial soundness. FmHA does compare the project's actual income and expenses to (1) its current budget, (2) its previous year's actual income and expenses, and (3) its next year's budget. The main purpose of these comparisons is to indicate trends in the project's operation and to discover any potential financial problems.

FmHA regulations require all subsidized projects, including section 8, to justify rent increases. However, FmHA officials in Ohio and Pennsylvania routinely grant HUD's automatic annual adjustment to the rents. FmHA officials in Pennsylvania and Ohio saw no purpose in analyzing a project's justification for an automatic rent increase. Pennsylvania officials foresaw problems with HUD if they tried to prohibit such an increase. Ohio officials said that if the yearly review shows the full rent increase results in a greater return on equity than allowed, the owner is asked to contribute additional funds to the project's reserve account. They knew of no instance, however, where such a contribution had ever been required.

The Pennsylvania Housing Finance Agency requires each project to submit (1) an operating budget, (2) a monthly operating report, and (3) annual CPA-audited financial statements. The monthly reports and annual statements are compared to the operating budget and explanations are required for questionable items. The agency annually audits section 8 projects, concentrating on cash receipts and disbursements to assess the projects' financial soundness.

Rent increases have been automatically granted in accordance with HUD's procedures. Agency officials told us that in the future they would like to require some justification for these rent increases because they believed that any rent increase should be based on individual project need as demonstrated by actual cost.

The California State Housing Agency--unlike HUD, FmHA, and the Pennsylvania Agency--does not grant automatic rent increases. It uses certified annual operating statements and quarterly unaudited statements to determine the justifiable amount of any rent increases. An official of the California State Housing Agency told us that, during the past year, 11 of 12 projects needed the full increase allowed by HUD. One project was not granted a rent increase because the agency concluded it was not needed.

Our evaluation of the reasonableness of operating costs for selected projects

We compared first year operating results for 14 selected projects with area data published by the Institute of Real Estate Management. The 14 projects (11 HUD and 3 SHFA) were part of 31 projects we selected for reviewing development costs. We analyzed only 14 of the 31 projects because of difficulty in obtaining comparable Institute and project data for the others. All 14 projects had been operating 2 years or less. Various authorities told us that the first few years of operation on any new housing project are not necessarily typical of later years and that costs in these early years should be evaluated with caution.

Apartment projects nationwide voluntarily submit operating data to the Institute of Real Estate Management. The institute's income and expense data is extensive; for calendar year 1979 such data came from over 4,500 properties with over 600,000 units. When enough properties report, analyses are published for a smaller geographical area, such as a metropolitan area. The institute's expense categories are compatible with HUD's accounting collection system because the HUD system is the one most widely used in the industry. The institute's data helps property managers, owners, developers, and investors compare their own operating expenses with others.

Using the data submitted for 1979, the institute computed the median (middle figure) and a range (central 50 percent of the sample), on a net square-foot basis. The institute generally considers an operating cost to be reasonable if it falls within the central 50-percent range.

For most of the expense categories, actual first-year operating expenses were within the range of the institute's criteria. In a few instances, actual expenses were significantly above or below the criteria. But taken as a whole and considering the newness of the projects, we believe that the operating costs for the 14 projects we examined would have to be characterized as reasonable.

Conclusions

HUD's policy of granting annual automatic rent increases without evaluating the need for such increases based on reviews of financial statements of project owners appears to us to preclude effective control by HUD over the reasonableness of section 8 operating costs. The required financial statements are either not received or, if they are, they are not reviewed in many cases; personnel responsible for reviewing them lack procedural guidance and training; and the review itself is considered by HUD area offices to be of low priority.

The loan management system, when fully operational, may provide a method to help HUD in the future to monitor project operations through prompt analysis of project financial statements.

Recommendations to the Secretary of HUD

We recommend that the Secretary of HUD:

--Enforce the requirement that project owners submit annual certified financial statements and use these statements to evaluate regularly the reasonableness of formula-based annual rent increases given to project owners.

--Develop uniform procedures and train staff to properly and promptly review project financial statements.

CHAPTER 4

OPPORTUNITIES TO REDUCE COSTS AND IMPROVE

THE RESULTS OF THE SECTION 8 NEW CONSTRUCTION PROGRAM

Based on work performed during this review and various earlier reviews, we believe a number of changes could be made beyond those matters discussed in chapters 2 and 3 of this report to reduce the cost of providing subsidized housing units to the needy and achieve greater effectiveness in the use of available resources. Because the Section 8 New Construction Program cannot be viewed entirely apart from the remainder of the section 8 program, however, nor from the various other subsidized housing programs authorized over the last 43 years, our comments in certain cases go beyond the Section 8 New Construction Program.

We believe that HUD should

--build more modest-size section 8 housing with fewer amenities and

--better use housing already built.

Recommendations made in certain recent GAO reports 1/ which encompass the Section 8 New Construction Program, and which we are summarizing below, concern the need to (1) consider less costly financing alternatives for low- and moderate-income subsidized housing and (2) improve program administration and cost consciousness in a variety of ways.

We recognize that our suggestions for somewhat lowering the caliber of housing being built under section 8 may invite objections. As we see it, however, the present policy of building new section 8 housing to a level better than most of the housing in the general area where it is located results in reducing both the number of housing units which can be built and the number of people who can be served within available funding and raises valid questions about the overall fairness and equity of federally subsidized housing programs. But we are in no way suggesting that section 8 housing be anything less than decent, safe, and sanitary.

1/A listing of earlier GAO reports is presented in app. I.

Another consideration is the cumulative cost of subsidized housing programs, which is growing more burdensome every year. Obligations during fiscal year 1980 for the section 8 program alone totaled about $1 billion. Future obligations for the section 8 program are conservatively estimated at over $128 billion and are expanding at the rate of about $25 billion a year, with additional billions expended through the income tax shelters this program provides. Many additional billions are committed to other programs such as public housing, rent supplement assistance, and FmHA's rural housing program.

