DOCUMENT RESUME

04607 - [B0125025]

Section 236 Rental Housing: An Evaluation with Lessons for the Future. PAD-78-13; B-171630. January 10, 1978. 151 pp. + 2 appendices (4 pp.).

Report to the Congress; by Elmer B. Staats, Comptroller General.

Issue Area: Domestic Housing and Community Development: Housing for Low and Moderate Income Families (2101); Domestic Housing and Community Development: Federal Credit Incentives to Stimulate Housing (2104); Program Evaluation Systems (2600).
Contact: Program Analysis Div.
Budget Function: Community and Regional Development: Community Development (451); Income Security: Public Assistance and Other Income Supplements (604); Commerce and Transportation: Mortgage Credit and Thrift Insurance (401).
Organization Concerned: Department of Housing and Urban Development; Office of Management and Budget.
Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs; Congress.
Authority: National Housing Act, sec. 236 (12 U.S.C. 1715z-1). Housing and Urban Development Act of 1968.

The section 236 rental assistance program provided new and rehabilitated rental housing to low and moderate income tenants. This program, along with other housing initiatives, was created in 1968 to boost the Nation's existing housing supply. It joined Federal Housing Administration mortgage insurance with a direct mortgage interest subsidy, the usual tax incentives for residential development, and special tax incentives for low and moderate income housing. This combination of subsidies and a 40-year mortgage term resulted in lower rents than would have been possible in conventionally financed projects. Findings/Conclusions: Section 236 has been effective in providing housing for moderate income families during a period when the supply of moderately-priced rentals has been shrinking. However, section 236 construction is complete, and the Department of Housing and Urban Development (HUD) has refused to make new commitments under the program. At the same time, current public policy provides housing assistance to low income households, and middle and upper income household benefit from tax expenditures for mortgage interest deductions and tax incentives for rental housing. Housing subsidy costs have been analyzed unsatisfactorily because little consideration has been given to indirect subsidies or long-term costs. Alternatives to construction continue to be stressed primarily because of short-term cost savings. Recommendations: The Secretary of HUD should design positive measures to assure that moderate income households receive some equitable share of future housing assistance. HUD should revive section 236 to provide moderate

income housing until workable alternatives are developed. Congress should provide additional funding for section 236 to allow HUD to enter into new commitments under the program and amend present housing law to require some percentage of housing assistance funds to be used to subsidize moderate income households. (RRS)

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Section 236 Rental Housing -- An Evaluation With Lessons For The Future

This report presents a comprehensive evaluation of the section 236 program; compares section 236 to many other Federal programs; and discusses investment incentives, program equity, subsidized tenants and program impact. The 236 program has succeeded in providing nearly half a million housing units to an income group which is now largely excluded from housing assistance.

It contains recommendations to the Congress and the Department of Housing and Urban Development which would assure that moderate income households receive a reasonable share of future housing assistance.

PAD-78-13

JANUARY 10, 1978

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

B-171630

To the President of the Senate and the
Speaker of the House of Representatives

This report evaluates the effectiveness and benefits of the Section 236 Rental Assistance Program. It was prepared in response to a request from Senator William Proxmire, Chairman of the Subcommittee on Housing and Urban Development and Independent Agencies, Senate Committee on Appropriations.

Although we sent a draft of this report to the Department of Housing and Urban Development on September 1, 1977, we received their comments too late for inclusion in this report. The Department raised general questions about the original purpose and long term viability of section 236, disagreed with our conclusions regarding multifamily insurance risk and methods for assisting moderate income households and made various technical points. Our preliminary review of the Department s comments does not alter our view with respect to the conclusions or recommendations set forth in this report. The Department's comments and our analysis of them will be forwarded separately.

Our evaluation was made pursuant to the Legislative Reorganization Act of 1970 as amended by Title VII of the Congressional Budget Act of 1974 (31 U.S.C. 1154).

Copies of this report are being sent to the Secretary of Housing and Urban Development and the Director, Office of Management and Budget.

Elmer B. Staats

Comptroller General
of the United States

D I G E S T

The rental assistance program under section 236 of the National Housing Act (12 U.S.C. 1715 z-1) has provided new and rehabilitated rental housing to low and moderate income tenants. The program couples Federal Housing Administration mortgage insurance with a direct subsidy and the usual tax incentives for residential development as well as some special tax incentives for low and moderate income housing. (See p. 65.)

This combination of subsidies plus a 40-year mortgage term resulted in much lower rents than would have been possible in projects financed conventionally. This is the foremost example of Government assistance for privately developed and financed rental housing.

The program was created in 1968 to boost the Nation's existing housing stock--still considered inadequate in spite of 30 years of Government support--and to provide new housing directly to low and moderate income households. Congress concluded that the private market could not provide needed additional housing without increased Government encouragement and assistance.

Section 236 was to tap the resources and talents of private lenders, entrepreneurs, and philanthropic organizations by allowing profit-motivated developers (or nonprofit organizations) to operate low and moderate income housing in addition to building it.

GAO's objective in performing this evaluation was to put the section 236 program into perspective with other Federal programs and provide an assessment of its performance. It examined accomplishments and shortcomings of section 236 to explain

--what the program did,

--why it worked, and

--why it experienced problems.

In addition, the report provides some general insights into various methods for providing rental assistance and illustrates valuable lessons which would be applicable to future housing policy.

CONCLUSIONS AND RECOMMENDATIONS

Moderate income housing

Section 236 has been effective in providing housing for moderate income households during a period when the stock of moderately priced rentals has been shrinking rapidly (see p. 64.) But section 236 construction is complete, and HUD has refused to make new commitments under the program. At the same time the very poor and middle and upper income households receive help in various ways which result in large Federal subsidies each year. GAO finds no reasonable explanation for excluding moderate income households from housing assistance while others receive significant help.

Accordingly, the Secretary of Housing and Urban Development should design positive measures to assure that moderate income households receive an equitable share of future housing assistance. HUD should also revive section 236 to provide moderate income housing until some workable alternatives are developed. This would also include the section 236 operating subsidy provision.

If the Congress wishes to assure that moderate income households receive some share of future housing assistance, it should provide additional funding for section 236 and amend present housing law to require that some percentage of new housing assistance funds go to subsidize moderate income households.

Housing subsidy costs and housing strategies

Housing subsidy costs often have been analyzed unsatisfactorily with little consideration given to indirect subsidies or long-term costs. Consequently, real costs have often been misunderstood. HUD

is now preparing a comprehensive comparison of its major programs, using methodology closer to that suggested earlier by GAO. 1/ In making such comparisons in the past, costs of leasing existing units, such as under the section 8 leasing programs, and providing housing allowances have been particularly elusive since the indirect costs such as insurance failures and tax expenditures for these alternatives generally are omitted and difficult to estimate.

These alternatives, nevertheless, continue to be stressed primarily because of short-term cost savings as compared to new construction. GAO questions the amount of short-term savings which can be achieved using leasing or allowances when indirect costs are considered and also whether long-term savings really exist when rent increases due to subsidy induced inflation and other uncontrollable factors are included. (See p. 124.)

If long-term savings under leasing and allowances do not materialize and these policies are substituted for new construction, the ultimate effect could then be a decline in housing production at a time when the Nation's housing stock is insufficient without the hoped for savings. Thus, the method of comparing subsidies is crucial to future housing policy decisions.

Accordingly, the Secretary of Housing and Urban Development should assure that the long-term costs of subsidizing extensive leasing of existing units or providing housing allowances are carefully analyzed using a methodology similar to GAO's (see p. 102), and compared to the long-term costs of subsidizing new construction.

Until these cost questions are resolved, the Congress should consider requiring that housing funds be expended to balance existing housing subsidies with new construction

1/"A Comparative Analysis of Subsidized Housing Costs," General Accounting Office, July 28, 1976, PAD-76-44.

subsidies. This should minimize the risk of pursuing a strategy which would be detrimental to either the future supply or cost of housing.

FHA MORTGAGE FAILURES

The mortgage default and failure problem under section 236 was not as serious as it might seem (see p. 75.) Some risk is necessary in any insurance program, and FHA is set up to take risks that private insurers will not. This is to induce added production, and, in the case of section 236, it represents production which would otherwise never have taken place. What has been missing is a perspective on the risks FHA should take and those which it should avoid.

Profit-motivated section 236 sponsors seem to have an acceptable failure experience in terms of numbers and cost of failures. Whereas nonprofits, cooperatives, and rehabilitations may be too expensive and troublesome to be justified (see p. 94.) In the past FHA had taken virtually any risk which met certain tests although private lending institutions and insurers have taken very little risk (see p. 79.) What FHA should do is undertake projects involving reasonable risks in terms of expected production and financial losses and administrative burden. However, serious difficulty has existed in identifying such reasonable risks, and HUD needs to better analyze multifamily insurance risks and consider these risks in starting new programs.

The Secretary of Housing and Urban Development should:

--Establish criteria for judging the performance of multifamily insurance programs as well as procedures for screening out high risk projects. This may require a study of multifamily mortgage risk which links actual loss rates to factors which make certain projects inherently risky. Similar work has already been performed by HUD for single family insurance risk.

--Provide the Congress with an analysis of past FHA program failure experience which makes this history more understandable.

--Evaluate future FHA insurance programs or changes to existing programs in terms of likely insurance losses and present these when proposing program modifications or new alternatives, such as the section 248 subsidy program for the working poor which is under consideration by HUD.

--Suspend commitments for nonprofit, cooperative, and rehabilitation projects until criteria are developed and procedures implemented for predicting and avoiding unacceptable risks.

AGENCY COMMENTS UNAVAILABLE

Although this report was furnished to the Secretary of Housing and Urban Development for comment, GAO was unable to get an official response in time for inclusion in this report.

Contents

ABBREVIATIONS

ACC	annual contribution contract
CRS	Congressional Research Service
FHA	Federal Housing Administration
FNMA	Federal National Mortgage Association
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HAP	housing assistance plan
HCD	Housing and Community Development
HUD	Department of Housing and Urban Development
MIP	mortgage insurance premium
PHA	public housing agency
PILOT	payment in lieu of taxes
SMSA	standard metropolitan statistical area
TDC	total development cost

CHAPTER 1

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The section 236 1/ rental assistance program provided new and rehabilitated rental housing to low and moderate income tenants. It couples Federal Housing Administration (FHA) mortgage insurance with a direct mortgage interest subsidy, and the usual tax incentives for residential development as well as some special tax incentives for low and moderate income housing. This combination of subsidies and a 40-year mortgage term resulted in much lower rents than would have been possible in conventionally financed projects.

This is the foremost example of Government assistance for privately developed rental housing. This program, along with other major housing initiatives, was created in 1968 to boost the Nation's existing housing stock which was still considered inadequate in spite of 30 years of Government support. It was to provide new housing directly to lower income households. The Congress concluded that the private market could not provide needed additional housing without increased Government encouragement and assistance. Section 236 was to tap the resources and talents of private lenders, entrepreneurs, and philanthropic organizations by allowing private developers to operate low and moderate income housing in addition to building it.

This approach had been attempted earlier under section 221(d)(3) which provided either private market rate loans or 3-percent direct Federal loans. But funding was insufficient to provide significant production since with direct loans, the total cost of housing was budgeted in the year a project was started. Another drawback was that the section 221 interest subsidy was insufficient to reach tenants who were just above public housing eligibility yet still unable to afford section 221 rents.

By using private financing, with the Government making yearly contributions to the debt service, the impact on the Federal budget was less severe. The deeper section 236 subsidy, which paid all but 1 percent of the mortgage interest, lowered rents and made the program more attractive. Participation by private developers and nonprofit organizations on a large scale also increased potential yearly production

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1/Section 236 (12 U.S.C. 1715z-1) was added to the National Housing Act by the Housing and Urban Development Act of 1968.

of low and moderate income units. Public housing production was limited by the number and talents of local housing authorities. Finally, the program was to concentrate its benefits on households which were earning too much to qualify for low rent public housing, yet too little to afford adequate housing without assistance.

In view of these objectives, section 236 achieved a great deal. It will ultimately result in constructing or rehabilitating more than half a million privately financed and privately developed rental units. The units primarily serve moderate income households. No other program has adequately served this group, and no current program promises to do so. Nevertheless, in January 1973, section 236 (and other major housing subsidy programs) was suspended and never reactivated. Some reasons cited were that these programs were inequitable, too costly, unsuccessful in concentrating benefits on the poor, difficult to administer, and ineffective in meeting the total housing need. Even with this moratorium, significant numbers of units have been produced under section 236 under earlier commitments. However, these commitments have largely been exhausted, and section 236 construction is nearly complete.

REASONS FOR THIS EVALUATION

The work for this report (PAD-78-13) was undertaken at the request of the Chairman of the Senate Appropriations Subcommittee on HUD and Independent Agencies. We were asked to undertake a broad based study of all aspects of the section 236 program. Our objectives were to put the section 236 program into perspective with other Federal programs and provide an objective assessment of its performance. The report examines the accomplishments and shortcomings of section 236 in order to explain what the program did, why it worked, and why it experienced problems. In addition, we felt we could provide some general insights into various methods for providing rental assistance and illustrate some valuable lessons which would be applicable to future housing policy.

The approach

The resulting research was performed primarily using studies and basic data which were readily available from HUD, other Government agencies, and private researchers. Much can be done using existing information to evaluate a program.

Since comparisons are essential to rational evaluation, they are essential in putting section 236 in perspective. The program is compared to national statistics for rental housing and renter households and to a variety of Federal programs. Program comparisons are made most frequently to the low rent public housing program, which is financed using Federal guarantees for tax free bonds, serves very low income households, and is administered by local housing authorities. Other programs also mentioned frequently include the section 207 (12 U.S.C. 1713) FHA mortgage insurance program for unsubsidized multifamily housing, which serves middle and upper income households and is produced by profit-motivated developers, and the section 8 (12 U.S.C. 1437f) leasing program, which emphasizes Government leasing of privately owned existing or newly constructed housing, and was designed as a replacement for both section 236 and public housing. Section 8 can be financed in many ways and has a flexible subsidy formula which theoretically can serve households which have a wide range of incomes.

WHO LIVES IN SECTION 236 HOUSING?

Households receiving assistance from the section 236 rental assistance program are strikingly different from those being helped by other multifamily subsidy programs. These households have higher incomes than public housing tenants. They have fewer members and tend to be younger. In addition, household members are more likely to earn the major share of their incomes instead of receiving welfare, retirement pensions, or other assistance.

	Median income	Percentage of elderly	Average family size		Percentage employed
			Nonelderly	Elderly	
Section 236 tenants	$5,785	19%	2.8	1.4	68%
Public housing tenants	3,531	42	4.2	1.5	26

Although these households have higher incomes, they generally cannot afford market rents and earn too much to qualify for public housing. Although they would be eligible for the section 8 leasing program, most existing units under that program are going to much poorer households which are similar to those served by public housing. Little construction activity has taken place under section 8, and roughly 70 percent of that construction is planned for the elderly.

Section 236 was intended to primarily serve moderate income tenants, and it does. The tenants are much poorer than the average U.S. family but earn more than public housing and section 8 tenants.

	U.S.	Section 236	Public housing	Section 8 existing
Median household income	$11,800	$5,785	$3,531	$4,000

The program also serves lower income tenants. This happened originally when the program was combined with rent supplement payments. However, the program also serves a larger percentage of poor tenants each year because of the subsidy mechanism and general inflation.

Using HUD data on tenants accepted for occupancy and Department of Commerce figures on poverty level, we estimated that in 1972, when the program was just getting started and average tenant income was $5,250, only 9 percent of all recipient households were at or below the poverty level. In 1976, the average tenant income had increased to about $5,800 and about 24 percent of all tenants were below the poverty threshold.

FHA CAN REACH INCREASINGLY LOWER INCOME HOUSEHOLDS AS TIME PASSES

This trend can be expected to continue. Supply oriented subsidies, such as section 236, which are aimed at increasing the number of units available, can serve relatively poorer tenants each year without significant increases in the subsidy, since rents, and hence the subsidy, are tied closely to the original cost of the project. Rents are, therefore, under control. Such results cannot be expected with a demand-oriented subsidy such as a housing allowance or existing leasing under section 8 which increases the recipient's ability to purchase housing. Such subsidies allow subsidized rents to respond to those in the market which are in turn a function of demand as well as cost. Some belief exists that demand-oriented subsidies contribute to inflated rents, but supporting empirical data is limited. Based on work now in process, we are unconvinced that the Experimental Housing Allowance Program, for example, will yield a reliable answer to this question. Section 236 really affected both supply and demand since it lowered rents to create effective demand and produced housing to respond concurrently to that demand.

QUALITY HOUSING AT REDUCED RENTS

The program provides good quality multifamily housing which is generally considered comparable (although with fewer amenities) to unsubsidized private housing which was built at the same time for more affluent tenants. However, the average monthly rent in section 236 housing was only $144 per month in 1976. (Rents for tenants in public housing and the new section 8 existing leasing program average less than $70 per month.) Nevertheless, section 236 households still pay a large percentage of their income in rent. In recent years most (64 to 68 percent) section 236 households paid in excess of 25 percent of their gross incomes for rent, according to HUD figures. Estimates of the actual rent reduction, which section 236 affords program beneficiaries, vary, but it is generally considered to average over $80 a month and is probably much higher when indirect effects such as longer mortgage term, limited profits, and tax expenditures are considered.

SERVICE TO THE ELIGIBLE POPULATION

The section 236 program and other housing programs probably serve a much larger share of low and moderate income households which have significant housing needs than is generally assumed. Past estimates of this housing program's impact have frequently shown that only a small percentage of intended recipients are served. One can reach this conclusion by examining a single program rather than all past and present programs and by defining eligibility based solely on income. The impact of all housing programs combined is much greater than a single program, and most housing programs are primarily intended to reach households with identifiable housing needs rather than financial needs. Many households which appear eligible for section 236 based on income, as well as public housing or other programs, actually own homes or already have adequate housing at affordable rents. For example, in "Housing in the Seventies," using income eligibility alone, HUD estimated the coverage of section 236 at a fraction of 1 percent. Our calculations indicate much higher impact.

During 1975, section 236 served about 250,000 households in the $5,000-$10,000 a year income group. Public housing and the rent supplement program provided housing to another 280,000 families in this group. Based on figures taken from the Annual Housing Survey, we estimated that fewer than 2.0 million households in this income group were in physical or financial housing need which had not been served by these

programs. As a result, more than 20 percent of those in need were probably served by these programs. Other Federal subsidy programs and older FHA unsubsidized programs are probably also providing significant help to this group.

EXCEPTIONAL INVESTMENT INCENTIVES

Section 236 spurred FHA multifamily production by providing a unique set of investment incentives, subsidies, and mortgage market supports. These were made credible with substantial program funding and created a demand to which builders, lenders, and investors were encouraged to respond. The interest subsidy lowered the monthly debt service to principal plus interest at 1 percent per annum, making rents affordable. Small downpayments allowed builders and sponsors to begin projects with little cash in contrast to conventionally financed projects. FHA mortgage insurance made lending on section 236 projects virtually risk free. Government mortgage purchase guarantees from the Government National Mortgage Association which are probably necessary to the success of FHA financing, assured lenders that they could sell mortgages without discount, providing liquidity. Finally, the low downpayment and resulting high leverage combined with the high yearly interest expense due to 40-year financing allowed exceptional tax shelter for the personal incomes of passive investors.

PRODUCTION WAS SIGNIFICANT

Critics have argued that direct subsidy programs (assisted housing) account for only a small percentage of new housing construction and that such production is undertaken at the expense of private efforts. They conclude that the country must rely on private or unsubsidized production for most new housing. This assertion is true in that "assisted" production has never exceeded 20 percent of total production. However, several important facts have been overlooked. First, virtually all new construction is subsidized somewhat by the tax laws. These indirect tax subsidies for "private" housing are much larger than those for direct subsidies and benefit primarily middle and upper income households. Second, housing producers cannot supply housing to the poor without some additional assistance since market rents for adequate housing are beyond the poor's reach. Also, no clear consensus exists on how much subsidized (assisted) housing production increases total housing construction activity. Some researchers have concluded that it largely replaces private construction. Others feel that the increases are substantial. It is likely, however, that the truth is

somewhere in between, with the relative split depending upon the economy, fund availability, and the health and capacity of the construction industry.

It is clear, however, that section 236 and other direct subsidies distribute housing to a group which could not successfully compete in the marketplace and that in recent years, these subsidy programs have been producing most newly constructed moderately priced rentals, even though the total number of such units has been shrinking. These points are supported by the following information:

--From early 1970 to late 1974, this program produced nearly a quarter of a million units which rented for between $100 and $150 per month. This was more than half of the 400,000 new rentals constructed during the period which had rents in this range, as reported in the Annual Housing Survey for 1974.

--Section 236, public housing, and rent supplements produced approximately 620,000 new units during the same period, which rented for less than $150 per month. This was 82 percent of the total U.S. production of low and moderate priced rentals during the period. State, local, and other small scale subsidy programs probably accounted for much of the remainder.

--During the same period the stock of low and moderate priced rentals (those with rents below $150 per month) shrank by nearly 3.8 million units while the number of renter households who could not afford higher rents, based on 25 percent of their incomes, decreased by only 1.5 million.

Whether subsidy programs actually increase U.S. housing production or merely replace private construction, low and moderate income tenants would not receive new housing without these subsidies. In addition, the stock of units available to these households has been shrinking.

THE SUBSIDY COSTS OF SECTION 236

New construction under the section 236 program resulted in major subsidy costs to the Federal Government which were incurred in a variety of ways, including sizable tax expenditures. The exact subsidy amount varies to a great extent with the tenant's income, the cost of the housing unit, and the interest rate on the mortgage. These subsidies would likely be the same for new FHA-insured

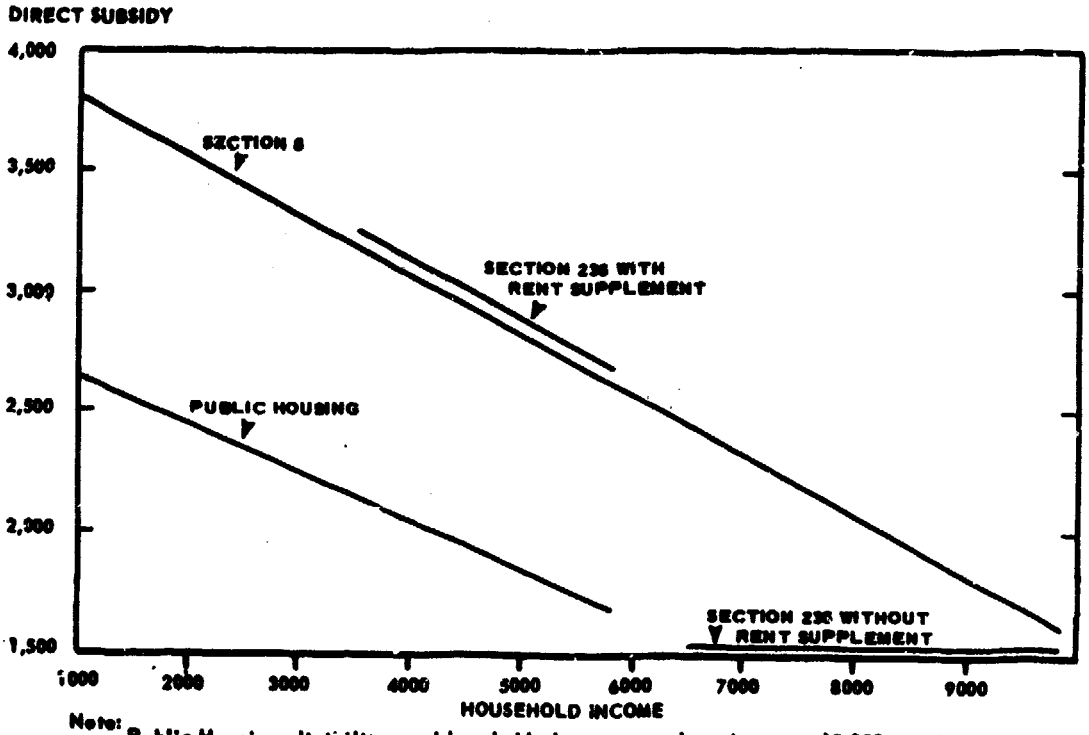
construction under section 8 or any other FHA-insured subsidy program except that many tenants would pay lower rents under section 8 than they did under section 236. (See ch. 10.)

Direct subsidy

For lower income tenants the yearly section 236 direct subsidy is generally higher than it would be under public housing and about the same as it would be for section 8. For a tenant at the higher end of the moderate income range, who would not ordinarily qualify for public housing, the direct subsidy under section 236 would generally have been less than anticipated under section 8. This occurs because of an upper limit on the section 236 subsidy. Tenants must pay at least the oper ting expenses plus principal and interest on the mortgage . 1 percent, unless they qualify for the additional rent supplement subsidy. This often caused section 236 tenants to pay in excess of 30 or even 40 percent of their incomes in rent, while section 8 tenants can pay no more than 25 percent of their income, after adjustments, for family size.

Direct subsidies, as a function of tenant income under all three of these programs, are shown in the following graph for a typical newly constructed apartment. The differences between sections 8 and 236 reflect the different tenant rents resulting from these programs' rules.

NEW CONSTRUCTION
DIRECT SUBSIDY (DOLLARS)
TWO BEDROOM APARTMENT, FOUR-PERSON HOUSEHOLD
TOTAL DEVELOPMENT COST = $27,125



Note: Public Housing eligibility would probably lapse somewhere between $5,000 and $6,000. Section 236 rent supplement payments would be dropped at about the point that public housing eligibility lapses.

Yearly Direct Subsidy for a Family of Four (note a)

Gross annual tenant income	Section 236 Limited dividend	Section 236 Non-profit	Section 8-limited dividend	Conventional public housing
$4,250	b/$3,041	b/$3,294	$2,988	$1,988
9,000	c/1,531	c/1,701	1,800	(not eligible)

a/Based on a unit development cost of $27,125.

b/With rent supplement.

c/Without rent supplement.

Indirect subsidies

The indirect costs for section 236 have generally been calculated as much lower than those of public housing, and our calculations show the same result. However, we found the difference was less than usually reported by HUD and others. In the past HUD has generally underestimated the cost of related tax expenditures, ignored or understated the cost of mortgage failures and Government National Mortgage Association Tandem subsidies, and used a very high estimate of public housing related tax expenditures.

Using assumptions which we feel still understates the cost of section 236 subsidies yet overestimates the costs of public housing subsidies, we calculated the long-term discounted costs of public housing as somewhat less than the other alternatives. If less conservative estimates were used, public housing could be shown as much less expensive than the FHA alternatives.

New Construction

Discounted Annual Subsidy Cost (20-Year Average) for a Family of Four With $4,250 Annual Income

	Section 236 with rent supplement		Section 8-	
	Profit motivated	Non-profit	Profit motivated	Public housing
Direct subsidy	$1,848	$2,002	$1,816	$1,208
Federal tax foregone	272	-	272	459
Tax revenue on sale (after 20 years)	-49	-	-49	-
Insurance losses	-15	323	-15	-
Tandem plan subsidy	105	158	105	-
Local tax foregone	-	-	-	318
HUD administration	20	20	20	20
Total	$2,181	$2,503	$2,149	$2,068

However, one cannot automatically conclude that the FHA alternatives are less cost-effective. Section 236 caused the production of a large number of units very rapidly. The program attracted many private investors who provided capital and entrepreneurial skills to a very new endeavor (that is, providing housing through the private market to low and moderate income households with considerable

Government assistance). This had never been accomplished on any credible scale under the older programs, and section 8 does not appear to be providing any new construction volume, except perhaps for elderly housing.

We also estimated the costs of rehabilitation under section 236. Assuming a rather high rehabilitation cost (which was typical under subsidized rehabilitation), the direct subsidy costs were lower than for new construction,

Average Yearly Cost (First 5 Years)
Two-Bedroom Unit, Family Income of $4,250

	New construction	Rehabilitation
Development cost	$27,125	$23,463
Direct subsidy	3,040	2,525
Federal taxes foregone	670	1,532
Total subsidy	$ 3,710	$ 4,057

but the long-term cost of rehabilitation, including sizable tax expenditures and other indirect subsidies, was substantially higher.

Discounted Annual Subsidy Cost
(Family of Four, $4,250 Annual Income)
(20-Year Average) (note a)

	Section 236 new construction	Section 236 rehabilitation
Total development cost (TDC)	$27,125	$23,463
Direct subsidy	1,848	1,535
Federal taxes foregone	272	474
Revenue on sale after 20 years	-49	-58
Insurance losses	-15	252
Tandem plan costs	105	123
HUD administration	20	20
Total subsidy	$ 2,181	$ 2,346

a/Both alternatives are with rent supplements and limited dividend sponsorship.

This conclusion would also apply to rehabilitation under other FHA programs which use profit-motivated developers since the factors contributing most to high cost under rehabilitation were exceptional tax savings for investors in the first 5 years and a much higher mortgage failure rate. These factors would probably affect any FHA rehabilitation program. However, certain indirect costs, which were not considered, might be saved under the rehabilitation approach since services such as streets and sewers probably already existed for rehabilitated units. Rehabilitation would probably be much cheaper when developed by nonprofit sponsors (since no tax expenditures are involved) if the exceptional mortgage failure problems experienced by both nonprofit and rehabilitated projects could be alleviated. Rehabilitation may encompass other goals such as rejuvenating or preserving residential neighborhoods which could outweigh the cost consideration in some circumstances.

Leasing existing units was compared to new construction in various housing markets. In the short run section 8 leasing resulted in savings in all these markets, but many factors could cause existing rents to increase more rapidly than new construction. By considering only a few of these factors, such as moderate appreciation in property values and periodic refinancing, we showed that in a tight housing market with relatively high existing rents, the long-term costs of leasing could easily outstrip new construction subsidy costs. More importantly, if all costs and factors which might increase leasing costs over time were considered, including inflation induced by high demand, leasing might in general prove more expensive than new construction or the magnitude of the hoped for savings could be much lower.

Cost compared to private housing

In preparing this paper we performed a literature search and analysis of previous attempts to show that newly constructed private housing was in some sense cheaper than new publicly assisted housing.

None of the research adequately dealt with the myriad problems involved in such comparisons. Therefore, we must conclude that little is really known about this question. Conceptual arguments and explanations exist as to why publicly assisted production should be more expensive, such as higher wage rates due to Federal law and higher financing charges resulting from construction delays. However, these

can be balanced by arguments that publicly financed construction may lower rents without increasing costs. For example, longer financing terms are available for assisted housing. These longer terms greatly reduce the rents necessary to carry the housing. In addition, housing which does not have to be competitive in the private market can be built with fewer amenities and smaller floor plans. One reason often cited to explain why assisted housing may be more expensive to construct is that stricter building requirements under FHA or Public Housing drive up costs. These requirements are really minimal and cannot be considered as increasing cost. Any lower quality might result in inferior construction, and competent private builders could be expected to meet these standards. When these standards were not met, higher maintenance and operating expenses would likely result.

FHA MORTGAGE FAILURES

Defaults and mortgage failures under FHA multifamily insurance programs were given by HUD as major reasons for the suspension of section 236. However, we found that the failure problem was probably not as pervasive as portrayed. This conflict may be partially explained by the lack of clear and concise information available on mortgage failures and a lack of perspective in most FHA failure comparisons. This report treats these shortcomings in some detail and concludes:

--Past comparisons by HUD have been misleading.

--No accepted criteria presently exists for judging failure experience other than whether insurance losses exceed premium income which is not valid for section 236 because this program was expected to incur somewhat greater losses than unsubsidized programs. (The Congress actually made provision for funding such losses.)

--Some general criteria are needed for projecting risk and analyzing failure experience in FHA programs.

Mortgage failure analysis

We also presented our own discussions and comparisons of section 236 failure experience. These explained the degree of risk involved in this program and examined the section 236 experience as objectively as possible. Most section 236 financial failures occurred in nonprofit and cooperatively sponsored projects rather than profit-motivated ones. Roughly 58 percent of all failures were in nonprofit and cooperatively sponsored projects although they comprised only about 30 percent of total insurance.

Nonprofit and Cooperative Sponsors Comprise a Disproportionate Share of Failures June 30, 1976

Type of sponsor	Percent of sponsored projects	Percent of project failures
Nonprofit	23	47
Cooperative	6	11
Limited dividend	71	42
Total	100	100

These failures very likely resulted from lack of experience and limited financial resources in the nonprofit or cooperatively sponsored projects which contributed to management problems and made it difficult to meet unexpected expenses during construction or operation. Rehabilitation projects have also had high failure rates. Avoiding these and other risky projects would have produced a much lower failure rate for section 236. But even including these projects, the failure rate is neither as high nor as costly as often implied.

Assisted by an actuarial consultant, we analyzed the failure experience of the section 236 program between 1968 and 1973, just prior to the moratorium on subsidized housing. We found that the failure rate for section 236 projects started during the period was equal to that of another unsubsidized FHA multifamily program for middle and upper income households, section 207. Section 207 was not suspended. Both these programs had failure rates which were substantially better than other programs operating at the same time.

Section 236's Failure Rate Was Equal to or Better Than Other FHA Programs During the 1968 to 1973 Period

Program	Percent of cumulatively insured units which failed
Section 236	8.8
Section 207	8.8
Section 221 BMIR	14.9
Section 221 MIR	15.3

Section 207's failure experience is usually considered the best among all multifamily programs. The reason section

207 is thought to be better may be that it tends to lose less money when it fails and units are subsequently sold. The following table shows that for projects started between 1968 and 1973, section 207 lost less per unit produced than did all section 236 projects. However, section 207, which is developed by profit-motivated sponsors, has lost much more when compared to profit-motivated (limited dividend) section 236 projects. As mentioned earlier the high failure rate for section 236 projects is attributed to nonprofit sponsors. The failure rate for limited dividend projects is much lower.

	Failure rate	Units failure costs	Cost per unit produced
Section 207	8.6%	$5,443	$ 478
Section 236			
All projects	8.8	9,174	807
Limited dividend	3.3	7,922	261
Nonprofits	14.6	9,671	1,411

A separate cost analysis was performed by us based on the pessimistic assumption that 2 out of 5 nonprofit units will fail and 1 out of 10 limited dividend projects will fail during a 20-year period. Calculations showed that when losses were subtracted from insurance premiums, nonprofit projects would cause substantial losses to the insurance fund for each unit produced while the fund would probably break even on limited dividend projects. (See p. 116.)

