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Designing Subsidized Rental Housing Programs: What Have We Learned?

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Introduction

For more than half a century, the federal government has provided subsidies under numerous programs to build, rehabilitate, and preserve affordable rental housing. In total, some than five million units have been produced using direct federal subsidies, block grants, and tax credits.[1] Subsidizing housing presents special challenges, because making the housing affordable to those who most need it requires administrative rules that govern how the rents are set and who may live in the housing. Typically, this disconnects the housing from the market in the following ways:

1. Owners of the housing are not able to finance cost increases by raising rents or to tap into the appreciated value of their properties to finance capital improvements. Instead they must apply for additional subsidies, which may or may not be forthcoming.
2. Owners are relieved of the discipline of a competitive market. Up to a point, tenants will stay even if the housing is not well managed and maintained, because they cannot find equally affordable rents elsewhere. Properties that have become obsolete in design or are in undesirable locations (because the neighborhood has changed or because the original decision to build there was misguided) are not allowed to fail financially. The flow of subsidies continues and, in many cases, is augmented by a well-intentioned preservation decision.

The central dilemma of project-based subsidized rental housing is this: the more the housing serves the neediest households (without whose needs there is no rationale for rental subsidies in the first place), the more it is disconnected from the market by rent setting policies and other administrative constraints. The public housing program is the extreme case, but developments using project-based Section 8 subsidies also operate at a distance from the market, despite recent efforts to reset their *total* rents (tenant payment plus subsidy amount) to market levels.[2] The Low Income Housing Tax Credit operates much closer to the market. The maximum rents permitted by law--and the rents permitted by state implementation of the Tax

[1] Including roughly two million HUD-assisted privately owned units, 1.5 million LIHTC units, and 1.5 million units of public housing (public housing is largely outside the scope of this paper).
[2] An important distinction is that the worst Section 8 properties have been allowed to fail financially, while that principle only recently has been applied to public housing.

Credit program—often are indistinguishable from market rents or only slightly below market. But these rents, as has often been pointed out, are not affordable for the neediest households.

This paper examines the lessons learned from decades of experience with the several programs under which project-based affordable rental housing has been developed. These lessons can guide future policies and programs aimed at developing and preserving affordable rental housing.

We begin by describing the reasons that it is necessary to provide rental housing at rent levels below those the market will create, focusing on the types of individuals and families most likely to need assistance. We describe the circumstances in which there is a case for providing project-based assistance as a supplement to tenant-based housing vouchers and the policy goals that such a policy should pursue. We then discuss the dilemmas that make it difficult to pursue those goals. We provide a brief history of rental housing production programs over the past decades.

We then describe the financial and management problems that portions of the pre-LIHTC subsidized rental housing stock have encountered as a result of the weak incentives in the design of those programs, combined with efforts to control their costs. Next we review the history of past "preservation" crises and assess the extent to which efforts to extend periods of affordability have been successful in the light of the purposes of project-based assistance. We consider the Low Income Housing Tax Credit program, drawing from lessons about how that subsidy vehicle has overcome the challenges of past programs and what challenges remain, given the inherent risk of real estate and the continued dilemmas posed by meeting the goals of rental subsidies through rental production programs. The last section of the paper draws on our interpretation of the half-century of experience with rental subsidy programs to provide some general recommendations for the design of property-based programs, some possible changes to the federal rules governing the Low Income Housing Tax Credit program, and, finally, some principles that both federal and state officials should follow when deciding to devote resources to preserving individual properties as affordable rental housing.

1. Purposes of Project Based Assistance

Rental housing assistance is necessary because the private market will not produce housing at rents low enough to be affordable for the lowest income individuals and families. Over time rents of some older housing "filter down," but owners of rental property must charge rents that are high enough to support a basic level of operating costs. Minimum standards for housing quality established by building, housing, and other codes prevent the widespread creation of low cost housing through subdivision of larger units, construction of ancillary rental units on existing single family lots, intensive occupancy of dwelling space, or placement of mobile homes.

The result is a housing stock that is largely of good quality, which affordable housing created by the filtering down process often would not be. However, this good quality housing stock has relatively few units that people with incomes below the poverty line (or a proxy that varies by geography) can afford. Severe housing cost burdens among very low-income renters dominate housing needs in most of the US.[3] Many households pay more than half of their income for rent;[4] while very few are overcrowded or live in substandard housing units [HUD 2005; Joint Center for Housing Studies 2006].

Renters with extremely-low incomes--below 30 percent of area median income—have a much greater incidence of severe cost burdens even than renters in the next highest income group—between 30 and 50 percent of area median income. Severe rent burdens virtually disappear among renters with incomes greater than 50 percent of area median. Elderly households and people with disabilities are particularly likely to have severe rent burdens or other "worst case" needs for housing assistance [HUD 2005].

Because most needy renters have severe rent burdens in standard quality, uncrowded housing, federal housing policy turned in the mid-1970s to demand-side subsidies--housing vouchers—that accept private market rents as a given but provide a subsidy that covers the difference between market rents and 30 percent of a household's actual income. The shift to vouchers began with a "moratorium" on HUD's rental production programs in 1973, followed by

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[3] Exceptions—housing conditions dominated by substandard and overcrowded housing--are found on or near Indian reservations and in Alaskan Native villages.

[4] Affordability is typically measured as the percentage of adjusted income (gross income, less certain adjustments, for example for high medical expenses or high child-care expenses) income required for rent and tenant-paid utilities. In this paper, we will use "rent" as shorthand for "rent and tenant-paid utilities." and "income" as shorthand for "adjusted income".

a high-profile federal study that detailed the high costs of current rental production programs and the conceptual case against them based on economic theory. Major legislation in 1974 created a dual system that included both vouchers and rental production: the Section 8 New Construction and Substantial Rehabilitation programs, as well as revived production of public housing. Large numbers of units were produced under the project-based Section 8 programs in the late 1970s and early 1980s.

Most supply-side subsidies were discontinued in 1983, following further review of the relative costs and benefits of demand and supply-side programs, and the 1980s saw major growth in the numbers of households subsidized through vouchers. However, there has never been a consensus that demand-side subsidies alone can meet the needs of poor renters, and accordingly some amount of subsidized production of rental housing continued during the mid 1980s.[5] The enactment of the Low Income Housing Tax Credit in 1986 and the HOME program in 1990 marked a return to substantial reliance on the production of affordable rental housing through new construction and substantial rehabilitation.

The case for rental production programs (supply-side subsidies) is that relying on private rental housing produced through market dynamics and incentives does not always work:

- In housing markets with unresponsive supply, production of additional affordable housing is needed to prevent the additional demand for rental housing (created by vouchers) from inflating rents for both subsidized and unsubsidized households.
- Some households have difficulty using vouchers, because the private market does not produce enough of the type of rental housing they need. Research on the voucher program suggests that this argument has the greatest merit for large families (those who need three or more bedrooms) and elderly people (who may need or want on-site services linked to their housing) [Finkel and Buron 2001].
- Production of rental housing can expand the opportunities for poor people and minorities to live in relatively high-cost neighborhoods, counteracting the tendency of housing market

[5] For example, the Section 8 Moderate Rehabilitation program, the interesting but short-lived Housing Development Action Grants (HoDAG) program, and the addition of project-based Section 8 subsidies to some previously unassisted FHA-insured properties.

dynamics—and historic patterns of racial segregation--to create concentrations of households by income and race.

- Production of rental housing can support efforts to revitalize distressed neighborhoods.

The intellectual debate surrounding the first point—the need to subsidize the expansion of the rental housing stock to prevent rent inflation created by vouchers—has never been resolved. Recent work by Scott Susin suggests vouchers may inflate rents at the low end of the housing market, but is not conclusive [Susin 2002; Khadduri, Burnett, and Rodda 2003]. Most likely is that in some metropolitan areas--those with expanding demand from population and income growth and with supply constraints caused by regulation or geography—subsidized expansion of the rental stock is warranted.

A further complication is the issue of substitution. Instead of expanding the rental stock, subsidized rental housing may simply replace housing that would have been built without a subsidy. The degree to which this happens has been investigated empirically [Murray 1983 and 1999; Malpezzi and Vandell 2002], with the conclusion that at least some substitution occurs, and the substitution is likely to be greater for subsidized rental housing that is most like private rental housing—that is, not intended for the lowest income renters and not intended for specific types of households with special needs.

