Increasing the Stock of Affordable Housing:

The Value of Different Strategies in a Growing Crisis

by

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Increasing the Stock of Affordable Housing: The Value of Different Strategies in a Growing Crisis

The United States is experiencing an affordable housing crisis.[1] Rental costs are rising at a faster rate than wages and waiting periods for public rental assistance are increasing. Research by Belsky and Lambert (2001) indicates that during the period 1996-1998, residential rent increased 6.3 percent while wages increased by 3.9 percent. During this same period, the waiting times for the Housing Choice Vouchers, formerly Section 8 certificates, and project-based housing increased by two months. Further, the unassisted development of housing that is affordable to low-income and very low-income renters is increasingly difficult in the face of rising production costs. In 39 states, more than half of Low-Income Housing Tax Credit projects, the cornerstone of federal affordable housing efforts, must utilize some other form of federal subsidy to make them affordable to low-income renters. Most of these projects also must use state or local subsidies to defray costs further.[2]

We are facing a situation in which nearly 13.4 million renter households and 14.5 million owner households, more than 80 million individuals, experience moderate to severe affordability problems. A moderate affordability problem is defined as spending between 30 and 50 percent of income on housing. A severe affordability problem is defined as spending more than 50 percent of income on housing.[3] The estimated national shortfall in affordable housing is approximately 3.3 million units.[4] An additional 3.82 million rental units are at risk of disappearing from the housing stock over the next ten years, including 3 million unsubsidized rental units, 640,000 subsidized rental units, and 180,000 Low-Income Housing Tax Credit Units.[5] Further, in no area in the United States can a person earning a minimum wage, full-time salary afford fair market rent[6] for a two-bedroom apartment or home.[7]

The above statistics are sobering given the vital role that affordable housing plays in individuals' and families' lives and in community-based and region-wide development. According to Dolbeare and McGowan (2003), "Affordable, stable housing makes it easier for adults to find and keep jobs, and improve the health and education of their children. It also contributes to strong communities by creating

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[2]Belsky, Eric S. and Matthew Lambert. *Where Will They Live: Metropolitan Dimensions of Affordable Housing Problems?* Joint Center for Housing Studies, Harvard University, September 2001: 6-7.

[3]See *Meeting Our Nation's Housing Challenges*, a report of the Millennial Housing Commission, available online at http://www.mhc.gov/MHCReport.pdf.

[4]The Joint Center for Housing Studies, Harvard University. *State of the Nation's Housing, 2001.*

[5]Bodaken, Michael. "The Increasing Shortage of Affordable Rental Housing in America: Action Items for Preservation" *Housing Facts and Findings* 4, no. 4 (2002): 1, 4-7.

[6]Fair Market Rent is defined by the Department of Housing and Urban Development and represents the amount needed to pay the gross rent (shelter plus utilities) for a privately owned, decent, safe and sanitary rental unit of a modest (non-luxury) nature with suitable amenities.

[7]National Low Income Housing Coalition, *Out of Reach 2002: Rental Housing for America's Poor Families: Farther Out of Reach Than Ever.* September 2002.

a positive environment for neighborhood residents and the surrounding region."[8] Despite the importance of and the demand for affordable rental housing, supply lags behind. The scope of the affordable housing crisis is extensive and requires a number of strategies to solve it.

The market for affordable housing units varies in different regional housing markets depending on differences between the supply of housing and the size of the low-income population. Housing markets are, for example, different in cities experiencing population growth than in those experiencing long-term population declines. These differences make a uniform federal housing policy with uniform incentives more or less useful depending on the fit between the policy and the particular housing market. The problems of preserving existing affordable housing are also different from the problem of building new affordable housing with the latter a much more expensive proposition than the former though just as necessary. There are also different kinds of owners and investors in the affordable housing market including two important groups, small scale for-profit developers who operate mainly without subsidy and investors who are in this market only because of the existence of the federal tax credits especially the low-income housing tax credit. (There are also nonprofit developers who constitute an important but smaller part of the market of affordable housing providers and in the 1990s were responsible for over 30 percent of low-income housing tax credit (LIHTC) tax credit deals. This paper does not focus on the role on nonprofit developers.) The small scale owners own and renovate existing housing stock. Only investors using deep public subsidies can afford to build new affordable housing and, in fact, 60 percent of the dollar value of the federal low-income housing tax credit is used for new construction.

This paper explores some issues about the maintenance and production of affordable rental housing. In particular, it examines the role of the small scale property owner. Some of the cost analyses are based on costs in Chicago. These analyses will be less useful in cities with different cost structures but national cost averages are misleading given the huge variations those averages contain and conceal.

The paper starts with a description of an important federal incentive for building rental housing that started in 1981 and was repealed in 1986.

Overview of Key Tax Code Changes, 1981-1986

Prior to 1986, tax shelter benefits were the primary means of funding the portion of multifamily housing development costs not funded by mortgage debt.[9] Almost all of the tax shelter benefits were achieved through the sale of limited partnership interests to investors who were able to use depreciation allowances and other tax-related benefits to shelter other income from taxation. The process of organizing and marketing such benefits is called syndication.[10]

Congress sets the rules of syndication in the tax laws. Housing related tax code provisions are changed partly on the need for either stimulating or cooling down the housing market. This process is evident in

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[8]Dolbeare, Cushing N. and Sharon S. McGowan, *Affordable Rental Housing and the American Dream: The Role For Foundations*. Neighborhood Funders Group Public Policy Paper, Spring 2003.