Given these huge economic costs, a policy decision which the Congress and the administration need to address is whether the Section 8 New Construction Program is affordable and desireable in its present form, considering all the other needs and commitments of the country. If it is not, or if cost reductions are believed essential, then approaches such as we are suggesting should be considered.

BUILD MORE MODEST-SIZE HOUSING WITH FEWER AMENITIES

Significant savings in construction and operating costs, which would translate into lower rental subsidies for the Government, could be achieved if new section 8 units were built to more modest standards in terms of size and amenities.

Size of family units could be reduced

The sizes of the 870 units in 12 family projects which we visited were significantly larger than the minimum sizes considered adequate using HUD's minimum property standards, as shown by the following table.

Actual Section 8 Unit Sizes for 12 projects (870 units)

Type of unit	HUD minimum	Range of sizes in our 12 projects	Variances over HUD minimum
	(square-feet)		
1-Bedroom	510	596 - 722	86 - 212
2-Bedroom	600	705 - 804	105 - 204
3-Bedroom	730	a/869 - 1,109	139 - 379
4-Bedroom	910	a/1,165 - 1,355	255 - 445

a/These amounts do not include basement space. One of the projects we visited contained townhouses with basements; the three-bedroom units were 1,920 square-feet, and the four-bedroom units were 2,040-square feet, including basements.

HUD's minimum property standards were developed to provide a sound technical basis for the planning and design of housing under HUD's numerous programs.

These larger units translate into higher construction costs per unit, higher operation and maintenance costs, and correspondingly higher subsidized rentals. We estimate that the additional square footage in the above 870 units (over and above the stated HUD minimum, plus 50 square-feet per unit) represents about $345,000 in additional annual direct rental subsidies alone. HUD has no data to show whether the 12 projects we reviewed were typical of most or all family projects being built under the Section 8 New Construction Program.

The unit sizes shown on the above table indicate that reductions well in excess of 100 square-feet could be made for most units included in our sample. Although we cannot say whether this would be the case nationally, we have data from a previous GAO study which indicates similiar findings. That study 1/ presents size data on about 20,000 units for the elderly and nonelderly in 248 projects in three States. When combined with the size standards shown above, we see a large potential for savings.

1/"Evaluation of Alternatives for Financing Low and Moderate-Income Rental Housing" (PAD-80-13, Sept. 30, 1980).

Three-State Sample of
Section 8 Average Unit Sizes

Type of unit	HUD minimum	Average unit sizes		Variances over HUD minimum	
		SHFA	FHA	SHFA	FHA
	-(square-feet)-				
1 Bedroom	510	662	660	152	150
2 Bedroom	600	894	935	294	335
3 Bedroom	730	1,245	957	515	227
4 Bedroom	910	1,516	1,151	606	241

For each unit type and for both finance mechanisms (SHFA and FHA) average size reductions of at least 100 square-feet (but generally much more) could have been achieved while still providing units well above FHA minimums.

Various HUD field officials, State officials, and developers told us that the size of subsidized housing units in the Section 8 New Construction Program is controlled to a large extent by the fair market rents which HUD allows in particular areas. HUD officials and developers also said that larger units add to project marketability (resale and/ or rental to nonsubsidized tenants). One developer said that potential renters like large units and thus developers build the units as large as the rent ceiling (HUD's fair market rents) will permit. Another developer explained that proposing smaller units to HUD jeopardizes his competitiveness with other developers because in getting approval from HUD for section 8 projects, HUD personnel give less weight to smaller but livable units in evaluating competing proposals.

Other HUD field officials and developers with whom we talked favored specifying maximum sizes for family units. They said that stipulating maximum unit sizes would help contain costs. Officials of certain building and finance organizations with whom we talked predicted that the downsizing of housing in the United States is inevitable, saying that inflation, high energy costs, and high interest rates require trade-offs. Included in these potential trade-offs, they said, were smaller units.

Single elderly persons could be housed in efficiency/studio type apartments instead of one-bedroom units

A significantly greater number of housing units could be built for the single elderly, within present funding limits, if the primary type of housing unit provided to these persons was efficiency/studio apartments instead of one-bedroom units. We estimate that when all currently authorized and built one-bedroom units are in operation, HUD could be paying additional rent of as much as $168 million annually to house elderly single people in one-bedroom units rather than in efficiencies.

Of the 411,733 units already built, under construction, or approved for future construction, about 91 percent are one-bedroom units, about 5 percent are two-bedroom units, and about 4 percent are efficiency/studio units. Between 80 and 90 percent of the elderly in the section 8 program are single.

Although HUD has no formal policy stating that elderly persons are to be given one-bedroom units, HUD routinely approves developers' proposals to build such units. Typical efficiency units are about 100-150 square-feet smaller than typical one-bedroom units and command lesser monthly rent, as shown below.

Comparison of Monthly Fair Market Rents (note a)

Type of unit	Columbus, Ohio	Los Angeles, California	Philadelphia, Pennsylvania
1-bedroom	$324	$424	$352
Efficiency	290	358	296
Monthly rent difference	$34	$66	$56
Percentage difference	12	18	19

a/We chose the rent as of June 1980, for walkup type structures. Many units are in high-rise structures where the rent spread is considerably larger; for example, in Los Angeles the HUD fair market rent in a 5-or-more-story building is $612 for a 1-bedroom unit and $474 for an efficiency--a spread of $138, or 29 percent.

For projects in these three cities, HUD is paying, on the average, an additional $34-$66 a month for one-bedroom units as compared with efficiencies.

Of the 1,623 one-bedroom units in the 17 projects in our study, only 165 units (10 percent) were occupied by two people while 1,458 units were occupied by one person. Officials explained that in projects having both one-bedroom units and efficiencies, the one-bedroom units filled first because the eligible person pays the same amount of rent regardless of which type of unit she or he occupies. All 17 projects had waiting lists of prospective tenants--usually single persons.

We solicited comments from developers, owners, managing agents, and HUD central office and field office representatives about the implications of making greater use of efficiency/studio units to house the elderly. The principal reasons given for not using efficiencies to house eligible elderly single persons included:

--The elderly person would be less comfortable.

