117656

REPORT BY THE

Comptroller General

OF THE UNITED STATES

October 1981 Recommendations Of The President's Commission On Housing: Issues For Congressional Consideration

In its interim report, the President's Commission on Housing made a number of recommendations which could substantially change current housing policies and programs and have major effects on the housing market. The recommendations, focusing on housing grants to the poor, measures to improve the availability of housing, and ways to increase mortgage credit, may have profound impacts on specific groups such as low-income households and first-time home buyers.

Based on its previous work and discussions with housing experts, GAO raises a number of questions the Congress should consider before enacting any of the Commission's recommendations.

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COMPTROLLER GENERAL OF THE UNITED STATES
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The Honorable Edwin Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

The Honorable Fernand J. St Germain
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

This report presents our comments and questions for your consideration on the recommendations made by the President's Commission on Housing in its interim report of October 30, 1981.

We performed this work to assist the Congress in its deliberations on the merits of the changes recommended by the Commission, for its recommendations could have far-reaching effects on future housing policy.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Housing and Urban Development; the Chairman, President's Commission on Housing; and other interested parties.

Charles A. Bowsher
Comptroller General
of the United States

REPORT BY THE
COMPTROLLER GENERAL
OF THE UNITED STATES

OCTOBER 1981 RECOMMENDATIONS OF THE PRESIDENT'S COMMISSION ON HOUSING: ISSUES FOR CONGRESSIONAL CONSIDERATION

D I G E S T

Many important questions should be weighed by the Congress in considering the recommendations made by the President's Commission on Housing in its October 30, 1981, interim report. The Commission's recommendations would substantially revise current housing policies and programs and likely have major effects on the housing market. GAO provides comments and raises pertinent questions regarding each of the proposals based upon its past work and discussions with a variety of housing experts.

GAO's review is intended to assist the Congress in its deliberations on the relative merits of the Commission's recommendations. It does not take positions for or against the various proposals, but rather focuses on possible barriers to their effective implementation. It also treats each of the recommendations separately rather than attempting to discuss the cumulative effects of these changes on the housing situation, the economy as a whole, or the capital markets.

The President's Commission on Housing was created to advise the President and the Secretary of Housing and Urban Development on options for developing national housing policy. The Commission's recommendations focus primarily on actions to improve the affordability of housing for the poor. Other recommendations are designed to improve the availability of housing and increase the flow of housing credit. Additional subjects, such as the public housing program, Federal tax policies, and the housing needs of special groups, are still under review. A final report is scheduled for release by April 30, 1982. GAO is responding at this time because the recommendations may have an important influence on housing policy debate.

CONSUMER HOUSING ASSISTANCE GRANTS

The Commission recommended a system of consumer housing grants or vouchers to be provided directly to families as the primary Federal subsidy program for low-income households. These grants, replacing production-oriented programs such as section 8 and public housing, would be targeted to the poorest families to enable them to live in "standard quality" units.

Important questions affecting the success of housing grants include:

--Is there sufficient housing in all localities to accommodate a housing grant program? (See p. 4.)

--What will be the fate of public housing under a grant program? (See p. 4.)

--Should grants be made on an entitlement basis? (See p. 4.)

--Will the very poor be likely to participate? (See p. 5.)

--How costly will housing grants be in the long run? (See p. 5.)

IMPROVING THE AVAILABILITY OF ADEQUATE HOUSING

Recognizing that housing may be inadequate in some markets, the Commission recommended several actions to expand the housing supply. These recommendations and GAO's concerns follow.

--Allow new construction of housing under the Community Development Block Grant Program. GAO raises questions regarding the willingness of local governments to undertake new construction without additional funding, how new construction can best be targeted to the needy and to eligible activities, and whether long-term funding authority should be provided. (See p. 6.)

--Consider changes in the mortgage revenue bond laws. The Commission is studying whether to allow or prohibit the continued use of tax-exempt financing of housing by State and local governments. GAO believes answers to questions of the cost to taxpayers, the impact on investment in other economic sectors, effects on State and local governments' financing activities, and the effectiveness in benefiting low- and moderate-income families are crucial to decisions on mortgage revenue bonds. (See p. 8.)

--<u>Provide a residential rehabilitation tax credit</u>. GAO's questions relate to how well such a tax credit would serve low-income households, its cost effectiveness, and the possible displacement of low-income households. (See p. 10.)

--<u>Encourage private entities to continue their sponsorship and financing of various housing activities</u>. GAO's questions focus on how production cutbacks will affect private groups' activities, the Federal role in encouraging private participation, and how groups should be selected for funding. (See p. 12.)

--<u>Eliminate legal obstacles to housing investment by pension funds</u>. GAO raises questions on the impact of increased pension fund housing investment on other economic sectors, the extent to which pension funds will actually invest in housing given competing investment opportunities, impact of changes on investment risk, and whether pensions should be singled out to support housing. (See p. 17.)

<u>HOMEOWNERSHIP AND FEDERAL INSURANCE</u>

The Commission will consider a program of individual housing accounts to allow homeowners a tax-free method for saving toward a downpayment. GAO believes questions of cost, who would benefit, the ability of individual housing accounts to spur mortgage investment, and potential alternatives should be the focus of debate regarding these proposals. (See p. 13.)

The Commission is also reviewing the role of Federal Housing Administration insurance with a view toward limiting it to households not served by the private market. GAO's questions relate to identifying those who would not be served by private insurance, administering Federal Housing Administration insurance equitably, and providing Federal subsidies. (See p. 15.)

Contents

ABBREVIATIONS

CDBG	Community Development Block Grant Program
FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
IHA	individual housing account
IRA	individual retirement account

CHAPTER 1

INTRODUCTION

The President's Commission on Housing was established by Executive order on June 16, 1981, to advise the President and the Secretary of Housing and Urban Development on options for developing a national housing policy and the Federal Government's roles and objectives concerning the future of housing.