[9]Wilkins, Charles S. *Background Paper: Tax Policy Reversals Affecting Investors in Affordable Housing*. Millennial Housing Commission Tax Issues Task Force.

[10]Orlebeke, Charles J. "The Evolution of Low-Income Housing Policy, 1949 to 1999." *Housing Policy Debate* 11, no. 2 (2000): 511.

the changes that were made to the tax code between 1981 and 1986. In 1981, Congress passed the Economic Recovery Tax Act (ERTA), as a means to stimulate the depressed housing industry.[11]

The introduction of the Accelerated Cost Recovery System (ACRS) was the key component of the ERTA relevant to tax shelter incentives. The ACRS allowed for the rapid depreciation of the costs associated with real property investment.[12] It provided a tax shelter to investors allowing them to write off against their incomes larger amounts of project costs earlier in the project's life, which enabled investors to recover larger amounts of their investments in a shorter period.[13,14] Low-income rental housing was afforded the most preferential treatment, with a tax/life recovery period to 15 years (and accelerated depreciation front loaded to the early years) for projects produced on or after January 1, 1981.[15] Low-income housing was also exempt from recapture provisions.[16,] In addition to the ACRS, the ERTA reduced the marginal tax rate of investors, with the top tax rate dropping from 70 percent to 50 percent.[17] While this reform was welcomed by high-income taxpayers, it reduced the value of tax shelter benefits because it reduced the amount of tax investors owed.

In 1986, Congress passed the Tax Reform Act (TRA) partly to eliminate loopholes in the tax system but the Act had a large negative impact on the real estate industry. First, the TRA of 1986 eliminated the accelerated depreciation and extended the depreciation period for residential property to 31.5 years.[18] Assisted housing investments placed in service after 1986 could be depreciated only on the straight-line method, generally with a 27.5 year useful life.[19] Second, the preferential capital gains treatment was dropped, with capital gains income now being taxed at the same rates as ordinary income. This eliminated one cornerstone of the tax shelter industry--the ability of investors to convert ordinary income into capital gains income, which was taxed at lower rates.[20] Third, the top marginal tax rate for investors was further reduced from 50 percent to 33 percent, benefiting high-income taxpayers but again reducing the value of tax shelter benefits. Finally, the ability of investors to deduct passive investment losses was essentially eliminated, although certain 'active' hands-on owners retained the ability to deduct passive losses. This will be discussed in greater detail later in the report.

The passive investment loss rules adopted in 1986 provide that costs associated with passive investments can be deducted only against income earned from passive activities. A passive activity is

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[11]Ibid.

[12]The concept of tax shelter syndication was not a new strategy in 1981. Tax shelter syndication first appeared in 1969 as part of the 1969 Tax Act, but the introduction of the ACRS as part of the ERTA of 1981 made tax shelter syndication significantly more attractive. See Orlebeke, 2000, page 511.

[13]Government Accounting Office. *Federal Rental Housing Production Incentives: Effect on Rents and Investor Returns*. May 10, 1985.

[14]Government Accounting Office. *Impact of Federal Tax Provisions on the Resyndication of Federally Assisted Rental Housing*. July 10, 1985.

[15]Government Accounting Office. *Federal Rental Housing Production Incentives: Effect on Rents and Investor Returns*. May 10, 1985.

[16]See Case (1990): 347.

[17]See Case (1990): 345-6.

[18]Cordato, Roy E. "Destroying Real Estate Through the Tax Code (Tax Reform Act of 1986)." *CPA Journal Online*. (June 1991).

[19]Millennnial Housing Commission Tax Issue Task Force, *Background Paper: Tax Policy Reversals Affecting Investors in Affordable Rental Housing*, Undated.

[20]Case (1990): 345, 349.

defined as the conduct of any trade or business in which the taxpayer does not materially participate. The new passive loss rules were created in order to eliminate perceived problems that existed in the tax code prior to the 1986 reforms. Pre-1986 passive loss deductions were seen as an abuse of the tax rules, with investors making large profits and paying few, if any, taxes. In 1986, rental real estate was categorized as passive by definition, meaning that all income from real estate was considered 'passive', regardless of the level of the investor's participation in the activity that generated the income. So since then, if a real estate investor experiences losses and has no non-passive income to offset them, those losses cannot be deducted from taxable income.[21] In short, the passive loss rules and other provisions of the Tax Reform Act of 1986 drastically reduced the value of 'tax expenditures' benefiting real estate development.

Possible Impacts of Reviving a Targeted Rapid Depreciation Allowance and Changing Passive Loss Rules

Of the 1986 changes, we focus on the repeal of the ACRS, or rapid depreciation allowance, and the changes made to the passive loss investment rules, because of their impact on equity investment in affordable housing. Equity investment is one of the basic financing components of affordable multifamily development in addition to mortgage financing and affordable housing subsidies.[22] Equity investments in rental housing traditionally take one of two forms: individual investors or limited partnerships. An individual investor is directly involved in the multifamily development either by building or purchasing a property. The individual investor often manages the property as well.[23] In a limited partnership, equity financing is raised by investors who provide funding by purchasing ownership shares in a project in exchange for a small profit and for the ability to shelter ordinary income from taxation, either by use of tax credits or depreciation deduction. As stated by Case (1991), "Virtually all private investment in low-income housing has been through limited partnerships."[24] The following section explores the impact of reinstating the rapid depreciation allowance or ACRS and revising the passive loss rules on small scale developers.

