Financing Housing and Community Development: Public, Private, and Not-for-Profit

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November 1999

Paper prepared for the National Conference on Reform and Renewal in Social Housing, November 29-30, 1999, Sydney, Australia. Tracy Gordon assisted greatly in the preparation of this paper.
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Abstract

This paper provides a selective review of two aspects of urban policy in the U.S. – federal policy providing housing subsidies for lower income households, and federal support for urban redevelopment and physical renewal.

The paper reviews four periods in the history of American housing policy, indicating the major equity and efficiency issues in delivering housing services, the factors affecting program costs, and the development of more effective programs.

The paper also traces urban development policy from the urban renewal partnership sponsored by the 1949 Housing Act to the present, indicating the linkage between theories of intergovernmental fiscal relations and the evolution of programs.

The analysis is mostly an exercise in positive economics, explicating the development of policies, their economic rationale, and economic consequences. However, inevitably, there is some attention paid to the normative aspects of these programs.

I. Introduction

Government policies directed specifically towards urban areas are certainly not new ideas. Indeed, two thousand years ago Caesar Augustus decreed a set of physical restrictions on Roman buildings and public infrastructure that affected the form and development of the city and whose effects are visible even today. Sets of policies intended to improve living conditions in the big cities were widely adopted in Europe during the latter half of the nineteenth century; the British Public Health Acts and the Salisbury Acts are but two well-known examples.

Urban affairs were, of course, a concern of the states and the cities they sanctioned since the beginning of the Republic. However, it was only after World War II and the end of the Great Depression that direct urban policies were articulated by the Federal Government. The Housing Act of 1949 espoused the goal of “a decent home and a suitable living environment" for all Americans and provided the rationale for an ambitious program of urban renewal and slum clearance begun in the 1950’s. The factors that led, ultimately, to the passage of the Housing Act included a severe nationwide housing shortage which continued long after the wartime victory. This shortage reflected the cumulative effects of the great depression, the explicit

limitations on residential construction during the war, the post-war shortages of construction material, and the massive immigration to the cities which had taken place during the war.

This paper reviews the American housing and urban development policy emanating from the landmark housing act enacted a half century ago. As we shall see, current U.S. policies and programs are directly descended from the 1949 Housing Act. From a broader viewpoint, housing and urban development is the most basic and durable aspect of national urban policy, and provides the spatial context within which other policies operate. The intra urban distribution of population, the concentration of the poor, the distribution of work sites, housing quality, and tax bases are all directly affected by the substantial resources devoted to housing and urban development policy. These spatial relationships in turn have a profound effect upon the economic health of the urban economy.

Other policies which entail substantial central government expenditures may also have important effects upon urban areas. For example, the Federal Tax Code in its treatment of owner-occupied housing may have substantial effects upon urban spatial structure (Gyourko and Voith, 1999), and the recent changes in

welfare entitlements will surely affect the incomes and opportunities of the poor who live in central cities. Yet neither of these policies is designed to pay attention to their distinctly metropolitan or urban impacts. Metropolitan areas are large, so most national policies do have some effect upon urban life. Housing and urban development policies are directly intended to affect the residents of urban areas -- and they do so in important ways.

For the most part, the text is an exercise in positive economics, indicating the course of urban policies, their economic rationale, and their economic consequences. Nevertheless, the paper cannot avoid discussing some normative issues and offering some evaluations.

II. Federal Housing Programs for Low-income Households

The history of housing programs for low-income Americans in the U.S. can be divided into four phases. During the first period, from the founding of the Republic through 1937, the national government provided no support at all for low-income housing. Many crucial policy decisions about housing were taken, for example, the treatment of housing under the new income tax law in 1913 and the establishment of the Federal Housing Administration in 1934. By increasing the demand for

owner-occupied housing, both had important consequences for urban form. However, neither these nor other national housing policies were directed specifically towards those with low incomes. During the second period, from 1937 to 1962, one federal government program subsidized poor households -- low-rent public housing owned and operated by government agencies. The third period, from 1962 through 1974, saw the first encouragement of private entities in the provision of federally subsidized housing for the poor. It was not until the fourth phase, beginning in 1974, that the link between the new construction of dwellings and the subsidy of low-income households was first broken.

Economists are quick to point out that public resources spent on low-income housing are small compared to the foregone revenues arising from the treatment of housing under the Internal Revenue Code. The imputed income an owner receives from an investment in owner-occupied housing has always escaped taxation. However, after passage of the Tax Reform Act of 1986 (TRA86), the treatment of imputed rent, local property taxes, and mortgage interest payments for homeowners has contrasted

even more starkly with the tax treatment of other investment returns, other taxes, and other interest payments.[1]

Of course, most of these "subsidies" imbedded in the tax code accrue to the wealthiest of households. It is estimated that these asymmetries in the tax code reduce federal revenues by almost $100B ($93.8 for FY 1998), and that two thirds of the benefits accrue to households in the top quintile of the income distribution.[2]

Table 1 illustrates the four historical phases in federal

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[1] The treatment of investment in rental housing also contrasts more starkly with investment in owner-occupied housing after TRA86. The 1986 change in tax laws lengthened the depreciation schedule, required that a straight line depreciation profile be used (instead of the more favorable ACRS method), increased the capital gains rate to 28 percent, eliminated passive loss deductions completely, and decreed a phase out of existing programs within four years. These had the net effect of increasing the breakeven rents charged by landlords and reducing the profitability of rental housing.

[2] The largest component of this total arises from the failure to tax the gross implicit rental income of owner occupants. The Congressional Budget Office (1996) estimates that federal tax revenues would increase by $40-$50B if the mortgage interest deduction were eliminated, but this is surely a large over estimate -- since many owner occupants would simply reduce their reliance upon mortgage debt finance in response to changes in the price of debt. (See Follain and Melamed, 1998). Federal efforts to increase homeownership through the FHA have been rationalized, in part, as a means to make lower income households qualify for federal tax "subsides."

housing policy. For the analysis of programs in each of these phases, two important economic characteristics are salient: the *identities* of the owners and managers; and the *form* of the subsidy. For government housing programs, identity and form have been intimately inter connected. Each aspect matters in evaluating the economic incentives in these programs.