Thus, the most effective use of subsidized rental production may be for large families and for people with special needs. However, producing such housing faces other dilemmas. The history of family public housing suggests that large numbers of children living in close concentration is a bad idea, especially if their families are poor and have weak social supports and even more so in high-density urban surroundings. There is a similar issue of "ghettoization" for people with some types of special needs. The strong preference of many people with disabilities (for example, those with severe mental illness) is to live in regular private market housing and not in specialized developments [Schutt, Goldfinger, and Penk 1992]. For both large families and special needs populations, the issue of scale might be addressed by limiting the size of a development or by integrating large units or units designated for special needs populations into a larger housing complex.

Using subsidized rental housing to support economic and racial integration also faces the issue of scale, but the perils of creating new concentrations of poor people and minorities should

not be exaggerated. The scale of subsidized rental developments need not be so large as to create a new concentration of low-income families. The location of developments can be sensitive to the pattern of change in a neighborhood, avoiding places that have relatively low but increasing shares of minorities and poor people. When subsidized rental housing is built in the same, low poverty, parts of metropolitan areas where other new construction is taking place—that is, on the urban fringe--it may well substitute for unsubsidized rental housing that would have been built on the same sites. However, the unsubsidized housing would not been affordable for low income renters and might not have been available to families attempting to use housing vouchers.[6]

Neighborhood revitalization is often given as the reason for developing subsidized rental housing in a particular location. However, there is little evidence that adding subsidized rental housing to a distressed neighborhood has a positive effect on that neighborhood. It certainly can have the opposite effect, drawing households away from the existing rental stock in the neighborhood and leading to increased deterioration and abandonment [Rothenberg 1991]. Recent careful empirical work by researchers at New York University shows that the production of subsidized rental housing can have a positive effect on neighborhoods [Schwartz, Ellen, Schill, and Voicu 2005; Ellen, Schill, Schwartz, and Voicu 2005.]. However, this may only work when the overall housing market is strong (as it was in New York City in the 1990s) and when redeveloped housing replaces deteriorated housing on a large scale. The case for using production of subsidized rental housing as a revitalization tool remains weak.

The policy goals that should be pursued by subsidized rental housing production are clear:

1. Avoiding rent escalation in markets where the private market supply response is not adequate to meet increasing demand for rental housing.
2. Serving types of households for which the private market housing does not provide the type of housing that can be accessed by a demand-side subsidy.
3. Providing opportunities for poor people to live in neighborhoods in which they would have difficulty using a demand-side subsidy.
4. Supporting comprehensive--and adequately funded--neighborhood revitalization efforts.

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[6] Some jurisdictions have laws that require owners of rental housing to accept a voucher as a source of income that can be used for rent, but most do not. In addition, the rent of the "substituted" housing could be beyond the reach of a voucher subsidy.

Fiscal prudence implies that subsidies should not benefit households with sufficient income to afford housing on their own and should not be used to create rental housing that the private, unsubsidized market would supply. However, it is very difficult in practice to serve the neediest households and avoid "substitution," while at the same time meeting the other policy objectives of subsidized rental housing. The housing markets where subsidized increases in supply are most warranted are also the most expensive, and the gap between the costs of developing and operating the housing and the rents that households with extremely low incomes can afford is very large in those locations. Housing for people with special needs implies additional on-site staff and associated operating costs. Units of the size needed by large families can be expensive to develop. (For example, units with multiple bedrooms usually do not exist in buildings that can be rehabilitated or preserved rather than built new.) For many poor households and households with special needs, the right kind of housing is integrated into larger developments, which implies providing some of the subsidy to households that do not need it.[7] Cross-subsidization[8] works only in highly specialized market conditions.

Neighborhoods that cannot easily be accessed with a voucher are, by definition, places where the costs of land or existing structures are high. And the type of housing production that can help turn around a distressed neighborhood has proven to be expensive, despite low land costs.

It may be impossible to avoid some of the high costs and inefficiencies associated with meeting the policy goals of subsidized rental production. Some of the production subsidy in a mixed income or mixed-population development will benefit less needy households or units that substitute for housing that would have been developed without a subsidy. In addition, it may be necessary to use both production subsidies and voucher rental assistance in order to reach the neediest households, leading to relatively high total subsidy costs per unit.

The history of privately-owned, property-based subsidized rental housing has gone through several phases over the past 50 years.[9] What has come to be called "older assisted" housing was produced during the late 1960s and early 1970s under the Section 236, Section 221(d)(3) below-market interest rate programs, and through the later addition of a rent subsidy

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[7] Without such subsidy, there would be no economic incentive for a developer to produce mixed-income housing rather than a 100 percent market-rate unsubsidized development.
[8] That is, using profits from market-rate units to support low-income units.
[9] We do not include the public housing program, which began almost 70 years ago and is outside the scope of this paper.

to properties that started out as market rate housing with FHA insurance. "Newer assisted" housing was produced under the property-based Section 8 programs between the mid 1970s and the early 1980s. The programs that preceded the Low Income Housing Tax Credit produced close to 2 million units of privately-owned housing subsidized by HUD. As these properties aged and reached the end of their long-term commitments to provide affordable housing, there have also been, essentially, two phases of "preservation" of these properties: older assisted housing during the early and mid 1990s and newer assisted housing starting in the late 1990s and continuing today.

Finally, in the early 1990s we entered the "devolution" era of the production of affordable rental housing, with the enactment of the Low Income Housing Tax Credit and the HOME program. Key decisions under these block grant-like programs are made by state (and, in the case of HOME, also local) officials, rather than by the federal government. The rent rules are much simpler: instead of 30-percent-of-income rents, these programs cap the "flat" rents that owners may charge (rents that do not vary with actual tenant incomes). Another simplification compared with earlier programs is that there is no ongoing operating subsidy built into the design of the program. The Low Income Housing Tax Credit (and HOME, which often is used together with LIHTC for the same development) provides capital subsidies only. The lack of an ongoing operating or rent subsidy both simplifies the administration of these programs and makes them popular with congressional funders. Unlike the programs that rely on an ongoing subsidy (both project-based Section 8 subsidies and vouchers), these programs do not create an overhang of annual obligations for fresh appropriations of funds that must be fit into a constrained budgetary envelope.[10]

The next section of this paper discusses the problems of pre-LIHTC property-based programs. Section 3 discusses the preservation efforts that have attempted to retain properties produced under those programs in the affordable housing stock. Section 4 turns to the Low Income Housing Tax Credit and considers both the successes of that program design in overcoming some of the earlier problems associated with project-based rental subsidies and the ongoing challenges faced by this major current program. The final section of the paper draws

[10] LIHTC creates ongoing annual costs to the federal budget in terms of tax revenue forgone from equity investors in rental housing who use the tax credit, but lawmakers are not forced by the federal budget process to confront these costs in the same way as annual appropriations.

lessons from the experiences of past and current production programs and preservation efforts to suggest lessons for the design of future rental production programs, for changes to the federal rules governing the LIHTC, and for the preservation decisions about individual properties that must be made by federal and state officials.

2. Problems with Pre-LIHTC Property-Based Rental Programs

The privately owned assisted housing programs that preceded the Low Income Housing Tax Credit have exhibited a variety of problems, most of which—ironically--are associated with the programs' major achievement. These properties enabled the neediest families, generally those with extremely low incomes, to live in structurally sound and (usually) well-maintained housing and to pay no more than 30 percent of their income for housing. The programs either were designed at the outset with rents set at 30 percent of the actual income of the housing unit's occupants or came to have that design as project-based Section 8 subsidies were added. Thus, these housing developments were far removed from the market, and the problems we detail below mostly result from the weak incentive structure for property owners and managers. Federal officials were unable to replace missing incentives with successful administrative controls on owner and manager decisions. A related set of problems stems from administrative attempts to impose cost control on properties that were inherently expensive to subsidize, given a subsidy structure that fills the gap between costs and the rents affordable to the programs' target households.

Many of the design features for these programs were stipulated in statute. This made them difficult to change, both because the process for enacting federal housing legislation is slow and because changing design features required lawmakers to take sides on issues that were difficult philosophically (to what extent to target assistance to the neediest) or that had powerful stakeholders in the housing industry (how to set limits on costs or profits).