Federal Rapid Depreciation Allowance

Since the 1986 Act was seen as a major reform to the tax code, there would probably be little political appetite for reinstating some form of rapid depreciation allowance for affordable housing. Moreover, gradual reductions in the marginal tax rate for capital gains have reduced the attractiveness of such tax breaks to large-scale investors. Any such reinstatement would have to ensure that the tax break was not being abused as a tax shelter for institutional investors. So eligibility criteria might include limiting its use to small buildings under a certain number of units, or a small number of units within a larger building, or limiting the number of times an investor could claim the allowance. But the question remains whether a reinstated depreciation allowance would materially assist the small-scale developer.

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[21] Cordato (June 1991).

[22] DiPasquale and Cummings (1992): 91.

[23] DiPasquale and Cummings (1992): 86.

[24] Case (1990): 343.

Our research indicates that reinstating the rapid depreciation rules would have a moderate impact on making affordable housing production a more attractive investment for the small developer. To illustrate, consider the following example comparing the difference in cash flow after tax (or profit) to the developer after one year between a 31.5 year straight line depreciation schedule and a 15 year straight line depreciation schedule (see Figure 1). This example is based upon a 24-unit building with a purchase price of $2 million, $500,000 in equity payment and $1.5 million in mortgage capital. Calculations are based upon monthly rents of $763 per unit and an interest rate of 5 percent.[25] That interest rate reflects the historically low interest rates prevailing in 2002 and the first half of 2003 that may well not be maintained.

Figure 1 – One Year Cash Flow Statement Comparing a 31.5 year and 15 year Depreciation Schedule for a Multi-Family Housing Development

		Depreciation Schedule	
		31.5 years	**15 years**
Taxable Income	Gross Scheduled Income	$220,000	$220,000
	Less: Vacancy & Credit Losses	($20,000)	($20,000)
	Effective Gross Income	$200,000	$200,000
	Less: Operating expenses	($100,000)	($100,000)
	Net Operating Income	$100,000	$100,000
	Less: Mortgage Interest	($75,000)	($75,000)
	Cost Recovery	($50,793)	($106,666)
	Real Estate Taxable Income	($25,793)	($81,666)
Cash Flows	Net Operating Income	$100,000	$100,000
	Less: Annual Debt Service	($75,000)	($75,000)
	Cash Flow Before Taxes	$25,000	$25,000
	Less: Tax Liability on Real Estate[26]	($8,511)	($26,949)
	Cash Flow After Taxes	**$33,511**	**$51,949**

As shown in Figure 1, a 31.5 year depreciation schedule yields a cash flow after tax of $33,511 compared to a cash flow after tax of $51,949 for the 15-year depreciation schedule, a difference of $18,429. The difference is extra profit generated by the building for the developer, who could either retain the difference as profit, or pass it on to the tenant in the form of rent reduction.

Figure 2 shows the annual monthly per unit savings that result from the shortened depreciation period. The savings are $767 per unit. If written into law that the savings gained by the developer from the shortened depreciation schedule must be passed along to the renter in the form of lower rents, the monthly rent savings would be $64 per unit. This example illustrates that the savings gained by a tenant from the reinstatement of the rapid depreciation allowance is quite modest, assuming that the developer

[25]This example assumes that the project is financed by a small-developer/owner with no investor. If an investor was involved in this project, the calculation would have to reflect a return on investment of at least 8 percent.

[26]The calculation assumes a 33 percent tax bracket. A negative figure in this line implies that the property is generating a tax refund for the owner. A positive figure implies that a tax payment is owed on the property.

was required to pass the savings on to the tenant. In the absence of such a requirement, it is unlikely that the developer would be motivated to lower rent because of depreciation savings, as developers typically charge tenants what the market–and their regulatory restrictions–allow. It is also not clear whether such a modest tax gain would enable small developers to purchase and/or renovate a building that they would otherwise be unable to afford.

Figure 2: Per Unit Savings From Shortened Depreciation Schedule

Annual Savings:	$18,429 ÷ 24 units = $767
Monthly Savings:	$767 annual savings ÷ 12 months = $64

It is important to note that the issue of reinstating the rapid depreciation allowance is further complicated by the fact that the allowance was part of a broader set of tax policies, some of which are mentioned earlier in this report, which have been modified or eliminated since 1986. It was the combination of these policies that added to the value of the rapid depreciation allowance. A full exploration of this issue is outside of the scope of this research, but should be considered as part of any proposal to reinstate the rapid depreciation allowance.

Passive Loss Rules

Our second area of focus is the potential for allowing small developers to deduct passive losses against non-real-estate income. Our research indicates that new passive loss rule revisions holds some promise for providing an incentive to the small scale developer of affordable housing. Figure 3 summarizes the passive loss rules.