A. Public Housing: Government Ownership and Management

For twenty-five years, beginning in 1937, low-rent public housing was the only federal program providing housing assistance to the poor. Indeed, it is still true that public housing provides shelter for more than 1,300,000 U.S. households (U.S. Department of Housing and Urban Development, 1999). Waiting lists for public housing accommodation are long, eleven months on average in U.S. metropolitan areas (HUD, 1999). For the largest public housing authorities, current waiting times average almost three years (Painter, 1997). Despite much criticism of public housing, there has always been excess demand at prevailing prices.

First, consider the ownership of public housing. For the first 28 years of the program, all public housing units were designed, built, and managed with direct oversight by local housing authorities. These housing authorities are established

by local governments to operate within a single political jurisdiction, or in groups of cities and counties. The local authorities issue long-term tax-exempt debt whose interest and amortization is guaranteed by an annual contributions contract with the U.S. Department of Housing and Urban Development (HUD). The proceeds are used to finance HUD-approved public housing projects.

Second, consider the form of the subsidy. For the first 33 years of the program, essentially all the capital costs of public housing were borne by the federal government. Conversely, after the construction of public housing, local authorities were required to meet all subsequent operating expenses out of current rental income.

These two features of the public housing program had far reaching consequences. Control by local authorities meant that decisions about public housing were responsive to the political processes buffeting small units of government. Local governments, fearful that the availability of public housing would encourage immigration of the poor, could opt not to establish housing authorities, thereby preventing the building of public housing within their borders. The 1949 Housing Act, extending the public housing program originally enacted in 1937,

included a requirement that local authorities' applications for funding be approved by local government. Moreover, any locality in which public housing was to be built needed a locally approved "workable program" for community development. This requirement was imposed until 1969.

Local governments, fearful of neighborhood reaction to public housing, can also intervene in decisions about the design and location of facilities serving low-income residents. Because public housing concentrates low-income households geographically, the program has been subject to intense political pressure.

The requirement, that housing authorities cover operating costs from rent revenues while the federal government finances all capital costs, led to predictable results, still visible in the urban skyline of many cities. Subsidizing only capital costs made it economically rational for local authorities to design housing requiring additional capital up front as long as the design reduced subsequent operations and maintenance costs. High rise structures, smaller windows, and smaller common areas were all predictable economic implications of the form of the public subsidy. The subsidy also increased the spatial concentration of program beneficiaries, typically the poorest

households in the urban area. The federal government began contributing to operating costs in 1970, but the legacy of economically inefficient design still exists.

The efficiency costs of subsidizing input prices rather than output quantities is also worth pointing out. Even with very elastic substitution of capital for operating inputs in response to prices, this feature of program design ensures that the cost of the program to taxpayers exceeds the value of the additional housing produced. It is estimated that, as a result of the form of this subsidy program, taxpayer costs for public housing were about forty percent greater than the value of housing produced (Muth, 1973).

The requirement that operating costs be covered out of current revenues gave local authorities a Hobson's choice: to help those families most in need; or to ensure the fiscal solvency of the agency itself. The Brooke Amendments of 1970 limited rents to 25 percent of income (increased to 30 percent in 1981), reducing wide disparities in rent burdens among public housing tenants in different geographic areas. The Brooke Amendments provided operating subsidies to local authorities and thus gave them greater incentives to serve a poorer clientele. However, as local authorities permitted greater access to public

housing by the very poor during the 1970’s and 1980’s, rent revenues accruing to the agencies necessarily declined, and consequently the need for federal operating subsidies increased substantially. The solution to the Hobson's choice facing local authorities involved limiting the exposure of local authorities to cost increases, but removing previous limits on the financial exposure of the federal government.

Some of the spatial and geographical problems encountered by local authorities, and tenants as well, were ameliorated by the Leased Housing (Section 23) Program and the Turnkey Program, both introduced as modifications to public housing in 1965. The former program permitted local authorities to rent privately owned dwelling units for occupancy as public housing. This provided more flexibility to local authorities. It reduced middle-class opposition to the geographical dispersion of public housing units -- since public housing recipients could be anonymous renters whose bills were paid by local authorities. The anonymity of the leased housing program also benefited tenants who were less easily identified as being “from the projects.” The Section 23 program also helped to reduce the geographical concentration of public housing recipients.

The Turnkey Program enabled private developers to propose

construction of additional public housing with a particular design and price tag at a specific location. Choosing among locations proposed by others proved to be less politically contentious for local housing authorities than proposing them de novo.

Figure 1 summarizes the course of the public housing program during the post-war period. The program began with a substantial financial commitment, quickly scaled back with the outbreak of the Korean War. By the late 1960's, the program had been restored to the level contemplated in the original act. From a total of 830,000 units under public management in 1970, the number increased to almost 1,200,000 by 1980. During the past two decades the size of the public housing program has scarcely grown: In 1998, there were just under 1,300,000 units in the public housing inventory, down from a high of 1,410,000 units in 1991. Since the early 1970s, half or more of the units added to the public housing stock have come from the leasing of existing units rather than the construction of new public housing projects.

With the aging of the public housing stock came the increasing need for substantial expenditures for rehabilitation and modernization. From 1980 to 1992, funds for modernization

were allocated to local authorities as conditional grants (under the Comprehensive Improvement Assistance Program). Beginning in 1992, this program was supplemented by disbursements under a formula taking structural conditions and management into account (the Comprehensive Grant Program).

The Housing and Community Development Act of 1982 also authorized HUD to set aside up to twenty percent of development funds for major reconstruction of obsolete public housing projects. This assistance also comes in the form of conditional grants (under the Major Reconstruction of Obsolete Projects Program).

