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FEDERALLY SUBSIDIZED HOUSING  
PROGRAM BENEFITS

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FEDERALLY SUBSIDIZED HOUSING PROGRAM BENEFITS

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FEDERALLY SUBSIDIZED HOUSING PROGRAM BENEFITS

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## FEDERALLY SUBSIDIZED HOUSING PROGRAM BENEFITS

In his transmittal to the Congress of the Third Annual Report on National Housing Goals, the President noted: "The need to deal with inequities which arise when some families receive subsidies and others do not, the inevitable result of having to allocate scarce resources." The President went on to state that his Administration was committed to search for answers to the above and other housing problems.

Within the Congress, too, there has been concern about the aggregate size and distribution of the Federal housing subsidy costs and benefits. The subject can be expected to receive a thorough review during the next year or two, looking toward major legislative changes in the Federally subsidized housing programs. This paper presents an analysis of the distribution of housing subsidy benefits which may prove useful as the legislative process for review of the present housing subsidy system gains momentum.

There are various types of benefits which are realized from the Federally subsidized housing programs. In the first part of this paper, different concepts of benefits which may accrue to different participants in the subsidized housing program are identified. The second part of the paper develops some qualitative judgments as to the nature and recipients of benefits that evolved in connection with the rapid growth of subsidized housing. The last part of the paper is devoted to an examination of some of the major subsidized housing programs to identify the incidence of net program benefits.

Only those programs which involve a non-repayable government expenditure are treated as subsidized housing programs. Mortgage insurance and guaranty programs are excluded; they are supposed to be self-sustaining, and thus far, in the aggregate, they have been. No attempt is made to assess auxiliary social benefits of subsidized housing. Also, in dealing with the subsidized housing programs, the relatively minor amounts of expenditure for program administration will be ignored. The focus will be on housing assistance or subsidy payments intended to benefit low- and moderate-income occupants under the various programs.

In accounting for the benefits which are engendered by the programs under consideration, however, certain Federal tax exemptions that affect required payments for housing under the programs will be analyzed. Certain other tax benefits, which may be defined as a subsidy in the context of inducing a greater overall housing supply,<sup>1/</sup> will also be noted, although not a benefit that relates specifically to the subsidized programs. Such tax benefits (e.g. accelerated depreciation) have been enacted as an inducement for greater rental housing production, in general, rather than for greater production under Federal subsidy expenditure programs. Therefore, while the auxiliary tax benefits accruing to owners of subsidized rental housing do not enter into net benefits which flow from government spending under such programs, they should be noted as a benefit accruing to the housing owners.

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<sup>1/</sup> For a broader definition of subsidy in government programs see "Subsidy and Subsidy Effect Programs of the U.S. Government" by Julius W. Allen, Committee Print, Joint Economic Committee, U.S. Government Printing Office, Washington, D. C. 1965.

Concepts of Housing Subsidy

In the context of developing a methodology for comparing costs and benefits of Federally assisted housing programs, William Ross had concluded that the most useful concept of measuring benefits to the occupant of an assisted housing unit would be the difference between rent for "private housing of comparable quality" and rent paid by the occupant of the assisted unit.<sup>1/</sup> Monthly housing expenses can be substituted for rent, with due differentiation regarding an equity interest accumulation, in considering benefits in subsidized home ownership programs.

In arriving at differences between rent for comparable private market housing and assisted housing, the comparable private market rent data must be used with caution. As a practical matter, in this paper the full unsubsidized rent or monthly housing expenses established by FHA will be used in comparison with the rent or expenses paid by the occupants in a number of subsidized housing programs. It then becomes necessary to judge whether those full rents or monthly housing costs (or the house prices) exceed the costs for comparable private housing that is provided in the unsubsidized market. An obvious case of excessive cost of assisted housing was uncovered by a Congressional Committee in March 1971 in connection with existing homes sold to eligible buyers under the Section 235 home ownership program. It was found that FHA had been overappraising numerous homes by amounts of a few thousand dollars for each, so that real estate

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<sup>1/</sup> William B. Ross, "A Proposed Methodology for Comparing Federally Assisted Housing Programs" American Economic Review, May 1967, Papers and Proceedings of the Seventy-Ninth Annual Meeting of the American Economic Association, pp. 91-100.

speculators had been reaping substantial windfall benefits.<sup>1/</sup> In some instances fraud and bribery were involved. The Secretary of HUD, after looking into the matter, temporarily suspended the program for existing housing and took corrective measures before he reinstated it.

The foregoing illustrates in an extreme degree the incidence of benefits from government spending programs in housing which may go to other than the intended beneficiary, the housing occupant. It represents a flow of net benefits which go to a participant in the housing supply process as a result of procedures and mechanisms of program operation. Less apparent net benefits may accrue to housing input suppliers under legal program structures and procedures if the payments for their services, capital and material are greater than for comparable unsubsidized housing,<sup>2/</sup> or if they are greater than they might be under another form of subsidy-- for example direct loans at below market interest rates versus interest rate subsidies. These questions will be explored later in analyzing individual programs.

A broader conceptual question concerns the effect of the growth of the subsidized housing programs upon cost levels for housing production and financing. Have the additional demands for resources needed to support

<sup>1/</sup> See "Interim Report on HUD Investigation of Low and Moderate Income Housing Programs." Hearings before the Committee on Banking and Currency, House of Representatives, March 31, 1971.

<sup>2/</sup> Different regional and local distributions of subsidized and non-subsidized programs cause national program data to reflect different geographic variations in costs, as will be indicated in qualifications of comparisons developed at later points in this paper.

the increased housing production led to higher wages, materials prices, financing charges and profit margins which absorb part of the subsidy payments? The price levels for the various inputs (land, labor, materials, and financing) are responsive to many demands besides subsidized housing. General economic inflation and price rises will contribute to higher wage demands, for example, at the same time that housing production rises by virtue of the growth of Federally subsidized housing programs. Non-residential building activity is also an influential factor with respect to many of the cost elements affecting housing.

Nevertheless, there is undoubtedly some marginal housing cost and price effect because of the higher residential construction volume than would occur in the absence of the subsidized housing programs. It is not possible to measure with any precision the degree to which such price changes have occurred in response to multitudinous non-residential building and general economic demands, and as a result of increased unionization and administered pricing. Higher labor and materials costs for housing will be involved if a greater proportion of available resources is to be attracted to increase housing production, unless there are offsetting influences through decreases in other demands or cost reductions due to technological advances and volume production. Some judgments can be made as to the types of effects upon materials and labor input costs induced by subsidized housing program activity, by examining cost levels associated with the growth of program activity, and broader economic influences during the same time period.



The question of land price increases associated with the growth of subsidized housing programs may be somewhat more measurable from program statistics. Thurow has written that "any plan designed to stimulate housing demand will tend to be self defeating. ... The subsidies become capitalized into the value of the land and policies that were designed to increase the supply of housing simply end up increasing the price of land." He also points out that a part of the subsidy, proportional to the land-to-housing cost ratio, simply transfers an existing resource from one owner to another. He raises a question: whether the benefits from increased land values should be allowed to accrue to present owner or whether they should be taxed away.<sup>1/</sup> The amount of land capital gain is a question of measurement, insofar as data will permit. The point that only transfer of an existing resource is accomplished might also be raised about transfers of available labor and materials resources at their market prices at a given point in time. If a distinction is made on the basis that land value has increased without productive effort by the owner, and land value increments are taxed away, such policies should be applicable to all land holdings, not just to sites for subsidized housing.<sup>2/</sup>

<sup>1/</sup> Lester C. Thurow, "Goals of a Housing Program" in Papers submitted to the Subcommittee on Housing Panels, Committee on Banking and Currency House of Representatives, June 1971, Part 2, p. 447.

<sup>2/</sup> Also, in order to cushion the impact of a large one-time tax upon current land value, it would probably be desirable to introduce land value taxation gradually over a number of years.

The form of interest rate subsidies inherent in the housing programs may cause a flow of net benefits in favor of lenders and savers, when compared with the return to them under possible alternative methods of program organization and subsidization.

Finally, how much of a net benefit accrues to the homebuilder as a consequence of the subsidized housing program volume? Are the profits greater than they would have been in the absence of such programs? Do they result in such volume and increased profit margin as to constitute a greater return than is commensurate with the effort and risk involved?

#### Subsidized Housing Production and Prices

The incidence of the foregoing specific types of net benefits can best be estimated for individual programs, because of differences in benefit payment formulas. However, the effects upon input price levels which absorb subsidies also have to be considered in terms of changes in the aggregated activity of housing programs involving government spending. In a sense, the several programs constitute a collective government program to provide low- and moderate-income housing, and they have a collective impact upon the demand for input resources required in housing production.

Four major continuing programs have provided the bulk of the subsidized new housing production: the HUD Section 235 and Farmers Home Administration home ownership programs; the low-rent public housing program and the Section 236 moderate income private rental housing program.

