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Improving the Efficiency of Federal Housing Subsidies

Statement of
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Committee on Banking, Housing, and Urban Affairs
United States Senate

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Mr. Chairman and Members of the Committee:

We appreciate the opportunity to assist the Committee in identifying ways to improve the use of the Section 8 Moderate Rehabilitation and Tax Credit Programs so that more low-income families will benefit. As you know, we testified before the Committee on August 2, 1989, on how these two programs had been used, in combination, to generate substantial cash proceeds to developers on eight projects that we reviewed.[1] This morning I will (1) highlight key points from my earlier testimony, (2) comment on our preliminary findings regarding the impact on low-income families when the Moderate Rehabilitation Program together with tax credits are not used efficiently, and (3) provide our observations on S. 980, which is intended to improve the effectiveness of the low-income housing tax credit.

In summary, we testified that the lack of centralized review of the total amount of financial assistance awarded to individual projects enabled developers to realize cash proceeds far greater than the cost of acquiring and rehabilitating the projects. In addition, our preliminary results of on-going work demonstrates that it is inefficient to use the Moderate Rehabilitation Program with tax credits in weak housing markets. Finally, S. 980 should improve the effectiveness of the Tax Credit Program, but we believe the bill requires clarification of certain project selection factors. Also the bill does not address the use of tax credits in markets where economic conditions have created a housing surplus.

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[1]Project Developer Cash Flows Under HUD's Section 8 Moderate Rehabilitation Program (GAO/T-RCED-89-58).

NEED FOR CENTRALIZED REVIEW OF FINANCIAL ASSISTANCE

The Moderate Rehabilitation and Tax Credit Programs were intended to increase the supply of units for low-income families. Under the Moderate Rehabilitation Program, owners agreed to upgrade substandard rental housing in exchange for 15 years of guaranteed, project-based Section 8 rental subsidies. Certain developers have coupled the Moderate Rehabilitation Program with tax credits.

In my earlier testimony, I stated that developers were able to generate sizeable cash proceeds by combining proceeds from the sales of income tax credits with coinsured mortgage loans that are secured by moderate rehabilitation rent subsidies. Tax credit awards for the eight projects ranged from a low of about $896,000 on one project to a high of about $5.8 million on another. Attachment I to my statement provides the names and locations of these projects along with financial data pertinent to each one. When the developers sold their ownership interests in these projects along with the related tax credits, and when these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds far greater than the costs associated with acquiring and rehabilitating the properties. We estimated cash flows to developers on the eight projects ranged from about $254,000 for a 36-unit project to about $2.1 million on a 352-unit project. On a per-unit basis, the range was from about $3,500 to $11,400.

This situation evolved because different administering agencies awarded multiple forms of financial assistance to eligible projects. With HUD, state tax credit allocation agencies, and local governments all allocating the assistance, there was little or no centralized oversight of the total financial assistance package provided to individual projects. It is our opinion, as well as that of HUD's Office of Inspector General, that under this

practice, some projects received more financial assistance than necessary to encourage the rehabilitation of housing projects.

IMPACT ON LOW-INCOME FAMILIES

To the extent that developers profited substantially from rehabilitating the projects, it was clearly at the expense of assisting additional low-income families. However, it is very difficult to measure the precise impact on low-income families because no benchmarks exist on what should be an acceptable developer profit. Despite how disturbing it may be that some developers realized substantial gains on their limited investments, also troublesome is that five of the eight projects we looked at were rehabilitated in weak to very weak housing markets where rental housing was frequently in oversupply relative to demand.

Given what we have found, the Moderate Rehabilitation and Tax Credit Programs are most helpful in housing markets with a shortage of rental housing. In housing markets with an adequate supply of rental housing, but where the problem is one of affordability, then the use of the existing housing supply with tenant-based Section 8 housing certificates or vouchers becomes a preferred, more effective, and less costly form of assistance. Certificates and vouchers subsidize the rent payments of low-income households in existing, privately-owned housing by paying a portion of recipients' actual rents.