The President appointed 25 members to the Commission. The members thereafter divided themselves into four reporting committees:

--Committee on Housing and the Economy,

--Committee on Federal Housing Programs and Alternatives,

--Committee on Private Sector Financing of Housing,

--Committee on Government Regulation and the Cost of Housing.

These committees were subdivided into subcommittees and task forces in order to address specific topics within each committee's general areas.

The Commission's mandate requires analysis, assessment, and review of all areas of housing. Some subjects, such as the public housing program, Federal tax policies, and the housing needs of special groups, are still under review. A final report is scheduled for release by April 30, 1982.

The mandate also required the Commission to issue an interim report by October 30, 1981, which is the subject of this report. This interim product is intended to serve a dual purpose: (1) to establish a basic set of principles and a housing policy framework for guiding Commission deliberations and decisions and (2) to offer recommendations for reforming federally subsidized housing programs. The interim report's recommendations will likely have an important influence on housing policy debate.

COMMISSION RECOMMENDATIONS

The interim report has six recommendations and two topics for further study for reforming federally subsidized housing programs and related areas. They provide for

--replacing public housing construction programs with a consumer-oriented housing assistance grant program;

--adding new construction to the housing activities eligible for Community Development Block Grant (CDBG) funds;

--considering various options for State and local agency tax-exempt housing finance;

--allowing owners of residential rental structures to enjoy the same investment tax credit for rehabilitation expenses as do owners of nonresidential real estate under the Economic Recovery Tax Act of 1981;

--continuing private institutions' participation in housing programs;

--considering saving incentives, such as individual housing accounts, to increase available mortgage funds;

--continuing Federal Housing Administration (FHA) programs for those not served by the private sector; and

--eliminating laws and regulations that inadvertently limit housing investment by major capital sources, such as private pension funds.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of our review was to assist the Congress in its deliberations on the relative merits of the Commission's recommendations. Even though the Commission's work is not completed, its initial recommendations could substantially change current housing policies and programs and have major effects on the housing market. If adopted they will constitute major revisions to the current Federal approach to housing and may have profound impacts on specific groups such as low-income households and first-time homebuyers. Before making such changes, the Congress needs to address a series of basic questions which underlie the ultimate effectiveness of these recommendations.

Our review was made in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." Our comments and the questions posed derive largely from information acquired over many years of reviewing Federal housing policy and programs. We supplemented this information by discussing the issues with many housing experts in and out of Government and reviewing the most pertinent research available. We have avoided taking positions for or against the Commission's various recommendations, but rather have concentrated on defining possible barriers to effective implementation. Finally, we have dealt with each of the recommendations separately, rather than attempting to discuss their possible cumulative effects on the housing situation, the economy as a whole, or the capital markets. Descriptions of selected housing programs referred to in this report are in appendix I.

CHAPTER 2

COMMENTS ON THE OCTOBER 1981 RECOMMENDATIONS

OF THE PRESIDENT'S COMMISSION ON HOUSING

The President's Commission on Housing views housing affordability as the most serious housing problem for poor people and recommends a system of housing assistance grants to replace existing Federal subsidy mechanisms. Most of the other recommendations are designed to improve the availability of adequate housing by allowing new construction to be an eligible CDBG activity and creating a rehabilitation tax incentive. The remaining recommendations focus on increasing credit allocation to housing and evaluating the Federal Housing Administration's role. We believe the Congress should give serious attention to the questions we have raised.

CONSUMER HOUSING ASSISTANCE GRANTS

Commission recommendation:

> "The Commission recommends that the primary federal program for helping low-income families achieve decent housing be a consumer-oriented housing assistance grant. This grant system should replace future commitments to build additional units under Section 8, Section 202, and public housing. The relationship of a consumer housing assistance grant to these and other subsidized housing programs will receive further Commission study."

Comments

The concept of housing assistance grants or vouchers--income payments given directly to households for the purchase of housing services--is not a new idea. As early as 1937, public housing opponents proposed giving "certificates" directly to tenants to help them pay their rents. In 1965, variants of the concept were called for in a rent supplement program and in the section 23 leased housing program. This concept was further refined with the section 8 assisted housing program and tested with the Experimental Housing Allowance Program. The experience of section 8 and the housing allowance experiment provides data on how a voucher program might work and who might be served. We and others have been critical of the methodology used in the housing allowance experiment. 1/

1/See "An Assessment of the Department of Housing and Urban Development's Experimental Housing Allowance Program" (CED-78-29, Mar. 8, 1979).

The Commission justifies its recommendation by defining the housing problem as one of affordability. Poor households have insufficient incomes to pay for standard quality housing (units which are structurally sound and have functioning heating and plumbing systems). The Commission believes the most efficient method of meeting the housing needs of poor families is to supplement their incomes. Production-oriented housing programs are considered inefficient and inequitable since relatively few households are served each year, costs are often quite high, and consumers are given little housing choice. The Commission also believes that grants should not be made on an entitlement basis (an entitlement program guarantees that anyone eligible would receive benefits) and that recipients should live in "standard quality" housing.

Questions for consideration

1. Is there sufficient existing housing stock for a housing assistance grant program to work effectively and how would supply affect participation? The Commission argues that the existing housing stock is generally sufficient to meet the housing needs of potential grant recipients. Whether or not there is a sufficient supply is controversial and crucial to the ultimate success of a grant program. We previously reported on the rental housing shortage that exists in many areas of the country. 1/ Housing availability varies significantly from locality to locality. Consequently, a short supply of standard quality housing in some communities would very likely inhibit participation, especially for large families, or drive up the cost of such housing.