--The person's furniture may not fit into the efficiency.

--Owners need the flexibility provided by one-bedroom units so they can rent to either a single person or a couple.

--Owners might be unable to rent efficiencies if the section 8 rent subsidy was discontinued after the 20-year commitment.

Some were not against more efficiencies for the elderly. One HUD area official commented that as long as the Government subsidized the rent, there would not be much risk to HUD in having efficiencies built. Another HUD area official recalled recommending building more efficiencies to HUD's central office, and a cost analyst in that area office estimated that savings of 15-20 percent were possible. A developer-owner in California explained that efficiencies would reduce the Government's cost but that he was discouraged from proceeding with building them by local housing officials. Two developers in Ohio said they would have no reservations about building subsidized efficiencies.

An architect for one of the projects in our study explained that efficiencies were marketable and the rent was significantly less than that of a one-bedroom unit. He explained that when a tenant pays his own rent, he willingly accepts a smaller unit if the rent is a significant factor in his decision. This same architect, who had designed a complex of 210 efficiency units and 77 one-bedroom units under another HUD low-income housing program, estimated that efficiencies rent for about 25 percent less than one-bedroom units.

One private developer advised us that since people with limited incomes are always interested in paying less money for housing, the elderly will live in efficiencies. He said his efficiencies, opened in early 1978, were among the first units rented by the elderly in a combination efficiency/one-bedroom unit complex. Another nonsection 8 developer opened projects, including efficiency units, in 1978 and 1980. He told us that the efficiencies rented without any problems.

Amenities could be reduced

We found a wide range of special features (amenities) at the 31 section 8 projects we visited. While these various features contributed to the appearance, livability, and tenant comfort of the projects, their necessity in many cases could be questioned for housing which is so heavily subsidized and which is serving only a fraction of the households in need. The following table shows the number of projects visited which had various amenities.

	No. of projects with amenities	
Amenity	Elderly (18 visited)	Family (13 visited)
Air conditioning	17	11
Balconies and/or patios	9	9
More than 1 bathroom	-	11
Swimming pool	-	1
Library	4	-
Carpeting	17	11
Hardwood floors	-	1
Drapes	7	4
Garbage disposals	12	12
Game and craft rooms	9	-
Skylights	2	-

A detailed description, with selected photos, of each of the 31 projects included in our review is presented in the supplement to this report.

Monthly rents are, in part, based on a housing unit's amenities. We found, for example, that housing units generally rent for between $10 and $20 more a month with central air conditioning and about $5 to $10 more a month with wall-unit air conditioning. One of the most common amenities we encountered in the 31 projects was air conditioning.

Other than stating that each dwelling unit shall have a bathroom, HUD's regulations are silent as to the number of baths allowed or needed per dwelling unit. HUD area officials estimated that each additional bathroom over one increases the rent about $5 to $10 a month.

While we found that one bathroom was standard for the efficiency, one-bedroom, and two-bedroom units, the number of baths varied for three- and four-bedroom units. Two of the 13 family projects we visited with three-bedroom units had one bath for each unit; 10 projects had one and one-half baths per unit; and one project had two baths per unit. HUD area officials explained that developers are encouraged to provide more than one bathroom in three-bedroom units to aid in the "marketability" of the units. In the eight family projects we visited having four-bedroom units, three projects had one and one-half baths per unit, four projects had two baths per unit, and one project had two and one-half baths per unit.

In calculating section 8 fair market rents for multifamily projects and in applying the "reasonable rent" test for proposed section 8 projects, HUD usually studies other multifamily projects. To achieve a degree of parity between projects, HUD area offices adjust each project's rent to reflect differences in amenities, age, and other factors. Each area office uses its own rent adjustment factors for amenities in these calculations.

The following schedule shows how HUD would adjust the rent of an existing project in the Los Angeles area if the proposed section 8 project had certain amenities not found in the existing project.

Monthly rent of a one-bedroom unit		$342
Add monthly rent adjustment for:		
Central air conditioning	$20	
Balcony	10	
Recreation area	5	
Garbage disposal	5	
Carpets	5	
Drapes	5	50
Adjusted monthly rent		$392

HUD's estimate of the value (rent per month) of the above-cited amenities was $50. Under a 20-year section 8 rent subsidy, these amenities in a 100-unit project could cost the Federal Government about $1,200,000 in additional subsidies.

Comments by HUD's Assistant Secretary for Housing

During this review we suggested that HUD define modest housing more explicitly under the section 8 program. The Assistant Secretary for Housing declined in a letter to us dated September 15, 1980. He said that section 8 was primarily a private market program, that section 8 units were built and owned by private owners, and that many projects contained a mixture of assisted and unassisted units. Rather than trying to impose specified standards for modest design on private owners, he said, HUD determines allowable rent levels for section 8 units using its estimation of what constitutes modest design in a given market area. Hypothetical units of modest design suitable for the market and climate of the specific market area, including designated unit sizes, number of bathrooms, and level of services and facilities, are used as the basis for establishing the market area's fair market rents.

In addition, he said, HUD has recently added provisions to the section 8 regulations to specifically limit amenities in section 8 projects to those generally provided in unassisted housing of modest design in the market area. He said that specification of modest design beyond the level of amenities was inappropriate considering the private market nature of the section 8 program and the partially assisted nature of many section 8 projects. Further, he said, HUD feels that greater specificity may result in poorer, more standardized design and a return to the appearance of and attitudes toward the "project" of past years. The limited variability permitted by HUD's established rent levels, he said, still permits the designing of projects which are suitable to the existing neighborhood, promotes local acceptance, and avoids a negative image to both tenant and neighbor.

With regard to housing the elderly in efficiency/studio type apartments instead of one-bedroom units, the Assistant Secretary advised us that although providing only efficiency units for the elderly might result in some added economy in the section 8 program, this viewpoint neglects the human side of the issue. He said that the elderly, in general, are not mobile and section 8 housing often represents a final move from a life-long home. He asked: Is it fair that the elderly, in order to benefit from section 8 assistance, be required to accept one-room occupancy which current marketing experience indicates is the least favored alternative?