Multifamily FHA insurance failures appear high when compared to private financing, but FHA insures the entire mortgage when construction begins. Private mortgage insurers will not insure construction loans since construction is the riskiest period in the life of a residential project. Furthermore, private lenders require higher downpayments from developers. Even after construction is complete, private insurers underwrite only 20 percent of the mortgage amount. So the lender still stands to suffer a financial loss if the project fails. This is not the case with FHA-insured projects which may cause lenders to be less concerned about working out problems when they arise. Lenders on private projects also require sponsors and developers to have had some successful experience. FHA does not. This means that private insurers take little risk compared to FHA and, consequently, have fewer and less costly failures. FHA is not competing with private insurers. Rather it is encouraging construction which otherwise would not take place.

We analyzed and summarized the specific factors which explain multifamily mortgage failures. The most important and most credible of these factors are shown below:

--Many projects fail during construction or because of problems originating during construction. These problems are often aggravated when the sponsors having the difficulty are inexperienced or underfinanced. In addition, the Department of Housing and Urban Development's monitoring may have been inadequate since it emphasized planning versus followup and because HUD was probably improperly staffed for monitoring.

--Operating costs were underestimated during project planning, and rents were inadequate to cover them.

--Utility costs rose unexpectedly in recent years, and HUD was probably slow in granting necessary rent increases. As a result, projects lacking strong financial assets will very likely fail.

--Projects had insufficient slack built into the rents to allow for unexpected cost increases. Section 236 limited dividend sponsored projects must limit cash flow to about six-tenths of a percent while similar privately financed projects plan a yearly return of 3 to 4 percent of the project's value. Nonprofit projects have no profit margin whatsoever.

--Projects which failed were often located on poor sites which were either too close to undesirable industry or too distant from places of employment, schools, and other needed services.

--Projects in urban renewal areas and rehabilitated projects are more prone to fail.

--When a section 236 project defaults, lenders are not motivated to work out the problems with project sponsors because of the full guarantee against losses. Lenders can pass off troubled projects to HUD easily by a process known as "assignment" in which HUD pays 99 percent of the mortgage balance and assumes responsibility for the lender. Thus, many projects may have failed when they could have been saved by proper handling by the lender.

CONCLUSIONS AND RECOMMENDATIONS

Moderate income housing

Section 236 has been effective in providing housing for moderate income households during a period when the stock of moderately priced rentals has been shrinking rapidly. But section 236 construction is complete, and HUD has refused to make new commitments under the program. Current public policy provides housing assistance to many low income households through public housing, section 8, and other State and local programs. Middle and upper income households continue to benefit from sizable tax expenditures for mortgage interest deductions and tax incentives for rental housing. Congress has repeatedly affirmed its conviction that moderate income households should be served by enacting programs which could serve this group. Although section 8 is also theoretically capable of subsidizing moderate income households, the leases for existing housing units have thus far been for the very poor, and new construction under section 8 seems to be aimed at the elderly. Section 8 may never reach moderate income households since no control exists in the subsidy mechanism to assure their inclusion. We find no reasonable explanation for why one American income group should be excluded from housing assistance while others receive significant help.

Recommendation

The Secretary of Housing and Urban Development should design positive measures to assure that moderate income households receive some equitable share of future housing assistance. HUD should revive section 236 to provide moderate income housing until some workable alternatives are developed. This would also necessitate implementation of the section 236 operating subsidy provision.

Recommendations to the Congress

If the Congress wishes to assure that moderate income households receive a reasonable share of future housing assistance, we recommend that the Congress:

--Provide additional funding for section 236 to allow HUD to enter into new commitments under the program.

--Amend present housing law to require that some percentage of new housing assistance funds be used to subsidize households which the Secretary defines as having moderate income.

These measures would provide added flexibility to the Department's housing strategy.

Housing subsidy costs and housing strategies

Housing subsidy costs have often been unsatisfactorily analyzed with little consideration being given to indirect subsidies or long-term costs. Consequently, the real costs have often been misunderstood. In an earlier staff study 1/ on subsidized housing costs, which is the basis for the cost information in this report, GAO suggested that HUD be required by the Congress to use long-term cost estimates when comparing programs. HUD is now preparing a comprehensive comparison of its major programs, using methodology closer to that suggested by GAO in that staff study. In making such comparisons in the past, the costs of leasing existing units, such as under section 8, and providing housing allowances have been particularly elusive since the indirect costs of these alternatives are generally omitted, and are quite difficult to estimate for the long term.

These alternatives, nevertheless, continue to be stressed primarily because of short-term cost savings as compared to new construction. We question the amount of short-term savings achieved using leasing or allowances when indirect costs are considered and also whether long-term savings really exist when rent increases due to subsidy induced inflation and other uncontrollable factors are included.

If the projected long-term savings under leasing and allowances did not materialize and these policies were substituted for new construction, then the ultimate effect could be a decline in housing production at a time when the Nation's housing stock is insufficient without the hoped for savings. Thus, the method of comparing subsidy costs is crucial to future housing policy decisions.

Recommendation

The Secretary of Housing and Urban Development should assure that long-term costs of subsidizing extensive leasing of existing units or providing housing allowances are carefully analyzed and compared to long-term costs of subsidizing new construction.

Recommendation to the Congress

Until these questions of costs are resolved, the Congress should consider requiring that housing funds be expended to balance existing housing subsidies with new construction

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1/"A Comparative Analysis of Subsidized Housing Costs," General Accounting Office, July 28, 1976, PAD-76-44.

subsidies. This should minimize the risk of pursuing a strategy which would be detrimental to either the future supply or cost of housing.

FHA mortgage failures

The mortgage default and failure problem under section 236 was not as serious as it might seem. Some risk is necessary in any insurance program, and FHA was set up to take risks that private insurers would not. This is done to induce added production, and, in the case of section 236, it is production which would otherwise never have taken place. What has been missing is a perspective on what risks FHA should take and those which it should avoid. Profit-motivated section 236 sponsors appear to have an acceptable failure experience in terms of both numbers and cost of failures. Whereas nonprofits, cooperatives, and rehabilitations may be too expensive and troublesome to be justified. In the past FHA has taken virtually any risk which met certain tests while private lending institutions and insurers have taken very little risk. What FHA should do is undertake projects involving reasonable risks as judged by the expected production and financial losses and administrative burden. However, there has been serious difficulty in identifying these reasonable risks. Determining whether a program, or an insurance fund, is actuarially sound (will reserves cover expected losses) is not necessarily a reliable measure since FHA insurance premiums are set arbitrarily, and under subsidized programs these premiums are really paid by the Government. Simply comparing one insurance program to another is rarely enlightening since few FHA programs are really comparable because they have operated over different time periods with different subsidy and management arrangements. FHA cannot be compared to private mortgage insurance funds since these handle only the best insurance risks.

In this report, we compared section 236 with other FHA multifamily programs which were in operation at the same time and found that for insurance written during those 5 years section 236 was no worse and often better than other FHA programs. We then looked at subgroups of section 236 projects to conclude that new profit-motivated projects did much better than nonprofits, cooperatives, and rehabilitation projects. We also explain the differences between private insurance funds and FHA in terms of risks taken and note that the most troublesome FHA projects could have been expected to have high failure rates based on the risks involved in these projects and prior program experience. For example, nonprofit sponsors were often inexperienced and lacked financial resources, and

nonprofits had established spotty records under earlier programs. In spite of HUD's experience with past multifamily programs, the Department plans to devote more than half of its 1978 construction commitments under section 8 to nonprofit sponsors and rehabilitation projects. Our work on mortgage failures helps to increase understanding of the problem, but additional and more focused information is needed. Until such information is developed, HUD needs to modify its policy for insuring subsidized projects.

Recommendations

The Secretary of Housing and Urban Development should:

--Establish criteria for judging the performance of multifamily insurance programs as well as procedures for screening out high risk projects. This may require a study of multifamily mortgage risk which links actual loss rates to factors which make certain projects inherently risky. Similar work has already been performed by HUD for single family insurance risk.

--Provide the Congress with an analysis of past FHA program failure experience which makes this history more understandable.

--Evaluate future FHA insurance programs or changes to existing programs in terms of likely insurance losses and present these when proposing program modifications or new alternatives such as the section 248 subsidy program for the working poor which is under consideration by HUD.

--Suspend commitments for nonprofit, cooperative, and rehabilitation projects until criteria are developed and procedures implemented for predicting and avoiding unacceptable risks.

AGENCY COMMENTS UNAVAILABLE

Although this report was furnished to the Secretary of Housing and Urban Development for comment, we were unable to obtain written comments in time for inclusion in this report.

CHAPTER 2

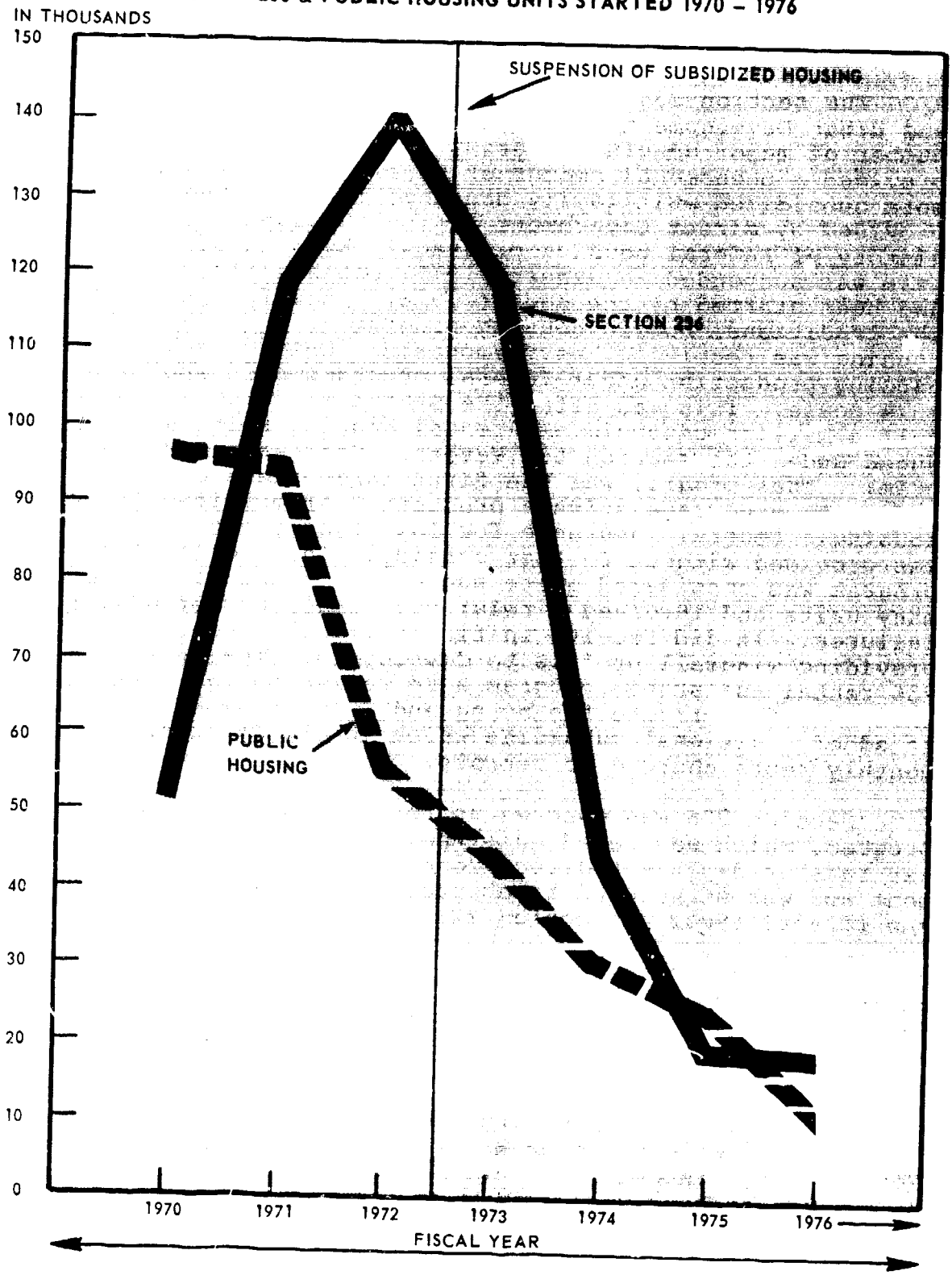
INTRODUCTION

The section 236 program was established by the Housing and Urban Development Act of 1968. This act included a number of major housing programs which, in combination, provided a phenomenal amount of housing in only a few years--more subsidized multifamily housing, in fact, than had been provided by direct Government action throughout the 40-year history of Federal housing programs. Even though the program was suspended in January 1973, roughly 500,000 units had been started by the end of 1976. This far outdistanced the traditional public housing program at a time when public housing was receiving heavy emphasis. Only once before did housing production under Federal programs even approach this scale. This was after the Second World War, when nearly half a million unsubsidized rental housing units were produced under the section 608 Veterans Emergency Housing program. That program was the first large-scale Government effort to encourage private production of multifamily rental housing. Federal insurance for low downpayment mortgages was provided without further subsidy. The section 608 program was considered quite successful since it provided many units and involved a relatively small number of mortgage failures. It did receive initial criticism, however, for providing windfall profits to developers. The section 236 rental assistance program also relied on FHA mortgage insurance for private financing and private ownership, but it added additional subsidies which in effect lowered the monthly rents charged to tenants.

Section 236 was enacted to replace the section 221(d)(3) program, which was based on either the current market interest rate or 3-percent direct loans from the Federal Government and was structured to overcome problems which undercut the effectiveness of section 221(d)(3).

The 3-percent direct loans featured under section 221(d)(3) were not providing a sufficient number of multifamily units to keep pace with perceived housing needs. There were probably a number of reasons for this, but two major problems with section 221(d)(3) were (1) the direct-loan approach required the Congress to provide the entire cost of new housing in a single year, so producing a large number of units would have a huge impact on the budget, and (2) increases in building costs were making it difficult to produce section 221(d)(3) units that eligible tenants could afford. Thus, a switch to insuring loans by private

SECTION 236 & PUBLIC HOUSING UNITS STARTED 1970 – 1976



lenders and providing a yearly subsidy, which would effectively lower the developers' mortgage interest rate from 3 to 1 percent, looked like a promising alternative. Only the yearly subsidy payments would appear in the budget, and the further reduction of the interest rate would allow lower rents.

Both section 236 and its predecessor were aimed at moderate-income tenants or, more precisely, those households whose incomes were too high to qualify for public housing, yet too low to obtain adequate housing in the market at affordable rents. Both programs were capable of reaching low-income tenants when combined with the rent supplement program, which provided assistance payments to private owners (or nonprofit sponsors) of housing insured under a variety of Government programs. Rent supplements were used extensively with the section 221(d)(3) market rate and section 236 programs. The rent supplement program was enacted to serve a subgroup of the households eligible for public housing and was intended as a private enterprise alternative to the public housing program. This deeper rent supplement subsidy was limited to a minority of the units in any one project, and consequently section 236 and its predecessor were still predominately moderate-income programs.

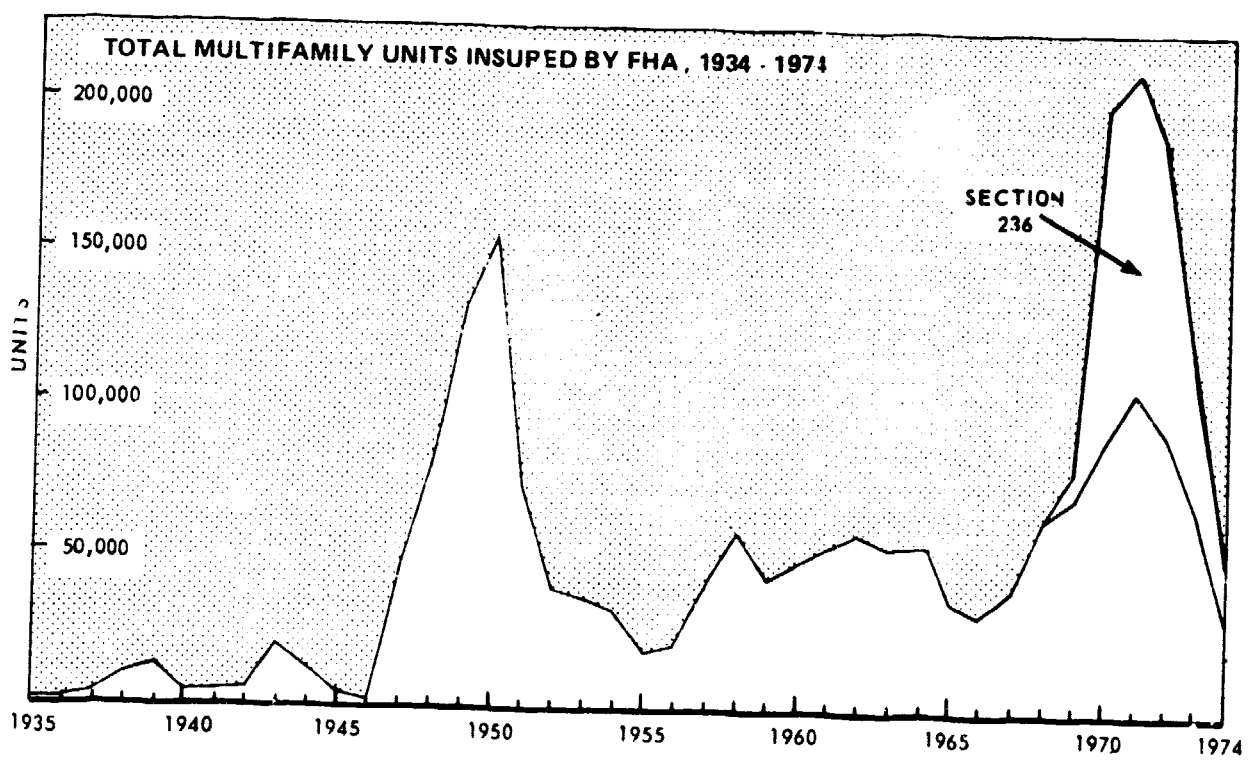
The section 236 rental assistance program was characteristically used by profit-motivated builders and developers who sold interests in housing projects to passive investors, but there were also a large number of nonprofit organizations who sponsored projects. These nonprofit organizations were very often inexperienced in the housing business. It is frequently said that neither of these entities had the skill and motivation needed to be successful in long-term management of subsidized housing.

In addition to the direct subsidy provided to section 236 projects, there are indirect subsidies, such as accelerated depreciation (available to all rental housing), and special subsidies, such as the Government National Mortgage Association (GNMA) tandem plan under which mortgages are purchased by GNMA and resold at a loss, which allows lower interest rates and increases availability of mortgage money. This combination of subsidies is costly, and critics maintain it is too costly.

The section 236 rental assistance program has also been criticized as having an inordinate number of projects that experience financial difficulty and as having excessively high (and costly) default and foreclosure rates to warrant continuation of the program.

HISTORICAL PERSPECTIVE

The Federal Housing Authority has played a long and dominant role in the provision of multifamily housing in the United States. Initially it provided mortgage insurance to privately produced unassisted housing with some limits on mortgage amounts to encourage developers to provide moderately priced units. Although public housing has also provided a large amount of multifamily housing since its inception in the thirties it was really intended to serve more needy families while FHA was originally not considered a subsidy program at all; in fact it made money. With the general growth in Federal expenditures and the nation's affluence, the government began to take a more active role in providing multifamily housing. A series of programs for the elderly, for those displaced by Urban Renewal and for moderate income tenants, as well as for more affluent households were added. Funding for these programs fluctuated but gradually increased over time. By the early sixties FHA insured financing was being combined with various subsidies and mortgage market supports and tax incentives to provide housing to an increasingly less affluent group. Problems with several programs and a general disaffection with subsidy programs culminated in the budget minded suspension of all major housing subsidy programs in 1973. Since that time the roles of FHA and public housing have been debated extensively as new programs have been developed to replace older ones. The last major FHA multifamily subsidy program was the section 236 rental assistance program. It provided more multifamily housing units in only a few years than any other multifamily insurance program and more total units than every other subsidy program except public housing which has operated since 1937.



The new section 8 leasing program, which is favored by HUD, has been developed to capitalize on the strengths of past programs while avoiding the pitfalls of older ones. It also provides a flexible subsidy formula which is not tied to the debt service, as in section 236 and public housing. This allows HUD to provide much deeper subsidies as necessary and allows subsidies to be increased by administrative action, should inflation require such action, without congressional approval. Section 8 can serve all the income groups served by the suspended subsidy programs and can use several different housing strategies. Section 8 can provide newly constructed housing through (1) FHA-insured loans and private or nonprofit sponsorship, (2) private financing, (3) State housing agencies, or (4) public housing authorities. Existing housing can also be used with a local housing authority or another intermediary acting as a leasing agent. In all cases, the subsidy is based on established fair market rents, which HUD publishes by type and size of housing within each local jurisdiction of the entire country.

The low-rent public housing program uses local housing authorities to provide predominately newly constructed housing. There are a variety of methods available to do this. The local authority will most often plan and contract for construction and float tax-exempt mortgage bonds to pay for the project. The debt service on these bonds is then paid by the Federal Government, and the rents collected must defray all operating expenses. In recent years additional operating subsidies have been provided to housing authorities when necessary.

This report examines the accomplishments and criticisms of the section 236 program and attempts to place the program and the housing which it produced in a clearer perspective so that the strengths and weaknesses of this and similar subsidy programs can be clearly understood.

CHAPTER 3

THE HOUSING MARKET AND HOW SUBSIDIES SUPPLY HOUSING TO THE POOR

This chapter describes the basic nature of the housing market and indicates how section 236 acts on this market to affect the supply of standard housing for low and moderate income tenants.

During the development of the Housing and Urban Development Act of 1968, the goal was established to build or rehabilitate 26 million housing units during the decade 1968-78, including 6 million federally assisted units for low and moderate income families. Several programs, including section 236, were devised and incorporated into the 1968 legislation to achieve the national production goal. A common thread through the various programs was the desire to attract large amounts of private equity capital rather than relying on the Federal Government for complete funding. These programs sought to make maximum use of the Nation's money markets.

In establishing this production goal, the 1968 legislation was attempting to achieve the national goal, stated in the Housing Act of 1949, of "a decent home and a suitable living environment for every American family." The production goal was to eliminate substandard housing from the Nation's housing stock. However, the production goal involved assistance for 6-million units, even though, at that time, an estimated 8.8-million units needed replacement or rehabilitation. It was thought that the difference would be made up by existing assisted housing, additional income supplement, or through a loosening of the housing supply, which would increase the supply of housing at lower rents or prices. This strategy was expected to be viable if the overall production goal of 26 million units could be achieved. In other words, it was assumed that the private market could not provide housing to those unable to pay market prices and that most of this demand could be satisfied only with assistance.

Section 236 was designed to provide a portion of the 6 million federally assisted units. Several studies performed during the past 10 years provide background information which permits us to examine the placement of this program within the context of the housing sector of the economy.

THE HOUSING MARKET

The supply of housing units remains relatively stable in the short run, with new construction added to the housing stock in any year amounting to no more than 3 percent of the number of existing units. Ultimately, the supply is determined by demand, but the process is inherently incomplete and, in any event, lags behind demand. Even if the suppliers of housing were able to recognize demand immediately the nature of the product precludes immediate adjustment. Nevertheless, available evidence does suggest that, in the long-run, the supply of housing is highly elastic, that is, responsive to changes in demand. Richard Muth, a housing economist, has estimated that in our economy it takes 6 years for such an adjustment to become 90 percent complete.

Demand is primarily a function of the number of households formed

The quantity of housing units demanded is a reflection of the number of households formed and their ability to purchase housing services. Other demand occurs to replace accidental losses, purchase second homes, and satisfy the desire for more modern housing or a better neighborhood.

Most new households are formed when young people leave their parents, when married couples divorce, and when young adults or elderly persons decide to keep their own households rather than sharing with others. During the 1960s, the headship rate (proportion of an age group who are heads of households) was increasing, primarily among the young and the elderly. A possible reason for the increase among the young is that they are tending to marry later and to maintain separate households before they marry. The headship rate increase among the elderly has probably resulted from increased affluence, permitting them to maintain separate households. Between 1950 and 1970, the average number of persons per household fell from 3.39 to 3.11 while the number of one-person households nearly tripled, increasing by 7.1 million.

Improvements in the quality of housing stock

Improvements in the overall quality of housing are evidenced by changes in several measures between 1950 and 1970. The number of substandard units to be removed and crowded households in standard units (the only measures of housing quality made in the 1970 Census of Housing, Components of Inventory Change) decreased from 20.5 million units, or 44 percent of the total housing supply, in 1950 to 10.4

million units, or 15 percent of the housing inventory in 1970. The median number of rooms per housing unit increased from 4.7 to 5.0 during the same period, at the same time that the average number of rooms per person increased from 1.42 to 1.65. These two measures may be combined to show a decrease in crowding from 1950 to 1970 such that the number of households with more than 1.01 persons per room changed from 6.7 million households (15.7 percent) to 5.2 million households (8.2 percent).

Improvement is related to rising income

The improvement in the average quality of housing is generally attributed to increases in family income. When incomes rise, families tend to demand and consume more housing services, even though they do so at a decreasing rate. As mentioned earlier, this increased demand is eventually translated into an increased supply of housing. However, since the existing stock is essentially fixed, except for the relatively insignificant conversion of single units into multiple units, any increase in the supply is affected by new construction.

The construction industry

In general, the residential construction industry is geared to supply new housing to replace old units which are removed and to serve new households which are formed. Rising incomes constitute a driving force behind new construction and induce a demand for housing that pushes prices up. The higher prices and increased profit potential attract entrepreneurs leading them to expand the capacity of the industry. New firms and labor are drawn into the industry. Since residential construction does not require substantial capital or highly skilled workers, entry to this market has few barriers. As a result, there is a high degree of mobility of resources into this industry to meet the demand generated by rising incomes.

Housing production sensitive to availability of credit

The industry is highly sensitive to the supply of credit needed both by builders (to complete construction and development) and by buyers (to finance purchase of completed units). When interest rates are high, demand for housing is reduced since the capitalized cost of the housing unit and the monthly mortgage payment are both higher. High interest rates are brought about when industrial production and capital expansion

are high. In addition, the higher interest rates available from investments in nonresidential capital formation are more attractive to the investor, so that the residential mortgage becomes an unattractive investment. These conditions, in part, lead to significant fluctuations in the supply of mortgage credit. As a result, residential construction is a relatively unstable industry. The Federal Government has devised several mechanisms over the years that have served as financial intermediaries such as FNMA and GNMA designed to temper cyclical fluctuations in the credit market.

SUPPLYING HOUSING FOR THE POOR

The housing wishes of most Americans are readily provided in the normal workings of the private sector. However, poor households do not have the same facility, since their incomes do not permit them to exert effective demand for housing. The proportion of their incomes that they can devote to housing is too low to support new construction designed for them or to pay rents for existing units that will be sufficient for maintenance and repair. As a result, many poor families are resigned to pay a burdensome proportion of their incomes for rent, to live in overcrowded conditions, or to live in dilapidated or deteriorated units.

The private market is inadequate

The private market alone never eliminates the housing deprivation of the poor. On the contrary, past experience suggests that, at least in part, the private market exacerbated the plight of the poor. At one time, tacit agreement among the FHA, lending institutions, and fire insurance companies served to block off loans or insurance for certain "redlined" districts of central cities judged to have unfavorable economic futures in that property values were likely to decline. The net result of such action was an even faster decline in the habitability of dwelling units in those areas, since property owners were unable to finance improvements. In addition, discrimination in the housing market tended to lead minorities (who, in general, have lower incomes already) to pay more than the white majority for comparable units.

Housing deprivation for the poor will decrease as incomes rise and unemployment falls, particularly when members of housing-deficient and poverty families get jobs. However, there is no easy solution by which such families can be decently housed without subsidy. The most desirable form of the subsidy (production- or consumer-oriented) is a matter of some controversy. Since section 236 is a production or

supply-oriented subsidy, the subsequent discussion focuses on the issues which are pertinent to its evaluation.

The existing stock is insufficient

The existing supply of housing is considered insufficient to satisfy the housing needs of all families. For example, in the third quarter of 1973, the national vacancy rate for rental units of 5.3 percent against a total supply of approximately 25-26 million rental units indicates that roughly 1.5 million units were vacant. Of the vacant units, only 600,000 had all plumbing and rented for less than $120 per month (which is close to the median rent charged families who moved into section 236 housing in the 12 months prior to September 30, 1973). In the 1970 Census of Housing, approximately 4.5 million units were lacking plumbing, 4.7 million units were overcrowded, and 8 million families paid more than 25 percent of their incomes for rent. Even if the vacant units were located precisely where they are needed, it is unlikely that even 10 percent of the families with some sort of housing need could be served.

Cash subsidies may not be the solution

Since the supply of housing is responsive to demand in the long run, cash subsidies (provided directly to those defined as having housing deprivation) should eventually provide the requisite number and type of units. Initially, however, since the existing supply is so short of needs, significant inflationary pressures for the vacant units would result and still the needs of many families would not be met. The prices for these units would increase and eventually trigger the response by suppliers of housing. It is not clear that suppliers would respond to an effective demand by the poor in the same way and in the same time that they respond in the unsubsidized market. Given the reluctance on the part of investors to build in the central city where much of the demand exists, the response to suppliers might, at the minimum, be slower than the 6 years it takes them to make a 90-percent response in the unsubsidized market.

SECTION 236: A SUPPLY-ORIENTED SUBSIDY

Section 236 constitutes an attempt to deal with part of the supply problem through its interest subsidy, which, when passed through to the tenant, decreases the amount of rent that must be paid. The availability of cheap credit, even zero percent, is not a complete solution to housing deprivation, because, even at such rates, there are substantial

numbers of households the incomes of which are still insufficient to pay the rent. However, section 236 was never designed to satisfy all housing-deficient households, but only a portion of those in the moderate-income range.

The filtering effect and its importance

Section 236 also works indirectly to improve the quality of housing for the poor by initiating a chain of moves that creates an increased supply of suitable housing for families of lower income than those moving into a section 236 project. This process, called filtering, is the underlying strategy of supply-oriented subsidies. The theory of filtering asserts that families moving into newly constructed housing vacate units of slightly lower quality which in turn are occupied by families of slightly lower economic status. This process supposedly continues after the initial move, eventually causing a substandard unit to be vacated and removed from the housing inventory. To be successful as a housing strategy, filtering must eventually eliminate substandard units and make livable housing available to the lowest income families. In order for the filtering process to work, new construction must exceed normal growth so that supply exceeds demand at the point where filtration begins. This increased supply must also exert downward pressure on rents (even relatively) so that lower income families can obtain better housing than they currently occupy. The filtering concept refers only to moves generated by the increase of the housing supply, with its concomitant downward price trend. It is distinguished from the upgrading of a family's housing due to an increase in income.

Intuitively, it would seem that new construction and the resultant filtering between 1950 and 1970 would account for the major part of the improvements in housing quality that occurred. However, the Census Bureau's data on inventory change suggest that rising incomes and upgrading of the existing stock have been more dominant factors in removing substandard housing. During that period, the housing needs of the country decreased by about 10 million units, while upgrading of the existing inventory occurred for 6 million units. Nevertheless, a strong relationship can be drawn between new construction and improvement of housing quality. In 1967 half the moves in the country were estimated to result from chains of moves initiated by new construction. The remaining moves arose almost totally from deaths, divorces, separation, and doubling. Many of the chains initiated by new construction, resulted in the improvement of housing status for a family.

Out migration

Between 1950 and 1970, many households migrated from the inner city to the surrounding suburbs, leaving a substantial number of units behind. New construction was estimated to account for two-thirds of all moves initiated outside the central cities, but only one-third of those in the central city. Moreover, as the value of the new home in the suburb increased, the likelihood decreased that the chain will involve moves in the central city. In other words, the chain of moves initiated by new construction in the suburbs frequently ends before reaching the inner city. In the most complete study of filtering to date, only 20 percent of the chains ended in the removal of a unit from the stock of housing, and less than half of these resulted in a demolition. Most chains ended with a unit which was still occupied by parents or other relatives.

Abandonment

The outmigration of many families to the suburbs should release many livable inner city housing units. Normally, the increasing availability of older housing should lead to a (relative if not absolute) drop in price and its readier availability to low-income families. However, another factor, abandonment, has become increasingly prevalent in recent years, disrupting the operation of the filtering process. The units vacated in the inner city are frequently occupied by renters whose ability to pay sufficient rent for normal maintenance and repair is limited. Owners of such rental properties are forced to decrease maintenance, leading to more rapid disintegration and deterioration of the property. Eventually, these owners are forced to disinvest in such properties and abandon them. As a result, properties capable of sustaining many years of useful service are prematurely removed from the housing inventory.

Filtering implications for section 236

Although no study of the chains of moves induced by section 236 construction has been performed, some observations can be made as to how these chains fit into the filtering process, based on the preceding discussion. Section 236 projects are generally located closer to the center of the inner city than most new construction in the suburbs. Since the section 236 projects are designed for moderate income families, they are much closer in value than most new private construction for the poor. For these two reasons, the chains of moves initiated by section 236 should have a

greater likelihood of reaching the poor through filtration than most new construction. On the otner hand, since the housing vacated by tenants moving into section 236 projects is presumably of lesser quality, more expensive, or in the inner city, such housing is a prime candidate for abandonment. However, the extent of abandonment caused by chains of moves initiated by the section 236 program has not been determined.

HUD conducted a study of section 236 projects in the Washington, D.C., metropolitan area to determine in part whether the higher proportion of blacks in these projects resulted from moves made by blacks already in the suburbs or by some from central city locations. It was determined that most of the minority residents in these suburban projects came from housing located in the suburbs. However, 21 percent had moved into the section 236 project from a previous residence in the Washington central city. It is also possible that some further dispersive effects occurred because of central city residents moving into units vacated by those that had moved from other suburban locations into the project. However, the chain of moves in this study was not pursued to determine if this was the case. Further study in three HUD regions provided a similar finding, namely, that 18 percent of blacks, who moved within the Standard Metropolitan Statistical Areas into all subsidized housing, moved from the central city to suburban locations, compared with 7 percent nationally for similar moves into housing between 1965 and 1970. It was concluded that "subsidized housing appeared to be providing suburban housing opportunities to some central city low and moderate income families, particularly black."