As shown in Figure 3, two categories of investors are exempt from passive loss rules as they pertain to rental real estate – 'Closely Held Corporations' and 'Real Estate Professionals'. A 'Closely Held Corporation' is defined as a corporation in which more than 50 percent of the stock is owned either directly or indirectly by five or fewer individuals. A 'Real Estate Professional' is defined as a person who owns at least one interest in rental real estate and materially participates in a real estate trade or business. More than half of a taxpayer's personal services in a given year must be performed in real estate trades or businesses and the taxpayer must perform at least 750 hours of service during the year in real property trades or businesses. Real property trades or businesses include development, redevelopment, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage. While these two categories would cover a number of small developers, the investors who might provide equity capital to small developers are not covered.

There is an exception to the passive loss rules in the tax code for investors in affordable housing. Our proposal for revising the passive loss rules is based upon this existing exception which pertains to investors in low-income rental property who actively participate in the investment and who have an adjusted gross income of less than $200,000. These investors may take advantage of a special allowance, which allows for the deduction of up to $25,000 in losses from active income sources, with non-deductible costs allowed to be carried over to future years when passive income might be realized.

Figure 3 – Passive Loss Rules

Exempt	Non-Exempt
Closely Held Corporation • Corporation in which more than 50 percent of stock is owned directly or indirectly by 5 or fewer individuals	**Small Developers** • Developers who do not fit Real Estate Professional Definition
Real Estate Professional • Person who owns at least one interest in rental real estate and materially participates in a real estate trade or business • More than half of taxpayer's personal services in a given year must be performed in real estate trades or businesses • Persons engaged in real estate trades/ businesses at least 750 hours per year	**Investors** • Any investor who provides equity capital to the small developer who is subject to the passive loss rules

The problem is that in order to raise sufficient equity for a project a small scale developer cannot afford herself she must recruit several investors who qualify for the special allowance deduction as described above. This is difficult, and can create a barrier to entry into development for small scale, mom and pop operations. Small-scale developers could play a larger role in the development of affordable housing. But to encourage their greater participation, they should have some of the tax incentives that exist for large developers and corporate investors in the form of passive loss exemptions and in production programs such as the Low Income Housing Tax Credit.

We propose the following. First, simplify the passive loss rules for individual or small developers. Simplification will reduce the cost of taking advantage of those rules. Second, eliminate the phase-out of the passive loss provisions for owners with adjusted gross incomes between $200,000 and $300,000 if they also qualify by a given standard as providing affordable housing. Third, increase the amount of the special allowance deduction from $25,000 to $50,000 or $100,000. Finally, the project should itself be qualified as a low-income housing development so that any developer can invest in the project without having to be certified individually. These changes could result in the creation of a new category of qualified low-income housing losses that would aid in bringing more producers into the affordable housing market. The key to the adoption of these changes by small scale developers is to keep the regulations simple thereby limiting the costs of participation and compliance.

There may be another way to help maintain the current stock of affordable housing in the absence of a major overhaul of federal tax policy. Federal or other units of government could provide modest subsidies to small developers to purchase and rehab rental housing for low-income renters. This program would take the form of small grants, possibly administered by an existing program, such as HOME, in the range of $5,000 to $10,000 per unit to defray rehab costs. Such a modest subsidy could greatly help building owners in low-cost neighborhoods and increase the number of them able to rehab to a reasonable standard. The key would be to keep the subsidy simple and user-friendly while

maintaining affordability and reasonable code standards for the subsidized unit. A program that contained too many regulations would force the developer to hire a variety of professional help to meet the program guidelines thus increasing costs and reducing the number of people willing to take advantage of the program.

The Broader Context of Affordable Housing Subsidies

The Low-Income Housing Tax Credit and Small Scale Developers

The focus of this paper has been on ways to encourage more small scale developers to enter the field of affordable housing through changes in the federal tax code. Such developers tend to exclude themselves from the major federal program for developers of affordable housing, the Low-Income Housing Tax Credit, because of the transaction costs associated with that program. (The LIHTC was a last minute legislative response to the abolition of the tax shelters contained in the 1986 Tax Act.) Those transaction costs are incurred in part by the process of syndicating the credits to a group of investors. Costs are also increased in projects with other public subsidies that carry with them additional standards such as adherence to federal Davis Bacon Act prevailing wage rules. The practical exclusion of smaller developers from the LIHTC deprives them of a major subsidy. The average national subsidy that results from use of the tax credit has been calculated at $34,000 per unit, with an additional $14,000 per unit in grants and concessionary loans, and $9,000 in depreciation deductions for a total of $57,000 of subsidy per unit in 1996 dollars.[27] (These averages conceal large differences among cities.)

We should note that 60 percent of LIHTC subsidies are used for new construction and new construction of affordable housing is not possible without deep subsidy. LIHTC projects are often the only new housing that has been built in low-income neighborhoods for years. The evidence suggests that the LIHTC has become more efficient over time with an increasing percent of the subsidy going to the actual housing costs. The return to investors has also declined since the inception of the credit as bidding for credits became more competitive. On the other side of the ledger, critics argue that the tenant income rules for LIHTC affordable units encourage developers to fulfill their affordable housing obligations by lending at the upper end of a fairly generous income scale based on median regional incomes for all households, not median income for rental households. The fact remains, however, that the LIHTC is the only major federal subsidy for affordable housing developers and that it attracts investors who otherwise would not be involved in such housing.