2. What will be the fate of public housing under an assistance grant program? The potential effects of housing grants on the public housing program need to be fully explored. At present, public housing depends on operating subsidies, yet the Commission foresees grants replacing such subsidies. If this occurs, tenant rents would have to cover all operating and maintenance costs. Tenants' ability to pay these expenses depend on whether they receive grants sufficient to cover operation and maintenance costs.

3. Should it be an entitlement? An entitlement program gives all eligible households a comparable measure of assistance. The Commission believes that grants, like all past housing assistance programs, should not be an entitlement program. However, past programs have been criticized and eventually deemphasized because, among

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1/"Rental Housing: A Growing National Problem Needing Immediate Attention", (CED-80-11, Nov. 8, 1979).

other things, they created inequities between recipients and eligible households not receiving assistance. While an entitlement program would be quite costly at a time of fiscal austerity, equity among eligible households would be achieved and this often-cited shortcoming of housing programs eliminated.

4. Does the structure of such a program tend to exclude the very poor? Several factors may preclude the participation of very poor households and others who have difficulty finding standard housing. For example, the very poor would receive the same maximum subsidy as those with higher incomes so that the incentive to participate increases with income. Also, programs which subsidize tenants in market housing, such as section 8, have been much more effective in reaching tenants already in standard quality housing than those in substandard housing. This has resulted in higher participation by small and elderly households, who are generally perceived as more desirable tenants and who can more readily afford adequate units in the marketplace. Larger households and female-headed minority households are more likely to encounter discrimination and therefore inhabit substandard housing. For them, participating in a grant program could mean (1) having to move to a less desirable neighborhood, (2) incurring moving expenses, or (3) convincing their present landlords to upgrade their housing to meet program standards. Finally, the severity of these problems depends upon the rigidity of the standards used to judge housing adequacy.

5. Will a grant system prove less expensive than rental housing construction in the long run? Various studies have concluded that vouchers would be less expensive than traditional production subsidies. Conversely, we reported that in certain tight housing markets, a voucher-type program could be more expensive than new construction. 1/ Conflicting results can be expected since estimating the relative costs of alternate housing subsidies is difficult and these estimates are highly sensitive to methodological assumptions. Realistic assumptions on future program rules, quality of units provided, rates of inflation, and changes in housing supply are nearly impossible to set, yet they affect the findings. The task is even harder when the programs being compared are as different from one another as subsidized new construction and housing vouchers. For example, public housing units built 20 years ago have very low monthly subsidies although when built their rents would have been much higher than older

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1/"Section 236 Rental Housing--An Evaluation With Lessons for the Future" (PAD-78-13, Jan. 10, 1978).

existing housing in the market. In past production programs the Government has shared with developers the risk that operating costs would increase sharply in return for some control over unnecessary rent increases. Under a grant program, the Government can take advantage of the lower subsidy costs associated with older units today, but tight rental markets could eventually make grants (1) ineffective if the subsidy is tightly controlled or (2) extremely expensive if it keeps pace with market rents.

NEW CONSTRUCTION WITHIN THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM

Commission recommendation:

"The Commission recommends that new housing construction be added as an eligible activity for Community Development Block Grants in order to expand local decisionmaking flexibility. Additional funding, giving weight to local housing problems, that would enable localities to support this activity, would be desirable when budget circumstances are favorable."

Comments

The Commission recommends terminating section 8 new construction and making it an eligible activity under CDBG. The Commission feels this should enhance local government's ability to address a full range of housing and community development problems.

Although residential new construction is specifically excluded within the CDBG Program, the regulations do allow uses to support construction projects, such as site acquisition and improvements. Further, nonprofit organizations can receive CDBG funds for new construction projects. From ongoing work, we have found that many communities assist new construction either directly or through nonprofit organizations as currently allowed. Many also facilitate substantial rehabilitation, which also adds to the housing stock. The Department of Housing and Urban Development (HUD) has reported significant housing activity under CDBG. For example, HUD estimates about 27 percent, or $1.3 billion, of CDBG funds from 1978 to 1980 went for housing rehabilitation activities alone. Another 17 percent, or $865 million, was spent on acquisition and demolition activities, which may be related to new housing construction. This indicates a willingness on the part of local governments to undertake a wide variety of housing activities.

Our current work also shows that CDBG funds benefit low- and moderate-income homeowners to a much greater extent than renters, that such housing initiatives are very often tied to other Federal categorical programs, that assessing the capacity of cities as a group to manage large-scale housing programs is difficult, and that housing activities are not always well targeted to need.

Questions for consideration

1. Will local governments use their CDBG funds to undertake new construction without receiving significantly increased funding? Any CDBG funds used for new housing construction activities, such as land acquisition, site clearance, and capital costs, would significantly reduce the amount available for other purposes. New construction will therefore compete with present housing and community development activities for limited program funds, while greater demands are being placed on the CDBG Program due to reduction or cancellation of other Federal nonhousing programs.

2. How would local governments "target" new construction activity to those in need and would explicit requirements for targeting be required? Any new construction activity should be directed at a recognized need for additional housing units. Likewise, with the increased congressional interest in program targeting, it seems likely that eligible tenants should be screened to assure selection of those most in need. To accomplish this, local governments would probably have to establish eligible income limits, develop and implement income-verification procedures, and require developers of multifamily units to monitor tenant eligibility. Our past reviews show that some communities have not developed such procedures even after several years of CDBG participation. Further, we previously stated that overall income requirements for recipients of CDBG rehabilitation funds need to be developed. 1/

3. How will CDBG program funds be allocated to eligible activities if new construction is added? Eligible local governments receive CDBG funds annually, based on an entitlement formula. Since new construction activity may be included, an important issue is whether the distribution formula should be changed to account for local needs for additional housing. The formula is now strongly weighted toward communities with large numbers of old housing units, but not necessarily toward those where housing is in short supply. Lack of such targeting was a problem with the older categorical housing production programs, which can be used to develop new housing, even in areas even where there are a large number of unused units.