CHAPTER 4

WHAT IS SECTION 236 HOUSING?

Section 236 housing, ranges from small two-story apartment buildings, with less than 20 units in marginal older areas of metropolitan areas or small towns, to medium-sized high rise buildings located with and virtually indistinguishable from unsubsidized high rise residences. It includes some huge multistory projects in excess of 500 units located in central cities and row houses, garden apartments, and walkups in every conceivable location. Projects are brick, frame, or prestressed concrete construction. The architectural styles are as varied as those of private multifamily projects. Statistical data characterizing section 236 housing is sketchy, but enough information is available to give a good understanding of the housing involved. Much of the data contained in this chapter is for 1973, which is the last year HUD prepared these statistics and the last year in which a large number of projects were started.

SECTION 236 IS PREDOMINATELY NEW

Section 236 housing is predominately new, although about 10 percent of the units started by the end of 1974 were in rehabilitation projects. This ratio has remained consistent.

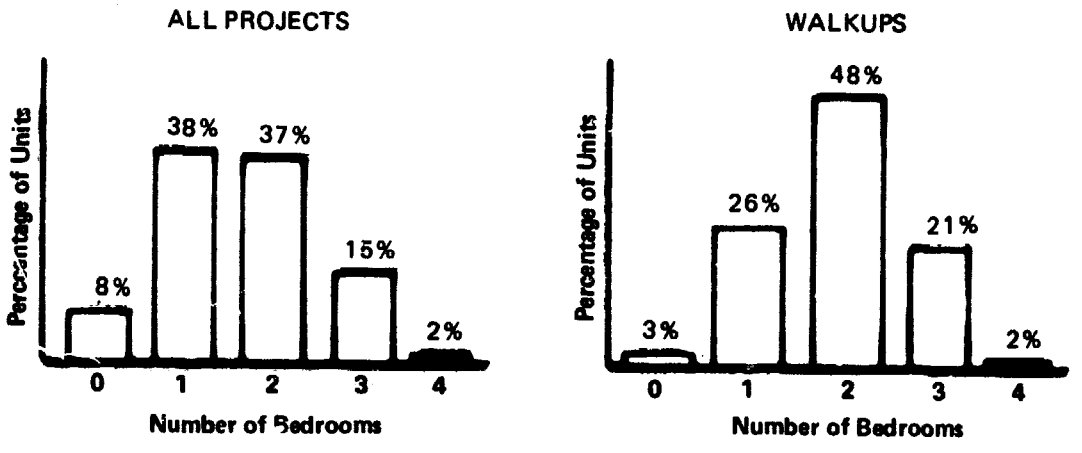
HOUSING QUALITY IS PROBABLY GOOD

Although actual statistics are not available, conversations with knowledgeable individuals indicate that section 236 housing is generally comparable to private housing built for middle income tenants, particularly in terms of exterior appearance. A 1973 GAO study found that the quality of section 236 housing was generally good based on inspection of 514 units in 40 projects. In all our reading and personal interviews, we found only an occasional reference to poor quality, and it was felt that these were probably isolated instances and that there were no particular problems with section 236 as opposed to other programs or private construction.

APARTMENT SIZE

Section 236 housing provides mostly one and two bedroom units, although a substantial number of three bedroom units are provided.

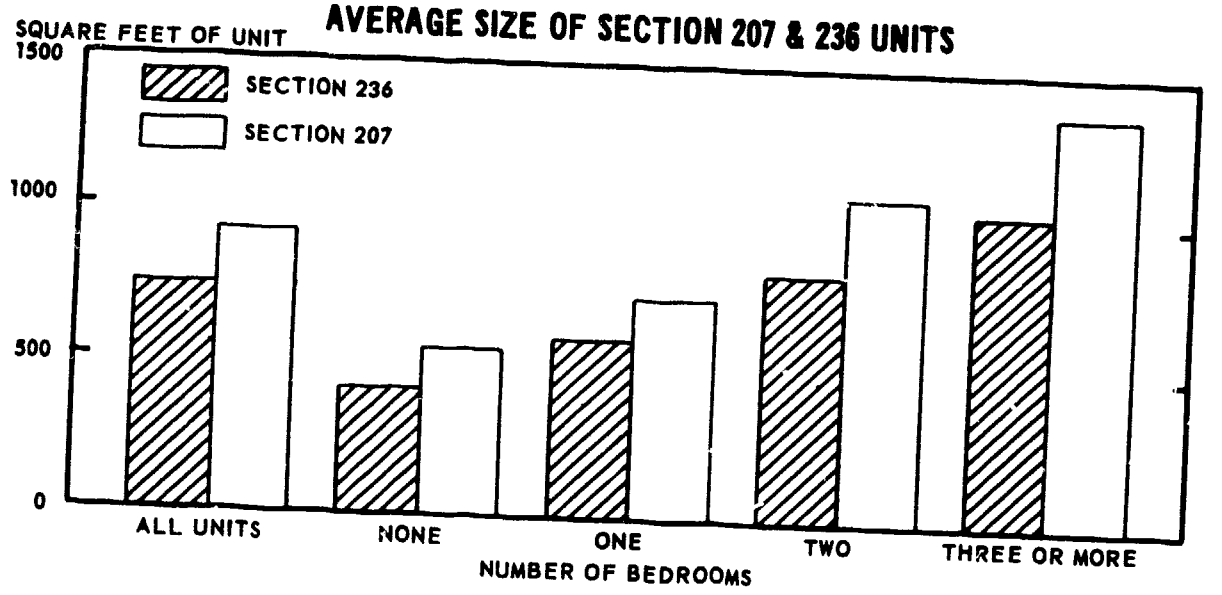
236 HOUSING NUMBER OF BEDROOMS



In 1973 the median number of bedrooms in section 236 units started was 1.7, which would imply 3.7 rooms/unit. This is roughly equivalent to the median for all newly constructed (between 1970-73) rental units in the U.S., which was 3.8 rooms per unit. Public housing units started were probably somewhat larger since they averaged 4.22 rooms per unit. Section 207 units started in 1973 had a median size of 1.6 bedrooms or 3.6 rooms. The median size rental unit in the U.S. (including new and existing) was 4.0 rooms in 1973. A recent HUD survey (1976) indicates the median number of bedrooms for section 8 existing housing is 3.2 rooms per unit.

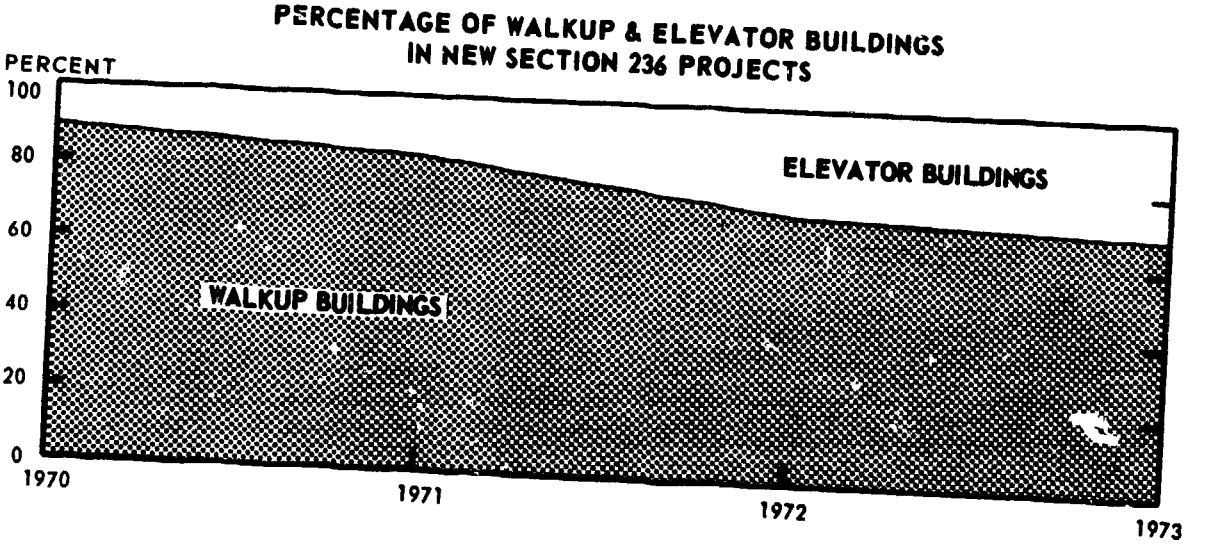
APARTMENTS ARE SMALLER THAN UNSUBSIDIZED FHA PROJECTS

In terms of square feet, section 236 units started in 1973 were slightly smaller than section 207 unsubsidized units.



Similar data on other housing was not available.

MOST APARTMENTS ARE IN WALKUPS



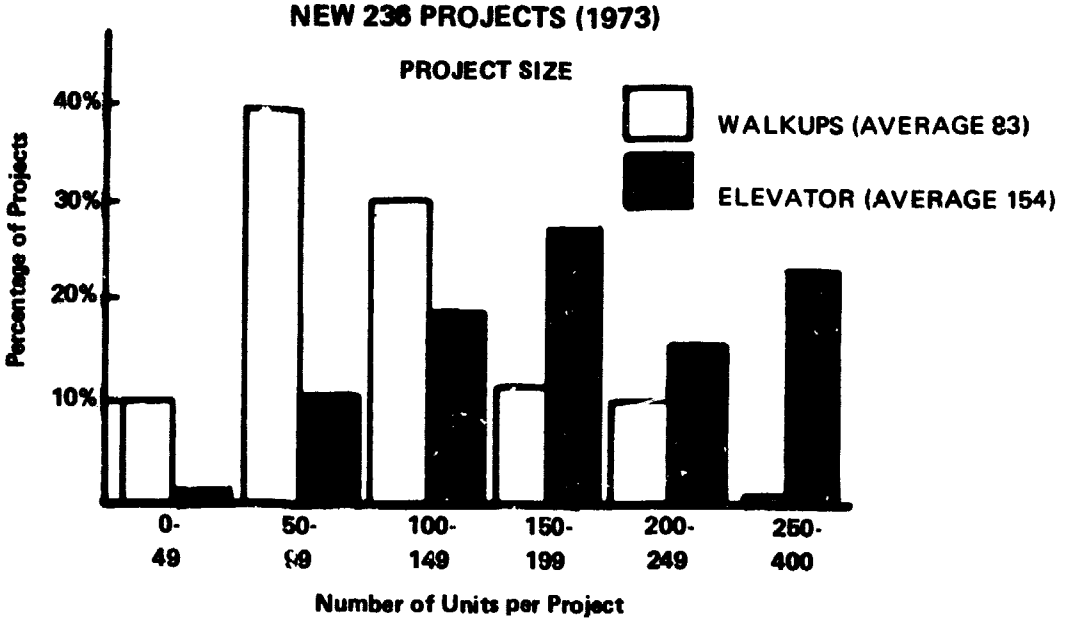
Most apartments are in walkups, although there has been a trend toward a smaller percentage of walkups as production has decreased in recent years.

The average size of section 236 developments has been relatively stable at around 100 units per project.

Projects Started (Average Number of Units)

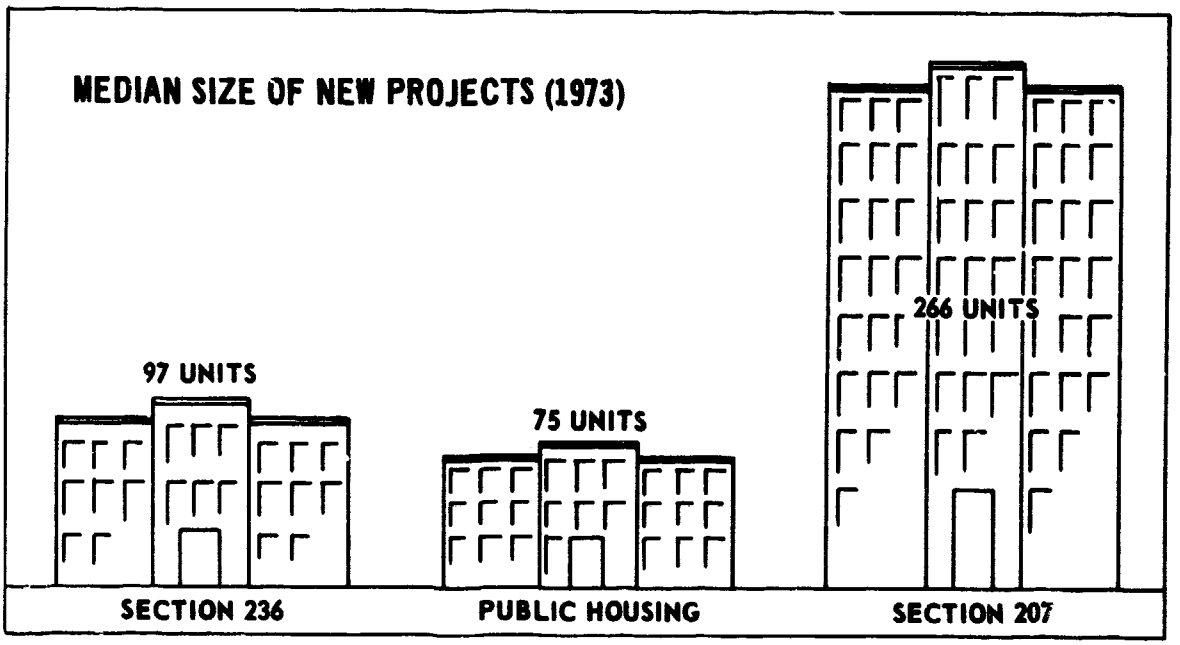
	1970	1971	1972	1973
Section 236	112	102	98.6	96.9
Section 207	148.5	126.1	134.7	266.3

Most of the projects started in 1973 contained between 75 and 250 units and walkup developments tended to have considerably fewer units than elevator projects.



PROJECT SIZE

In 1973 new section 236 projects started were slightly larger than new public housing projects but much smaller than section 207 projects.



Section 236 has probably been quite successful in erasing the projects image and stigma from publicly assisted housing. The projects are really not identifiable as subsidized except for an occasional reference on signs or in advertisements to minimum rents available to qualified families. It should be noted, however, that most types of assisted housing, including public housing, now have greater dispersal of units and varied architectural treatments in order to overcome the traditional project's stereotype of public housing.

CHAPTER 5

WHO LIVES IN SECTION 236 HOUSING?

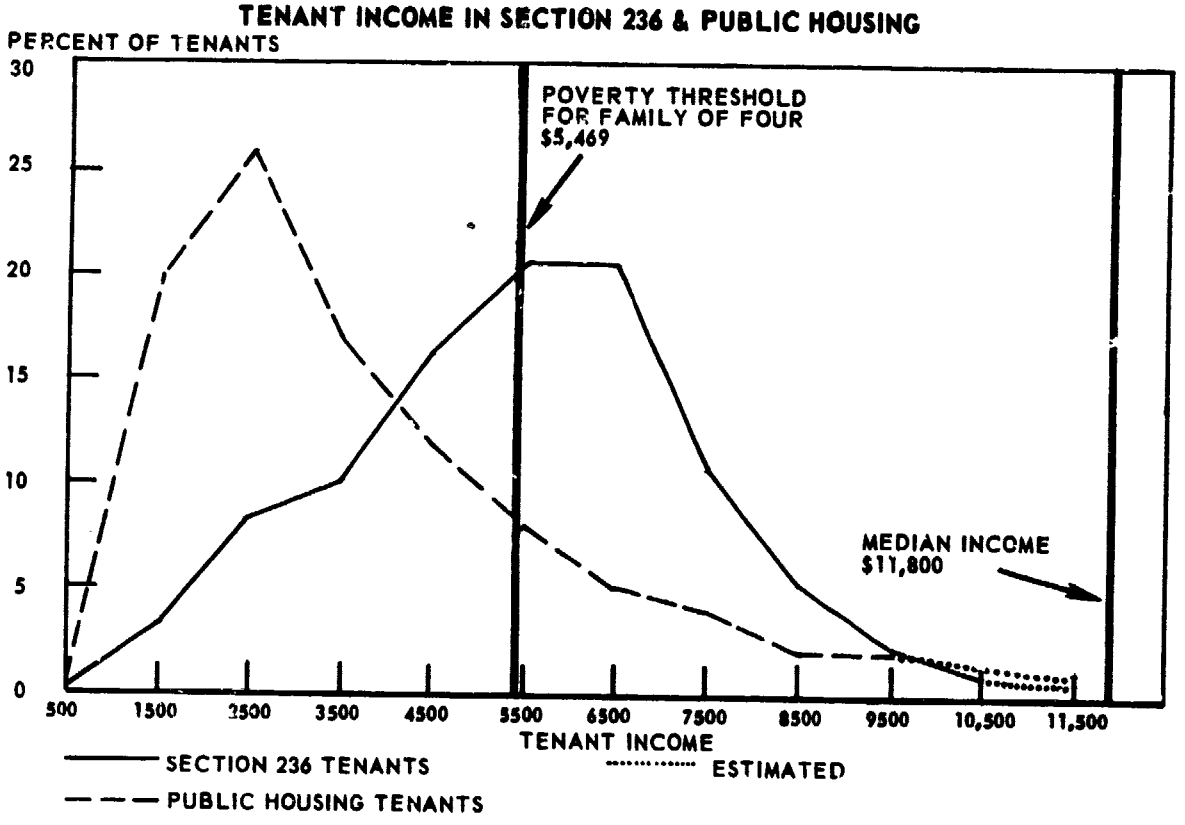
The group of households who receive help from the section 236 program are distinctly different from those being helped by other Federal housing programs. Although there are overlaps and similarities among the section 236 tenant group and those of public housing and the section 8 program, the differences are so striking as to deserve careful attention.

Although the section 236 tenant group is generally better off financially than the tenants under the other subsidy programs, 236 tenants still have significant housing needs. These needs cannot be adequately met by the private market without some subsidy, yet most section 236 tenants are either ineligible for other programs, or these other programs have for some reason systematically excluded them. Section 236, by its very design, was sure to affect this somewhat higher income group.

In this chapter we describe in detail the tenants who live in section 236 housing. This information is compared to public housing data and some early indications about the tenants who reside in section 8 existing units and who will reside in newly constructed section 8 units. The program data is taken primarily from HUD reports for the past several years and interspersed with national statistics on all rental housing where possible. In some cases the program data used is for 1974, which allows comparison to the 1974 Annual Housing Survey. However, the 1974 program data is very likely representative of the present situation since we looked at similar information for a number of years and observed little change over time except where specifically noted.

SECTION 236 TENANTS EARN MORE THAN TENANTS IN PUBLIC HOUSING OR SECTION 8 EXISTING HOUSING

The 1975 median income for section 236 households was $5,634 compared to $11,800 for all U.S. households and a poverty threshold of $5,469 for a family of 4. Both section 236 and public housing generally help families whose annual income is less than $10,000. In 1976, 97 percent of section 236 tenants and 96 percent of public housing tenants had annual incomes of less than $10,000. However, most section 236 tenants (60 percent) had incomes between $5,000 and $10,000 while most public housing tenants (71 percent) had incomes of less than $5,000. The chart below shows this difference in distribution between the tenants in section 236 and public housing in 1975.



The 1976 median household income of section 236 tenants was $5,785, compared to $3,531 for public housing tenants, while a recent HUD study indicates that the average household income for existing housing under section 8 was about $4,000 in 1976.

Fifty percent of the households in section 236 projects had adjusted incomes which were less than 50 percent of the median national income for U.S. households. A comparable figure for public housing is 87 percent. Based on analogous data for section 8, we estimate that more than 80 percent of section 8 existing housing tenants have household incomes which are below the national median income.

THERE ARE FEWER ELDERLY TENANTS

In 1974, 17 percent of the U.S. renter households were elderly (65 years and over), while elderly renters comprised about 19 percent for section 236 housing and 42 percent for

public housing. A recent HUD survey showed that 33 percent of the tenants in section 8 existing housing were elderly. HUD has indicated that about 70 percent of the new section 8 authority is going to the elderly.

Elderly tenants usually have very low incomes. The 1976 median income for elderly section 236 tenants was only $3,620 compared to $6,207 for nonelderly section 236 tenants. This wide income difference between elderly and nonelderly tenants is also present in public housing. During 1976 the median income was $2,909 for elderly public housing tenants and $4,451 for the nonelderly tenants.

MOST SECTION 236 TENANTS ARE EMPLOYED

In 1976 the majority of section 236 households (68 percent) had one or more members working while only 26 percent of the public housing households had one or more workers. A 1976 HUD survey showed that about 22 percent of households in existing housing under section 8 had one or more workers. The majority of both public housing and section 236 households without workers were elderly, but the percentage of nonelderly households with workers was considerably higher for section 236 housing than for public housing. Section 236 housing had 83 percent of the nonelderly households with workers compared to 41 percent for public housing.

RENT IS A MAJOR EXPENSE FOR SECTION 236 TENANTS

Rent payments take a large share of section 236 tenant income. For the last 3 years, the majority of section 236 tenants (64-65 percent) paid more than 25 percent of their income for rent while only 42 percent of all U.S. renters paid more than 25 percent of their income for rent. Although section 236 tenants pay a higher proportion of their income for rent than all U.S. renters, they seem slightly better off than those renters with annual incomes under $10,000 (the income group usually served by section 236 housing). A smaller proportion of section 236 tenants (24 percent) paid more than 35 percent of their income for rent than the under $10,000 income renters (40 percent). The structures of both the public housing and section 8 programs are such that virtually all tenants pay less than 25 percent of their income for rent. The following table shows tenant rents for section 236 and U.S. renter households as a percentage of income.

Percentage of income paid for rent	Percentage of households			
	Section 236 housing		U.S. rental housing	
	1974	1976	All	$0 to $10,000 tenant income
Less than 25%	36%	34%	58%	37%
25% to 34%	40	38	17	23
35% or more	24	28	25	40

The average rent paid by section 236 tenants is over twice that of public housing tenants. In 1976 the average monthly rent in section 236 was $144 while the average rent was $67 in public housing. Although conclusive data is not yet available, the average tenant rent for section 8 existing units is probably less than $70 per month.

SECTION 236 FAMILY SIZE IS SMALLER

In 1974 the average number of persons per unit for section 236 housing was 2.66 compared to a U.S. average of 2.97 per unit and 3.09 per unit for public housing. Both section 236 and existing housing under section 8 tend to serve a larger percentage of smaller families than public housing, although section 236 serves a larger share of three and four person households.

Family Size Distribution by Housing Program (1976)

Housing program	Number of persons		
	One or two	Three or four	Five or more
Public housing	52%	25%	23%
Section 236	54	38	8
Section 8, existing	59	30	11
All U.S. renters (1974)	62	27	11

The real difference between section 236 and public housing can be seen by looking at nonelderly households. The nonelderly section 236 household averages 2.83 per unit compared to 4.16 for public housing. Related to household size is the number of minors per family. Public housing households generally have more children than section 236 tenants as shown in the table.

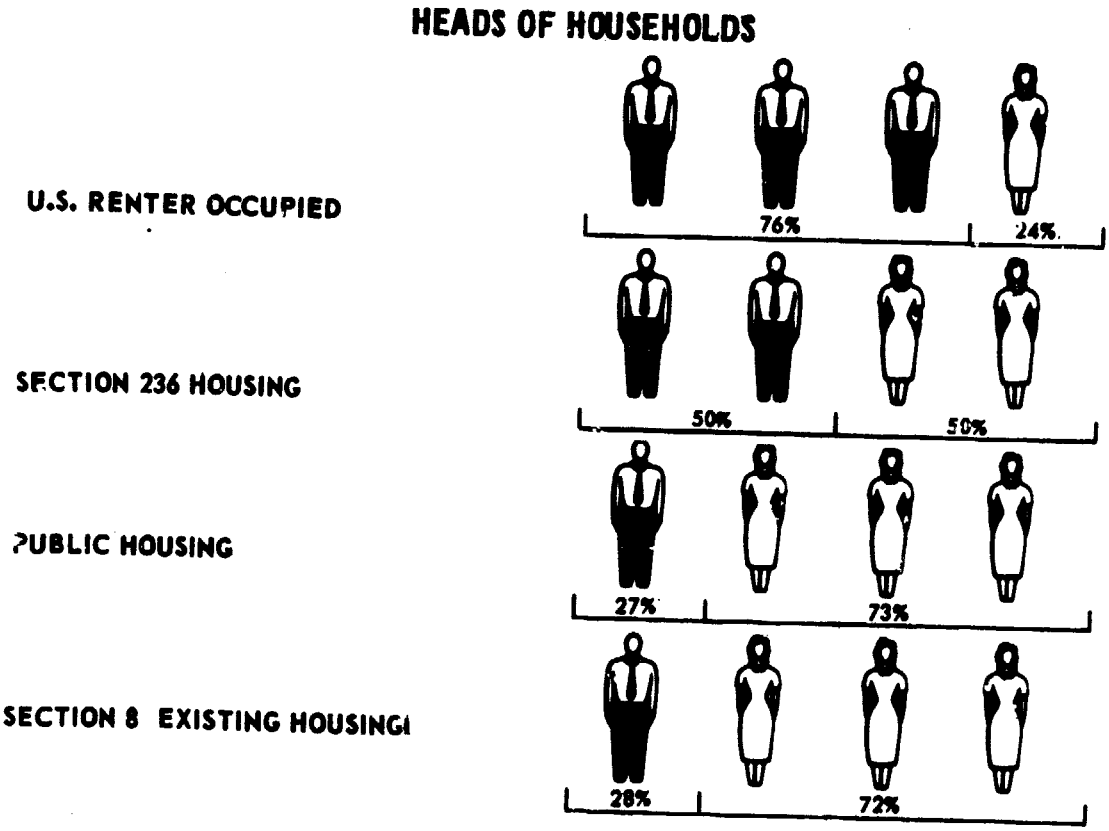
Public housing has more rooms per unit than either section 236 housing or existing housing under section 8. The median number of rooms per unit for public housing was 4.2, while the median number of rooms per unit for section 236 and


PERCENT
DISTRIBUTION OF MINORS PER NONELDERLY HOUSEHOLD IN 1976
50
40
30
20
10
0
SECTION 236 HOUSING
PUBLIC HOUSING
NONE
ONE
TWO
THREE
FOUR OR MORE

section 8 existing housing were 3.7 and 3.2, respectively. This relationship would help to explain why public housing serves larger families than either the section 236 program or existing housing under section 8.

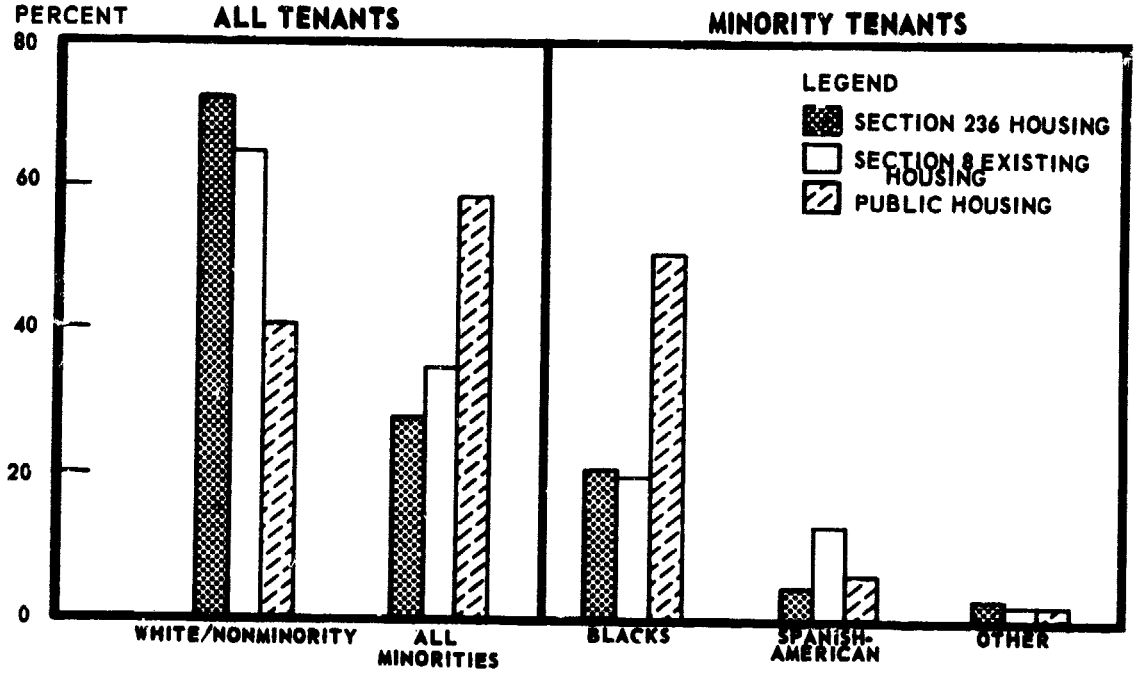
WOMEN HEADED FEWER HOUSEHOLDS THAN IN OTHER PROGRAMS

The composition of male and female heads of households is considerably different between section 236 housing, public housing, and total U.S. rental housing. In 1974 the majority of U.S. renter-occupied households had male heads while the male/female composition was equal for section 236 households. The majority of households in public housing were headed by women. In 1976 the head-of-household composition shows very little variation in this pattern for section 236 housing and public housing, while existing housing under the section 8 program is similar to public housing, with 72 percent of the households being headed by women.



SECTION 236 HOUSING SERVES A WIDE RANGE OF ETHNIC AND RACIAL GROUPS

In 1974 about 18 percent of the United States population was minorities (Black, Spanish-American, American Indian, and Oriental) compared to about 30 percent for section 236 housing, 35 percent for existing housing under section 8 and almost 60 percent for public housing. The following graph identifies the various minority groups and their representation in each housing program in 1976:



NOTE: The Spanish-American segment of the section 8 "existing" population is high primarily because the Dallas Regional Office is using existing section 8 exclusively rather than new construction under section 8.

MINORITY HOUSEHOLDS HAVE SLIGHTLY HIGHER INCOMES

In 1976 the average annual income of nonelderly minority section 236 households was $6,117 compared to $5,667 for nonminority households. Although public housing tenants have lower income levels, minority households still have higher incomes than nonminority households. The mean income was $4,658 for minorities and $3,913 for nonminorities in public housing.

MINORITY AND NONMINORITY TENANTS ARE EMPLOYED AT THE SAME RATE

Nonelderly minority and nonminority households in the section 236 program have similar employment characteristics. In 1976 the majority of section 236 households had one or more members employed in almost the same proportions between minority and nonminority households.

SECTION 236 AND PUBLIC HOUSING TENANTS WITH SIMILAR INCOMES ARE DIFFERENT

Both section 236 and public housing serve families with annual incomes of less than $10,000. However, public housing tenants are generally in the under $5,000 range, while section 236 tenants are usually in the $5,000 to $10,000 range. But income does not explain other distinguishing differences between these two groups. When tenants with equal incomes (under $5,000 and between $5,000 and $10,000) were compared for both groups, they were found to have quite different characteristics. Both income groups in section 236 households had fewer children, fewer minority households, more working tenants, and higher rents than in public housing.

Household Characteristics vs. Income

	Section 236	Public housing
Percent of nonelderly households with one or more children		
Under $5,000	56%	88%
$5,000-$10,000	72	93
Percent of households with one or more workers		
Under $5,000	54	19
$5,000-$10,000	93	67
Percent of minority households		
Under $5,000	25	54
$5,000-$10,000	29	69
Percent paying more than $100 rent a month		
Under $5,000	88	1
$5,000-$10,000	99	43

In all cases the tenants in section 236 in both income groups have more in common with one another than they do with tenants having similar incomes in public housing.

CONCLUSIONS

The group of tenants served by section 236 is distinctly different from those being served by public housing. Although Government housing strategies have historically aided nearly all income groups to one extent or another, the moderate income group which section 236 served well, has characteristically been neglected by Federal housing policies. Section 236 was created primarily to fill a gap which was identified in research and debate prior to the passage of the 1968 Housing legislation. No new programs are being contemplated to fill this gap, and the section 8 program gives no indication that it will do so. Section 8 is structured with a flexible subsidy mechanism which should help nearly all those in need. However, existing housing under section 8 is going to a subset of the group eligible for public housing, and new construction under section 8 has thus far been rather limited and is being constructed primarily for the elderly. It is likely that this will continue since (1) there is presently no means of controlling who will receive the subsidy, (2) public housing authorities who administer most section 8 subsidies have historically aided the poorest tenants first, and (3) developers faced with additional costs, responsibilities, and constraints under section 8 will probably continue to opt for elderly housing which is less expensive to build and generally considered less risky. 1/ Whether Federal policy should now abandon this group of needy tenants in order to concentrate on the very poorest of households is a question of profound importance.

1/For a fuller discussion of problems related to sec. 8, see ch. 11 of this report and a comprehensive treatment in "Major Changes Are Needed in the New Leased-Housing Program," General Accounting Office, CED-77-19, Jan. 28, 1977.

CHAPTER 6

THE DISTRIBUTION OF BENEFITS

The distribution of the benefits of a subsidy program is central to any question regarding that program's effectiveness. If it does not concentrate its benefits on those intended by law, it is immediately suspect. Or, if it distributes its benefits in a way that some or most people consider inequitable, it can rightly be questioned.

In the last chapter we characterized the tenants of section 236 housing in terms of income, race, family size, age, and other characteristics. In this chapter we look at a number of criticisms of section 236 involving the way in which benefits of the program were distributed. This is done to provide a sensible framework for discussing the distribution of program benefits. We then look at the distribution of section 236 services as compared to housing need to see how well it satisfied that need, and whether there are patterns of exclusion which are not readily apparent. To do this we compare the number of section 236 households in various subgroups of the tenant population to need indications for those subgroups in the population at large. Such calculations are rough but nevertheless provide useful insights. We also show comparisons to the public housing program which emphasize the differences between these two programs.

DISCUSSION OF CRITICISMS

The program does not serve all those eligible

The fact that the section 236 program does not serve all who appear eligible on the basis of income or some other criteria does not necessarily reflect on either the design or administration of the program. Virtually no Federal program serves all those with incomes below a certain eligibility threshold, and housing programs, like other categorical subsidies, were not designed as income supplements to all individuals or households. Instead they are aimed primarily at those who lack adequate housing. Beyond this there are practical constraints imposed by the amount of available subsidy money and the housing industry's ability to respond immediately to subsidized demand.