But the totality of private market activity and subsidized activity falls far short of meeting the need for affordable housing as we documented in the introduction and it falls short of maintaining the existing stock of affordable housing. The six-county Chicago metropolitan area, for example, is estimated to have 100,000 substandard units, with two-thirds of those units in Chicago itself, mainly on the South and West sides. Given the shortage of federal credits, most of the substandard units will have to be rehabbed by private developers using private equity and loan funds. The largest nonprofit loan fund for small scale owners of affordable housing in Chicago estimates that the experienced "mom and pop" housing developer can purchase and rehab a building affordable to families at 50 percent of the Chicago

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[27]The information on the Low-Income Housing Tax Credit comes from Cummings, Jean L., and Denise DiPasquale, "The Low-Income Housing Tax Credit: An Analysis of the First Ten Years" *Housing Policy Debate* vol. 10, 2, 1999.

area's median income for about $50,000 a unit.[28] Other Chicago affordable housing developers calculate average costs of $50,000 to $70,000 a unit.

Whatever the arguments about reshaping the LIHTC, much more affordable housing activity is needed than that produced by the tax credit. Providing modest support to private market small scale owners would enable more of them to get into the affordable housing market where they may become long-term players because a major part of their economic incentive would be growing equity in their buildings. However, no matter the source of financing, it remains true that many landlords can only afford to rent to families with incomes below 30 percent of median-income with some form of public subsidy. We should also point out that the Community Investment Corporation, the nonprofit loan fund that funds and provides technical assistance to many small developers in Chicago is itself reliant on a key public policy initiative. Many of its more than 50 investors are regulated financial institutions that invest in CIC as part of their obligations under the Community Reinvestment Act.

The Severe Inadequacy of Federal Support for Affordable Housing

The goal of our research is to advance debate and action about the most sensible form of federal subsidies for the creation and maintenance of low-income housing. To this end, we focused on the depreciation and passive loss provisions of the Tax Reform Act of 1986. Our research indicates that the reinstatement of the federal rapid depreciation allowance would have a modest effect on lowering the costs of affordable housing. The passive loss provisions show greater promise as an incentive for bringing the small-scale developer into the affordable housing market. Our passive loss rule proposal is one step in the direction of increasing the supply of rental housing affordable to lower-income households. It must be recognized, however, that such a proposal would be politically difficult given the widespread, bi-partisan support for the Tax Reform Act of 1986, and the belief that it was a just solution to the abuse of tax shelters that occurred prior to its passage. The proposal for modest grants to small scale developers of affordable housing may be more politically viable. But more important, these proposals, on their own, cannot solve America's housing crisis. What we have set out is a modest part of what the appropriate federal response to the affordable housing crisis should be.

Regardless of the politics, any dialogue must address the two underlying issues that are preventing for-profit and nonprofit developers, investors, and government entities involved in affordable housing development from solving the affordable housing crisis: the mismatch between the cost of production and the ability of renters to pay rents sufficient to cover this cost and declining federal support for affordable housing.

The first underlying issue in the affordable housing crisis is the mismatch between the cost of production and the ability of renters to pay rent that both covers the operating costs of the property and is affordable to the renter. In a typical development, the developer borrows capital to finance the development, and the tenant's income pays off the debt plus operating expenses in the form of rent. However, too many renters make too little money to make this structure function properly. To illustrate, consider the following example as shown in Figure 4.

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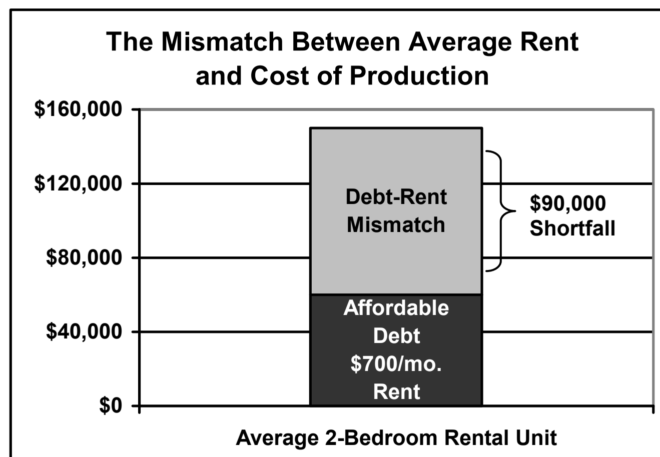
[28] The Community Investment Corporation, (CIC) is a nonprofit loan fund with assets of $550 million that lends money to small developers in lower-income communities and provides those developers with technical assistance and training.

Figure 4 – Mismatch Between Per Unit Average Rent and Cost of Production



The median rent for a two-bedroom apartment in Chicago is $700 per month. Of this $700, approximately $400 is needed to cover the monthly operating expenses for the unit. This leaves $300 per month to cover debt service. At a modest 6 percent interest rate on a 30 year mortgage, a developer can afford to service approximately $60,000 in debt per unit. However, the average per unit cost for new development is approximately $150,000. Thus, the mismatch between manageable debt service and per unit development costs is approximately $90,000.

