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BY THE COMPTROLLER GENERAL

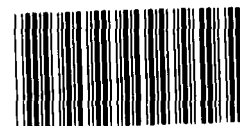
Report To The Chairman, Committee On Banking, Housing And Urban Affairs United States Senate

OF THE UNITED STATES

Rental Rehabilitation With Limited Federal Involvement: Who Is Doing It? At What Cost? Who Benefits?

Over 34 percent of all families in the United States rely on rental housing for shelter; millions of these existing rental units, the only source of shelter for most low-income households, are in substandard condition.

Based on detailed analyses of 73 communities' rental housing rehabilitation activities under the Community Development Block Grant Program, GAO raised a number of program design issues and options the Congress should consider in drafting legislation to address this problem. These options include cost controls, targeting provisions, and program evaluation requirements.



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JULY 11, 1983

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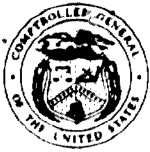


COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-171630

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

Dear Mr. Chairman:

Your November 10, 1982, letter expressed concern about how little detailed information is available on rental rehabilitation activities being funded under the Community Development Block Grant (CDBG) Program. Specifically, you wanted to know what it cost and who is benefiting.

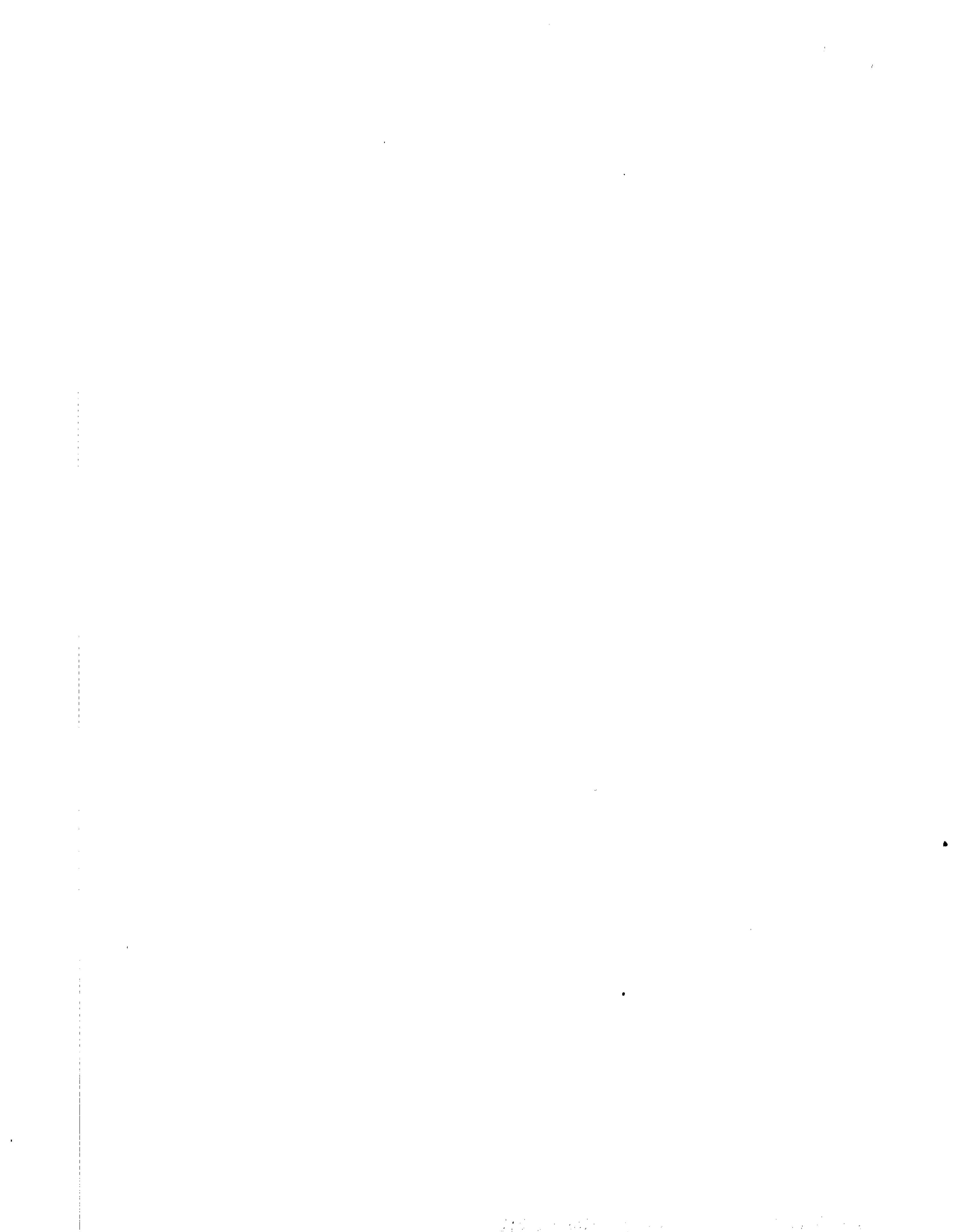
This report discusses types of rental rehabilitation activities performed by 73 communities under CDBG along with pertinent analyses from our previous work, "Block Grants for Housing: A Study of Local Experiences and Attitudes" (GAO/RCED-83-21, Dec. 13, 1982). We are suggesting that appropriate safeguards be considered for any rental rehabilitation program to control rehabilitation costs and to facilitate national oversight. In addition, we are recommending that the Secretary, Department of Housing and Urban Development, require communities to provide adequate documentation that rental rehabilitation activities are benefiting lower income households.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 5 days after its issuance. At that time we will send copies to the Director, Office of Management and Budget; the Secretary of Housing and Urban Development; and other interested parties.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States



COMPTROLLER GENERAL'S
REPORT TO THE CHAIRMAN,
COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
UNITED STATES SENATE

RENTAL REHABILITATION
WITH LIMITED FEDERAL
INVOLVEMENT: WHO IS
DOING IT? AT WHAT COST?
WHO BENEFITS?

D I G E S T

In studying rental housing rehabilitation activities funded with the Community Development Block Grant (CDBG) Program, GAO found that (1) relatively few communities have had much recent experience in designing, implementing, and evaluating rental rehabilitation programs, (2) excluding two large atypical cities, rehabilitation costs averaged about $7,000 per unit, including improvements which communities said were beyond those needed to eliminate housing deficiencies, (3) subsidies may often be greater than necessary because localities did not tailor finance methods to individual projects' situations, and (4) localities often did not know whether lower income households were being assisted or displaced because such data was not kept.

GAO assessed the rental rehabilitation programs of 73 communities which ran CDBG-funded programs during the last 3 years. A variety of evidence led GAO to conclude that under the present CDBG Program, the potential for poor benefit targeting and displacement of lower income households is strong. (See p. 11.)

The Chairman of the Senate Committee on Banking, Housing and Urban Affairs asked GAO to make this review in order to provide information relevant to the Congress' consideration of a new rental rehabilitation program.

WHO IS DOING RENTAL REHABILITATION?

Roughly half of all CDBG communities with populations over 50,000 reported having rehabilitated some investor-owned housing at some time during the 6 years prior to 1982. Nevertheless, only about 7 percent of those communities have assisted more than 100 rental units during the last 3 years, and although most communities show greater housing needs for lower income renters than for homeowners, most spent much more money on rehabilitation programs for homeowners. Therefore, if

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the Congress wants more rehabilitation assistance to go to lower income renters, it will probably be necessary to develop a new rental program or explicit targeting strategies for the CDBG Program, buttressed by technical assistance to localities. (See p. 14.)

WHAT DOES REHABILITATION COST?

Seventy-one of 73 communities GAO studied reported an average cost per unit of $7,129, with CDBG providing $3,742. New York and Chicago had a much higher per-unit rehabilitation cost, averaging $16,571, with CDBG providing $6,523.

When GAO visited 22 of the 73 communities, it found that rehabilitation costs often included repairs beyond those needed to correct substandard housing conditions or to extend the useful life of the structure. When asked about what it would cost to eliminate only code violations in the majority of the communities' substandard rental units, 11 of the 22 communities said it would cost $5,000 or less and 18 said $10,000 or less. More importantly, 19 of the communities said that a program limited to correcting code violations could be successfully implemented. Finally, 13 communities estimated that rehabilitation costs to eliminate substandard conditions averaged about 50 percent of their past rehabilitation costs. (See p. 20.)

WHY CONTROL REHABILITATION COSTS?

There are two major reasons to limit rehabilitation costs under a rental rehabilitation program--to increase the number of households and units which can be assisted and to avoid pricing lower income households out of the rehabilitated housing units. Higher costs imply higher rents unless rents are otherwise restrained, and GAO's survey showed rent increases in many cities ranging from 5 to 50 percent following rehabilitation. (See p. 22.)

GAO found that restraints on rents after rehabilitation were used by 45 of 73 communities to control costs, along with other measures such as limits on grants, loans, or costs of improvements beyond those needed to correct code violations. For example, the most prevalent rent restraint used was to limit rent after rehabilitation to the Department of Housing and Urban Development's (HUD's) published

fair market rents. But 18 of the 22 localities GAO visited said that lower income households could not afford these fair market rents without additional rent assistance.

GAO concluded that without some explicit safeguards, there is nothing to preclude higher than desirable rents or rehabilitation expenditures. These factors could lead to displacement.

DISPLACEMENT?

GAO attempted to discover whether rent increases after rehabilitation were adversely affecting the original tenants of assisted housing units, but the absence of adequate before-and-after rehabilitation data on tenant incomes made this impossible. (See p. 22.)

WHO IS BENEFITING
FROM RENTAL REHABILITATION?

Although most communities GAO contacted said that rental rehabilitation was targeted to lower income neighborhoods for the benefit of lower income households, most could not provide income data or other tenant demographics to establish firm conclusions about income targeting. In fact, communities were able to provide tenant demographics for only about 8 percent of the rehabilitated units--1,613 of 19,239. (See p. 35.) Most units where records were kept were assisted with the Section 8 Program which specifically requires landlords to rent to lower income households and to collect demographic data. The data showed strong income targeting, but a variety of other facts indicated that income targeting may not be as good as these statistics imply.

For example, Chicago reported that 56 percent of the 801 rental units rehabilitated in the last program year were occupied by middle rather than lower income households before rehabilitation. Chicago did not know who was occupying the units after rehabilitation, in spite of a requirement that investors rent 20 percent of their rehabilitated units to lower income households. San Diego had a similar experince. (See p. 35.)

GAO believes that if rental rehabilitation is to result in greater housing opportunities for lower income households, some explicit strategy

for assuring good benefit targeting should be adopted in addition to neighborhood selection.

STRENGTHENING ACCOUNTABILITY

The issue of how scarce resources should be allocated is always important. Program evaluation is a key tool in making such decisions and has to be an integral program component if program administrators are to have information necessary to manage their programs and if the Congress is to be able to exercise its oversight responsibilities.

Since program evaluation (which is not required by present CDBG rules) has been relegated to a minor role in local rental rehabilitation programs, Federal guidelines are necessary if adequate program evaluation is to take place, and a standardized reporting requirement is probably necessary to facilitate such an evaluation.

MATTERS FOR CONSIDERATION BY THE COMMITTEE

GAO raised a number of program design issues and related options which the Committee on Banking, Housing and Urban Affairs should consider in deliberations on a new rental rehabilitation program. These options would help control costs, facilitate income targeting, and require program evaluation at both the local and Federal levels.

If the Committee wishes to target a new rental rehabilitation program to lower income households, it should consider explicitly defining the intended program beneficiaries and the extent to which rehabilitated units must be occupied by those beneficiaries. In the absence of such guidelines there would be a natural tendency among landlords and program officials to allow residency by middle income households who are able to pay for more costly rehabilitation.

To control program costs and help assure that housing units remain affordable by lower income households, the Committee should consider explicit cost control features such as:

--Placing an overall dollar limit on the per-unit rehabilitation funding provided by the program. HUD could be empowered to make

exceptions in cities where it was specifically justified.

--Limiting Federal rehabilitation expenditures to generally those necessary to correct substandard conditions or repair major systems in danger of failure, thus extending the useful life of housing units. HUD could define "substandard" on a national basis using generally accepted measures for the census or Annual Housing Survey. (See p. 31.)

--Requiring communities to enter into agreements with landlords restraining the allowable rent in subsidized units for some period of time to the lower of (1) the rent affordable by the program's lower income beneficiaries (without additional rent subsidies) or (2) the rent necessary to cover increases in debt service and owner equity.

To provide information needed for program evaluation and congressional oversight, the Committee should consider requiring the collection of verified income and demographic information and periodic program evaluation. This could be done by requiring

--project owners to collect income and demographic information or local governments to develop an alternate method for developing such data,

--local governments to report periodically to HUD on what they are accomplishing, and

--the Department of Housing and Urban Development to report to the Congress periodically with consolidated information on the costs and benefits of local programs.

RECOMMENDATIONS TO THE SECRETARY OF HUD

HUD and localities have lacked sufficient data to determine whether lower income households are being helped or harmed by local rental rehabilitation activities. Therefore, regardless of whether the Congress enacts new or additional legislation, GAO recommends that the Secretary of HUD explore requiring communities to (1) evaluate their CDBG rental rehabilitation programs and (2) require participating landlords to provide standardized income and demographic information on assisted households annually, or make other provisions for collecting this information.

AGENCY COMMENTS
AND GAO's EVALUATION

In commenting on the report, HUD agreed that technical assistance would be needed for any new program; that cost controls may have been ineffective under CDBG; and that explicit program evaluation and information collection would be needed under a new program for good program management. HUD believed, however, that the administration's current Rental Rehabilitation Demonstration Program--a program designed to separate the property rehabilitation subsidy from the tenant subsidy--would correct a number of the deficiencies identified by GAO in the present CDBG Program without resorting to specific cost control. Further, HUD said that its "marketplace" approach requiring private matching funds, allowing rents to seek their own level, and targeting units to lower income neighborhoods would be a better method of restraining costs and targeting benefits than the possibilities raised by GAO. HUD also said that providing section 8 tenant subsidies to eligible lower income households residing in units to be rehabilitated would solve the problem of tenant displacement. (See p. 27.)

GAO did not review the demonstration program because it had not been in existence long enough. However, early data on HUD's demonstration program showed higher rehabilitation costs than those under CDBG. Also, certain design features, such as the absence of specific rent restraints, raised the possibility that HUD's approach could result in higher overall costs to the Government and housing which is less affordable by lower income households. On the other hand, providing section 8 certificates to existing tenants would either reduce displacement or mitigate its negative impact since tenants could relocate to other standard housing.

Ultimate displacement in the sense of lower income households being replaced as a group by middle-income households over time can only be evaluated after the program's impact on affordability has also been observed. Meanwhile, other strategies may be necessary to control costs and target benefits. Regardless of whether the Congress makes available tenant subsidies, as in the HUD demonstration program, GAO believes the Committee should consider the option of providing more explicit cost control and benefit targeting mechanisms for any new rental rehabilitation program.

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ABBREVIATIONS

CDBG	Community Development Block Grant
GAO	General Accounting Office
HUD	Department of Housing and Urban Development

CHAPTER 1

INTRODUCTION

Rental housing is the source of shelter for 27.5 million families--34 percent of all families--and the only source for most low-income households. For example, more than 50 percent of households with incomes below $10,000 are renters. Today's rental housing market is typified by older housing units located in urban areas and primarily in structures containing two or more units. Numerous Federal programs have attempted to deal with the problem of providing decent, affordable rental housing with varying degrees of success.

RENTAL HOUSING CHARACTERISTICS

Rental structures are predominantly older housing consisting of two or more units located in urban areas.

The South has the largest share of rental housing

In 1980, about 76 percent (21 million) of all occupied rental units were located in standard metropolitan statistical areas.[1] Of these, about 57 percent were located inside central cities. The following table shows the location of rental housing units in 1970 and 1980 by geographic regions.

Region	Number of renter-occupied units			
	1970	Percent	1980	Percent
	(000 omitted)		(000 omitted)	
Northeast	6,566	27.9	6,784	24.6
North central	5,613	23.8	6,226	22.6
South	6,801	28.9	8,338	30.3
West	4,579	19.4	6,208	22.5
Total	23,559	100.0	27,556	100.0

As shown, all regions have increased the number of rental units, with the South and West showing the greatest increases. Rentals accounted for only 32 percent of the South's occupied housing stock but accounted for over 39 percent of the Northeast's and West's occupied housing stock.

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[1] A standard metropolitan statistical area is a county or group of contiguous counties which contains at least one city or twin cities with 50,000 or more inhabitants.

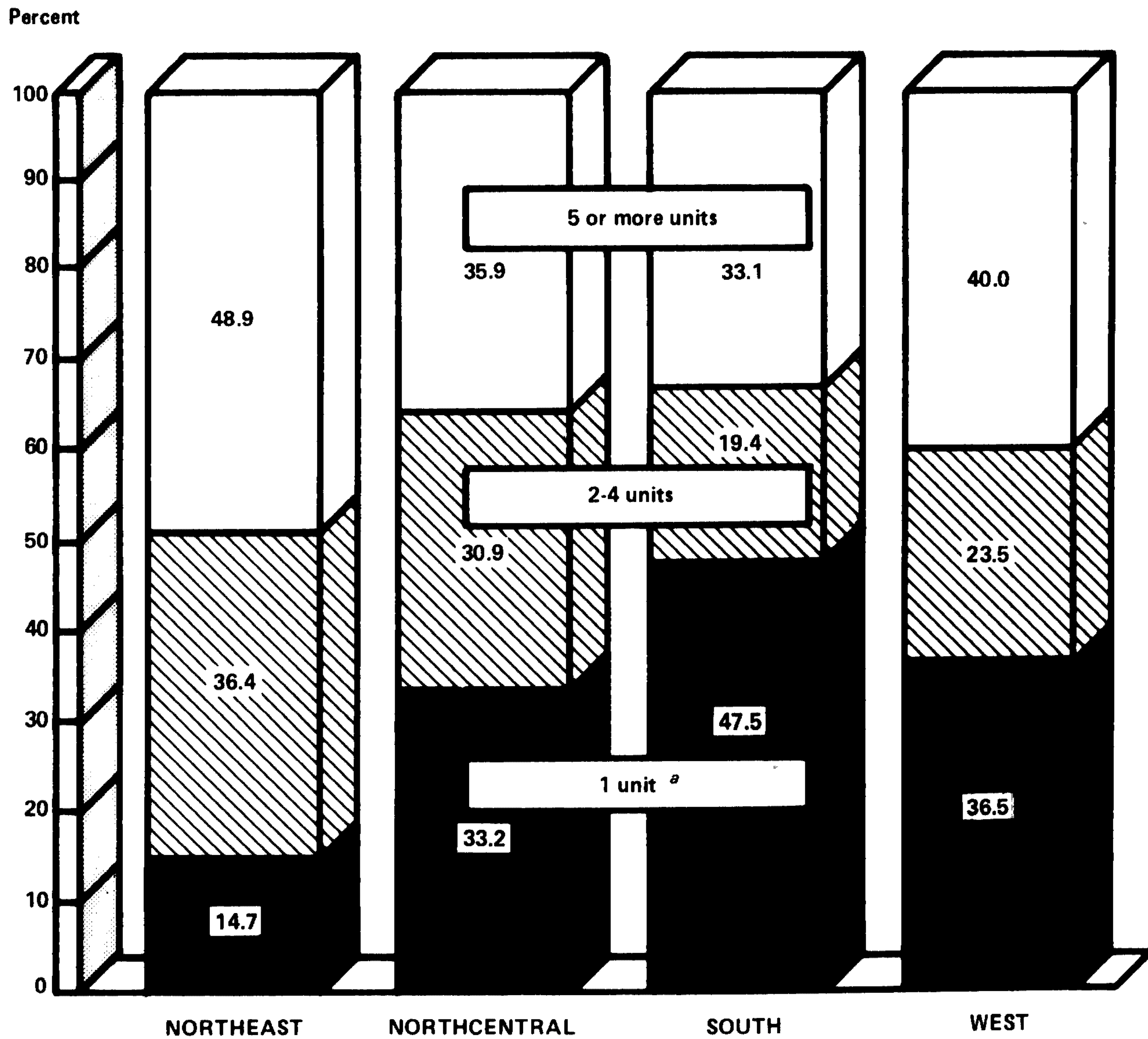
Most rental structures had multiple units

Small housing structures (those with 1 to 4 units) make up about 60 percent of all renter-occupied units, while large structures (5 or more units) account for the remaining 40 percent. The following table compares the number of units in the various types of structures for 1970 and 1980.