1/"The Community Development Block Grant Program Can Be More Effective in Revitalizing the Nation's Cities" (CED-81-76, Apr. 30, 1981).

4. Should forward budget authority be provided to grantees? The Commission recommends maintaining annual funding rather than multiyear funding, even if new construction is added as an eligible activity. A consistently cited barrier to new construction is that it requires either a very large upfront subsidy to reach the poor or a long-term commitment for continuing subsidies. One solution to this problem is guaranteeing a long-term budget authority that will allow grantees to make long-term commitments to developers and investors.

MORTGAGE REVENUE BONDS

Commission recommendation: 1/

"The Commission has considered the following three options for state and local agency tax-exempt financing of housing:

1. Continue tax-exempt bonds as an instrument for financing new construction and rehabilitation with appropriate targeting (the Commission is not making any recommendations at this time as to appropriate targeting), or

2. Withdraw tax-exemption on all such bonds and provide direct unrestricted federal payments instead, in the form of a subsidy to make up the difference between tax-exempt and taxable yields, or

3. Offer bond-issuing agencies their choice of the alternatives of either continuing tax-exempt status for their bonds or switching to taxable bonds with a compensating direct unrestricted federal payment to make up for the switch from tax-exempt to taxable status."

Comments

The Commission believes all three approaches deserve consideration as ways to finance local housing and intends to establish a task force to consider the fiscal policy, market, and regulatory implications of increased use of tax-exempt revenue bonds.

While tax-exempt bonds may reduce financing costs for homebuyers and rental housing developers and have proven to be administratively manageable on the State and local levels, a substantial Federal tax revenue loss is incurred. Taxable bonds

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1/Although not a recommendation, the Commission is considering various options on mortgage revenue bonds.

permit greater Federal budget control, since the subsidy rate can be established by the Government and changed when market conditions change. Interest rates on taxable bonds, however, are close to those offered by conventional financing. Although single-family housing and multifamily rental bonding may differ somewhat, we have demonstrated that reduced interest rates offered by tax-exempt bonds incur Federal tax revenue losses greater than the savings provided to borrowers, due to the avoidance of taxes by the bond purchasers. 1/

Bond issuers have the choice of taxable or tax-exempt financing until 1983. The Commission hopes that State and local experience in both tax-exempt and taxable bond financing will assist in evaluating and directing the future of mortgage revenue bonds.

Questions for consideration

1. What is the real cost of tax-exempt bond financing? In addition to the lost Federal revenues (for each billion dollars of bonds issued, assuming a 10-percent taxable interest rate, an estimated $35 million per year of revenue loss is incurred), 2/ any substantial increase of tax-exempt bonds issued by State and local governments will very likely result in higher interest rates on tax-exempt bonds issued for other purposes. Thus, taxpayers must make up revenue losses caused by tax-exempt bonds while paying more to retire tax-exempts issued for capital improvements and other non-revenue-producing purposes. Also, savings and loan institutions, mutual savings banks, and others who provide housing credit may suffer losses as a result of having "business" taken from them by bond-issuing agencies.

2. Would significant credit reallocation result from greater use of tax-exempt bonds? A preference provided by the tax laws can have the effect of diverting funds from one sector of the economy to another or among investments within a sector. Given the country's economic recovery goals and other demands on capital, an important issue is the extent to which this kind of mechanism may reallocate credit and capital.

3. Would further Federal restrictions on the use of tax-exempt bonds hamper State and local financing activities? With substantial decreases in Federal funding slated for

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

2/Peterson, George--Tax Exempt Financing of Housing Investment, D.C. Urban Institute, 1979, p. 123.

housing production programs, some States may need to develop new strategies for housing construction and enhancing the availability of credit. Restrictions on tax-exempt bonds could severely limit the tool which States have increasingly used to deal with their housing needs.

4. Would tax-exempt bonds be more effective than taxable bonds in reaching low- and moderate-income households? With current construction costs and even if interest rates were well below those we have today, it would still be impossible for either taxable or tax-exempt bonds to reach low- and moderate-income renters or homeowners without additional subsidies. Taxable bonds with a direct subsidy (which is currently authorized) may be a better way to reach low- and moderate-income families, while providing lower total costs and maintaining some control over total subsidy expenditures.

REHABILITATION TAX CREDIT

Commission recommendation:

> "The Economic Recovery Tax Act of 1981 provides owners of nonresidential real estate with a 15 percent tax credit on rehabilitation expenses for structures 30 to 39 years old and a 20 percent credit for older structures. The Commission recommends that owners of residential rental structures enjoy the same investment tax credit for rehabilitation expenses."

Comments

The Commission believes that tax credits can encourage private-market-controlled rehabilitation without the administrative complexity and cost of an additional Federal program. The Economic Recovery Tax Act of 1981 increased existing special tax credits for rehabilitating nonresidential real estate and certified historic structures. It raised the tax credit available for rehabilitating commercial and industrial real estate from 10 percent to 15 or 20 percent, depending on the structure's age. The act also liberalized the tax incentives under the Internal Revenue Code, which allows a 5-year amortization for rehabilitating low-income rental housing. No special tax incentives have been provided for rehabilitating rental housing which is neither low-income nor certified historic.