Our evaluation

We believe that HUD overstates the degree of mix of assisted and nonassisted units which has been achieved in section 8 new construction projects. Earlier studies by GAO; the Subcommittee on Manpower and Housing, House Committee on Government Operations; and ICF Incorporated, done for HUD's Office of Policy Development, all conclude that section 8 new construction/substantial rehabilitation projects are overwhelmingly composed of assisted households.

We commented in an earlier report 1/ that the high cost of new and substantially rehabilitated housing was blocking attainment of the goal of promoting an economic mix in this housing. ICF Incorporated had similar findings. It found that only 5 of 354 proposed section 8 projects it reviewed would be less than 100-percent assisted.

We found that the housing produced was often so costly that moderate-income and even middle-income households could not afford to live in it. In that report, we cited findings resulting from a year-long probe in 1978 by the Subcommittee on Manpower and Housing, House Committee on Government Operations, that many section 8 projects were so expensive that only the poor could afford to live in them, and that little or no income dispersion existed in the new construction/substantial rehabilitation segments of the program.

1/"Section 8 Subsidized Housing--Some Observations on its High Rents, Costs, and Inequities" (CED-80-59, June 6, 1980).

We do not believe that HUD's emphasis on the "private market" nature of the Section 8 New Construction Program justifies the continued building of these heavily subsidized housing units to a level significantly better than most of the housing in the area in which it is located. In the various cities we visited during this and earlier reviews, the new housing being built under section 8 was usually readily recognizable by being not only the newest and best housing in the area but often the only rental housing being built in those areas. This observation seemed to us to belie HUD's claim that section 8 housing is designed to blend with and conform to other modest housing in market areas in which it is located.

The high quality of new section 8 housing appeared to us to be primarily the result of the manner in which fair market rents are established for the housing. In our earlier report 1/ we pointed out that these rents were being set unjustifiably high and that some agency officials seemed unconcerned about the program's high rents and costs. We attributed this condition to an attitude or philosophy which may have been fostered by HUD headquarters pressure on field offices to produce units and meet production goals. As noted above, various developers of new section 8 housing told us that they use the high fair market rents established by HUD as the basis for designing the overall unit sizes and amenities to be included in their section 8 proposals.

HUD's recent attention to limiting amenities reflects its concern that the units developed earlier under the program had frequently been above the modest quality levels envisioned by policymakers. The four HUD area offices included in our study published their acceptable amenities criteria in the spring of 1980. However, these criteria would have had little impact on reducing the number and types of amenities for most of the 31 projects we visited.

With regard to housing for the elderly, we would not dispute the Assistant Secretary's contention that the larger, one-bedroom apartments are more desirable and more comfortable than efficiency units. Our concern is for the many thousands of needy elderly persons who are denied any help from the section 8 program because available funds are

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1/"Section 8 Subsidized Housing--Some Observations on its High Rents, Costs, and Inequities" (CED-80-59; June 6, 1980).

insufficient to provide them with any type of unit, let alone a one-bedroom unit.

Conclusions

Much ambiguity surrounds the concept of "modest housing" and what it should consist of under the Section 8 New Construction Program. This ambiguity has resulted in ineffective controls and the construction of much housing which seems to us unnecessarily costly in terms of its size and amenities.

We are not convinced that, because section 8 new construction is privately owned and certain units in some projects may be rented to unassisted households, it would be inappropriate to stipulate more restrictive limits on unit sizes and amenities. There is a serious shortage of rental housing in the United States, and vacancy rates in many cities are at all-time lows. This shortage, together with the increasingly burdensome cost of housing generally and the Government's inability to serve more than a fraction of those in need, seems to strongly suggest that HUD should seek economies in terms of size and amenities in new section 8 projects. We believe that present HUD policy generally does not address the need for greater equity in the distribution of benefits to the eligible and needy.

Recommendations to the Secretary of HUD

We recommend that the Secretary of HUD:

--Develop an explicit definition of "modest housing" for use under the Section 8 New Construction Program which limits the size of family housing units to dimensions closely approximating those based on HUD's minimum property standards and reduces the types and number of amenities permitted in new section 8 housing.

--House the single elderly in efficiency/studio type units instead of one-bedroom units.

HUD NEEDS TO MAKE BETTER USE OF FAMILY HOUSING UNITS

Over half of the 862 family housing units included in our review appeared to be underutilized. We estimated that an additional 700 to 1,100 persons could have been housed in these units. The principal reasons for underuse were:

(1) HUD's regulations on minimum acceptable occupancy levels for new section 8 family units are vague and permit considerable latitude of judgment by HUD field staff and family project owners and managers; (2) family projects owners and managers have little or no incentive to achieve optimum occupancy levels in their units; in fact, the incentive appears to be to minimize occupancy in order to reduce operating costs and other problems; (3) tenants typically seek the largest units they can find because under section 8 procedures they pay the same rent for a large unit as they do for a small unit.

The high cost of the section 8 program would seem to dictate that HUD should strive for optimum use of family housing units by strengthening its regulations on occupancy and monitoring more closely the assignment of family units.

Under the Section 8 New Construction Program, tenants are assigned to living units by project owners or their agents. HUD's regulations and its handbook for this program set forth no specific occupancy level criteria. However, instructions to the owners or their agents for completing the application for "Tenant Eligibility and Recertification" state that the appropriate bedroom size should be assigned on the following basis:

Number of bedrooms	Number of occupants Minimum	Maximum
0 (Efficiency)	1	1
1	1	2
2	2	4
3	4	6
4	6	8
5	8	10
6	10	12

Nothing in the HUD instructions requires owners and their agents to seek more than the minimum occupancy of section 8 housing.

The number of family members and their age, sex, and relationship need to be considered in assigning families to units of an appropriate size. While no such guidelines were developed for the Section 8 New Construction Program, occupancy specialists at the three HUD area offices we visited told us that as part of preoccupancy conferences with project owners and their agents, HUD provided either verbal or written guidance for assigning appropriate size units to families. HUD officials told us that they followed the guidance provided for the Section 8 Set-Aside, Section 236, Section 221(d)3, and Rent Supplement Programs.