Structure type	Number of occupied rental units 1970	1980	Percent change
	(000 omitted)		
1 unit	8,530	8,558	0.3
2 to 4 units	6,218	7,468	20.1
5 or more units	8,490	10,801	27.2
Mobile home or trailer	321	728	126.8
Total	23,559	27,555	17.0

According to the table, multifamily structures have increased and one-unit dwellings have remained constant during the past decade. In the South, however, single-unit structures continue to be predominant in the rental housing market. As shown on the following page, almost 50 percent of the South's housing units are single-unit structures. In contrast, only 15 percent of the Northeast's rental housing consists of single-unit structures.

FIGURE 1
SIZE OF RENTAL STRUCTURE BY REGION



[a] *INCLUDES MOBILE HOMES*

Rental housing inventory is aging

As houses age, they often need to be fixed. In fact, most housing units over 20 years old are generally in need of some moderate rehabilitation, such as new heating systems or roofs. This is particularly important for the rental market because almost 60 percent of the Nation's rental housing is over 20 years old, and about 40 percent is over 40 years old. The following table taken from the 1980 census data shows the age of the Nation's rental units.

Year structure built	Renter-occupied units	Percent
	(000 omitted)	
1939 or earlier	10,569	38.3
1940 to 1949	2,546	9.2
1950 to 1959	3,269	11.9
1960 to 1964	2,416	8.8
1965 to March 1970	3,110	11.3
April 1970 or later	5,646	20.5
Total	27,556	100.0

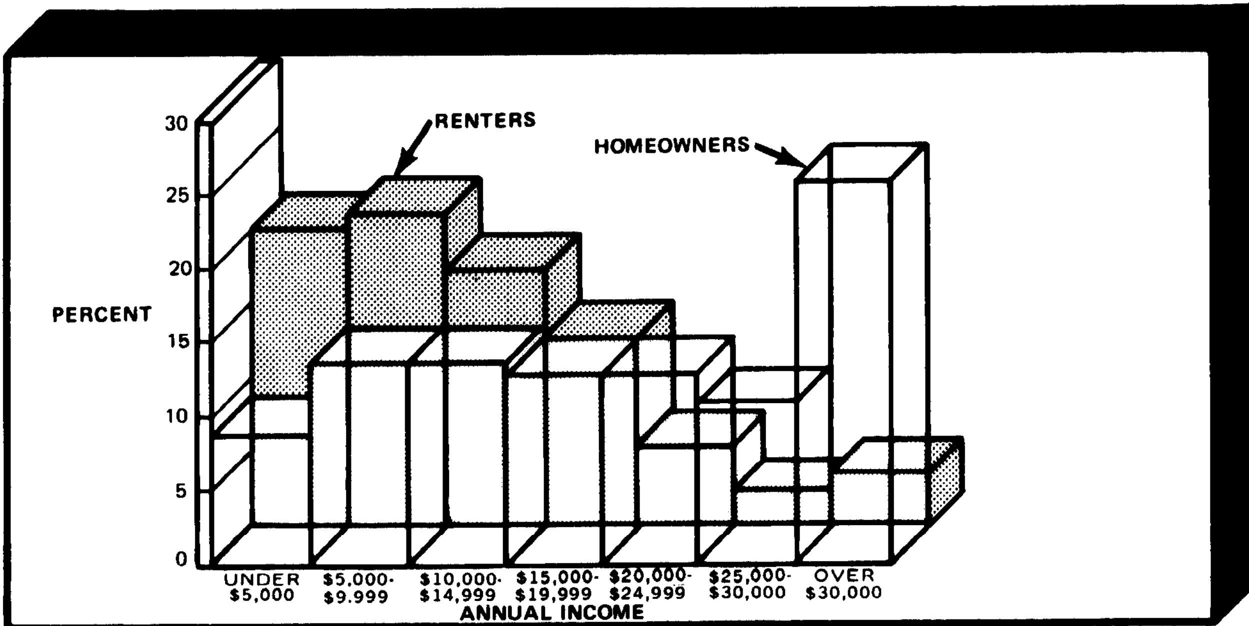
RENTERS' CHARACTERISTICS WERE SUBSTANTIALLY DIFFERENT FROM HOMEOWNERS'

According to the 1980 census data, renters had substantially lower annual incomes and fewer household members than homeowners. In addition, while most renters were white, minorities were more likely to rent than own homes. The following graphics depict renter versus homeowner characteristics.

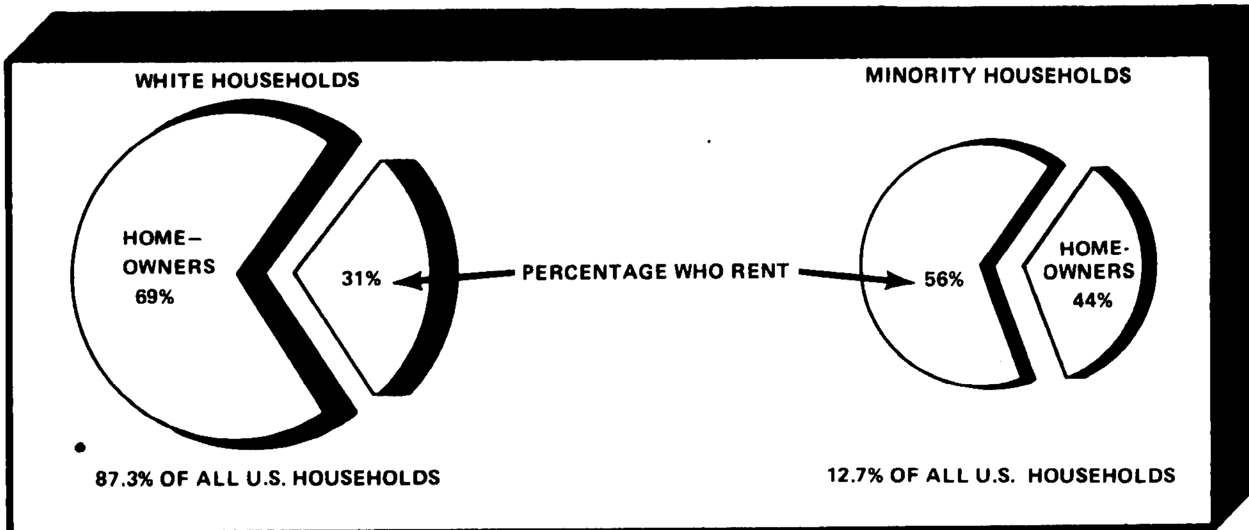
FIGURE 2

COMPARED WITH HOMEOWNERS, RENTER HOUSEHOLDS...

HAVE LOWER INCOMES...



ARE MORE LIKELY TO BE MINORITIES...



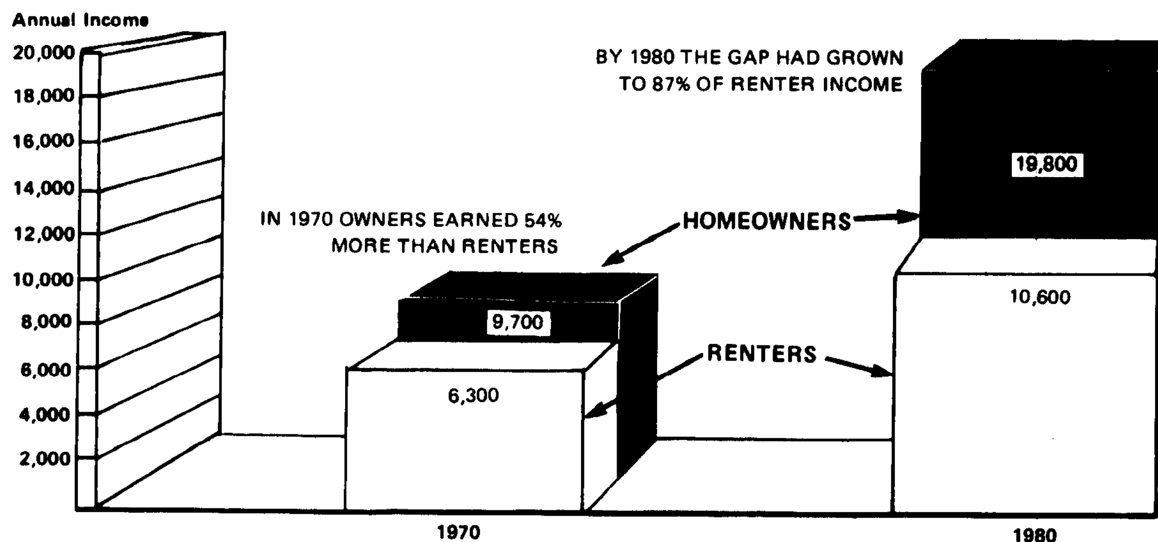
HAVE FEWER HOUSEHOLD MEMBERS.

HOUSEHOLD SIZE					
RENTERS	36%	29%	16%	11%	9%
HOMEOWNERS	15%	32%	18%	19%	15%

In 1980, renters had a median annual income of $10,600, whereas homeowners had a median income of $19,800--an 87 percent difference. The following chart shows how this gap in incomes has steadily widened since 1970.

FIGURE 3

INCOME GAP IS GROWING BETWEEN HOMEOWNERS AND RENTERS



Source: Annual Housing Survey: 1980

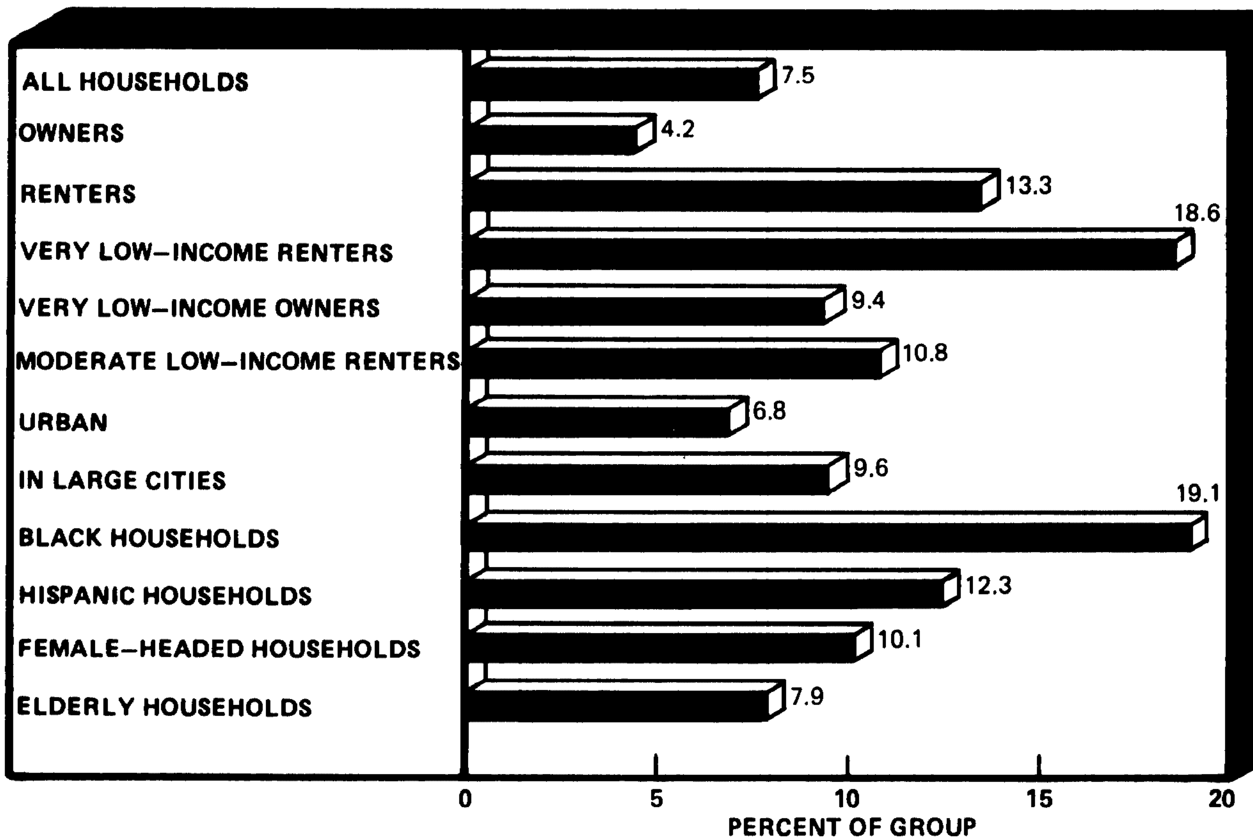
RENTERS ARE EXPERIENCING HOUSING DIFFICULTIES

The need to preserve and increase the Nation's rental housing stock, particularly for low- and moderate-income households, is clear. According to the President's Commission on Housing report of 1982, 3.6 million renter households live in physically inadequate housing and far more are in financial need. For many households, renting is the only choice available.

Inadequate housing

The 1977 Annual Housing Survey found that not only is inadequate housing far more common among renters than homeowners, but such housing is concentrated among very low-income families (those with incomes of 50 percent or less of the local area median income). Almost twice as many very low-income renters live in inadequate housing as do very low-income owners (18.6 percent versus 9.4 percent).

FIGURE 4
PERCENTAGE OF INADEQUATE HOUSING
AMONG VARIOUS HOUSING GROUPS



SOURCES: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development.

There are also some geographic concentrations of inadequate housing units. Such housing is found disproportionately in rural areas in the South and in older, larger cities. The 1977 Annual Housing Survey data showed that New York City and the nearby New Jersey cities of Newark, Paterson, and Jersey City had a particularly high concentration of inadequate housing. In fact, it was double the average of other large cities. New York City alone accounted for more than 29 percent of all deficient housing in large cities and for 9 percent of all inadequate housing in the Nation.

Moderately priced rental housing stock shrinking

Between 1977 and 1980, the number of renter households earning less than $10,000 per year decreased by about 1.8 million households (12 percent) from 14.9 million to 13.1 million. Yet, the number of moderately priced rentals decreased substantially more during the period. For example, the number of units with gross rents of less than $200 per month decreased from 14.2 million to 8.6 million units (39 percent) over the 3-year period. Thus, the inventory of units that households earning less than $10,000 per year could conceivably afford dropped by roughly 5.6 million units, while the potential renter

population decreased by only 1.8 million households. Whereas in 1977 the proportion of affordable units to renters was in approximate balance--14.9 million households/14.2 million units--by 1980 a substantial imbalance had occurred.

CURRENT FEDERAL ROLE IN RENTAL HOUSING

The Department of Housing and Urban Development (HUD) is the primary Federal agency responsible for administering programs designed to encourage production or maintenance of rental housing. HUD's role in the rental housing market has been to (1) provide funds for, or to facilitate through mortgage insurance, the financing of construction, purchase, or rehabilitation of multifamily housing and/or (2) assist lower income families, through rental subsidies, to obtain decent, safe, and sanitary housing. This role is changing.

Historically, the private sector and the Federal Government have shared the burden in providing multifamily rental housing with the private sector dominating the market. In recent years, however, the roles have been reversed with the Federal Government subsidizing most of the new rental units. For example, while the Federal Government provided 35 percent of multifamily rental units in 1977, it provided 59 percent in 1981. The following table shows this trend.

Comparison of Private Versus
Subsidized Rental Starts, 1977-1981

	Total rental units started	Private		Subsidized	
		Number	Percent	Number	Percent
1977	459,800	298,500	65	161,000	35
1978	471,800	268,300	57	203,500	43
1979	392,900	202,100	51	190,800	49
1980	297,400	110,500	37	186,800	63
1981	220,000	97,300	41	138,700	59

Sources: Bureau of the Census Construction Report C-20. Office of Housing, HUD; Office of Finance, Farmers Home Administration.

Section 8 Program

Although other Federal programs are providing rental housing assistance (see app. I), the Section 8[2] Lower Income Housing Assistance Program is currently the major Federal program for providing rental housing assistance. The Section 8 Program consists of two approaches: one is to use existing housing

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[2]Section 8 of the National Housing Act of 1937, which was added by the Housing and Community Development Act of 1974, 42 U.S.C. §1437f.

units and the other is to produce newly constructed and rehabilitated units. Under either approach, the Government may pay the difference between a market competitive rent and up to 30 percent of a tenant's income. To be eligible for assistance, a family's income generally must not exceed 80 percent of the median income (adjusted for family size) for the geographic area in which the family lives. It should be noted that the Omnibus Budget Reconciliation Act of 1981 set limits on the number of tenants with incomes between 50 to 80 percent of the area's median who could be assisted.

Rental housing and Community Development Block Grants

The Housing and Community Development Act of 1974 (Public Law 93-383) marked the start of a new era in housing relations between Federal and local governments. Title I of this legislation created the Community Development Block Grant (CDBG) Program, replacing seven categorical grant-in-aid programs.[3] The change to the block grant approach reflected a desire to shift the responsibility for community development from the Federal Government to the local governments, as well as to streamline the application and review process.