There are a number of older assisted housing programs which are presently inactive or being phased out.<sup>1/</sup> They will not be examined individually, but their program activity levels will be included in considering the collective impact of the change in assisted new housing program activity upon input cost factors and net benefit distribution.

In the past four fiscal years, the annual volume of new housing units started under the Federally-assisted housing programs has increased significantly, from 126,000 in fiscal 1968 to an estimated 438,000 in fiscal 1971. Over the same period, as a proportion of total new housing starts, the Federally subsidized program starts rose from 8 percent to 25 percent. The most substantial increases occurred in the last two fiscal years, ending June 30, 1970 and June 30, 1971, when the total subsidized new unit starts were 302,000 and 438,000, respectively, and accounted for 21 and 25 percent of total new housing starts. (See table 1.)

During the first of those two years, in fiscal 1970, unsubsidized housing starts declined drastically (in response to tight money conditions) and total new housing starts declined by 15 percent. However, nonresidential building volume was 7 percent greater than in the preceding 12 months.<sup>2/</sup> General inflationary forces were strong, as reflected in a 6 percent rise in the Consumer Price Index. The Boeckh indexes of

<sup>1/</sup> These include the Section 22(d)(3) below-market interest rate moderate income rental housing program and the Section 202 direct loan rental housing for the elderly program--both financed with 3 percent interest rate loans; and the rent supplement low-income, private rental housing program financed with market rate FHA-insured mortgages.

<sup>2/</sup> U.S. Department of Commerce, Bureau of Domestic Commerce. Based on new construction put in place in constant dollars, Construction Review, monthly issues.

construction costs rose about 6 percent for nonresidential buildings, but only 3 percent for residential. The rise in the latter index was limited by a significant decline in lumber prices, following an upsurge in the preceding twelve months. Prices of materials less sensitive to homebuilding activity levels and building construction labor wage rates rose significantly, with wage rates rising more than materials prices. On balance, the rise in residential building construction costs in fiscal 1970 would seem to be related primarily to nonresidential building and general economic inflationary influences, rather than to the growth of the subsidized housing programs, although that growth probably had some marginal effect.

In fiscal year 1971, the unsubsidized component of new housing starts rose 28 percent and combined with a 45 percent increase in the subsidized housing starts for about a one-third rise in total starts. In contrast with a gain in the preceding fiscal year, non-residential building volume (in constant dollars) declined by about 13 percent.<sup>1/</sup> The Consumer Price Index rose by only 5 percent, compared with 6 percent in the preceding twelve months. Over the fiscal year, however, the Boeckh construction cost indexes rose by about 8 percent for residences and about 9 percent for other types of buildings.<sup>2/</sup> In contrast with fiscal 1970, there was an upsurge in lumber prices as housing construction rose sharply in the

<sup>1/</sup> Department of Commerce. Construction Review, July 1971, Table A-2 fiscal 1971 estimated on the basis of figures for first 11 months.

<sup>2/</sup> HUD-Housing and Urban Development Trends.

Table 1.

Total and Federally-Assisted Housing Program Starts  
Fiscal Years 1968-71

(in thousands of units)

<u>Fiscal Year</u>	<u>Total Housing Starts</u>	<u>Federally-assisted Housing Program Starts Number</u>	<u>As Percent of total starts</u>
1968	1,460	126	8
1969	1,600	163	10
1970	1,359	302	21
1971	1,791	438	25

Sources: 1968-70. Second and Third Annual Reports on National Housing Goals; 1971 estimated on the basis of preliminary data from HUD and Farmers Home Administration.

second half of fiscal 1971. There was also a 9 to 10 percent increase in hourly earnings of all workers in contract construction.<sup>1/</sup>

Data for fiscal 1971 indicate a stronger influence of the subsidized housing construction than in fiscal 1970 in leading to a rise in residential construction costs. A rough approximation of this influence might be based on the assumption that, without the rise in residential construction occasioned by the increase in subsidized housing, residential construction costs would not have risen more than the general price level, as reflected in the Consumer Price Index, or only about 5 percent instead of 7.5 percent. That would mean that roughly 2½ percent of the cost would be due to the incidence of the subsidized housing. It would represent incremental compensation to the labor and material input suppliers to reallocate more resources to housing production. Under the subsidized housing programs, since the occupant's required debt service or rental payments are generally a fixed percentage of his income, the amortization of the increased cost requires an increase in subsidy which represents a transfer inducement payment to the labor and materials suppliers. The higher labor and material costs were necessary for reallocation of resources to produce more housing. The change in cost levels did not represent an added cost only for subsidized housing, but for all housing. Therefore, to the extent that subsidies had to be increased to cover increased production costs for comparable private housing, the

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<sup>1/</sup> Estimated on the basis of data for 11 months from Department of Labor, published in Department of Commerce Construction Review for July 1971, Table G-4.

dollar amount of benefit to the subsidized housing occupant was being increased. Whether certain component costs of housing increased more for subsidized housing than for other housing can be judged in the context of selected individual program analyses.

Section 235(i) Home Ownership Assistance Program

The HUD Section 235 homeownership program was enacted in 1968.

An estimated 140,000 units started in fiscal year 1971 were sold with Section 235 financing. To be eligible for purchase of a home and subsidy benefits under the 235 program, a family's adjusted income generally may not exceed 135 percent of local public housing admission limits. Under an alternative income limit formula, 20 percent of the subsidy funds may be used for somewhat higher income families. The adjusted annual income is the gross income minus 5 percent of income of adults and \$300 per minor, exclusive of all incomes of minors.

An eligible buyer purchases a home with a private FHA-insured mortgage bearing the prevailing rate of interest, currently 7 percent. A monthly assistance payment, made on his behalf by HUD, is the lesser of either (a) the difference between 20 percent of monthly adjusted income and the required monthly payment (for principal, interest, mortgage insurance premium, hazard insurance and property taxes); or, (b) the total monthly debt service (excluding hazard insurance and property taxes) and the monthly principal and interest obligation at a 1 percent interest rate.

Although up to 30 percent of the subsidy funds may be used to assist purchasers of existing homes, the Section 235 program has become primarily a new home program. New homes accounted for about 84 and 89 percent, respectively of homes financed under the program in the last quarter of 1970 and the first quarter of 1971.<sup>1/</sup> Furthermore, new homes built under Section 235 have become the dominant new 1-4 family home program financed with FHA-insured mortgages. They accounted for 13 percent of the FHA new home units in 1969, 64 percent in 1970 and 71 percent in the first quarter of 1971.<sup>2/</sup> Consequently, certain inferences about effects of the Section 235 program may be drawn from time series for all new homes sold with FHA-insured mortgages during 1970-71, as well as from program data.

Most of the available data are national data, so that comparisons of cost components for subsidized versus non-subsidized housing may be affected by differences in the geographic distribution of units produced under the two programs being compared. There would probably be differences in the cost comparisons were the cost elements for subsidized and non-subsidized housing available for a smaller geographic area with relatively uniform component costs.

An element of cost for identical areas was compared by looking at land costs for new homes under Section 235 and under the regular non-subsidized FHA Section 203 mortgage insurance program. Sample data on

<sup>1/</sup> Based on information in HUD-FHA quarterly reports on "Characteristics of Home Mortgage Transactions Insured by FHA under Section 235(i)."

<sup>2/</sup> Ibid., and FHA Monthly Reports of Operations (301 reports).



the cost per square foot of the improved site under both programs was obtained for the first quarter of 1970 and the first quarter of 1971 for 45 SMSA's in which there had been new home construction activity over this year of rapid growth in Section 235 activities. Under that program, the price of the site, per square foot, had increased in 29 places, decreased in 12 and showed no change in 4; under the 203 program it had increased in 30 places, decreased in 14 and showed no change in 1. The direction of change was the same in 27 of the 40 areas for which there were changes under both programs. Of the 13 areas for which the square foot prices moved in opposite directions, in 8 prices increased under the Section 235 program, and in five under the Section 203 program. In the great majority of places, land used for Section 203 homes was significantly more expensive than for Section 235 homes in the first quarter of 1970 and also in the first quarter of 1971, although the differences were narrowed during the year in many places.

The use of more expensive land for new homes financed under Section 203 than for those financed under Section 235 is also reflected in annual data for 1970. The average cost per square foot was 39 cents for Section 235 homesites and 84 cents for Section 203 homesites.

The average lot size for the subsidized Section 235 homes in 1970 was actually larger than for the 203 homes--9,849 square feet versus 8,851 square feet.<sup>1/</sup> Apparently, as phrased in an FHA report summarizing

<sup>1/</sup> FHA reports - "Trends of Home Mortgages Insured Section 203(b) and "Specific Characteristics by Total Acquisition Cost, New 1-Family Occupant Purchase Homes, 235(i), 1970."

the 1970 Section 235 new and existing home activity, "the new homes were more often in the less urbanized locations."<sup>1/</sup> Also, within SMSA's the new Section 235 homes were probably on cheaper more outlying land than the Section 203 homes.