We are quick to point out that not all properties exhibited each problem, that most properties survived, and that many properties can be judged successful at their basic mission of providing structurally sound housing, affordable for needy renters. Some properties provided housing in neighborhoods that were or have become difficult for low income, minority families to access. Many properties provided housing enriched with essential services for frail elderly people or for people with disabilities.

2.1 Weak Incentives Resulting from Isolation from the Rental Housing Market

The production and operation of rental housing is an inherently risky business, requiring judgments about property design and location based on a careful assessment of demand, plus ongoing property management decisions in response to changing circumstances. The isolation of pre-LIHTC subsidized rental properties from the market weakened the incentives that lead private market investors, owners, and managers to make good decisions.

Because most of the properties were financed with FHA mortgage insurance (or direct loans from HUD or the Department of Agriculture), default risk was transferred from lender to government, severely weakening the incentives for the private mortgage lender to underwrite the project carefully. Typically, the private mortgage lender bore little if any risk.

In order to make the projects appear feasible, operating costs frequently were underestimated, and unrealistic assumptions were made about the time period for achieving full lease-up. The worst problems resulted from a combination of intense competition among developers for limited subsidies and the ability to access additional subsidies later if projects ran into difficulty. In these conditions, developers had little to lose and much to gain from overstating achievable occupancy rates, understating expected operating expenses, and understating lease-up costs.

Because of government guarantees for debt and a guaranteed stream of income, typical financial structures included a high ratio of debt to total development cost, to the extent that often the owner had "no skin in the game." Because owners had no substantial equity in the property, the asset management function of a property owner often was absent or weak. This sometimes led to poor decisions about how to use operating budgets and inattention to growing capital needs. HUD staff responsible for monitoring the properties (because they had Section 8 contracts, or FHA-insured mortgages, or both) were not able to substitute for the self-interest of an owner with an equity stake.

Financial incentives consisted disproportionately of tax losses, with the bulk of losses expected in the first five to seven years. By contrast, there were relatively few long-term incentives for proper maintenance and good ownership. Typically, after the developer had pocketed the development fee and the investors had received their front-loaded tax losses, the property represented an economic liability rather than an economic asset. Properties were excessively vulnerable to increased operating costs—for example, from sudden spikes in utilities

or insurance costs. Properties generally could not--or owners would not--self-fund their ongoing capital needs.

Because Section 8 rents were often above-market—in the case of the Section 8 New Construction/Substantial Rehabilitation program, this was created by the design of the program—owners' and managers' decisions were not based on preserving and enhancing the value of the property in a competitive market. Instead, the 30-percent-of-income subsidized rents gave them an automatic market, and the above-market contract rents disconnected owners from market discipline on costs and quality. An additional perverse outcome was that owners and managers correctly perceived HUD (rather than residents) as the primary customer.

Owners and managers typically had few if any ongoing incentives for efficiency in operations. Causes included rents that were based on operating costs or formulae rather than on market factors, and restrictions on profit. Rent levels for many properties were based on a negotiation with federal officials, which reduced or removed the incentive for the owner and manager to make the cost-effective management choices that would have been necessitated by market-based rents. For other properties, automatic adjustment of rents based on inflation factors provided larger-than-needed operating budgets and exacerbated pressures on the federal budget caused by rents exceeding market. Restrictions on taking profits from cash flow for many properties (typically allowing no profits at all for nonprofit owners) further dampened incentives for efficiency.

Because of the low risk of financial loss through front-loaded profits, a guaranteed subsidy stream, and government guarantees of debt, inexperienced owners (both for-profit and non-profit) were willing to invest in subsidized rental housing and to take on the responsibility of managing it, and the housing finance industry was willing to lend to them. Federal program administrators could not replace self-selection into the programs of the most skilled and experienced owners and managers with project selection criteria or subsequent administrative controls.

Projects often were located on sites where, if forced to rely on market rents to cover costs, investors would not have built or rehabilitated rental housing. Many properties are located in neighborhoods with very high rates of poverty. This tended to make the properties "housing of last resort," and some of the larger properties came to have sufficient numbers of families with multiple social problems to themselves constitute dysfunctional concentrations of poverty. Neither of these problems is as common as in the public housing program. Conversely, many

privately owned, assisted projects were located in relatively low-poverty neighborhoods, including projects occupied by families with children. It is clear, however, that many properties were developed in areas with over-concentration of poverty and lack of access to jobs, compared to the places where market-motivated investors would have built or rehabilitated housing [Newman and Schnare; Khadduri, Shroder, and Steffan].

2.2 Problems Related to Attempts to Control Subsidy Costs

Recognizing week incentives for efficiency and sensitive to the high costs of programs that built or substantially rehabilitate housing and make it affordable for people with the lowest incomes, policy-makers and administrators attempted to impose bureaucratic cost controls that had further perverse effects on program design.

In order to be competitive in terms of total development costs, developers had a powerful incentive to prefer low-cost sites. This had at least the following effects. First, it largely prevented developments from being located consistent with what we now call smart-growth principles. Second, it tended to concentrate affordable housing opportunities inside traditional low-income (low land cost) areas.

Cost limits typically were stated in terms of initial costs only, which created a powerful incentive to use materials with low initial costs without regard to potential adverse impacts on ongoing maintenance, energy, and replacement costs. To make projects appear feasible at lower costs, development budgets and rent structures were approved with inadequate provision for replacement reserves. It is now universally recognized that rules of thumb that are appropriate for market-rate apartments result in insufficient reserves for replacement when imported into subsidized apartments [Millennial Housing Commission 2002]. Unsubsidized properties have high cash flow and ready access to capital markets, so they are able to make fluid decisions about capital improvement programs. Regulated properties lack discretionary cash and often are locked out of refinancing (by mortgage contract, economic infeasibility from soft debt, or regulatory prohibition), so if they need capital for rehabilitation, it must be accumulated within the regulatory restrictions before it is needed.

In an attempt to control costs, programmatic requirements to house the elderly in efficiency units were added in the mid 1980s. Experience has shown that these units are difficult to market, even with deep subsidies.

Other cost limits resulted in a tendency to under-invest in community space relative to in-unit space. At the same time, "mission costs" (non-housing services) were not adequately provided for. Attempting to provide for them within the property's operating budget has several problems. It creates a moral obligation to continue the services program even if the property can no longer afford it; it increases the property's operating costs and gives the impression that the management is inefficient even when it is not; and it shifts costs from other public and private systems to budgets for housing subsidies.

Finally, attempts to achieve cost efficiency—by providing preferences for occupancy by the neediest households and by increasing the tenant portion of the rent from 25 to 30 percent of income—exacerbated the image, and sometimes the reality, of these housing developments as concentrations of the poor.

3. Efforts to Preserve Project-based Subsidized Rental Housing

As the end of the restrictive-use period approached, first for older assisted properties and then for newer assisted properties, the best properties were at high risk of conversion to market-rate operation, and the worst properties needed large governmental investments in order to avoid physical and/or financial collapse. The era of preservation of the already-subsidized stock of privately owned rental housing began.

3.1 The "Pre-payment Crisis" and LIHPRHA

In the late 1980s owners of older HUD-assisted properties (those that had been developed with below-market FHA-insured financing under the Section 236 and Section 221(d) (3) programs), began to reach the dates at which owners were eligible to prepay their mortgages and thus end the restrictions on incomes and rents that ran with the mortgage documents rather than being included in a separate use agreement. The programs had not been designed with a formal option that the federal government could exercise to keep these properties within the affordable housing stock.

The first response to this problem was to prevent the prepayments to which the owner had an apparent contractual right. [11] Then, the Low Income Housing Preservation and Resident

[11] The Emergency Low Income Housing Preservation Act of 1987 ("ELIHPA") made prepayment requests subject to a significant set of new requirements. Owners contended that these new requirements amounted to a repudiation

Homeownership Act of 1990 ("LIHPRHA"), while continuing to restrict prepayments, provided incentives to owners not to prepay. Ultimately, prepayment was again allowed beginning in 1996, and residents were protected with what have come to be known as "enhanced vouchers." Many of these properties already had Section 8 rent subsidies attached to some or all of the units, and these were replaced with vouchers set at the market value of the units, so long as the original tenant used the voucher within the property rather than moving elsewhere. Section 8 subsidies were added to other units in order to make them affordable for residents who could not afford the rents charged after prepayment.