While the 1974 act and recent amendments provided greater authority to cities--compared to the categorical programs CDBG replaced--local discretion was somewhat limited because CDBG activities must address broad national statutory objectives. For instance, CDBG's primary objective is the development of viable urban communities by providing decent housing, a suitable living environment, and expanding economic opportunities--principally for persons of low and moderate income.

Communities assisted under CDBG can undertake a wide range of activities. These include (1) rehabilitating private properties, (2) acquiring and disposing of property, (3) improving streets, (4) fixing water and sewer facilities, and (5) building and servicing public parks, playgrounds, and other recreational facilities. In the most recently completed program year (1981) for which data is available, entitlement cities spent the greatest amount of CDBG funds--about 35 percent--for housing rehabilitation and related activities. During the same period, urban counties spent about 31 percent of their CDBG funds for housing rehabilitation and related activities.

[3]Urban Renewal, Model Cities, Water and Sewer Facilities, Open Spaces, Neighborhood Facilities, Rehabilitation Loans, and Public Facilities Loans.

Rental Rehabilitation
Demonstration Program

In the summer of 1981, HUD competitively selected 23 cities and counties to participate in its Rental Rehabilitation Demonstration Program. The purpose of the program is to encourage local governments to use CDBG funds for rehabilitating rental properties and to improve their ability to effectively and efficiently administer these activities. The demonstration provides a subsidy for property rehabilitation and Section 8 rent subsidy for eligible households residing at the time of rehabilitation but does not tie the tenant subsidy to the rehabilitated unit. This is a significant departure from previous HUD programs. In August 1982, an additional 176 applicants were selected for the program. Over 6,700 units will be rehabilitated using CDBG funds totaling $46 million.

OBJECTIVES, SCOPE, AND METHODOLOGY

The basic objective of this review was to respond to the questions asked by the chairman of the Senate Committee on Banking, Housing and Urban Affairs in his letter of November 10, 1982. (This letter is reproduced in app. II.) The chairman specifically requested that for those communities which have already developed rental rehabilitation programs under CDBG, we identify

--per unit rental rehabilitation costs,

--specific rehabilitation financing methods and results, and

--program beneficiaries.

The chairman stated that he was specifically interested in "high cost" cities because such data may be beneficial in considering a cost ceiling in any new legislative proposal.

Given the chairman's interests and the focus of the new rental production and rehabilitation programs introduced in 1982, we did not look at these local CDBG rental rehabilitation programs in terms of neighborhood revitalization, economic development, or other possible program goals. In its comments, HUD suggested that we clarify that local programs could legitimately have these other goals. In fact, most localities we studied told us that lower income renters were the major intended beneficiaries of their programs.

In our previous CDBG work,[4] we sent questionnaires to 531 entitlement cities and counties receiving CDBGs during the first

[4]"Block Grants for Housing: A Study of Local Experiences and Attitudes" (GAO/RCED-83-21, Dec. 13, 1982).

6 years of the program. These communities were queried on their housing activities. Of these, 424 cities and counties (80 percent) responded. One of the questions required the cities and counties to identify the types of housing activities done under CDBG. Of the 424 communities responding, 210 cities and counties (50 percent) reported that they were or had been using CDBG to rehabilitate investor-owned rental housing. Using the 210 figure as our starting point, we eliminated 74 cities and counties which reported that they had had assisted less than 100 renters[5] during the first 6 CDBG years because it was unlikely that these communities would have any extensive rental rehabilitation activities. We then interviewed, by telephone, housing officials in the remaining 136 communities. Through this method, we determined that 82 cities and counties had rehabilitated investor-owned rental units during the 3 CDBG years ended September 30, 1982. Appendix III identifies the 82 communities.

Between December 1982 and February 1983, we had each of the 82 cities and counties provide us with data about their rental rehabilitation programs, including financing methods used, who benefited, and type of rental dwelling. Seventy-three communities responded. Comparing respondents with non-respondents, we found no reason to believe that the non-respondents differed in any significant way from those who provided data. Therefore, results of our review could be expected to be representative of the entire CDBG Program. We did not verify the data received from communities but did make internal consistency checks to provide reasonable assurance that the data made sense.

During January 1983, we also visited 22 cities and counties. At these locations, we observed the communities' recordkeeping, obtained examples of rehabilitation activities, and observed some rental units which had been or were being rehabilitated using CDBG funds. We selected these 22 communities to provide balanced geographic coverage. The map on the following page shows the locations we visited.

Finally, we met with officials in HUD's Community Planning and Development Department and reviewed various documents, reports, and studies that we believed were pertinent to rental rehabilitation. Our review was made in accordance with generally accepted government auditing standards.

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[5]Renters could have been assisted by several alternatives, including rehabilitating rental units.

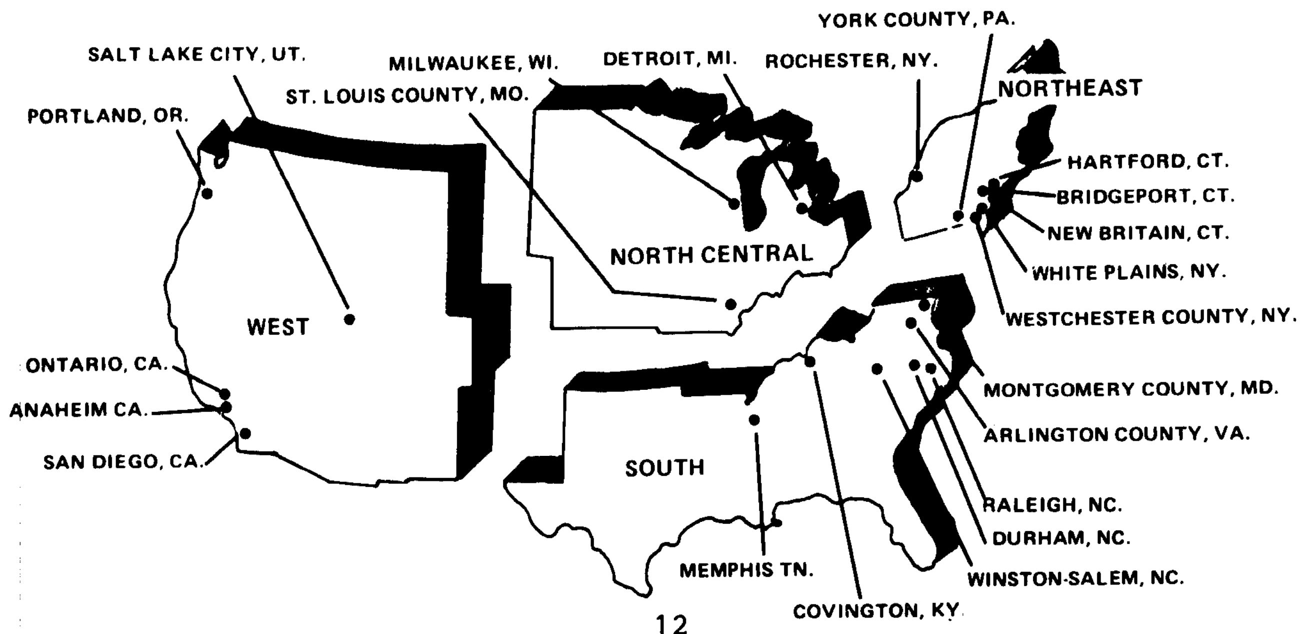
AGENCY COMMENTS AND OUR EVALUATION

HUD said that our report did not address the approach used by HUD's Rental Demonstration Program--subsidy for property rehabilitation and tenant are kept separate--to resolve the low-moderate benefit and displacement problems identified in the CDBG rehabilitation programs. Further, HUD said that the experience thus far with the new approach has been encouraging.

Although we considered evaluating HUD's Rental Demonstration Program, we did not do so even though several of the 82 communities were using CDBG funds to finance rental rehabilitation with and without the program, and three other communities--Atlanta, Georgia; Kansas City, Missouri; and Evanston, Illinois--were financing rental rehabilitation only through the demonstration program. We made this decision because few units had been completed at the time of our study and because the program was quite different from the CDBG Program in which communities design, implement, and evaluate rental rehabilitation programs without much Federal guidance. Under the demonstration program, HUD prescribed the rent and tenant conditions and how the program would be evaluated, whereas the programs being considered by the Congress appear to involve a much greater decisionmaking role by local governments.

HUD agreed that at the time of our study the demonstration program experience was not sufficiently developed to be used for analysis but that an extensive body of information is now available. However, we do not believe that sufficient time has passed to make judgments regarding the success of HUD's demonstration program.

FIGURE 5
LOCATION OF FIELD VISITS
(22 JURISDICTIONS)



CHAPTER 2

RENTAL REHABILITATION ACTIVITY IS CONCENTRATED

IN RELATIVELY FEW COMMUNITIES

Nationwide, low-income renters are experiencing serious problems in obtaining adequate and affordable housing. Nevertheless, under the CDBG Program, rental rehabilitation has taken a "back seat" to owner-occupied rehabilitation. Those communities doing rental rehabilitation under CDBG were primarily located in older areas in the Northeast and West and generally had little experience in designing, implementing, and evaluating rental rehabilitation programs.

CDBG COMMUNITIES EMPHASIZED HOMEOWNER ASSISTANCE, BUT RENTERS HAD THE GREATER NEED FOR ASSISTANCE

We reported in "Block Grants for Housing: A Study of Local Experiences and Attitudes" (Dec. 13, 1982) that communities have concentrated on helping homeowners even though they reported that renters have a greater need for assistance. Specifically, data provided by over 80 percent of the communities responding to our questions indicated that more renter households needed assistance and that more rental units needed rehabilitation. Nevertheless, even though the renter problem was substantially greater, communities reported that CDBG funding assisted more homeowners.

Renters had the greater need

Local officials responding to our November 1981 survey reported that renters had a much greater need for assistance than homeowners. They reported that about 3.9 million renter households were in need of housing assistance compared to only 1.2 million owner households. Thus, 225 percent more renter households needed housing assistance.

Likewise, local officials reported that substantially more rental units needed rehabilitation than owner-occupied units. About 1.7 million rental units were reported in substandard condition suitable for rehabilitation compared to 1.3 million homeowner units. Thus, 31 percent more rental units needed rehabilitation.

Homeowners were provided most of the assistance

Ninety-eight percent of the communities were financing rehabilitation of owner-occupied units with CDBG funds. In contrast, only 50 percent were financing investor-owned rental rehabilitation. In addition, the extent of renter assistance

was far less than the need. Forty-six percent of the communities reporting housing rental rehabilitation programs also reported that renters' needs were four times greater than homeowners'; however, only 11 percent of the communities were providing renter assistance at that level.

In commenting on our December 1982 report, HUD officials told us that when the CDBG Program began, communities initially emphasized homeowner assistance because their major housing experience had been under the Section 312 Program, which is a homeowner program. Communities expected to provide rental assistance through other Federal programs, particularly the Section 8 Program. While the Section 8 and Public Housing Programs do provide for rental rehabilitation, most of the funding is for assistance to unrehabilitated existing housing and new construction activities. These activities cannot effectively address the rental rehabilitation needs identified by local officials. According to HUD officials, homeowner assistance was likely to be more politically acceptable to locally elected officials making CDBG Program decisions. In commenting on this report, HUD officials said that recent HUD initiatives have tended to encourage communities to shift their emphasis on the use of CDBG funds to rental assistance. They also said that our findings showed the need for a separate program for rental rehabilitation as opposed to merely adding funds to CDBG.

LIMITED RECENT EXPERIENCE INDICATES A NEED FOR TECHNICAL ASSISTANCE

In our December report, we found that roughly 50 percent of CDBG entitlement communities assisted some investor-owned housing rehabilitation during the first 6 years of the CDBG entitlement program.

In spite of this apparently wide use of rental rehabilitation programs, our present work indicates that relatively few communities have helped rehabilitate more than 100 dwelling units during the past 3 years. Specifically, we estimate that only one-third of the communities with programs operative during the last 3 years assisted more than 100 units. As compared to the universe of approximately 650 entitlement cities, this means that only about 7 percent of entitlement communities have had significant recent experience.

This limited recent experience and other information we developed on the shortcomings of these local programs leads us to conclude that local capabilities to design, implement, and evaluate rental rehabilitation programs need further development. This suggests a need for Federal technical assistance during the early stages of implementation of any new legislation.

HUD officials told us that they agreed with our assessment and that they plan on providing such assistance in implementing either their new rental rehabilitation program or the program now being considered in the Senate which also addresses the technical assistance problem.

WHICH COMMUNITIES ARE FUNDING RENTAL REHABILITATION?

In comparing communities with and without CDBG-financed rental rehabilitation programs, it is apparent that certain community characteristics increased the likelihood that the community would have a program. Specifically, we found:

--Over 55 percent of the communities in the Northeast (53 of 95) and West (57 of 96) had rental rehabilitation programs. In contrast, less than 45 percent of North central (47 of 109) and Southern regions (52 of 117) had programs.

--Sixty-three percent of the communities with declining populations (105 of 167) had a rental rehabilitation program compared to only 42 percent of the communities with increased populations (103 of 248). Apparently, the degree of decline or increase made little difference since the participation rate was fairly uniform across the spectrum. We did note that only 26 percent of the communities with increases in population exceeding 40 percent (10 of 38) had a rental rehabilitation program.

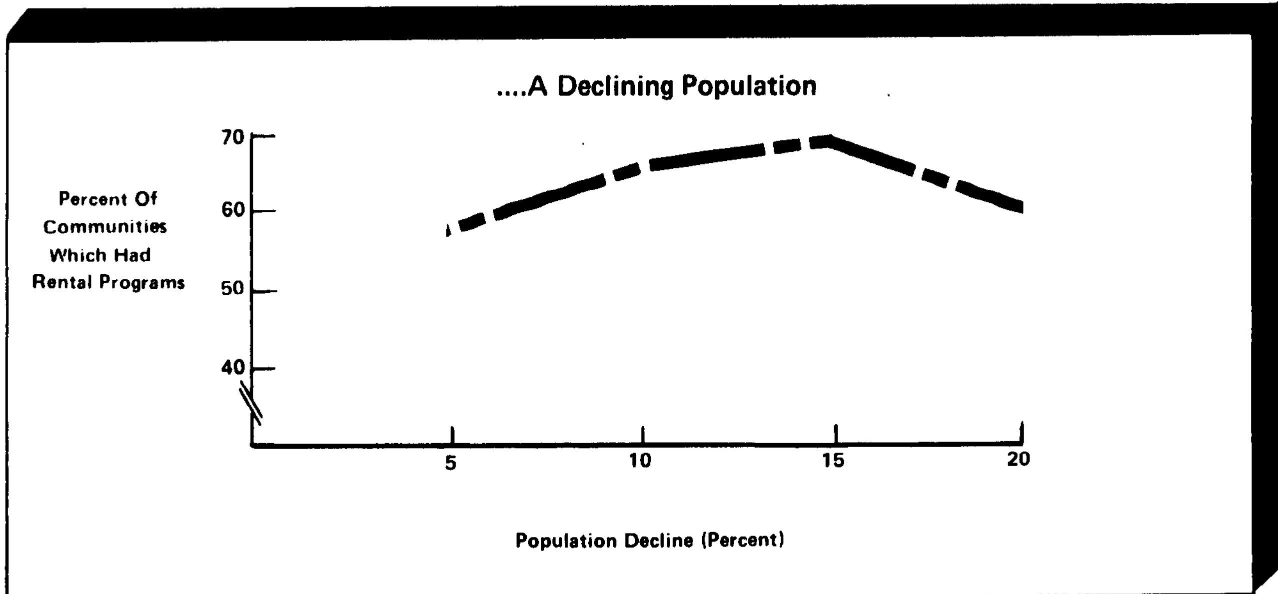
--Communities with rental rehabilitation programs had an average of 35 percent of their housing stock over 40 years old compared to 25 percent for those communities without such programs. In addition, 65 percent of the communities with over half their housing stock more than 40 years old reported having a rental rehabilitation program.

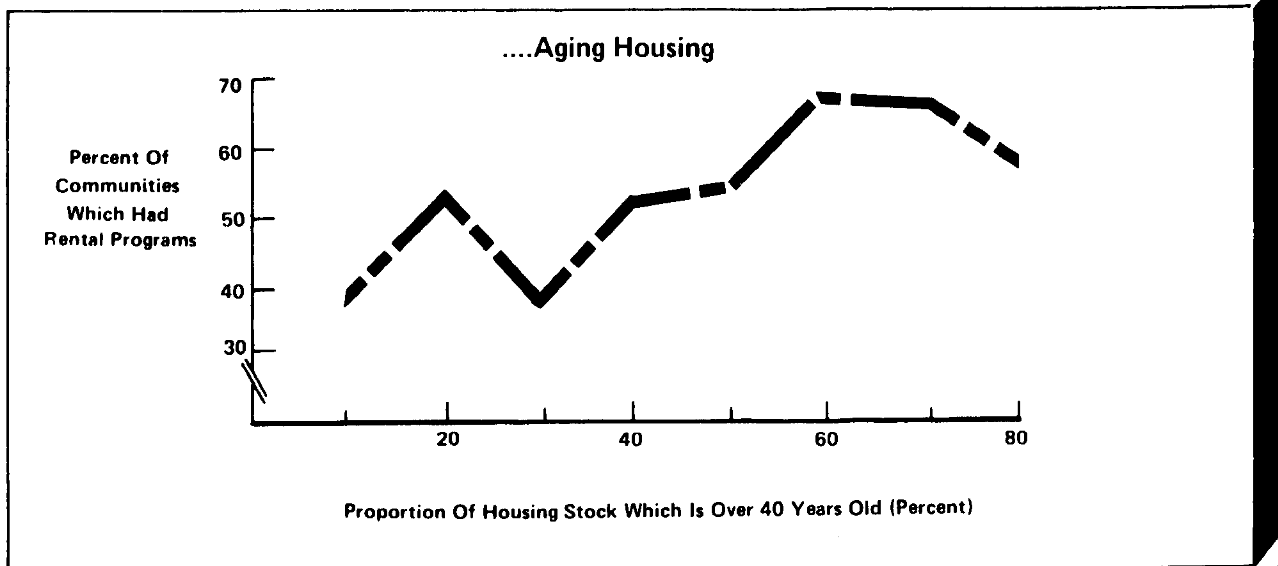
--Where substandard owner-occupied units were in the majority, most communities--60 percent--did not have a rental rehabilitation program. However, where substandard rental units outnumbered owner-occupied units, 62 percent of the communities had a rental rehabilitation program.