To simply take the amount of money currently being spent for subsidies, such as section 236 or section 8, and spread

it evenly among the present recipients and eligible nonrecipients, would not result in a more equitable situation, but rather would supplement each household's income slightly, without providing any significant improvement in anyone's housing situation. This would be particularly detrimental to those with the greatest housing need.

Government housing strategies are necessarily based on a gradual satisfaction of the total housing need. It is impossible for any program to immediately reach all those in need, yet housing provided by Government action many years ago still provides service today and decreases the total current housing need. To criticize a program for not serving all those in need leaves no really acceptable solution to housing problems. Adequate housing is expensive, and any workable strategy must initially fall short of total success. Such criticisms lack historical perspective.

The program does not concentrate benefits on the poorest households

It is also unrealistic to expect a given program to distribute benefits in some precise way to insure that no identifiable subgroup is slightly favored. What we can hope for is that no eligible subgroup, having a significant housing need, is totally excluded while another subgroup is greatly favored. Fine tuning to some formula is impossible, but avoiding complete exclusions is probably easy if programs are properly designed.

This raises another important point--certain programs have been designed to concentrate benefits on specific groups, and this is not in itself inequitable (section 236 was created to fill a gap between two older programs). Concentrating a program on some subgroup of those in need can be an indispensable aspect of preparing a housing strategy which gives some attention to all those with significant need. Put another way, one program can (through its design) compensate for the shortcomings of some other housing program or more realistically complement the workings of another program. This does not necessarily mean that both programs have failed but, rather, that the mix of the two programs is quite effective. For example, the fact that certain past programs have concentrated benefits on urban areas does not necessarily indicate that these programs are inadequate. It may indicate instead that increased emphasis should be given to rental assistance in rural areas under the Farmers Home Administration.

It is not our intention for this chapter to describe these subsidy programs as equitable or inequitable, or to prove or imply that HUD has managed these programs poorly. We feel that the important lessons to be learned are where these programs are having the most impact and where some special emphasis may be required.

THE SECTION 236 ELIGIBLE POPULATION IS BETTER SERVED THAN PREVIOUSLY ASSERTED

In "Housing in the Seventies," HUD noted that section 236 was providing a subsidy in excess of $1,000 per year per household served but was serving less than half a percent of the more than 35 million households with incomes below $10,000 per year. This statistic overlooks a number of important considerations. First, at the time of the comparison, public housing provided nearly 1.2 million units to tenants with incomes generally less than $10,000 per year not to mention the many other programs which were not included in the HUD comparison. Section 235 was primarily targeted at and impacted moderate income households, although a minority of 236 units, some in combination with the rent supplement program, also served the below $5,000 group which is served primarily by public housing. Second, the 36 million households cited by HUD include homeowners and tenants in adequate housing. Third, the full impact of section 236 and other subsidized programs was far from completed when the HUD analysis was done. Only 141,000 units of section 236 had been completed compared to about half-a-million 236 units completed or under construction today.

If we perform similar calculations, taking these factors into account, the picture changes drastically. Approximately 7.6 million renter households were in the primary section 236 target group ($5,000-$10,000) in late 1971, but the majority of these households were adequately housed and paid a reasonable percentage of their income for rent. There were also about 1.8 million nonelderly one person households who were ineligible for the program.

Less than 900,000 of the households earning between $5,000 and $10,000 per year were overcrowded or in units lacking some or all plumbing facilities. Slightly more than 1.9 million households paid in excess of 35 percent of their incomes in rent. Since these two groups may overlap somewhat, there were fewer than 1.9 million households in the $5,000-10,000 income group with a significant housing need. Even some of these households would not qualify for subsidies since they were composed of single persons under

age 62. During 1975 the 236 program served about 240,000 households in the $5,000-$10,000 income renter group. In addition, public housing and the rent supplement program were providing at least another 280,000 rental units at the lower end of this income group. This implies that more than 500,000 households in this income group were served by subsidized rental housing programs while fewer than 2 million households were clearly in need and unserved. Thus, more than 20 percent of those with a significant need in the $5,000-$10,000 income group were actually being served.

This comparison contrasts sharply with HUD's finding that less than half of one percent of eligibles indicates an unprecedented impact for a Federal program, and this does not include any moderate income housing constructed under section 221d(4), section 202, or other programs which can serve those with incomes between $5,000-$10,000 per year.

SECTION 236 WAS INTENDED TO SERVE MODERATE INCOME TENANTS AND DID

The section 236 program has been described as inequitable in that it did not concentrate benefits on the lowest income households but rather on those above the poverty threshold. This criticism is accurate but, nevertheless, invalid. The 236 program was never intended (or administered) to serve the lowest income households eligible and in fact had income limits which were somewhat higher than public housing. These limits allowed the 236 program to serve a greater income range of tenants. The subsidy mechanism was also structured to literally insure that it could not concentrate benefits on the poorest households since most tenants (except for those receiving rent supplement) had to pay a basic rent pegged to a prorated share of operating costs and project debt service at a 1-percent interest rate. Thus, the subsidy was not as deep as in the public housing program which pays the entire debt service and could not in general serve tenants with the same incomes.

The Congress and the administration which proposed the section 236 program saw it as a means of alleviating a previous inequity. Tenants eligible for public housing could receive a large subsidy under public housing, while those earning slightly more than the upper limit for public housing were ineligible and could receive nothing. This is a problem since those with slightly higher incomes may have roughly the same housing need as those earning just under the limit. Section 236 was structured to serve the income group just

above that served by public housing. The subsidy would taper off as income increased and a tenant whose income exceeded the income limit while residing in section 236 would not have to move out.

Distribution of benefits by income

In the last chapter we illustrated the emphasis of the section 236 program on moderate income tenants. The following table shows that it does indeed serve this group better than any other and that public housing concentrates its benefits on much poorer households.

Household income	Ratio of section 236 households to all U.S. renter households	Ratio of public housing households to all U.S. renter households
$0 - $3,000	1 : 118	1 : 10
$3,000 - $4,999	1 : 44	1 : 11
$5,000 - $6,999	1 : 25	1 : 21
$7,000 - $9,999	1 : 69	1 : 43

Section 236 serving an increasing number of poverty households

Although section 236 concentrated its benefits on moderate income tenants it also served a limited number of low income tenants. This proportion is increasing. The income level of section 236 tenants has remained much the same over the past several years although the poverty threshold for the U.S. has increased much more rapidly.

	Section 236 average tenant income	Poverty threshold four-person household
1972	$5,250	$4,247
1973	5,373	4,512
1974	5,495	5,008
1975	5,605	5,469
1976	5,794	5,961
Change from 1972-1976	$ 544	$1,714

This means that section 236 is serving a progressively poorer tenant population each year. Based upon tenant characteristics compiled by HUD and poverty thresholds for households of various sizes, we estimate that in 1972 roughly 9 percent of 236 households were below the poverty threshold. In 1974

about 16 percent of the tenants who moved into section 236 housing were below the poverty threshold and, by September 1976, 24 percent of all tenants who moved in during the previous year were poverty households. This trend will likely continue and is probably representative of the entire 236 tenant population. This phenomenon is one of the strengths of a supply subsidy, such as section 236 or public housing, since rents and the resultant subsidy are strongly tied to the original cost and mortgage rather than increasing with the general inflation in the housing market. This allows tenants to remain without receiving as large a periodic increase in income as otherwise would be necessary and also allows the housing to provide what amounts to a deeper subsidy each year without commensurate increases in cost. This feature of supply subsidies cannot be expected when a purely demand-oriented subsidy such as a housing allowance is used. The following discussion illustrates how this phenomenon works.

Section 236 rents are increasing more slowly than private rents

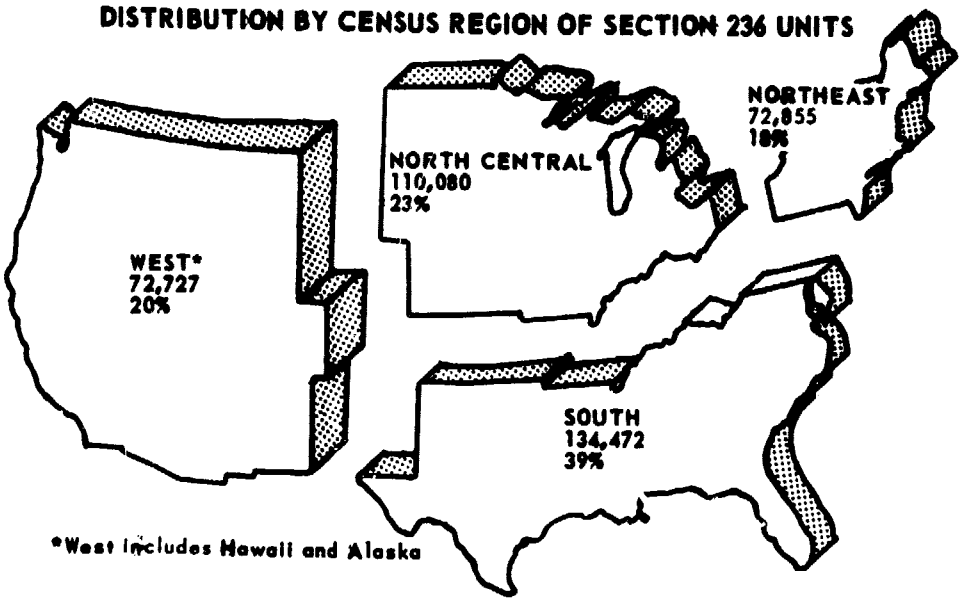
Average rent of tenants moving into section 236 housing has increased an average of less than 5 percent per year since 1972, which is roughly the increase that private rents have experienced based on the CPI rent index. But the 236 data is heavily weighted toward new units in each year and is based on tenants moving in as opposed to the CPI data which includes much older units and many tenants with extended tenure. Looking only at vacant units available for rent, the increase in rents nationwide has been closer to 8 percent per year since 1972 and the newer and more desirable units have very likely increased more rapidly than 8 percent. This supports a conclusion that section 236 rents are increasing more slowly than private rents for similar housing.

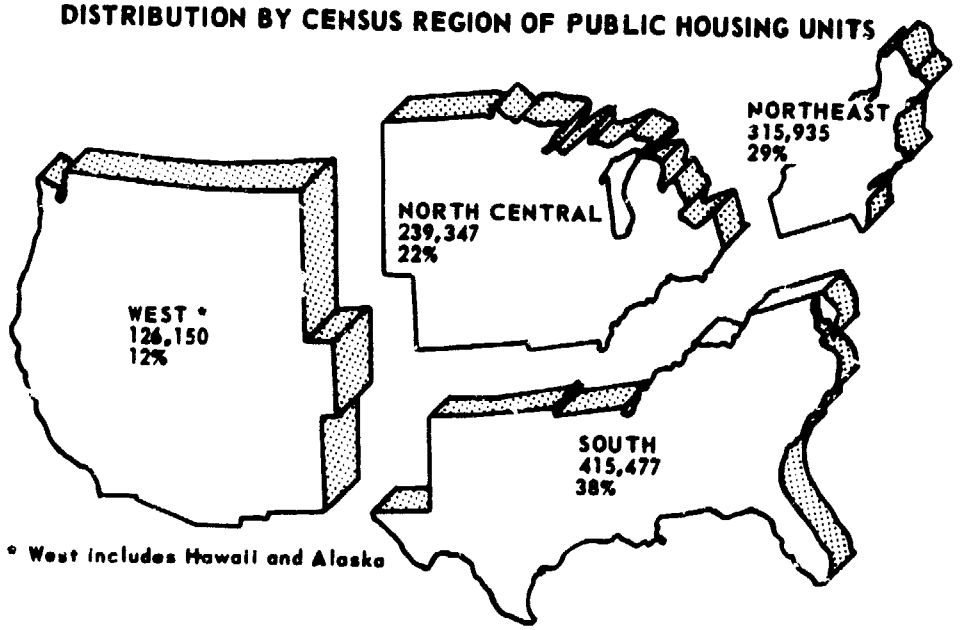
Section 236 will continue to serve households with incomes above those in public housing

Since section 236 units receive a shallower subsidy than public housing and have generally been developed to have higher debt services, we can expect section 236 units to have relatively higher rents and, therefore, serve relatively higher income tenants as time passes. Both programs, however, will be able individually to serve a relatively poorer group of tenants each year. New units under section 236 would, if they were being developed, serve progressively higher income households initially to keep pace with increases in development costs and then begin to filter down as general income levels rise.

REGIONAL DISTRIBUTION OF SECTION 236

The South has received the largest number of section 236 units and has often been characterized as getting more than its share of subsidized housing, but it may still be the region of the country least well served by the program as measured by the number of occupied inadequate housing units in the region. The maps below show the distribution of section 236 and public housing units by region as of 1974:





By numbers of units alone, the South seems favored by both section 236 and the public housing program. But if we compare occupied inadequate housing units in each region to the number of subsidized units provided, the North Central region and the West seem favored by section 236, while the Northeast is favored by public housing.

Ratio of Occupied Inadequate Housing Units to Total Subsidized Units by Region in 1974
(note a)

	Section 236	Public housing	Both programs
Northeast	14.7 : 1	3.3 : 1	2.8 : 1
North Central	11.5 : 1	5.3 : 1	3.6 : 1
West	11.3 : 1	7.0 : 1	4.3 : 1
South	18.5 : 1	6.0 : 1	4.5 : 1

a/Inadequate is defined as lacking essential plumbing facilities and/or having more than one person per room.

Other measures used as proxies for housing needs, such as the number of lower income households in the region, resulted in similar rankings among these regions. A similar comparison done by the Rural Housing Alliance using 1970 census estimates of the poverty population and 1971 data on public housing showed these regions to be served by public housing in the same order as above. 1/

Distribution of new subsidized units by region 1970-74

Although the public housing program includes a large number of much older units than section 236, it should be noted that in recent years (1970-1974) public housing seems to be going to these regions in a slightly different proportion than in the past, with the share to the Northeast decreasing slightly and the percentage to the West increasing. This recent distribution is closer to that of section 236 although 236 still seems to provide a slightly greater percentage to the West and less to the Northeast.

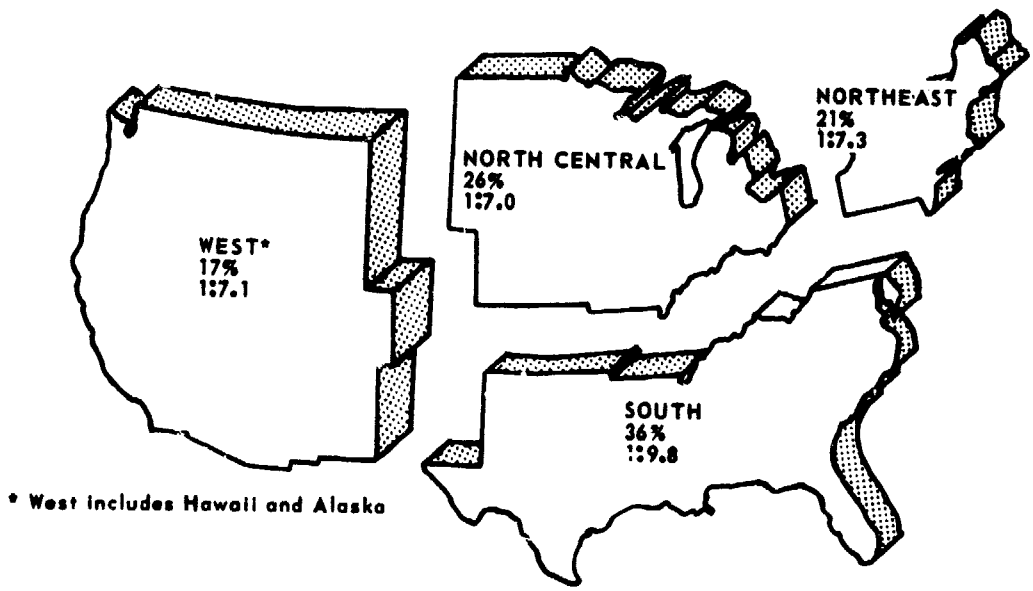
1/"Public Housing: Where It Is and Isn't," Rural Housing Alliance and Housing Assistance Council.

Percentage of Total Public Housing and Section 236 Units Produced by Region

	Public Housing 1937-69	Public Housing 1970-74	Section 236 1970-74
Northeast	31%	23%	18%
South	38	39	39
North Central	21	23	23
West	10	15	20

Finally, if we compare the total units provided by the two programs between 1970-74 to the number of inadequate units in 1974, we find that each region appears to have received units in accordance with need almost equally, except for the South which was probably underserved.

DISTRIBUTION BY CENSUS REGION OF SECTION 236 AND PUBLIC HOUSING UNITS BUILT 1970-1974 AND RATIO TO INADEQUATE UNITS AS OF 1974



STANDARD METROPOLITAN STATISTICAL AREAS (INSIDE AND OUTSIDE)

The number of section 236 units provided inside Standard Metropolitan Statistical Areas (SMSAs) is much greater than the number of units provided in localities outside SMSAs.

The following table shows percentage distributions for several types of housing as of the end of 1974.

Distribution of Housing Units and U.S. Population

Percent	Section 236	Total new rental housing 1970-74	Public housing	U.S. population
Inside SMSAs	83	83	74	68
Outside SMSAs	17	17	26	32

It is interesting to note that the distribution of section 236 housing is virtually the same as that of all new rental housing built for 1970 to 1974. This is probably not surprising since section 236 is produced in much the same manner as private housing, the major differences being the rent charged and the method of financing.

Urban areas clearly favored by section 236

Although the simple statistics shown above do not indicate how well these programs are serving those in need, almost any available measure indicates that those inside SMSAs are much better served than those outside. The table below is based upon data as of the end of 1974.

	Inside SMSA	Outside SMSA
Section 236 housing units:		
Number of renter households earning less than $10,000 per year	1 : 43	1 : 77
Number of inadequate occupied units	1 : 12	1 : 47
Number of overcrowded units	1 : 3	1 : 5
Population of region	1 : 535	1 : 1,204

Public housing somewhat more equitable

Public housing also seems to favor urban areas, but much less than section 236.

	Inside	Outside
Public housing units:		
Number of renter households earning less than $10,000 per year	1 : 14	1 : 14
Number of inadequate occupied units	1 : 4	1 : 9
Number of overcrowded units	1 : 1	1 : 1
Population	1 : 175	1 : 230

Although none of these measures are really adequate to clearly determine how well benefits are distributed, they do indicate how the programs tend to discriminate. It should be noted that rural housing programs, if included, would change this picture only slightly since they have historically provided little rental housing.

HOUSEHOLD SIZE

The table below shows the percentage distribution of section 236 households by size of household as compared to public housing and to all renter households in the United States earning less than $10,000 per year.

Household Size

Persons per household	Section 236	Renters earning $10,000 or less	Public housing
One	22%	39%	43%
Two	29	28	15
Three and four	40	23	24
Five, six, or more	9	10	18
Total	100%	100%	100%

Source: Subsidized housing statistics are based on 1974 tenant statistics compiled by HUD. U.S. renter data is taken from the 1974 Annual Housing Survey.

Section 236 appears to favor 3- and 4-person households since 40 percent of all 236 units are occupied by these households, and only 23 percent of all households earning below $10,000 per year contain 3 and 4 persons.

Public housing, on the other hand, shows nearly the opposite in that it appears to favor single person households slightly and those with five or more persons considerably at the expense of two-person households which are underserved.

It should be noted that nonelderly single person households are substantially excluded from both programs, which may explain why section 236 seems to underserve single person households. It also explains why public housing, which serves many more elderly households, seems to overserve the single person households.

Though the percentages shown above do not necessarily prove our conclusions, the ratios in the next table do support these conclusions.

Ratio of Subsidized Households to Renter Households in U.S. Earning Less Than $10,000 Per Year

Persons per household	Section 236	Public housing
One	1 : 89	1 : 13
Two	1 : 47	1 : 26
Three and four	1 : 28	1 : 13
Five or more	1 : 51	1 : 8

This seems to bear out the general conclusion (often made) that subsidized rental housing favors larger families than private rental housing. This finding, however, does not necessarily extend to the section 8 program which is structurally and administratively different from its predecessors. Early indications are that section 8 existing units will serve only small families, and the new housing produced under section 8 may do the same. This subject is discussed in detail elsewhere in this report.

RACE AND ETHNIC GROUP

We also wanted to determine if different racial and ethnic groups were served by section 236 and public housing in proportion to their eligibility and need within the general population. We used two different income groups as proxies for eligibility since the below $5,000 and below $10,000 comparisons for public housing gave different results when we looked at inadequately housed families as an indication of need. The following table gives some basic information about the distribution of units among three groups.

Percentage of Households by Race in Various Types of Housing in 1974

	Subsidized housing		All U.S. renter households	
	Section 236	Public housing	Income $10,000	Income $5,000
Black	21%	52%	20%	24%
Spanish-American	4	7	8	7
White and others	75	41	72	69

Other minorities occupied such a small percentage of units that it is impossible to make sensible conclusions about them. Using this information one might conclude that blacks are overserved by public housing and whites are underserved while section 236 serves both groups in about the proper proportion. But this kind of analysis is not always dependable since it ignores the absolute numbers of units and households and deals only with percentages.

Comparing the actual numbers of subsidized households to income eligible population in 1974 (renter households below a certain income) provides a similar finding, except Spanish-Americans clearly seem underserved.

Ratio of Subsidized Households to U.S. Renter Households by Income Group

	Section 236 Households to Households Earning Less Than $10,000	Public Housing Households to Households Earning Less Than $5,000	Public Housing Households to Households Earning Less Than $10,000
Black	1 : 46	1 : 3	1 : 6
Spanish-American	1 : 91	1 : 8	1 : 15
White	1 : 48	1 : 13	1 : 26
All	1 : 49	1 : 7	1 : 14

When one looks concurrently at both income and the incidence of inadequate housing among these groups in 1974, the picture changes drastically. The table below shows that by this measure blacks are least well served by section 236 while Spanish-Americans are served equitably and whites appear slightly overserved.

Ratio of Subsidized Households to the Number of Inadequately Housed Renter Households by Income Group

	Section 236 Households to Households Earning Less Than $10,000	Public Housing Households to Households Earning Less Than $5,000	Public Housing Households to Households Earning Less Than $10,000
Black	1 : 11	1 : .8	1 : 1.3
Spanish-American	1 : 7	1 : .5	1 : 1.1
White	1 : 6	1 : 1.8	1 : 3.0
All	1 : 7	1 : 1.2	1 : 2.0

The explanation for this shift is that proportionately more blacks are inadequately housed than whites or Spanish-Americans. This also illustrates the original point made in this chapter--that whether or not a program is equitable depends greatly on one's point of view and, in a more rigorous sense, on the measure one uses to judge equity.

CHAPTER 7

IMPACT ON HOUSING STOCK VERSUS REDISTRIBUTION OF SERVICES

It has also been said that the 236 program and other subsidized housing programs have little impact on the total housing stock or, more precisely, that new construction activity is not significantly increased by subsidies but merely shifts from the private sector to Government subsidy. If true, this would be particularly applicable to section 236 since it is provided through much the same production mechanism as private housing. Estimates of this impact vary substantially, but it is nearly impossible to answer the question satisfactorily. Experts disagree, and statistical studies reach differing answers.

One study estimated that for every 100 units produced under direct Government subsidies, 14 units were actually added to the housing stock which would not have been added in absence of the subsidies. Others have argued that the impact is higher. One reason advanced for such a phenomenon is that the production of subsidized housing requires private mortgage credit, which is made available at the expense of nonsubsidized production. Another reason is that the subsidy must be made available by providing funds from additional Government borrowing or taxes, thereby reducing investment expenditures in the capital and mortgage markets.

This debate, however, overlooks the more important question of whether the program redistributed the housing services among possible recipients or encouraged certain investor activities. This change in behavior of housing producers and consumers is the primary goal of all housing subsidies. In this regard section 236 was quite successful. The group of subsidies which contributed to the program's effectiveness will result in construction or rehabilitation of over half a million units for a group of tenants (moderate and low income households) which previously had attracted little unsubsidized construction activity. The reasons for this inactivity are complex but can generally be characterized as resulting from two opposing forces. Building codes, zoning restrictions and custom mandate reasonably large and high quality housing. But moderate income households have difficulty affording such housing. This situation has become far more critical in the last decade as rents and other consumer expenditures have rapidly increased.

SECTION 236 PROVIDES THE MAJORITY OF NEW MODERATELY PRICED UNITS

The Annual Housing Survey for 1974 estimates that during the 4-1/2 years from April 1970 to October 1974, approximately 3 million newly constructed rental units were added to the housing inventory. Of those only 740,000 were still renting for under $150 per month when the survey was taken in 1974. A million and a quarter of these new units were renting for over $200 per month.

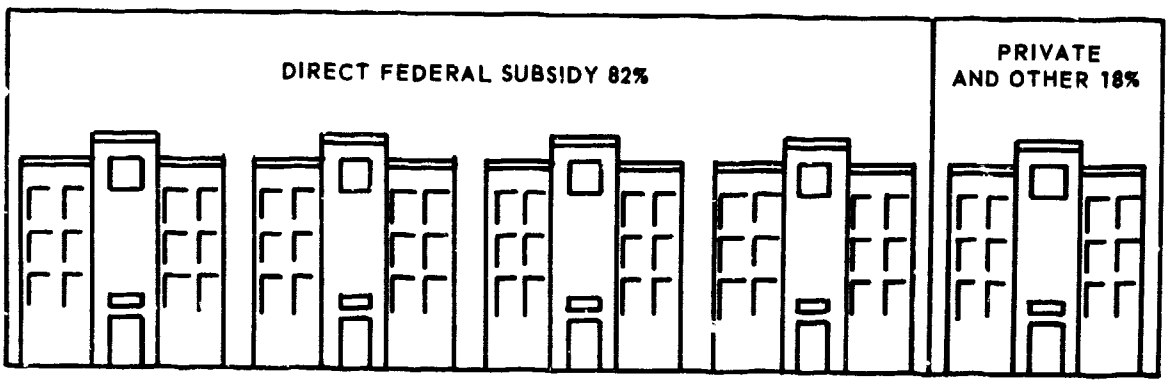
Only 411,000 of these 3 million units were renting for between $100 and $150 per month. This is the rent range in which the majority of the section 236 housing units would fall. As of this same date, October 1974, there were about 320,000 section 236 units available for occupancy. In the year prior to and the year immediately after October 1974, roughly 70 percent of the tenants moving into section 236 housing paid between $100 and $150 per month in rent. Thus there were probably about 224,000 units of section 236 housing renting for between $100 and $150 per month in October 1974. Since all these section 236 units were created after 1970, we can conclude that well over half (224,000 out of 411,000) of all U.S. rental housing produced after 1970 and which rented for between $100 and $150 per month in 1974 was supplied by section 236.

The percentage of units in this rent range supplied by section 236 varied somewhat from region to region. We have estimated that in the Northeastern United States, section 236 supplied perhaps 48 percent of new rental housing in the $100 to $150 per month rent range. The percentages in the North Central region, the West, and the South were 62, 46, and 51 percent, respectively.

NEARLY ALL NEW LOW AND MODERATELY PRICED RENTAL HOUSING IS SUPPLIED BY SUBSIDY PROGRAMS

If we include public housing and rent supplement in our calculations and look at all rents below $150 per month, the finding is even more striking. The following illustration shows that the great majority of the moderately priced rental units produced between 1970 and 1974 were subsidized.

PRODUCTION OF MODERATELY PRICED RENTALS 1970 - 1974



This conclusion is based on the following facts. There were about 350,000 public housing units and 60,000 rent supplement units added from April 1970 to October 1974 in addition to 244,000 section 236 units, all of which were renting for less than $150 per month. Thus the three programs added about 609,000 units during the 4-1/2 years and accounted for about 82 percent of the 740,000 new rental housing units in the United States which rented for less than $150 per month. State, local, and other small scale Federal programs probably accounted for much of the remainder.

STOCK OF LOW AND MODERATE RENTALS SHRINKING

Thus it seems unreasonable to argue over whether subsidized programs actually increase total housing production when they have such a decisive role in supplying new low and moderate priced rentals. This is particularly true since the total number of rental units renting for less than $150 per month decreased by nearly 3.8 million units during this time while the number of renter households which could easily afford to pay no more than $150 per month for rent decreased by only 1.5 million households. This very likely implies a tightening of the supply of moderately priced rentals in spite of the unprecedented subsidized production. Related to this is the fact that the 63 percent of all renter households in the United States which had incomes of less than $10,000 per year in 1974 paid at least 25 percent of their incomes in rent. This compares to 53 percent who payed 25 percent or more in 1970.

CHAPTER 8

ATTRACTION OF INVESTORS TO SECTION 236 HOUSING

An underlying aim of the section 236 program was attracting investment capital for housing units which would not likely be built by private developers without subsidies. A mortgage is not the most appealing investment for many investors since the funds tied up are not easily converted into cash, and, if there is a default, redress through foreclosure is frequently difficult. In addition, investors are not attracted because of the inability of the poor to support the costs of decent housing. Unless some form of aid is provided, private owners will be unable to make a profit without charging rents beyond the capacity of the poor to pay.

It seems likely that there were a great many reasons why section 236 provided a large number of units in a relatively short time and that these reasons deal with interrelated factors which cannot be satisfactorily isolated. The basic interest subsidy of 236 made it possible to lower rents to the point where such projects could feasibly operate with moderate income persons as tenants. Rent supplements made it feasible to reach lower income tenants. But these direct subsidies alone would probably not have induced developers, lenders, and investors to produce such a large amount of section 236 housing. Lower income housing could be expected to be riskier than higher income housing (this is certainly an axiom in the housing industry). Thus, lenders would prefer to lend on better risks, and developers and investors would prefer to build housing which would be more likely to appreciate over time. Investors prefer to rent to tenants who can pay increased rents when utilities and other expenses increase. Higher income tenants are more able to afford to do some minor maintenance and are considered less likely to damage rental property in the first place although this may be arguable. Apartments which have relatively high unsubsidized rents are more likely to appreciate than are those which house lower income subsidized tenants. Thus it would seem unlikely that private developers and lenders would opt for subsidized versus nonsubsidized properties. But there are a number of other factors which enter into the decision.

First of all, new residential construction projects, regardless of the intended occupants, are inherently risky for lenders. If delays are encountered, construction costs rise and rents may become too high to be competitive in the

market. But with section 236, the mortgages are guaranteed by the Federal Government and essentially risk free. In addition, many lenders are reluctant to make 40-year loans, but with subsidized projects, GNMA characteristically issues a commitment to buy the mortgage at face value. This insures the lender that he can collect a fee for handling the transaction, sell the mortgage if this is desirable, and relend the same funds again within a relatively short time period.

The developer, on the other hand can make an immediate profit for packaging the project and constructing the building. Mortgage money may be more available for subsidized projects than for completely private ventures, and the FHA interest rate may be below the market rate, which enhances a project's feasibility. In addition, certain fees for services performed by the developer though not actually charged can be counted by the developer as part of the required cash investment of 10 percent, which can lower the amount of cash required to start such a venture. Commercial lenders often require as much as 25 percent or more equity in order to lend on an unsubsidized residential construction project.

This lower equity also makes subsidized 236 projects more attractive to passive investors who are mainly interested in sheltering income from other sources. Since the depreciation on a given project is the same regardless of the down payment, the lower the equity, the higher the tax savings per dollar of investment.

The following pages discuss in detail the various aspects of section 236 which induce private lenders, builders, and investors to participate.

Opportunities for financial returns (or profits) from investment in multifamily residential housing projects are present at several points in the development process. Cash fees may be obtained for building or developing the project, for packaging or syndicating the project (i.e., obtaining passive investors), or for managing it. Cash distributions are available during the project's operating phase. Tax shelters are available during the construction and operation stages. Finally, proceeds are available from the sale or refinancing of the project. In evaluating a project, an investor will consider the above factors as well as the financing leverage, the risk of loss, and the liquidity or ease of sale of the project. The importance attached to individual criteria varies with the type of investor and the stage in the housing process in which the investor participates.

The investor in limited-dividend projects puts up equity capital to secure financing for a project. Investors that also package, build, or manage the projects are referred to as active investors. Those that only advance capital are called passive investors. Active investors usually include real estate corporations, partnerships, proprietorships, or subsidiaries of corporations, the primary business of which is not real estate. Passive investors are typically insurance companies, real estate investment trusts, or individuals.

According to a HUD study, the annual cash return, or cash flow, is the most important financial criterion for each group in evaluating an investment decision. Capital appreciation has an equivalent importance for insurance companies. Real estate investment trusts view a low risk of loss as the second most important factor. Real estate organizations and subsidiaries of non-real estate corporations rate financing leverage second, while individuals consider tax shelter as second in importance. Active investors rated tax shelter and financing leverage as second to annual cash return.

In evaluating section 236 investments against the various criteria, table I summarizes a comparison with conventional multifamily project investments. As can be seen, section 236 is equivalent to conventional projects only with respect to cash fees for building and packaging the project and the tax shelter available to investors.

Moreover, the cash fees for packaging arise from syndicators selling interests in the tax shelters by converting future tax losses into income for the builder-developer. The builder-developer's incentive, for such cash fees is often given as the explanation for the large number of section 236 housing units that have been produced.

Comparison of Section 236 with Conventional Multifamily Housing Investments

	Section 236	Conventional
Cash fees from development	Significant to active participants in development process	Significant to active participants in development process
Cash fees from management	Controlled by HUD--considered inadequate by some managers	Subject to market forces--a source of profits
Cash flow	Limited to 6 percent of stated equity; discounted by many investors	Very significant to investors; not restricted
Tax shelter	Significant to high tax bracket investors	Moderate to high tax bracket investors
Proceeds of sale or refinancing	Doubtful: - Contingent upon property appreciation quality of management - Subject to HUD's controls on sale for 20 years	Significant: - Appreciation expected by most investors - Subject only to market forces and lender's controls on prepayment or refinancing

Source: U.S. Department of Housing and Urban Development, "Tax Incentives and the Long-Term Ownership of Section 236 Projects," Report of Touche, Ross & Co., under HUD Contract H-2108, Sept. 1, 1973, p. 16.

TAX BENEFITS TO INVESTORS

Exceptional financing leverage enhances return on investment

The tax benefits available to investors in section 236 projects arise through a combination of section 236 and the

Tax Reform Act of 1969, which enhanced the value of residential shelters as compared to other tax sheltered real estate investments. 1/ Under section 236, a profit motivated investor is limited to a maximum annual cash flow of 6 percent of the stated equity. In view of the relatively small amount permitted compared to conventional projects, the prospective owner must search elsewhere for any profits or return on investment.