After restoration of the right to prepay, at-risk properties were preserved whenever an existing owner or a purchaser[12]—and, often, local and State governments that used resources under their control to supplement federal incentives—decided that the property was worthy of preservation. Otherwise, the property exited the use-restricted stock, but residents received vouchers that provided ongoing affordability (on a tenant-based rather than project-based model, in that the tenant could move out, carrying the voucher subsidy to a different property).

Later in the LIHPRHA program, a "capital grant" financing approach was used, under which HUD made a grant to the nonprofit purchaser to cover the selling owner's equity and pay for needed repairs, without the need to increase rents. Because rents did not increase as a result of a capital grant transaction, typically the preservation package did not did not require additional Section 8 units. Similarly, capital grant transactions retained the ability to adjust rents higher as needed to cover unexpected cost increases, and were less dependent on Section 8 generally.

Some 700 properties were preserved under ELIHPA and LIHPRHA, mostly with existing owners but with a significant number (roughly one-third) transferred to new – generally nonprofit – owners.

The LIHPRHA program may have cost more to preserve each unit than was necessary. The incentive program sometimes led to a "war of the appraisers" through which some owners were over-compensated compared to the contemporary market value of the properties. In

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of the owners' contractual rights to prepay their mortgage loans.

[12] Preservation purchasers could be non-profit or for-profit and in any event were willing to own and operate the property subject to a new long-term use and affordability agreement.

addition, it is widely believed that some nonprofit purchasers, as a result of HUD's willingness to bear 100 percent of rehabilitation costs, over-rehabbed properties.

Post-LIHPRHA, the sales price demanded by some existing owners who sold the property to be preserved—for example, in an attempt to cover the "exit taxes" of current investors[13] —made it difficult to structure the financing of some properties in a way that made the property sustainable in the long term.

Furthermore, the "enhanced voucher" approach, by focusing on protecting the sitting tenants, took attention away from assessing the role of the properties within their rental housing markets. That is, a particular property may be important for providing affordable housing in the long term, and that role may be lost unless a supply-side preservation approach is used.

3.2 The "Opt Out Crisis" and Mark to Market

In the late 1990s, attention shifted to the newer assisted stock, for several reasons:

1. The properties built or redeveloped in the late 1970s and early 1980s began to reach the end of the multi-year contracts under which they agreed to accept tenants qualifying for Section 8 rent subsidies. At the end of those contract terms, owners would be able to "opt out" of the section 8 program.
2. Congress was concerned about the implications for federal budgetary outlays associated with Section 8 contracts that had automatic adjustments for inflation. In the early 1990s, Congress began to impose upper limits on contract rents based loosely on the Fair Market Rents used for the voucher program. Some properties were able to operate within those constraints, while others were squeezed.
3. The newer assisted properties were beginning to show their age and usually had not built up replacement reserves adequate to meet their looming capital needs, for the reasons we have detailed already.

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[13] After 15-20 years, owners of investment real estate often have a "negative capital account" – that is, their remaining eligible basis is less than their share of non-recourse indebtedness, so that upon sale, when they are relieved of contingent liability (the mortgage), the negative capital account represents gain (taxable income) even in the absence of any cash price.

Ultimately, the response of the federal government to this new preservation crisis was a comprehensive program to restructure the financing and subsidies of the newer assisted stock. This program included new Mark to Market statutory authorities (for properties with above-market rents) and a new HUD initiative ("Mark Up To Market") for properties with below-market rents that were at risk of opt-out. These policies applied as well to older assisted properties that had not already been restructured and had not left the assisted housing stock.

Enacted in 1997 and still active as of 2006, Mark to Market was conceived as the response to the phenomenon that the rents of many project-based Section 8 properties, particularly for properties produced under the Section 8 New Construction program, were higher than market-comparable rents. In return for reducing the monthly payments on the FHA-insured debt, and for the owner's acceptance of a new 30-year use and affordability agreement, the Section 8 rents are reset at market level. A certain number of above-market "exception" rents are permitted.

Mark to Market is also a preservation program, because of the new 30-year affordability commitment, and because the underwriting of the properties is designed for sustainability -- taking into account their current and future capital needs and their operating expenses.

The Mark-to-Market program has become a laboratory for preserving properties in a way that pays attention to their long-term sustainability. Significant sustainability initiatives include especially careful underwriting of revenues and expenses, underwriting an "expense cushion" of 7-10 percent of operating expenses, including a replacement reserve deposit sized to cover 100 percent of expected 20-year capital needs, a performance-based Incentive Performance Fee, and a "cash flow split" in which excess cash is shared between the owner and the government. By comparison to LIHPRHA, much more attention was paid to: accurately assessing ongoing revenues and expenses, an adequate margin of cash flow after debt service, accurately assessing 20-year capital needs, and stronger incentives for performance.

M2M avoids the "war of appraisers" by being a voluntary program; owners are free to opt out of the Section 8 program, at market, and therefore the government can set the rules. This enables HUD to commission a single private appraisal, in a transparent process that gives the owner the ability to participate in the process of determining comparable market rents. M2M also avoids over-rehabbing properties through underwriting that covers only the work needed to

restore the property to original condition, and by requiring the owner to invest 20 percent of repair costs.

Through fiscal year 2005, the M2M program had completed assessments of 2751 properties, 1377 of which underwent a restructuring of debt in connection with a new long-term use agreement. Another 823 properties had their rents reduced to market levels, without debt restructuring. These transactions produced almost $3 billion of savings in Section 8 costs (net present value, measured over 20 years), and $1.8 billion of net savings (taking into account FHA mortgage insurance claim payments and expected recoveries from future cash flow).

Although most M2M properties are performing well, some are experiencing financial stress. It seems safe to say that future preservation programs should regard the M2M approach as a floor rather than as a ceiling. This, of course, has implications for costs.

An evaluation of the Mark to Market program as of 2003 suggests that the M2M process has been very effective overall in preserving affordable housing. Underwriting decisions have been based on careful assessments of individual projects' financial strengths and weaknesses and on the need to provide for the properties' ongoing capital needs. However, the process has been less effective in assessing the need to preserve a property within the broader community context, including the feasibility of alternative ways of meeting the community's housing needs (such as housing vouchers) or of the property's potentially important role in providing housing opportunities where they otherwise might not exist [Hilton et al., 2004]. Overcoming concentrations of poverty by income and race—by preserving affordable housing in places that do not have such concentrations—was not a strong mandate for the program, either in legislation or in the guidance through which the program has been implemented.

Just as many properties with project-based Section 8 contracts had above-market rents, many had rents below the comparable market rent. This was especially common for the older HUD-assisted stock, properties produced between the late 1960s and the mid 1970s. Under a "mark up to market" policy, HUD permitted those rents to be reset at appraised market values, in an attempt to obtain owners' agreement to retain expiring-use properties within the affordable housing stock. The implicit assumption is that, if a property has current rents below comparable market rents, the government is well served by increasing rents at the margin through an increase in Section 8 subsidies, rather than allowing an opt-out and replacing the project-based subsidies

with vouchers. Unlike Mark to Market, Mark up to Market does not involve comprehensive underwriting of the property's long-term finances.

3.3 Which Properties Have Been Preserved and Which Have Not?

Both hard evidence and anecdotal evidence indicates that properties that have been preserved are more likely to be in low-market-rent, high-poverty, low-growth areas. Similarly, properties that opt out are more likely to be in high-market-rent, low-poverty, high-growth areas [Finkel et al. 2006.]. Accordingly, there is reason to fear that preservation-worthy properties are not being preserved. It is also reasonable to ask whether non-preservation-worthy properties are being preserved.

A recent analysis that compares multifamily assisted properties that opted out of the assisted housing stock between 1998 and 2004 with properties whose owners chose to keep their Section 8 contracts in force shows that opt out properties are in neighborhoods with higher median incomes, higher median rents, and lower poverty and vacancy rates. Opt out properties also are more likely to be family housing—that is, to have two and three-bedroom units and to have smaller numbers of units in the development. [Finkel et al. 2006.]