The Commission states that this recommendation is an integral part of a balanced program to improve the ability of low-income families to afford decent housing and, where necessary, to augment the supply of decent housing. The Commission recognizes that assistance payments alone will not provide sufficient incentive for major rehabilitation but believes that broadly available tax incentives, when combined with assistance payments, might spur rehabilitation. This was the case under past Federal categorical programs, such as section 236, which combined both tax incentives and direct subsidies.

Questions for consideration

1. Will the rehabilitation tax credit serve lower income housing needs? The tax incentive is not tied to housing located in lower income census tracts or to investors willing to certify that some minimum percentage of rental units would be reserved for lower income tenants. If the Commission's objective is to increase the supply of rental housing in general by relying on the "trickle down" theory to increase the availability of rental housing to lower income persons, a serious question of feasibility exists. This type of approach is presumably based on the premise that lower income persons (especially those receiving housing assistance grants) can afford the rents that substantially rehabilitated housing will demand. To our knowledge, HUD has not developed data to support this assumption. Therefore, without some mechanism to specifically target funds to lower income renters, the proposed tax credit may not significantly increase rental housing opportunities for the poor.

2. What are the costs and benefits of alternative strategies for promoting rehabilitation of rental housing? Another important issue is whether the proposed credit would be less costly than a federally subsidized housing rehabilitation program. The Commission's report does not compare the Government's cost of rehabilitating rental properties via a tax credit with, for example, the section 312 housing rehabilitation loan program, the CDBG program, or other Federal categorical grant programs. Without a comparison of the costs and benefits of various rehabilitation alternatives, evaluating the merits of any one technique is difficult.

3. What is the likelihood that lower income families will be displaced from their existing housing and will the Government assist these families? The Commission concedes it does not know how a tax credit will affect displacement of low- and moderate-income renters. While HUD believes displacement is not a significant nationwide problem, it recognizes that displacement is more severe in cities and neighborhoods experiencing revitalization. A tax credit may lead to increased displacement of low-income tenants, creating a need to develop strategies for relocating displaced families. The wide availability of vouchers to such households and coordination of these two mechanisms could greatly reduce the amount of displacement which actually occurs. An earlier tax provision for the rehabilitation of low-income housing was effective only when combined with direct subsidies.

PRIVATE INSTITUTIONS

Commission recommendation:

> "The Commission recommends that private foundations, religious groups and other private institutions be encouraged to continue their sponsorship and financing of innovative programs in housing construction, rehabilitation, and access to homeownership."

Comments

The Commission believes its proposals--especially that for new construction under CDBG--will enable private groups to continue to help meet local housing needs despite the general curtailment of Federal development activities. Private organizations have experienced mixed success as sponsors in past HUD programs. A notable success is HUD's elderly and handicapped housing program (section 202). The program has experienced low default rates while maintaining a semi-independent lifestyle for many elderly. The successes of the section 202 program, however, must be viewed in perspective. Despite having a low failure rate, projects generally house middle-income elderly tenants who have been a low-risk group under all insurance programs. Inflation also strains Federal debt service subsidies while projects age and operating costs rise, eventually causing financial problems which many nonprofit organizations do not have the resources to absorb. In the Section 236 Rental Assistance Program, where nonprofit groups served low-income, nonelderly households, nonprofit sponsors accounted for 23 percent of the projects but 47 percent of all failures. Profit entities had much lower failure rates. 1/

Questions for consideration

1. Is it realistic to expect continued housing involvement by private institutions, especially nonprofit sponsors, given the expected phaseout of the Government's major production programs? Eliminating the section 8 and section 202 production programs, an option currently being considered by the Commission, will remove a primary development opportunity for these private organizations. The Commission believes that permitting new construction to be an eligible activity for CDBG funds will broaden the range of activities where public and private groups can work together. However, it is questionable what impact, if any, this recommendation will have for nonprofit organizations which are presently eligible to receive CDBG funds for new construction. No additional guidance has been provided to encourage their continued

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1/"Section 236 Rental Housing--An Evaluation With Lessons for the Future" (PAD-78-13, Jan. 10, 1978).

involvement in housing activities. The success of the continued role of these groups in providing housing assistance may depend a great deal on the fate of other programs.

2. In what areas should the Federal Government encourage the participation of private organizations in meeting the housing needs of low-income households? In the effort to curb Federal credit growth, the extent and nature of future Federal involvement should be considered and delineated before additional loan guarantees and other financial liabilities are incurred. Mechanisms guaranteeing adequate funding for approved projects, coordination with other public and private agencies providing similar or related services, and Federal liability for projects sponsored by private institutions that fail are some issues to resolve.

3. Should certain private groups be targeted for funding over others? With limited public funds available for housing, maximizing impact at minimal cost is an important consideration. Selecting existing private organizations with demonstrated management ability and financial resources may reduce risks and involve entities with proven management expertise. Targeting could also allow tapping sponsors previously not included that could make significant contributions. While selecting organizations with these characteristics over others may exclude some equally competent entities, funding limitations require selecting those that can achieve the needs of low-income households at reasonable risks and least cost.

HOMEOWNERSHIP

Commission recommendation: 1/

"The Commission will consider a program of Individual Housing Accounts to encourage and assist savings for a downpayment by the first-time buyer and other savings incentives to increase the volume of mortgage funds available to homebuyers, subject to careful review of the fiscal implications."

Comments

The Commission intends to form a task force, which would include outside experts, to consider proposals such as individual housing accounts (IHAs) and modifications of individual retirement account (IRA) rules to facilitate homebuying. The Commission

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1/Although not a recommendation, the Commission has included this as a possible course of action.

emphasizes that any recommendation should be targeted toward first-time buyers who could not otherwise buy homes. It does not want to recommend proposals that will help people who would buy homes anyway.