From all of the foregoing, it would appear that the Section 235 program activity had spurred a greater utilization of cheaper, probably more outlying land (for the limited price homes that could be built under the program) than has been used for new unsubsidized 1-family homes. The statutory mortgage limits, which also establish practical home price limits, have tended to keep prices of land for Section 235 new homes relatively low. The home purchasers receive a decent sized lot--and probably will benefit from future appreciation in land values. Whether the sellers and developers of the Section 235 lots are benefitting from unduly high land values cannot be ascertained in the absence of recent year data on land value for comparable sites in specific localities. However, an average Section 235 new homes site-to-value ratio of 17 percent in 1970, compared with 21 percent for new Section 203 homes, indicates that if land values have increased in response to Section 235 activity, they have risen to a comparatively reasonable level in relation to the value of the house. Although there may be individual area exceptions, the data do not indicate that a significant capitalization of subsidy into higher land values had occurred under Section 235 by 1970.

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<sup>1/</sup> FHA "Statistical Highlights" of the 235 program in 1970.

On the other hand, 1970 data on the sales price per square foot of living area, after land cost is eliminated, would suggest that higher profit margins may be entering into 235 home sales than prevail for comparable Section 203 unsubsidized housing. The average square foot sales data for all 235 and all 203 new homes are not comparable because the Section 235 homes had an average of only 1,017 square feet of living area and the 203 home had an average of 1,267 square feet, almost one-fourth more. The square foot cost is partly a function of size, tending to go down with increased size which permits the cost of kitchens and bathrooms, and their equipment, to be spread over a larger area.

The average sales price of a new Section 203 unsubsidized home in 1970 was \$23,056, and the living area square foot sales price, exclusive of the cost of land, was \$14.15. The comparable average square foot sales price was \$15.00 for new homes in the upper-end interval of the Section 235 price distribution, where the average sales price was \$23,313. In the next lower Section 235 price interval, with an average sales price of \$20,233, the comparable square foot sales price, excluding land, was \$14.90.<sup>1/</sup> The differences are, no doubt, in part a result of the smaller size of the Section 235 homes, averaging 1,160 and 1,128 square feet in the two price intervals cited, compared with 1,267 square feet for the Section 203 homes. In comparing homes of roughly the same price ranges, however, a 9 to 10 percent smaller living area indicates a higher price for equivalent housing.

<sup>1/</sup> Calculated from data in FHA reports - Trends of Home Mortgage Characteristics - Mortgages Insured - Section 203(b) "and Specific Characteristics by Total Acquisition Costs, New 1-Family Occupant Purchase Homes, 235(i), 1970."

A higher square foot cost of Section 235 than comparable nonsubsidized housing is also indicated by Census data for all new homes sold in 1970. About 80 percent of the FHA-insured homes sold in the \$15,000 to \$20,000 price range were Section 235 homes whose characteristics were reflected in all FHA-insured homes in that price range.<sup>1/</sup> The Census data on average price per square foot, excluding value of the improved lot, for homes sold in the \$15,000 to \$20,000 price class in 1970, showed the following by different types of financing:<sup>2/</sup>

FHA-insured.....	\$12.90
VA-guaranteed.....	12.20
Conventional.....	12.80

The higher Section 235 square foot costs than for other homes in the same price bracket might be explained by either (1) locations in higher construction cost areas, (2) greater amenities, or (3) higher profit margins.

The Section 235 homes did not entail higher construction costs. They are generally located in less-urbanized, lower-rent areas than Section 203 homes,<sup>3/</sup> and probably in lower-cost areas than most conventional homes. New homes sold in the \$15,000-\$20,000 price class were

- <sup>1/</sup> Ibid. About 64 percent of all new homes financed with FHA-insured mortgages in 1970 were under Section 235 and about 2/3 of those were in the \$15,000-\$20,000 price class, but only about 30 percent of the non-subsidized new homes under FHA programs were in that price bracket.
- <sup>2/</sup> Department of Commerce, Bureau of Census - HUD, "Characteristics of New One Family Homes: 1970", Table 39.
- <sup>3/</sup> 30 percent of Section 235, but only 14 percent of Section 203, FHA new home commitments in 1970 were located in six southern states (S. Carolina, Georgia, Florida, Alabama, Louisiana and Mississippi.)

71 percent financed with FHA-insured mortgages<sup>1/</sup> (primarily under Section 235), and roughly 60 percent of the new homes in that price bracket were in the South,<sup>2/</sup> which is a relatively low construction cost region.

As far as amenities are concerned, among Section 235 homes, only 14 percent were centrally air conditioned--although the ratio was 17 to 21 percent in some of the upper-price brackets, but 30 percent of all Section 203 homes were centrally air-conditioned. Over 77 percent of all the Section 203 homes had more than 1 bathroom, a ratio matched by 235 homes only in the highest income bracket, but among all Section 235 new homes in 1970, only 39 percent had more than 1 bathroom. Garages were included with 58 percent of all Section 203 homes, but only 40 percent of all 235 homes, although the comparable ratios were 45 and 49 percent in some of the upper-price brackets. A higher proportion of 235 than 203 homes had basements, 22 percent versus 17 percent. On balance, it would appear that higher square foot costs do not reflect greater amenities in Section 235 than 203 homes; in fact the amenities provided are probably less and entail a lower cost for a house of a given size.

The data suggest, therefore, that higher square foot living area prices produce a relatively higher profit margin in Section 235 new homes sales than in the sale of comparable non-subsidized homes.

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<sup>1/</sup> Ibid. Table 42.

<sup>2/</sup> Ibid. Table 68.

Based on comparing the sales price per square foot of living area (exclusive of land cost) for roughly comparable price brackets, the builder of Section 235 homes may have a profit that is greater by about 5 percent of the non-land sales price or 4 percent of total sales price. This is expected due to the greater saleability of a substantially subsidized home, (which also enhances the profit margin through lower construction financing interest costs).

The greater saleability is corroborated by the reported selling time of new homes by type of financing. In the 1968-early 1969 the average time from start to sale for a new home financed with an FHA-insured loan was about one-half month less than for a home financed with VA-guaranteed loan and about one month less than for a home financed with a conventional loan. The FHA faster selling advantage has increased over the past two years. By the 1970-early 1971, the FHA-insured home selling time was averaging about 1 1/2 months less than for homes with VA-guaranteed financing and about 2 1/2 months less than for conventionally financed homes. For homes completed before 1970, the time from completion to sale had become less than 1 month for those with FHA-insured financing, over 2 months for those with VA-guaranteed loans and 3 to 3 months for conventionally financed homes.<sup>2/</sup> The average savings in construction financing interest would probably be about 1/2 of 1 percent of the total cost, a net benefit of the program which is not reflected in the selling price or subsidy, but is realized by the builder.

<sup>1/</sup>Sales prices of \$14.90 to \$15.00 per square foot exclusive of land for Section 235 homes in the \$20,000-\$23,000 price range, versus \$14.15 for Section 203 homes with an average price of \$23,056; all figures for 1970.

<sup>2/</sup>Department of Commerce, Bureau of Census and HUD, "Sales of New One-Family Homes," C-25 Construction Reports, March 1970 and June 1971.



The median monthly subsidy for a new home buyer under Section 235 was \$77 during 1970 and it had gone up to \$81 by the first quarter of 1971.<sup>1/</sup> These amounts represented about 47 percent of the regular total monthly payment. The regular total monthly payment was divided about as follows:<sup>2/</sup>

- 78 percent for mortgage principal and interest
- 5 percent for mortgage insurance premium
- 3 percent for hazard insurance
- 14 percent for real estate taxes.

The mortgage amount to be amortized is essentially the sales price in Section 235 cases. Since mortgage debt service absorbs three-fourths of the subsidy, the higher selling price of about 4 percent than for comparable non-subsidized housing means that about 3 percent of the subsidy payment represents a net benefit to the builder-seller. The rest (i.e. 97 percent) is a net benefit to the homeowner.

However, the entire subsidy may be greater than the cash payment. The Internal Revenue Service now has under consideration, the question of whether an owner of a subsidized home may deduct the full mortgage interest on the mortgage and the full real estate taxes from his income for Federal income tax purposes, even though close to one-half of those expenditures are covered by subsidy. For the median income, median-family size Section 235 homeowner, the deductions for that part of interest and property taxes paid by subsidy would be worth about an additional \$10 per month.

<sup>1/</sup> FHA annual and quarterly reports on characteristics of transactions and profiles of homebuyers.

<sup>2/</sup> Based on preliminary data provided by FHA".