The occupancy guidelines for these other HUD programs provide minimum and maximum levels of occupancy. However, the guidelines are vague and differ on the appropriate type of bedroom unit to be assigned when considering the number of family members and their relationship, age, and sex. The lack of specific guidance to HUD occupancy specialists and project managers has resulted in varying interpretations of what these guidelines require. Further, the guidelines state that units are not to be assigned in such a way that underoccupancy will result; however, they do not define "underoccupancy."

Our analysis of the occupancy levels for 12 family projects showed that 55 percent of the units were underutilized. These projects, which were housing about 2,600 persons, could have been assigned to achieve optimum use of space. We estimated that HUD was paying about $335,000 extra annually in rent subsidies because families living in underutilized units could have occupied smaller units. One of the major reasons for low occupancy was assigning a single parent and child of the same sex to a two-bedroom unit rather than having them share a bedroom.

In determining the degree of over- or underutilization of living units in the projects we reviewed, we used the minimum and maximum unit occupancy ranges cited above, plus HUD's guidelines for the Section 8 Set-Aside Program. These guidelines provide that:

--One-person families should be assigned to efficiencies unless none are available.

--Living units should be assigned so it will not be necessary for persons of the opposite sex, other than husband and wife, to occupy the same bedroom. As an exception, when necessary, two children of opposite sex, under 4 years of age, may occupy the same bedroom.

--Units should be assigned to achieve the maximum use of space.

These guidelines do not prohibit family members of the same sex from sharing a bedroom.

For one- to four-bedroom units, the minimum and maximum unit occupancy ranges for the Section 8 New Construction Program are the same as those established for the Section 8

Set-Aside Program. The set-aside guidelines state that these ranges provide for varying family needs without overcrowding.

These 12 projects contained a total of 862 one- to four-bedroom units. As shown below, 472, or 55 percent, of these units were not being used efficiently.

Bedroom type	Total number of units	Number underutilized	Percent of underutilization
1	128	120	94
2	323	81	25
3	314	193	61
4	97	78	80
Total	862	472	55

The degree of underutilization for these 862 units is illustrated in the following table which compares the actual number of persons per bedroom with HUD's minimum and maximum occupancy per bedroom and with our estimate of the utilization which should have been achieved. Our estimate, it should be noted, was generally less than the maximum occupancy achievable under HUD's instructions. This comparison shows that many families were occupying units larger than they needed.

Bedroom type	Number of persons per bedroom: HUD minimum	Actual	GAO estimate	HUD maximum
1	1	1.06	2.00	2
2	1	1.22	1.41	2
3	1.3	1.23	1.56	2
4	1.5	1.27	1.64	2

Actual occupancy in three and four bedroom units was even less, on the average, than HUD's minimum occupancy guidelines. The fact that the occupancy of three- and four-bedroom units is low seems particularly wasteful at a time when research sponsored by HUD shows that large families are finding it very difficult to rent adequate housing. If the units we reviewed had been assigned to achieve the optimum use of space, a potential increase of at least 27 percent in occupancy could have been achieved.

Comments by HUD field officials

During our review HUD area office officials told us, generally, that there is little they can do to force owners to optimize the occupancy of their projects because section 8 has no occupancy criteria other than the flexible minimum and maximum occupancy ranges.

Occupancy specialists in the Columbus HUD area office said that the occupancy levels for the seven southern Ohio area family projects included in our sample were probably typical of the occupancy levels of other new section 8 projects in that area. Occupancy specialists in the Los Angeles and Philadelphia HUD area offices did not know if the occupancy levels for our sample family projects were typical of other family projects. It was the opinion of a Los Angeles HUD occupancy specialist, however, that the occupancy levels of new section 8 family projects located in the inner city and in minority areas are more comparable to our estimates than actual levels for the three southern California family projects included in our sample.

Some HUD occupancy specialists and project managers seemed more concerned about overcrowding than ensuring that units were assigned to achieve an efficient use of space. One specialist noted that it is HUD's unwritten policy to prevent overcrowding and that underutilization is only a concern when the project's occupancy level is below HUD's established minimum level of one person per bedroom. She said that overcrowding can be partially prevented by giving children separate rooms, and she encouraged project owners not to put too many children in a project. One project manager indicated that she would definitely want children over 8 years of age to have separate bedrooms, if at all possible, because of her desire that the project not be overcrowded.

The effect of HUD's inadequate guidance, and the divergent opinions we received on occupancy, contributed to the low density rates we observed. At the time of our review, HUD was in the process of finalizing a new occupancy handbook entitled "Occupancy Administration, Multifamily Subsidized Programs." Among other things this handbook will standardize the occupancy guidelines for many of the HUD housing programs, including the Section 8 New Construction Program.

The draft thus far developed, however, is still not explicit enough, in our opinion, in describing various situations which arise in assigning families to units. For example, the draft handbook states that:

"Normally it is expected that two children of the same sex will share a bedroom. However, the owner may make allowances for large differences in age (eg., two girls age 6 and 15) or two children age 13 and over."

These guidelines state that units are not to be assigned in such a way that underoccupancy will result; but, like the previous guidelines, they do not define what constitutes "underoccupancy."

Comments by HUD's Assistant Secretary for Housing

During our review we suggested that HUD might do more to optimize the occupancy of family projects. In September 1980 HUD's Assistant Secretary for Housing said that HUD feels that its present occupancy standards optimize occupancy by balancing efficient use of available space with occupant needs and the desire to minimize unit maintenance due to overuse. But HUD was certainly willing to consider our specific recommendations for strengthening controls in this area. The Assistant Secretary pointed out again that section 8 was designed primarily as a private market housing program rather than a Government housing program. As such, he said, the private owner of a section 8 project is responsible for all management functions, including selection of tenants. He said tenants were selected according to procedures stated in the owner's HUD-approved management plan and families were assigned to appropriate-sized units in accordance with HUD occupancy standards. These standards, he said, were developed on the basis of past experience and represented HUD's best judgment as to the size unit most appropriate for a certain family composition.