Since 1993, other HUD programs have provided grants and regulatory flexibility to local authorities to revitalize severely distressed public housing. For example, the HOPE VI Program has funded planning, revitalization implementation, and demolition-only grants for public housing. Local authorities administer the program, and can use these grants in conjunction with modernization funds or other HUD funds. Local authorities can co-mingle these funds with municipal and state contributions, public and private. Figure 2 summarizes information about HUD funds expended on operating costs and the rehabilitation of public housing projects. HUD currently spends

about $3B annually in operating subsidies and another $3B in rehabilitation (in 1997 dollars).

The most recent public housing programs are those encouraging private ownership of individual dwellings. Enacted as part of the Cranston-Gonzalez Act of 1990, the HOPE Program provides funds that nonprofit organizations, resident groups, and other eligible grantees can use to develop and implement homeownership programs for the residents of public housing units.

The end game of the public housing program is not a pleasant sight. In the new millennium, no one would countenance the construction of high density over-capitalized buildings concentrating the most deprived households in particular urban neighborhoods. Yet the overhang from a half century of public housing is a large stock of such buildings. Moreover, the buildings are deteriorating and many of them are functionally obsolete. There are limits to the possibilities of converting this stock to mixed use or to home ownership units, and the

costs of rehabilitation are exorbitant.[3]

Yet, it is worth emphasizing: this stock of public housing provides higher quality housing services to the lowest income households than they could afford on the open market. At rents of thirty percent of household income, there is substantial excess demand by the poor for public housing.

B. Private Suppliers

The 1960's saw the first efforts to subsidize low-income housing units that were not owned by an agency of government. As noted above, the Section 23 lease program of 1965 allowed local authorities to contract with private sector owners for units of public housing to be managed by the public sector.

[3] Despite HUD's annual expenditures of roughly $6B on operations and maintenance, it is estimated that more than a million units of public housing are in jeopardy due to depreciation and under maintenance (Schnare, 1991). Gabriel (1996) reports that about 15 percent of all public housing units are in need of renovations costing $20,000 or more; more than $15B would be required to put the public housing stock in an "acceptable" physical condition. HUD currently reports that a fifth of all publicly subsidized units are not in "good condition" (HUD, 1999b).

At about the same time, beginning in 1961, a series of programs was initiated which invited greater participation by nonprofit and limited-dividend corporations, and ultimately by private profit-maximizing landlords.

These programs, including those with such colorful names as BIMR Section 221(d)3, Section 235, and Section 236, were short-lived in some cases. Several contained perverse incentives that led to escalating expenses, and invited waste and fraud. Here are two examples:

The Section 236 Rental Assistance Act provided subsidies equaling the difference between one fourth of tenant incomes and the amortization of construction costs for new low-income housing over forty years at market interest rates. Now in a period of rising interest rates, amortization costs increase much more than proportionately with interest rate increases. Thus, the annual subsidy due under the Section 236 program can simply explode.

The Section 235 Homeowner Assistance Program required participants to pay a fixed percentage of their incomes for home purchase regardless of the selling price of the house they purchased (as long as it was appraised within general guidelines). Thus, buyers had no real incentive to negotiate

for lower prices or better terms, and honest appraisers had incentives to report the highest value that could be justified. Dishonest appraisers had strong incentives to collude with sellers.

Table 2 provides a summary of the major housing programs developed during the period of The Great Society.[4] With the exception of the Section 235 and Section 312 Programs, these programs involved federal subsidies paid to private entities for the construction of rental housing for occupancy by low income renters (As already indicated, Section 235 was a low income homeownership program beset by problems in the design of the subsidy). By 1975, about 400,000 dwellings were subsidized under Section 236, and another 165,000 were subsidized by the rent supplement program (which augmented the rental payments of households living in designated newly constructed dwellings).

Despite many problems in subsidy design, the new programs of the 1960's were real innovations in the course of U.S.

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[4] The table reports little information about subsidies under the short-lived BIMR (Section 221, d, 3) program, passed in 1961, but effectively scuttled when government accountants ruled that the present value of the program had to be charged as a public expense in advance of the housing services emitted over the life of the project.

housing policy. These programs represented the first time that federal government provision of low-income housing relied upon units supplied by the private as well as the public sector. The owners and managers of units under these programs were private entities who would reap some of the benefits of increased productive efficiency.

These programs also freed subsidized housing provision for low-income populations from the threat of veto by local governments. By removing the requirement of a locally-sanctioned “workable program” for community involvement, these programs increased the potential for some dispersion of low-income populations among urban communities. The liberalization of the “workable program” requirement did not come until 1969, however, and the programs -- below interest mortgages (BIMR), homeownership (Section 235), rental assistance (Section 236), and rent supplements -- floundered well before President Nixon announced a moratorium on new obligations under these programs in his State of the Union Address in January 1973.

C. Existing Housing

Section 8 of the Housing and Community Development Act of 1974 opened the way for greater participation by private entities in the provision of housing for the poor. The Act

proposed federal funds for the “new construction or substantial rehabilitation” of dwellings for occupancy by low-income households. This project-based assistance was a logical extension of the rental programs introduced in the 1960’s. HUD entered into housing assistance payments contracts for up to forty years with private housing suppliers, guaranteeing a stream of rental payments for the dwellings. Income-eligible households paid 25 percent (now 30 percent) of their incomes in rent, and the difference between tenant payments and the contractual rate was made up by direct federal payments. Landlords received a reliable source of payment at an agreed-upon rule (For newly constructed or rehabilitated units, agreements about the rental stream included provisions for its escalation during the contractual period). Moreover, landlords were able to shift the cost and risk of vacancies to the government. This program continued the advantages of the 1960's programs over the traditional public housing program. Section 8 involved private enterprise -- non-profits, and syndicates but also for-profit firms -- in the building and management of low-income housing, and the program reduced the historical incentives for concentration of the poor in large projects.