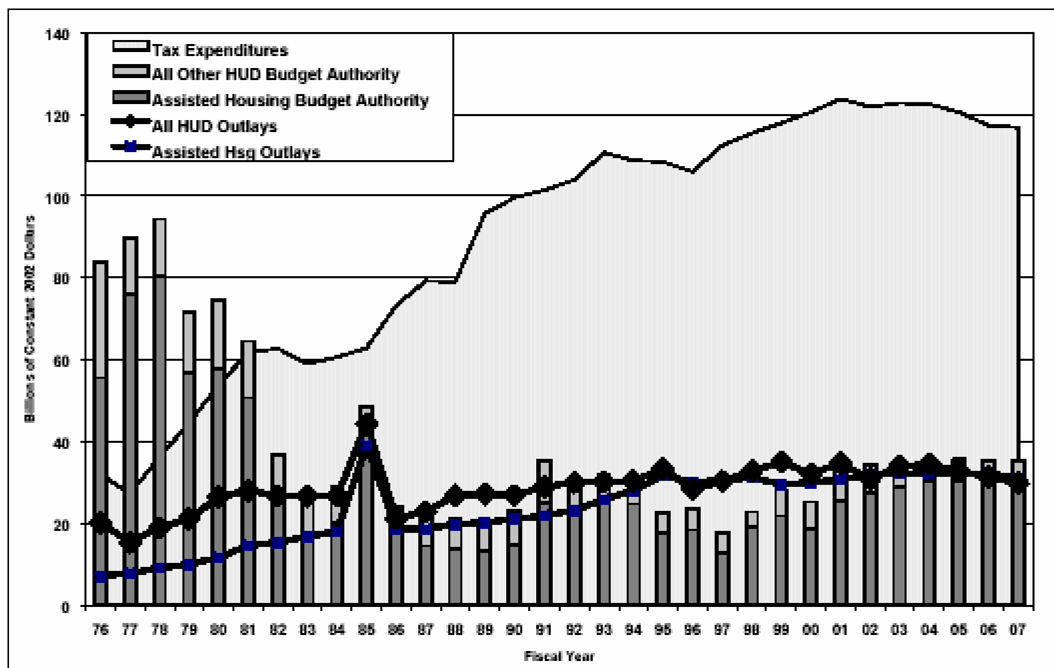
As the above figure illustrates, a severe mismatch between development costs and affordability exists, particularly for those households making less than 50 percent of the area median income. However, this is not a new problem. In fact, an examination of the market for new affordable housing markets in Chicago in the last century suggests that in only two periods, in the 1920s and 1960s, was unsubsidized rental housing produced in any quantity. In the 1920s, costs of construction of regular housing were in line with rents, and in the 1960s the invention of four plus one buildings[29] lowered the cost of housing. However, some people consider the four plus ones to be substandard.

The second underlying issue which is a consequence of the first is that the federal government must play a larger role if we are to solve the affordable housing crisis. However, over the past two decades, the federal government has backed away from this responsibility, as evidenced by the sharp decline in federal funding for subsidized housing since the early 1980s. The following paragraphs explore trends in funding for the United States Department of Housing and Urban Development (HUD) which administers more than 95 percent of all housing assistance programs in the United States. All of the data and analysis in this section is summarized from the report, *Changing Priorities: The Federal Budget and Housing Assistance, 1976 – 2007* by Cushing Dolbeare and Shelia Crowley, of the National Low Income Housing Coalition.

[29]A four plus one is an apartment building with four residential floors constructed over a below-grade concrete frame parking garage. Using a loop-hole in city codes that permitted four story, wood framed buildings to be built above basements, the four plus ones were inexpensive to build and maintain and since they were constructed in well-situated neighborhoods provided dependable high occupancy. After protests that the rapid development of these buildings was destroying the character of the neighborhoods, the city zoning code was changed in 1968 to prohibit any further development of this kind.

Figure 5 presents a historical view of HUD funding and housing-related tax expenditures during the period 1976 to 2002 in year 2002 constant dollars. HUD's housing assistance budget authority peaked in the mid-1970s, reaching its height in 1978, with an appropriation of $82 billion. HUD budget authority declined sharply in the early 1980s because of program cuts. The spike in budget authority in 1985 was the result of converting outstanding public housing debt to capital grants. While this move saved money in interest payments, it created no additional housing units. HUD budget authority continued to decline after 1985, reflecting both program cuts and changes in the way subsidized housing was financed.[30] The financing changes also served to decrease the disparity between budget authority and outlays, which can be seen in the later years in the chart. By fiscal year 2002, HUD's total budget appropriation was just $27.5 billion. The bottom line is that HUD funding has declined substantially since the 1970s. HUD's 1976 budget authority of $56 billion was more than twice the Bush Administration's request for fiscal year 2003. HUD's total FY 2002 budget of $34.3 billion was just 41 percent of the FY 1976 budget of $83.6 billion.

Figure 5 – HUD, Housing Assistance, and Housing-Related Tax Expenditures, 1976-2007



Source: Cushing N. Dolbeare and Shelia Crowley. *Changing Priorities: The Federal Budget and Housing Assistance, 1976-2002.* National Low Income Housing Coalition, August 2002.