This would be for a family of 4 with an annual income of \$6,150 who would be in the 16 percent marginal income tax bracket. About 84 percent of Section 235 homebuyers in the first quarter of 1971 had incomes of between \$3,600 and \$7,200.

If that additional subsidy benefit is allowed, and if the interest rate form of subsidy is accepted as a "given", it would appear from the foregoing that 97 to 98 percent of the Section 235 subsidy benefits accrue to the homeowner. That conclusion has to be modified, however, if direct loans are considered as a possible alternative method. Direct loans would be made with funds borrowed by the Treasury so that the basic interest cost might be reduced to a 6 percent rate (on Treasury obligations) instead of an effective mortgage interest rate of  $7\frac{1}{2}$  to 8 percent. Although the FHA ceiling mortgage interest rate presently is 7 percent, the payment of discount points brings the effective rate up to about  $7\text{-}3/4$  percent. Furthermore, between one-fourth and one-half of the discount point payments are being absorbed by the Government National Mortgage Association under its "tandem plan",<sup>1/</sup> providing an additional subsidy. In effect, the government presently is subsidizing an interest difference between  $7\frac{1}{2}$  or  $7\text{-}3/4$  and 1 percent, or providing an interest rate subsidy of about  $6\frac{1}{2}$  percent. Under a direct loan program the difference would be between 6 percent and 1 percent, or 5 percent, about 23 percent less. Since about 84 percent

<sup>1/</sup> Under this plan, GNMA issues a commitment to purchase the Section 235 mortgage at 97. At the same time it obtains a commitment from FNMA for the latter to buy its mortgage at its secondary market "free auction" price. The latter prices have been at 94-96 for the bulk of the 7 percent 235 mortgages. GNMA absorbs the difference, using authorized special assistance funds.



of the mortgage debt service in the first five years of a 30-year 7 percent loan goes to interest, that proportion or about 66 percent of the (78 percent) of cash subsidy toward debt service is for interest, and 23 percent of that, or about 15 percent of the subsidy payment could be looked upon as a net benefit accruing to lenders and savers. Under that concept, only about 83 percent of the net benefits would be flowing to the homeowners. (The other 2 percent would accrue to the builders.)

Before leaving the Section 235 program, some differences between new home and existing home buyer benefits and characteristics should be noted.

In the first quarter of 1971, the monthly Section 235 subsidy was \$81 for a new home purchaser and \$75 for an existing home purchaser. There were also noteworthy differences between new and existing home purchasers. There was little difference in median gross annual income--\$6,155 for new home purchasers and \$6,089 for existing home purchasers. Significant demographic differences were indicated, however, by medians for age and size of family. Among new home buyers, the median age of head of family was 29 and the median number of persons was 4, compared with an age of 34 and 6 persons for existing home buyers. Also only 1 percent of the new home buyers, but 18 percent of the existing home buyers, had welfare assistance as their primary source of income. Finally, the new home median sales price was about \$17,900 (including closing costs), but the existing home sales price was about \$16,600. The median mortgagor share of the monthly payment was \$91 for new home buyers and \$89 for existing home buyers. The figures--particularly as to family size--suggest that

new home buyers were receiving greater qualitative benefits than existing home buyers in terms of housing acquired relative to housing needs.

Farmers Home Administration Section 502 Home Loans

The Farmers Home Administration Section 502 program, operating in rural areas (i.e. of up to 10,000 population) provided financing for between 90,000 and 100,000 home purchases in fiscal year 1971, about two-thirds being new homes. Low- and moderate-income families may purchase homes under income limits determined for local areas; subject to an established state adjusted income limit; the adjustment is the same as under Section 235 - \$300 per minor, plus 5 percent of income are deducted.

There are two layers of subsidy. A "thin layer" of subsidy is received indirectly by all home purchasers under the program through a below-market interest rate on the mortgage loans. Thus, during fiscal year 1971, the interest rate on the Section 502 mortgage loans was  $7\frac{1}{4}$  percent. These loans are insured but made directly by Farmers Home Administration, pending later sale to private investors. In borrowing money in the market for purposes of making the loans, Farmers Home Administration paid about  $8\text{-}\frac{3}{4}$  percent (issuing notes collateralized by the mortgages). Therefore, there was about a  $1\frac{1}{2}$  percent interest rate subsidy to all home purchasers that is made up from appropriations.<sup>1/</sup> In dollar terms, that subsidy amounted to about \$195 per year, or \$16 per month on a \$13,000 loan.

<sup>1/</sup> If the subsidy is measured as the difference between the interest rate that the homebuyer would have had to pay on an insured mortgage loan from a private lender and the  $7\frac{1}{4}$  percent that he paid, it would be a  $1\text{-}\frac{3}{4}$  to 2 percent interest rate subsidy.

In addition, about 38 percent of the Section 502-financed homes-- those of buyers with the lower incomes--also received an "interest credit" to reduce their effective interest rate to  $2\frac{1}{2}$  percent, adding an additional  $4\text{-}3/4$  percent interest rate subsidy for the lower one-third. The "interest credit" in dollar terms averaged about \$608 per year or \$51 per month on the average loan amount of about \$13,000. The "interest credit" is subject to reduction in later years if incomes of the borrowers rise.<sup>1/</sup>

For the one-third of Section 502 home purchasers who received both layers of subsidy, the initial total subsidy amounted to about \$800 per year, or \$66 per month. Few of the Section 502 home buyers would also be able to receive a tax benefit from an income deduction of interest paid by the Government. Their family size is larger than other home buyers and their median gross income is less than \$4,000, and 80 percent had incomes of under \$5,000.<sup>2/</sup> Their adjusted income after personal exemptions, therefore, would in most cases be below the minimum taxable amount for a joint return filed by a married couple.

There is little in the way of available unsubsidized housing cost data for comparison with costs of the Farmers Home Administration housing which is produced in small communities scattered across the country. The land costs probably are a relatively minor part of the total. The median square foot area is between 1100 and 1200 square feet, so that the per square foot sales price, including land, is about \$11.30. Since square

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<sup>1/</sup> Based on data provided by Farmers Home Administration.

<sup>2/</sup> Ibid.

foot costs of all new homes sold in calendar 1970, exclusive of land, averaged between \$13 and \$14,<sup>1/</sup> the \$11.30 appears to be relatively low. Judging from the available data, a major portion of the subsidy benefit would appear to accrue to the home buyer. However, the Section 502 homes are often in sparsely populated areas of relatively low market values, and data were not available on what they may have in the way of amenities, so that a judgment cannot be made as to whether any of the subsidy supports a greater sales price than would be prevalent in the absence of subsidy.

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<sup>1/</sup> Department of Commerce, Bureau of Census--HUD, "Characteristics of New One-Family Homes: 1970", Table 41, p. 89.

Rental Housing - The Section 236 Program

Section 236 is the rental housing counterpart of Section 235. The subsidy formula is similar, although the mechanics of subsidy payment are geared to a rental housing operation. A monthly housing assistance payment is made by HUD to the project owner on behalf of an eligible tenant. The established local income limit for eligibility is generally 135 percent of the local public housing admission income limit. The assistance payment may not exceed the lesser of (a) the difference between the FHA-established "market rent" based on the full mortgage interest rate (currently 7 percent) and rent based on a 1 percent mortgage interest rate; or (b) the difference between the "market rent" and 25 percent of the tenant's income.<sup>1/</sup>

There is a lack of adequate data to provide a basis for judgment whether the subsidy is supporting higher land or construction costs than would be entailed in the production of nonsubsidized comparable rental housing. A few observations can be developed from the data, and, perhaps more importantly, points in the production process which may lend themselves to sizeable gains can be identified.

Land costs per dwelling unit for Section 236 projects were considerably lower in 1970 than for non-subsidized FHA-Section 207 projects.

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<sup>1/</sup> A 25 percent proportion of income is required as a minimum rental payment, in contrast with 20 percent for the Section 235 homeowners payment toward housing expenses, because the homeowner separately must pay for maintenance, repair, fuel and utilities which are included in the rent.

The 236 median per-unit land cost was about 20 percent or \$200 lower than Section 207 for walk-ups, and more than 45 percent or \$830 lower for elevator apartments. Part of the explanation may be in the fact that the 207 units were larger, with a median size of 915 square feet, versus 815 square feet for the 236 units. The Section 207 units also, no doubt, had better locations which would make for higher land prices. That is suggested also by the fact that about 37 percent of the Section 207 units but only 11 percent of the Section 236 units were in elevator apartments which usually are built where land is expensive. Also the median ratio of land price to project replacement cost was close to 8 percent for Section 207 projects and about 5 percent for 236 projects. All of the foregoing evidence that higher per unit land costs were involved in Section 207 than in Section 236 projects in 1970. This may have been due to a different geographic location within the country as well as to differences in location within given metropolitan areas. There is no indication whether the land being used for Section 236 projects was priced higher than similar land in comparable locations in the same locality.