However, a crucial modification to housing policy was introduced in Section 8 of the 1974 Housing Act: the restriction

that subsidies be paid only to owners of new or rehabilitated dwellings was removed. An equally important modification permitted payments to landlords on behalf of a specific tenant rather than by a long-term contract with the landlord. Through these modifications, project-based assistance program authorized under Section 8 came to be dominated by the tenant-based assistance program authorized under the same section of the housing act. Under the latter, tenant-based subsidies, HUD enters into an annual contributions contract with local authorities for program administration. Local authorities ensure that the specific low-income households assisted by Section 8 are income eligible and that the housing units selected by assisted households meet minimum quality standards. Households receiving tenant-based assistance use the resources provided by HUD's annual contribution to lease dwellings from landlords of their choice (as long as the dwelling selected meets HUD standards and the owner agrees to participate in the program). Landlords receive HUD's currently published fair market rent for the unit (FMR's are calculated by survey to be the fortieth percentile of the rent distribution).

The Housing Act of 1974 also set comprehensive income limits on eligibility for housing assistance across all federal programs. These limits were set at eighty percent of area

median income (At the time, this made almost forty percent of the entire U.S. population eligible for assistance). However, other factors made the effective targeting of public assistance somewhat narrower -- with the lowest income households in public housing and those with somewhat more resources in other programs.[5]

The targeting of federal housing assistance was again strengthened in the 1981 Omnibus Budget Reconciliation Act which established eligibility for those entering federal housing programs at 50 percent of area median income, subject to a variety of exceptions.

Figure 3 summarizes the new units supplied by project-based assistance under Section 8 as well as the number of households assisted by the tenant-based demand-side program. As the table indicates, during the first few years of the program, the number of project-based subsidies (i.e., dwellings provided in newly constructed or rehabilitated dwellings) was about the same as

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[5] Indeed, several observers have cited the geographic isolation and unpleasant surroundings of public housing as factors "helping" to target assistance by discouraging all but the most desperate households from applying for assistance under the program. (See Nelson and Khadduri, 1992; Mayer, 1995.)

the number of tenant-based subsidies (i.e., the number of certificates outstanding). During the early 1980's, there was increased emphasis on new construction. By 1990 this had been completely reversed. There are now about 1,600,000 households subsidized through Section 8 vouchers and certificates, while 1,400,000 households are subsidized through the project-based program.

Under the original version of the Section 8 program, households receiving tenant-based assistance would qualify on income terms for a "certificate" issued by the local authority. The household in possession of a certificate would then be required to occupy a unit renting for less than the HUD-established fair market rent and to pay a stipulated fraction of its income (currently 30 percent) on rent. The difference between the tenant contribution and the FMR would be paid to the landlord as the federal subsidy.

Note that the certificate program suffers from the same incentive problem as the Section 235 Homeowner Assistance Program. Since the recipient pays a constant amount towards housing and since the recipient is far better off with the certificate than searching for unsubsidized housing on the private market, he or she has little incentive to bargain for a

lower price as long as the unit rents below FMR.

These incentives were changed by the more flexible "voucher" program introduced in 1987. Under this program, households in possession of a voucher may choose to pay more than the fair market rent computed by HUD for a particular dwelling, making up the difference themselves; they may also pocket the difference if they can rent a HUD-approved dwelling for less than the FMR.

In 1998, legislation made vouchers and certificates “portable,” thereby increasing household choice and facilitating movement to other regions where employment opportunities may be greater. Also in 1998, the voucher and certificate programs were essentially merged; local authorities were permitted to vary their payment standards from 90 to 110 percent of FMR. The 1998 changes (in the Quality Housing and Work Responsibility Act) also sharpened the targeting of housing assistance. Three quarters of all new vouchers must now be issued to those whose incomes are below 30 percent of local median incomes. All new vouchers must go to recipients with incomes below 80 percent of the median income of the area.

With the unwillingness to appropriate new funding for public housing or for Section 8 new construction, additions to

the stock of subsidized housing now rely almost entirely upon used dwellings.[6] The cost advantage in producing low income housing from the existing stock rather than by new construction is enormous. (This is something private suppliers of low income housing have always known.)

Table 3 reports trends in new commitments by the federal government for rental assistance (across all programs) through new construction and through the existing stock of housing. Two trends are apparent in this summary. First, the distribution of newly subsidized units between newly constructed units and existing dwellings has changed markedly. In 1977, 65 percent of the newly subsidized units were newly constructed. By 1997, 72 percent of new federal commitments were made to existing dwellings. Second, the net number of new federal commitments for housing has plummeted. During 1977-1980, the number of new commitments averaged 350,000 a year. During 1995-97, the number of new commitments averaged 49,000 -- a decline of 86 percent.

One way to illustrate the downward trend in incremental housing subsidies is to compare HUD's outlays and budget

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[6] The principal programmatic exception, the Low Income Housing Tax Credit (LIHTC), is discussed below.

authority. Figure 4 presents trends in outlays and budget authority, in real terms, during the past two decades. Current outlays (e.g., checks written on the Treasury in any year to subsidize tenants) are incurred as a result of budget authority previously or contemporaneously granted. Thus the sharp downward trend in budget authority is a reduction in the stock of funds which can be used to subsidize households in the future.[7]

The legacy of previous program commitments, of course, means that the current mix of housing subsidy includes a larger fraction of dwellings which were originally constructed for occupancy by subsidized low-income households. Table 4 reports these trends. During the last two decades, subsidized units involving existing housing have increased almost tenfold, from 268,000 to 2,051,000. Subsidized units involving new construction have increased from 1,825,000 to 3,305,000. By 1997, forty percent of the dwellings subsidized by HUD for low income renters made use of the existing stock of housing. Sixty

[7] This is subject to qualification; the accounting issues are somewhat more arcane but do not affect the point of the comparison. See Congressional Budget Office, 1994, for a detailed discussion.

percent involved new construction at the time of their initial occupancy.