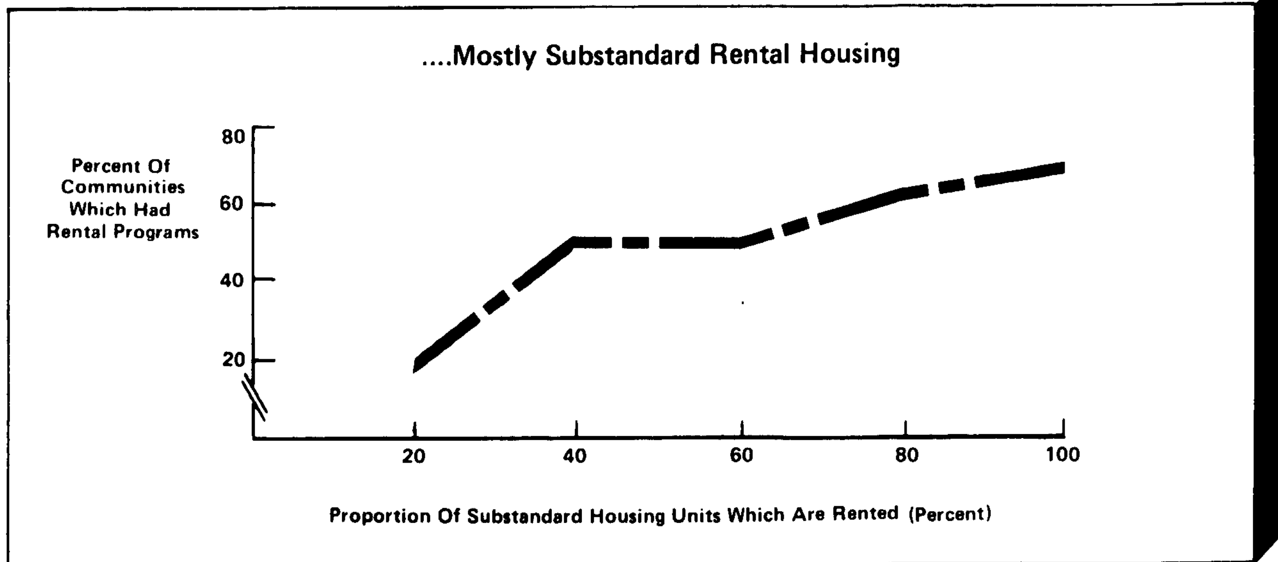
The following figures depict some of the characteristics of communities with rental rehabilitation programs.

FIGURE 6

COMMUNITIES WITH RENTAL REHABILITATION PROGRAMS ARE MORE LIKELY TO HAVE....







CHAPTER 3

RENTAL REHABILITATION COSTS

AND SUBSIDY MECHANISMS CAN CAUSE

SUBSTANTIAL RENT INCREASES

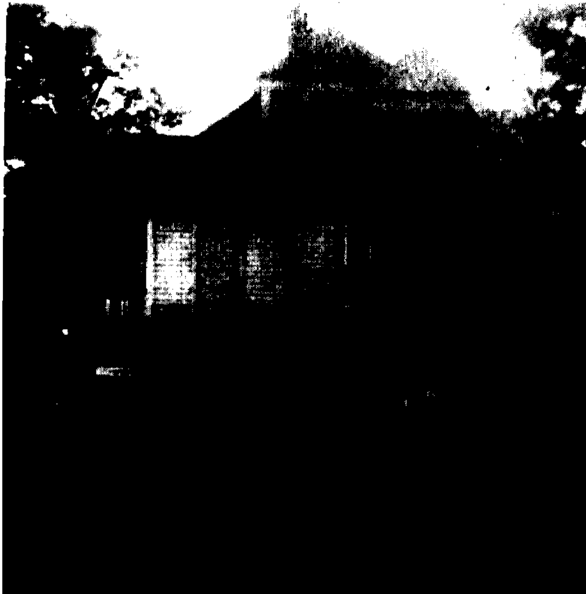
In this chapter and the next, we will report on the rental rehabilitation activities of 73 communities which had CDBG rental rehabilitation programs during the last 3 program years. Appendix IV provides selected data concerning the 73 communities. The main points to be made in this chapter are:

--Excluding two communities with exceptionally high per unit rehabilitation costs, average rehabilitation cost per unit was about $7,000 (the median for all cities was about $8,000). This figure could generally be reduced because it included improvements beyond those needed to eliminate substandard housing conditions and to preserve housing by extending the useful life of the housing unit. Nonessential repairs can increase rents unnecessarily.

--Most communities surveyed said their programs controlled rents after rehabilitation. Nevertheless, local officials questioned said that these controls allowed rent increases from 5 to 50 percent. While many reported not knowing the extent of the rent increases, most said that the rents allowed would be beyond the means of the low- and moderate-income households targeted by their localities. This could result in the displacement of many lower income households.

--Below-market interest rate partial and full loans were by far the most common subsidy mechanism used. In fact, almost half of the 73 communities were providing full loans. Using CDBG funds to make these loans as opposed to subsidizing interest rates on loans made by private institutions limits the number of units which can be rehabilitated in the short run and will increase tenant rents unless principal and interest payments are deferred.

--Few communities were tailoring their subsidies to particular housing units or projects; rather they used a standard subsidy formula, such as providing loans with fixed below-market interest rates, thereby increasing the local government's costs. Although subsidy in some localities may be tailored, in a sense, to overall market conditions, we believe variations within local markets will inevitably result in subsidies and rehabilitation expenses which are greater than necessary.



Source: City of Milwaukee's Department of Housing

Before **After**

A 2-unit substantial rehabilitation project costing $45,000. CDBG funds provided a $45,000 loan at 6 percent interest.

WHAT DOES RENTAL REHABILITATION COST?

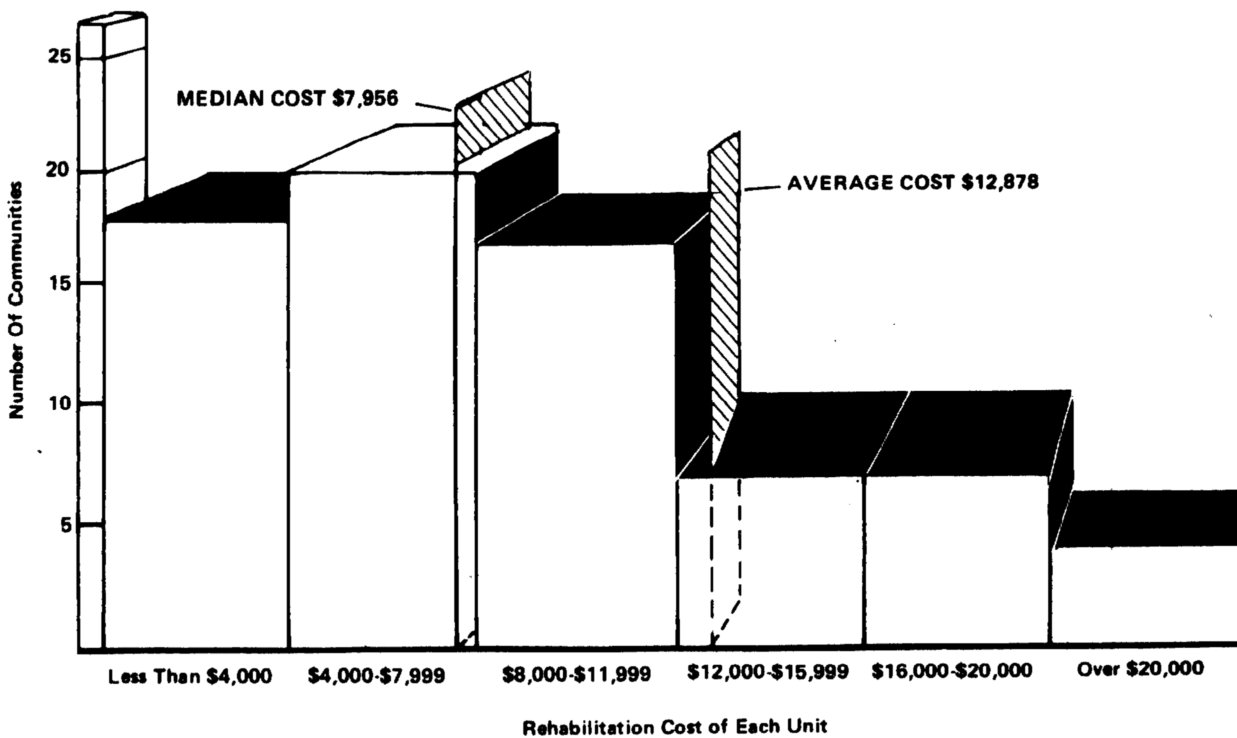
The average per-unit cost for CDBG rental rehabilitation was $12,873, with $5,432 being Federal dollars. However, New York and Chicago substantially affected this average, with an average per-unit rehabilitation cost of $16,571 and CDBG providing $6,523. Without these two communities, the average per-unit cost was $7,129, with $3,742 being Federal dollars. In addition, over half of the communities reported an average per-unit cost of less than $8,000. Included in these figures are repairs not needed to eliminate code violations and bring units up to standard condition. (Communities were not required by statute or regulations to restrict rental repairs to code violation conditions.) Therefore, it is likely that the Congress could set a maximum Federal dollar limit on per-unit rehabilitation costs without unduly hampering the flexibility of local governments to operate an effective program. Based on our review, we believe the program funding limit could be in the range of $5,000 with HUD being allowed the flexibility to make exceptions.

The cost of rental housing rehabilitation for units covered in our review of 73 communities totaled about $247 million for 19,239 housing units--$12,873 per unit. Costs varied from less than $1,000 per unit in Boston, Massachusetts, to over $25,000 per unit in Milwaukee, Wisconsin.

We believe much of the variation from community to community can be explained by the extent to which communities limited per-unit subsidies or loans and to the extent to which nonessential improvements were allowed. The following graph shows the community distribution of average rental rehabilitation costs.

FIGURE 7

AVERAGE REHABILITATION COSTS PER UNIT IN JURISDICTIONS STUDIED



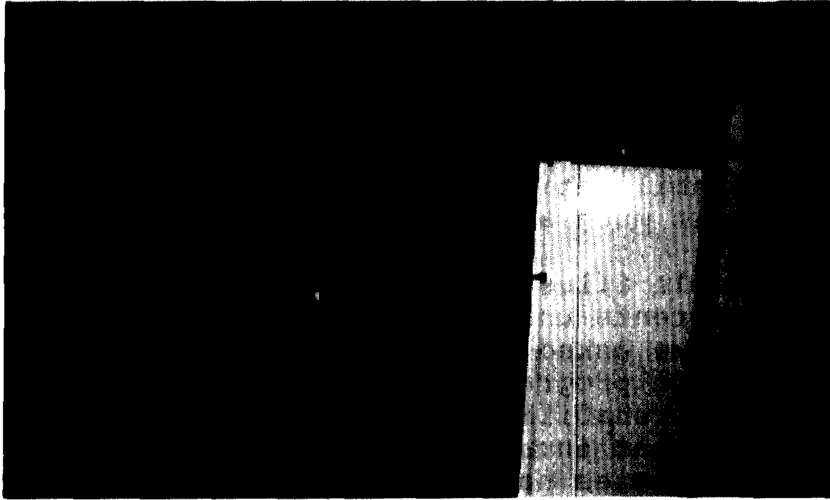
Forty-nine of 71 communities surveyed--69 percent--allowed improvements over and above those needed to correct code violations (2 were unknown), but only 2 communities said they funded rehabilitation without the presence of some code violations or substandard housing conditions.

To further explore the question of what level of rehabilitation expenditures are generally needed in a program of this kind without performing a very detailed and expensive field study, we asked the localities we visited what level of rehabilitation spending would be necessary to eliminate code violations in the majority of substandard rental units in their jurisdiction. Eleven of 22 said that the average cost would be $5,000 or less. Another seven said that $10,000 per unit or less would be sufficient, and one said that the cost would range from $10,000 to $20,000. (Photographs on the following page show rehabilitation being done by the latter community.) Three localities declined to answer. Comparing these estimates in each city to the actual amounts spent in each city showed that if programs were limited to code violations alone, rehabilitation costs could have been reduced an average of 51 percent below what was actually spent in 13 of the communities. Six of the communities estimated that correcting code violations would, in fact, cost more than the actual rehabilitation costs.

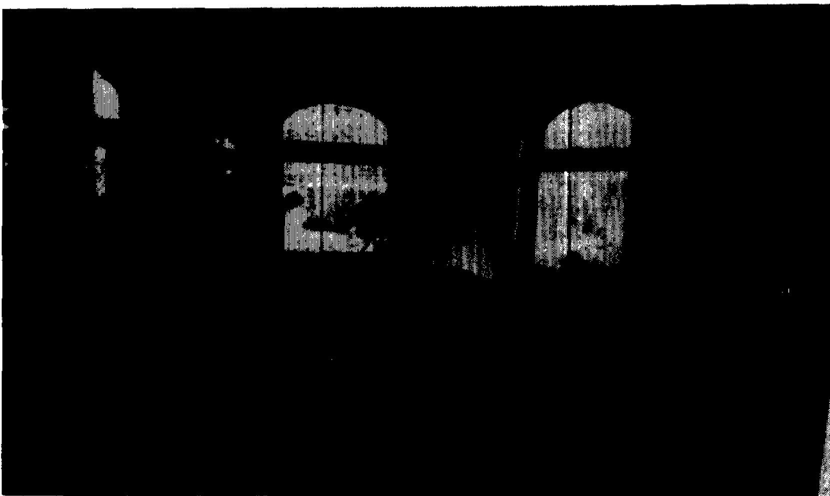
Additionally, 19 of the 22 communities said such a program was workable; however, 5 of the 19 had some reservations--fewer investors would be interested and the community would have less flexibility in addressing its housing needs.

WITHOUT COST CONTROL, HIGHER RENTS CAN DRIVE OUT LOWER INCOME HOUSEHOLDS

It is necessary to control rental rehabilitation costs to avoid pricing lower income households out of the rehabilitated housing because of increased rents. For example, the City of New Britain, Connecticut, Housing Department sent a housing inspector out to a proposed six-unit rehabilitation project site to determine what code violations existed. The inspector noted that two units had faulty kitchen plumbing and fixtures and various other problems; for several reasons, the inspector could not assess the remaining units' problems. In the two units he visited, he did not cite any bathroom fixture or plumbing problems. However, the subsequent rehabilitation work performed included replacing the bathroom fixtures and kitchen and pantry floor coverings in three of the units. The total cost for this work was over $6,800, or 19 percent of the total rehabilitation cost. When we inquired about this example, the program



A 24-unit structure rehabilitated for $405,000 using a CDBG-financed loan at 3 percent for 20 years.



Source: City of Detroit's Department of Housing

administrator said that the investor-owner had requested the general improvements as part of the rehabilitation work and that the city had incorporated it into the work scope. The official also stated that post-rehabilitation rents increased 36 percent. The contractual rent control agreement between the owner and the city's rehabilitation department would have permitted rents to increase as much as 47 percent.

What the example illustrates is that higher rehabilitation costs imply higher rents unless rents are directly or indirectly constrained. When we asked a sample of 22 communities with rental rehabilitation programs, all but one said that rents increased following rehabilitation. Those who responded provided estimates of rent increases ranging from 5 to 50 percent. Nine of these communities had no specific knowledge of how much rents increased after rehabilitation was completed.

In our larger sample of 73 communities having rental rehabilitation programs, over 60 percent (45 of 73) had some form of rent constraint. The most prevalent method was to limit post-rehabilitation rents to HUD's fair market rents, which are benchmarks set for wide market areas and which assume standard quality housing.

Using this form of rent restraint, however, does not mean that the rehabilitated housing is affordable by lower income households. We asked representatives of the 22 communities we visited whether lower income households targeted by their programs could afford section 8 market rents without additional assistance. Over 80 percent (18 of 22) said that lower income households in their jurisdictions probably could not afford the local fair market rents without additional assistance.

New York City, which we did not visit, reported controlling rents on rehabilitated units and had rehabilitation costs substantially above average. The city reported in the seventh-year Housing Assistance Plan that "In <u>some</u> cases this [below-market interest rate mortgage] can then <u>be carried</u> by rents that <u>some</u> families with moderate-income <u>can afford</u>." (Underlining provided by GAO.) The assistant to the Assistant Commissioner of New York's Department of Housing Preservation and Development said that lower income households generally cannot afford the current established fair market rents for the city.

Information on displacement not available

We attempted to discover whether rent increases after rehabilitation were adversely affecting the original tenants of assisted housing units, but the absence of adequate before-and-after rehabilitation data on tenant incomes made this impossible. However, San Diego was tracking how many tenants moved from their apartments after property rehabilitation. This city's data showed that the average rent went up 26 percent

following rehabilitation and that within 2 years almost 60 percent of the affected tenants subsequently vacated their apartments. The community did not determine if the new tenants were economically better off than the tenants who moved.

WHY REHABILITATION SUBSIDIES MAY BE NEEDED

Rental rehabilitation subsidies can take many forms, but if they are not merely to substitute for private investment, they must somehow encourage investors to do what they would not otherwise have done--to remove blight or bring substandard rental housing to standard condition for the benefit of lower income households. In providing subsidies, it is in a local community's best interest to minimize the subsidy required, both from a political standpoint--avoiding windfalls to investors--and from a programmatic standpoint--"getting more bang for the buck."

Subsidies to rental property can be either grants or loans calculated either to reduce the principal amount of a loan or to reduce the interest payable on it. Grants may have specific conditions tied to them, i.e., that rents remain constant for several years. Loans may carry similar conditions plus the characteristics of all debt: they are repayable--either at market interest rate, below-market interest, or no interest--and are either continuously repaid or due at some point in time. A further discussion of the advantages and disadvatages of different types of subsidy mechanisms is included in appendix V.

Without subsidies, private investors will spend money to rehabilitate rental property only if the return on investment after rehabilitation justifies the additional investment (which implies higher rents). Unfortunately, many low- and moderate-income households cannot easily afford their present rents, let alone those needed to provide adequate investment returns to support renovation of the housing they occupy. Rent levels are now rising more rapidly than in the past, and recent tax law changes are encouraging the purchase of existing rental housing, which is likely to add further upward pressure on rents without necessarily improving substandard units.

LOW INTEREST LOANS WERE THE PRIMARY SUBSIDY MECHANISM USED

Low-interest loans were by far the most common subsidy mechanism and were used by 45 of the 73 communities. The remaining communities were using grants and interest subsidy payments.

Low interest loans provide a continuing source of funding for future rehabilitation work--as loans are repaid, the "recaptured" funds are loaned out again. Nevertheless, they have several disadvantages: fewer units can be rehabilitated in

the short term and repaid funds are worth less because of inflation.