An examination was made of site costs per square foot for Section 236 projects built in the same metropolitan area to see whether the price had increased as the program progressed. Data for some twenty areas failed to indicate a definite pattern of increases.

The foregoing facts do not gainsay the observation that perhaps the greatest potential for gains in the development of multifamily housing--subsidized and nonsubsidized--is through land acquisition and revaluation.

The FHA estimate of the fair market value of the land, prior to construction of improvements, is added to development costs to make up the total project replacement cost. The latter amount serves as the basis for a 90 percent mortgage for the limited distribution sponsor,<sup>1/</sup> or a 100 percent mortgage for the nonprofit sponsor. The mortgage proceeds, therefore, can be the vehicle for realization of a significant gain in the value of the land above the true acquisition price of the land to the sponsor-builder of a limited distribution project, or to the builder or land developer who supplies land for a project sponsored by a nonprofit organization.

For income tax purposes the builder-sponsor of a limited distribution project will often have a separate corporation that acquires the raw land, gets it rezoned and then sells it to the builder-sponsor organization. Regardless of who handles the rezoning, that is a process by which the value of the land can be greatly enhanced. Suburban land in undeveloped or farm use, that does not have any residential zoning classification, might sell at prices in the range of \$500 to \$2,500 an acre and if zoned for 1-family residential in a range of \$2,500 to \$10,000 per acre. When rezoned to multifamily use, however, the land may take on a value of \$25,000-\$30,000 per acre for garden type apartments and \$40,000-\$50,000 per acre for high-rise apartments. It can be seen that, on a five acre site a value gain in

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<sup>1/</sup> A private sponsor whose annual distribution of cash dividends from rental income are limited to a 6 percent return on the equity investment, generally a limited partnership or a corporation.

the range of \$100,000-\$200,000 is quite possible. Not all of that will be pure profit since there are expenses involved in the rezoning proceedings, plus property taxes and mortgage interest to be paid while the land is held prior to development. However, the taxes and mortgage interest will be related to the pre-rezoning land value and will be slight compared with the gain to be realized. Also, if the pre-rezoning land-owning corporation holds the land at least 6 months and then sells it to the sponsor-builder, the gain is taxed at the lower capital gains tax rate, rather than at regular income tax rates.

Rezoning and a separate land acquisition corporation may not be necessary to get essentially the same effect if useable land can be picked up in a marginal location. Once the FHA accepts the land for a multifamily insured mortgage project, the land value is likely to be based on recent sales of land for comparable uses, with some allowance for difference in location. The greatly enhanced land value accrues, once the site is to be used for multifamily housing. It is necessary to carry the project through to construction completion and have a high loan-to-value ratio mortgage, however, in order to realize the gain in a relatively short time.

A potential for unusual gain during the construction stage also may be available to the builder-sponsor limited distribution corporation, and to a lesser extent to a builder acting as a contractor for a nonprofit sponsor. First, there are tax shelter benefits because various current expenses, such as construction financing interest and fees and property taxes can help to establish losses to offset current income from other sources in a consolidated income tax return.



The builder-sponsor of a limited distribution project is allowed certain fees and other expenses which certainly cut down on actual cash investment requirements. These include:

- (1) A builder-sponsor profit and risk allowance equal to 10 percent of total costs exclusive of land and legal and organization fees.
- (2) Builder's general overhead allowance of  $1\frac{1}{2}$  percent of such costs.
- (3) Organizational expense allowance of  $1\frac{1}{2}$  percent of such costs.

These fees are probably reasonable for most projects in the light of risk, effort and know-how required of the builder-sponsor. There may be economies of scale which make the remuneration relatively high on large projects. More significant, however, is the capability to build up the required 10 percent equity largely or wholly from such fees, and the builder can then recoup his payment by selling equity shares in a limited partnership to investors in high income tax brackets.<sup>1/</sup> For them, tax benefits can be realized through losses that are established by virtue of accelerated depreciation allowances. Since such allowances are available with respect to all new rental housing, however, the tax benefits are primarily a subsidy to rental housing production in general, rather than a subsidy for Section 236 or other subsidized housing programs.

A limited distribution owner of a Section 236 project must have an equity investment equal to at least 10 percent. Irrespective of whether this equity comes in whole or in part from a cash investment, from land

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<sup>1/</sup> There are also architectural design and supervision fees of 4 percent and  $1\frac{1}{3}$  percent, respectively, which might be paid for partly through equity stock shares.

owned by the project owner, or from a builders profit and risk allowance (of 10 percent on construction costs exclusive of land), it represents an equity. A limited return of 6 percent, calculated on the basis of that equity, may be distributed from project income. Such cash distributions are only a small part of the return to investors, however, after taking account of the value of annual tax deductions. These deductions permit book operating losses to be established which can then be offset against other income earned by the owner or owners. Losses can be passed through to limited partnership shareholders in proportion to their percentage of equity ownership. The losses are established primarily through deductions for accelerated depreciation allowances which are very high in the early years of ownership. Since depreciation is allowed on the entire value of buildings (equal to roughly 90 percent of total property value) there is a great deal of leverage for deductions created by a 10 percent equity. Thus, assuming a building value equal to 90 percent of total (land and improvements) investment, the deductions during the first year on a 40 year-life project, using double declining balance depreciation might be 4.5 percent of total project investment. Furthermore, there are also one-time non-operating deductions, such as construction financing interest costs and local taxes which will raise total deductions in the first year or two to over 5 percent of the total project investment. Against a 10 percent equity, such deductions are equal to 50 percent of the equity investment. For an equity investor in the 50 percent income tax bracket the after-tax value of the deduction would be equal to 25 percent of the equity investment.

The value of the depreciation plus the 6 percent cash distribution that is permitted, can give the equity investor in the 50 percent tax bracket a return of roughly 30 percent in the construction and initial operating year of a Section 236 project. As the depreciation base, and the mortgage interest rate deductions are decreased in ensuing years, the annual rate of return to the equity investor will decline, reaching perhaps 20 percent by the fourth year, 15 percent by the eighth year and 12 to 14 percent in the tenth year. The undiscounted annual rate of return on equity, from cash flow distributions plus depreciation allowances, could average about 20 percent for the first ten years of ownership, as the total of the returns could have a value equal to roughly twice the initial equity investment.

As has been noted, the main factor in producing a high annual rate of return is the accelerated depreciation, which is available to the owners of new non-subsidized rental housing, as well as for subsidized rental housing. In fact, the non-subsidized rental project owner might be able to set rents high enough to obtain a higher annual cash flow return than 6 percent. On the other hand, the non-subsidized project, over a period of years is much more likely to experience higher vacancy rates which would reduce rental income and the rate of cash flow return. That risk is to a large extent eliminated in a Section 236 project where occupancy is likely to average better than 95 percent, the rate upon which rental income to provide the 6 percent cash flow return was calculated.

The rate of return on equity will not be quite as high on new housing investments with higher equity to replacement cost ratios where the leverage effect is less. However, there are non-subsidized rental housing programs under which FHA-insured mortgages may equal up to 90 percent of value. Also, the value appraisal of conventionally financed rental housing may produce a mortgage which covers 90 percent of the actual replacement cost.

If the return on equity resulting from accelerated depreciation were to be considered, in part, a subsidy, it would have to be considered a subsidy for the provision of all new rental housing owners rather than a subsidy for owners of Section 236 housing.

There is another tax benefit which is available to owners of Section 236 projects, upon disposition after ten years, however, which is not available to owners of non-subsidized projects. That is the provision for capital gains treatment of sales proceeds representing depreciated book value in excess of straight line depreciation. Such "recapture" of excess depreciation is entirely taxable as income if the Section 236 project is sold during the first 20 months and thereafter the amount subject to recapture is reduced by 1 percent per month. All proceeds from sale of a Section 236 project are subject to capital gains treatment after ten years of ownership by the original owner. The total of accelerated depreciation over the ten years may equal about 40 percent of the total original property cost.<sup>1/</sup> Assuming that the property is sold for an amount equal

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<sup>1/</sup> This is more than would be possible on a 40 year life for the entire property because certain components, such as plumbing, appliances and others are depreciated on a shorter life basis.

to original cost, the capital gains tax would equal 10 percent of the original project cost, reducing the potential average annual return on equity from about 20 percent to about 19 percent. However, the remainder of sales proceeds above the outstanding mortgage balance,<sup>1/</sup> available for after-tax distribution would raise the average annual return by about 0.6 of 1 percent. The net effect of the sales transaction, therefore, would be to make for a potential annual average return on equity of 19.6 percent.