The construction of new housing for low income households has simply atrophied as the federal government curtailed the expansion of conventional public housing and Section 8 new construction in the early 1980s. During this period, state and local governments continued several subsidy programs which relied upon federal tax expenditures. State housing finance agencies, and in many cases local governments as well, issued tax-exempt bonds and used the proceeds for housing subsidies. These programs (and a variety of other private-purpose bond programs) were severely curtailed by the Tax Reform Act of 1986. As indicated previously, other provisions of TRA86 made investment in rental housing favorable less profitable. TRA86 replaced these provisions, as well as the unlimited right of states to issue tax-exempt debt for housing subsides, with a flat per-capita tax credit for new low income housing allocated to each state. These credits are administered by state agencies (typically state housing finance agencies) which distribute credits among projects proposed by developers. Project eligibility requires that the rents charged for subsidized dwellings be no more than 30 percent of the incomes of households at 60 percent of local median income (See Wallace,

1995).

These Low Income Housing Tax Credits (LIHTC) are used by developers in partnership with individuals and firms willing to invest capital in low-income housing in return for federal credits. Some of the investor capital is applied to "syndication costs," those costs required to make the business connection between investors and developers. The competitive returns required by investors are higher than treasury borrowing rates (since there is always some danger that a given project will fail, or that it will fail to qualify for tax credits).

So, in present value terms, the tax credits represent more in lost federal revenue than an equivalent investment in housing through direct federal government appropriations. Estimates by Stegman (1991) after the first few years of LIHTC experience suggested that the increased housing investment generated by the tax credit was only about half of its cost to the federal treasury.

Recent research by Cummings and Di Pasquale (1998) provides a somewhat more optimistic assessment. Cummings and Di Pasquale evaluated some 2300 projects funded by the LIHTC during its first decade, confirming Stegman's estimates for the early years but also indicating an upward trend in the value of housing

output per dollar of tax credit expended. Figure 5 reports their results, suggesting that the market for these credits has become far more competitive during the past decade. Still, in 1996, the evidence shows that a dollar of federal subsidy produces only about 62 cents in housing output.[8] The economic efficiency of the LIHTC is roughly the same as the public housing program.

But the Low Income Housing Tax Credit is a small program. The aggregate tax credit was set at $1.25 per capita each year and has been unchanged since the program was established in 1986. Currently, this represents about $45 for each household in poverty.

D. Summary

During the period since the explicit recognition of the goal of "decent home" for all Americans, four important economic trends have emerged in housing subsidy programs. First, the locus of subsidy has changed from the dwelling unit to the

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[8] The figures reported by Cummings and DiPasquale represent the value of housing produced divided by the sum of the stream of tax credits incurred, rather than the present value of the stream. Thus they represent a slight underestimate of program efficiency. See Cummings and Di Pasquale, 1999.

household occupying the dwelling unit. Second, the type of property subsidized has changed from newly constructed dwellings to used dwellings which were originally constructed for higher income households. Third, the ownership of subsidized dwellings has changed from agencies of the government to private non-profit agencies, and increasingly to for-profit landlords. Fourth, there has been a downsizing of the relative commitment to housing programs in comparison to other objects of federal government expenditure.

During the decade of the 1970s, the experimental housing allowance program (EHAP), still the most expensive social experiment in history, provided subsidies based upon a formula analogous to the current Section 8 rent subsidy rule. These subsidies were offered to all low income households in two medium-sized metropolitan areas, Green Bay, WI and South Bend, IN. EHAP also provided subsidies through a variety of more complicated formulas in two other metropolitan areas. These latter subsidies were offered to only a small number of households in Phoenix and Pittsburgh and were intended to elicit the housing demands of low-income renters. The central findings of the experiments were that: income transfers and housing price reductions had modest, but inelastic, effects upon the housing consumption of low income households (Hanushek and Quigley,

1981); and market-wide subsidy programs had no perceptible effects upon the price of housing suitable for low-income households (Bradbury and Downs, 1981).

Almost two decades later, it appears that U.S. housing subsidies have grown to resemble more closely the modal experimental program evaluated by EHAP. Eligible households are offered the difference between the market price of "just standard" housing and 30 percent of income. To qualify, recipients must live in dwellings which pass a minimum standard. The one big difference between the experimental housing allowance program as evaluated in the early 1980's and current policy is the extent of coverage. Under current housing policy, subsidies are given to only a fraction of qualifying households, and housing subsidies are rationed by queues.[9] For example, as reported in Table 5, in 1997 there were about 7.3M poverty households among the 35.1M renter households in the U.S. About 14.6M households paid in excess of 30 percent of their incomes on rent, and more than 7.3M paid more than half of their incomes

[9] The effectiveness of the allocation of certificates and vouchers among metropolitan areas has recently been criticized by Susin (1999) who argues that rents for low income housing have risen more rapidly in cities with larger allocations of certificates.

for rent. At the same time, about 5.1M renter households received assistance under HUD programs. About 10 to 15 percent of the assisted households were not poor.

In 1987 there were about 3.7M renter households spending more than half of their incomes on rent. This was 1.5 times the number of subsidized rental households. In 1997 there were 7.4M renter households paying more than half of their incomes on rent, about 1.4 times the number of subsidized rental households. In 1987 there were 2.2 households in poverty for each subsidized renter household; by 1997 there were 1.4 poor households for each subsidized renter household.

The limiting factor in improving the housing condition of most poor households is the federal budget devoted to existing programs. The economic effects of these programs are pretty well known and their costs can be pretty well calculated. There now seems to be consensus among professional economists and housing policy officials that a flexible shelter allowance program should be the backbone of housing assistance programs. This consensus was not achieved quickly.[10]

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[10] And, to be sure, the consensus does not yet extend to powerful congressional constituencies.

Finally, as indicated in Table 5, deficiencies in the physical adequacy of rental accommodations have declined quite substantially, even in recent years. In 1978, it was estimated that 1.68M renters, more than 6 percent of rental households, lived in severely inadequate housing. By 1995, the estimate was less than 850,000 households. Less than 2.5 percent of U.S. renters currently reside in severely inadequate housing. Increasingly, housing problems are those of rent burdens, not physical condition. Problems of rent burden are best addressed by the transfer of resources to those so burdened.