In analyzing the financing mechanisms used, we noted that average per-unit rehabilitation costs were substantially higher when loans were used in contrast with grants and interest subsidy payments. The 45 communities using loans which were fully or partially funded by the CDBG Program to finance rehabilitation programs had a median cost per unit of about $10,600 and ranged from $1,867 to $27,000. In contrast, when grants and interest subsidy payments were used, the median cost was $7,400 and $5,264 per unit, respectively.

Thus, it is possible without considering the extent of rehabilitation work needed that communities are asserting more control over rehabilitation costs when a grant-type subsidy is used because of the concern about community reaction to so-called giveaway programs. In contrast, communities may believe they should have less control over costs when a loan program is used because the investor pays back the loan. In our discussions with HUD officials, they stated that a possible reason for the difference is that the subsidy is more visible with grants than with loans and thus tends to induce greater care in managing the public funds.

INFLEXIBLE SUBSIDY MECHANISMS CAN INCREASE COSTS AND RENTS

Few communities were providing flexible financing based on the individual project. The results may be higher rents and additional governmental subsidies. In addition, most communities appear to be leveraging CDBG funds, which may or may not be a problem.

Few communities tailor their subsidies

We noted that program costs may be greater than necessary to induce landlord participation because most of the localities (61 of 73) we surveyed do not tailor the subsidy amount to the particular project being rehabilitated. Instead, they typically use a set subsidy formula or dollar amount which may be greater than necessary. Without taking into consideration the project's economics, fixed subsidies may provide windfalls to investors and reduce the number of units rehabilitated.

To illustrate, Memphis, Tennessee, provided full loans at 3 percent for 20 years to investors and spent CDBG funds totaling $5.3 million to rehabilitate 297 rental units. (It is unlikely that each investor needed this deep a subsidy to rehabilitate rental housing.) In contrast, Montgomery County, Maryland, provided full and partial loans at interest rates of 0 to 11.5 percent and spent $1.1 million to rehabilitate 215 rental units. The Director of the Montgomery County Housing and Community Development Department stated that the department provided only

the subsidy necessary to get the individual investor to do the rehabilitation work.

Leveraging--advantage or problem?

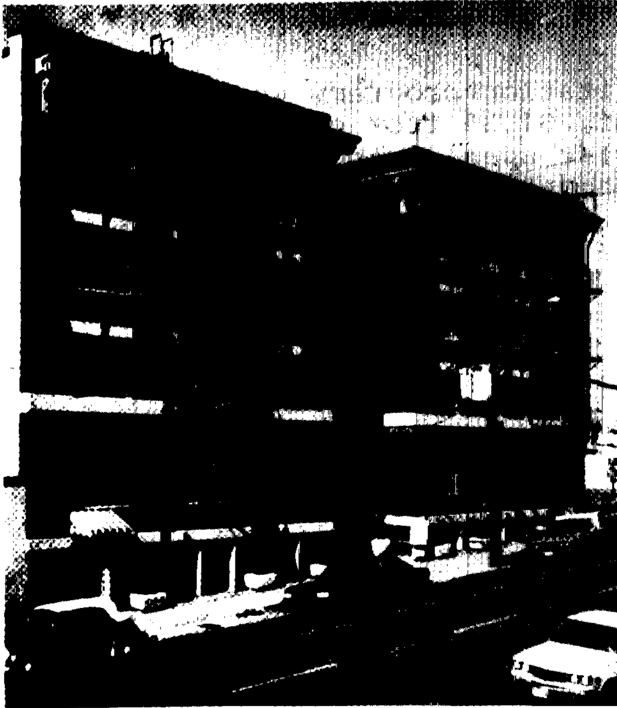
Overall, CDBG rental rehabilitation programs were leveraging, or inducing the investment of, $1.35 from other-than-Federal sources for each CDBG dollar spent. About 30 percent of the communities were not leveraging any additional funds because the finance mechanism used was full loans. Full loans have the distinction of being costly to the local government in the short run and driving up rents to a greater extent than grants or other methods, even though loans are recoverable.

Interest subsidy payments provided the greatest leveraging

Leveraging is generally considered a strength of block grant programs. Therefore, we asked communities to identify sources of funds used with CDBG funds.

The communities reported that non-CDBG sources (almost all were private funds) provided $143 million to rehabilitate 19,239 units, while CDBG provided $106 million, thereby leveraging $1.35 for every CDBG dollar. In comparing subsidy mechanisms, we noted that interest subsidy payments provided the best leveraging--over 150 percent better than loans and about 96 percent better than grants. Data provided by one community clearly showed the leveraging difference between financing techniques. During the first 2 years covered by our study, the community provided a partial grant financed with CDBG funds. The average per-unit cost was $9,213 with CDBG providing $2,303 (25 percent). In the third year, the community switched to an interest subsidy payment technique, and even though the average per-unit cost went up to $9,936, CDBG provided only $900--9 percent.

Looking at the leveraging data exclusive of full loans showed that communities obtained $1.60 for each CDBG dollar spent. However, about 30 percent of the communities were providing full loans, thus financing all the rental rehabilitation work and providing no leveraging. Such financing mechanisms provided maximum returnable funds but required substantial CDBG funds. For instance, New London, Connecticut, using full loans financed with CDBG funds totaling $2.7 million, rehabilitated 224 units, while Anaheim, California, spent CDBG funds totaling $541,000 to rehabilitate 301 units. The first community's average per-unit rehabilitation costs were two times higher, but the amount of CDBG funds used was almost seven times higher--$12,266 versus $1,797. Rental units rehabilitated using leveraged loan financing are shown on the following page.



NUMBER OF UNITS: 53
PROJECT COST: $200,000
PROJECT FEATURES: Boiler repair, new windows and doors, interior painting and remodeling, roof repairs. Minimum code and general property improvements were made to an old, brick apartment building to improve its energy efficiency and fire/life safety systems.

FINANCING:	Amount	Rate	Term
Bank of California	$100,000	16%	15 years
Portland Development Commission	$100,000	3%	15 years

Source: Portland, Oregon's Development Commission

NUMBER OF UNITS: 46
PROJECT COST:
PURCHASE: $138,000
REHABILITATION: $573,593
TOTAL: $711,593
PROJECT FEATURES: Substantial rehabilitation of a vacant fire-damaged building into 46 units of new housing. New roof structure incorporated additional living units.

FINANCING:	Amount	Rate	Term
Charter First Mortgage/ Standard Insurance Co.	$400,000	10.5%	20 years
Portland Development Commission	$250,000	3%	20 years
Owner Cash Investment	$ 61,593		

The leveraging dilemma

Leveraged rehabilitation requires a return on the investor's investment which is likely to be passed on in rent increases. However, these rent increases may displace lower income households, thus creating a dilemma. The Government wants to decrease the amount of CDBG funds used on any one project but it also wants to stabilize rents to prevent displacement.

It is possible to moderate rent increases by providing grants instead of loans; however, grants have the stigma of a "giveaway" program. In fact, we noted some communities which called their grants interest subsidy payments to avoid the grant stigma. Nevertheless, it is possible to combine the advantages of both grants and loans into one subsidy mechanism--deferred loans. Deferred loans are loans which will be paid off some time in the future, such as when the property is sold. Such loans would not affect the property's cash flow, and thus rents would not have to be increased. The loans, therefore, act very much like grants, but unlike grants, the funds have to be paid back. Only four communities were providing deferred loan financing and two of the four provided only one deferred loan.

CONCLUSIONS

As noted, communities had several reasons for rehabilitating rental housing and these reasons could conflict. Nevertheless, if the primary purpose of a rental rehabilitation program is to provide housing to lower income households, then cost will have to be controlled or rent subsidies provided permanently for the rehabilitated unit.

This chapter has shown that it is quite likely that rehabilitation costs are greater than necessary to correct housing deficiencies, that they may be resulting in significant rent increases, and that the form of rent restraint being used is ineffective in making rehabilitated housing affordable by lower income households. Without some explicit agreement on the part of landlords, nothing precludes them from increasing rents to recover the costs of improvements which were actually paid for with Government subsidies.

AGENCY COMMENTS AND OUR EVALUATION

HUD believes that costs and rents can be effectively controlled if the underlying forces of the "marketplace" are used rather than rent restraints and that its approach would therefore be less burdensome. Further, HUD officials told us that this marketplace approach is part of their present Rental Demonstration Program and the proposed Senate housing bill. While we did not evaluate either the HUD Rental Rehabilitation Demonstration Program or the present Senate bill, we believe

that either alternative could result in the creation of high quality rental housing, but that an approach which incorporates cost controls and beneficiary targeting is more likely to result in affordable units for lower income households without direct Federal tenant subsidies. Regardless of whether the Congress makes tenant subsidies available as in the HUD demonstration program, we believe the Committee should consider the option of providing more explicit cost control and benefit targeting mechanisms for any new rental rehabilitation program. The details of our reasoning are included below.

Rent restraints and income targeting

HUD noted that we found a relatively uniform program design--rent regulation was generally included by most communities to help assure low- and moderate-income benefit. The approach was uniformly taken even though we concluded that the method was not successful in assuring housing for low- and very low-income tenants.

HUD believes, however, that if the administration and the Congress wish to introduce a new approach not dependent on rent controls, then at least two additional elements are necessary. First, rental subsidy funds (housing payment certificates) should be allocated to local and State governments in a manner and with appropriate regulations which permit local and State governments to coordinate separate rental subsidies to work with their rehabilitation subsidy funds. Second, the national program should have some rules designed to assure implementation of the non-rent-control concept.

HUD noted that the administration's rental rehabilitation proposal, the Senate committee bill, and the Department's demonstration program all include these two elements. Section 8 certificates are made available to aid low-income tenants and protect their occupancy, and local and State governments would be prohibited from creating project rent restrictions as a part of their rental rehabilitation programs. HUD also stated that provisions are now included in the Senate committee and administration bills to assure that rehabilitation takes place in buildings which will be affordable by low- and moderate-income persons with section 8 certificates provided, thereby assuring a high degree of low- and moderate-income benefit, including benefit for very low-income tenants.

Our research indicated that the most frequently used rent restraint, which limited post-rehabilitation rents to HUD's fair market rents, could allow rents to rise to levels which are generally not affordable by lower income households. Furthermore, allowing unneeded rehabilitation improvements could in turn raise rents more than necessary and price lower income households out of subsidized units. Finally, local CDBG rental rehabilitation programs we studied usually did not explicitly require landlords to rent to lower income households or to

certify that they were doing so. Our view is that the lack of cost controls and enforceable income eligibility requirements are more likely to cause poor income targeting, and we found strong evidence of this possibility in our review. Additionally, HUD's method of supplying section 8 certificates to rehabilitated units, which implies the use of fair market rents, may in effect result in placing essentially the same rent cap after rehabilitation, as that used in local CDBG programs.

Combining two subsidies--rental rehabilitation and section 8 existing subsidies (to the present tenants of rehabilitated units)--will assure that at least initially, most tenants will have low or moderate incomes and that displacement will be minimal. What is more important, however, is that the affordability of units by lower income households be maintained in the longer term, particularly for those households that do not have section 8 rent certificates available. If affordability is substantially degraded by over-improvement, the impact of a rehabilitation program could be a reduction in the stock of rental units available to lower income households. Also, cost controls on rehabilitation expenses would help limit the cost of direct tenant subsidies if, as contemplated, section 8 certificates are provided to households residing in rehabilitated units.

HUD also believes that unless the rent restrictions are applied for a long period of time, there would be widespread displacement when rents increase after termination of short-term rent restrictions and that the administrative arrangements for such a system would be extensive.

It is clear that under any approach used, (1) elimination of controls on rents or tenancy must eventually occur unless subsidies are periodically renewed and (2) upon elimination, displacement is likely. If HUD's approach is ineffective, substantial displacement of lower income households could occur in just a few months or years after rehabilitation, as households with certificates move on. With more explicit income targeting, the probability of displacement could be greatly reduced. Since most communities were using rent restraint and believed that rent restraint was necessary, we concluded that the restraints very likely were not considered burdensome by local governments.

HUD comments on cost controls and excessive rehabilitation expenses

HUD agreed that rehabilitation costs should be constrained in order to maximize program benefits but believed that a specific cost level could be arbitrary and might be too low to support modest rehabilitation, correcting all code deficiencies in all circumstances. HUD asserted that the rigidities, artificialities, and expense of enforcing such a limit would be very great. More importantly, HUD said that its experience with the rental rehabilitation approach contained in the administration

proposal and the Senate committee bill indicates that arbitrary national limits are not necessary. Although we believe a limit is desirable, we agree that some flexibility should be allowed and have altered our proposal to acknowledge this need for flexibility.

According to HUD, rehabilitation under its approach would be targeted to low-income areas with modest free market rents falling within the section 8 rent limits. The rehabilitation subsidy is then a leveraged public expenditure of not more than half the cost of the rehabilitation. HUD reasoned that the inducement for part of the money to be borrowed at market rates which then must be amortized within the low rent levels possible under the program, creates one effective economic limit on the amount of rehabilitation. Further, localities in the demonstration program appear to have a reasonable incentive to minimize rehabilitation costs and generally use local codes and section 8 housing quality standards as the program rehabilitation standards. The average rehabilitation cost thus far in the demonstration program is in the range of $10,000-$12,000 per unit, with less than $5,000 per-unit subsidy. HUD believed that allowing flexibility to local administrators would greatly outweigh any benefits which could be achieved by imposing what HUD characterized as burdensome and arbitrary national limitations on the cost of rehabilitation.

While one can debate the level of expenditure which should be allowed, of greater importance is the fact that cost must be controlled if lower income households are to be able to afford rehabilitated housing. Using the "marketplace" to control costs does not assure affordable housing for lower income households unless additional tenant subsidies are provided. Rents may vary considerably in a given neighborhood, and landlords will generally attempt to rehabilitate up to the maximum rent increase which can be supported. In many communities rents are more affected by the quality of housing than by market-wide rent levels, meaning that upgrading housing could attract higher income tenants to individual projects.

The Senate rental rehabilitation bill (S.1338) sets forth guidelines to be used when communities finance moderate rather than substantial rehabilitation. The guidelines are much more stringent for substantial rehabilitation in order to assure that substantial rehabilitation is done only when communities cannot develop moderate rehabilitation projects. Likewise, we believe that the Congress could provide additional guidelines, through cost limits and limitations on general property improvements, which would explicitly define the type of rental rehabilitation to be subsidized.

HUD argues that private financing will actually serve as a barrier to unnecessary improvements. But under the HUD demonstration program, rehabilitation expenses are actually higher (thus far) than in most CDBG-funded programs--$10,000 to

$12,000 in improvements with about half being funded by CDBG. At current interest rates these figures imply average rent increases of at least $85 to $120 per unit per month to provide a return on the private contribution and $170 to $205 per month if property owners attempt to capture the benefit of the subsidy. Rent increases could be even higher where initial rents are very low and market conditions will permit such increases.

MATTERS FOR CONSIDERATION BY THE COMMITTEE

Regardless of whether a new program for rental rehabilitation provides direct tenant subsidies as in HUD's demonstration program, we believe the Committee should consider the option of including explicit cost controls such as:

--Placing an overall dollar limit on the per-unit rehabilitation funding provided by the program. HUD could be empowered to make exceptions in cities where it was specifically justified. We believe a reasonable limit would be in the range of $5,000 per unit.

--Limiting Federal rehabilitation expenditures to generally those necessary to correct substandard conditions or repair major systems in danger of failure, thus extending the useful life of housing units. HUD could define substandard on a national basis using generally accepted measures for the Census or Annual Housing Survey and provide further guidelines limiting other property improvements funded to some small percentage of total funding.

--Requiring communities to enter into agreements with landlords restraining rents in subsidized units for some period of time to the lower of (1) rents affordable by the program's lower income beneficiaries (without additional rent subsidies) or (2) rents necessary to cover increases in debt service and owner equity.

With these cost controls explicitly stated, localities would be able to tailor their subsidies to that amount needed to correct substandard conditions while assuring that rehabilitated units would be affordable by a substantial number of those households with incomes which would qualify them for Federal housing assistance under section 8. As a practical matter, rents would need to be affordable by households well below the income cutoff for program eligibility to be meaningful. For example, if a program were designed for and targeted to households below 80 percent of area median income, then to be workable for households without additional tenant subsidies, the rents should be affordable by a substantial proportion of households with incomes below 80 percent of median. This could be done by requiring that the rents be affordable for households at 50 percent of area median income.

CHAPTER 4

COMMUNITIES DID NOT KNOW IF LOWER INCOME HOUSEHOLDS WERE BEING ASSISTED

Have local communities been able to deliver assistance to the needy? This is an important question because a housing program that does not provide assistance to its targeted beneficiaries can be considered a failure. Quite simply, the assistance may go to someone without a need, while the intended recipient is still in need.

Unfortunately, this important question is not easy to answer for the rental rehabilitation program in local communities because most did not know who was being assisted. This leads us to believe that communities were stressing rehabilitation and placing less priority on targeting and tracking benefits to lower income people. Requiring program managers to demonstrate program effectiveness would go a long way toward enhancing program accountability.

TARGETING TO MEET PROGRAM OBJECTIVES

A primary objective of the CDBG Program is to develop viable urban communities by providing decent housing and a suitable living environment, principally for persons of low and moderate income. With this in mind, communities were to "target" housing rehabilitation programs to meet the needs of low- and moderate-income families. Nevertheless, communities were allowed to and did target rental rehabilitation to remove blight and stabilize neighborhoods, which only indirectly affected lower income renter households.

By varying eligibility requirements, funding mechanisms and levels, and scope of rehabilitation work, communities can target their programs to different types and numbers of beneficiaries. For example, if a city's strategy is intended to reach the lowest income tenant households, a program mix which emphasizes grants or deferred payment loans to investors is likely to attain that objective. Alternatively, if the expressed strategy is to rehabilitate the largest number of housing units in the shortest period of time, an interest subsidy loan program, under which funds are supplied by private lenders and only the interest portion is subsidized with block grant funds, would extend those public funds to the widest populations.

CDBG communities were using several targeting mechanisms

The 73 communities which provided us with program data were using several types of targeting mechanisms for their CDBG rental rehabilitation programs. In fact, all of these communities

were using at least one targeting criterion, with most using several criteria in combination. The criteria being used were:

--Housing had to be in such violation of the city's housing code that it was considered to be substandard.

--Housing had to be located in low-income neighborhoods designated for community development.

--The investor in the housing had to agree to restrict rents for a period of time.

--The investor had to agree to rent to low- and moderate-income households.

The following table identifies how many communities were using each targeting criterion.