Conclusions

We believe our findings show that much more can be done to use new section 8 projects more efficiently. The root of the problem appears to be the lack of an effective incentive for project owners/managers and the lack of explicit HUD guidelines and effective monitoring to achieve optimum utilization.

Recommendations to the Secretary of HUD

We recommend that the Secretary of HUD:

--Develop definitive guidelines for section 8 projects, requiring that units be assigned and reassigned to achieve optimimum utilization of all units.

--Direct HUD field offices to monitor the use of section 8 units more closely, especially at the time of initial occupancy, and to invoke appropriate penalties where owners/managers consistently fail to comply with HUD occupancy guidelines.

OTHER GAO REPORTS RELATED TO SECTION 8

We have issued a number of reports related to the section 8 program since its inception in 1974. A complete listing of these reports is presented in appendix I. Following are highlights of certain more recent reports which contain recommendations for cost reductions and improving program results. We are not commenting on HUD's responses to these recommendations.

Less costly financing alternatives could be used for low- and moderate-income subsidized housing

In a report issued in September 1980, 1/ we made a number of recommendations to the Congress and to HUD that could reduce housing subsidy costs and improve program effectiveness. On the basis of our analysis, we concluded the Federal Government could save millions if it financed more housing with the less expensive methods. The following table illustrates a few realistic steps HUD could take to achieve this savings under current legislation. These estimates are based on the total subsidy cost estimates discussed in the body of that report.

1/"Evaluation of Alternatives for Financing Low- and Moderate-Income Rental Housing" (PAD-80-13, Sept. 30, 1980).

Examples of Possible Savings Achievable by Shifting Emphasis Among Financing Alternatives

Action	Yearly savings	Total 20-year savings
1. Shift 30,000 units from SHFA financing to FHA/ Tandem financing	$11,760,000	$235,000,000
2. Finance 20,000 units using taxable bonds and the 802 subsidy rather than SHFA tax-exempts	5,280,000	105,600,000
3. Shift 10,000 units from SHFA financing to public housing	5,120,000	102,400,000
4. Shift 40,000 units from FHA/Tandem financing to public housing	4,800,000	96,000,000
5. Finance 50,000 units through FHA/MBS rather than FHA/Tandem	2,950,000	59,000,000
6. Finance 10,000 units through public housing rather than 11(b)	4,560,000	91,000,000

The key cost-related recommendations in this report were:

The Secretary of HUD should:

--Place more emphasis on public housing by producing a larger proportion of assisted housing units with this mechanism. The Congress should provide necessary funding shifts to make this recommendation feasible.

--Experiment with the use of mortgage-backed securities to finance section 8 multifamily housing.

--Provide budget estimates to the Congress which show all major costs over an expected subsidy life discounted to reflect current year dollars.

The Congress should:

--Require HUD to use taxable bonds rather than tax-exempt bonds for State agency section 8 financing.

--Reappropriate funds for subsidizing State housing taxable bonds under another existing program, section 802, which provides an interest reduction payment to State agencies using taxable bonds. This provision would result in a lower total subsidy. HUD should also adjust section 8 fair market rents or approved contract rents to reflect the higher debt service needed for the use of taxable bonds.

--Reevaluate the use of the section 11(b) finance mechanism as presently structured.

Program administration needs to be improved

In a report issued in June 1980, 1/ we made a number of suggestions for improving the administration of the section 8 program. The review on which that report was based examined whether any opportunities existed for better containing the rapidly rising costs of the section 8 program, thereby enabling it to serve more people. We also wanted to determine how well the section 8 program was dealing with certain problems experienced by the subsidized housing programs which preceded it.

We recommended in that report that the Secretary of HUD:

--Issue a notice to all program personnel outlining the economic, social, and political reasons why section 8 costs must be curbed and why greater equity and uniformity in the distribution of benefits is needed.

--Ensure either through strengthened procedures or better monitoring of established procedures that fair market and contract rents are properly established.

--Strengthen the procedures used in verifying tenant income and allowances.

1/"Section 8 Subsidized Housing--Some Observations on its High Rents, Costs, and Inequities" (CED-80-59, June 6, 1980).

--Increase tenant contributions toward rents as authorized by the 1979 legislation.

--Establish a work group within HUD to conduct socio-economic research directed to finding ways in which section 8 and other federally subsidized housing costs can be reduced and a greater degree of equity achieved among the many households determined to be in need.

Effects of the Davis-Bacon Act on section 8 costs

In a report issued in April 1979, 1/ we recommended that the Congress repeal the Davis-Bacon Act because, among other things, the act is inflationary and results in unnecessary construction and administrative costs of several hundred million dollars annually. An undetermined part of this amount would involve the Section 8 New Construction Program. The Davis-Bacon Act requires that each contract for the construction, alteration, or repair of public buildings or public works in excess of $2,000 to which the United States is a party--or, under 77 related laws, in which the United States shares the financing--state the minimum wages to be paid to various classes of laborers and mechanics. We concluded that the act is no longer needed because other wage legislation and changes in economic conditions and in the construction industry since the law was passed make the law obsolete.

Various Federal, State, and local officials and developers told us that the act significantly increased the cost of the Section 8 New Construction Program in particular areas. The increase, they stated, resulted from the higher wages that often must be paid because of the act, the administrative burden the act imposes on contractors, and the reduced competition for construction contracts because certain contractors choose not to get involved in contracts with Davis-Bacon requirements.

In this review we did not ascertain what portion, if any, of the costs of the 31 projects we reviewed were attributable to the operation of the Davis-Bacon Act. In southern California, however, several HUD officials and developers estimated that the act increased the cost of section 8 projects from 5 to 15 percent. In Pennsylvania, estimates we received ranged from $1,000 per housing unit to 15 to 25 percent for entire projects.

1/"The Davis-Bacon Act Should Be Repealed" (HRD-79-18, Apr. 27, 1979).