Tax-subsidized IHAs have been proposed in the Congress many times during the past several years. IHAs would permit prospective homeowners to deposit a maximum amount into a savings account whose balance could be used only to buy a first home. Similar to IRAs, annual contributions to the account could either be tax deductible or qualify for tax credits, while interest earnings would be tax-free. Unlike IRAs, however, account balances would probably be limited to a maximum size.

Never attempted in the United States, IHAs have been offered by several European countries, notably France and West Germany. In the United States, homeownership is already at an historically high level, which is higher than any other industrialized country.

Questions for consideration

1. How much will IHA savings incentives cost? The cost of such tax incentives could be substantial. For example, the Congressional Budget Office estimates that IHAs with a $1,500, 10-year criterion, effective January 1, 1982, could reduce Federal revenues by approximately $300 million in fiscal year 1982, $5.7 billion in fiscal year 1983, and $7.8 billion in fiscal year 1984. 1/ Furthermore, once initiated, the Government has little control over such expenditures.

2. Would IHA funds have to be earmarked for mortgage investment? Increased savings resulting from tax incentives do not alone encourage lenders to prefer mortgages over other investments. In recent years, many lending institutions invested in high-yielding commercial paper. To receive maximum preferential tax treatment under the taxable income method for computing bad debt reserves, the IRS requires that 82 percent of all savings and loan and 72 percent of all mutual savings bank assets be invested in housing. This provision provides incentives for using IHA deposits to finance mortgages.

3. Who benefits from IHA incentives? IHAs would provide tax savings to those who can accumulate substantial savings toward a first home. According to the Congressional Budget Office, this group is most likely to include higher income taxpayers and exclude many less affluent households for whom high prices and interest rates have made

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1/"The Tax Treatment of Homeownership Issues and Options," Congressional Budget Office, pp. 64-5, Sept. 1981.

affording a home difficult. 1/ Under many IHA plans, high-income households benefit because contributions to an IHA would qualify for a deduction from taxable income, rather than a tax credit. Deductions and exclusions from taxable income provide greater savings to taxpayers in high marginal tax brackets. Also, some higher income taxpayers may set up IHAs to accumulate downpayments by shifting funds from other savings, thus merely displacing other forms of savings rather than encouraging new savings.

4. Should IHAs be offered only to people who could otherwise not afford to buy a house? Limiting IHAs to only needy potential buyers would have positive and negative effects. On the positive side, lost tax revenues would be minimized because IHAs would not be available to most homebuyers. As the Commission pointed out, a large number of young families have in the past been able to save or borrow money (perhaps at significant personal cost), for the downpayments without an IHA. On the negative side, imposing and enforcing some type of income or asset criterion to determine who must have IHA assistance in order to save would likely be an administrative problem.

5. Are there alternatives which would also encourage personal savings and increase the volume of mortgage funds? In addition to income tax credits discussed above, a number of alternatives exist. For example, the housing industry suggests providing tax benefits for prepaying mortgage principal, thus expanding the pool of housing capital if prepaid funds were required to be reinvested in housing loans. Other ideas may exist for assisting first-time homebuyers and increasing housing credit. Careful consideration of their costs and impacts are warranted.

FEDERAL HOUSING ADMINISTRATION INSURANCE PROGRAMS

Commission recommendation: 2/

"The Commission supports the continuation of Federal Housing Administration insurance programs for segments of the housing market not adequately served by the private sector."

1/"The Tax Treatment of Homeownership Issues and Options," Congressional Budget Office, p. 64, Sept. 1981.

2/Although not a recommendation, the Commission has included this as a possible course of action.

Comments

The Commission states that Federal Housing Administration insurance programs should be available only to those not adequately served by the private sector. The Commission expects to review specific FHA programs for its final report. The review will attempt to identify those areas where FHA is needed and how best to achieve an orderly transition toward a greater reliance on the private sector.

At issue is whether FHA is continuing to provide services not otherwise available or whether it is directly competing with private mortgage insurers for essentially the same markets. FHA opponents contend that although it served a vital need in earlier years, private industry now has the capacity and the willingness to serve the entire unsubsidized home mortgage market on essentially similar terms and should be allowed to do so without Government competition. Others contend that FHA does not compete with private industry but effectively functions as an insurer of last resort for many low-, moderate-, and middle-income buyers, especially during cyclical economic downturns that tend to restrict access to mortgage funding.

Questions for consideration

1. How will those segments of the housing market which are and are not being adequately served by private mortgage insurers be identified? Thus far no adequate data base has been developed to compare FHA activities to those of the private market.

2. If FHA's presence in the home mortgage insurance market is reduced, how will FHA insurance programs be equitably administered and monitored? If market overlap exists between FHA and private mortgage insurers and FHA is restricted to insuring only those not served by the private sector, a system would have to be developed and implemented to identify eligible applicants to ensure that only they will benefit from FHA insurance. In addition, if future annual limits on FHA commitment authority are established below the effective demand, then it would be necessary to allocate the available FHA insurance among lenders and eligible applicants. (The administration has recently noted that it expects to propose a 12.5-percent reduction in FHA commitment authority for fiscal year 1983--from the congressionally approved $40 billion in fiscal year 1982 to $35 billion in fiscal year 1983.)

3. If FHA is limited exclusively to providing mortgage insurance only to those homebuyers whom private insurers are unwilling to serve, will FHA's currently self-supporting insurance programs require prohibitive premium charges or require Federal subsidy? As long as FHA has been able to insure a mix of both higher and lower risk homebuyers

under its Mutual Mortgage Insurance Fund, the premiums cover all expenses and provide a reserve to cover potential losses from mortgage defaults. If FHA is restricted to those homebuyers whom private insurers would be unwilling to insure (presumably the higher risk borrowers), FHA would probably have to either (1) raise insurance premiums in order to maintain the fund's actuarial soundness to reflect the greater probability of default, and thus preclude homeownership for some borrowers who can least afford such increases or (2) accept greater claims and losses from a portfolio consisting of higher risk loans which could lead to a request for Federal appropriations to pay these claims.