In August, the Committee asked us to assess the impact of the inefficient use of the Moderate Rehabilitation and Tax Credit Programs on the number of housing units available to low-income families. We have been gathering data from the market areas in which the eight projects are located, and although we expect it will take another 4 to 6 weeks before our work is complete, I would like to share with the Committee this morning some of our preliminary findings.

I will use a project that was rehabilitated in Denver, Colorado, known as Sierra Vista, to illustrate these findings. The Sierra Vista project provided 209 subsidized units. Like other developers, the Sierra Vista developer, combined the Moderate Rehabilitation Program with tax credits. Upon completion of the project, a two-bedroom unit rented for about $600 per month. This rent level was approved by HUD to cover operating costs and to service the debt incurred in acquiring and rehabilitating the project. The rent also met HUD's fair market rent guidelines.[2] When this project was placed in service, the Denver rental market was very weak, with an 11- to 14- percent vacancy rate, and 2-bedroom apartments on the open market rented for about $450 per month, or $150 less than at the Sierra Vista project. Given the market conditions in Denver, use of existing suitable, vacant housing with Section 8 certificates or vouchers would have been the preferred means of assisting low-income families. We believe these programs would have been preferable because significantly more subsidized units could have been provided with the federal funds expended.

Using what we believe to be conservative assumptions, we estimated the total federal subsidy for this project to be about $23 million over the 15-year duration of the subsidy. This $23 million is made up of $5 million in tax credits and $18 million in rental subsidies over the 15-year period. Attachment II shows our calculation of federal expenditures per unit for the Sierra Vista project. The federal subsidy for this project equates to a present value per unit of about $58,000 in comparison to a $36,000 per unit federal subsidy for private rental housing in the same market. Expending

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[2]HUD allows rents of up to 20 percent above the area's fair market rent for moderate rehabilitation projects. The fair market rent in Denver at the time Sierra Vista was placed in service was $502 for a 2-bedroom unit.

the same amount of funds but relying on the existing housing supply in Denver and using Section 8 certificates and vouchers, the government could have subsidized 128 additional units. This figure represents about 60 percent more units than were actually subsidized in the Sierra Vista project.

OBSERVATIONS ON TAX CREDIT LEGISLATION

As you know, low-income housing tax credits are set to expire at the end of this calendar year. There are currently several bills pending that would extend the tax credit authority. Although some of the problems we reported in our August testimony would tend to be self correcting as states gain experience in tax credit allocation and as increasing competition for available tax credits permits states to be more selective in their allocation of credits, we believe it may be appropriate to amend the law as well as extend it. S. 980, now before the Finance Committee, would address many of the issues we have identified. The most important features of the bill are highlighted below.

You may recall that we recommended in our earlier testimony that a central authority be designated to review the tax credits as one part of a total financing package for low-income housing. S. 980 gives responsibility for coordinating and overseeing the tax credit program to the state housing credit agencies. It directs those agencies to develop formal plans for allocating their available tax credits among competing qualified projects. The bill specifies general criteria for the preliminary screening of tax credit applications and gives priority in the final selection to projects (1) serving tenants with the lowest incomes, (2) serving tenants over the longest period, and (3) producing the most units for the least tax expenditure.

An advantage of this last selection factor is that it encourages states to carefully review developer costs and to allocate tax

credits to projects that are most cost-efficient. However, this factor may need further clarification because it could override the other two selection factors. To illustrate the potential conflict this might engender, we should consider the newly authorized tax credits on single-room occupancy dwellings and the stepped up basis (the amount upon which the credit is based) available to be applied to development activities in high building cost or extreme poverty areas. If maximizing the number of units were the overriding selection criterion for allocating credits, single room occupancy buildings would invariably be preferred because they provide the most units per credit dollar. However, single-room units may not meet community needs for family housing. Similarly, bonus tax credits--intended particularly to stimulate development activity in high building cost or extreme poverty areas--would almost never be made available because they produce fewer units per credit dollar, even though such development may be the state's most critical need.