LISTING OF PRIOR GAO REPORTS

RELATING TO THE SECTION 8 PROGRAM

	Report No.	Date	Title
1.	RED-75-349	4/1/75	Comparative Costs of the Department of Housing and Urban Development's Section 8 Leasing and 236 Rental Housing Programs
2.	RED-76-85	3/12/76	Cost of the Section 8 Lower Income Housing Assistance Program
3.	PAD-76-44	7/26/76	A Comparative Analysis of Subsidized Housing Costs
4.	CED-76-152	9/24/76	Review of HUD's Consideration of Strawbride Square, Fairfax County, Va.
5.	CED-77-19	1/28/77	Major Changes Are Needed in the New Leased-Housing Program
6.	CED-77-84	6/16/77	Review of Fair Market Rents Established by HUD for New Housing Units in Lancaster, Pa.
7.	PAD-78-13	1/10/78	Section 236 Rental Housing--An Evaluation with Lessons for the Future
8.	CED-78-117	5/10/78	Elimination of the Rent Credit Feature of the Section 8 Existing Housing Program
9.	N/A	6/27/78	Savings Possible Through the Recognition of Favorable Financing and Tax Abatements in Establishing Section 8 Contract Rents

10.	CED-78-150	7/17/78	Review of Decision to Cancel Section 8 Elderly Housing in Harrisburg, Pa.
11.	CED-78-181	10/20/78	Review of Efforts by HUD to avoid, through its Section 8 Program, Undue Concentrations of Lower Income Persons
12.	CED-79-7	1/10/79	Review of HUD's Processing of Section 8 Project in Miami Township of Clermont County, Milford, Ohio
13.	PAD-79-43	1/16/79	Cost of Section 8 Housing Could Increase if Owners Sell or Convert Projects Early
14.	CED-79-51	3/ 1/79	Duplicate Payments of Section 8 Assistance to Some Project Owners
15.	CED-79-76	4/25/79	Evaluation of HUD's Comments to Our January 10, 1979 Letter to Congressman Harsha
16.	CED-80-7	10/30/79	Housing Leased to Lower Income Persons: Better Federal Guidance and Management Could Improve Quality
17.	CED-80-59	6/ 6/80	Section 8 Subsidized Housing--Some Observations on its High Rents, Costs, and Inequities
18.	N/A	8/21/80	Ineligible Households in Section 8 Assisted Housing
19.	PAD-80-13	9/30/80	Evaluation of Alternatives for Financing Low and Moderate Income Rental Housing

HYPOTHETICAL INVESTMENT PROJECT

DESCRIPTIVE INFORMATION

Type of project: elderly
Location: Washington, D.C.

Type of units: 1-bedroom
Number of units: 100

COST AND FINANCING

Cost:	
Land cost	$ 100,000
Construction period costs	525,000
Depreciable costs	2,875,000
Total development costs	$3,500,000
Financing:	
Mortgage (88 percent of costs) (note a)	$3,080,000
Equity investment (12 percent of costs)	420,000
Total development costs	$3,500,000

a/7.5 percent plus 0.5 percent mortgage insurance premium interest rate for a 40-year period.

SYNDICATION

Syndication proceeds: $615,000 (20 percent of mortgage amount)

Investor	Total contribution (note a)	Equity interest	Tax bracket
		- - - (percent)	- -
A	$205,000	32	50
B	205,000	32	60
C	205,000	32	70
Developer	-	4	30
Gross proceeds	$615,000	100	
Less: syndication fee (12 percent of gross proceeds)	73,800		
Net syndication proceeds	$541,200		

a/Each investor contributes $68,333 each year for 3 years, beginning with the construction period year.

PROJECT INCOME

Number of units	X	Monthly rent per unit	=	Monthly income	X	12 months	X	Annual income
100	X	a/$516	=	$51,600	X	12	X	$619,200

a/Based on fair market rent for 1-bedroom unit in elderly project for the Washington, D.C., area.

OPERATING COSTS

Operating expense: $324,731 annually (assumes that income is sufficient to cover all expenses plus provide the allowable cash distribution)

Debt service: $258,289 annually for principal and interest (8.4 constant)

Depreciation expense: 200-percent declining balance method for the following depreciable assets:

Asset	Cost	Life
Building	$2,530,000	40 years
Land improvements	b/143,750	20 years
Equipment	b/115,000	20 years
Furnishings (note a)	b/ 86,250	10 years
Total depreciable assets	$2,875,000	

a/Furnishings are replaced in year 11 at a cost of $85,000 and have a useful life of 10 years.

b/The depreciation method was changed to the straight-line method when straight-line deductions exceeded the deduction under the 200-percent declining balance method.

Replacement reserve: $15,180 annually (0.6 percent of the cost of total structures-- $2,530,000 X 0.006 = $15,180)

DISTRIBUTION LIMITATION

For elderly projects, HUD limits distributions to 6 percent of an owner's equity investment, which is 10 percent of the project's replacement cost. (Assumes that the project's replacement cost is the same as the total development costs; therefore, $3,500,000 X 0.10 = $350,000 X 0.06 = $21,000 distribution limit.)

SALE CONDITIONS

The gain on sale and the cash flow from sale were computed for sale after both 10 years and 20 years. Excess depreciation is recaptured for the sale after 10 years. There was no excess depreciation to recapture for the sale after 10 years. The sale price, under both cases, assumes a 2-percent per year appreciation rate. Also, transfer costs are assumed to be 10 percent of the sale price.

	Sale after 10 years	Sale after 20 years
Net gain on sale:		
Sale price	$4,266,500	$5,200,650
Less: adjusted basis as follows		
Original cost	$3,500,000	$3,500,000
Less: accumulated depreciation	(1,269,973)	(2,053,030)
Adjusted basis	2,230,027	1,446,970
Gain on sale	$2,036,473	$3,753,680
Less: excess depreciation (note a)	(421,848)	-
Capital gain on sale (note b)	$1,614,625	$3,753,680
Net cash flow from sale:		
Sale price	$4,266,500	$5,200,650
Less: mortgage balance	(2,907,765)	(2,535,922)
transfer costs	(426,650)	(520,065)
tax on sale	(627,807)	(882,866)
Net cash flow from sale	$ 304,278	$1,261,797

a/Recaptured depreciation is taxed at ordinary income tax rate for each owner.

b/Only 40 percent of the capital gain is taxed at ordinary income tax rate for each owner.