II. Urban Development and Intergovernmental Fiscal Relations

As with housing programs, it is possible to distinguish four historical phases in post-war federal policies and programs for urban development, although the timing of these phases is less distinct. Table 6 illustrates these phases which are distinguished by the objectives of federal programs, the economic incentives provided to lower levels of government, the overall level of financial commitment, and the flexibility provided to localities.

A. Slum Clearance

The ambitious program of housing investment contained in

the 1949 Housing Act included the template for a federal-local partnership for urban development -- later termed urban renewal -- and successively expanded in scope through the 1950s and 1960s. "Urban development" as envisioned in the 1949 Act was quite clearly directed towards housing rather than some broader definition of development. The act authorized financial assistance from the federal government to a local agency for a “project,” consisting of site assembly, clearance, site preparation and final disposition for uses specified in an approved redevelopment plan. A "project" was defined to include an area that was "predominantly residential" either before or after redevelopment, and the project could not include construction or improvements of non residential buildings. The basic program was one of *slum clearance*, in which the federal government paid two thirds of the net project costs as a matching grant to the local government. Indeed, the 1949 Act *required* the removal of one unit of slum housing for each unit of public housing constructed.

The slum clearance aspects of the conditional matching grant program were weakened slightly when the name "urban renewal" was adopted in the 1954 version of housing act. The 1954 revision permitted ten percent of federal capital grants to be used for non-residential projects. However, these projects

were eligible only if they were slums containing substantial numbers of deteriorated dwellings or if the projects removed other substandard living conditions. By 1959 this exception had grown to twenty percent, and the requirement that a project area contain a substantial number of substandard dwellings was abandoned. It was not until 1969 that the Act stipulated that a federally financed urban renewal project *could not* reduce the supply of low income housing. During much of the heyday of urban renewal, it operated, by design, to remove units of low cost housing from the inventory.

The inherent contradictions in programs aimed at destroying low income housing and replacing it with housing that the previous residents could not afford were not well understood, at least initially. (Foard and Fefferman, 1960, attribute the "predominantly residential" requirement in urban renewal legislation to the dominance of physical planners rather than social scientists among the early advocates of urban policy.)

By the early 1960's, it was clear that these urban investments would not be sufficient to attract back to the central city the white middle class households who had been suburbanizing at a rapid rate during the post-war period. By this time, there was also fairly coherent theory suggesting that

attracting large numbers of suburban households back to the city was infeasible without large and recurrent subsidies (Alonso, 1964).

B. The Great Society

The first of the Great Society antipoverty programs, the Economic Opportunity Act (EOA) of 1964, included the Community Action Program (Title II) among a broad panoply of new initiatives.[11] With the establishment of the Department of Housing and Urban Development a year later, the concept of Community Action was expanded to the Model Cities Program. As originally envisioned (Haar, 1975), a half dozen large urban centers would be chosen for intensive investment of public resources. A task force appointed by President Johnson increased the demonstration tenfold to 66 cities. By the time legislation passed Congress (The Demonstration Cities and Metropolitan Development Act of 1966), a total of 150 cities had been chosen for the Model Cities Program.

Cities chose to participate in the program through their

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[11] The EOA Act included, for example, titles fostering small business development, adult education, VISTA (the domestic Peace Corps), and, inevitably, a Rural Action Program.

elected officials, who promised that citizen participation would be widespread, that renewal projects would be comprehensive, and that coordination of public and private resources would be enforced. HUD committed funds for planning and subsequently for implementation in each city. HUD maintained overall supervision of the federal commitment to testing "whether we have the capacity to understand the causes of human and physical blight [and] the skills and the commitment to restore quality to older neighborhoods…" (HUD, 1966, ii)

The model cities program survived for less than two and a half years before the newly elected president, Richard Nixon, began to dismantle it.

Although the ambitious urban development programs of the Johnson Administration did not survive long enough to produce results which could be evaluated, the programs begun under the Great Society changed the nature of federal-local fiscal relations in a fundamental way. The decade of the 1960's witnessed a substantial reorientation of the system of fiscal federalism in the U.S. Intergovernmental transfers and federal grants to state and local governments increased substantially. As Figure 6 indicates, between 1960 and 1969 federal grants to lower levels of government more than doubled from $35.0B to

$82.1B (in 1997 dollars). The expansion of federal grants continued apace until the "new federalism" initiatives of the Nixon administration were adopted in 1974. Between 1960 and 1974 intergovernmental grants increased from 7.6 percent of federal government outlays to 17 percent of federal outlays -- while at the same time the Vietnam War was consuming major federal resources. During the period of "creative federalism" of the Johnson administration, the number of grant programs to local governments increased enormously. A total of 240 new categorical programs were enacted (U.S. Department of the Treasury, 1985, pxxi), including 109 separate grant programs in 1965 alone. During this period, grant programs for urban development were created that bypassed state governments and local officials and established direct fiscal contact with community and neighborhood groups. For example, the EOA noted above encouraged the formation of 850 community-action organizations to promote maximum feasible citizen input in deciding upon expenditures for urban development and housing rehabilitation.

The explosion in the system of grants was predicated on three arguments. First, it was suggested that the objects of many expenditures by lower level governments, particularly in metropolitan areas, have substantial spillouts. These

expenditures may include transportation, environmental protection, even expenditures on local schools.[12] A system of grants to urban governments thus had efficiency-enhancing motives.

Second, it was argued that vertical fiscal imbalance was more-or-less chronic in the U.S. federal system. A generally progressive federal tax system contrasts with the more regressive structure of state and local taxes, while the intra metropolitan mobility of taxpayers depresses the tax rates which can be imposed by urban governments. A program transferring federally raised revenue to city governments is one solution to the imbalance (Heller and Pechman, 1967).

Third, existing fiscal disparities among urban governments meant that wealthy communities were able to buy high quality public services at low tax rates. Thus, one object of equity was a reduction in the variation in the tax price required to produce a given quality of public services. (Models of this process were produced by Musgrave as early as 1961; the Serrano-

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[12] Break, 1980, reviews many of the spillover arguments put forward in the 1960s by proponents of an expanded system of grants.