Targeting criteria	Number of communities	Percent
Substandard (A)	1	1.4
Low-income areas (B)	3	4.1
Restricted rents (C)	1	1.4
Restricted to low- and moderate-income tenants (D)	0	-
Combination of A, B, C, and D	18	24.7
Combination of A, B, and C	18	23.3
Combination of A and B	21	28.8
Combination of A, C, and D	6	8.2
Other combinations	5	8.2
Total	73	100.1

These targeting methods do not necessarily work

Over 86 percent of the communities were targeting their rental rehabilitation programs to lower income neighborhoods. Although neighborhood selection is a key factor in determining where a community should invest its rehabilitation funds, that factor cannot by itself assure housing for lower income households. According to a June 1980 report by the National Citizens' Monitoring Project on Community Development Block Grants,

"geographic targeting does not by itself ensure that the * * * units rehabilitated will be * * * rented by lower income persons, even though they may be located in an area with a majority of low- and moderate-income residents."

The above statement was supported by several examples noted in our review concerning communities which were targeting to code-violation housing located in low-income neighborhoods.

--In the last 3 years New York City rehabilitated 8,800 rental units--three time more than any other community. According to its proposed Housing Assistance Plan, New York plans to rehabilitate 2,275 units and reported that it is unlikely that many lower income households will be assisted by the city's rental rehabilitation program.

--San Diego reported that 148 rental units were rehabilitated in the last program year. Prior to the rental units being rehabilitated, 102 units (69 percent) were occupied by middle- and upper-income households. The city did not identify who was occupying the rental units after rehabilitation. No tenant subsidies were provided.

--Chicago reported rehabilitating 801 rental units during the last program year. Fifty-six percent of the units were occupied by middle-income households before rehabilitation. Chicago, like San Diego, did not know who was occupying the rehabilitated units. No tenant subsidies were provided.

WHO IS OCCUPYING THE REHABILITATED RENTAL UNITS?

Communities were unable to provide income data on 92 percent of the tenants occupying rehabilitated units. Of the remaining 8 percent, over two-thirds of the data was obtained only after we requested it. The communities had not previously compiled this data. It should be noted, however, that communities were not required by statute or regulation to keep tenant demographics.

Communities reported rehabilitating 19,239 rental units but provided tenant income data on only 1,613 of them. The communities provided numerous reasons for not collecting the data, including that

--landlords or tenants refused to cooperate,

--data was too costly to collect, and

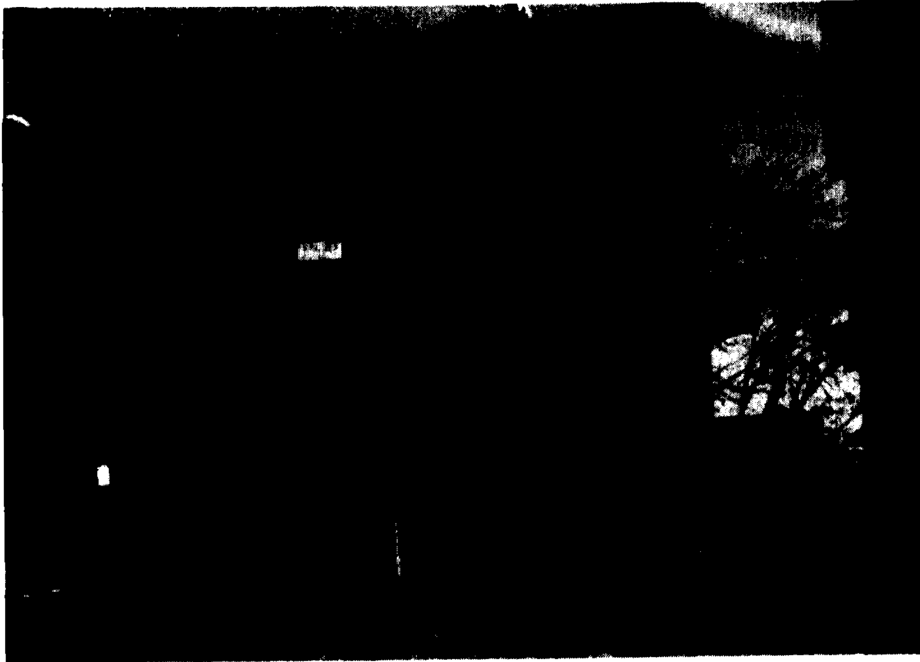
--it was not necessary because housing is located in lower income neighborhoods.

Only 22 of the 73 communities we surveyed (30 percent) were able to provide any statistics on the incomes of households occupying rehabilitated housing. Twelve of these 22 had programs tied to HUD's Section 8 Program which explicitly requires landlords to certify income and collect demographic data. Only 10 (14 percent) of the communities had income and demographic data independent of the Section 8 Program. (The photographs on the following page show a section 8 rehabilitation project.)

According to the demographic data provided, most rehabilitated units are occupied by lower income households, small families, and non-minority households. However, we do not believe the results are statistically projectable to the entire universe of 19,239 rental units since most of the tenant demographics (67 percent) were section 8 beneficiaries. Section 8 units represented only 7 percent of the 19,239 units. Additionally, we are not aware of any study which has specifically identified tenant beneficiary data on CDBG-financed rental rehabilitation and could be cited as supporting the data obtained on the 1,600 units. The following data shows all the tenant demographics we were able to compile on the rental units rehabilitated.

Tenant Demographics Provided by the Surveyed Communities

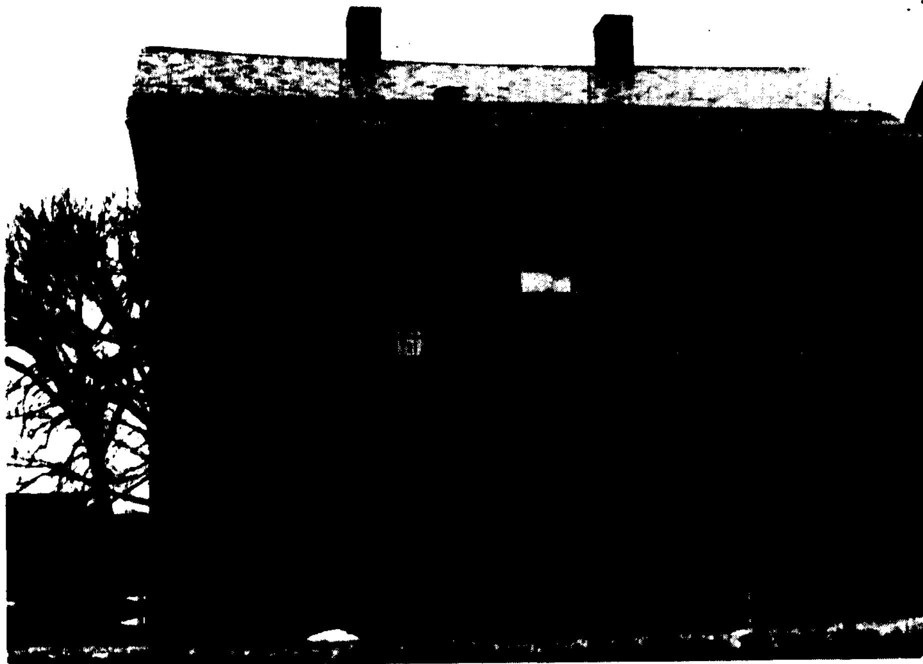
	Section 8	Percent	Non-section 8	Percent	Total
Income					
Lower	1,004	93	491	92	1,495
Middle/upper	78	7	40	8	118
Total	1,082	100	531	100	1,613
Family size					
Elderly	125	13	60	12	185
Small (1-4)	773	78	398	81	1,171
Large (5 or more)	88	9	35	7	123
Total	986	100	493	100	1,479
Minority status					
Minority	520	50	223	45	743
Non-minority	513	50	269	55	782
Total	1,033	100	492	100	1,525



Before

A 16-unit structure rehabilitation for $487,000 under the Section 8 Moderate Rehabilitation Program. Financing was provided by a CDBG loan of $152,000 at 1 percent; private financed loan of $160,000 at 11½ percent; and owners' contribution of $175,000.

After



Source: City of Hartford's Department of Housing

A few examples will help illustrate the difficulty of establishing how effective income targeting has been under these local programs.

- --One community rehabilitated over 700 rental units and had no data on the tenants occupying these units. The local program administrator believed that keeping such data would create an administrative burden, that tenants and investors would not want to comply, and that the location of projects in low- and moderate-income areas was an adequate targeting mechanism. He admitted, however, that there were "pockets" of middle-income households in these neighborhoods.

- --Even when rental rehabilitation programs were tied to the Section 8 Program, which requires tenant income certification, several communities did not compile or maintain the available demographic statistics.

- --Several communities explicitly required landlords to rent to low- and moderate-income tenants as a condition of receiving the subsidy, yet these communities still did not obtain tenant income data to verify contract compliance. For example, Chicago assisted the rehabilitation of 2,843 rental units with the stipulation that landlords rent at least 20 percent of their units to low- and moderate-income tenants. Tenant income data was not collected and the community representative could provide no rationale for not monitoring landlord compliance.

STRENGTHENING ACCOUNTABILITY CAN IMPROVE PROGRAM EFFECTIVENESS

The issue of how scarce resources should be allocated is always important but even more so in these days of large Federal budget deficits and economic hard times. Program evaluation is one of the key tools in making effective allocations because it allows a community to determine what has been done. Nevertheless, program evaluation has been relegated to a minor role in these local rental rehabilitation programs. Program evaluation has to be an integral program component if Federal or local governments are to have information necessary to manage their programs and for the Congress to exercise its oversight responsibilities.

We believe that when records are kept in varying formats and at varying levels of detail, it is extremely expensive and time consuming to aggregate and analyze the data on a national basis. Indeed, it may well be impossible to do so except through a separate study.

Communities can continue to assert that they are assisting lower income households as long as they are not required to provide adequate documentation about the tenants occupying the

rehabilitated rental unit. It is our view that program evaluation is a fundamental part of effective program administration and that the responsibility for evaluations should rest initially upon the responsible local governments. If the Congress wishes to have comparative data on how programs are working, it must specify the most important information needed for national oversight.

CONCLUSIONS

Most, if not all, of the communities we visited and spoke with said that the objective of their rental rehabilitation program was to provide decent and safe rental housing for lower income households. Nevertheless, without having a method of determining who is occupying the rehabilitated units and evaluating this information, communities will not know if the national or local program objectives are being met.

RECOMMENDATIONS TO THE SECRETARY OF HUD

Regardless of whether Congress enacts new or additional legislation for rental housing rehabilitation, we recommend that the Secretary of HUD explore:

--Requiring communities to evaluate their CDBG rental rehabilitation program in terms of cost effectiveness, tenant benefits, and displacement of lower income households.

--Requiring communities to have project owners provide standardized income and other demographic information annually to the local administering government on each household residing in a CDBG-assisted housing unit so that the results can be aggregated at the national level, or make some alternative provision for collecting this information.

MATTERS FOR CONSIDERATION BY THE COMMITTEE

To facilitate national oversight of any new rental housing grant program, we recommend that the Committee should consider:

--Requiring communities to have project owners provide standardized income and other demographic information annually to the local administering government on each household residing in an assisted housing unit so that the results can be aggregated at the national level,or make some alternative provision for collecting this information.

--Requiring each participating local government to submit annual reports to HUD showing what it has accomplished during the fiscal year. To avoid excessive paperwork,

HUD regulations would specify what records local governments need to keep.

--Requiring the Department of Housing and Urban Development to report to the Congress on a periodic basis as to the overall progress of the program. Certain minimum reporting requirements should include consolidated, verified information from all local governments on costs, services delivered, and program beneficiaries.

--Explicitly defining the intended program beneficiaries and the extent to which rehabilitated units must be occupied by those beneficiaries. In the absence of such guidelines there would be a natural tendency among landlords and program officials to allow residency by middle income households who are able to pay for more costly rehabilitatiion.

AGENCY COMMENTS

HUD agreed with our conclusions and recommendations which stress the importance of requiring rather complete information on tenants who benefit from rental rehabilitation programs. HUD said that the Senate rental rehabilitation proposal does not specifically address the data need, but does so by implication. HUD officials said they are devoting considerable attention, even before new legislation has been enacted, to implementing our recommendations.

SELECTED MULTIFAMILY

RENTAL HOUSING PROGRAMS

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Subsidized

Direct Loans for Housing for the Elderly or Handicapped (Section 202, Housing Act of 1959, 12 U.S.C. §1701q). Long-term direct loans to finance rental or cooperative housing facilities for elderly or handicapped persons. The interest rate is based on the average rate paid on Federal obligations during the preceding fiscal year. Since 1974, participation in the Section 8 Rental Housing Program is required for a minimum of 20 percent of the units.

Multifamily Rental Housing for Low and Moderate Income Families (Section 221(d) (3), National Housing Act (1934), as added by Housing Act of 1954, 12 U.S.C. §1715l(d)(3)). Mortgage insurance to facilitate construction or substantial rehabilitation of multifamily rental or cooperative housing for low- and moderate-income or displaced families. Originally, projects could qualify for a below-market interest rate (as low as 3 percent) and for rent supplements. These subsidies are no longer available for new projects; however, units may qualify for assistance under the Section 8 Program if occupied by eligible low-income families.

Rental and Cooperative Housing Assistance for Lower Income Families (Section 236, National Housing Act (1934), as added by Section 201, Housing and Urban Development Act of 1968, 12 U.S.C. §17775z-1). Mortgage insurance and interest subsidies (to as low as 1 percent) to produce new or substantially rehabilitated rental or cooperative units for low-income households. The program was suspended by the housing moratorium of 1973; current authority consists of funding commitments issued before the moratorium and amending existing contracts. Beginning in 1974, HUD paid additional subsidies to projects to cover the difference between the tenant's contribution (25 percent of adjusted income) and the actual cost of operating the project.

Rent supplements (Section 101, Housing and Urban Development Act of 1965, 12 U.S.C. §1701s). Federal payments to reduce rents for eligible tenants in multifamily projects insured under sections 221(d) (3), 231, 236, and 202. The payment makes up the difference between 25 percent of a tenant's adjusted income and the fair market rent determined by HUD. The program was suspended by the housing moratorium of 1973, and new rent supplements contracts are no longer available.

Nonsubsidized

Multifamily Rental Housing (Section 207, National Housing Act (1934), as amended, 12 U.S.C. §1713). Mortgage insurance to facilitate the construction or rehabilitation of multifamily rental housing by private or public developers. The projects must contain at least eight dwelling units and should be able to accommodate families at reasonable rents.

Multifamily Rental Housing for Low- and Moderate-Income Families (Section 221(d) (4), National Housing Act (1934), as added by Housing Act of 1954, 12 U.S.C. §17151(d)(4)). Mortgage insurance to finance construction or substantial rehabilitation of multifamily rental or cooperative housing for low- and moderate-income or displaced families. The insured mortgage amounts are controlled by statutory dollar limits per unit which are intended to assure moderate construction costs. Units may qualify for section 8 assistance if occupied by eligible low-income families.

Existing Multifamily Rental Housing (Section 223 (f), National Housing Act (1934), as added by Section 311, Housing and Community Development Act of 1974, 12 U.S.C. §1715n(f), (g)). Mortgage insurance to purchase or refinance existing multifamily projects originally financed with or without Federal mortgage insurance. Projects must contain eight or more units, must be at least 3 years old, and must not require substantial rehabilitation.

FARMERS HOME ADMINISTRATION

Rental and Cooperative Housing Loans (Section 515, Housing Act of 1949, as added by Senior Citizen Housing Act of 1962, 42 U.S.C. §1485). Direct loans to finance rental housing and related facilities for low- and moderate-income families and persons 62 years of age or older. Profit-oriented borrowers must pay maximum interest rate, while nonprofit sponsors can qualify for interest credit. Units may qualify for assistance under the Section 8 Program.

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

November 10, 1982

Honorable Charles A. Bowsher
Comptroller General
United States General Accounting Office
Washington, D. C. 20548

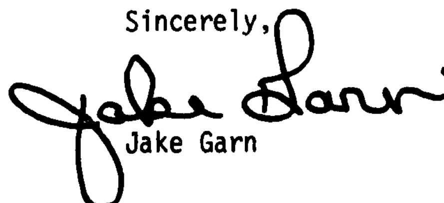
Dear Mr. Bowsher:

In the next legislative session the Committee plans to reintroduce legislation to establish, among other programs, a new rental rehabilitation block grant program. However, very little detailed information is available on rental rehabilitation activities. Detailed information on per unit rehabilitation cost, financing methods, leveraging of funds, and beneficiaries would be extremely helpful to the Committee.

In this respect, we have been following with considerable interest your survey of communities' experiences in providing housing assistance under the CDBG program. Mr. William Gainer of your housing staff recently provided us with some preliminary information on rental rehabilitation activities reported by the survey communities. Based on those results, however, it was not possible to determine per unit rental rehabilitation costs or specific methods and results of rehabilitation financing. Such data, especially for high cost cities, would be beneficial in considering a cost ceiling in any new legislative proposal in estimating the impact of different funding levels.

I am therefore requesting that you identify communities which have already developed rental housing rehabilitation programs, based on your past work, and do any further research necessary at selected communities to provide the Committee with this information characterizing rental rehabilitation activities under the CDBG program. The Committee staff is available to meet with your staff to help select sample communities and to discuss the additional information needed. Your final report to the Committee must be completed by the end of March 1983 so that revisions can be made to the proposed legislation before it is introduced. We appreciate your continued cooperation.