FHA permits projects to be financed with a mortgage that is 90 percent of the estimated replacement cost, so that an investor can buy into the tax benefits with only 10 percent equity, as compared with the usual 25 percent required by lenders for conventional loans. Certain allowances may also be added to the available mortgage amount under section 236 which further reduced the cash investment required to a level of 2 to 5 percent. To the extent that an investor can reduce the cash investment, financing leverage is gained, thereby increasing the return on the initial investment.

Construction period deductions

During the construction period, the owner of a project may deduct expenses that will not be capitalized into the mortgage. These expenses, such as interest payments on the construction loan, real estate taxes, and certain other fees and charges, were typically advanced by the lender, and yet the owner still received the benefit of the expense deduction. Thus, these expenses could be used for sheltering the investors' other income.

Accelerated depreciation

The most noteworthy tax benefit for section 236 investors is the depreciation of the construction cost during the operating phase of the project. Depreciation is one of the few expenses against the income from a project that is not a cash expense. The Internal Revenue Code permits several methods by which the depreciation can be accelerated over the straightline method. Table 2 shows the methods that are permitted for different types of residential real estate. Section 236 has an advantage with depreciation in that,

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1/The tax provisions for new residential property were changed slightly in 1976, and these changes are discussed in [illegible]

because of the greater financing leverage, the investor has a higher ratio of depreciation losses to equity invested.

The investor also receives additional benefits during the operating stage which further reduce an owner's tax liability. Because of the greater financing leverage, the interest expense of the project mortgage will be higher. Since HUD permits a 40-year mortgage (as opposed to the 20 or 25 years with conventional mortgages), the interest expenses during the first years are greater than that for a similarly mortgaged conventional project.

Table 2
Depreciation Methods Permitted by the Tax Reform Act of 1969

Type of real estate	Most accelerated method permitted	Rules of recapture of excess depreciation
New residential for low and moderate income families	200 percent declining balance and sum-of-the-years digits	Declines 1 percent per month after 20 months. No recapture after 10 years.
All other new residential	200 percent declining balance and sum-of-the-years digits	Declines 1 percent per month after 8 years and 4 months. No recapture after 16 years and 8 months
Used residential	125 percent declining balance if useful life exceeds 20 years, otherwise straight line	Declines 1 percent per month after 8 years and 4 months. No recapture after 16 years and 8 months
Section 167 (K) rehabilitation for low and moderate income housing	Straight line with 5-year useful life	Same as used residential housing
Commercial	150 percent declining balance	All excess depreciation recaptured regardless of time of sale

Rehabilitation writeoff

For investors in multifamily rehabilitations made under section 236, the Internal Revenue Code, under section 167 (K), provides that any rehabilitation expense may be written off in 5 years rather than the remaining useful life of the project. This section, available only for expenses incurred before 1975, has been credited with stimulating development of a rehabilitation industry that did not exist prior to 1969. Although this provision has been an incentive for attracting investors, it has not been sufficient to induce lenders to finance such projects. For that, direct housing subsidies and mortgage insurance, particularly under section 236, have been necessary. As a result, the vast majority of rehabilitation projects for lower income households have been directly subsidized.

Attractive recapture provisions

The Internal Revenue Code also provides other tax benefits to section 236 investors with respect to the timing and manner of disposal of a project. As shown in table 2, different provisions for recapturing depreciation in excess of straight-line depreciation apply to low and moderate income housing as compared with all other new residential multifamily properties. When an accelerated depreciation method is used and the project is sold, the excess depreciation is taxed as ordinary income unless the property has been held for a certain period. In the case of low and moderate income housing, no excess depreciation is recaptured if the project has been held 10 years, while the comparable period for nonsubsidized projects is 16 years and 8 months.

Other tax benefits

The tax on the gain realized from the sale of a section 236 project (or other federally assisted rental projects) may be deferred if the project is sold to the tenants, a cooperative, or qualified nonprofit organization and if the project owner purchases a similar type of subsidized housing usually within 1 year from the date of sale of the first project. Moreover, treatment of excess depreciation (as described above) is dated from the date of acquisition of the first project. If the project owner donates the project to a qualified charitable organization, the fair market value rather than the project's depreciated cost (the difference could be substantial) may be deducted.

TAX SYNDICATION ATTRACTS PASSIVE INVESTORS

The builder-sponsor of a section 236 project does not generally have sufficient income to take advantage of the tax losses that will be generated. As a result, the available shelter will be converted into cash fees for the builder-sponsor by selling equity interests in the project to passive investors. These ownership interests may reach the passive investors directly from the builder-sponsor or through a syndicator or an underwriter. The mechanism for passing the tax losses through to the passive investor is typically the limited partnership in which the losses and the income of the partnership accrues directly to the partners (who may be individuals or corporations). The sale of the ownership interests generates cash contributions for the builder-sponsor to use for the legal and syndication fees, for cash requirements of the construction phase not covered by the mortgage, and for the profit that the builder-sponsor gains for the development of the project. This mechanism, with its attendant benefits for the builder-sponsor, acts as a substantial inducement to develop a section 236 project.

This syndication process is considered the primary reason for the success of section 236 in attracting investors and, in turn, as a stimulus for housing production. By using tax shelters, section 236 investors can obtain, after tax, returns of 15 to 25 percent on their initial investments, compared with 14 percent indicated as the median average rate of return for all investors in multifamily projects.

LENDERS REQUIRE FURTHER INCENTIVES

The previous considerations show the substantial inducements provided to the investor by section 236 and the pertinent Internal Revenue Code provisions. However, these may attract investors, but they do not affect the decision of the mortgage lender to provide the necessary financing. The willingness of lenders to make funds available is adversely affected in the case of section 236 projects by the expectation that tenants will be unable to pay increased rentals. The availability of a market capable of supporting a project is strengthened by the relative depth of the subsidy, through both section 236 and the rent supplement program. The availability of FHA insurance for the loans makes such loans one of the safest investments in the mortgage market. Finally, although the ceiling interest rate permitted under section 236 is usually less than the market rate, the fact that the Government National Mortgage

Association may purchase such mortgages and resell them to the Federal National Mortgage Association (FNMA) or other investors at the lower prevailing market price (the Tandem Plan), further enhances the lenders' willingness to provide mortgages for section 236 projects.

CHAPTER 9

DEFAULTS AND FAILURES UNDER SECTION 236

One of the major criticisms of section 236 was that the mortgage insurance failures were unacceptably high. The publication "Housing in the Seventies" reported that the section 236 program would probably see a 20-percent failure rate over 10 years and 30-percent or more during the 40-year life of section 236 mortgages which are insured by the Federal Housing Administration (FHA). The same report also stated that because of losses up to that time, the program did not appear actuarially sound. 1/

In this chapter we look at both these contentions as well as other criticisms of this program and show that its failure experience is probably not as bad as such statements seem to indicate. In addition, much of the problem can be explained in terms of the risk taken or isolated to particular subsets of section 236 projects which are particularly risky. To do this we present the program's failure experience with that of other FHA programs and privately insured lending in order to put section 236 in perspective. We also present a reasonable method for comparing the failure experience of FHA insurance programs which sheds new light on this program. Finally, information on the probable causes of section 236 failures is presented. The causes of failures have been postulated or established by various researchers in a variety of ways, and in this report we present those which we consider most plausible. Where reasonable we apply the section 236 experience to present FHA insurance programs by making observations or recommendations about how these programs can be altered for use with the section 8 program.

THE MEANING OF A FAILURE

Lenders on section 236 projects are guaranteed that if a project defaults on its mortgage obligation, FHA will pay the mortgage balance. There are two ways in which lenders can file a claim for payment. The lender can assign the mortgage note and receive 99 percent of the mortgage balance or foreclose upon the loan and surrender

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1/"Housing in the Seventies: A Report of the National Housing Policy Review," U.S. Department of Housing and Urban Development, 1974.

the title to FHA for the entire mortgage balance. Most lenders elect to assign the note since foreclosure is generally a lengthy and costly process.

The following table illustrates the number of projects and units which have failed.

Section 236 Failures
December 31, 1976

Type of claim	Projects	Units
Notes assigned to HUD	539	52,920
Projects foreclosed by lender	27	3,340
Total failures	566	56,260

When the mortgage note is assigned, FHA essentially becomes the lender and tries to solve the financial difficulties with the project sponsor. If the project loses too much money during this period, FHA will obtain title through foreclosure and attempt to sell the project.

The total cost of a failure is realized when FHA sells the project. The cost of a failure is the difference between the amount for which the project is sold and its acquisition cost plus the net income or expense while it is held by FHA. These costs are met by the income generated from premiums paid on viable mortgages. The following table illustrates that HUD has lost about 65 percent of its capitalized investment on 59 section 236 projects.

The Losses on Sales of 236 Projects
December 31, 1976

Capitalized cost for 59 projects	$77,818,637
Sales prices for 59 projects	-27,414,457
Loss on sales	$50,404,180

Percentage loss on sales ($50,404,180 ÷ $77,818,637) = 64.8

The 59 projects contain 5,473 units for which the likelihood of service to low and moderate income tenants is greatly reduced. Of the 59 projects, 22 have been sold with HUD holding the mortgage. This means that there would be some control over rent increases but little over the rent

level at the time of sale. Thus, the majority of projects have been sold for cash in which case HUD has no control over the rents which will likely be established by the market.

THE FAILURE EXPERIENCE OF SECTION 236

As of December 31, 1974, 7.5 percent of section 236 projects were in default (i.e., at least one payment behind). As of the same date, 6.8 percent of all projects ever insured under section 236 have been assigned or foreclosed. Failure rates are available for recent years. However, we present the failure experience at this date because we have comparable failure rates for other programs available only as of 1974. (However, as of December 31, 1976, the section 236 failure rate was 13.6 percent.) The next section illustrates the failure experience of various FHA programs.

THE SECTION 236 FAILURE EXPERIENCE IN PERSPECTIVE

What is an acceptable failure rate? This question is central to our understanding of the section 236 failure situation. Yet most criteria, which are routinely used, suffer from (1) a lack of perspective in that they compare section 236 to programs or loan failure experiences which are considerably different and hence not comparable, or (2) they compare various programs in a way which is misleading. In this section we will look at several types of criteria or comparisons which have been used in the past which we consider inappropriate. Then after an analysis of the similarities and differences among several FHA insurance programs which provide some background information, we will present an adequate comparison.

Actuarial soundness is not a valid criterion

Actuarial soundness is not a valid criterion for judging section 236 because the insurance fund, under which 236 loans are insured, was not intended to be actuarially sound. When the Congress authorized the 236 program, it created a Special Risk Insurance Fund (SRIF) to cover the losses of such high risk ventures. The legislative history clearly reveals that the Congress never intended the fund to be actuarially sound. On the contrary, they expected the fund to require a separate appropriation to cover losses. The 1968 Conference Report called for appropriation "of such sums as may be needed from time to time to cover losses sustained by the fund in carrying out the mortgage

insurance" obligations. 1/ The meaning should be clear. Financial assistance to cover fund deficits are the liability of the U.S. Treasury.

HUD's method of predicting an ultimate failure rate was questionable

The other criterion which probably had a great impact upon the way section 236 was perceived was the ultimate failure rate. HUD concluded that the ultimate failure rate would be highly unacceptable based upon a prediction that at least 30 percent of all projects started would eventually fail over the life of the program. Yet this prediction was based upon a methodology which we consider questionable and which our actuarial consultant described as indefensible.

First of all predictions of this sort are nearly impossible to support since the future economic situation is unpredictable and past experiences with other programs were determined as much by the environment in which they operated as by the characteristics of those programs. Secondly, the projection which HUD made was based on limited data on section 236 and predicated on the assumption that section 236 would behave like section 221(d)(3) BMIR in the early years and later like section 207, both of which were quite different from section 236 and very different from one another. In subsequent discussions these differences and the variation in actual failure experience will be explained.

Cumulative failure rate comparisons can be misleading

It has been said that a program's failure experience should be judged against the failure rates of other FHA multifamily programs. The table on the following page shows the cumulative failure rate for several FHA programs.

1/Conference Report No. 90-1785 on the Housing and Urban Development Act of 1968.

Comparison of Cumulative Failure Rates December 31, 1974

Multifamily program	Failure rate	
	Projects	Units
608 VEH	15.2	16.0
207 Post War	15.0	14.8
221(d)(3) MIR	23.2	27.6
221(d)(4)	9.8	10.1
221(d)(3) BMIR	20.8	19.5
221(d)(3) BMIR; RS	23.8	21.2
221(d)(3) MIR; RS	8.1	9.3
236	6.8	5.7
202	11.0	n/a

By looking at cumulative failure rates in this table, it appears as if the section 236 program has the lowest rate compared to other FHA programs. Although a better comparison will indicate that this is probably an accurate characterization, the information in this chart cannot be used to make such a conclusion since these programs have operated at different times for different lengths of time and have produced from a few thousand to nearly half a million units. This can be seen in the next table.

Time and Production Data of Multifamily Programs December 31, 1974

Multifamily program	Produced	Experience	Projects	Units
608 VEH	1946-1952	28	6,549	427,750
207 Post War	1949-1974	26	1,848	237,716
221(d)(3) MIR	1954-1974	21	159	18,415
221(d)(4)	1959-1974	15	1,587	196,989
221(d)(3) BMIR	1961-1973	14	1,464	172,466
221(d)(3) BMIR; RS	1965-1974	10	126	17,138
221(d)(3) MIR; RS	1965-1974	10	1,303	101,462
236	1968-1974	7	3,953	427,935
202	1959-1968	15	318	n/a

Judging section 236 failures against those of privately financed projects is also not valid because of differences in risks

It is often said that Government programs such as section 236 have an unacceptably high failure rate when compared to

the experience of private projects. To a certain extent this is probably true, but it is unfair to compare a Government program, particularly a subsidized one, to private projects since the risks are significantly different.

The first difference between private and Government insured projects is the amount of money invested by the sponsor. In a Government project a sponsor is required to invest anywhere from zero to 10 percent of the project's value while a sponsor of a privately financed project must invest 20 to 25 percent. It is generally believed that the more a sponsor invests, the more cautious he will be when planning and managing since he has more to lose in the event of failure.

Another reason why privately financed project failures are not comparable is that lenders would probably work harder to resolve financial difficulties since they cannot assign the problem to HUD. We were unable to locate nationwide data on the proportion of privately financed projects which fail, but we have talked to several large lenders who said they have few foreclosures because it is easier to work out the difficulties with the project owner than go through foreclosure. Not only is foreclosure troublesome, but the lender may not recoup his investment should he sell the property. This differs markedly from an FHA-insured project in which the lender can assign the mortgage note and collect 99 percent of the mortgage balance without the inconvenience and expense of foreclosure.

It would also be unfair to say that privately financed projects have a better failure experience without understanding the difference between private and Government insurance. If a private project is insured, the lender's potential loss is lower but still much greater than a fully insured FHA project. When a private project is insured, it is "coinsured" by the lender and the mortgage insurance company--that is, the insuring institution insures only the top 20 percent of the mortgage amount while the lender is exposed to a risk on the remaining 80 percent of the mortgage. Private insurance for multifamily projects did not come into existence until 1968. There are now four companies which have most of the insurance business, but the Mortgage Guarantee Insurance Company (MGIC) does about 60 percent of the private underwriting. As of December 31, 1974, MGIC had a cumulative failure rate of 1.3 percent. This compares to a 6.8 percent failure rate for section 236.

The difference in the amount invested and the amount insured partially explains the difference in failure rates, but equally important is the fact that private insurers, like MGIC, begin insuring when the project is complete while FHA projects are usually insured when construction begins. The construction period is probably the riskiest time in a project's life. Later in this chapter we will illustrate that if FHA insures projects when construction is complete, it can have roughly the same failure rate as MGIC. Before presenting our comparisons, we will present some background information on other FHA programs.

OTHER FHA MULTIFAMILY PROGRAMS

The Government's role in multifamily insured mortgages began in 1934 when the Congress authorized section 207 (12 U.S.C. 1713). To stimulate production, FHA provided mortgage insurance on private developments for up to 80 percent of a project's estimated value. During the early years (1936-45) section 207 produced 75,000 multifamily units. This production was considered modest when compared to the 1,400,000 single family units insured. In 1956 the Congress liberalized the financing terms of section 207 by increasing the mortgage limit to 90 percent of the project's value. From 1956 to 1973 roughly 198,000 units were insured.

The section 207 program is a nonsubsidized program, and, by virtue of the mortgage limits per unit, it is designed for higher income tenants. We include the 207 program in our comparison of failure rates because even though 207 caters to a higher income group than 236 and is thought to be less risky, it will later be shown that the failure rates of the two programs are roughly equivalent.

War housing

Before the financing under section 207 was liberalized, the Congress enacted several provisions to accommodate housing needs during and after the Second World War. The section 608 program (12 U.S.C. 1743), which was passed in an amendment in 1942, was a major inducement to private investment to produce rental housing for workers in the war industries. This program and a program which followed it--Veterans Emergency Housing (VEH)--insured 90 percent loans for privately developed projects. The VEH program was ideal for developers. Mortgage amounts were based on a percentage of a project's estimated replacement value rather than its actual cost. This allowed the builder/developer to receive compensations for his services without any

equity investment--and in many cases, an actual cash withdrawal. This compensation was possible because the Government did not verify the estimated replacement cost. As a result, subsequent programs have had requirements to verify actual costs. However, before the 608 program was curtailed, the construction industry produced over 400,000 units from 1946 through 1952. This represented a tenfold increase over FHA multifamily production for the period 1941-45.

The 608 VEH program is important because like section 236 the program required low equity investments by developers which undoubtedly stimulated housing production, and low equity is generally considered to increase risk of failure. Section 608 VEH was also designed for moderate income households, and the long-term failure rate is probably acceptable.

Multifamily housing during the 1950s and 1960s

There were a number of multifamily housing programs in the 1950s and early 1960s, but two of the most important were section 221 (12 U.S.C. 17151) and section 202 (12 U.S.C. 1708).

Section 221 actually contains a variety of programs which evolved during this time. Section 221(d)(3) contains two programs, one known as the Market Interest Rate (MIR) program and the other the Below Market Interest Rate (BMIR) program. The 221(d)(3) MIR program was enacted in 1954 and authorized nonprofit sponsors to obtain federally insured market rate loans to construct multifamily housing for the elderly, handicapped, and displaced families affected by slum clearance. In 1961 the Congress changed the target population to include what it termed low and moderate income families. The target population was actually restricted to moderate income tenants because the interest rate, although set by FHA, was close to the actual market rate which made rents too high for low income people.

This program was coupled with the Rent Supplement Program in 1965, and it drastically changed the tenant population because it was designed for families whose incomes qualified them for public housing. Under this approach the Government paid the difference between 25 percent of a tenant's income and the market rent. Almost all of the 221(d)(3) MIR projects were coupled with the Rent Supplement Program. The 221(d)(3) MIR coupled with

Rent Supplement is no longer active, but the original MIR program is and is being used in conjunction with section 8.

In 1961 the Congress authorized the BMIR program which was also designed for low and moderate income tenants but by virture of a subsidy, the intended target group had incomes lower than the original 221(d)(3) MIR program. The subsidy involved a reduced interest loan made directly from a private lender and then sold to the Federal National Mortgage Assoication (FNMA), which at that time was a quasi-Government organization. The interest on these loans was generally 3 percent, so it allowed sponsors to reduce rents. This program was terminated shortly before section 236 was enacted.

Also under section 221 is the 221(d)(4) program which insured profit-motivated sponsored projects originally designed for the elderly, handicapped, and displaced families. This program was enacted in 1959 and later amended in 1961 to include "low and moderate income" families. As in the case of the 221(d)(3) MIR program, the interest rate used to finance these projects is close to the market rate so that the intended target population is usually moderate income tenants. This program is still active, and it is being used in conjunction with section 8.

The section 202 program was enacted in 1959 and was designed specifically for the elderly. Unlike the previous programs, section 202 was not an insurance program. Rather, it consisted of direct 100 percent loans made to nonprofit sponsors at an interest rate which was originally set at the rate for comparable Federal borrowings and later established at 3 percent. As can be seen from the table on page 58, section 202 never played an important role in providing housing, but it is likely to be used extensively under section 8.

AN APPROPRIATE COMPARISON OF FAILURES

We stated that the cumulative failure rates presented earlier were not comparable since these programs operated at different times, for differing lengths of time, and for other reasons. In the following discussion, we will illustrate these problems.

The first problem with the cumulative failure rate comparison is the difference in the length of time projects

have been insured. When we compared section 207 failures against those of section 236 we were comparing section 207 in which the average project had been insured for 13 years to section 236 where the average was only 3 years. Experience has shown that most projects fail in the first 10 years, so the high failure rate for 207 (15 percent) does not mean that the section 236 failure experience (6.8 percent) is better. It merely means that section 236 has not had enough experience for the major portion of its failures to occur.

The second major problem with these comparisons is the fact that programs which are no longer insuring units will have a higher failure rate than those programs still insuring units. For example, the 221(d)(3) BMIR program, which is no longer active, had a cumulative failure rate of 12.8 percent at the end of 1972. During 1973 nearly 4,000 units failed, but few new units were produced and consequently, the cumulative failure rate increased to 14.8 percent. Under section 207, which is still active, 1973 saw some new production as well as failures so that the cumulative failure rate only increased from 13.5 percent at the end of 1972 to 13.9 percent at the end of 1973. Thus the cumulative rate for 221(d)(3) will continue to increase since no more units are being produced, while as long as 207 continues to produce new units at significant levels its failure rate is likely to remain stable.

There are a number of other factors which make comparisons difficult:

--Each program operated under a different economic environment. For example, the section 608 VEH program was initiated during a time when there was very likely a greater demand for housing than when section 236 was initiated.

--The mortgage repayment plans differed drastically. Section 236 has a level annuity payment plan, while section 608 (as well as other programs) has plans where the mortgage payments were higher in the early years and lower in the later.

These differences, coupled with the fact that projects have the most trouble in the early years, means that in a certain sense, earlier programs were probably somewhat more risky than section 236.

A more valid comparison could be made if two programs were initiated at the same time, had the same number of years experience, and had the same type of repayment plans. The only two insurance plans which have all these features in common are section 236 and MGIC, but as we showed earlier, vast differences exist in the way insurance is written under these plans. Therefore, in order to make an adequate comparison, we must isolate those units or mortgages for each program which were insured during the same time period and compare the failure rates for these subsets. With the exception of section 608 VEH, all other insurance programs can be compared for the 1968 to 1973 period since each had some new activity during the period and because HUD had changed all programs to the level annuity plan. This comparison is shown in the next section.

The section 236 failure rate is better than or equivalent to other FHA programs

The following table shows failure rates for units which were started and failed during the 1968 to 1973 time period. 1/ During this period the section 236 failure rate was identical to the failure rate for nonsubsidized units under section 207, but section 207 was not suspended in January 1973 even though section 236 was. Section 207 is generally believed to be the most sound FHA multifamily program.

Program	Percent of units which started and failed from 1968 to 1973
Section 236	8.8
Section 207	8.8
Section 221 BMIR	14.9
Section 221 MIR	15.3

Given this result, one might ask why section 207 is generally thought to be better in terms of failures. One reason is because section 207 projects have had lower per unit losses when they fail and are sold. For example, out of all 207 projects started between 1968 and 1973, seven have failed and been sold at a loss of $5,443 per unit. For the same period, 59 section 236 projects failed and were sold at a loss of $9,060 per unit.

1/These computations were made by Mortimer Kaplan in a report prepared for GAO: "Viability of the Section 236 Program," Oct. 14, 1975.

Given the identical failure rates, section 207 clearly has a better failure record since it has been less costly than section 236. However, if we exclude nonprofit sponsored projects which accounted for a disproportionate share of section 236 failures and compare only section 236 limited dividend projects with section 207 projects which were all profit-motivated we get an interesting result. The section 236 limited dividend failure rate for this period was roughly 3.3 percent, and these projects lost $7,922 per unit when sold. Thus, section 236 limited dividend projects had less than half the failure rate of section 207, yet lost roughly $2,500 per unit more when sold. Now it is more difficult to tell which program's failure experience is better. To properly compare these losses, we combine the failure rate and the loss per failure to determine the failure cost per unit started.

If 1,000 units were started between 1968 and 1973 for both 236 and 207, then at the end of 1973 there would have been 88 section 207 failures (8.8 percent x 1,000) and 33 section 236 failures (3.3 percent x 1,000). The loss on the 207 units would have been $478,984 (88 units x $5,443 loss per unit) and $261,426 for the section 236 units (33 x $7,922 loss per unit). This means:

--For every section 207 unit started between 1968 and 1973, the per unit failure cost due to failures occurring during that period was $478.98.

--For every limited dividend section 236 unit started between 1968 and 1973, the per unit failure cost due to failures occurring during that period was $261.43.

Section 236 versus private insurance

The failure rate of section 236, as of December 1974, was 6.8 percent. Seventy-five percent of these failures had problems before project completion and would have been suspect to a private insurer. A company such as MGIC would insure only those projects whose problems were resolved, but FHA would have already insured such projects because most FHA projects are insured from the start of construction. Thus the potential for increased losses under FHA as opposed to private insurance could be as much as 75 percent of the 6.8 percent failure rate which section 236 experienced. Or to restate this, had FHA had the alternative of refusing this group of troubled projects, the failure rate as of 1974 could

conceivably have been reduced to as low as 1.7 percent, depending on how many projects were refused. This does not mean that we advocate such a change since changing the terms of the insurance would probably have a devastating effect on production. This calculation does, however, demonstrate the vast difference in the risk taken by FHA and private insurers.

WHAT ARE THE CAUSES OF FAILURE?

The failure rate comparison of programs during the 1968 to 1973 period provides a clearer picture of the failure experiences of various programs. The next step is to explain why projects fail. This section explores some of the more important factors related to failed 236 projects and, where possible, we try to show how the experiences of section 236 can be applied in future FHA programs.

PROBLEMS DURING DEVELOPMENT

It has been determined by an internal HUD study that if a project defaults on its construction loan, it is more likely to default again after construction is completed and also stands a greater chance of ultimate failure. 1/ Of all the projects which defaulted before HUD had certified that construction was complete, which is called final endorsement, roughly 39 percent failed. Furthermore, as of September 1973, of all the failed 236 projects, 75 percent defaulted before final endorsement. Final endorsement also indicates that all costs have been certified correct by an independent certified public accountant and that HUD is committed to insure the project for a specific amount.

Two reasons for defaults before final endorsement were identified in another HUD evaluation. 2/ These included:

1/"Multifamily Defaults Study: An Evaluation Report by the Division of Special Studies, Office of Program Analysis and Evaluation, Department of Housing and Urban Development, 1973, p. B6.

2/These reasons were reported by HUD's region IX evaluation report, entitled "Multifamily Defaults Before Final Endorsement," June 1974. p. 3.

--Delays at any point in project development caused either by HUD or outside factors.

--Ineffective monitoring by HUD or the construction lender during the development process.

Some of the delay-related problems identified by HUD were:

--Unrealistic construction time estimates.

--Approval of inexperienced and underfinanced sponsors.

Some of the delays which are not attributable to HUD include poor construction management, construction changes required by local governing bodies, bad weather, and other uncontrollable occurrences.

Delays

A delay in construction can cause a default before final endorsement and can lead to a failure if the increased finance charges needed to carry the construction loan for a longer period of time cannot be met either by income generated from units which have been completed or by additional sponsor investment. A delay might also cause the construction lender to ask the sponsor to begin payments on the permanent loan. In this case the sponsor would be required to pay interest in arrears on the construction loan as well as make debt service payments. If the project has not rented enough units to support these expenses, it will default and the lender will probably assign the loan to HUD.

Underestimated construction times caused some projects to default before final endorsement

The HUD region IX study found that some projects were not delayed in construction but actually had construction times underestimated. Out of 31 projects which had failed before final endorsement, 5 had construction times underestimated.

Under HUD procedures, construction times are to be estimated by the field offices' cost analyst who is required to base his estimates on completion times of completed projects. The analyst is responsible for compiling this

information for both FHA-insured and conventionally financed projects. However, it was discovered by a HUD audit that eight field offices were (1) not making surveys on conventionally financed projects nor were they establishing a schedule of actual construction times for FHA-insured projects, (2) collecting inaccurate information, and (3) substituting their own procedures for those prescribed. 1/

Underestimating construction times may not be a widespread problem since the audit included only eight offices. Whether this problem is serious enough to warrant examination by HUD is debatable since the majority of all section 236 projects did not fail. However, it is possible that many successful projects had construction times underestimated, and the additional cash required was paid by the sponsor. Since underestimating the construction time can have the same severe consequence on a project as a delay in construction, HUD should assure itself that construction times are realistic.

Many delays may have been caused by the sponsor's and contractor's lack of experience and financial resources

The HUD region IX evaluation also discovered that 15 out of 31 failed projects had sponsors and contractors without previous construction experience. Furthermore, 18 of the projects had inadequate financial information on which to judge the capability of the participants.

Although this evaluation was not specific about the errors that contractors and sponsors had made during construction, the evaluators generally felt that if the participants had enough resources they could weather almost any problem which occurred. Evaluators also felt that HUD had not been careful in screening sponsors and builders. Not having the financial wherewithall to weather adversity is, as we shall discuss later, a crucial factor in the vulnerability of nonprofit sponsors.

1/"Internal Audit of Multifamily Mortgage Insurance Programs--Feasibility Processing to Final Endorsement," Mar. 31, 1975, pp. 49-51.

That previous experience in multifamily construction is desirable is hardly subject to question. But we do not know the proportion of sponsors who had previous experience or the number which did not who were successful. However, we do know that FHA does not require previous experience although private lenders do. We talked to several lenders on private projects. They all said they would not lend if the sponsor did not have previous successful experience. They also felt that this was a general rule in the industry.

HUD's monitoring has been inadequate

Whether projects were poorly planned, mismanaged while under construction, or delayed for any reason, HUD might have avoided many failures, had it properly monitored construction and worked out small problems before they became large.

Under HUD procedures the HUD architectural section is required to inspect the project's construction. The time interval between inspections is different for each field office. In some offices inspections are weekly. In others, reviews will be once a week during the early stage of construction and then cut back if the work is proceeding properly. The only other required inspections are when the sponsor requests more construction money. This inspection is to insure that the construction is proceeding according to plan. The cost section of the field office insures that the construction advances correspond to the construction cost breakdown and that the builder is not drawing down too rapidly for particular construction items.

This procedure would probably result in proper monitoring. However, it has been reported that some field offices have used this system very ineffectively. Instead, field offices "become aware of substantial delays or potential defaults on a crisis basis, either because inspections were not performed according to instructions or the inspection reports were not used."

If HUD properly monitored projects it could probably have identified problems early on and worked toward solving them before they became unmanageable.

MANY PROBLEMS OCCUR DURING OPERATION

Up to this point we have discussed problems which caused projects to fail before they are complete. In the following sections we mention numerous problems which either

originated when the project was planned or occurred when the project was in operation.

Underestimated operating expenses may have caused numerous failures

Among a sample of multifamily projects under several insurance programs in three HUD regions, it was determined that when operating costs were underestimated, the projects failed at the rate of 33 percent. 1/

During the feasibility stage, the sponsor estimates the cost of a project based upon estimates of income and operating cost. The difference between estimated income and expenses determine the amount available for debt service and allowable cash flow in the case of limited dividend sponsors. These estimates determine the development cost and general characteristics of a project, for example, size of units, quality of construction and amenities. A HUD audit report found that "estimated expenses did not realistically depict the expenses of maintaining a project and could influence the approval of an otherwise unsound project."2/ Although this report did not determine the extent to which operating expenses were underestimated, a HUD central office task force reviewed section 236 activities in five field offices and reported that "operating expenses were consistently underestimated." The reason for these underestimates was cited in the same report. After the cost estimates are completed by the sponsor, HUD personnel are required to compare the estimates with available "facts and figures on land sales, project operating expenses, construction costs, apartment occupancy rates" for the area. The audit found these facts and figures to be "outdated, incomplete, and otherwise unreliable * * *." The auditors concluded that the prime reason for this problem was the lack of staff to collect the information. 3/ The auditors reemphasized this conclusion 3 years later when they found that

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1/"Multifamily Failures Study in Regions III, VI and XI," Department of Housing and Urban Development, Spring 1973, p. 14.

2/"Report on Audit of Section 236 Multifamily Housing Program." Jan. 29, 1972, pp. 38-39.

3/HUD Audit Report, Jan. 29, 1972, p. 39.

operating expense data was still insufficient to allow appraisers to realistically depict operating expenses. 1/

Unexpected increases in utilities may have caused some projects to fail

The implications of insufficient operating expense data and the resulting underestimates are clear, especially for section 236 projects because utilities drastically increased while 236 projects were being built. Prior to September 1973 utility costs were relatively stable. From the inception of section 236 to September 1973 (56 months), the CPI for fuel oil, gas, and electricity increased by 12.9 and 21 percent, respectively. But from September 1973 to December 1974 (16 months) these energy items increased by 25 percent on the average.

Possible delays in rent increases may have made it more difficult for troubled projects

It has been said that HUD has been slow in approving needed rent increases to cover these costs. We were unable to ascertain the truth in this matter, but it should be clear that underestimating operating cost coupled with dramatic increases in utilities (and perhaps taxes) without a concomitant increase in rents can be detrimental to a project's success.

Projects are planned too close

Many section 236 projects may have failed because they had insufficient cash flow built into the rents. A project which is sponsored by a limited dividend entity is allowed a cash flow equal to 6 percent of the nominal investment, which is 10 percent. A project which is sponsored by a nonprofit entity has no return built into rents. This means that any increase in operating cost or any decrease in income such as might occur if vacancies were greater than those anticipated when rents were set, is likely to cause a default.

This situation may partially explain why section 236 limited dividend sponsors had a 3.3 percent failure rate while privately insured projects under MGIC had only a 1.3

1/HUD Audit Report, Mar. 31, 1975, p. 14.

percent rate at the end of 1974. Privately sponsored projects generally strive for 15 percent cash return on investment. Since most lenders on private projects require an investment of 20 to 25 percent of the project's value, sponsors plan on a return of 3 to 4 percent of the project's value each year. Limited dividend sponsors under section 236 are required to invest 10 percent of the project's estimated replacement cost. A 6-percent return on this amount is six-tenths of a percent of the project's value. This means that sponsors of privately insured projects have 5 to 6 times the cash return (or cushion) that section 236 limited dividend sponsors do.