Priest school finance lawsuit, directly on this point, was filed in 1968.) George Break (1980) claimed that "one of the strongest forces behind the rapid growth in intergovernmental grants" in the 1960s was simply the desire to assist low income groups, expounding the proposition that a variety of local government programs should be thought of as merit goods, particularly those serving low-income groups.

C. The New Federalism

After the election of Richard Nixon in 1968, the grant program which had expanded so rapidly during the previous eight years, was increasingly called into question. The explicit and implicit incentives of categorical grants, seemingly capricious restrictions on the uses of grant funds, and the set of regulations governing federal grants were increasingly thought to have affected the behavior of recipients in arbitrary ways.

For example, the theory of fiscal federalism which had been developing over this period (see Oates, 1972, for the definitive statement) showed that matching grants from higher levels of government to lower levels were sufficient to internalize inter-jurisdictional spillouts in service provision in urban areas. But, of course, the efficiency gains of these grants were dependent upon the informed choice of a matching rate which

correctly calibrated the spillouts of benefits associated with local spending. On this there was little evidence. There was even less evidence that the Congressional sponsors of legislation (or their staffs) considered these issues in their choice of matching rates. Examples arose in which the same local expenditure on urban development could be justified under several grant programs at different matching rates.

The availability of categorical grants for some functions, but not for others, is premised on the theory that the Federal government transfers resources in pursuit of its own national objectives. These objectives were questioned by many who also observed that local decision makers have better information about local costs and efficient production than federal grantors. Increasingly, a system of grants for some narrow and specific functions but not for others was questioned as were federal preferences for capital spending rather than program operations.[13]

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[13] In much the same way as the original public housing program was criticized for encouraging the use of too much capital, so, too, were federal programs supporting mass transit criticized for encouraging overcapitalization of the transportation sector. The rationale for these capital subsidy programs was the same as that implicit in housing programs. Operating subsidies opened

Finally, the administrative difficulties in processing grant applications from nearly 40,000 units of general purpose government were thought to encourage waste at the federal level and inordinate local attention to “grantsmanship.”

The proposed solution to these inefficiencies was the program of General Revenue Sharing embedded in the State and Local Fiscal Assistance Act of 1972, followed soon after by the Community Development Block Grant Program (CDBG), Title I of the Housing Act of 1974. Like Revenue Sharing, CDBG grants were transfers of fixed resources to eligible jurisdictions (cities and suburbs with 50,000 or more people and all urban counties) where the level of the transfer was determined by a congressional formula.[14] Recipient governments retained a high degree of discretion over the disposition of CDBG funds.

As enacted, the CDBG program replaced eight Great Society categorical programs which had been funded on a competitive

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the way to increased federal liability in a way that capital subsidies did not.

[14] Some thirty percent of CDBG funds are distributed to smaller rural jurisdictions on a competitive basis, not by formula.

basis, including the urban renewal and model cities programs; the open space, historic preservation, and urban beautification programs; and water and sewage treatment grants.

The CDBG funds are intended to foster “viable urban communities, by providing decent housing and suitable living environments and expanding economic opportunities principally for persons of low and moderate income” (Connerly and Liou, 1998). Appropriated funds are intended to be used on local projects in which “maximum feasible priority” is given to the “benefit of low and moderate income families or in the prevention or elimination of slums or blight.”

The program is thus the lineal descendant of the urban renewal program originally authorized in the 1949 Housing Act. However, the 1974 program differed enormously from the original urban renewal program in the discretion afforded recipient governments in planning their own expenditures.[15]

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[15] While retaining much local discretion, entitlement jurisdictions were required to make formal application for CDBG funds, justifying their proposed budgets until 1981. The Ford and Carter administrations differed somewhat in their interpretations of the Congressional mandate. The former was more sympathetic to the expenditure of CDBG funds by local governments to protect their middle-class tax bases (see Peterson, et al., 1986: pp. 87-93). The latter increased HUD

The CDBG program began with appropriations of $2.5B (in 1975 dollars) which increased steadily during the Ford and Carter administrations. (See Table 7 and Appendix Table A1.) In large part, these expenditures were financed by reductions in other federal grant programs. As reported in Figure 6, aggregate grants in aid to state and local governments were declining during the mid and late 1970's, in real terms. As a fraction of federal outlays, grant programs plummeted.

In any event, increases in funding for the CDBG program itself came to an abrupt halt with the inauguration of Ronald Reagan. During the Reagan administration, real expenditures on Community Development Grants declined by more than 6.5 percent per year (and the Revenue Sharing Program was eliminated altogether in 1985). CDBG funding remained stable during the Bush administration and increased slightly recently.

Urban development activities that are routinely funded by CDBG's include the acquisition and disposition of real property; the rehabilitation of residential and non-residential

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monitoring and oversight in attempts to target benefits to low and moderate income households.

structures; social service delivery systems; public works projects; and assistance to private businesses.

Connerly and Liou (1998) report that the distribution of CDBG allocations across entitlement communities has stabilized, with about 40 percent of transfers spent by local governments for housing and housing rehabilitation. The fraction spent on public works projects has declined to about 20 percent, while economic development and public services consume, respectively, about 13 percent and 10 percent of available funding. Evaluations by the Urban Institute (1994) suggest that the fraction of funds devoted to housing is somewhat larger. Statistical analyses of the funding choices made by grant recipients suggest that older central cities with larger populations and those with higher levels of urban "distress" spend considerably more of their urban development funds on housing and housing rehabilitation. (See Urban Institute, 1994, chapter 4.)

It is also reported that the geographic targeting of expenditures has declined over time, within recipient jurisdictions (as the locations in which expenditures are made

have diffused) and across jurisdictions (as more communities have been made eligible for CDBG entitlements).[16]

Over time, the relative size of these block grants, as a fraction of HUD outlays, has declined, from more than 30 percent in the 1980's to less than 15 percent in the 1990's. As indicated in Figure 7 and Appendix Table A1, however, CDBG funds are still the backbone of all federal expenditures on urban and regional development activities, constituting more than half of all these expenditures. As a fraction of all grants-in-aid to governments, CDBG appropriations are not large, and never constituted as much as 8 percent of the total.