4. The LIHTC Program: Positive Attributes and Remaining Challenges

Enacted as part of 1987 tax reform legislation that removed other incentives for investment in affordable rental housing, the Low Income Housing Tax Credit is unusual among tax provisions in that it is not an entitlement that can be claimed by any taxpayer who meets certain qualifications. Instead, a fixed quota of tax credit authority is assigned to each state on a per capita basis and then allocated by the state to individual rental housing developments through a competitive process. While based on federal law and regulations, LIHTC is administered by state officials who make both policy-level decisions on goals and priorities for the use of the resource and retail decisions on which developers and housing projects receive the subsidy.

LIHTC represented a return to major federal support of rental housing production, producing an estimated 1.5 million units between 1987 and 2005 [Khadduri, Buron, and Climaco, 2006], roughly the same number of units produced since 1937 by the public housing program. LIHTC and the other contemporary block grant-like program, HOME, also moved away from the "Brooke rents" used in the Section 8 programs—that is, rents charged as a

percentage of the tenant's actual income—to "flat rents"—that is, rents that must be less than a maximum related to local affordability but are the same regardless of the actual income of the occupant of the housing unit.

4.1 Positive Attributes of the LIHTC Program

Competition for the Subsidy

Although pre-LIHTC programs featured competition, the level of competition achieved by the LIHTC exceeds anything achieved by pre-LIHTC programs. If they choose to do so, state allocating agencies can design their Qualified Allocation Plans so as to emphasize the factors on which they desire competition and select from among competing developers and projects accordingly. Developers can be sensitive to small numbers of points awarded in LIHTC competitions and design or redesign their properties accordingly. While a tax incentive will always have some inefficiency,[14] the market for LIHTC among investors has become sufficiently competitive that the loss of efficiency has been much reduced.

Incentives to Provide Good Quality, Well-Managed Housing

Because most American markets have rents that roughly approximate current LIHTC ceilings (that is, 30 percent of 60 percent or area median income), LIHTC properties can face competition from older conventional housing. Households who would rent LIHTC units often have other choices at similar (if not identical) rents. This avoids the guaranteed market and the weak incentives to manage the property well that characterized earlier programs based on percent-of-income rents. Tenants will have other alternatives and will leave a badly managed and maintained LIHTC property.

The relatively high LIHTC rents also limit the magnitude of a potential LIHTC preservation crisis created by the lure of higher unregulated rents. Changing market circumstances will create that pressure for some properties in some places, but in many other

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[14] Inefficiencies include the transaction costs of packaging and selling the tax benefit and the return investors must receive in order to be willing to invest. In the case of LIHTC, tax benefits include the value of the income tax credits over the 10-year credit period, the value of "tax losses" driven by depreciation deductions, and the residual value (if any) of the property. While the tax reform legislation that created LIHTC ended the rules for rapidly accelerated depreciation available to earlier subsidized rental properties, depreciation still has some value to investors.

cases LIHTC rents will be every bit as attractive to owners as unrestricted rents. Some owners have agreed to set LIHTC rents considerably below the regulated maxima, but this is most common for mission-driven non-profits who are unlikely to leave the program because of economic incentives.

All LIHTC properties have private investors who have purchased the LIHTCs. Most first mortgage debt for LIHTC properties is also private, with no government guarantee. As a result, properties have one or two additional stakeholders who are knowledgeable and who have a financial stake in the property's success. Many LIHTC properties have debt in excess of economic value—especially properties that have significant "soft debt." [15] This leads to the same problem of "no skin in the game" that was typical of pre-LIHTC programs. However, the problem is mitigated during the LIHTC compliance period, when syndicators (and developers, who typically guarantee LIHTC compliance) have a powerful asset management interest.

The maximum allowable rents rise in step with area median income. In effect, this is a factor-based rent increase mechanism, allowing owners to increase rents modestly each year without the need for property-specific government approval. Regardless of one's views about whether the factor should be based on area median income, [16] or market rents, or operating costs, it seems clear that a factor-based approach, in which actual rents are the *lower* of the factor-based limit or what the local market will bear, is superior to the budget-based approach followed in some pre-LIHTC programs.

Contrary to tax-shelter syndication, which created the near-certainty of exit-tax and phantom-income problems, LIHTC investors can leave the program 15 years without a LIHTC recapture tax. This increases the owner's incentive to continue to invest in the property during the compliance period.

Outcome-Based Compliance

The tax credit can be claimed based primarily on two simple objective outcomes: (a)

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[15] "Soft" debt has deferred payments, or payments that are contingent on availability of funds.

[16] LIHTC rents are tied, by IRS revenue ruling, to HUD's local very-low income limits, which usually rise over time, but can fall in some areas in low-inflation environments. After this occurred and gave rise to industry complaints, HUD instituted a "hold harmless" policy under which very-low income limits remain flat until data indicate that they should increase. In cases in which very-low income limits would show a significant reduction—for example, because of a geographic change in metropolitan area definitions, LIHTC rents might remain unchanged for many years. Failure of rents to grow in concert with expenses under these circumstances could jeopardize project viability.

units occupied by eligible households and (b) at rents within program limits.[17] This contrasts sharply with the highly complex process-oriented compliance requirements of pre-LIHTC programs. Because the annual LIHTCs can be claimed only so long as the property remains in compliance, the risk of future noncompliance—and the function of monitoring compliance--is borne primarily by the private sector. In the event of noncompliance, the government simply recaptures the LIHTCs, rather than having to take protracted "enforcement" actions against owners or arrange for a transfer of the property to another owner, actions the federal government has found exceedingly difficult.

Stability Combined With Ability to Adapt to Specific Circumstances

The LIHTC has permanent status and resides in the Internal Revenue Code. Because the Code is not subject to annual appropriations, is difficult to change, and is in the custody of Congressional committees other than those normally concerned with housing issues, the LIHTC does not experience the year to year fluctuations characteristic of other affordable housing programs. An ancillary benefit is that the LIHTC does not face direct annual competition with other housing programs. Perhaps the LIHTC program's most significant positive attribute is its resilience during the current era of decreased funding for other housing programs for low income renters.

Because the state allocating agencies have great flexibility in designing their Qualified Allocation Plans, fifty-plus program administrators are trying new approaches each year. There are few barriers to innovation, and communication among states is good. Accordingly, worthy ideas spread quickly. For example, some states determined early on that the minimum 15-year compliance period was inadequate and changed their QAPs accordingly. No statutory change was required, and other states followed suit when and as they agreed, adding their own innovations.

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[17] There are other requirements as well--in particular, physical condition standards and Fair Housing compliance.

4.2 Shortcomings of the LIHTC Program

Under-funding of Operating Costs and Capital Needs

The LIHTC has not entirely overcome the financial problems associated with earlier programs. Despite the stronger incentives for equity investors and lenders to underwrite properties carefully, operating costs and capital needs often are understated. With regard to operating costs, LIHTC underwriting standards often do not fully recognize the extent to which LIHTC operating budgets need to include non-traditional expenses such as computer learning centers, after-school programs, and service coordination. While rent adjustments are pegged to increases in local incomes and are automatic, they may not be sufficient to cover such increases in operating costs as utilities and insurance, which could easily exceed growth in local household income. Basically, real estate is a risky business, and no program—including LIHTC—has managed both to control rents (inherent in property-based subsidized rental housing) and to provide the full measure of flexibility needed to respond to changing market circumstances. LIHTC controls rents with a lighter hand, so this problem is less severe than it was for some of the earlier programs, but it is still there.

At the same time, while returns to investors are not nearly as front-loaded as they were for earlier programs, typically future capital needs are not adequately provided for when the properties are underwritten.

There is limited information about the capital needs of the early LIHTC properties that now are reaching or passing their 15-year mark, but anecdotal evidence indicates that most properties have significant capital needs that cannot be funded from reserves. Whether refinancing alone—that is, refinancing that takes advantage of a reduced mortgage balance or a lower interest rate or both—will be sufficient to meet these capital needs varies from property to property. Whether the owner has the potential to raise rents beyond the LIHTC-regulated levels also varies. Thus, while LIHTC may not have a preservation crisis in the sense that many owners will see opportunities to charge higher rents at the end of their compliance period, many LIHTC properties will need a fresh infusion of subsidy in order to remain viable.