Lenders may not have been motivated to work out delinquencies because of FHA's full guarantee against losses

Another possible reason for the large disparity between 236 failure rate and MGIC's might be that permanent lenders on FHA projects may not be willing to work out project defaults as they have less to lose in the event of failure. For example, lenders on FHA projects have 99 percent of the mortgage guaranteed against losses while coinsured lenders stand to lose anywhere from 75 to 80 percent of the outstanding mortgage balance. Furthermore, uninsured lenders stand to lose 100 percent of the mortgage balance.

Several lenders of uninsured projects told us they had almost no failures because they watch projects very carefully and generally try to work out problems should they arise. A typical work out arrangement might include deferring the principal and modifying the mortgage amount to account for delinquencies. However, the record of work out arrangements under the section 236 program is mixed. Most 236 loans are held and serviced by FNMA and prior to 1972, many HUD personnel felt that FNMA was particularly insistent on assigning a delinquent loan rather than modifying the note or granting some other form of mortgage relief. However, as a result of congressional pressure, FNMA's policy toward workouts has improved in recent years. We were told by FNMA and HUD officials that FNMA generally tries to cooperate with HUD and the sponsor to work out delinquencies and will assign a project only as a last resort. We were unable to determine the work out records of other permanent lenders, but it seems that if the FNMA--which is a federally chartered corporation founded to help finance low and moderate income housing--took a conservative position toward defaults, then it is likely that other section 236 lenders took a similar or more conservative position.

TYPES OF PROJECTS WHICH FAIL

Nonprofit sponsored projects are riskier because they have limited resources, inadequate experience and may tend to admit the neediest tenants

Nonprofit sponsored 236 projects failed at four times the rate of limited dividend sponsored projects. Many of these failures could have been avoided if HUD had insured that nonprofit sponsors (1) understood their responsibilities and (2) had the necessary assets or financial capability to weather adversity.

As of June 30, 1976, 23 percent of all section 236 projects were sponsored by nonprofit owners, yet accounted for 47 percent of the failures. Cooperative sponsors make up roughly 6 percent of all projects ever insured yet account for 11 percent of the failures. Furthermore, nonprofit and cooperative sponsors had twice the default rate before final endorsement as the limited dividend sponsors.

The following table compares the failure experience of limited dividend and nonprofit-sponsored projects of section 236.

Failure Experience of Section 236 by Sponsor Type
December 31, 1974

	Limited dividend	Nonprofit
Projects insured	2,550	880
Failures	87	151
Percent failures	3.3	14.6
Percent of total failures	32.7	56.8

This pattern is common in other programs. The following table compares the default and failure experience of various programs as of September 1973.

Mortgage Status by Type of Project and Type of Sponsor 1/
September 1973

	Nonprofit		Limited dividend		
	236	221 BMIR	236	221 BMIR	207
Always current	68%	40%	87%	63%	75%
Now or previously in default	21	19	11	15	6
Assigned or foreclosed	11	40	2	22	19

Nonprofit-sponsored projects fail because they have little resources to weather adversity.

Although few studies have explained why nonprofit projects have greater financial difficulty, there have been some reasons postulated by researchers. Unlike limited dividend sponsors, nonprofit sponsors have less in the way of financial resources and must operate without losses to be viable. A HUD audit report found in a sample of nonprofit-sponsored projects that most were "(1) almost totally devoid of assets; (2) a new organization in the community and therefore had no established membership or other means available as a reliable source of additional funds; and (3) totally separate and apart from the originating entity; therefore the originating entity was not financially responsible to the project." 2/ These findings were based on a sample of 16 projects. The report concluded "* * * that nonprofit section 236 projects were generally conceived and promoted by either (1) a builder who aspires to profit on the proposed site, profit resulting from project construction, or both; or (2) a housing consultant motivated by the subtantial fee involved."

We do not know whether most nonprofit 236 projects were conceived for profit motives but if this was generally a problem, HUD tried to correct it in June of 1974 when it reinforced its requirements for nonprofit sponsors. HUD now requires that nonprofits must:

--Meet the definition of a nonprofit sponsor.

1/"Multifamily Default Study," HUD, 1973, p. B-10.

2/HUD Audit Report, Jan. 29, 1972, pp. 64-65.

--Act on his own behalf and not be under the control of any outside party seeking to derive profit.

--Have continuity and a long-range desire to provide housing for the intended client group.

--Have strong roots and an established reputation in the community.

These requirements seem to be adequate to insure that nonprofits are well established and committed to providing housing to low and moderate income families. However, the new definition is devoid of any asset requirement. We have been told such a requirement would discriminate against groups who have a desire to provide low and moderate income housing yet lack a sound financial backing. We believe that some form of asset requirement or a potential to produce a minimum income can be established without discouraging interested nonprofit groups. Having the ability to produce income is probably more important than initial assets because it is during construction or during difficult times that cash is needed to maintain a project. Not having the cash in hard times is probably the major reason that nonprofits fail at four times the rate of limited dividend sponsored projects.

Nonprofit sponsors fail more often because they are probably less experienced

Another important reason for a higher failure rate among nonprofit sponsors is lack of experience and an understanding of the responsibilities involved with owning and operating a multifamily project. One HUD evaluation surveyed several troubled nonprofit projects and found the following conditions:

--"In some cases sponsors did not understand the limits of government support; they believed that if they needed additional capital, the government would always be there."

--Church groups "often looked upon the projects they sponsored as a form of charity, kept rents artificially low, and were willing to overlook rent delinquencies."

--Some "sponsors stay solvent only by deferring expenditures as much as possible and providing minimum maintenance." 1/

We were unable to ascertain the proportion of sponsors which had previous experience. However, it is likely that a higher percentage of nonprofits were inexperienced than limited dividend sponsors because FHA usually requires an experienced management firm when a nonprofit sponsor is involved. Since the limited dividend sponsor is profit motivated, he is more likely to be experienced or possess the skills necessary to produce and manage a multifamily project.

Other reasons why nonprofit sponsors have a higher failure rate

Another possible reason for nonprofit sponsors having a higher failure rate than limited dividend sponsors is that nonprofit sponsors tend to admit the lowest income eligible tenants who are more likely to have difficulty paying rent.

One HUD study showed that in a sample, nonprofit sponsors have 79 percent of their tenants who pay more than 25 percent of their income for rent while limited dividend sponsors have 54 percent of their tenants paying more than 25 percent of their income for rent. 2/

Another difference between nonprofit sponsors and limited dividend sponsors, which may partially explain the failure difference, is the fact that nonprofit sponsors serve more needy families than limited dividend sponsors. Based on one random sample, nonprofits serve a higher percent of the elderly and disabled, and among nonelderly and nondisabled families, they serve more families with either the wife or husband absent and more families in which no one is employed.

1/"Multifamily Failures Study," HUD, pp. D 4-5.

2/Program Paper on Section 106--Technical Assistance and Loans to Nonprofit Sponsors, DHUD, Apr., 1976, pp. 31-32.

Some section 236 projects failed because they were poorly located

It has been said that placing projects in a desirable location is one of the most important factors in determining a project's success. During the underwriting process a good location is to be insured by a careful market analysis. However, it was found in the 1972 audit report that due to a lack of complete and current market data during the application processing, several projects were developed, even though they were infeasible from a marketing standpoint. FHA instructions require that after an application for insurance is made, the site and location are to be examined to determine suitability. Part of this examination includes an analysis of data bank information to determine whether there is a need for the project at a specific location. The data bank should include facts and figures on land sales, project operating expenses, construction cost, and the percent of units within an area which are occupied (occupancy ratio). Such data is to be collected on FHA projects as well as conventional projects. In the 1972 audit report, HUD found that the basic data of the locality was not maintained or was outdated. In a follow-up audit, HUD sampled eight field offices and discovered that the occupancy ratios were not maintained for six. 1/ The report concluded that the deficient market data was caused by appraisers not devoting enough time to collect the information.

The 1972 audit also reported that the market analyses were not fully taken into consideration, and, as a result, some of the projects reviewed had subsequent problems renting all units. One of the problems mentioned was the approval of marginal locations because HUD officials were more concerned about producing housing units than insuring that the projects were well located. For this review, HUD selected 62 projects from 21 field offices and discovered that 24 projects had undesirable site characteristics or locations. Of the 62 projects, four had serious topographical problems which may later result in hazardous conditions, poor drainage, and potentially costly maintenance; five were contiguous to undesirable industry; five projects were located in areas which were concentrated with minorities or low-income people; and 16 projects were situated in outlying areas remote from shopping and

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1/HUD Audit Report, Mar. 31, 1975, p. 13.

other community facilities. This report did not specify whether these projects were in financial difficulty as a result of these undesirable conditions, but it is easy to see how such problems could cause financial problems. For example, projects located on unstable slopes and ravines or where there is soil erosion or drainage problems would have to be corrected by grading. Such repairs would have to come from operating funds. If the project is operating marginally to begin with then such expenditures could be fatal. Another example of a poorly located project is when the project is located in a remote area where there is no convenient transportation to places of employment, shopping centers, schools, churches, playgrounds, parks, libraries, hospitals, and other civil and social centers. Such a project would have a difficult time occupying all units.

Projects located in urban renewal areas fail more often than those not located in urban renewal areas

Two other HUD studies have analyzed failure with respect to location. One study, which included three regions, took a 52 percent sample of projects in section 221(d)(3) Rent Supplement, 221(d)(3) BMIR and 236. 1/ The study characterized location by core city, other than core city, and suburban. It was found that "failure of projects cannot be connected with location." However, when the categories of location were redefined, it was determined that "projects located in urban renewal areas failed at a rate of 38 percent as compared to a nonurban renewal failure rate of 23 percent." The other HUD study--which looked at section 236 and other programs separately and on a national scale--also found that projects located in urban renewal areas tend to fail more often than those not in urban renewal areas. 2/ This study compared failures under 236 and 221(d)(3) BMIR to those under section 207. The following table summarizes the default and failure experience of these three programs as of September 1973.

1/"Multifamily Failures Study," HUD, p. 9.

2/"Multifamily Default Study," HUD, p. A 1.

Mortgage Status by Type of Project and Location Relative to Urban Renewal Area

	In urban renewal				Not in urban renewal			
	236	221	BMIR	207	236	221	BMIR	207
Always been current	52%	49%	-		82%	59%		75%
Now or previously in default	41	20	-		13	19		7
Assigned or foreclosed	7	31	-		5	22		18

From the table, it seems as if 221 BMIR projects located in urban renewal areas have a worse record of failure when compared with section 236. However, it must be remembered that the 236 experience is based only on 5-years experience while 221 has 13 years. Since the program is young, the failure rate is likely to rise. In fact, as of June 30, 1976, the failure rate among 236 projects located in urban renewal areas was 17.5 percent. The failure rate among projects located outside of urban renewal areas was about 9 percent.

Although the failure rate among urban renewal located projects is worse than those elsewhere, the total impact of these failures is relatively small when compared to the total failures. As of June 1976 about 6 percent of the total 236 projects ever insured were located in urban renewal areas, and they accounted for about 9 percent of the total failures. The section 221 BMIR program, on the other hand, had a much larger portion of projects located in urban renewal areas. As of September 1973, 17.4 percent of the total percent of the total 221 BMIR projects ever insured were located in urban renewal areas. This difference may explain the difference in the total failure rates between these two programs. (We earlier showed that over comparable times section 236 had a failure rate of 8.8 percent while 221 BMIR had a 14.9 percent rate.)

Rehabilitated projects fail more often than newly constructed projects

Rehabilitated projects have a much higher failure rate for subsidized projects than for nonsubsidized ones. The following table illustrates this difference.

Mortgage Status by Type of Project and Type of Construction 1/

	Newly constructed			Rehabilitated		
	236	221 BMIR	207	236	221 BMIR	207
Always current	83%	62%	75%	55%	27%	73%
Now or previously in default	13	19	7	20	17	15
Assigned or foreclosed	4	19	18	25	56	12

The failure rate of rehabilitated section 236 projects has remained about the same over time, but the failure rate for newly constructed projects has increased. As of June 30, 1976, rehabilitated projects had a failure rate of 29 percent while newly constructed projects had a 9-percent failure rate.

There are several reasons which can be hypothesized for such differences. It is possible that rehabilitated projects are located in the poorest areas where the project caters to the lowest income groups who have the most difficulty paying rent. It is also probable that rehabilitated projects have old heating systems which are expensive to maintain, causing added cash flow problems.

1/"Multifamily Default Study," HUD, p. B 12.

CHAPTER 10

WHAT ARE THE COSTS?

The costs involved in a subsidized housing program are difficult to comprehend. The absolute magnitude of the cost of a program like the section 236 rental assistance program, which has provided roughly a half million housing units, must be measured in billions of dollars. Housing subsidy costs are incurred through a variety of mechanisms, from direct monthly or yearly subsidies to foregone tax revenues resulting from housing investors' deducting accelerated depreciation on their tax returns. The direct subsidy can clearly be attributed to the program, whereas foregone tax revenue could not easily be attributed to a specific program, and investors could be expected to seek alternate tax shelter through some other means if the housing alternative were not available. The bulk of housing subsidy costs under most housing programs are delayed to future years. Payments run as long as 40 years. Thus, the changing value of money and the way in which delayed expenditures tend to be discounted in the minds of decisionmakers become very important considerations. Certain costs are impossible to estimate accurately, such as the ultimate cost of mortgage defaults under a program like section 236, which involves Federal Housing Administration (FHA) insurance. The cost of the housing unit provided varies with locality, type of construction, and many other factors.

Very often the housing cost information presented to the Congress is sketchy, including only first-year direct subsidies or only a portion of the indirect subsidies. Cost comparisons are often made on the basis of first-year costs, which can be misleading since the current housing programs have different expenditure patterns over time. For example, section 236 has relatively high initial costs which taper off rapidly during the first 10 years. For a similar unit under public housing, the initial subsidy is lower but decreases slowly over the 40-year financing period.

In this chapter we demonstrate a method for presenting the long-term costs of housing policy alternatives which can facilitate rational decisionmaking and attempt to give better answers to questions about the realistic costs of various housing programs and subsidy methods. Although housing programs have generally been tailored to serve a particular purpose or specific income group, their goals may sensibly result in overlaps, such as the section 236 rent supplement combination, which can serve tenants who would also be

eligible for public housing. In such cases it is reasonable to compare such alternatives to see which method results in a lower subsidy, even though there may be other considerations which would result in the choice of the higher cost alternative. When one program is proposed as a replacement for another, such comparisons should be mandatory.

This chapter examines section 236 housing subsidy costs. Section 236 is then compared to the conventional public housing program and the new section 8 rental assistance program. The comparisons which we present are based to some extent upon costs and assumptions which have been used before by the Department of Housing and Urban Development (HUD) or other researchers, but we have consciously attempted to understate the cost differences between the various programs. This was done because our initial calculations indicated that, if we based our analysis on identical development costs, which is customary (and probably necessary) the public housing alternative appeared to be a less costly method of providing new housing to low-income tenants. This seemed contrary to conventional wisdom, and we chose to be cautious in our approach. Had we used less conservative assumptions, we could probably have shown substantially greater differences in total subsidy among the programs compared. This same principle was observed whenever possible in comparing section 8 leased existing housing to newly constructed housing under section 236 and public housing. Although much of the material in this chapter was previously published as a GAO staff paper, it is included here to make our treatment of section 236 comprehensive and because it is considered of interest to the entire Congress.

SPECIFIC QUESTIONS ADDRESSED

A number of basic questions about housing subsidy cost are addressed.

--First, are there real differences in the cost of subsidized new housing units under the section 236 program and the other major multifamily housing programs for low- and moderate-income families, namely public housing and the new section 8 program? To give insight into this question, we compare the total cost for each program of subsidizing a low- or moderate-income family in a newly constructed two-bedroom unit for an extended period of time.

--Are there any savings in subsidy costs as a result of using rehabilitation as opposed to new

construction. To examine this we calculated the total cost of providing similar section 236 housing under the rehabilitation method and compared this to our new construction estimate under various assumptions about sponsor type and relative magnitude of development costs.

--One important cost difference between section 236 and other programs is that it has used predominately new and rehabilitated housing, whereas public housing and the new section 8 program make use of existing housing which has not been rehabilitated. To analyze the cost implications of this, we compare new section 236 development to existing leasing under section 8. This comparison is based upon fair market rents for three U.S. cities and is not generalized to the country as a whole. Rather, the analysis demonstrates the impact of local market conditions, such as growth rate and size of the housing stock on leasing cost. Also discussed is the possible inflationary impact of extensive leasing and its long-term cost implications in various types of housing markets.

--Another question which arises is whether subsidy cost under nonprofit sponsorship of housing by churches, fraternal groups, or other philanthropic organizations differs substantially from the subsidy cost under limited dividend sponsorship by a partnership or syndication. This question could be asked in regard to a number of HUD programs, such as 221(d)(3) or section 8, where these alternatives exist, but is addressed here in terms of section 236 only. The results of this comparison apply equally well to other programs and highlight the essential differences resulting from the tax-exempt status of nonprofit organizations and their historical tendency toward financial difficulty.

Finally, in presenting the various elements of subsidized housing cost, we try to explain how each cost arises, how much variation there might be in each subsidy cost, and how much variation would affect the relative position of the alternatives compared here.

NEWLY CONSTRUCTED HOUSING UNDER SECTION 236, SECTION 8, AND PUBLIC HOUSING

Early HUD comparisons of the section 236 program to a revised leasing approach, essentially section 8, which were furnished to the Congress during the fiscal year 1975 appropriation hearings, indicated that total subsidy costs for the two alternatives were virtually the same for newly constructed units. These estimates assumed identical development costs for each program and developed direct subsidy costs based on identical tenant contributions of 25 percent of gross income. Indirect costs were estimated on a discounted basis and added to the undiscounted direct subsidy. Though this approach did not particularly favor either of these two alternatives, it did greatly blur any comparison made between these alternatives and public housing for which indirect costs were not discounted. It also had the effect of making certain of the indirect costs appear insignificant, although they are not.

The Library of Congress, Congressional Research Service (CRS), reviewed the HUD estimates and argued that the development cost for section 8 would likely be greater than for section 236, since the general guidelines for section 8 indicated that preference would be given to projects where no more than 20 percent of the units would receive assistance payments. CRS reasoned that this requirement would probably force developers to build market-competitive units with more amenities and larger floor plans, necessitating higher development costs. This argument is buttressed by the fact that nonsubsidized multifamily housing under section 207 (another FHA-insured program) is considerably more expensive than section 236 housing per unit.

It is also true that public housing is probably built to higher standards than section 236 and that the inspection to these standards is probably more rigorous, but this generally results in a higher quality unit. Based on discussions with housing experts and considering the wide variety of housing provided under each of the programs compared here, it is our feeling that differences in quality (and construction cost) are not integral to housing programs or subsidy methods and that they could be controlled up or down by careful program administration.

It also seems unlikely that profit-motivated sponsors will be willing to participate in constructing new units under section 8 without receiving subsidies for all or most of the units in a given project. If section 8 is to be

successful, the program will probably result in new construction projects with 100 percent of the units receiving subsidies, and early program experience seems to bear this out. Our estimates are therefore based on the assumption that 100 percent of the units in section 8 projects will receive subsidy and that the total development cost per unit will be the same under each program or alternative (except for rehabilitation). This allows us to compare the same type of structure and the same benefit to the tenant. If fewer than 100 percent of the units in a project are assisted under section 8, the indirect subsidies for section 8 units are going to be higher per subsidized unit, since items like the tandem subsidy must be incurred for the unsubsidized units as well as the subsidized units in any given project.

NEW CONSTRUCTION DEVELOPMENT COST ESTIMATES

Our development cost estimates are based upon (1) a 1975 HUD estimate of national average fair market rent for section 8, (2) a HUD estimate of multifamily operating costs based on public housing data, and (3) a national average property tax rate. The national average fair market rent of $3,900 for a two-bedroom unit was capitalized using an interest rate of 8.5 percent (plus 0.5 percent for mortgage insurance) and a 10-percent downpayment to arrive at a total development cost of $27,125 for a two-bedroom unit completed in 1975. The 8.5-percent rate was used to maintain a conservative differential of 2.5 percent between the FHA rate and the statutory limit on the public housing bond rate of 6 percent although this differential is usually greater, and also because the FHA rate was probably about 8.5 percent when the new construction fair market rents which we used were established. It is felt that cost increases since 1975 will not significantly alter the results presented here.

PROPERTY TAXES

Property tax rates vary drastically from area to area and from one part of a single jurisdiction to another. Taxing policies toward multifamily properties in general and subsidized properties in particular are quite unpredictable. We have used a national average tax rate of 2.5 percent of total development cost based on 1970 census data for multifamily rental properties. This rate has been used by HUD and other researchers. When applied to the total development cost estimate of $27,125, this results in a rather high ($678 a year) tax estimate. Property taxes

for the projects in the three cities which are discussed later in this report were uniformly lower than indicated by a 2.5-percent rate. Had we assumed a lower tax rate of 1.5 percent, it would favor public housing, since lowering the tax rate while holding the gross rent constant at $3,900 increases the debt service for section 8 and section 236 more than for public housing.

OPERATING COSTS

The operating cost used here is a 1975 national average figure for public housing developed by HUD. This figure ($950 a unit each year) is adequate for the nationwide comparison, but when we look at local housing markets, we will use local figures. If the $950 figure is seriously in error, it will not affect the relative position of alternatives from our calculations. The estimate includes maintenance, management, utilities, and all other expenses not included elsewhere.

PROFIT

We have not explicitly analyzed the impact of profit under the limited dividend alternatives. The variation in total subsidy cost that it introduces due to changes in direct cost is slight, and it would result in higher but nearly identical costs for the two FHA limited-dividend cases which will in turn be shown to be more expensive than public housing but much less expensive than the non-profit case.

DIRECT SUBSIDY UNDER NEW CONSTRUCTION

The direct costs involved in the alternatives considered here consist primarily of monthly subsidy payments. In the case of public housing, the subsidy payment is made to a local housing authority to cover debt service on nontaxable bonds, but our estimates also include an additional subsidy to defray a portion of the operating cost, without which these projects would not be feasible. Under section 236 the payments are an interest subsidy paid to the lender on behalf of the sponsor (and a rent supplement for lower income tenants). The section 8 payment is the difference between fair market rent and tenant contribution (limited to 25 percent of adjusted income) which is paid to the landlord.

The following tables show our direct subsidy calculations for a newly constructed two-bedroom unit servicing both low- and moderate-income four-person households.

Direct Subsidy

(Family of Four, Gross Annual Income of $4,250)

	Section 236 (rent supplement)		Section 8 limited dividends	Conventional public housing
	Limited dividends	Nonprofit		
Total development cost	$27,125	$27,125	$27,125	$27,125
Loan amount	24,410	27,125	24,410	27,125
Terms (years)	40	40	40	40
Interest rate (MIP) (note a)	8.5(+0.5)	8.5(+0.5)	8.5(+0.5)	6.0
Annual debt service	2,272	2,525	2,272	1,793
Operating expenses	950	950	950	950
Property taxes/ PILOT (note b)	678	678	678	51
Gross rent	3,900	4,153	3,900	2,794
Tenant contribution	-859	-859	-912	-806
Direct subsidy	$ 3,041	$3,294	$2,988	$1,988

(Family of Four, Gross Annual Income of $9,000)

	Section 236 (without rent supplement)		Section 8 limited dividend	Conventional public housing
	Limited dividend	Nonprofit		
Gross rent	$3,990	$4,153	$3,900	(not eligible)
Tenant contribution	-2,369	-2,452	-2,100	
Direct subsidy	$1,531	$1,701	$1,800	

a/Mortgage insurance premium.

b/PILOT stands for "payment in lieu of taxes," which is paid by local housing authorities to local governments. It is usually calculated as 10 percent of shelter rent, which is the rent paid by tenants less utilities.

Section 236 with rent supplement versus section 8

The annual direct subsidies under limited dividend sponsorship of section 8 and section 236 with rent supplement are virtually the same for the lower income household. The slight difference ($53 per year) is caused by different income adjustment rules for the two programs. In both instances tenants pay 25 percent of adjusted gross income. Nonprofit sponsorship, which is shown only for section 236, exhibits a higher subsidy, since no downpayment or equity is required, causing a higher debt service. Nonprofit sponsorship of section 8 would also result in a proportionately higher annual subsidy. For new construction the only potential for lower subsidy costs under section 8 than under section 236 seems to be the possibility of lower development cost, which seems unlikely.

Direct subsidy under public housing is much lower

Public housing direct subsidies are substantially lower than the other alternatives for lower income households. It is more than $1,000 less per unit under our calculations than with section 236 or section 8. This is in spite of the fact that tenant contributions are about $50 or $100 more, respectively, than under public housing, due to different income adjustment rules. This substantial difference in the direct subsidy arises because of the lower debt service and the local property tax relief granted public housing. Local housing authorities pay a percentage (in practice less than 10 percent) of tenant rent to the local government in lieu of property taxes, which generally results in a great reduction in their expenses and, hence, in the subsidy. In this case it is the difference between $678 for section 8 or section 236 and $51 for public housing. This is a very real savings which we offset as foregone local tax revenue when we look at indirect subsidy costs. However, this offsetting effect may only exist when comparing public housing to section 236 or section 8 since there is no guarantee that this lost property tax revenue would actually be available if public housing were not created. For example, the land might have remained vacant. If this foregone property tax is not counted when computing the total cost of public housing and if the cost of providing municipal services to the public housing units is less than the $678 per year, then public housing is even more attractive than shown in our calculations.

In our cost estimates, the assumption of a 6-percent tax-free bond rate for public housing probably overestimates the subsidy cost for public housing. As of March 1976, the bond rate for public housing had never exceeded 6 percent (although it could), and the construction period is financed with short-term notes at much lower interest rates (frequently in the neighborhood of 3 to 5 percent). This has two effects: (1) lower construction financing lowers the development cost for public housing and (2) HUD, which arranges the sale of housing authority securities, often rolls over (resells) the short-term lower interest rate notes several times in order to arrange permanent financing when long-term bond rates are down. So during this waiting period, substantial additional interest savings may be realized. Thus, our direct subsidy estimates overstate the direct cost of public housing and still show public housing to be much cheaper.

Direct subsidy for moderate-income tenants

For higher income tenants ($9,000 per year), who are not eligible for public housing, the direct subsidy per unit which we calculated for limited dividend sponsorship under section 8 is considerably higher than for section 236 ($1,800 versus $1,531) because the subsidy for section 236 is limited to the excess of debt service above what would be paid for a 1-percent mortgage, which in this example means a limit of $1,531. Thus, the section 236 tenant pays about 30 percent of his adjusted gross income while the section 8 tenant pays 25 percent.

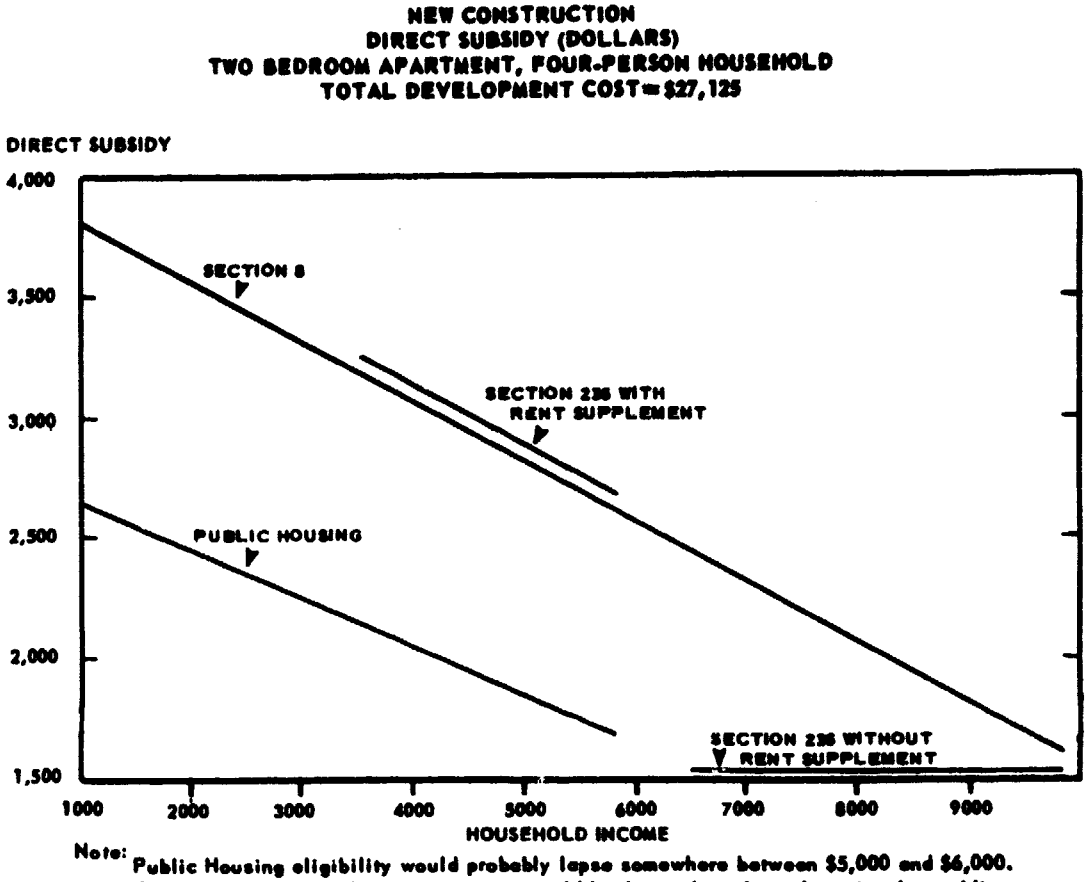
Deeper direct subsidy under section 8

Under section 236 a large percentage of tenants have paid rents in excess of 30 percent of their gross income before adjustments. Thus, with the 25-percent limit under section 8, the subsidy will be proportionately higher than it was under section 236. For example, under section 236 the average yearly income of section 236 tenants was about $5,500 during 1973 and 1974, and the average rent of these tenants was roughly $133 a month or about $1,600 a year. This was 29 percent of gross income or 32 percent of their adjusted gross income. Under the section 8 adjustment rules and by limiting rent to 25 percent of adjusted income, the average tenant rent would have been $1,300 a year, which is $300 a year less than it was under section 236. Thus, if the section 8 method had been used, the subsidy for each unit of the approximately 439,000 section 236 units subsidized during fiscal year 1975 would have been an

average of $300 a year higher. This would have amounted to an additional $132 million expenditure above the $375 million spent. With greater construction and operating costs in the future, this difference would be even greater. In addition, section 8 may pay an even greater subsidy for some tenants, since the legislation authorized HUD to reduce tenant payments to as little as 15 percent of their adjusted gross income.

Direct subsidy varies with income

The graph below shows how direct subsidy under these programs varies with income for our hypothetical two-bedroom unit.



Note: Public Housing eligibility would probably lapse somewhere between $5,000 and $6,000. Section 236 rent supplement payments would be dropped at about the point that public housing eligibility lapses.

For lower income tenants, the cost of the direct subsidy is about the same under section 8 and section 236 with rent supplement. But section 236 could not serve some households with very low income because of limits on rent supplement subsidies.

Public housing has a much lower direct subsidy for lower income tenants than either section 8 or section 236 but does not serve moderate-income tenants. For moderate-income tenants the direct subsidy for section 236 without rent supplement would be much lower than section 8 since there is an upper limit on the section 236 subsidy, and section 236 tenants would pay higher rents. These moderate-income tenants were the primary target group under the section 236 program, and, indeed, most of the households served in the past were in this group. Thus, section 8 will probably result in a uniformly higher direct subsidy than the other two programs, which it has replaced at all household incomes, except where rent supplement is used in conjunction with section 236.

One difference between section 8 and section 236 is that section 236 holds out the possibility that, if tenant income increases faster than operating costs, the average per unit subsidy will decrease, since rents in excess of the basic rent set by HUD must be returned to HUD. Excess rents have thus far amounted to only a few dollars per unit, and recent HUD administrative decisions allowing excess rents to be applied to operating losses may further reduce these payments. Average tenant rents have been rather stable despite inflation, and even large increases in tenant rent in the distant future would be modulated by operating cost increases and the time value of money. Thus, it seems unlikely that the excess rent provision will have any appreciable effect.

INDIRECT SUBSIDY COSTS

Indirect subsidy costs range from about 20 percent of direct cost for section 236 with limited dividend sponsorship to about 70 percent of the direct cost in the case of public housing. These indirect costs are more difficult to estimate and are incurred irregularly over time. To clearly show the significance of these costs, we must make careful assumptions about alternatives, estimate the longevity of the units, discount future costs, and amortize the total unit cost over the expected life.

Discounting the value of money expended in the distant future to reflect present value is a common technique in cost and economic analysis and is important for comparative purposes here, since the rate at which costs are insured under public housing is quite different from the rate under section 236 or section 8. Discounting allows us to view all expenses as if they were being incurred today at the score value of money as opposed to showing disbursement over the next 20 or 30 years at varying values of money.

The indirect costs are those which are not explicitly charged against a program but which nevertheless are incurred as a result of creating units under the program. For section 236 these costs are for program administration, losses to the insurance fund in excess of mortgage insurance premiums, Federal and local taxes foregone, and Government National Mortgage Assoication tandem subsidies. Some of these costs are great in magnitude and differ drastically from program to program. Administrative costs are slight compared to the other cost elements and have been given little attention. Our estimate is taken from an estimate prepared by HUD for the 1976 HUD budget hearings.

Indirect costs for section 236 and section 8 are assumed to be identical. We can find no reasons why they would differ greatly if the development costs were the same.

Federal taxes foregone

These costs are significant and varied. Undiscounted 5-year averages are shown in the next table.

Yearly Average

Federal Taxes Foregone, Two-bedroom Unit

(Total Development Cost of $27,125)

Years	Section 8 and section 236 limited dividend	Section 8 and section 236 nonprofit	Public housing
1 to 5	a/$839	-	$800
6 to 10	270	-	767
11 to 15	121	-	730
16 to 20	18	-	662

a/Includes construction period tax savings.

Section 8 and section 236 taxes foregone under limited dividend sponsorship are based on Touche Ross estimates of tax savings for a 50-percent tax bracket taxpayer. These estimates are considered quite good and would be in error only to the extent that we have guessed wrong about the income tax bracket of the investor.