In contrast if a non-subsidized property is sold during the first 100 months, all sales proceeds representing depreciation in excess of straight line depreciation are subject to income tax "recapture". Thereafter, the excess depreciation subject to recapture reduces by 1 percent a month. Therefore, if a non-subsidized rental housing project, is sold at original cost after 10 years, about 80 percent of the excess depreciation is subject to regular income tax. The income plus capital gains taxes then would equal about 13 percent of the original project cost, in contrast with the 10 percent in the case of the Section 236 project sale.<sup>2/</sup> After subtracting taxes and adding the value of mortgage amortization in the sales proceeds, the potential average annual rate of return would be 19.2 percent, in contrast with 19.6 percent for the subsidized project. That difference in return, which represents an additional tax revenue loss to the Treasury, represents a further subsidized housing subsidy cost.

<sup>1/</sup> That amount, representing amortization of the original mortgage loan amount, would be equal to about 6.6 percent of the original mortgage amount, or 6.0 percent of the total original cost.

<sup>2/</sup> The 13 percent is derived from a 50 percent income tax on 80 percent of the excess depreciation. The latter is equal to 20 percent of original cost, and 80 percent equals 16 percent, so that income tax accounts for 8 percent. The balance of the tax is capital gains on the balance of depreciated book value (equal to 20 percent of original cost) at a 25 percent rate.

There is a potential for further enhancement of the return on equity investment through a higher project rental income than calculated when the project was approved. The project rental income was calculated on the basis of 95 percent occupancy. There is a good probability that a higher than 95 percent occupancy rate will be achieved for subsidized rental housing. Although such additional income would provide a greater net cash income after expenses than required for the permitted 6 percent annual return through cash distribution, the extra cash can be used to make mortgage prepayments. The accelerated reduction of mortgage debt principal can be realized as an additional equity gain upon disposition of the property. Such additional equity gain would represent a subsidy benefit in proportion to the ratio of subsidy payments to full "market rent" collections during the period of ownership.

There is one other possible tax benefit that the owners of a Section 236 project might be able to realize. If the project is sold at a net profit to the tenants (or a cooperative or other nonprofit organization of the tenants) and the profit is reinvested in another Section 236 project the capital gains taxes may be indefinitely deferred and the recapture of sales proceeds representing excess depreciation for income taxation can be avoided entirely.<sup>1/</sup>

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<sup>1/</sup> The excess depreciation represented in the reinvested sales proceeds is subject to recapture upon sale of the new property, although the holding period to avoid recapture is reduced by the period of ownership of the property that has been sold.

If such sales can be arranged after a few years of ownership the average annual returns on equity to investors in Section 236 limited distribution projects, from tax savings and cash distributions, could be 25 percent or more. In such instances the 6 to 7-percent greater return than on a non-subsidized housing project would represent an additional subsidy for low- and moderate-income housing producers who also organize tenant ownership organizations to purchase the property.

Most of the foregoing discussion has been applicable to builder-sponsors who act as limited distribution profit-motivated sponsors. As such, they also are responsible for the provision of adequate project management to "deliver" the subsidized housing service benefits to eligible families. Where there is a non-profit sponsor, it has to provide management and the builder-contractor and/or land supplier are the only ones who make a profit. In such instances, a failure in management will curtail the value of benefits for tenants, and may make the project short-lived, leaving the builder-contractor as the chief beneficiary. Such a sequence of events has developed in some instances where builders have found church groups or other organizations to sponsor a project on land in which the builder has an interest. The number of such cases has been limited, as FHA attempts to screen nonprofit sponsors rigorously.

The maximum contractual assistance payment per unit in Section 236 projects for which FHA mortgage insurance commitments were made from the (fiscal year 1969) inception of the program through fiscal year 1971 is

about \$75 per month.<sup>1/</sup> Perspective as to value received for the \$75 amount, which is heavily weighted by activity during the calendar 1970 months, can be gained through some comparisons between new Section 207 non-subsidized unit rents and rents charged to tenants in new Section 236 projects committed in calendar 1970. The median rent for a Section 207 unit was \$227 and the median rent to be paid by a Section 236 unit occupant was \$139, a difference of \$88, or \$13 more than the previously mentioned \$75 Section 236 per unit subsidy.<sup>2/</sup> This would indicate that the Section 236 "market rent", before deduction of subsidy was also less than Section 207 rent by \$13. (The Section 236 "market rent" had not been tabulated.)

Since the mortgage terms are the same and the median per unit mortgage amounts were almost the same--a median of \$15,172 for Section 207 and \$14,975 for Section 236--there would be (practically) little difference in debt service. About a \$800 greater per unit equity investment under 207 would also explain only part of the difference in the establishment of market rents. Most of the difference, therefore, would have to be found in operating and maintenance expenses. The greater incidence of elevator projects under the 207 program and the probable related greater concentration of the 207 projects in large

<sup>1/</sup> April 30, 1971 HUD table and accompanying text in "HUD-Space-Science Appropriations for 1972", Hearings before a Subcommittee of the Committee on Appropriations, House of Representatives, Ninety-second Congress, First Session, Part 2, Department of Housing and Urban Development, pp. 466-68.

<sup>2/</sup> These and other unit characteristics are based on data in Tables 57-59 and 73-75 prepared for the 1970 HUD Statistical Year Book.



central cities would contribute to higher maintenance and operating costs. In addition, greater market competition to attract renters to nonsubsidized housing might lead to better maintenance, albeit at somewhat increased cost.

The \$800 greater equity investment plus \$200 greater mortgage amount per unit adds up to about \$1,000 more in total per unit capital cost for Section 207 units than for Section 236 units. This would be accounted for by somewhat higher land costs and by about 100 more square feet of living area in the median sized unit in Section 207 projects.<sup>1/</sup>

On the whole, the available evidence would suggest that the housing services being obtained through payment of occupant rent plus subsidy is in line with private market rent for equivalent housing. If this observation can be sustained, the low- and moderate-income occupants are the beneficiaries of the housing subsidy payments. Whether the observation can be sustained will depend upon the quality of management during operation as well as the durability built into the Section 236 projects. Only detailed field investigations or time will tell.

Insofar as the tax benefits arising from accelerated depreciation and capital gains treatment are concerned, they represent a subsidy to the equity investors who are in high income tax brackets. There is no doubt that they have stimulated the production of subsidized multifamily housing. Exclusive of public housing, the production of subsidized new

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<sup>1/</sup> We are dealing with added space after the kitchen and plumbing equipment costs are already established, so that the cost per square foot added is lower than total development costs per square foot.

rental housing, has increased from 73,000 units in fiscal year 1969 to 162,000 units in fiscal year 1970 and was at an estimated level of about 145,000 in fiscal 1971.<sup>1/</sup> If the available tax incentives are reduced, it would probably lead to some reduction in production of low- and moderate-income rental housing. However, there are possible alternative means of compensating for such a reduction in tax incentives to high income investors. One course would be to fill a higher proportion of the subsidized housing requirements through the homeownership programs where moderate tax benefits may go to the low-income homeowner, rather than to high-income equity investors. Another possibility would be to foster a strengthened, expanded body of nonprofit sponsors. The latter course would entail government expenditures for increased training for and technical assistance to nonprofit sponsors. However, the cost of such activities would probably be less than the tax revenue losses entailed in tax benefits for equity owners of limited distribution projects.

#### Public Low Rent Housing

There are now several programs to provide low-rent housing under the heading of public housing. The more important of these programs will be treated briefly, to identify variations in the basic subsidy formula and in program mechanisms which affect the net subsidy benefit distribution.

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<sup>1/</sup> 1969 and 1970 data from "Third Annual Report on National Housing Goals," Table A-2, p. 31. 1971 estimate based on preliminary data provided by HUD and Farmers Home Administration.

The basic subsidy formula and program mechanism can best be described with regard to the original public housing program, now identified as the "conventional" public housing program. Under this program, a local housing authority acquires the site for a project, has project design plans prepared and takes competitive bids for the construction of the project.

There is some hidden subsidy involved in construction financing, which is obtained primarily through the sale of short-term, tax-exempt notes by the local housing authorities. The notes are backed up by the local housing authority's right to borrow an equal amount from HUD, if necessary. The short-term notes are usually repaid from the proceeds of long-term (40 year), tax-exempt bonds issued by the local authority after the project is completed. Such bonds are, in effect, guaranteed by the U.S. Government through an annual contributions contract between HUD and the local housing authority. It calls for Federal annual contributions, up to a maximum amount sufficient to meet the debt service on the bonds. Less than the maximum annual contribution may be required if there are residual receipts from rents charged to the low-income occupants after all operating expenses have been met.