The exhibit below shows a financial simulation for a "plain vanilla" LIHTC property with all units restricted at 60 percent of area median income.[18] The financial simulation used assumptions we consider reasonable for moderate-cost areas: rents averaging $588 per unit per month, operating expenses averaging $350 per unit per month, and a replacement reserve deposit of $25 per unit per month. Total development cost of $100,000 per unit were financed 72 percent through LIHTC equity, 25 percent through private mortgage debt (at 7 percent / 30 years), and 3 percent through government-funded "soft debt" (accruing interest at 5 percent but not requiring any payments until maturity at 30 years).

The property has a small but positive cash flow (its debt service coverage ratio varies between 1.05 and 1.10); properties typically are underwritten to have more cash flow than this, but experience suggests that actual performance is more typically at or close to break-even. The simulation assumes that rents grow at 3 percent per year and expenses grow at 4 percent per year.

The simulation estimated capital needs (e.g., roof replacement, HVAC replacement, appliance replacement) include estimates for each building system (e.g., kitchen cabinets, siding).[19] For purposes of this analysis, capital needs were divided into "must pay" items (e.g., appliances) that must be replaced when they wear out and "deferrable" items (e.g., siding replacement) that can be and often are postponed by making piecemeal repairs. The simulation assumes that "must pay" items are funded from the reserve for replacements, and that "deferrable" items are deferred until the end of the 20 year analysis period (the 15 year basic LIHTC compliance period, plus 5 years).

The simulation shows that:

- There is no capital needs backlog of any size until after year 10.
- The backlog rises sharply after year 10.
- If market rents are 5 percent higher than affordable rents, the increased equity from a potential conversion to market rents will be sufficient to fund around half of the backlog as of year 20. If market rents are 10 percent higher than affordable rents, the increased equity will be sufficient to erase the full backlog as of year 20.

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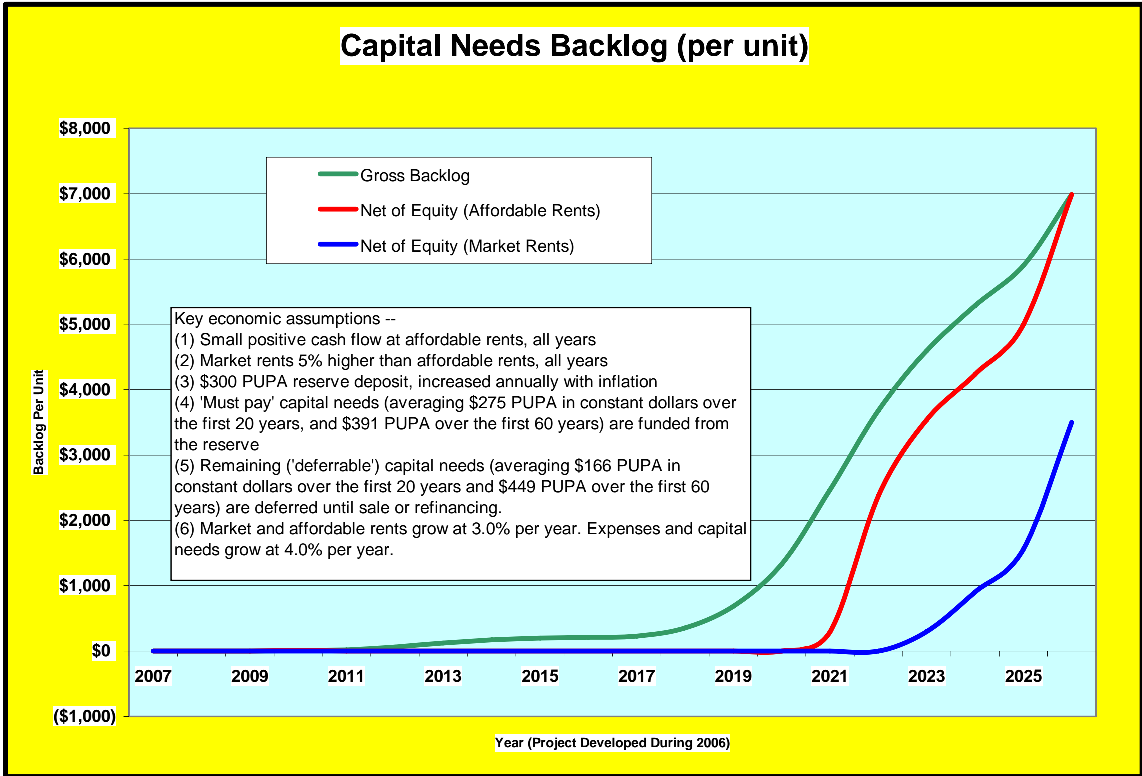
[18] That is, the total of rent and tenant-paid utilities is limited to no more than 30 percent of 60 percent of area median income, and occupants may not have incomes higher than 60 percent of AMI.

[19] Estimates were developed for the Millennial Housing Commission by Mr. Wilkins, with invaluable advice from David Whiston of On-Site Insight.

- There is unlikely to be enough equity, if operations continue at affordable rents, to erase any significant portion of the capital needs backlog, unless the then current interest rates are materially lower than the actual interest rate on the first mortgage loan.
- The capital needs backlog roughly triples between years 20 and 30 (not graphed on the exhibit).

<u>Exhibit: Financial Simulation of Capital Needs Backlog</u>



Thus, a typical LIHTC property will need a capital infusion between years 15 and 20 in order to maintain physical and financial viability while continuing to provide affordable housing at LIHTC rents. Of course, results will vary considerably from property to property.

Financing Structures That May Make Recapitalization Difficult

Nor have LIHTC properties avoided entirely the issue of long-term tax side effects. Since the vast majority of LIHTC investors are businesses and, therefore, exempt from passive loss rules, they are allowed to book the excess depreciation losses of their LIHTC investments. Such owners may run into "exit tax" issues at the end of the LIHTC compliance period, and this

may complicate the property's future sale or recapitalization either as continued well-maintained affordable housing or as market-rate housing.

In addition, many LIHTC properties have been financed with large "soft debt"—accruing financing provided by a state and local government that "balloons" upon sale or refinancing. Localities and states may be reluctant to forgive or roll over their position at the end of the compliance period or when the property needs recapitalization.

Difficulty in Reaching Households with Extremely Low Incomes

Compared with the earlier subsidized rental production programs, LIHTC has a major shortcoming as an instrument of public policy. Because it has flat rents rather than percent-of-income rents, it does not easily reach households with extremely low incomes or incomes below the poverty line. Fortunately, there are ways of overcoming this problem without introducing the disadvantages of the earlier programs. The LIHTC subsidy can be made more explicitly part of a "split subsidy" approach, in which extremely low-income families have housing vouchers and LIHTC developments are among the rental housing options available to voucher families.

This does not mean that all LIHTC units should be occupied by voucher-using extremely low-income families. An important virtue of the LIHTC program is that it lends itself to the creation of mixed-income housing, in which families with extremely low incomes live in the same development as families with incomes close to the 60 percent-of-median maximum that applies to most LIHTC developments.

This dual approach to rental housing assistance has the drawback that some subsidy dollars are spent on relatively less needy households. This is unavoidable, if mixed income housing is to be achieved within LIHTC developments and if LIHTC developments are to avoid the stigma (and the community resistance) that makes it hard to locate subsidized rental housing in places with low absolute rates of poverty and low minority rates relative to the metropolitan area.

Limited Information on What the Program is Accomplishing

On-budget subsidy programs are now squarely in the world of performance measurement and reporting. The LIHTC program, in contrast, as a tax provision, has no mandate to report

periodically (or ever) on the public policy purposes it is achieving that go beyond narrow compliance with the rules for household eligibility and maximum rents.

For example, LIHTC units that are large enough to house families with children have been located in low poverty areas in numbers that compare favorably with earlier property-based programs and, indeed, with the voucher program [Khadduri, Buron, and Climaco 2006]. What we do not know is the extent to which the program is creating mixed income housing, because of the paucity of information on who actually lives in the LIHTC units. We have an old GAO study and a few case studies, also old [GAO 1997, 1999, Buron, et al. 2000]. We have some information that results from address matching between LIHTC developments and vouchers [Climaco et al. 2006]. Without more information, we do not know whether voucher allocations need to be tied explicitly to new LIHTC developments.