Our estimate of the Federal tax foregone for public housing is straightforward. We assume that the debt will be financed using 6-percent tax-free bonds and that the bond holder would have paid tax on this interest at 50 percent without the tax-free feature. We also estimated this cost using a number of other methods, the most convincing of which yielded a lower estimate, which would make public housing even less expensive. Under nonprofit sponsorship no taxes are due. Thus sponsors do not use losses to offset income from other sources.

The 20-year average discounted costs are $272 a unit each year for section 8 and section 236 with limited dividend sponsorship and $459 a unit each year for public housing. The discount rate used is 6 percent, which is considered conservative. A higher rate would favor public housing.

Local taxes foregone

This indirect cost applies only to public housing and reflects the special treatment accorded public housing by local governments. This cost is balanced by property taxes paid by developers of section 236 (or section 8) and is then counted in the direct subsidy.

Tandem plan costs for section 236

The Government National Mortgage Association (GNMA), a corporate entity within the Department of Housing and Urban Development, intervenes in the secondary mortgage market on behalf of lenders to subsidized housing projects. GNMA buys federally insured mortgages at a price equal to the unpaid balance on the mortgage (with certain adjustments) and sells such mortgages to the Federal National Mortgage Association or other investors. This encourages mortgage bankers to lend for subsidized housing since they know that the mortgage can always be sold without a loss.

It is difficult to predict what tandem costs will be in the future since "tandem points" absorbed by GNMA have varied widely and depend on the interest rates of the mortgages being sold and their current market value.

GNMA sells mortgages at a price which allows the buyer to get the same yield as if the mortgage bore an interest rate at or near the current interest rate for mortgages salable without GNMA intervention. GNMA issued many commitments to purchase 7-percent mortgages for projects which would be completed 2 or 3 years later. GNMA then purchased and held such mortgages for a year or more before disposing of them at auction (there are several other methods of disposal). At the time of disposal the market interest rate might have been 9 percent or more on conventional mortgages, making the market price for 7-percent mortgages particularly low. If the market rate were closer to the rate of interest on the mortgage, the selling price would be higher. For example, during 1974 section 236 mortgages at 7 percent were purchased by GNMA at 100 percent of the outstanding balance and sold at auction at prices near 90 percent of the balance, which means that GNMA absorbed about 10 percent of the mortgage amounts on that transaction. Prior to June 1973 the subsidy was only about 2.75 percent. In fiscal year 1973, when GNMA sold $1.1 billion in mortgages, its losses were about 6 percent or $65 million. According to HUD, GNMA sold $70.7 million in 7-percent section 236 mortgages during the second quarter of 1975 at prices of 81 to 82 percent of the face amount, which indicates a subsidy of 18 to 19 percent of the mortgage amounts.

The tandem subsidy is a significant one-time payment which will probably be paid on the vast majority of section 236 units. Whether this subsidy will continue to be paid on units started in the future (for section 236 or section 8) is a matter of policy, but for units already started or in the pipeline, there are still a large number of outstanding commitments which will result in large subsidies. Our tandem plan estimate for this comparative analysis is 8 percent of the mortgage amount, which may be low compared to recent experience. However, this percentage results in a total discounted cost figure which is close to that for public housing. When a higher percentage is used, public housing looks even more attractive. At 8 percent the cost of the tandem plan for providing a two-bedroom unit with total development costs of $27,125 is roughly $2,100 under limited dividend sponsorship and $2,940 under nonprofit sponsorship. 1/

1/These estimates include an adjustment for units lost through foreclosure and sale that do not complete a full 20 years of service.

The cost of FHA insurance failures

The Department of Housing and Urban Development issues mortgage insurance for privately built housing under a number of programs. In exchange for monthly insurance premiums and other fees, HUD enters into contracts to pay off loans in the case of default by the borrower. In the case of non-payment by the borrower, the lender, which is usually a mortgage company or commercial bank, can either (1) assign the mortgage to HUD, which then becomes the lender, or (2) foreclose on the mortgage and sell the property with HUD paying any loss. When either of these things happens, there is said to be a failure. Each failure will very likely result in a loss to the insurance fund.

The insurance losses are extremely difficult to predict, and the costs shown by HUD in the past for section 236 insurance costs have probably been somewhat misleading, since they were often exhibited on a discounted basis adjacent to undiscounted first-year direct subsidy costs, causing the discounted losses to appear insignificant. HUD also used a single figure for limited dividend and non-profit sponsorship, although the failure rates are drastically different. We will make an order-of-magnitude estimate of these losses and sufficiently warn the reader about probable error so as to avoid misunderstanding. It is necessary to do this, since the foreclosure rates for different subsets of section 236 projects are dramatically different. These differences will be treated in more depth in subsequent reports and are presented briefly here with the presentation of costs. Nonprofit sponsors have experienced much larger termination rates than limited dividend sponsors so that expected losses to the fund for nonprofits are much greater. As noted earlier, there are no tax losses for nonprofits. Indeed, one reason that nonprofits fail could be that they cannot rely on tax savings through depreciation to absorb operating losses. Thus, one cannot necessarily conclude that greater nonprofit termination losses should lead to a policy of avoiding nonprofit sponsorship.

For our new construction cost estimates, we have chosen 20-year cumulative failure rates of 10 and 40 percent for limited dividend and nonprofit sponsors, respectively. These rates imply a total program failure of 19 percent if 30 percent of the sponsors are nonprofit and 70 percent limited dividend. This is roughly the current split if cooperatives (which also have a higher failure rate) are grouped with nonprofits. This 19-percent rate is slightly lower than, but roughly

equivalent to, the 20-percent 10-year rate predicted in "Housing in the Seventies." It is extremely treacherous to make estimates of ultimate failure, but we are using such an estimate to show what the costs will be if the failure situation is roughly what HUD projected on the first 10 years and to distinguish in terms of cost between various program alternatives and show the relative cost of failures in a total cost framework. The HUD 40-year projection of 30-percent failures is considered even more tenuous and not considered there.

If the total losses in the limited dividend projects are fewer than assumed in these calculations, the relative cost of new construction under section 8 and section 236 would decrease as compared to public housing. The potential for such improvement among limited dividend projects is slight, since the failure experience thus far is 3.4 percent and the average age of 236 mortgages is still less than 3 years, leaving many risky years (most failures occur in the first 10 years). As for nonprofits, it is unlikely that enough improvement could take place in the failure rate to greatly change their cost relative to public housing or limited dividend sponsorship of section 8 or section 236. The nonprofit failure rate was already 15 percent at the end of 1974.

Projected losses

Losses were estimated by (1) calculating the expected insurance claims over the years, likely income from resale of projects, and expected revenues per unit from mortgage insurance premiums for 20 years, (2) discounting each amount back to the first operating year, (3) adjusting for lost units, and (4) dividing by 20 to get yearly costs. Based on a cumulative failure rate of 10 percent and a per unit insurance loss of approximately 54 percent of the outstanding mortgage, which is commensurate with historical evidence on similar programs, the insurance fund would actually make money on limited dividend units with an average yearly profit of about $15 per unit. If the cumulative failure rate for limited dividends is increased to 15 percent, then the fund would incur an average yearly loss of $23 per unit. For nonprofits the average annual discounted insurance loss associated with providing one two-bedroom unit for 20 years is $323 per year based on a 40-percent cumulative failure rate. Much improvement could take place for nonprofits without changing their relative cost positions.

TOTAL SUBSIDY COST UNDER NEW CONSTRUCTION

When we consider both the direct and indirect costs of these alternatives, the 20-year costs are rather close, given the diversity among the individual cost elements. The following table shows our calculation of the average discounted yearly cost of providing a two-bedroom unit of housing to a lower income tenant for a total of 20 years.

New Construction

Discounted Annual Subsidy Cost

for a Family of Four with $4,250 Annual Income

(20-year Average)

	Section 236 with rent supplement		Section 8-limited dividend	Public housing
	Limited dividend	Non-profit		
Direct subsidy	$1,848	$2,002	$1,816	$1,208
Federal tax foregone	272	-	272	459
Tax revenue on sale (after 20 years)	-49	-	-49	-
Insurance losses	-15	323	-15	-
Tandem plan subsidy	105	158	105	-
Local tax foregone	-	-	-	318
HUD administration	20	20	20	20
Total	$2,181	$2,503	$2,149	$2,068

These figures indicate that under reasonable assumptions about mortgage failures, the insurance losses for nonprofit sponsorship are nearly balanced by the taxes foregone for limited dividend sponsorship. The remaining cost difference between nonprofit and limited dividend sponsorship is caused by the higher mortgage amount which increases the potential insurance losses and the tandem subsidy as well as debt service.

The yearly average public housing subsidy is somewhat less than the section 8 and section 236 figures. This is in spite of the fact that we purposely overstated the cost of public housing wherever possible and understated the cost of the other alternatives. In addition the discount rate used was considered low but used since it favors section 236 and section 8 rather than public housing which would

benefit from a higher rate of 8 or 10 percent. There are no insurance losses or adjustments for lost units of public housing since, based on HUD data, roughly 99 percent of all public housing units constructed since 1937 are still in existence. Even in cases where financial difficulties are encountered, the housing generally continues to serve the intended tenants.

As noted, these comparisons utilize a 20-year time period, even though housing units can be expected to last much longer. The reason for this choice is that limited-dividend sponsors will probably liquidate their investment after 20 years or refinance the property without Federal subsidy, so that it is unlikely that it will continue to serve subsidy tenants.

The bulk of the tax shelter for investment in new rental housing expires after 8 or 10 years, and it is common for investors to sell or refinance residential properties to get their equity out and/or convert to better tax shelters. In the case of section 236, the limited dividend investor is bound by his agreement with HUD to hold the section 236 project for 20 years or to get HUD's permission to sell.

Public housing and nonprofit rental assistance housing may serve longer

Public housing and nonprofit-sponsored section 8 and section 236 projects that survive a full 20 years can be expected to go on providing low- and moderate-income tenants with housing for many additional years. This will greatly diminish the yearly subsidy costs of these alternatives. If we compare the cost of these alternatives amortized over 30 years to the limited dividend alternatives for a 20-year period, both public housing and section 236 nonprofits are much less expensive than limited dividends.

Discounted Annual Subsidy Cost

(Family of Four, $4,250 Annual Income)

	20 years		30 years	
	Section 236 (rent supplement) limited dividend	Section 8 limited dividend	Section 236 (rent supplement) non-profit	Conventional public housing
Direct subsidy	$1,848	$1,816	$1,602	$ 967
Indirect subsidy				
Federal tax foregone	272	272	-	-
Less revenue on sale	-49	-49	-	-
Insurance losses	-15	-15	205	-
Tandem plan subsidy	105	105	106	-
Local tax foregone	-	-	-	305
HUD administration	20	20	20	20
Total	$2,181	$2,149	$1,933	$1,622

In addition to the lower subsidy under public housing, the building is still owned by the housing authority after it has been paid off at the end of 40 years. If it has been adequately maintained and modernized, it can continue to provide housing. Other analyses have shown that public housing is more expensive and sometimes conclude that, since the buildings and land are retained and have residual value, perhaps it is worth the expense. Our calcualtions indicate that public housing is the cheaper alternative even before the residual value is considered. We have not tried to estimate this value, since the real value is the continuation of housing services and the freedom from starting new units at the end of 20 years. Another method for making this comparison would have been to assume that new section 236 housing would again be provided at the end of 20 years and that the public housing would continue to serve for a total of 40 years. This would result in much higher costs for section 236 as compared to public housing.

REHABILITATION VERSUS NEW CONSTRUCTION

There are significant cost-related differences between the provision of section 236 housing through new construction

and provision by rehabilitation of existing units. First of all, the total development cost (TDC) of the two alternatives differs. Estimates of TDC for rehabilitation as a percentage of new construction TDC vary widely. The best estimate which we could find is about 86 percent, which is the figure used here. Secondly, the mortgage failure rate among all section 236 rehabilitation projects is much higher than new construction under limited-dividend sponsorship.

The cost comparison below uses roughly the same methodology as the nationwide new construction comparison of section 236, section 8, and public housing. An ultimate mortgage failure rate of 40 percent of rehabilitated units over 20 years is used, which is the same rate used for new nonprofit section 236 development. This is done to reflect a much greater likelihood of failure. The current failure rate for nonprofit new construction is very close to the current rate for rehabilitated projects. Rehabilitation projects for lower income housing qualify for a rapid writeoff of rehabilitation expenses during the first 5 years of operation. To qualify, the developer must expend at least $3,000 per unit for renovation over 2 consecutive years up to a maximum of $15,000. The cost of renovating dwellings under section 236 was usually quite high, since most section 236 rehabilitation projects were of the "gut rehabilitation" variety. One study of rehabilitation tax incentives found that a sample of rehabilitation projects, the median amounts expended for renovation, was 67 percent of the total rehabilitation development cost. Consequently, the bulk of depreciation is on rehabilitation expenses, which implies that tax savings for developers are completely exhausted in the first 5 years of operation, and projects develop taxable income in the sixth year. The rehabilitation expense used in this comparison is slightly higher than the $15,000 maximum, but it has been included to show how these alternatives compared in the past and would compare in the future if the rapid writeoff provision were extended with a higher ceiling on eligible rehabilitation costs.

Direct subsidy less costly under rehabilitation

Rehabilitation looks attractive at first glance since it results in lower development costs and, hence, a lower direct subsidy cost. Our standard two-bedroom unit serving a lower income family of four has an undiscounted direct subsidy cost of $3,040, whereas servicing the same family with a comparable rehabilitated unit requires a direct subsidy of $2,525 per year.

Indirect cost for rehabilitated housing is higher

Higher tax losses under rehabilitation, however, cancel out the savings in direct subsidy. Average tax savings in the first 5 years for an investor in the 50-percent tax bracket are shown below with the direct subsidy for these alternatives.

Average Yearly Cost (First 5 Years)

Two-bedroom Unit, Family Income of $4,250

	New construction	Rehabilitation
Development cost	$27,125	$23,463
Direct subsidy	$3,040	$2,525
Federal taxes foregone	670	1,532
Total subsidy	$3,710	$4,057

The rehabilitated unit in this example generates taxable income after the first 5 years, and the newly constructed unit costs an average of $136 a year in taxes foregone over the next 15 years. When tandem points and other indirect costs are added and the costs are discounted and amortized over a 20-year period with adjustments for lost units, the rehabilitation option appears to be more expensive if TDC for the rehabilitated unit is calculated as 86.5 percent of new construction TDC.

Discounted Annual Subsidy Cost

(Family of Four, $4,250 Annual Income)

(20-Year Average) (note a)

	Section 236 new construction	Section 236 rehabilitation 86.5% of new TDC	Section 236 rehabilitation 75% of new TDC
Total development cost	$27,125	$23,463	$20,344
Direct subsidy	1,848	1,535	1,339
Federal taxes foregone	272	474	411
Revenue on sale after 20 years	-49	-58	-51
Insurance losses	-15	252	218
Tandem plan costs	105	123	107
HUD administration	20	20	20
Total subsidy	$ 2,181	$ 2,346	$ 2,044

a/Both alternatives are with rent supplements and limited dividend sponsorship.

The total subsidy cost under rehabilitation is quite sensitive to development cost and, as noted in the table, would be less than for new construction if development cost for the rehabilitation unit were 75 percent of the development cost for new construction. The break-even point under our assumptions seems to be about 82 percent of new construction development cost.

profit rehabilitation costs less than limited dividend

The calculations shown thus far have considered only rehabilitation under limited dividend sponsorship. A major rehabilitation cost is foregone Federal tax revenue, which is not incurred under nonprofit sponsorship.

If we assume the same mortgage failure rate (40 percent over 20 years), the cost of a two-bedroom unit serving the same lower income family using nonprofits is considerably lower. Direct subsidy is slightly higher, due to the higher mortgage (100 percent versus 90 percent), but this is outweighed by the tax situation.

The discounted annual subsidy to serve a family with income of $4,250 under nonprofit rehabilitation would be $2,104. This is much less than the limited dividend rehabilitation subsidy of $2,346 a year and also less than the limited dividend new construction subsidy, which was $2,181 per year. As noted, there are indications that the failure rate for nonprofit rehabilitations may be greater than that for limited dividend rehabilitations, but the failure rate could be much higher than assumed for this calculation, and the cost would still be lower than the limited dividend alternatives.

External factors not considered

There is a good possibility that newly constructed units will have a longer life than rehabilitated units, which would lower the cost of new construction further as compared to rehabilitation. On the other hand, there may be cost savings under the rehabilitation approach that are not easily estimated. Community and neighborhood services that may already be in place need not be provided. Some examples are sewer lines, streets, curbs, gutters, and traffic signals. Under new construction the local government surely incurs such costs. We were unable to locate this type of cost information, but field studies could certainly establish a range for such costs.

Secondly, rehabilitation may have salutary effects on the neighborhood that contains the project. It may contribute to the preservation of established neighborhoods and greatly improve the environment for individuals not directly benefiting from the housing. It may directly replace substandard housing with adequate housing.

Finally, rehabilitation probably adds fewer units to the low-rent housing stock than new construction, because it replaces units which may have already been providing minimal housing services to poor households.

LEASED EXISTING HOUSING UNDER SECTION 8 VERSUS NEW CONSTRUCTION

To this point we have dealt only with new construction or rehabilitation alternatives and have shown little cost difference between section 8 and section 236 when tenants pay identical rents under each. But section 8 will also replace leased housing under the public housing program, and this is where section 8 shows a real potential for cost savings.

It should be kept in mind that the housing services provided under the leased housing approach may differ considerably from the services provided under new construction in a number of ways. We will point out the likely differences as cost estimates are presented for new construction and leasing in three American cities. These cities have distinctly different housing markets due to demographic and housing stock characteristics and will allow us to demonstrate a range of possible cost savings as a function of market conditions.

These estimates represent the per unit savings associated with providing a limited number of units in each city, but we make no attempt to estimate the impact of full-scale implementation of the leasing approach within these cities. We will, however, report on some previous research indicating that heavy utilization of leasing might have a considerable inflationary effect on general rent levels.

Another consideration is the long-term costs likely under the leasing approach as compared to the short-term cost advantage. Long-term costs of leasing versus new construction were calculated using a reasonable scenario for property ownership and appreciation. Leasing under section 8 is compared to new construction under section 236 and public housing.

The three cities used for this analysis are Pittsburgh, Pennsylvania, Durham, North Carolina, and San Bernardino, California. The counties containing these cities were used in our previous study on the relative costs of section 236 and section 8 which projected total first-year direct subsidies for serving eligible households. We found that the subsidy cost of new construction under the two programs was about the same and that existing leased housing would provide substantial savings. Our analysis utilizes some of the cost data we developed for that study, augumented by actual operating costs for projects in these cities and fair market rents for 1975. We also looked at the possible indirect costs for the two alternatives and projected the costs of these alternatives into future years.

Direct subsidy: New construction

The estimating methodology for new construction in the three cities is roughly the same as for the nationwide estimates. Fair market rents are capitalized using an 8.5-percent interest rate, a 40-year mortgage, local tax factors, and operating expenses to arrive at total development costs.

Section 236

Total Development Cost for a Typical Two-bedroom Walkup and Resulting First-year Direct Subsidy for a Family of Four

	Pittsburgh	Durham	San Bernardino
Fair market rent	$ 3,756	$ 2,484	$ 2,952
Total development cost	26,309	18,668	21,190
Debt service	2,204	1,564	1,775
Operating cost	1,235	712	852
Property taxes	317	208	325
Gross rent	$3,756	$2,484	$2,952
Direct subsidies:			
Very low income (45% of area median)	a/$2,508	a/$1,328	a/$1,828
Moderate income (70% of area median)	a/ 1,746 b/ 1,485	615	1,133

a/Indicates that rent supplement is necessary if tenant pays only 25 percent of adjusted gross income.

b/Without rent supplement.

These total development costs are very close to estimates prepared by HUD for actual projects in these cities for the earlier GAO comparison of section 236 and section 8 costs. Operating costs were based on the most recent operating statements for these projects that we could obtain. Costs used are not meant to be averages for the three cities but are considered quite realistic. The margin of error in these costs is considered small enough to allow us to distinguish between cities and between new construction and existing leasing within each city.

The median family incomes for these cities do not differ markedly, yet the subsidies necessary to serve the households shown vary greatly, due to large differences in construction and operating costs from city to city. The costs in Pittsburgh are so much higher that, despite a

higher median income than the other cities, the moderate-income family of four in our example requires a rent supplement to keep their rent at 25 percent of their adjusted income. If they were to pay the normal basic rent (which is more likely), their subsidy would be $1,485 a year and their tenant contribution (rent) would be $2,271 or 28 percent of their adjusted gross income. This again points out that actual subsidies under section 8 may be considerably higher than they would have been under section 236, since section 236 tenants have characteristically paid much more than 25 percent of their adjusted incomes in rent.

Existing housing in the three cities

Cost and resulting rents are generally lower in older existing units than in newly constructed units of comparable quality and type. This is true of all types of housing and, hence, for existing housing under section 8 as compared to newly constructed subsidized housing. Some warnings need to be made, however. If little or no new rental housing were being provided and there were a shortage of housing (as there is in some parts of the country), then provision of subsidies to existing housing on a large scale might very likely have the effect of bidding up the price of housing in general and redistributing the current supply among income groups. Many supporters of a housing allowance approach (which has much in common with the section 8 existing provision) agree that this is likely. Their contention is that increasing the demand for housing services will result in the provision (construction, rehabilitation, or improved maintenance) of additional housing services. Although this increased demand will probably raise the price of all existing housing, the allowance advocates feel that eventually enough new housing services will be efficiently provided to justify a general increase in the cost of housing. This argument is far from conclusive. While increased demand can be expected to increase prices, it does not assure that additional housing will be provided, since there are other factors, such as the availability of credit, that affect supply. This is a judgmental area where the phenomenon is not clearly predictable.

The 1975 fair market rent (FMR) limitations for existing two-bedroom walkup apartments in the three cities are shown below. New construction FMRs are shown again to allow comparison.

	Pittsburgh	Durham	San Bernardino
Existing FMR	$1,788	$2,028	$1,872
New construction FMR	3,756	2,484	2,952
Difference between existing and new	+100%	+22%	+58%

These fair market rents seem reasonable in light of available information on local housing markets. For example, Pittsburgh is an area which had little or no population growth between 1960 and 1970. It has a large stock of older existing housing. Pittsburgh experiences reasonably high operating and construction costs, due to its temperate climate and high labor and material costs. Thus, the difference between the rents for older existing buildings and those rents necessary for units in newly constructed apartment buildings would be expected to be significant. In Durham the population has grown rapidly, the housing stock is much newer, housing production probably trails demand, and construction and operating costs are lower. Thus, the difference between new and existing fair market rents in Durham, which is much lower than in Pittsburgh, seems reasonable.

First-year direct subsidy for existing units is much lower

The first-year direct subsidies for existing units under section 8 are shown below for low- and moderate-income comparable to those used for new construction. The new construction subsidies are included to allow easy comparison.

	Direct Subsidy (note a)		
	Pittsburgh	Durham	San Bernardino
Very-low-income tenant (45% of area median):			
Section 236 new	$2,508	$1,328	$1,828
Section 8 existing	-467	-803	-681
Potential savings	$2,041	$ 525	$1,147
Moderate-income tenant (70% of area median income):			
Section 236 new	$1,746	$ 615	$1,133
Section 8 existing	(not needed)	(not needed)	(not needed)
Potential savings	$1,746	$ 615	$1,133

a/Existing leasing estimates do not include an amount for local housing authorities who act as the leasing agent for HUD.

The rent subsidy is not needed for four-person households making 70 percent of median income in these cities. This is because at this income level the tenant rent, which is calculated as 25 percent of adjusted gross income, exceeds or nearly meets the existing housing fair market rent limitations in these cities. This results in a great potential for savings if such families can indeed locate adequate housing at rents near or below these fair market rents. For the lower income families, there is an even greater potential saving under the leasing approach as compared to new construction, but the savings vary greatly from place to place. In Pittsburgh the direct subsidy savings for our example would be more than $2,000 for a family of four in a two-bedroom walkup apartment. Whereas in Durham the calculated saving in direct subsidy is only about $500 per year.

These differences in subsidy probably arise from the market factors mentioned earlier, namely an older housing stock and surplus in Pittsburgh as opposed to a much newer housing stock and a tight market in Durham.

Indirect subsidies for leasing in the three cities also lower

Indirect subsidies in these cities are also lower for existing housing than for new housing. They are much harder to estimate than for new housing. HUD administrative costs, which are slight, are assumed to be the same as for new housing but could be somewhat greater. Tandem points and insurance losses do not occur under existing leasing. The only indirect costs then are Federal tax expenditures that landlords receive as a result of depreciation and other expenses. Under new construction the development cost and, hence, the depreciable base are known and debt service and operating expenses usually offset income. Consequently, the tax loss is easier to estimate. With existing leasing, apartments that can rent at or below fair market rents must necessarily be in buildings at least several years old. Consequently, there may or may not be a loan on the property, and the property may or may not be fully depreciated. We can, however, use a maximum tax savings figure for existing housing to, in effect, estimate the minimum subsidy reduction available under existing leasing. Tax savings are greatest when a residential project generates no net income yet has a significant depreciation expense. Thus, if we assume that all of the rental income in excess of utilities and property taxes is used to service a debt, it has the effect of fixing the debt service at

the highest level, which would allow the project to operate without net cash loss. Investments that actually lose cash are undesirable to investors, and cash loss is less likely after the mortgage is a few years old since rents rise with inflation. Using this maximum-debt service and the normal-depreciation rules, we are able to estimate maximum tax savings for each city. These estimates are shown below along with the direct subsidy for the lower-income family of four. New construction tax savings are estimated in a manner similar to the nationwide calculations. All costs represent averages for the first 5 operating years. A HUD estimate of local program administration is also included.

First-5-year Average
Yearly Direct and Indirect Costs (note a)
(Very-low-income Family of Four, Two-bedroom Walkup)

	Pittsburgh		Durham		San Bernardino	
	New section 236	Existing section 8	New section 236	Existing section 8	New section 236	Existing section 8
Direct subsidy	$2,508	$467	$1,328	$ 803	$1,828	$ 681
Indirect subsidies:						
Federal tax foregone	650	106	461	271	523	185
HUD administration	20	20	20	20	20	20
Local housing authority administration	-	179	-	179	-	179
Yearly subsidy	$3,178	$772	$1,809	$1,273	$2,371	$1,065

a/ Family income equal to 45 percent of the area median income. These costs are not discounted.

The minimal potential savings through leasing are quite significant, ranging from an approximate 80-percent saving compared to the new construction subsidy in Pittsburgh to a 40-percent saving in Durham.

No general conclusions can be drawn for the Nation as a whole from these calculations, since each locality has a unique set of characteristics just as do these three cities. Savings will, however, be somewhat proportional to the difference between new and existing fair market rents if the FMRs are realistic.

LEASING COSTS IN A DYNAMIC FRAMEWORK

The cost relationships between the various programs for newly constructed housing would be expected to hold, regardless of the degree to which these approaches were applied within a given area, since our calculations are based on equal development costs. Hence, if the price of land, construction, or financing increased, the cost of new units under all programs or subsidy types would increase accordingly.

The relationships between rents for newly constructed units and existing units leased concurrently cannot be expected to remain the same. Under leasing with new construction, HUD can be expectecd to have control over rents for 20 years, just as it does under section 236. But under the existing leasing approach, agreements between landlords and local authorities can be expected to be much shorter in duration, and the stated fair market rents will need to be increased periodically to keep pace with increases in private rents.

The Urban Institute compared leased public housing to conventional public housing and, using cost data on years prior to 1969, concluded that inflation in the monthly rent of a leased unit would be roughly $1 greater per year than for a conventional public housing unit. This was equivalent to a 0.8-percent increase in the leasing rent per year. This is probably a very conservative estimate, in view of recent inflation in property values, local taxes, and interest. In addition, this estimate considers only direct costs.

The cost of leasing will increase with time

We have prepared a sample calculation based on Durham to show how subsidy cost under existing leasing might increase, as compared to new construction under section 236, as a result of property appreciation alone.

In this analysis, as previously, we do not account for inflation in operating cost and utilities, since these could be presumed to increase equally for both newly constructed and leased housing. The only factors that we consider are property appreciation and the tendency of investors to turn over their property (or refinance) every few years. Also not considered here is the possibility that rents might rise even faster than necessitated by appreciation or that property taxes are more likely to rise when property is sold. Durham was used because the new

and existing subsidy costs were closest there and because the housing services are probably similar for both alternatives. In the first few years, the likely savings through leasing in Durham are great, but since the existing housing is probably relatively new (or equivalently desirable), it will probably appreciate and be salable unless it is poorly located. Our scenario is that the building was originally built around 1972 (because the $2,028 fair market rent for a two-bedroom unit will support a building constructed in that year) and that the project is resold twice in 1980 and 1988, which is realistic. If multifamily property appreciates at 4 percent per year (which is probably a conservate rate based on recent experience), then the existing fair market rents in the years 1980 and 1988 would have to be about $2,600 and $3,300, respectively, in order to carry the debt, without increases in operating costs.

The indirect cost due to depreciation would also increase for the existing alternative since with each sale the new owner starts depreciating the building again from a higher basis. Tax revenue on sales and local housing authority administrative costs are included for the existing leasing alternative. The following table shows the total yearly subsidy for our two-bedroom walkup apartment serving low- and moderate-income families of four.

Hypothetical Calculation of

Total Direct and Indirect Subsidy

New Section 236 Versus Section 8 Leasing

Durham, Two-Bedroom Walkup

	New section 236	Existing section 8	Public housing
Very low income ($5,500 a year):			
First year	a/$1,862	$1,302	$1,625
Twentieth year	1,586	2,793	1,503
Average yearly (20-year discounted)	1,057	1,007	965

a/Includes a prorated share of tandem plan costs.

First-year subsidy is lower for the existing unit, but in the 20th year the existing unit has a much greater cost than the new construction unit. When the costs are discounted, the yearly subsidy costs for leasing are slightly lower than newly constructed section 236. Public housing, however, is cheaper than both the other alternatives. This example does not prove that leasing will in general be more expensive than new construction under section 236 or public housing. What it shows is that in this situation, when new and existing fair market rents are only a few hundred dollars apart, it is quite possible that existing leasing might result in higher total subsidy cost than new housing development, even when many factors that could further increase the cost of existing housing are not considered. This analysis illustrates our conclusion that first-year direct cost savings should not be used as justification for a leasing program until the long-term indirect costs are considered. The next few sections discuss factors which would tend to cause the existing leasing alternative's cost to increase.

Extensive leasing may have an inflationary impact

Another important consideration is that the use of the leasing approach on a large scale might have its own inflationary impact on rents beyond that of the normal escalation that could be expected in its absence. The Urban Institute has done housing market simulations to determine the long-term effects of a housing allowance. These simulations indicate that full-scale subsidies to existing housing might cause a significant long-term increase in rents. The housing allowance approach subsidizes the tenant directly, who then locates his own housing. The existing leasing provision of section 8 is similar to the housing allowance approach, although section 8 utilizes local housing authorities as intermediaries. In the six cities simulated, which included Durham and Pittsburgh, the average percentage of increased housing expenditures that went to higher prices (not better services) was 28 percent. They also found that, although slower growing cities such as Pittsburgh had a greater initial price discount than faster growing cities, the amount of increased housing expenditures lost to higher prices was oddly enough, greater in the simulations for cities having initially high discounts. Furthermore, the cost increase was greatest in the lowest third (lowest rents) of the housing market. Thus, they concluded that the inflationary impact is greatest in the cities where the

leasing approach is initially the best bargain and that concentrating allowances on poorer households may concentrate demand pressures on the most inflationary segment of the market.

Housing scarcity and leasing costs

Increased scarcity of housing due to the current housing recession may drive up the cost of existing housing and decrease the savings possible, compared to new construction subsidies. Large savings presently possible are, to a certain extent, due to the rapid building during the last decade. The national housing boom is now over, and adjustments in the price differential between new and used housing will probably speed up. Just as the cost of rent in existing buildings is now generally a good buy, due to rapid building in the late sixties and early seventies, existing rents could be driven up rapidly in the last part of the decade as a result of the continued demand for housing and the dearth of mulit-family construction in the last few years.

Leasing economy and interest rates

Existing rental housing is also a bargain compared to new construction because of the rapid increase in financing charges since the mid-sixties. Much of this advantage will disappear as housing is refinanced at current interest rates, unless interest rates continue to rise, which would certainly not give any relief to the low- and moderate income housing situation.

CHAPTER 11

MANAGEMENT OF SUBSIDIZED HOUSING

Effective housing management is important because it determines the ultimate character of the housing services provided. A good manager can, to an extent, provide agreeable surroundings in a wide variety of circumstances. On the other hand, poor management can convert a good physical structure or an amiable neighborhood into a bad living environment. This chapter is based primarily on a series of studies on housing management done by the Urban Institute for the Department of Housing and Urban Development. Most of these studies did not include public housing, but included section 221(d)(3), below market interest rate, and section 236 low and moderate income subsidized housing programs. Twenty projects, of each of three ownership types, spread geographically around the United States made up the sixty-project sample. The projects sampled by the Urban Institute differ from the population of section 236 projects in that they were selected to facilitate comparisons among ownership types as opposed to comparing housing configurations or other variables. For example, it was necessary to eliminate high rise projects from the study since very few cooperatives had that type of building. But the Urban Institute feels their results are applicable to multifamily housing in general, since equating the social, physical, and locational characteristics allowed them to isolate the relationship between ownership and management success. We find this to be a reasonable conclusion.

OWNERSHIP TYPES VERSUS SUCCESS

One question the Urban Institute investigated was which type of ownership form most assures good management. The ownership types compared were:

--Limited dividend. The sponsor is a private developer or investment company. In exchange for a 90-percent mortgage, the sponsor agrees that the annual return on his original 10-percent capital investment will be no higher than 6 percent.

--Nonprofit. The sponsor, typically a church group, volunteer service group, or other organization receives mortgage financing to cover 100 percent of the development cost. The sponsor may receive no profit.

--Cooperative. Also benefited by 100-percent mortgage financing, a cooperative is owned by the occupants. Each household has one share in the ownership and has a voice in the management of the development.