INCOME AND EXPENSES FROM OPERATIONS

Analysis year	Project income	Operating expenses	Replacement reserve	Interest expense	Depreciation expense	Construction period costs	Total deductions	Total income (loss)
0	-	-	-	-	-	$525,000	$525,000	($525,000)
1	$619,200	$324,731	$15,180	$246,400	$169,625		755,936	(136,736)
2	619,200	324,731	15,180	245,499	157,262		742,622	(123,422)
3	619,200	324,731	15,180	244,422	146,165		730,498	(111,298)
4	619,200	324,731	15,180	243,312	136,153		719,376	(101,176)
5	619,200	324,731	15,180	242,114	127,077		709,102	(89,902)
6	619,200	324,731	15,180	240,820	118,814		699,545	(80,345)
7	619,200	324,731	15,180	239,422	112,392		691,725	(72,525)
8	619,200	324,731	15,180	237,913	106,368		684,192	(64,992)
9	619,200	324,731	15,180	236,283	100,713		676,907	(57,707)
10	619,200	324,731	15,180	234,523	95,404		669,838	(50,638)
11	619,200	324,731	15,180	232,621	101,762		674,294	(55,094)
12	619,200	324,731	15,180	230,568	94,575		665,054	(45,854)
13	619,200	324,731	15,180	228,350	88,258		656,519	(37,319)
14	619,200	324,731	15,180	225,955	82,664		648,530	(29,330)
15	619,200	324,731	15,180	223,368	77,676		640,955	(21,755)
16	619,200	324,731	15,180	220,574	73,199		633,684	(14,484)
17	619,200	324,731	15,180	217,557	70,269		627,737	(8,537)
18	619,200	324,731	15,180	214,299	67,485		621,695	(2,495)
19	619,200	324,731	15,180	210,779	64,841		615,531	3,669
20	619,200	324,731	15,180	206,979	62,328		609,218	9,982

APPENDIX II

CASH DISTRIBUTIONS

Analysis year	Project income	Operating expenses	Replacement reserve	Interest expense	Amortization of loan principal	Total deductions	Cash distributions
0	-	-	-	-	-	-	-
1	$619,200	$324,731	$15,180	$246,400	$11,889	$598,200	$21,000
2	619,200	324,731	15,180	245,449	12,840	598,200	21,000
3	619,200	324,731	15,180	244,422	13,867	598,200	21,000
4	619,200	324,731	15,180	243,312	14,977	598,200	21,000
5	619,200	324,731	15,180	242,114	16,175	598,200	21,000
6	619,200	324,731	15,180	240,820	17,469	598,200	21,000
7	619,200	324,731	15,180	239,422	18,867	598,200	21,000
8	619,200	324,731	15,180	237,913	20,376	598,200	21,000
9	619,200	324,731	15,180	236,283	22,006	598,200	21,000
10	619,200	324,731	15,180	234,523	23,766	598,200	21,000
11	619,200	324,731	15,180	232,621	25,668	598,200	21,000
12	619,200	324,731	15,180	230,568	27,721	598,200	21,000
13	619,200	324,731	15,180	228,350	29,939	598,200	21,000
14	619,200	324,731	15,180	225,955	32,334	598,200	21,000
15	619,200	324,731	15,180	223,368	34,921	598,200	21,000
16	619,200	324,731	15,180	220,574	37,715	598,200	21,000
17	619,200	324,731	15,180	217,557	40,732	598,200	21,000
18	619,200	324,731	15,180	214,299	43,990	598,200	21,000
19	619,200	324,731	15,180	210,779	47,510	598,200	21,000
20	619,200	324,731	15,180	206,979	51,310	598,200	21,000

APPENDIX II

(382270)

ESTIMATED PROFIT (LOSS) OF SELECTED BUILDERS

Project	Cost overrun (underrun)	Cash fees paid to builder on contract	Builder's profit (loss)	Profit (loss) as a percentage: Certified construction cost	Profit (loss) as a percentage: Contract price
	- - - - - - - (000 omitted)		- - - - - -	- - - - - (Percent)	- - - - -
A (note a)	$ 21	$233	$212	4.4	4.4
B (note a)	0	0	0	0	0
C (note a)	385	205	(180)	(4.8)	(5.3)
D (note a)	0	158	158	13.1	13.1
E (note a)	0	61	61	12.3	12.3
F (note a)	134	179	45	1.7	1.8
G (note a)	413	208	(205)	(9.7)	(12.1)
H (note a)	115	261	146	6.1	6.4
I (note a)	0	0	0	0	0
J (note a)	b/ 1	0	0	0	0
K	63	0	(63)	(2.8)	(2.8)
L	0	206	206	12.5	12.5
M	81	0	(81)	(6.5)	(7.0)
N	214	0	(214)	(16.9)	(20.3)
O	73	0	(73)	(4.4)	(4.6)
P	247	239	(8)	(.4)	(.5)
Q	7	190	183	4.5	4.5
R	0	194	194	3.7	3.7
S	360	429	69	1.8	1.9
T	0	216	216	5.0	5.0
U	53	56	3	.1	.1
V	0	191	191	4.7	4.7
W	81	117	36	1.3	1.3
X	85	20	(65)	(5.0)	(5.3)
Y	0	71	71	7.3	7.3
Z (note a)	0	33	33	8.3	8.3
AA	0	11	11	1.4	1.4

a/Syndicated projects

b/Developer responsible for cost overrun

APPENDIX III

AN EQUAL OPPORTUNITY EMPLOYER

UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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PENALTY FOR PRIVATE USE, $300

POSTAGE AND FEES PAID
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