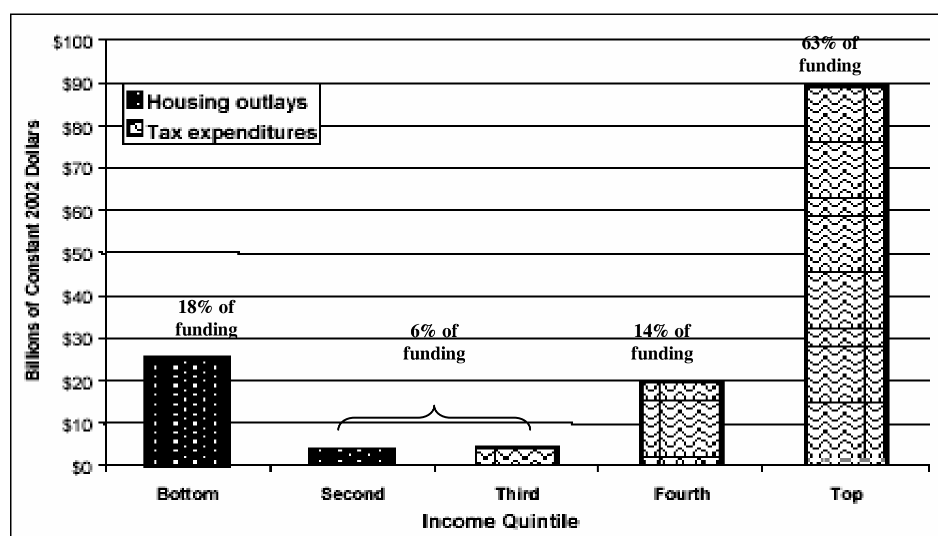
While HUD's budget authority has declined since the 1970s, housing related tax expenditures have risen sharply. Housing related tax expenditures are mainly made up of homeowner deductions for mortgage interest and property taxes, as well capital gains deferments and exclusions for home sales.

[30]As stated by Dolbeare and Crowley, "In the 1960s and 1970s, subsidy contracts ran for 30 years (or 40 for public housing), so a high level of budget authority was required to finance the developments. The calculation of budget authority was the maximum subsidy commitment multiplied by the length of the commitment. This had the effect of making low income housing appear to be outrageously expensive. So contract lengths were shortened, to 15 years, then 10, then 5, then 1, bringing budget authority and outlays more closely into line." See Cushing N. Dolbeare and Shelia Crowley. *Changing Priorities: The Federal Budget and Housing Assistance, 1976-2002.* National Low Income Housing Coalition, August 2002.

Housing related tax expenditures also include investor deductions for tax-exempt housing bonds, accelerated depreciation, and low income housing tax credit. Between 1976 and 2002, housing related tax expenditures increased 281 percent, from $32 billion to $121.8 billion. As shown in Figure 5, FY 2002 tax related expenditures are more than three times the total HUD budget authority.

The contrast between federal spending for housing assistance and housing related tax expenditures points to a great disparity in the distribution of federal housing expenditures in favor of upper income Americans. Figure 6 shows the estimated 2002 distribution of direct housing assistance outlays and housing-related tax expenditures by income quintile.

Figure 6 – Estimated Distribution of Housing Subsidies, By Income Quintile, 2002

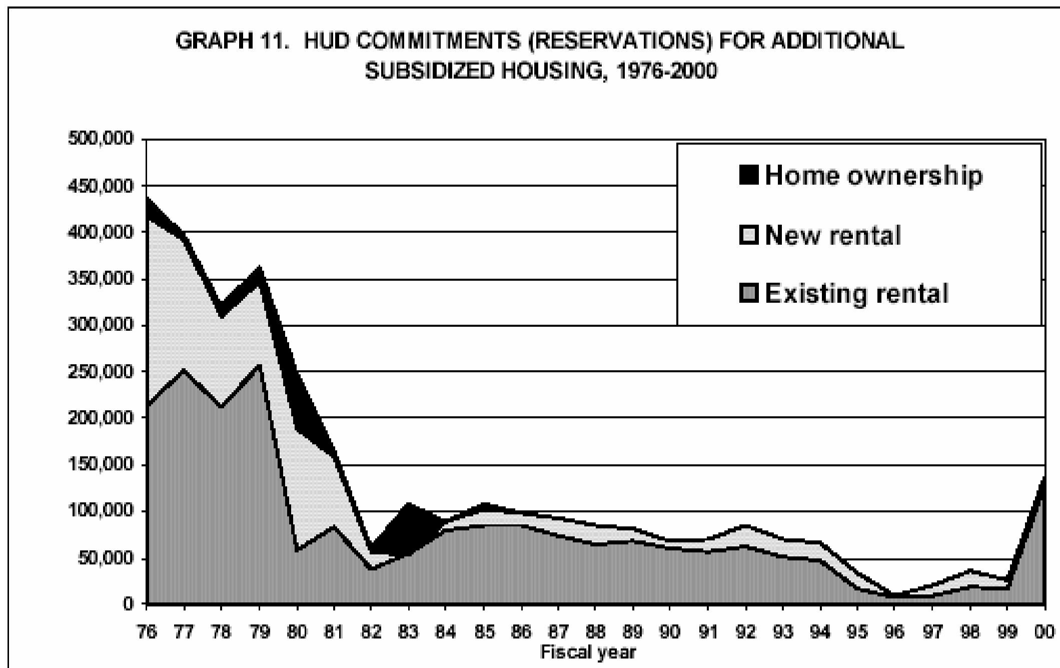


Source: Cushing N. Dolbeare and Shelia Crowley. *Changing Priorities: The Federal Budget and Housing Assistance, 1976-2002.* National Low Income Housing Coalition, August 2002