Over the past decade, as project operating costs increased while tenant incomes and rents lagged behind, there were fewer and fewer local authorities with residual receipts, with the result that Federal annual contributions approached the contractual maximum for annual contributions. In many local public housing programs operating costs exceeded rental income and local authorities resorted to rent raises to avoid insolvency. Initial

attempts to cope with the problem consisted of authorizations for additional subsidy of up to \$120 per year for units occupied by elderly or handicapped persons, displaced, disaster victims, large families and very low income families. This proved to be insufficient. Then Congress enacted in 1969, and clarified in 1970, the Brooke Amendment. It stipulates that no public housing tenant should pay more than 25 percent of income for rent, and it authorizes Federal public housing subsidies for operating and maintenance expenses, where needed, to assure the low-rent character of the projects and to achieve and maintain adequate operating and maintenance services.

The Federal subsidy, thus consists of four parts: (1) annual contributions to pay the debt service on the bonds issued to raise the capital costs; (2) special subsidies for the elderly, handicapped, etc.; (3) additional subsidy for operating expenses---and also for deferred maintenance, repair and modernization at this time; and (4) tax-exempt financing benefits. There is also a local contribution of partial tax exemption, as 10 percent of shelter rents collected are paid in lieu of property taxes under cooperation agreements entered into with local governments.

Public housing is the oldest subsidized housing program in the country, established by the U.S. Housing Act of 1937. By 1971, there were some 965,000 units in projects under management, and most of them had been built under the conventional public housing program. Federal subsidy payments (excluding the Federal cost of tax exempt financing) were estimated at about \$675 per unit annually or \$56 monthly for fiscal year 1971.<sup>1/</sup>

<sup>1/</sup> Based on HUD data in "Summary of the HUD Budget for Fiscal Year 1972", p. FM-1.

This relatively low per unit subsidy reflects the low construction costs of many older projects built over the past 33 years, and the lower bond interest rates which were prevalent during most of the period. The per unit monthly subsidy payment for public housing units owned by local authorities, for which commitments will be made in fiscal 1972 is estimated at \$131, and for leased units at \$127.<sup>1/</sup>

The latter figures are before taking account of the hidden subsidy involved in the tax-exempt financing. Based on an average total per unit development cost of \$18,667 in 1970<sup>2/</sup> and public housing tax-exempt bond interest rates of about 5-3/4 percent (in May and July 1971), there is an additional subsidy of \$30 per unit per month.<sup>3/</sup> Total monthly per unit subsidy cost for current new construction thus would be about \$160 per month.

The latter figure is considerably higher than the estimated per unit subsidy of \$75 per month under Section 236. However, the public housing occupants have substantially lower incomes and pay substantially less rent than Section 236 project occupants. Thus, whereas the previously cited median rent in Section 236 projects committed in 1970 was \$138, the median gross rent paid by all families moving into public housing in 1969 was \$50.<sup>4/</sup>

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- <sup>1/</sup> Hearing - "HUD-Space-Science Appropriations for 1972", *op. cit.*, p.469.  
<sup>2/</sup> HUD table on total development cost per unit for low-rent public housing projects placed under construction in 1970.  
<sup>3/</sup> Total monthly payments over 40 years to amortize \$18,667 at 5-3/4 per cent would include a total interest cost of \$29,073 or \$60 per month, assuming that the holders of tax-exempt bonds are in the 50 percent income tax bracket, the lost revenue is \$30 per month.  
<sup>4/</sup> 1969 HUD Statistical Year Book, LRPB Table 20, p. 208, The actual period is 12 months ending September 30, 1969.

The Section 236 median rent, at a 25 percent rent-to-income ratio reflects an income of \$6,624. The median income of the public housing tenants who moved in in 1969 was \$2,548. Although the move-ins to public housing were into older as well as new public housing, the incomes would not be measurably different. Nor has the income distribution of public housing occupants been changing much from year to year. About two thirds of those who moved in were receiving assistance or benefits and the same was true for 95 percent of elderly and 44 percent of non-elderly occupants reexamined for continued occupancy in 1969.<sup>1/</sup>

Part of the higher subsidy per unit for public housing than for Section 236 housing is, no doubt, due to higher development costs of close to \$3,000 per unit. There are probably a number of contributing factors which make for higher average public housing development costs. One of them may be a high concentration of public housing units in high-cost northern localities. Thus a State distribution of public housing units started in 1970 shows New York with the largest percentage, 6.3 percent, Pennsylvania second with 5.8 percent and Illinois third with 5.5 percent. The comparable State percentages for Section 236 units in projects committed in 1970 were New York 4.2 percent, Pennsylvania 4.3 percent and Illinois 4.5 percent. About 10 percent of the Section 236 units were in California which is not a low construction cost State, but well below New York. There may also be somewhat less economies of scale in public housing which had

<sup>1/</sup> Ibid. "Assistance" consists of funds given on the basis of need by organizations, some private, but primarily public. "Benefits" are non-salary funds, not given on the basis of need by government agencies; and old age, survivor and disability insurance paid by the Social Security Administration.

an average of 96 units per project compared with 112 under Section 236.<sup>1/</sup>

Per unit land cost are to a large extent a matter of geographic location and require local data to judge their reasonableness. Insofar as national data provide a clue, it is noted that the national average per unit land costs for new public housing in 1970 was \$940. Available data on Section 236 average per unit land costs by project show a median of \$830. Comparable measures would probably show the figures to be fairly close. As indicated in the discussion of the Section 236 program, the supplier of land can make a substantial capital gain, but there are no data to indicate the degree or frequency of such gains in public housing.

Given the low-income character of the public housing occupants and the low rents which they are charged, there can be little question that they are the recipients of a substantial net benefit, representing most of the Federal subsidy. The admittedly inadequate land and development cost data which have been scanned do not suggest any significant above-normal market costs in those areas. A substantial amount of local area construction cost and land data for public and comparable private housing would have to be obtained and analyzed to ascertain whether the public housing cost levels account for some of the net subsidy benefits.

There is an identifiable question, however, with regard to the net benefit incidence of the subsidy involved in the tax-exempt financing which is Federally guaranteed through the HUD annual contributions

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<sup>1/</sup> HUD tabulations for 1970.

contracts, assuring funds for debt service. The Federal subsidy pays virtually the full interest on the bonds (since project residual receipts to reduce annual contributions below the maximum are negligible), but the Federal cost also involves the loss of taxation. The net cost to the Federal government would be less if it financed the projects through Treasury borrowing. When public housing bonds in 1971 carried about a 5-3/4 percent interest rate, long-term Treasury bonds were yielding about 6 1/2 percent and could have been sold for about 6-3/4 percent. The net cost of Treasury financing would be reduced to between 3-3/8 and 4 1/4 percent, however, assuming that the average marginal income tax rate for the bondholders was between 50 and 33-1/3 percent. If net Federal annual financing-cum-taxation cost is 2 percent greater than necessary, about \$20 of the calculated \$160 monthly subsidy might be viewed as a result of the financing structure of the program, which channels about 1/8 of the subsidy to the high income holders of tax-exempt bonds.

The matter is complicated by the political aversion to Federal capital grants which would greatly raise the total expenditures figure in the annual budget and the Federal debt level. As a practical matter, the Federal government is just as committed to repayment of the tax-exempt public housing bonds as it would be to repay Treasury bonds and the continuing annual costs are significantly higher. Separate capital budgeting for subsidized housing might help to clarify the matter and make it more acceptable to finance such housing with direct loans from funds borrowed by the Treasury.



The tax-exempt financing device is used in the various public housing programs, but other program elements differ. The largest "other" program than the "conventional" new construction is the "turnkey" method program under which most of the new public housing is now being built. Under this method, local housing authorities invite proposals for the provision of a specified number of public housing units with a given unit size distribution and certain other general characteristics. Any private builder or developer having a site or a structure, or an option to buy, can submit a proposal to the local housing authority to build or rehabilitate in accordance with his prepared plans and specifications. The local authority selects the best proposal and enters into a contract with the builder or developer to purchase the property upon satisfactory completion.

Aside from the avoidance of preparation of plans and issuance of invitations to competitive bidding by the local authority, the chief departure from conventional method is the provision of the site by the builder or developer. Such sites have tended to have a higher per unit cost than conventional public housing sites selected and acquired by local housing authorities. This difference has been more than offset, however, by lower site improvement costs on turnkey project land.<sup>1/</sup>

The turnkey developer receives a developer's fee and an overhead allowance, which covers many of the planning and administration costs incurred by the local housing authority under the conventional method.

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<sup>1/</sup> Based on 1970 average cost data compiled by the HUD Cost Analysis Section, Low Rent Public Housing Branch.

Furthermore, the dwelling construction and equipment costs per square foot of area have been lower under Turnkey.<sup>1/</sup>

It should be noted, also, that there are still significant costs of administration, negotiation, etc. incurred by the local authority under the Turnkey method.

There would appear to be potentials for less time consuming construction with lower square foot costs under the Turnkey method. Whether the savings are reflected in lower subsidy, or whether they result in net subsidy benefits accruing to land suppliers, builders and/or local housing authorities will depend on (1) Turnkey prices negotiated by the local housing authorities and (2) their efficiency in carrying forward such negotiations and other functions in connection with Turnkey projects.