D. The New Flexibility

As noted previously, federal grants as a percentage of total outlays declined precipitously during the Reagan years.

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[16] During the first two decades of the program, for example, the number of entitlement jurisdictions increased by almost 50 percent (Urban Institute, 1994: 2-7). There is surely a general lesson about the realistic possibilities for targeting expenditures in the U.S. political system. Note that six demonstration cities became 150 cities authorized under the 1966 Model Cities Act. Similarly, 594 entitlement jurisdictions under the CDBG program grew to 889 over two decades. Note finally that the Senate and the House of Representatives never could agree on a common disbursement formula for General Revenue Sharing funds (Reischauer, 1975). Targeting is politically very difficult.

The number of federal grant programs declined from 534 to 478 during the 1981-1989 period. The decline was substantial in both project-based and formula-based grants. Since 1989, there has been a substantial increase in the number of discretionary grant programs, some of which serve urban development objectives.[17]

The most important of these new programs are the McKinney Emergency Program, the HOME Investment Program, and the HOPE VI Program for public housing. Under the McKinney Act, funds are provided for emergency shelter, supportive housing, the rehabilitation of single-room occupancy dwellings and other programs benefiting the homeless. The Hope VI Program provides funds to local housing authorities to “transform” distressed public housing projects. As an operational matter, this typically involves the demolition of obsolete structures.

The HOME Program provides formula grants to local governments and also provides lines of credit to participating jurisdictions. The program also disburses funds to each state

[17] Appendix Table A1 provides more detail on the course of Community Development funding relative to other federal government expenditures.

government. Applications for assistance typically include proposals for site acquisition and improvement, demolition, and rehabilitation of public and privately owned housing. As a part of the HOME Program, the Home Investment Partnership is designed exclusively to create or preserve low income housing. Local jurisdictions must provide a 25 percent match for these block grants and must earmark 15 percent of program proceeds for non-profit Community Housing Development Organizations.

The hallmarks of these programs are flexibility and local responsibility. Federal funds can be co-mingled with state and local resources, and can be used in partnership with not-for-profit participants. Increasingly, McKinney Act funds are used to contract with non-profit providers of emergency services and shelter. HOME Act funds are used to provide incentives for non-profit developers to provide housing affordable to those of low-income. Units are often owned, developed, or sponsored by community-based non-profit groups.

The increased flexibility is enhanced by the possibilities for coordination with the LIHTC program. In many states, the state portion of the HOME block grant is distributed by the same agency that distributes tax credits. Increasingly projects for new affordable housing that involve tax credits also include gap

financing using HOME funds and local contributions using CDBG grant funds. The remarkable thing about this increased flexibility is the extent to which program priorities and decisions are made by local rather than HUD officials and by members of non profit community organizations.

Table 8 indicates the funding for these grant programs sponsoring housing and urban development. Note that the HOME Program is funded at about $1.2B per year. For completeness, the table also documents expenditures on the Urban Development Action Grant Program.[18]

III. Conclusion

During the half century since the passage of the 1949 Housing Act espousing the goal of a "decent home and a suitable living environment for all Americans," the shape of housing and urban development policy has changed radically. Programs in which the public sector owns and operates housing have been

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[18] The UDAG program included only a modest housing component. It was principally focused on business development, rehabilitation or re-use of hotels or business property. See Rich (1992) for an extensive evaluation.

reduced in relative importance, and recently in absolute number (by 116,000 during the Clinton administration alone). The locus of responsibility for urban development activities, and for choices between housing and other development activities, has been returned to local decision-makers. Many economists and policy analysts would applaud these directions.

The mix between project-based and tenant-based housing assistance projects has been changed to favor the latter. Many of the long-term contracts for project-based assistance, entered into between HUD and the developers of new housing early in the Section 8 program, will soon expire. Current monthly payments to landlords plus tenant contributions under these housing assistance payments contracts typically exceed HUD's estimates of fair market rents in the metropolitan areas in which these units are located.[19] Thus, there is room for expanding the number of households served for the same program expenditure by shifting subsidies to tenant-based vouchers as project-based contracts lapse.

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[19] This is because it is far more expensive to create low-income housing through new construction than through depreciation. It also arises because rent escalation clauses favorable to landlords were negotiated *ab initio*.

But there are other reasons for favoring the substitution of tenant-based for project-based subsidies wherever possible. For example, it is far simpler to phase out subsidies for those whose incomes have risen if these households are not required to vacate project-based dwellings to make room for other households. The subsidy can be transferred without incurring a residential move.

Even more important than this, however, is the greater possibility for dispersion of the poor throughout urban areas if poor households are subsidized regardless of their residential location choices. Careful research (e.g., Straszheim, 1981) suggests that demand side subsidies have only modest effects in decentralizing the urban poor. However, other research, summarized for example by O'Regan and Quigley (1999), indicates that there are substantial social benefits to even modest deconcentrations of urban poverty in big cities.

These changes in program emphasis would make the existing housing subsidy program for low-income households approximate more closely the housing allowance experiments and demonstrations of the late 1970's. The only difference — and it is a big difference — is the universality of the program. A more effective program for assisting low-income households by

substituting tenant-based subsidies for project-based subsidies under the Section 8 Program would still be highly inequitable. As documented in previously, fifty years after the landmark Hourg Act of 1949, the "housing problem" in the U.S. has been converted to an "affordability problem:" at unsubsidized market prices many poor households must pay large fractions of their low incomes on shelter. Few economists would prefer to subsidize landlords or to distort market rents in order to improve the lot of poor households -- not when deserving households can be subsidized directly. However, it is clear that a housing allowance for *some* of the poor would be highly inequitable.

A universal and fair program would require a much stronger political commitment than we have seen up to the present.

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