Of the $142.9 billion federal housing subsidies, just $29.2 billion are earmarked for housing assistance outlays, with $113.7 billion going for housing relating tax expenditures. The top income quintile, with an average annual income of $132,455, receives 63 percent ($89.3 billion) of all federal housing subsidies, all in the form of tax expenditures. The fourth quintile, with an average annual income of $62,594 receives 14 percent ($19.8 billion) of federal housing subsidies, almost entirely in the form of tax expenditures. Households in the second and third quintiles, with average annual incomes of $24,188 and $40,472 respectively, receive approximately 6 percent ($8.4 billion) of federal housing subsidies, with a mix of tax expenditures and outlays to reduce housing costs. Households in the bottom quintile receive an estimated 18 percent ($26 billion) of all expenditures, all in the form of subsidies to reduce housing costs. This data shows that the most well off Americans are receiving the majority of federal housing subsidies. Thus, even if no additional federal support was available, redistribution of existing federal housing subsidies would help ease the affordable housing crisis.

Declining federal funding for housing assistance programs has resulted in a sharp decline in the number of new federally subsidized housing units subsidized during the period 1976 to 2000 as shown in Figure 7.

Figure 7 – Net Number of New Federally Subsidized Housing Units, 1976-2000



Source: Cushing N. Dolbeare and Shelia Crowley. ***Changing Priorities: The Federal Budget and Housing Assistance, 1976-2002.*** **National Low Income Housing Coalition, August 2002.**

The height of federal subsidies for housing was in 1976, when approximately 435,562 units of housing were subsidized. Of these, 203,046 were new rental units, with 213,742 existing rental units supported through Section 8 vouchers and certificates and other programs. By FY 1982, the number of new federally subsidized housing units dropped dramatically, to just 60,590. Only 18,018 were new rental units. In FY 1999, the last year for which non-estimated data is available, the federal government subsidized 27,285 more housing units, of which just 11,060 were new rental units. In addition to a decline in the number of units, there has been a shift from an emphasis on production, rehabilitation of housing units, and tenant based assistance to an almost complete reliance on vouchers.

Conclusion

The bottom line is that the private market is incapable of producing new units of affordable housing without deep subsidy. This has been the case for over 70 years. To solve the affordable housing crisis, we must close the gap between income of renters and the cost of production and increase federal funding to subsidize affordable housing production. The Millennial Housing Commission acknowledged these issues in its final report *Meeting Our Nations Housing Challenges*. The Commission proposed a 100 percent capital subsidy for the construction, rehabilitation, or acquisition of housing units for extremely low-income renters. The proposed subsidy, which would be allocated by states, would address the debt-rent mismatch illustrated above by eliminating the need for debt, so that rents would

only be needed to cover operating expenses and adequate reserves. The subsidy is intended to be used in mixed-income developments.[31]

The United States Congress is addressing these issues as well, with the introduction of legislation that would create a national low-income housing trust fund. On March 5, 2003, The National Affordable Housing Trust Fund Act of 2003 (H.R. 1102) was introduced in the U.S. House of Representatives by Representatives Bernie Sanders (I-VT), Barbara Lee (D-CA), and Robert Simmons (R-CT). The bill, which currently has 200 co-sponsors, calls for the creation of a national housing trust fund, a permanent, dedicated funding source that would build, rehabilitate, and preserve 1.5 million units of rental housing for low-income families over the next 10 years. The proposed trust fund places a special emphasis on very low-income renters, those earning less than 30 percent of the area median income.[32]

Until the gap between the cost of production and income is closed and federal funding is increased, the affordable housing crisis will continue. Policymakers and researchers should continue to explore all options, in order to advance toward the larger goal of solving America's affordable housing shortage. Whatever approach is taken, a large and long-term federal effort is required. As Dolbeare and Crowley (2002) conclude, "It will not be possible to reduce waiting lists or meet even a significant portion of critical housing needs without returning to the production levels of the late 1970s. Even at those levels, it will take years."[33]

[31]The complete report is available on-line at http://www.mhc.gov/MHCReport.pdf.

[32]For more information, please see the National Housing Trust Fund Campaign website at www.nhtf.org.

[33]Dolbeare, Cushing N. and Shelia Crowley. *Changing Priorities: The Federal Budget and Housing Assistance, 1976-2002.* National Low Income Housing Coalition, August 2002.

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Woodstock Institute

Woodstock Institute, a Chicago nonprofit incorporated in 1973, works locally and nationally to promote sound community reinvestment and economic development in lower-income and minority communities. It collaborates with community organizations, financial institutions, foundations, government agencies, and others to promote its goals.

The Institute engages in applied research, policy analysis, technical assistance, public education, and program design and evaluation. Its areas of expertise include: CRA and fair lending policies, financial and insurance services, small business lending, community development financial institutions, and economic development strategies.

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