Related to the limited information on the program is limited debate about what the program should accomplish. While the competitive nature of the program and the flexibility of the Qualified Allocation Plans make it possible for states to apply changing priorities, this does not necessarily mean that states have made choices consonant with the basic case for property-based assistance as we have articulated it. There is little evidence that states have favored systematically housing for large families or individuals with special needs, or housing in low poverty, low minority locations [Climaco et al. 2006; Khadduri, Buron, and Climaco, 2006]. The tendency common to block grant-like programs to spread the money around broadly—in this case, around the state--almost certainly means that a substantial number of LIHTC units have been developed—or LIHTC has been used for housing preservation--in areas that have an adequate supply of housing that can be reached with tenant-based vouchers.

5. Lessons for the Future

In this section we draw on what we have learned from the problems of pre-LIHTC programs, the accomplishments of preservation programs, and the advantages and shortcomings of LIHTC to attempt to provide a road map going forward. We first set forth some general concepts about what to do in the design of a property-based subsidy program. We then propose some changes to the federal rules governing the LIHTC program that would improve its design in the light of those concepts. Finally, we lay out some principles that should be followed by

state officials who make preservation decisions within the LIHTC program or federal officials charged with determining the future of the assisted housing stock.

5.1 How to Design Property-based Rental Subsidy Programs

If we were designing a new property-based rental subsidy, it would incorporate the following features:

The program would permit rents close to market-determined rents, and it would not include financial incentives or selection preferences that favor lower rents. Many of the problems with the pre-LIHTC programs stemmed from the lack of connection between management of the properties and market-based competition for tenants. Rents close to the market both maintain competitive pressures for managing the property well and discourage the development of rental housing in neighborhoods in which people with choices would not choose to live.

The program would use a split subsidy approach to reach poor people who cannot afford rents close to the market, by combining a supply of new or redeveloped housing at rents around the middle of the housing market with adequate funding of demand-side housing vouchers.

The rules for selecting properties to receive the subsidy would mirror the basic purposes of property-based subsidized rental housing that we described in the first section of this paper. The rules would:

- Avoid the development of new affordable rental housing in sub-markets that already have an over-supply of housing.
- Favor housing for large families, either in small-sized developments or as parts of larger developments.
- Favor housing for special needs populations and encourage (or even require) agreements with other systems (e.g., state mental health systems) to provide funding for needed services.

- Favor housing in neighborhoods with low rates of poverty and outside areas of minority concentration.

The program would provide a built-in way of dealing with the increase in capital needs that will occur from year 10 to around year 30. One mechanism is front-end funding of substantial reserves (which could be held at the property level or by the funder). Another mechanism is debt that amortizes rapidly enough to permit refinancing of the property when needed to meet the property's capital needs.

The program would require a debt service coverage ratio (or, more to the point, operating expense cushion[20]) high enough to withstand income/expense shocks—e.g., short-term spikes in rent loss (e.g., vacancies from supply/demand imbalance in the local market, bad debt loss, concessions) and in operating costs (e.g., insurance, utilities).

The program would provide a more flexible way of changing ownership and management. Ownership capacity rises and falls, regardless of organizational size and maturity. The same is true of management capacity. The result is that properties need an efficient, low-cost means of swapping out sponsors desiring to exit (or who must exit because of program violations or simple lack of attention) and swapping in better providers, without requiring a real estate transfer or acceleration of financing (whether public or private).

The program's affordability restrictions would survive financial failure of the property. The restrictions would be in a covenant running with the land and separate from the property's mortgage, which would make them foreclosure-proof.

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[20] HUD's Mark-to-Market program introduced an important conceptual innovation: the operating expense cushion. This measurement is calculated by dividing cash flow after debt service by total operating expenses. The resulting percentage is the increase in operating expenses that the property could sustain without incurring negative cash flow. Compared to the traditional debt service coverage ratio, the operating expense cushion is a more direct way of measuring the ability of a property to withstand economic shocks and is particularly appropriate in affordable rental housing that often has minimal debt service.

The program would include a formal option, held by government, for long-term preservation. This could be structured as a right (assignable to a purchaser) to purchase the property at the time the affordability restrictions expire. For example, a structure that provided for an option price that is not lower than outstanding debt, and not higher than the appraised value of the property assuming continuation of the affordability requirements, would provide incentives for good ownership and management while still keeping the option price reasonable from a public-purpose viewpoint.

5.2 Potential LIHTC Policy Changes

The LIHTC program already exists, has been quite successful, and has many positive features, not the least of which is its high level of support from lawmakers in an era of severe budget cuts for on-budget domestic programs. Another attractive feature is the flexibility built into its administration by the states. While keeping in mind these positive features, we offer the following proposals for changes to the federal rules governing the LIHTC program.

Eliminate the Concept of "Qualified Basis" and the Associated "Basis Boost" For Qualified Census Tracts and Difficult Development Areas

Presently, LIHTCs are limited to a formula based on the proportion of development costs that are eligible to be depreciated under the Internal Revenue Code. Instead, we believe that Congress should allow States to allocate LIHTCs to applicants without regard to "qualified basis," in accordance with the State's determination of the public-purpose benefits of each proposed project. States could choose to allocate LIHTCs based on total development costs or using any other reasonable approach developed with the benefit of public comment under the existing Qualified Allocation Plan process. Under this approach, some developments would receive more LIHTCs than under the current approach, and others would receive less, in accordance with each development's public-purpose benefits.

In addition to the obvious problem of creating enormous complexity, limitation of the LIHTC to qualified basis has at least two additional perverse consequences. First, it creates a powerful incentive to maximize investments in eligible basis (for example, construction and rehabilitation). This is controlled to some extent by the competitive nature of LIHTC

allocations, but the extent to which state reviewers of applications have the capacity to question the construction costs needed by a project is not clear.

Second, it creates a powerful disincentive for investments that do not constitute eligible basis: prominently, land. This makes it more difficult to site LIHTC properties on high-value land--for example, along transportation corridors in accord with smart-growth principles or in neighborhoods difficult to reach with vouchers.

Congress recognized some of the problems with the current approach by creating the additional "basis boost" of up to 30 percent for developments located in Qualified Census Tracts (QCTs) and Difficult Development Areas (DDAs) to allow for more LIHTCs in areas in which development costs are presumed to be higher than normal. Allocating directly would include repeal of both the DDA and the Qualified Census Tract (QCT) "basis boost." This would have the further advantage of removing an incentive currently in the program for locating LIHTC units in high poverty areas. (QCTs by definition are high-poverty neighborhoods).

QCTs and DDAs were intended to make it possible to write down rents further in areas where prospective tenants would not have sufficient income to afford LIHTC maximum rents. Providing tenant-based vouchers that make it possible for households with extremely low incomes to pay LIHTC rents set a the maximum is a superior way of handling that issue, because it does not lock real estate (and its residents) into high poverty neighborhoods. We believe that LIHTC developments should be located in high poverty areas only if the development of subsidized rental housing is part of a comprehensive neighborhood revitalization effort with a realistic chance of success.

An argument against making land costs eligible for the LIHTC is that developers could claim the credit on inflated land prices based on "sweetheart" deals, especially if repeal of "qualified basis" were combined with repeal of the "ten year rule,"[21] another change to the federal LIHTC rules worthy of consideration. The ten-year rule is intended to prevent "churning," that is, multiple transactions on a single property. However, it may be desirable to invest LIHTCs in properties that have changed hands in the prior ten years, as these properties may be in locations in which it is difficult for low-income households to use vouchers.

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[21] IRC 42.d.2.B.ii.

If "qualified basis" and the "ten-year rule" are repealed, it may be necessary to substitute federal rules that require attention to the land transaction to ensure that it reflects a fair market price.

Removing the link between LIHTCs and basis in the allocated "9 percent" LIHTCs should be accompanied by similar changes to the "4 percent" LIHTCs that accompany tax-exempt bond financing. One example of such a change would be to allocate annually to each State a dollar amount of 4 percent LIHTCs that corresponds to the amount of the State's tax-exempt bond authority; States could then use the existing Qualified Allocation Plan process to develop a method for awarding those LIHTCs to tax-exempt-bond-financed developments. Some such developments would receive more LIHTCs than under the current system, and others would receive less.