Sincerely,



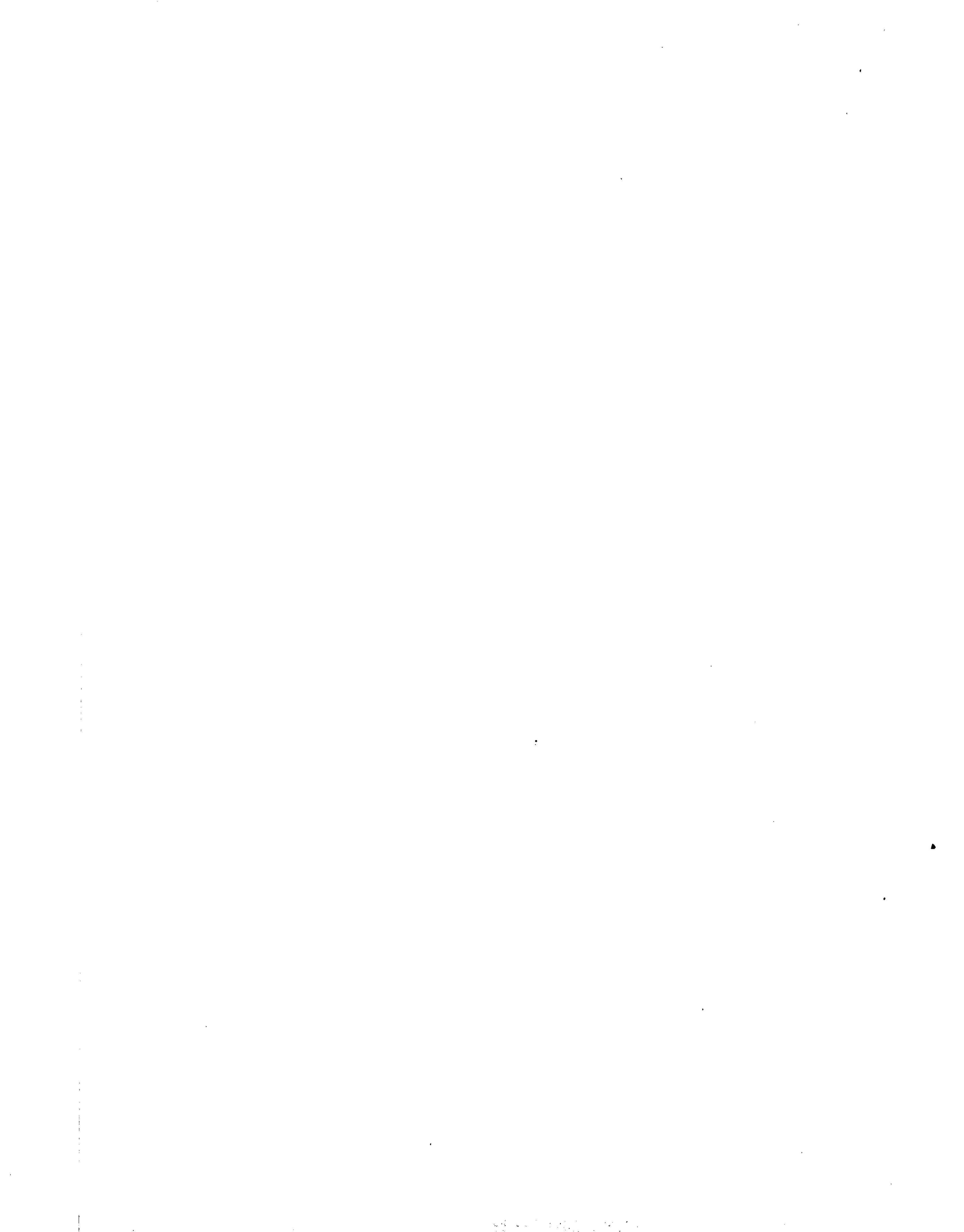
Jake Garn

JG:psn

LIST OF COMMUNITIES WHICH HAD CDBG-FUNDED RENTAL REHABILITATION PROGRAMS

Akron, OH
Albany, NY
Albuqurque, NM
Altoona, PA
*Anaheim, CA
***Ann Arbor, MI
*Arlington County, VA
***Asbury Park, NJ
Ashland, KY
Ashville, NC
Auburn, ME
Bay City, MI
Bayonne, NJ
Binghamton, NY
Birmingham, AL
Bloomington, IL
Boston, MA
*Bridgeport, CT
Charleston, SC
Chicago, IL
Columbus, GA
Columbus, OH
*Covington, KY
*Detroit, MI
Des Moines, IA
*Durham, NC
Eugene, OR
Fairfield, CA
Flint, MI
Grand Rapids, MI
*Hartford, CT
***Hudson County, NJ
Huntington, WV
Joliet, IL
Lakewood, OH
Lancaster Count,y, PA
Las Vegas, NV
***Lynn, MA
***Los Angeles, CA
Manchester, NH
*Memphis, TN
***Middlesex, NJ
*Milwaukee, WI
*Montgomery County, MD
Modesto, CA
Nassau County, NY
*New Britain, CT
New Brunswick, NJ
New Castle County, DE
New London, CT
New York, NY
Norfolk, VA
***Ogden, UT
*Ontario, CA
Parkersburg, WV
Pittsfield, MA
*Portland, OR
*Raleigh, NC
Redwood City, CA
Reno, NV
*Rochester, NY
Rockford, IL
Rock Island, IL
*Salt Lake City, UT
*San Diego, CA
***Santa Ana, CA
Schenectady, NY
South Bend, IN
Spartanburg, SC
St. Clair County, IL
Stockton, CA
*St. Louis County, MO
Tampa, FL
***Texarkana, AR
Town of Union, NY
Troy, NY
Utica, NY
Vallejo, CA
*Westchester County, NY
*White Plains, NY
*Winston-Salem, NC
*York County, PA

Note: Those communities designated by an asterisk (*) were visited by GAO staff during the study; those designated by a triple asterisk (***) did not respond to our request for program data.



SELECTED CDBG-FUNDED

RENTAL REHABILITATION PROGRAM DATA BY REGION

Region	Number of units assisted	Rehabilitation cost: CDBG funding	Rehabilitation cost: Other funding	Rehabilitation cost: Per unit	CDBG funding per unit (note a)
		(in millions)			
Northeast	11,695	$ 68.1	$ 90.7	$13,579	$5,872
North central	4,073	22.5	40.1	15,361	5,528
South	1,269	10.1	2.8	10,100	7,997
West	2,202	3.8	9.7	6,115	2,721
Total	19,239	$104.5	$143.3	$12,873	$5,650

a/CDBG funding per unit represents the average loan and/or grant or subsidy cost, regardless of whether or not the funds are to be paid back. Thus, actual subsidy cost may be less than shown here.

Source: Data provided by 73 communities. Detailed information is provided on the following pages.

APPENDIX IV

SELECTED CDBG-FUNDED RENTAL REHABILITATION PROGRAM DATA FOR NORTHEASTERN UNITED STATES COMMUNITIES

Community	Finance method	Number of units assisted	Demographics	Rehabilitation Cost: CDBG funding	Rehabilitation Cost: Other funding	Rehabilitation Cost: Per unit	CDBG funding per unit
Albany, NY	Partial grant, partial loan	78	No data available	$ 811,950	$ 852,249	$21,336	$10,410
Altoona, PA	Full loan	6	3 units vacant; 100 percent lower income, small family, minority	11,199	0	1,867	1,867
Auburn, ME	Partial loan	80	No data available	129,610	129,610	3,240	1,620
Bayonne, NJ	Interest subsidy payment	35	No data available	0	73,453	2,099	233
Binghamton, NY	Interest subsidy payment	9	100 percent lower income; 56 percent small family; minority/non-minority status unknown	0	35,574	3,953	1,670
Boston, MA	Partial grant	232	No data available	95,022	120,938	931	410
Bridgeport, CT	Partial grant	385	No data available	325,486	1,335,156	4,313	845
Hartford, CT	Full loan	171	No data available on income; 76 percent small family; 57 percent minority	243,720	0	1,425	1,425
Lancaster County, PA	Full loan Partial grant	7 28	100 percent lower income; 71 percent small family; 11 percent minority	22,000 270,000	0 330,000	(b) 17,771	3,143 9,643
Manchester, NH	Interest subsidy payment	181	27 units vacant; 81 percent lower income; 80 percent small family; 2 percent minority	0	1,210,617	6,688	2,895
Nassau County, NY	Partial grant	17	100 percent lower income; 94 percent small family; 88 percent minority	32,000	77,125	6,419	1,882
New Britain, CT	Partial grant	210	No data available	119,748	424,559	2,592	570
New Brunswick, NJ	Partial grant	20	No data available	12,266	23,810	1,804	613
New Castle County, DE	Full loan	8	No data available	93,126	0	11,641	11,641

(b) All programs are combined to provide one per-unit average.

Community	Finance method	Number of units assisted	Demographics	Rehabilitation Cost			CDBG funding per unit
				CDBG funding	Other funding	Per unit	
New London, CT	Full loan	224	No data available	2,730,552	0	12,190	12,190
New York, NY	Partial loan	8,860	No data available	60,813,641	82,434,978	16,168	6,864
Pittsfield, MA	Partial/ full loan	83	100 percent lower income; 6 percent minority	343,368	126,999	5,667	4,137
Rochester, NY	Full or partial grant	133	No data available	826,901	1,079,434	14,333	6,217
Schenectady, NY	Partial grant	32	No data available	46,992	200,336	7,729	1,469
Troy, NY	Partial grant	71	No data available	248,251	422,699	9,450	3,497
Westchester County, NY	Partial grant	272	No data available	122,607	418,013	1,988	451
White Plains, NY	Full or partial loan	50	No data available	18,549	78,906	1,949	370
Town of Union, NY	Partial grants/ Subsidized loan	150	No data available	156,609	162,673 91,275	2,737	1,044
Utica, NY	Partial grant	287	No data available	295,400	684,400	3,414	1,030
City of York/ York County, PA	Partial loan	66	23 units vacant; 100 percent lower income; 77 percent small family	351,321	377,908	11,049	5,323
Total		11,695		$68,120,318	$90,690,712	$13,579	$5,872

APPENDIX IV

SELECTED CDBG-FUNDED RENTAL REHABILITATION PROGRAM DATA FOR NORTH CENTRAL UNITED STATES COMMUNITIES

				Rehabilitation cost			
Community	Finance method	Number of units assisted	Demographics	CDBG funding	Other funding	Per unit	CDBG funding per unit
Akron, OH	Partial grant	3	100 percent lower income; 67 percent small family; 33 percent minority	$ 2,400	$ 9,600	$ 4,000	$ 800
Bay City, MI	Full loan	33	3 units vacant; 100 percent lower income; 83 percent small family	100,687	0	3,051	3,051
Bloomington, IL	Interest subsidy payment	21	No data available	0	104,000	4,952	1,854
Chicago, IL	Partial loan	2,843	No data available	15,530,221	35,155,649	17,828	5,463
Columbus, OH	Full loan Partial loan	135 30	No data available	1,795,500 144,210	0 292,790	(b) 13,530	13,300 4,807
Des Moines, IA	Partial grant	28	No data available	81,040	206,407	10,266	2,894
Detroit, MI	Full or partial loans	222	No data available	2,201,350	328,000	11,393	9,916
Flint, MI	Full loan	32	No data available	255,455	0	7,983	7,983
Grand Rapids, MI	Partial loan	10	No data available	51,120	76,679	12,780	5,112
Joliet, IL	Partial loan	39	100 percent lower income; 87 percent small family; 82 percent minority	53,076	355,199	10,469	1,361
Lakewood, OH	Partial loan or partial grant	113	No data available	130,100	1,170,900	11,513	1,151
Milwaukee, WI	Full loan	25	100 percent lower income and large family; 92 percent minority	510,400	130,761	25,646	20,416
Rockford, IL	Partial grant (years 1, 2) Interest subsidy payment (year 3)	48 24	No data available	110,556 0	331,668 283,464	(b) 9,454	1,824 864
Rock Island, IL	Partial grant Full loan	22 11	No data available	39,010 65,130	154,256 0	(b) 7,830	1,773 5,921
South Bend, IN	Full loan	9	No data available	42,269	0	4,697	4,697

(b) All programs are combined to provide one per-unit average.

APPENDIX IV

Community	Finance method	Number of units assisted	Demographics	Rehabilitation cost			CDBG funding per unit
				CDBG funding	Other funding	Per unit	
St. Clair County, IL	Interest subsidy payment	9	100 percent lower income; 67 percent small family; no minority tenants	$ 0	$ 52,672	$ 5,852	$2,682
St. Louis County, MO	Partial grant	416	100 percent lower income; 79 percent small family; 64 percent minority	1,338,413	1,509,274	6,845	3,217
Total		4,073		$22,450,937	$40,116,319	$15,361	$5,528

APPENDIX IV

SELECTED CDBG-FUNDED RENTAL REHABILITATION PROGRAM DATA FOR SOUTHERN UNITED STATES COMMUNITIES

Community	Finance method	Number of units assisted	Demographics	Rehabilitation cost: CDBG funding	Rehabilitation cost: Other funding	Rehabilitation cost: Per unit	CDBG funding per unit
Arlington County, VA	Partial grant	96	77 percent lower income; 59 percent minority	$ 426,967	$ 363,713	$ 8,236	$ 4,448
Ashland, KY	Partial loan	10	Units all vacant	35,253	82,258	11,751	3,525
Ashville, NC	Partial loan	99	No data available	164,116	164,116	3,315	3,315
Birmingham, AL	Full loan	119	No data available	393,971	0	3,311	3,311
Charleston, SC	Partial loan	16	44 percent lower income; 75 percent small family; 56 percent minority	98,280	174,720	17,063	6,143
Columbus, GA	Full loan	20	No data available	329,949	0	16,497	16,497
Covington, KY	Deferred payment loan	6	100 percent lower income; 63 percent small family; 37 percent minority	9,959	89,927	(b)	1,660
	Partial loan	6		20,295	60,000	12,512	3,383
	Interest subsidy payment	7		0	57,551	(b)	788
Durham, NC	Conditional grant	18	100 percent lower income; 89 percent small family; 100 percent minority	65,507	98,260	9,098	3,639
Huntington, WV	Full loan	10	No data available	105,634	0	10,563	10,563
Memphis, TN	Full loan	297	50 units vacant; 99 percent lower income and minority; 93 percent small family	5,307,393	0	17,870	17,870
Montgomery County, MD	Full loan Full grant	215	No data available	302,013 18,390	43,000	1,690	1,490
Norfolk, VA	Partial loan	108	No data available	276,310	1,105,240	12,792	2,558
Parkersburg, WV	Full or partial loans	5	100 percent lower income; 100 percent small family; no minority tenants	12,700	47,000	11,940	2,540

(b) All programs are combined to provide one per-unit average.

APPENDIX IV

Community	Finance method	Number of units assisted	Demographics	Rehabilitation cost: CDBG funding	Rehabilitation cost: Other funding	Rehabilitation cost: Per unit	CDBG funding per unit
Raleigh, NC	Partial loan	28	No data available	$ 152,000	$ 228,000		$ 5,429
	Interest subsidy payment	30		0	245,000	10,776	2,800
Spartanburg, SC	Full loan	51	No data available	748,196	0	14,671	14,671
Tampa, FL	Full loan	9	89 percent lower income; 89 percent small family; 22 percent minority	183,400	0	20,378	20,378
Winston-Salem, NC	Full loan	119	No data available	1,407,800	0	11,830	11,830
Total		1,269		$10,058,133	$2,758,785	$10,100	$ 7,997

APPENDIX IV

APPENDIX IV

SELECTED CDBG-FUNDED RENTAL REHABILITATION PROGRAM DATA FOR WESTERN UNITED STATES COMMUNITIES

Community	Finance method	Number of units assisted	Demographics	Rehabilitation cost: CDBG funding	Rehabilitation cost: Other funding	Rehabilitation cost: Per unit	CDBG funding per unit
Albuquerque, NM	Full loan	18	No data available	$ 349,998	$ 0	$19,444	$19,444
Anaheim, CA	Interest subsidy payment	301	81% lower income; 82% small family; 29% minority	0	1,584,538	5,264	1,797
Eugene, OR	Partial loan	59	No data available	53,359	357,091	6,957	904
Fairfield, CA	Interest subsidy payment	12	No data available	0	94,530	7,878	2,113
Las Vegas, NV	Full loan	16	No data available	89,807	0	5,613	5,613
Modesto, CA	Full loan	32	No data available	325,815	0	(b)	10,182
	Interest subsidy payment	148		0	1,541,000	10,371	2,242
Ontario, CA	Interest subsidy payment	124	No data available	0	415,951	3,354	989
Portland, OR	Full loan	381	No data available	896,400	0	(b)	2,353
	Partial loan	375		1,026,698	1,906,725	5,066	3,054
Redwood City, CA	Full loan	110	No data available	458,500	0	4,168	4,168
Reno, NV	Full grant	94	100 percent lower income; 91 percent small family; 32 percent minority	86,667	0	922	922
Salt Lake City, UT	Full loan	33	No data available	244,583	0	(b)	7,411
	Partial loan	4		16,978	17,671	7,547	4,245
San Diego, CA	Escrow leverage loan	473	No data available	0	3,763,012	7,956	Escrow balance
Stockton, CA	Full loan	2	No data available	54,000	0	27,000	27,000
Vallejo, CA	Full loan	20	No data available	181,540	0	9,077	9,077
Total		2,202		$3,784,345	$9,680,518	$ 6,115	$ 2,721

(b) All programs are combined to provide one per-unit average.

REHABILITATING RENTAL HOUSING

ALTERNATIVE SUBSIDY TECHNIQUES[1]

INTRODUCTION

This paper describes alternative techniques for providing public subsidies for the rehabilitation of rental housing. The past few years have seen an increasing recognition of the problems of rental housing and the resulting need for appropriate public sector invervention. Many localities have responded with the creation of financing assistance and other aid for the owners and tenants of rental properties. At the national level, the Department of Housing and Urban Development is sponsoring a Rental Rehabilitation Program Demonstration. Legislation for a Rental Rehabilitation Program has been proposed by the Administration and is currently being considered by the Congress. The major national programs of the recent past, the Section 8 program and various titles of the FHA insurance program, have, of course, always focused predominantly on rental housing. What is new, however, is the increasing focus of locally controlled and administered resources on the problems of rental housing. Local programs for the most part funded with Community Development Block Grants, are now devoting more attention and resources to rental housing.

The purpose of this paper is to discuss how local programs can assist in the rehabilitation of rental housing. Alternative methods of subsidy are described; their economic, administrative and policy-related implications are discussed. Ways of choosing between types of subsidies are outlined. The material is oriented towards local officials and program managers who are considering designing a rental rehabilitation assistance program, either as a new local effort, as a part of a redesign of existing programs, or as a part of the HUD-sponsored Rental Rehabilitation Program Demonstration. The paper first considers some of the issues of the rental rehabilitation subsidy program as differentiated from the design of a program for owner-occupants. It then discusses a series of questions about subsidies for rental housing. What kind of subsidies should be considered? How much subsidy is the right amount? What effects should the subsidy have and amongst the bewildering range of options, how does one evaluate and choose?

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RENTAL HOUSING COMPARED TO OWNER-OCCUPIED HOMES

Many communities have been running programs for single-family structures and owner-occupants for a number of years. Programs for the rehabilitation of rental housing must, however consider new options and issues. In targeting resources to owner-occupants one can fairly easily define the family types and their respective needs. They are either large families or small, or moderate income or poor, young or old, upwardly mobile of not. Subsidy amounts and types can be tailored to the resulting financial needs of each family. In rental housing the differing needs of differing families also exist, but the needs of a new actor--the investor/owner/landlord--must also be analyzed.