PENSION FUNDS

Commission recommendation:

> "The Commission recommends the elimination of provisions of current regulations or laws that inadvertently limit the housing investments of pension funds, insurance companies, and other potential major sources of housing capital."

Comments

Pension funds represent an attractive source of capital for real estate financing due in part to their substantial size (estimated at $600 billion) and relative stability of member contributions. While some public pension funds have made mortgage investments, very little private pension capital has been similarly invested. The Employee Retirement Income Security Act of 1974 restricts private pension fund investments. Department of Labor regulations prohibit certain investments and set investment standards, thus impeding pension fund investment in mortgages and mortgage-related securities. The Commission suggests revisions be made in Labor's regulations to increase the flow of normal market operations between pension funds and housing.

Questions for consideration

1. What is the potential for increased pension investment in housing? Since pension fund managers follow investment criteria such as rate of return, risk, liquidity, marketability, and diversification, housing will have to compete with many other investment opportunities. Pension fund managers are not generally familiar with housing finance investments and may be reluctant to invest heavily. On the other hand, pension fund stability and long-term investment goals make mortgage investment better suited to pension fund capital than to other financial institutions which must continually raise money at market rates.

2. <u>If significant pension fund money is diverted to housing, what will be the impact of this investment shift on the economy?</u> Investment funds may be shifted at the expense of other economic sectors. A careful analysis of the impact on the investment market and on the economy as a whole seems reasonable prior to making adjustments affecting pension fund behavior. However, financial institution deregulation, the expectation of inflation, and high interest rates have already started to shift capital away from housing. The net effect of these and other factors should be considered before making substantial changes in housing policy.

3. <u>Can pension laws and regulations be changed without creating risks of conflicts of interest and unwise investments?</u> The Commission, while recommending that only laws and regulations that "inadvertently" limit pension housing investment be eliminated, also stated that such laws "have failed to recognize the realities of the housing finance marketplace***." Any laws and regulations targeted for change must be carefully analyzed in the context of preventing conflict-of-interest transactions and unwise investments which in the past have been major considerations in structuring pension fund regulations.

4. <u>Should pension funds be singled out to support housing?</u> Although the Commission recommendation mentions other sources for housing finance, the accompanying discussion and most public debate has singled out pension funds as the prime source for additional housing capital. There are, however, other sources which could be encouraged to provide funds for housing. IRA and KEOGH accounts and insurance companies' assets are just a few examples. Thus, a search for additional sources of housing capital should not exclude non-pension fund sources.

DESCRIPTIONS OF SELECTED HUD PROGRAMS

Community Development Block Grants

Federal aid to promote sound community development.

Nature of Program: HUD awards "block" grants to local governments to fund a wide range of community development activities. In a single, flexible-purpose program, the block grants finance activities previously eligible under separate categorical grant programs: Urban Renewal; Neighborhood Development Grants; Model Cities; Water and Sewer Grants; Neighborhood Facilities Grants; Public Facilities Loans; Rehabilitation Loans; and Open Space, Urban Beautification and Historic Preservation Grants. Spending priorities are determined at the local level, but the law enumerates general objectives which the block grants are designed to fulfill, including adequate housing, a suitable living environment and expanded economic opportunities for lower-income groups. Specifically, recipients are required to estimate their lower-income housing needs and address them in the overall community development plan they submit to receive their grant.

Applicant Eligibility: Metropolitan cities and qualified urban counties are guaranteed an amount called an "entitlement." It is based on need, objectively calculated by a formula that takes into account population, poverty, overcrowded housing, age of housing and growth lag. Small communities compete for the remaining ("discretionary") funds. However, local governments that participated in certain categorical grant programs, but do not qualify for an equivalent block grant, are "held harmless" for three years; i.e., they are funded at two-thirds of the excess of hold-harmless over formula amount for one year and then one-third of the excess for the next year.

Funding Distribution: Of each year's appropriation, three percent goes directly into the Secretary's discretionary fund which is available for contingencies, emergencies and other special purposes. The rest is divided between standard metropolitan statistical areas (generally cities of at least 50,000 population and urban counties of 200,000 or more) and non-metropolitan areas, with 80 percent earmarked for the former and 20 percent for the latter. Money for metropolitan areas is allocated first to entitlement grants; the balance is available for discretionary grants.

Legal Authority: Title I, Housing and Community Development Act of 1974 (P.L. 93-383), as amended by Title I, Housing and Community Development Act of 1977 (P.L. 95-128).

Administering Office: Assistant Secretary for Community Planning and Development, Department of Housing and Urban Development, Washington, D.C. 20410.

Information Source: HUD Field Offices

Current Status: Active

Scope of Program: $10.95 billion authorized for three years (Fiscal Years 1978-80). The program has been fully funded each year. More than 1,300 communities received entitlement grants in each of the first two years of the program's operation; approximately 1,800 qualified for discretionary grants in both years.

Source: Departmental Programs, U. S. Department of Housing and Urban Development, HUD-214-5-PA, Aug. 1980

Lower-Income Rental Assistance (Section 8)

A rent subsidy for lower-income families to help them afford decent housing in the private market.

Nature of Program: HUD makes up the difference between what a lower-income household can afford and the fair market rent for an adequate housing unit. No eligible tenant need pay more than 25 percent of adjusted income toward rent. Housing thus subsidized by HUD must meet certain standards of safety and sanitation, and rents for these units must fall within the range of fair market rents as determined by HUD. This rental assistance may be used in existing housing, in new construction, and in moderately or substantially rehabilitated units. Different procedures apply in each case.