Another feature of S. 980 intended to improve efficiency is the requirement that a state consider the total financing available to a particular low-income housing project. Under this provision, the state would examine other sources of state and federal funds and other tax benefits provided to specific projects. With the total financing picture in view, the state would be permitted to allocate only the amount of tax credit it determines is actually needed to ensure the financial feasibility of the particular undertaking and to ensure the long-term viability of the project as low-income housing. While the statutory selection criteria and allocation factors are mostly general, we believe that the states' motivation to get the most out of this housing finance option will probably help ensure that at least the minimum requirements are met.

The bill would also increase competition for tax credits by expanding their availability to include buildings acquired from HUD and the Farmers Home Administration. Another change would

liberalize the current restrictions on credits for federally subsidized buildings. In areas where high building and operating costs and the extremely low incomes of potential tenants otherwise discourage development and rehabilitation, the bill would permit a stepped up basis (130 percent) to be applied to buildings in these areas. This would yield bonus tax credits and could attract development. The bill's final eligibility expansion would make tax credits available for the first time to single room occupancy, special needs housing projects, and small owner-occupied buildings.

In addition, the bill permits a 1-year carry forward of unused tax credits. This carry-forward provision eliminates the "use or lose" aspect of the previous legislation and encourages the more selective allocation of available credits. Nonetheless, we expect that the demand for tax credits will far exceed the credit ceiling allowable in most states. In this regard, tax credits alone cannot solve the problem of providing sufficient affordable housing for low-income families. There will still be a need to continue other housing subsidies for construction and occupancy at all levels.

Finally, with some limited exceptions relative to foreclosures, the bill would double the current 15-year commitment to keep the property available for low-income housing. This provision would improve the return on the public's heavy investment in tax credits.

To us, these provisions of S. 980 appear responsive and can address the problems and inefficiencies encountered in administering the tax credit program thus far. We believe the Congress should continue to monitor how state agencies are implementing these provisions so that these types of problems do not occur in the future. However, the bill does not address the specific problem of using tax credits to produce housing in markets that have surplus rental units. A basic purpose of tax credits is to increase the production of housing units. But, in some states, housing markets exist in which economic conditions have created a housing surplus.

As we have noted, in such markets more families could be served if they were provided with Section 8 certificates or housing vouchers to help them afford to live in the rental housing that already exists. The Congress may wish to consider restricting the use of tax credits in markets where vacancy rates in suitable housing are high.

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Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Committee may have.

ATTACHMENT I

Project Name[1]	Project Location	Number of Units	Tax Credits Awarded	Estimated Cash Proceeds to Developers
Windsong	Tulsa, Oklahoma	202	$5,369,440	$2,089,727
Sierra Pointe	Clark County, Nevada	160	5,788,360	1,821,006
Cleveland Gardens	Las Vegas, Nevada	36	896,150	253,740
Sierra Vista	Denver, Colorado	209	5,132,350	1,970,440
West Dade	Dade County, Florida	122	1,345,270	434,571
Baltimore Gardens	Las Vegas, Nevada	166	3,363,960	1,061,026
Pebble Creek	Arlington, Texas	352	5,823,300	2,102,963
Sun Garden	Tulsa, Oklahoma	207	4,930,240	1,732,906

[1]Source: Selected from projects reviewed by HUD's Office of Inspector General. See Inspector General report 89-TS-103-0005 dated April 26, 1989.

GAO Project Comparison in Denver Housing Market – 1987

	Moderate Rehabilitation Project (Using Tax Credits)	Section 8 Certificate/ Voucher Projects	Differences
Rent (2 Bedroom)	$600	$450	$150
Present Value of 15-year Subsidy	$57,697	$35,782	$21,915
Number of Assisted Units (15 years)	209	337	128 (60% more units)