Investors as a group are as diverse as the tenants who occupy their buildings. They range from relatively unsophisticated "Mom and Pop" investors who own a few small building to virtual conglomerates, who own many properties and provide an integrated set of management, maintenance, and repair services. The investment objectives of each owner also vary. Some make their profits through management fees; some by virtue of fluctuating resale values; others by an incresing market rent. All have differing expectations as to the amount and timing of investment returns.

There are other critical differences between a rental program and a single family program. When comparing subsidy determinations in single family programs to investor oriented programs, the analysis goes from individual income analysis to rental income analysis. Owner-occupied programs deal with known users whose ability and willingness to pay depend on market conditions. In a rental program the minimum subsidy needed to induce rehabilitation will vary with the fluctuations of the market. In markets with a high level of demand, investors may not have to offer high quality rehabilitated apartments in order to rent units. In softer markets a rehabbed unit may be the key to rapid rental. In each, the amount of public subsidy required to induce rehabilitation activity will be different and in this sense, subsidies are related to market conditions.

The tax aspects of each type of housing are also different. For the owner-occupant, mortgage interest payments and real estate taxes are deductible and capital gains taxes can be deferred. For a given occupant at a given marginal tax bracket, the enonomic consequences of these considerations are easily calculated, and, if desired, considered in a subsidy determination. For investors in rental property, the tax implications become significantly more complex. First, there is the consideration and recognition of income and expenses; non-cash allowances such as depreciation can determine the usefulness and value of the tax position. All of the tax aspects interact complexly and have the economic power to make marginally unprofitable deals into lucrative tax shelters.

The goal of investment ownership is profits and that can make difficult choices for the public program designer. On one hand it is recognized that investor-owners of property undergoing public treatment should be allowed to make a fair and reasonable profit. On the other hand, what is fair and reasonable is subject to great variance in interpretation. This may result in public programs being accused of allowing windfall profits at the taxpayer's expense. Indeed, the magnitudes of the profits in real estate investments is a complex issue. There are three components to real estate profits. First, there are the cash surpluses after the payment of all annual operating and financing expenses. These profits are commonly known as the operating profit of the cash-on-cash. Second, there are the tax benefits that accrue to the owners of real estate. Third, there is the future value that can result in substantial profits through capital gains. The return on investment from the ownership of rental housing is a combination of all these.

Given all of these complications in an investor oriented program--a changing group of users; various owners with differing goals; the requirements of difficult market judgements; complex tax considerations; the possibility of significant private profits seemingly at public expense--how does one decide what kind of subsidy and how large a subsidy to offer? And, how can it be done fairly, with minimum administrative burden and with a high enough program volume to be worth the effort?

LOANS OR GRANTS

Subsidies for rental rehabilitation projects are needed for different reasons. Some properties are simply not profitable. In order to make them so and to forestall owner abandonment a subsidy is therefore necessary. Other properties may offer a return on investment, but not at a high enough level to make rehabilitation desirable. In general, subsidies exists because there is a gap in a property's finances relative to a public goal. In order to achieve the public goal a subsidy must be offered. Without a subsidy the project is not feasible.

This section discusses what kind of subsidy to offer to investor-owner of a rental property in order to facilitate its rehabilitation. How to subsidize tenants to be able to afford to live in the property is not considered here because the HUD-sponsored Rental Rehabilitaton Program Demonstration considers rehabilitation subsidies and tenant subsidies separately.

A rehabilitation subsidy starts with a simple premise--a certain amount of cash or in-kind subsidy can provide sufficient incentive to an investor-owner to undertake rehabilitation of his/her property. In areas where market forces make rehabilitation a relatively safe and profitable investment, the incentives can be modest and may only be needed to get the process started. In

other markets, the subsidies may have to be substantial and offered over a long period of time.

Properties needing a subsidy in order to make rehabilitation feasible all have similar problems. After performing the required level of rehalbilitation, the property's income and expenses don't balance. One can hope that the market will improve and income will rise accordingly or that expenses will stablize (and perhaps fall due to energy conservation). In any case, a subsidy will be required in order to make the rehabilitation investment occur.

Subsidies serve to increase the return on investment to the investor. This can be done in a number of ways: reduction in the capital cost of construction; assistance in meeting the operating expenses of a property; the creation of favorable financing terms and rates; and/or changes in the tax treatment of the property's income. An increased cash flow will make the investment profitable and thus individual owners will participate.

Subsidies to rental property can be either grants or loans calculated either to reduce the principal amount of a loan or to reduce the interest payable on it. Grants may have specific conditions tied to them, i.e., that certain rehabilitation items be done or that the property is maintained up to an established standard. Loans may carry similar conditions plus the characteristics of all debt: they are repayable--either with market-rate, below-market or to interest--and either continuously repaid or due at some point in time. Whether to choose a grant or a loan is discussed below.

Grants

Grants have the great benefit of both actual and perceived simplicity. The rental rehabilitation program determines the appropriate amount of the grant (a topic that will be discussed later), ties certain conditions to the grant award, and writes out the check. The program administrator doesn't have to bother with figuring out an interest rate or with servicing a loan. For a property owner, grants are also desirable. Since they are not repayable, they don't effect profitability, either by claiming a portion of operating cash flow or of future value. In underwriting the grant may be considered as a form of equity and thus increase the loan-value ration. They appear hassle-free, without requiring a lot of interaction with government officials.

There are, however, disadvantages to grants. For one, many public programs want to avoid even the appearance of "giveaways" to landlords. Grant programs can be seen as creating windfalls for property owners without even a chance of public participation in the value created. In addition, grants may not be taken

seriously by participating property owners. After all, if the money doesn't have to be repaid, then the condition tied to it cannot be too important either. Another major consideration with grants is their tax treatment. Depending upon how they are structured the IRS may not treat them as part of the depreciable basis for the property or may treat the grant as operating income to the property and ultimately the investors. Tax treatment is a complex area and should receive careful consideration by the individual investor in consultation with professionals.

Loans

Loans as a form of subsidy have differing marketing, administrative and tax aspects. As many a program administrator has noted, loan repayment create a stream of income that can be used in the program. Loans can be structured so that they can be added to the tax basis and thus to the depreciable basis of the property. They are taken seriously by investors participating in the program and give less perception of windfalls or giveaways.

Loans may be made on a deferred basis, requiring no current payment of interest or they may be made at a below market interest rate with periodic repayments required. The advantages and disadvantages of deferred loans or revolving loans is considered later in this paper.

PRINCIPAL REDUCTION SUBSIDIES OR
INTEREST REDUCTION SIBSIDIES?

There are two primary ways of structuring a loan or grant as a capital subsidy to a property. The subsidy can be either a principal reduction subsidy or an interest reduction subsidy. Although the tax and administrative effects provides the same amount of subsidy for a given property. This is illustrated in the case study below.

> A typical property applies to a program for rehabilitation assistance. The property needs $40,000 worth of rehabilitation to be performed. At a market rate of 17.25 percent for 15 years, annual payments of $7,598 are required. (In order to simplify the example, annual rather than monthly repayments are assumed.) However, based on reasonable underwriting standards, the property has only $4,416 of available cash flow to service the rehabilitation loan. At the market rate, the $4,416 will service a loan of $23,247. In order to generate the $40,000 necessary for the rehabilitation, a principal reduction subsidy of $16,753 would be needed. (The difference between $40,000 - $23,247 = $16,753.) This subsidy could be made available as a loan or a grant. Alternatively, the funds necessary for the rehabilitation could be

structured as an interest reduction subsidy. In this subsidy, the available $4,416 of cash flow is devoted to servicing the full $40,000 loan. That amount of annual payment creates an interest rate of 7.09 percent of the loan. In order to generate a yield of 17.25 percent (the required market rate) the difference between $4,416 and $7,598 must be paid. Over a fifteen year period the discounted annual difference is $16,753, an amount that could be repaid to the private lender as an interest reduction subsidy.

In summary there are two options for a property with $4,416 of available cash flow. These are portrayed in the table below. Depending on the investors and the private lenders with whom a program is working, either a principal reduction or interest reduction technique may be more desirable.

Table 1

	Principal amount of private loan	Interest rate	Annual payment	Subsidy necessary
Market Rate	$40,000	17.25	7,598	-0-
Principal Reduction	23,247	17.25	4,416	16,753
Interest Reduction	40,000	7.09	4,416	16,753

REVOLVING LOANS OR DEFERRED PAYMENT LOANS?

If the program designer has chosen to offer a loan to the investor rather than a grant, the next question is to decide how the loan should be structured. There are many choices for structuring a loan. This section discusses two general types of loans: (1) loans which are structured as deferred loans where repayment of both principal and interest is postponed to some point in the future; and (2) loans which are at a below-market rate (BMIR), with periodic payments required.

Deferred Payment Loans do not have an effect on a property's cash flow and thus allow higher level of private debt to be supported. They, therefore, look very much like grants. Below Market Interest Rate loans require monthly payments for interest and principal and, therefore, reduce the cash flow available for sustaining conventional debt. Whether to defer or to collect payments is often a key decision for a program designer and the effects of this choice are considered in the case study below. The purpose of the case study is to illustrate and quantify the trade-offs that must be made in achieving two goals in rehab subsidies: the desire to receive a stream of repayments of some of the limited public funds committed versus the goal of achieving the highest possible leveraging ratios of private investment.

Consider the property described previously. There is a need for $40,000 of rehabilitation work and there is $4,416 of cash flow available each year to service debt. If the full $4,416 is devoted to a private rehabilitation loan, at market rates, a loan of $23,247 can be underwritten. A public subsidy of $16,753 is required for a leveraging ration of 1.39-1. As a DPL, this $16,753 must be repaid at some point in the future, most likely at time of sale. Alternatively, the program could charge interest on its loan. Suppose a rate of 3 percent for fifteen years is chosen. It would then be necessary to provide $30,000 worth of public funds, receiving back annual payments of $2,516. The private loan amount would drop to $10,000. The two options are portrayed in the Table below.

Table 2

	DPL		BMIR	
Available for debt service	4,416		4,416	
Private loan debt service	4,416	(23,247)	1,900	(10,000)
Public loan debt service	0	(16,753)	2,516	(30,000)
Leveraging ratio	1.39-1	(40,000)	.33-1	(40,000)

These are the options available to the program: Put in $16,753 and forget about it until some point in the future or put in $30,000 and get back $2,516 per year for fifteen years. Which option is the best choice? Although getting back a yearly stream of payments sounds nice; it is in fact not of enormous value. with an interest rate of 3 percent, a below market rate less than the expected rate of inflation, the value of the annual repayment declines over time. A payment of $2,500 fifteen years from now does not have the purchasing power that cash today has. As long as a public loan is offered on a BMIR basis, its future value generally will not keep up with inflation.

Without going into more detailed mathematical treatments the results and choices are relatively straightforward. One can structure a subsidy as a DPL, requiring less public funds initially, charge no current interest, and achieve a higher leveraging ratio. Alternatively, the BMIR repayable loan can be used, costing more funds initially, achieving a lower leveraging ratio as the operating cash flow has to meet the debt service requirements of both the public and private loan, and generating a repayment stream that diminishes in true value over time.

HOW MUCH SUBSIDY IS THE RIGHT AMOUNT?

The above discussion shows the difference between deferred payment loans and revolving loans. Whether the subsidy is a loan of any type or a grant the next question is how much subsidy should be provided and what is the easiest administrative mechanism to determine the amount. How to minimize the amount of subsidy necessary to meet public rehabilitation goals is a very complex question. It will vary with a wide range of considerations, including:

--the regional and neighborhood housing market and expected changes in the rental levels of the market;

--the investment goals of the property owners including cash returns, tax benefits and expectations of future appreciation in the property;

--the rates and terms of the conventional debt that will be used in combination with the public subsidy; and

--the risks and uncertainty of predicting any of the above factors.

These factors all work together and interact. In some markets, investors will perform rehab even though initial cash flows are very low because they are relying on tax benefits and expected future profits. For other owners, tax benefits are unimportant and all decisions will be made on a current cash basis without a prediction of the future. If conventional interest rates remain high, the neighborhood market as a whole may soften and subsidies must be increased to deal with slackened demand and high debt service requirements. The range of permutations in the interaction of all of these variables is infinite.

The best way to think of all of these interactions is that the granting of subsidies for investment property is very much a marketlike activity. The amounts necessary are subject to supply, demand, risk and uncertainty, just as all markets are. Sometimes a small subsidy will get investors to make decisions the public program wants; sometimes the amount will have to be larger. And the amounts will change as the neighborhood, external events, perceptions and exceptions change.

Given the changing markets for subsidies is there a way to determine the right amount? Intutitively, it is easy to describe the right amount of public funds for a subsidy. It is the minimum amount of money that will induce an investor to participate in a particular program design in a particular neighborhood and in a specific building. The wrong amounts can also be described in a parallel fashion. Too much subsidy will create so much investor demand for a lucrative option, that the

public agency will be swamped with requests. Too little subsidy will not get investors excited enough to respond to the offer and the program will not achieve the desired volume. This model assumes there is a marketplace full of investors waiting to start rehab in a neighborhood. If we offer them subsidies to get started and too many come in, the subsidy can be decreased. If no one uses the program, the subsidy must be increased.

How can a public agency that typically has conflicting pressures and demands upon it manage a process that constantly judges the market for subsidies and still operate in a fair, equitable and efficient manner?

In order to set an appropriate subsidy level, analyzing the financial structure of actual or sample projects is an important and useful step. However, trying to find a "perfect formula" to be applied to all individual projects to determine the appropriate subsidy level for each will be a fruitless search. For exemple, trying to give all investors the same "cash on cash return on equity" will result in an unfair distribution of benefits and some good projects will not be feasible or unnecessarily high subsidies will be given to other projects. There are simply too many other profit and loss factors of importance to an investor for any one factor like cash on cash return on equity to be the only determinant of the subsidy. There are too many factors, and each project is too individual, for any single formula to produce the right subsidy level on all cases. Three methods of judging the marekt for subsidies are described below:

Individual project negotiations

The "current subsidy level" as previously described is the mimimum amount necessary to be paid to induce a particular rehab project to take place. To find that amount, one essentially must bargain or "haggle" over the price as in any business or marketplace transaction. The correct subsidy for a given project is the amount which will just barely keep the investor from walking out the door.

One method of finding the correct subsidy level is thus to negotiate a subsidy amount project by project. To negotiate a project well, one needs a certain amount of business sense, intellectual toughness, intelligence, and understanding of the economics of the project, and, preferably some experience and sense of the market. Negotiations work best when the public negotiator is holding discussions with a number of investors at the same time so that all parties know there is competition. Negotiating individual projects can be very effective; it is feasible; and, it is being done by a number of localities. It is the system used nationally in the UDAG program, for example. After a reasonably short period, local officials can get a good "feel for the market" and negotiate effectively. On the other hand, individual negotiations require a consistent level of

staff skill and can be very touchy in a political context, unless it is a very open process accompanied with appropriate levels of review by disinterested parties.

Competitive techniques

Individual project negotiations are not the only way to determine the right subsidy level or "price" to get the rehab done. Another mehtod would be some form of an auction. The locality could make available subsidies to be "auctioned off" to owners of investment properties. The subsidy, either a loan or a grant would be made available to the investor who was willing to take the lowest level of subsidy for a given amount of rehab work in a given neighborhood.

The competition could be structured through a Request for Proposal (RFP) process. In the RFP the locality would define the terms of the competition--the eligible buildings and neighborhoods, the required rehab work, the type of subsidy to be provided. The investors would be encouraged to submit applications for their properties. The applications meeting the mimimum requirements and treating the most units (or performing the most work) for the least amount of subsidy would win. They would be offered the subsidy dollars then available.

Even if the local government does not use the competitive approach it is helpful for local officials to think through and understand how they could be used. Conceptually, competition is the purest way of finding the lowest subsidy level that the "market" would accept for inducing rehabilitation of investor properties in the targeted neighborhoods. All other techniques to minimize subsidies are approximations of an auction and will work to limit subsidies to the extent that they similarly extract the best price in the market place.

Fixed subsidy with periodic adjustments

Determining the lowest possible subsidy level though a market approach, does not have to be done on a project by project basis as with a negotiation or competition. If the local government offers a fixed rehab/subsidy, (e.g., a deferred loan of 35 percent of the cost of the rehabilitation) to be available to any investment project in a target neighborhood, then only those projects which would be feasible at that subsidy level would apply and accept funding. By periodically adjusting the subsidy offered, the local government could, over time, balance out supply and demand. That is, the local government could find the correct subsidy price to offer that would produce just enough feasible projects to use all the available funds. At that point the subsidy level chosen would be perfect for the "marginal project", i.e., the project which is just barely feasible. The better, or more feasible, projects, receiving the same fixed subsidy, however, would get somewhat more subsidy than needed.

That loss of subsidy funds, compared with individual negotiations or auctions, should be weighed against the benefit of greater program simplicity. This administrative simplicity is worth emphasizing. The staff of the agency, based on projects that have been previously received or on its knowledge of the market sets a given amount of subsidy, available to all projects feasible at that level. Although the amount must be periodically adjusted, this "market-tuning" is probably less time consuming than individual negotiations.

Combination Techniques

There are several variations on the fixed subsidy with periodic adjustments, described above, which may help make funds go further. The local government could offer the fixed subsidy as a maximum, subject to some reasonable negotiations downward should any project appear workable with a lower level of subsidy. In other words, there could be a combination of fixed rate subsidy with periodic adjustment and individual project negotiations, with the emphasis placed on either element at the preference of the local government.

There could also be a combination of fixed rate subsidy with period adjustments and an auction. The fixed subsidy would be offered with a public announcement that those investors who were willing to put in the greatest amount of their own funds (i.e., take the least subsidy for the rehabilitation) would get a priority. The applications could then be batched every two or three months and those offering to accept the least subsidy would be approved for funding with other potential projects passed over to the next funding cycle.

All three techniques could be combined by offering a fixed rate subsidy, batching applications, negotiating lower subsidies project by project, and then funding, within each batch, only those projects offering the best return for the subsidy dollar.

CONCLUSION

No matter what type of subsidy is used, an important point to remember is that rental markets and thus subsidy requirements change over time and for different owners. It is extraordinarily hard for a public agency to constantly "beat the market" and minimize subsidies. Indeed, if the staff of a public agency is constantly correctly guessing the market trends they will probably leave and become developer/investors. Retaining the flexibility to adjust subsidies is an important aspect of program design. The key lessons of designing a subsidy is to know your market, both the rent levels in the neighborhood and the goals of potential investors.

Just as markets, rent levels and investor motivations change--so do lenders and public agencies. The right technique of subsidy

depends on the willingness of lenders to participate and the ability of an agency to administer. The selected start-up subsidy mechanism must change over time as needs change. Learning from the experience of managing a program is probably the most valuable learning that a program designer can have.

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