A third program or method for provision of low-rent public housing is through leasing. Local housing authorities may lease units in private structures which are made available to low-income families at subsidized rents. The local housing authorities receive annual contributions from HUD which are used to pay the balance of the required rents. The Federal subsidy may not exceed the subsidy that would be required for a comparable newly built structure to be owned by the local housing authority. Leased units are generally in existing structures, but agreements may be made with a builder for new housing to be constructed for lease by the local authority for low-rent public housing. Lease terms, including optional renewals, can be for up to 20 years for new housing and 15 years for existing housing.

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<sup>1/</sup> Ibid.

Subsidized rent for privately owned housing focuses attention upon the net subsidy value reflected in equity accumulation. To the extent that value in land and useable structures exceeds unamortized debt on the property, there is an equity accumulation which reflects subsidy payments that have contributed to the capital debt amortization. In public housing owned by a local housing authority that equity interest accumulates to the benefit of the public body, the local housing authority. A stock of publicly owned housing to meet low-income rental housing needs is accumulated. In leased private housing, the accumulated equity interest which reflects debt amortization through subsidy accrues to the property owner in the form of a stock of privately owned housing.

When new private housing is constructed and leased for low-rent public housing, pursuant to a pre-construction agreement with a local housing authority, the property owner can also take advantage of accelerated depreciation tax benefits. The maximum twenty year lease assures rental income on a 100 percent occupancy basis, so that buildings can be held and operated profitably for at least 16-2/3 years, after which all sales proceeds above depreciated book value are taxed at a capital gains rather than at a regular income rate.

The tax benefits are no greater than those available to an owner of non-subsidized new rental housing. However, the long-term leases remove a great deal of the risk in rental housing investment which creates the need for tax incentives for rental housing production. If the rents nevertheless provide the owner with a return equal to that enjoyed by other rental property owners--and perhaps higher in view of the allowable leases assuring 100 percent occupancy rental income--the rents and supporting

subsidy would appear to provide a higher return than warranted by market conditions. To the extent that such higher returns are realized, the property owners are receiving some of the subsidy benefits. A detailed analysis of leased new housing under the public housing program would be required to ascertain whether the property owners are actually obtaining an equal or higher return on their investments than other rental property owners under the negotiated lease agreements.

One other public housing program, which is still small in volume should be mentioned. That is the Turnkey III Homeownership program for low-income families. Under this program, an occupant of a dwelling unit owned by a local authority can acquire ownership of the property. He makes monthly payments based on a percentage of his income and also provides all maintenance and repairs. His monthly payments are sufficient to cover all operating expenses and reserves, including a budgeted amount for maintenance and repair. The latter amount is credited to a Home Ownership Reserve account set up for him. At the same time, the local housing authority utilizes Federal annual contributions to make debt service payments, amortizing the capital debt. When the homeowner's income and assets, including the reserve account set up for him, improve so that he can assume ownership with FHA-insured or conventional financing at a price equal to the unamortized capital debt on the structure, he may acquire it at that price. Under this program, therefore, the occupant benefits from the rental housing subsidy while he is a tenant and also receives the benefit of the accumulated equity.

The Tandem Plan - Interest Rate Subsidies

The tandem plan originated during the tight money period of 1969, to help provide mortgage financing for the subsidized private housing programs, primarily Sections 235 and 236, which are financed with private FHA-insured mortgages. During the tight money period, lenders required that discount "points" be paid by the builder or developer, or other seller of a housing to be financed with FHA-insured loans, in order to increase the yield above the ceiling interest rate on such mortgages. In many instances this would have made it economically infeasible to produce subsidized housing.

Under special assistance authority of Section 301 of the National Housing Act, the President could authorize the Government National Mortgage Association (GNMA) to purchase subsidized housing mortgages at par or at modest discounts. However, this would involve very substantial Federal outlays--billions of dollars--which would add to budget deficits.

The tandem plan gets around the budgetary problem. GNMA issues a commitment to purchase a Section 235 mortgage, for example at 97, so that the builder would not have to pay more than 3 points (i.e. 3 percent of the mortgage amount) when he delivers the mortgage after completion and sale of the house. Simultaneously, GNMA obtains a commitment from the privately-owned, Federally-sponsored Federal National Mortgage Association to purchase the mortgage at its "free market" price. If that price should be less than 97, GNMA would absorb the loss, which might be, for example 2 points, if the free market price were 95. In effect, an additional subsidy is added through this process.

In Aug. 1971, when mortgage discounts were again climbing, the tandem plan was extended to all FHA-insured and VA-guaranteed mortgages of up to \$22,000 and \$24,500 for homes of 4 or more bedrooms. Certain FHA-insured multifamily mortgages were also made eligible. Special assistance funds in the amount of \$2 billion were made available. In this way, the present FHA and VA 7 percent mortgage interest rate ceiling could be maintained, instead of raising it to a level competitive with other security yields. The financing subsidy was thus made available for "nonsubsidized housing."

The subsidy contributes to the payment of higher effective mortgage interest rates. In one sense, homebuyers and renters are the beneficiaries, since the higher effective interest rates are occasioned by market supply and demand for long-term funds, and have to be met for the housing to be made available. Viewed in a broader framework, fiscal and monetary policies (and the lack of other credit allocation policies) have permitted the rise in effective interest rates, which cause a redistribution of income in favor of savers and lenders, the creditors. In that framework, the savers and lenders are the beneficiaries of the subsidy distributed via the tandem plan.

#### Conclusion

Any conclusions about the distribution of housing program subsidy benefits that relate to comparable costs of subsidized and non-subsidized housing costs are dependent upon the quality of available data. In this paper, therefore, its conclusions related to comparable costs must necessarily be highly qualified.

The greater, though still inadequate, data available for home ownership than rental housing programs, suggest that limited income owners of subsidized new homes receive a very high proportion of the subsidy benefits. These include some equity accumulation, as well as part of the current housing expense. A small part of the benefits from a program serving a broad and ready market may go to the housing producers.

Evidence as to comparable costs of unsubsidized and subsidized housing is scarce and tenuous. It provides little basis for judgments as to absorption of housing assistance payments to support greater housing production costs for subsidized housing than for comparable housing that is not subsidized.

Tax benefit incentives in the form of accelerated depreciation are available to producers of all new rental housing, not just for private subsidized rental housing. That tax benefit, therefore, should be viewed as a subsidy for rental housing production in general, rather than specifically for subsidized housing. There is an additional tax benefit for subsidized housing investors, however, in a shorter holding period requirement before all sales proceeds, including those which equal past excess depreciation deductions, are taxed as capital gains, rather than income. Another potential tax benefit can be realized by the owners. If a subsidized private (Section 236) rental project is sold to tenants, even after only a few years of ownership, any sales profits reinvested in a similar project within one year are not subject to regular income taxation.

The availability of many tax benefits to private subsidized rental housing investors suggest that low-income needs can be met at a lower subsidy cost through subsidized home ownership and programs to foster more qualified non-profit sponsorship of subsidized rental projects.

Low-rent public housing has occupants with a much lower income distribution than other subsidized housing. The rents they pay are much lower, making for a much higher monthly subsidy per unit. Per unit development costs in public housing have also been somewhat higher than in other subsidized rental housing, but this may be due to differences in geographic distribution of housing units, and somewhat smaller public housing projects (in 1970).

Public housing entails a "hidden" subsidy through financing by tax-exempt local bonds that are virtually Federally-guaranteed. Direct Treasury loans would be less costly to the Federal government, but would have a greater impact on current budget accounts. The extra interest cost subsidy involved in tax-exempt financing flows to high-income investors in such bonds.

Leased public housing (in private structures) operates so that part of the subsidy which covers capital debt amortization accrues to the private property owner in the form of his housing stock. In publicly owned housing, the stock is retained for public equity ownership. Leased new housing, under the public housing program, gives the private owner the tax benefits available to rental property investors while removing substantially all risk of vacancies for 10 to 20 year lease terms.



Financing of private Federally subsidized housing through private mortgage lending also entails a higher interest rate than would be entailed through direct Federal loans. The latter would have a large impact on current budget accounts. The impact on the economy would not be significantly different. The differential in interest cost of private over direct loans might be viewed as a subsidy to savers and lenders.

A similar subsidy may be entailed in the "tandem plan" under which the Government National Mortgage Association pays "discount" points above a certain level in the financing of "non-subsidized" housing with FHA-insured and VA-guaranteed loans. In one sense, the government is helping to pay a higher effective market interest rate than the homebuyer is charged, and it is a subsidy to the homebuyer. In a broader sense, if alternative fiscal and monetary policies or other credit allocation tools could have brought about lower interest rates, then the higher rates in effect might be viewed as causing a subsidy to be paid in favor of savers and lenders.

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