Make it Easier to Use LIHTC in Combination with Other Subsidies

The first of these changes would simplify the administration of the program by reducing or eliminating conflicting requirements when LIHTC is used in conjunction with (in particular) HOME and CDBG. One approach has been termed "hierarchy of compliance;" in this approach, HOME and CDBG compliance would be deemed to have occurred if LIHTC compliance were maintained. Another is to create a universal set of compliance requirements that would be deemed to satisfy all three programs.

A more far-reaching change would repeal the provisions that penalize the use of the LIHTC in conjunction with other federal funds.[22] The original concept was that the LIHTC alone should be sufficient to cover the gap between the project's development costs and the rents available to retire debt and pay for operations. This clearly is not the case when today it is normal for LIHTC developments to have as many as six sources of funds. The LIHTC is a finite resource for which there is stiff competition. In keeping with the block grant-like nature of the program, states should be charged with limiting total subsidies to the level necessary to carry out each project.

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[22] IRC 42.b.1.B.i.

Require States to Assess the Need for LIHTC Developments in the Context of a Mixed System That Also Includes Housing Vouchers

The federal LIHTC legislation includes many mandates for the content of QAPs, some of which operate at cross purposes [Gustafson and Walker 2002]. These mandates should be recast to relate more explicitly to the fundamental reasons for having property-based subsidized rental housing and to use tenant-based vouchers as a benchmark against which allocating agencies make the choice to invest their limited LIHTC resource in particular properties.

For example, QAPs should favor those areas within a state in that have low rental vacancy rates, high rates of population growth, and Housing Choice Voucher programs with low rates of success for families trying to use tenant-based rental assistance. QAPs should encourage developments in portions of metropolitan areas where market rents are out of reach of families with vouchers—that is, where most rents are higher than the voucher program's payment standards. QAPs also should favor LIHTC developments in which some or all units are combined with services for special needs populations.

Sustain and Increase Appropriations for Housing Choice Vouchers and Overcome Barriers to Their Use in LIHTC Properties

Currently, many LIHTC properties have residents who use vouchers, but many do not [Climaco et al. 2006]. The federal government—and the states—should learn more about the extent to which vouchers are used in LIHTC properties, the characteristics of the households using them, and the reasons that some LIHTC properties do not have vouchers in use (e.g., rents may be low enough that vouchers are not needed, lack of information may prevent voucher-holders from learning about LIHTC properties, LIHTC rents may be greater than local voucher payment standard, owners may be violating the rule that prohibits discrimination against voucher users).

This learning should be part of a more general congressional mandate for states to report on their use of LIHTC and to evaluate whether their LIHTC properties are serving specified public purposes.

Require the Use Restriction to Be Structured in a Way That Survives Foreclosure

The federal rules than govern the LIHTC should require the Land Use Restriction Agreement ("LURA") to be a covenant running with the land that will survive foreclosure. Consistent with the general principle that private lenders and equity providers (and not the government) should take all economic risks in the LIHTC program, Congress should require that the LIHTC LURA face no risk of cancellation in the event of a foreclosure. Some states already use this approach.

5.3 How Should Preservation Decisions Be Made?

We recommend that the following factors be taken into account when making a decision *whether to preserve* an expiring-use property for an additional (say) 20 years. These factors should be taken into account both by state officials deciding on the use of the LIHTC and by federal officials considering whether to sustain (or increase) subsidies for pre-LIHTC subsidized rental properties.

The Degree to Which the Property Provides Housing Opportunities Not Likely To Be Available To Families Trying To Use Household-Based Housing Vouchers

Given the difficulty of preserving affordable housing in the long term and the costs that must be incurred to preserve it, there is some threshold--when market alternatives are plentiful and likely to remain so--below which it makes no sense to preserve properties as rent restricted affordable housing. This is particularly the case when the resources that can be devoted to preservation are scarce, as they almost always are. Resources should instead be prioritized as suggested earlier in this paper – for example, to areas in which prevailing market rates exceed the voucher payment standard, and to areas experiencing high growth rates.

Even housing occupied by the elderly or by persons with disabilities may not need to be preserved as rent restricted housing if alternatives exist that are affordable to the same types of individuals when they use vouchers. Such properties may need to continue to have use restrictions only if they have specific physical features and/or non-housing services that are not present in other housing these populations might occupy.

The success rate of the local Voucher program is a good indicator of whether the property is needed.[23] When recipients of Housing Choice Vouchers have difficulty securing housing, preservation of existing successful affordable rental housing is indicated. The voucher success rate should be examined for rental units of different sizes. Large low-income families typically have more difficulty securing affordable housing than smaller families; thus, a property with three-bedroom and larger units usually is more worthy of preservation.

The Current Level of Demand for the Particular Type of Rental Unit or Property

For example, there may be little demand for 3rd floor, walk-up units or for efficiency apartments, even with affordable rents, suggesting that these units should not be preserved long-term as affordable housing. The history of rent loss for the property under consideration often is an indicator of the importance of preserving this particular property-based subsidized rental housing in this particular neighborhood.

Prevailing vacancy rates are one indication of the extent to which the local housing market already provides adequate opportunities for renters to use household-based assistance without the preservation of property-based subsidized rental housing. However, current high vacancy rates in a jurisdiction or a neighborhood may reflect the absorption of newly developed rental housing in high-growth areas [Belsky and Goodman 1995]. The assessment of need for preservation of the property should take into account the 1990, 2000 and most recent population data for the city, the county, and the neighborhood.

Quality of Ownership and Management (of the Current Team or the Proposed New Owner/Manager Team)

Relevant factors include compliance performance and operating performance in comparison to peer properties. If other factors make a property with a weak owner/manager team preservation-worthy, a transfer of ownership or management should be sought.

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[23] Voucher administrators are required to maintain data for reporting to HUD that make it possible to measure the rate at which families issued vouchers are able to use them.

The Level of Poverty in the Area

Potential indicators include level of poverty in the census tract.[24] Another possible indicator is the ratio between the median income of the census tract and the median income of the metro area. If the property is in a neighborhood with a low poverty rate, the preservation decision also should assess the degree to which the property is (or, as improved, can become) a positive resource for the community.

If the property is in a neighborhood with a high poverty rate, the property might still be worthy of preservation if it is part of a comprehensive neighborhood revitalization plan that has realistic expectations of being funded at sufficient scale to change fundamentally the character of the neighborhood.

The Cost to Make the Property Sustainable Compared To Alternative Uses of the Same Funds—For Example, To Preserve Other Properties or To Build or Rehabilitate Other Properties That Provide Affordable Housing

Commonly, the public costs to produce additional affordable rental housing via new construction are three to five times higher than those needed to preserve an existing affordable property. For example, work that one of the authors is performing for a State indicates that a typical expiring-use LIHTC property (for which the nonprofit general partner has an option to purchase at a favorable price) can be preserved at a public cost of roughly $10,000 per unit, while the level of public investment necessary to produce a new LIHTC unit significantly exceeds $100,000 per unit.

The Length of Time for Which the Property Can Be Made Truly Sustainable

Given how difficult it is to create new affordable rental housing, there is much interest in providing for very long-term preservation. However, a "set it and forget it" strategy (under which government would fund a property once, with the expectation of more or less permanent sustainability) has powerful practical drawbacks:

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[24] Most multi-family assisted properties do not *by themselves* dominate their census tracts, which typically have 3000-5000 people. Only 7.4 percent of multifamily assisted developments have more than 200 units, and 40.4 percent have fewer than 50 units.

- The difficulty of anticipating evolving markets. A property worth preserving today may not be worthy of continued preservation twenty years from now. Unit sizes, features and amenities will become sufficiently outdated that the property may no longer be worthy of preservation. The history of the public housing program—which, in effect, assumed permanent preservation—is instructive.
- The difficulty of anticipating capital needs past about twenty years. As a property's age approaches or exceeds 50 years since construction, ongoing capital needs will start to include very long-lived systems (for example, the need to tuck-point brick walls, to replace utility pipes inside the walls and under the ground, and to replace electrical wiring).
- The substantial cost of providing up-front funding for very long-term capital needs.

Experience demonstrates that properties benefit from a financing event—sale, refinancing, recapitalization, intra-partner transfer—roughly every fifteen to twenty years. Building financial flexibility into longer-term affordability schemes remains an ongoing policy challenge.

That said, a preservation structure that included a series of twenty-year governmental options to extend preservation, coupled with a "twenty year check-up" (and new subsidies) as each option matures, would be a good framework for long-term preservation.

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