Local public housing agencies administer the existing housing and moderate rehabilitation programs, certifying eligible tenants, inspecting the units proposed for subsidy, and contracting with approved landlords for payment. (Tenants execute separate leases with landlords to pay their share of rent.) In the Moderate Rehab program, local public housing agencies also provide technical assistance to owners of units being rehabilitated.

Nonprofit and profit-motivated developers, alone or together with public housing agencies, submit proposals for rehabilitation or new construction in response to invitations from HUD; or they may apply to their State housing finance agency. On approval of the proposals, HUD contracts to subsidize the units to be occupied by eligible families.

Applicant Eligibility: Tenants must be lower-income households with incomes amounting to 80 percent of the area median income or less. Project sponsors may be private owners, profit-motivated and nonprofit or cooperative organizations, public housing agencies and State housing finance agencies.

Legal Authority: Section 8, U.S. Housing Act of 1937, (P.L. 73-479), as added by Housing and Community Development Act of 1974, (P.L. 93-383).

Administering Office: Assistant Secretary for Housing-Federal Housing Commissioner, Department of Housing and Urban Development, Washington, D.C. 20410.

Information Source: HUD Field Offices.

Current Status: Active.

Scope of Program: As of October 31, 1979, 728,948 units of new construction or substantial rehabilitation and 804,847 units of existing housing were reserved since inception of the program, for a total of 1,533,795 units; 399,408 new units were started, and 63,067 substantially rehabilitated. There were 173,308 new and 23,585 rehabilitated units completed and 707,475 existing units made available for occupancy.

Low-Income Public Housing

Federal aid to local public housing agencies to provide decent shelter for low-income residents at rents they can afford.

Nature of Program: Local public housing agencies develop, own and operate low-income public housing projects, financing them through the sale of tax-exempt obligations. HUD furnishes technical and professional assistance in planning, developing and managing the projects and gives two kinds of financial assistance: preliminary loans for planning; and annual contributions to pay the debt service of PHA obligations, assure low rents and maintain adequate services and reserve funds. Rents that are based on the resident's ability to pay contribute to the costs of managing and operating the housing.

Several different methods are used to provide housing. Under the "Turnkey" program, the PHA invites private developers to submit proposals, selects the best proposal and agrees to purchase the project on completion. Under conventional-bid construction, the PHA acts as its own developer, acquiring the site(s), preparing its own architectural plans, and advertising for competitive bids for construction. The PHA may also acquire existing housing, with or without rehabilitation, from the private market under the acquisition program.

Applicant Eligibility: Public housing agencies established by local governments in accordance with State law.

Legal Authority: U.S. Housing Act of 1937, as amended, (P.L. 75-412); Title II, Housing and Community Development Act of 1974 (P.L. 93-383).

Administering Office: Assistant Secretary for Housing-Federal Housing Commissioner, Department of Housing and Urban Development, Washington, D.C. 20410.

Information Source: HUD Field Offices.

Current Status: Active.

Scope of Program: Approximately $155 million of contract authority was approved for 49,650 units during Fiscal Year 1979.

As of September 30, 1979, 24,800 units were under construction, and 115,000 were in the preconstruction processing stage.

Direct Loans for Housing for the Elderly or Handicapped (Section 202)

To provide housing and related facilities for the elderly or handicapped.

Nature of Program: Long-term direct loans to eligible, private nonprofit sponsors finance rental or cooperative housing facilities for elderly or handicapped persons. The current interest rate is based on the average rate paid on Federal obligations during the preceding fiscal year. (Until the program was revised in 1974, the statutory rate was 3 percent). Participation in the Section 8 rental housing program is required for a minimum of 20 percent of the Section 202 units.

Applicant Eligibility: Private, nonprofit sponsors may qualify for loans. Households of one or more persons, the head of which is at least 52 years old or is handicapped, are eligible to live in the structures.

Legal Authority: Section 202, Housing Act of 1959 (P.L. 86-372).

Administering Office: Assistant Secretary for Housing-Federal Housing Commissioner, Department of Housing and Urban Development, Washington, D.C. 20410.

Information Source: HUD Field Offices.

Current Status: Active.

Scope of Program: From the date of enactment through 1972, loans for 45,275 units have been approved with a value of $579,444,000. After a brief suspension, the program was revised and reactivated by the Housing and Community Development Act of 1974. From resumption to September 30, 1976, loans were approved for 26,400 units; 21,000 units were approved for Fiscal Year 1977, 19,600 units were approved for Fiscal Year 1978, and 21,100 units were approved for Fiscal Year 1979, approximately 20,000 units are anticipated for Fiscal Year 1980.

Experimental Housing Allowance

A test of the efficacy of direct cash assistance to low-income households for housing.

Nature of Programs: The Housing Allowance experiments are testing the feasibility of direct cash assistance to lower-income households to help them afford adequate housing from among existing units in the private market.

The program seeks information on three fundamental questions: how families use their allowances; how the housing market responds to allowances; and how allowance programs can best be administered. The findings will be analyzed for meaning and national applicability.

Applicant Eligibility: Low-income households in cities participating in the experiments. But additional enrollment is currently open only in two housing markets, metropolitan Green Bay, Wis., and South Bend, Ind.

Legal Authority: Sections 501 and 504, Housing and Urban Development Act of 1970 (P.L. 91-609).

Administering Office: Assistant Secretary for Policy Development and Research, Department of Housing and Urban Development, Washington, D.C. 20410.

Information Source: See administering office.

Current Status: Active.

Scope of Program: A 10-year program initiated in 1972 involving more than 25,000 households in 12 metropolitan areas. Overall cost: approximately $163 million.

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