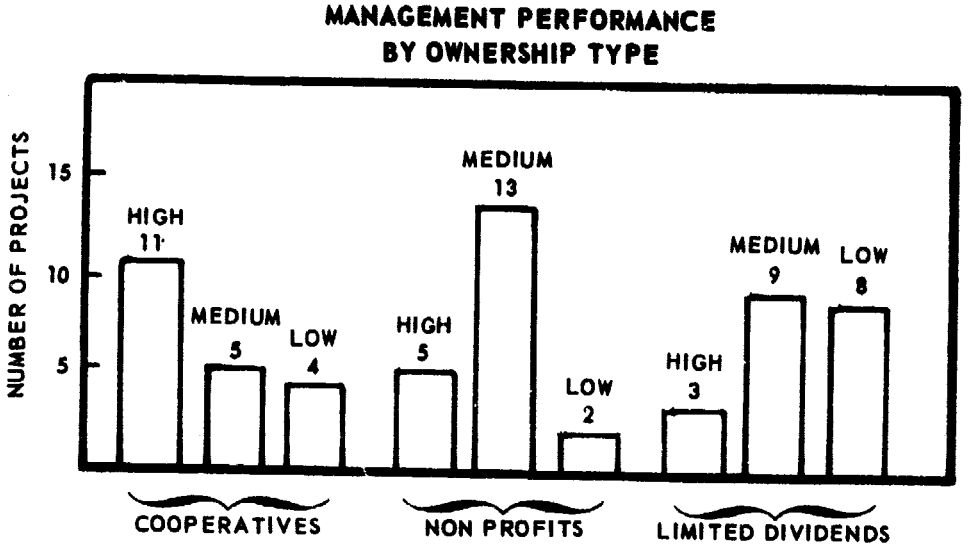
This sample included 20 projects from each type of ownership selected from throughout the United States. The Urban Institute concluded no single form of ownership assures successful management. There are both well-managed and poorly managed developments within each ownership type. But cooperatives were judged most effective, and limited dividends least effective, with nonprofits in between, based on 24 measures of management performance.

These success criteria included such measures as per unit operating profit or loss, eviction rate, and expressions of satisfaction on the part of residents. Examples of the sample means for the low, medium, and high performance groups for 3 of the 24 success criteria are shown below in table 1.

Table 1. Examples of Sample Means for Performance Criteria

	Low	Median	High
Residents' satisfaction with development (range 0-4)	1.82	2.39	3.08
Eviction rate (annual)	30%	15%	4%
Per unit operating profit or loss (monthly) (includes depreciation)	$41.04	$86.05	$103.12
Per unit total cost of operations (monthly) (includes depreciation)	$185.16	$127.46	$105.64
Occupants' rating of condition of units (range 0-2)	1.50	1.69	1.76

The distribution of management performance by ownership type for the Urban Institute sample is shown below.



FACTORS RELATED TO SUCCESSFUL MANAGEMENT

The second area the Urban Institute investigated was the difference between the management of successful projects and the management of less successful ones.

In order to investigate differences in performance, 40 measures of "management style" were included in the study. Thirteen of these management measures were found significant for all three performance groups and are shown below:

Significant Management Style Variables

--Occupant rating of management strictness.
--Manager rating of need for strictness.
--Relative time spent by manager in rent collection.
--Encouragement of occupant repair and painting.
--Management provides social services support (e.g., day care project space).
--Degree to which tenants volunteer their services for recreation programs.
--Degree to which tenants volunteer their time to aid the young and elderly.
--Occupant activity levels in trying to improve management.
--Number of occupant organizations.
--Degree of owner authority and responsibility.

--Degree of management firm authority and responsibility.
--Degree to which occupants carry out cleaning and maintenance jobs.
--Extent of the owner's personal contact with residents.

From these measures, four principles of good housing management were identified:

--Firmness in establishing and enforcing standards of behavior. Rules must be made known and enforced consistently and strongly.

--Responsiveness to residents' needs. Maintenance requests should be dealt with promptly and satisfactorily. Responsiveness also requires the flexibility to deviate from or make exceptions to the rules in unusual circumstances.

--Occupant responsibility. Residents should take an active role in making the project a better place to live by assuming responsibility for keeping their units well kept and furthering community and neighborhood development.

--Owner participation. In the best run projects, the operation and major decisions are not turned over to a management firm. The owner himself often gets involved in the important phases of operation.

The Urban Institute concluded that the key to housing management success is its style and that the first three principles mentioned above are the key qualities of management style. To test this hypothesis, a composite management style variable was created using seven variables related to firmness, management responsiveness, and occupant responsibility.

Composite Management Style Variables Used To Predict Performance

--Managers should encourage occupant participation in management.
--Occupant rating of management strictness.
--Manager rating of need for strictness.
--Relative time spent by manager in rent collection.
--Degree to which tenants volunteer their services for project recreation programs.
--Responsiveness of manager's supervisor.

--Degree to which occupants carry out cleaning and maintenance jobs.

Using the scores of the sample projects on the composite variable, the Urban Institute was able to predict with 82 percent accuracy whether one of the sample developments was in the high, medium, or low performance group. The Urban Institute feels these results give strong reason to believe that changes in management style in the directions indicated by the management variables would improve management performance.

GENERAL MANAGEMENT PROBLEMS

Several potential problem areas for managers were noted in the Urban Institute studies. One problem mentioned was project design. For example, it was found that the greater the number of units per entrance, the more management has to contend with janitorial and security problems. In addition to too much common space, inaccessible pipes and plumbing, and poorly located trash collection points were also design-related problems. Larger housing developments were found to have higher per unit expenses than smaller developments.

Location is another problem source. The Urban Institute found developments in the poorer performing groups were often poorly situated with regard to neighborhood services. In a separate study, the Organization for Applied Science in Society (OASIS) found that multifamily projects often have to supplement city services that are inadequate, thus causing additional strain on their operating budgets. Sources both within and outside the Department of Housing and Urban Development have mentioned the possibility that some projects were placed in locations either undesirable to tenants or too close to competing projects, resulting in high vacancy rates.

OASIS Corporation surveyed 37 cooperatives and found that 86 percent of them had changed management firms in a 5-year period, with 73 percent giving dissatisfaction as the reason. OASIS feels the percentage basis allowed for management fees by HUD is too low to secure a qualified professional management firm because it lacks any financial incentive for them. This parallels a finding by Touche Ross & Co. that multifamily projects are too small and scattered to be managed profitably.

COMPARISON OF MANAGEMENT UNDER VARIOUS PROGRAMS

To investigate the difference in managing conventional public housing and other Government-assisted multifamily housing for low and moderate income families, the Urban Institute studied 120 local housing authorities throughout the country. When compared to the finding of their study of 60 private projects, the keys to success were found to be similarly related to management style.

They concluded that in public housing, as in federally assisted private housing, it is an illusion to think that a housing manager can spend his way to good management. Operating costs were actually found to be relatively high when performance scores were low. This implies that good management is economical.

CHAPTER 12

SECTION 8--A NEW PROGRAM IN A DIFFERENT ENVIRONMENT

Housing experts, HUD officials, people in the housing industry and GAO 1/ have raised many questions about the way section 8 is structured and the way it is being implemented by HUD. Many of these questions involve aspects of section 8 which are in sharp contrast to past subsidy programs. Some of these changes, such as shifting more responsibility to developers, were deliberate and resulted from reactions to what were perceived as shortcomings in the section 236 or public housing programs. Other changes are not directly related to section 8 but involve other Government housing or tax policies or administrative changes which, nevertheless, may obliquely affect the success of section 8. These indirect effects would very likely hamper section 236 or any other privately financed FHA-insured programs in operation today. In this chapter we compare section 236 (and other programs) and the environment in which it operated to the section 8 program and the present environment for multifamily housing investment. Although GAO issued a comprehensive study of the section 8 program in January 1977, this chapter is included because our analysis of section 236 highlighted some additional problems for section 8 which are deemed worthy of congressional consideration.

THE REQUIREMENT TO CONFORM TO HOUSING ASSISTANCE PLANS MAY DISCOURAGE SPONSORSHIP

New subsidized housing under section 8 must be provided in accordance with the local government's Housing Assistance Plan (HAP) and is indeed contingent on the existence of such a plan. This was not the case when section 236 commitments were being made. This provision effectively gives the local government control of the type of housing which can be built, its location, and who it will serve. Such control may be desirable, but it destroys the autonomy which sponsors had under section 236 to provide the type of housing which they thought would be profitable (or was needed) in a location of their choosing.

1/"Major Changes Are Needed in the New Leased-Housing Program," General Accounting Office, CED-77-19, Jan. 28, 1977.

Now when HUD advertises for proposals for section 8 from developers, advertisements may stipulate the exact size of the project and perhaps even a specific parcel of land which is designated for section 8 housing. This change in policy is intended to restore some local autonomy and perhaps result in better siting of projects than in the past. The net effect of this change may not be known for many years but some possible implications are clear:

--It may discourage developers from getting involved who already have parcels of land which they would like to develop. Under section 236 if the sponsor's parcel was already properly zoned, he could proceed subject to HUD approval. Now if a developer's parcel does not fall within the parameters set out in the HAP, the developer may decide to build higher income multifamily housing or continue to hold the parcel.

--A prospective sponsor may not consider the type and size of the project which the HAP would allow to be a profitable venture. For example, the HAP might call for rehabilitation which some sponsors would avoid as too risky.

--The HAP may be an all too effective tool for localities to avoid economic and racial integration since it provides another barrier to low and moderate income housing development which may prove more restrictive than the local zoning laws. HUD has anticipated difficulty and constructed an elaborate system of checks and balances designed to avoid placing projects in areas of minority concentration or significantly changing the racial mix in a given area while at the same time promoting economic integration. But it will be some time before the impact of this requirement can be assessed.

ALLOCATION OF FUNDS

In order for assisted housing to be provided by private sponsors in a particular community there must be a capable and willing sponsor and/or developer with sufficient capital. This developer must locate a lender willing to loan on subsidized housing, obtain land suitable for development, and, under section 8, he will generally need the cooperation of a local housing authority which may or may not exist. The developer must also be willing to develop housing which is in conformance with the Housing Assistance Plan.

Thus allocating funds as is currently being done may limit development in areas where all the factors mentioned are readily available, while strongly encouraging it in areas where the necessary ingredients may not be available.

Under section 236, development could take place anywhere that these factors were available, to the extent that sponsors felt there was a demand for the housing. This probably contributed to the success of section 236 in providing a large number of units quickly. The environment for housing development changes over time so that although a particular locality might not be capable of using their allocation today, they might be perfectly capable in the future and vice versa.

Other problems with fund allocations were identified in the earlier GAO report on section 8.

LACK OF CONTROL OVER INCOME GROUP SERVED

Section 236 was designed to serve a relatively higher income group than public housing. These moderate income households could not qualify for public housing, but, nevertheless, were in housing need. That the program would serve this group was insured by the shallower subsidy provided which was tied to the interest expense and by the limit on the percentage of units which could receive the deeper rent supplement subsidy. This resulted in higher minimum rents with higher income tenants getting lower per unit subsidies than in public housing. Section 8 is structured to serve a much broader income range than either program since it has a more flexible subsidy formula which can range from a small percentage to 100 percent of market rent depending on the tenant's income. The only positive control really exerted on the tenant population is that 30 percent of the units in a project must serve households with incomes below 50 percent of the area median income. There is no control which insures that any share of the units goes to moderate income tenants.

So far section 8 seems to be concentrating its benefits on small or elderly households with very low incomes and largely excluding moderate income households and larger families. Although the bulk of section 8 experience is with existing housing, there are indications that section 8 new construction commitments are going primarily to elderly housing projects (see ch. 4 for tenant characteristics). There are undoubtedly many reasons for this shift in tenant population under section 8. Public housing authorities probably try to serve the neediest tenants first and have historically served very low income persons. Other reasons have been proposed which are equally plausible and probably

contribute to the situation, but without some positive control, it seems unlikely that the situation will change.

FAILURE RATE COULD BE LESS UNDER SECTION 8

It is possible that the more flexible formula under section 8 may result in fewer failures under the mortgage insurance programs being used (sections 221(d)(3) MIR, 221(d)(4)). One difficulty with section 236 was that there was no provision for increasing the subsidy should operating cost increases outstrip rental income. Under section 8 there will be periodic increases in the maximum rents which landlords may charge, which means automatic increases in the subsidy based on increases in operating costs for the geographic area. There will also be a mechanism for increases due to extraordinary circumstances. Under section 236 the only possible means of increasing revenue was to raise tenant rents, which required a sometimes slow approval by HUD. This often increased the financial burden on tenants, which in turn exacerbated the financial instability of the project.

This problem could of course have been avoided by slight change in the structure of section 236 to allow essential increases in subsidy. The Congress enacted such a provision, known as the "deep subsidy" provision, but HUD did not implement the provision, which very likely resulted in some section 236 failures.

Lower defaults and failures under section 8 may result from the deeper subsidy provided, but the lower failure rate will be purchased at considerable expense and could have been achieved under section 236 by providing deeper subsidies. HUD intends to do something similar now by providing section 8 subsidies to troubled section 236 projects.

This does not, however, eliminate the possibility of failures under section 8. It is impossible to guess at what the net effect of the many differences between these programs will be on the ultimate failure rate of section 8. Many of the failures under section 236, however, took place before operation ever started, and such failures will not be affected by the deeper subsidy. There are also a number of changes in the regulations for section 8 which may increase the chance of failure before operation begins. For example, it will be difficult to increase rents once they have been fixed, even if the project encounters unexpected problems in construction which increase costs. This, however, may easily be changed since HUD has the discretion to do so.

CONVENTIONAL FINANCING IS NOT A SOLUTION

HUD has made a number of changes in section 8 to encourage conventional financing of these projects. This is very likely being done to avoid FHA-financing and problems associated with failures in FHA-insured projects. There is little indication that conventional financing will actually be used since GNMA subsidies would also have to be provided, but if it were it would probably result in higher costs. Another consideration is that FHA financing actually results in considerably lower gross rents than would be possible under conventional financing.

The reason for this is that the FHA 40-year mortgage term and low down payment (10 percent of total development cost) allow investors to profitably operate housing with very little cash flow. Under conventional financing with 25-year mortgages and 25-30 percent downpayments, a project generates only enough tax loss to shelter the rental income since a large part of the monthly payment must go to principal, which is considered income. Thus tax losses are not available to shelter income from other sources, which is the main incentive for investment in FHA projects. Thus, to make a profit the project must generate a substantial cash return on investment (generally 15 percent per annum on the sizable cash investment). Under section 236 subsidized investment, a much lower cash return (6 percent) on a lower downpayment, combined with the tax shelter, gives an attractive yield but requires much lower rents than conventional financing. Thus, conventional financing would result in higher rents and, consequently, higher direct subsidies as well.

HUD has taken a number of measures to encourage conventional financing, such as increasing the length of section 8 contracts to 30 years to encourage lender participation and increasing allowable fair market rents above the usual limit to accommodate the higher debt service. There has even been discussion of adding GNMA Tandem subsidies for conventional loans. This last measure is probably not advisable for a number of reasons:

--Conventional mortgages would result in higher rents and subsidies.

--Lenders would very likely be unwilling to loan conventionally to nonprofits. Also, limited dividend sponsors were not high risks under section 236 and, therefore, avoiding them doesn't seem necessary.

--Tandem subsidies would likely be large with conventional financing since the interest rate being used for section 8 tandem is far below market interest rates, causing a very large discount to be absorbed by GNMA.

--HUD would not have control of ownership, rents or other important variables which they have under FHA financing.

It is true that there might be some decrease in Federal tax expenditures, but it is unlikely to compensate for the higher direct subsidy and the high tandem subsidy which is paid out in a lump sum early in the operating life of the project. The incentive for continued ownership is also less under such an arrangement since investors attracted by this kind of investment will tend to have different tax positions and the disincentives associated with an early sale may be less.

CHANGES IN GNMA PROCEDURES MAY INCREASE CASH NEEDED BY INVESTORS

It is also possible that rather subtle changes may have an impact on section 8 failures and at the same time discourage investment. These changes involve the tandem subsidy provided by GNMA when it purchases multifamily mortgages and resells them to FNMA or private investors at a loss. The purpose of this subsidy as explained earlier is to assure the liquidity of subsidized housing mortgages so that lenders will be willing to loan on subsidized projects. Evidence indicates that without this subsidy virtually no subsidized housing investment would take place. The changes involve increases in the commitment fees collected from lenders and investors by GNMA to reserve funds to purchase a mortgage and an increase in the discount which GNMA makes on loans which it purchases. The following chart recaps these changes.

Points Charged to Developers/Sponsors (FHA Financing)

	Section 236	Section 8
Financing fee for lender	2%	1.5%
GNMA/FNMA commitment fee	1.5%	2%
Mortgage purchase price (discount as % of face amount)	100% (0%)	97.5% (2.5%)
Total points payable to lender	3.5%	6.0%
Points which FHA will allow to be included in the mortgage	-3.5%	-3.5%
Net additional cash needed	0%	2.5%

The financing fee is the mortgage brokers fee for handling the financing transaction, which has been slightly decreased under section 8. This may cause lenders to increase their point charge to make up for the 1/2 percent profit although this is not included above. This fee also covers their cost of arranging interim financing for construction. The GNMA/FNMA commitment fee is a nonrefundable charge by GNMA which can be thought of as a servicing fee. If the mortgage is not eventually placed, the fee is not returned to the sponsor.

The mortgage purchase price has been decreased for section 8. Under the section 236 program, GNMA paid 100 percent of the mortgage amount to lenders, but under section 8 GNMA will charge a 2.5 percent discount. This will help defray GNMA's operating losses somewhat (they have often sold mortgages for which they paid the full mortgage amount, at prices of less than 90 percent of the mortgage amount) but also increases the points which the lender must charge the borrower.

All these expenses must either be paid by the sponsor/developer in cash or must be included in the mortgage. Since only 3-1/2 percent can be included in the mortgage, the developer will probably need to put up to at least 2.5 percent more of the mortgage amount as a downpayment under section 8 than under section 236. This is a crucial increase since the actual cash requirement for the sponsor may have been less than 5 percent under section 236, which is to say the cash needed may be half as much again under section 8.

Developers and investors will be affected by this in several ways:

--It may decrease the developer's profit since when he syndicates, the tax losses which are being sold are not worth any more than if he had put less money down. So that the developer may have to absorb the points.

--If the developer insists on regaining this increased expense, the tax losses which the project generates will look less desirable to limited partners since it will cost more to buy an interest in the project.

--Both developers and investors may be less inclined to deal in subsidized housing since their rates of return on investment may be much lower than in the past.

FEASIBILITY TESTS MAY DISCOURAGE ACTIVITY

Section 236 projects had to meet certain marketability tests, but these were based on the basic rents as opposed to market rents. Thus, sponsors could build projects which would have market rents well above those of older existing units and possibly even above those of new nonsubsidized projects, as long as the subsidized rents (basic rents) were competitive. This gave section 236 a real edge in the marketplace and probably encouraged development. Under section 8 the project must first meet the fair market rent test--that is, it must be under the fair market rent for the locality and type of unit or within a certain percentage of the fair market rent since exceptions are allowed. The rents also must meet a rent comparability test in which the rents must be competitive in the local area without subsidy. Both of these are applied to the gross rent so that the units must truly be market competitive. This will make it much harder for projects to qualify in areas where the comparable rents are well below new construction rents, which is probably the general rule. It also means that the developer must be able to build a project which would attract unsubsidized tenants and not just those with lower incomes who have little to choose from in the way of good housing. If the sponsor can achieve this, one might wonder why he would even consider a low and moderate income project.

The purpose of these tests is probably to assure that should a project fail, the property is salable to another investor at a price closer to its replacement cost or

mortgage balance. This would in turn decrease the loss to the FHA insurance fund. The effect will probably be to limit, if not the quantity, at least the type of projects which developers are willing or able to undertake. So far the predominate form of development is elderly housing which is easy to manage, in high demand, and relatively risk free under any subsidy program.

HOUSING MANAGER AUTONOMY PROBABLY REDUCED UNDER SECTION 8

Under section 236, housing managers had roughly the same autonomy to manage their property after it was completed as under private development although rents were controlled. With section 8 this autonomy may be limited by the interplay with local housing authorities which is built into the section 8 program.

CONSTRUCTION PERIOD DEDUCTIONS

Prior to the 1976 Tax Reform Act, investors could shelter other income by deducting construction expenses, such as interest payments on the construction loan, real estate taxes, and other fees. Investors had the choice of either deducting these expenses or capitalizing them and depreciating them over the life of the property. Apparently, many investors had elected to deduct these expenses in the year in which they were incurred because the 1976 act required expenses to be capitalized and written off over a 10-year period. For conventional residential construction started after the passage of the 1976 act, the writeoff period will increase gradually from 4 years in 1978 to 10 years in 1984. For low income housing, such as under section 8, the time schedule is retarded with the requirement to amortize, beginning with a 4-year writeoff in 1982 and increasing to 10 years in 1988.

This change will not affect low income housing production immediately but could when it becomes effective since it will change the developers' intial rate of return.

RECAPTURE OF TAX SAVINGS DUE TO ACCELERATED DEPRECIATION FOR SECTION 8

The recapture provisions for accelerated depreciation for new residential property which will be used under section 8 are not as favorable as they were when section 236 was most active.

All new rental housing can be depreciated for tax purposes at a rate which is initially twice the normal rate. This method, known as the 200 percent declining balance method, shelters the income generated by the property in the case of privately financed projects and with the lower down payments and longer term of FHA mortgages allows investors to shelter income from other sources in the case of subsidized development.

All or a portion of this accelerated or excess depreciation over the amount claimable using the straight line method is recapturable when the property is sold unless it has been held longer than a specified period. For section 236 the amount of depreciation which was recapturable declined by 1 percent per month after the property had been owned for 20 months so that after 10 years (120 months) none of the accelerated depreciation would be recapturable. The amount of excess depreciation recapturable under section 8 development will not begin to decline for 100 months so that to avoid recapture altogether the property must be held for 200 months rather than 120. It is difficult to say whether this will have a significant impact on investors, but it may for a variety of reasons.

First of all great care was taken under section 236 to assure that investments were somewhat more liquid than in previous subsidy programs while still allowing the Government to maintain control of sales for at least 20 years. Provisions were made to allow sales to nonprofit entities with HUD approval. Changing the recapture rules means that capital gains, defined as the difference between sales price and depreciated value at sale, will not be taxed entirely as capital gains until after 200 months. A portion of the excess depreciation will thus be taxed at ordinary income rates. This further constrains the options of the investor, and when a sale takes place prior to 200 months, it will mean a lower rate of return on a section 8 investment than on a section 236 investment.

This change will also affect investors who own projects which fail financially. Foreclosures are treated for tax purposes as if the property were being sold for the balance on the mortgage, so that foreclosures between the 20th and 200th month of operation would result in a larger tax liability under section 8 than they would have under section 236. This must certainly have some impact on investors' decisions to invest in section 8. Although it may not choke off activity, it may also shift the activity to the least risky of developments. Such developments would probably be those

serving the elderly, who have been adequately served under older programs. This is what appears to be happening.

UNCERTAINTY ABOUT FUTURE TAX CHANGES

When the section 236 program was initiated, Government at all levels seemed anxious to encourage private industry to provide subsidized housing. Changes in the tax laws in the 1960s, which made it possible for limited partnerships to own and operate subsidized projects and encouraged rehabilitation of residential property, were attracting a variety of new investors. Local governments were experimenting with property tax abatement policies. Everyone seemed firmly committed to making the new programs work.

Today we have witnessed a gradual disenchantment with this form of housing subsidy accompanied by philosophical changes regarding the use of the taxing system as a subsidy mechanism. New tax reforms are debated each year and all forms of tax shelters are being reappraised.

Investors, aware of the changes already made in the tax laws applying to real estate, are wary of other possible changes, such as the disallowance of accelerated depreciation and the recent attempt by IRS to do away with the pass-through of real estate losses to limited partners. Even if such changes are not made, the knowledge of what impact such changes would have on the resale of property combined with the possibility that they might occur is probably enough to discourage many investors.

Doing away with the accelerated depreciation allowance would greatly decrease the possibility of sheltering income from other sources, and disqualifying limited partners from passing through real estate losses would virtually eliminate passive investors who were the primary source of sponsorship under section 236.

CHAPTER 13

SCOPE

This study focused on the evaluation of the section 236 Rental Assistance Program, with comparisons to other subsidized multifamily rental programs, such as public housing and section 8 when such comparisons were either instructive or had policy implications.

We first reviewed available housing literature, particularly evaluations and related publications dealing with section 236 and other multifamily housing programs, concentrating on HUD reports and those of independent researchers and consultants. More than 2,000 titles were reviewed. Several hundred documents were obtained and scanned for useful information, and well over a hundred documents were used extensively to formulate our approach or describe and evaluate the various programs. Pertinent housing legislation was also analyzed.

In addition, we utilized agency records and information systems to perform original research and analysis to answer important questions which we felt were inadequately treated in the literature. It should be noted that the most germane analytical work which we encountered and the most useful basic data found was prepared by HUD or under contract to HUD.

In the course of our work, we spoke with dozens of HUD officials and spoke with a number of housing authorities to gather information and obtain divergent points of view. We also employed the services of an actuarial consultant, Mr. Mortimer Kaplan of Springfield, Massachusetts, who gave us invaluable advice and prepared an analysis of certain FHA mortgage default statistics.

APPENDIX I

SUMMARY OF HUD INTERNAL AUDIT RESULTS ON SECTION 236 PROJECTS

We inspected about half of the 79 audit reports conducted by the Office of the Inspector General of HUD between July 1972 and August 1974 to ascertain what management problems were experienced in those section 236 projects selected for audit. These problems are not necessarily representative of the entire population of section 236 projects. Projects selected by HUD for audit were very likely known to have problems and may, therefore, describe some of the more poorly managed projects. The results of these audits did not seem sufficiently useful to warrant looking at more recent reports, but the information has been included since it buttresses discussion in the body of the report dealing with management and financial problems.

INTERNAL CONTROL IS WEAK

The majority of problems presented related to weaknesses in recordkeeping at the projects. The failure to keep accurate records was usually explained by project managers as due to lack of knowledge of the requirements or that they were too busy attending to more important matters.

The most common deficiency was the failure to keep complete records of all transactions involving the disbursement or receipt of funds and to require documentation to support entries. For example, one project was making checks out to cash to reimburse employees for supplies purchased. In those cases, checks not only failed to show what the expense was, but the projects also required no receipts to verify the purchases claimed.

Failure to maintain inventory records was also noticed in a few audits. This not only could result in losses due to theft but also increased expenses if material is purchased that is already available.

The failure to keep records up-to-date not only creates management problems for determining tenant receivables and other account balances but also prevents the project from preparing the required financial statements accurately, as mentioned in the next section.

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FINANCIAL STATEMENTS NOT TIMELY OR ACCURATE

The failure to submit timely and/or accurate financial statements is another problem common to these audited projects. Some failed to submit any statements at all. Many statements were of questionable value due to weaknesses in the underlying data from project records.

If financial statements are not submitted promptly and accurately, as required in the HUD Regulatory Agreement, potential problem areas may go unnoticed and delay remedial action.

Almost every audit report contained one instance of improper use of funds. Seven of the thirty projects sampled had failed to remit to HUD any rents collected in excess of the basic rents, as required in the Regulatory Agreement. Five projects had failed to report all income. For example, one project failed to record income from its laundry and vending machines although all expenses for space and utilities incidental to their operation were charged to the project. In this case, income had been diverted to the personal benefit of the mortgagor.

Other misuses of funds that distorted project financial position included transfer of funds between projects with common ownership and payment of nonoperating expenses from project operating funds. Some practices can also cause projects to default, as occurred in several audited projects.

A few fund misuses discovered during the audits were deliberate attempts by project management to use project funds for their own personal benefit, rather than ignorance of regulations. These violations included use of project funds to repay personal obligations, use of the project's security deposit trust account as collateral on a personal loan, and outright embezzlement of funds. Upon discovery, corrective action was taken.

PROBLEMS DUE TO POOR PLANNING

Nine of the projects audited had problems caused by poor planning in the feasibility stage or construction defects. For example, 39 percent of total estimated annual gross project income for one project was to come from commercial space. However, due to the project's location in an urban renewal area, the physical design of the commerical space, and lack

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of demand, the space remained vacant. This was considered to be the primary factor in the project's eventual default.

PHYSICAL DEFECTS

Other projects had problems due to installation of improper capacity equipment or construction defects. These deficiencies caused higher than normal maintenance expenses, which sometimes had to be paid from operating funds because management failed to have them corrected while the contractor's bond was in effect. This also affected financial stability.

MANAGEMENT AGREEMENTS AND FIDELITY BONDING

Ten of the projects examined either had not submitted a management agreement for HUD's approval as required or had unqualified management for some other reason. These reasons included failure to obtain fidelity bond coverage and too few members on the project's board of directors. Failure to submit a management agreement can be a contributing factor in failure to comply with HUD regulations as noted earlier. Fidelity bond coverage of management is necessary to protect projects from large unexpected expenses resulting from misuse or fund embezzlement.

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT RESPONSIBLE FOR THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF HOUSING AND URBAN DEVELOPMENT:		
Patricia R. Harris	Jan. 1977	Present
Carla A. Hills	Mar. 1975	Jan. 1977
James T. Lynn	Feb. 1973	Feb. 1975
George W. Romney	Jan. 1969	Feb. 1973
ASSISTANT SECRETARY FOR HOUSING-FEDERAL HOUSING COMMISSIONER (note a):		
Laurence B. Simons	Mar. 1977	Present
James L. Young	June 1976	Mar. 1977
ASSISTANT SECRETARY FOR HOUSING MANAGEMENT:		
James L. Young	Mar. 1976	June 1976
Robert C. Odle, Jr. (acting)	Jan. 1976	Mar. 1976
H. R. Crawford	Apr. 1973	Jan. 1976
Abner D. Silverman (acting)	Jan. 1973	Mar. 1973
Norman V. Watson	July 1970	Jan. 1973
ASSISTANT SECRETARY FOR HOUSING PRODUCTION AND MORTGAGE CREDIT-FHA COMMISSIONER:		
David S. Cook	Sept. 1975	June 1976
David deWilde (acting)	Dec. 1974	Sept. 1975
Sheldon B. Lubar	July 1973	Nov. 1974
Woodward Kingman (acting)	Feb. 1973	July 1973

a/On June 14, 1976, HUD combined the functions of the Assistant Secretaries for Housing Management and Housing Production and Mortgage Credit under a single Assistant Secretary for Housing-Federal Housing Commissioner.


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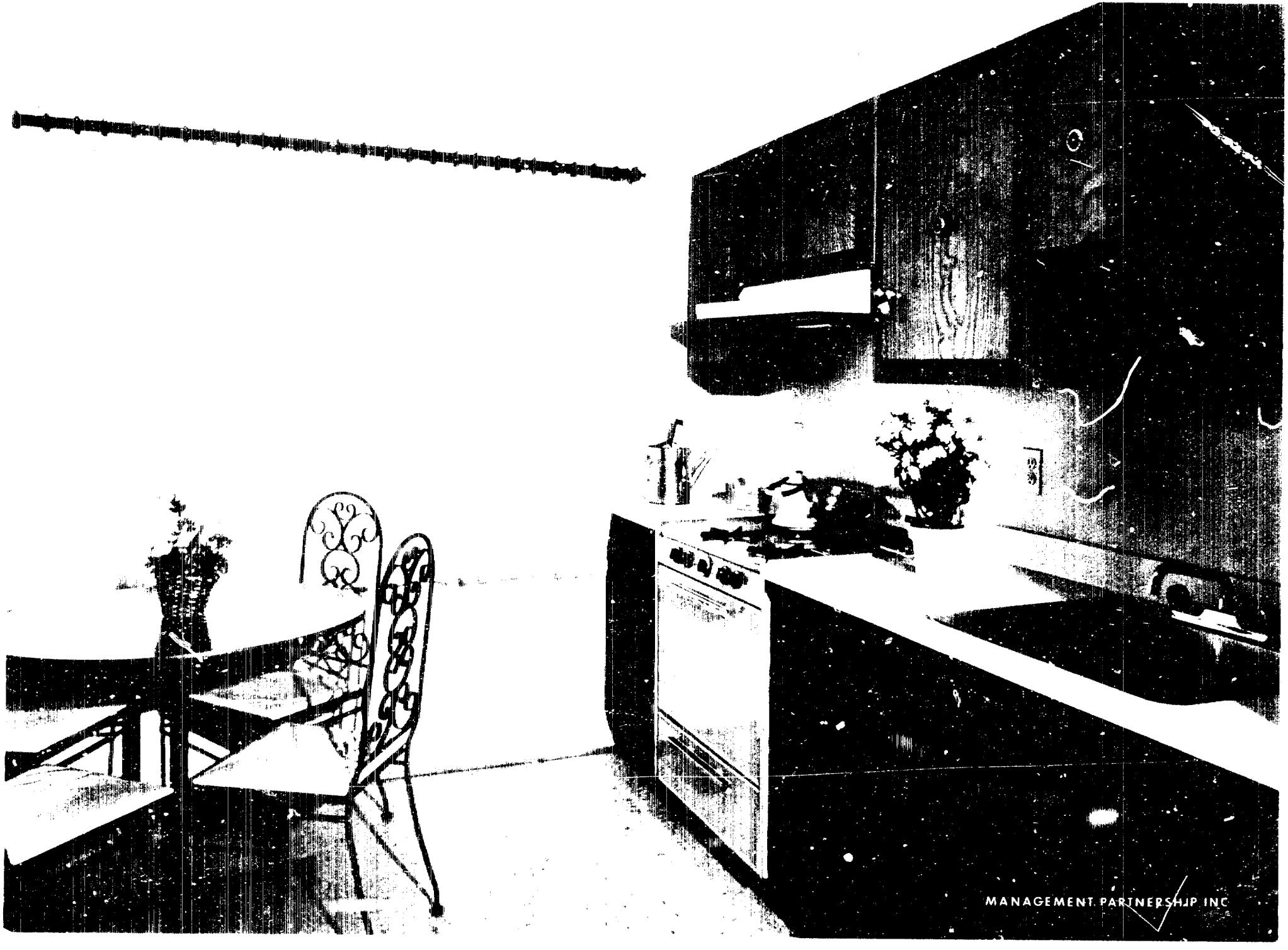
MANAGEMENT PARTNERSHIP INC


NATIONAL HOUSING PARTNERSHIP


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