Introduction to Session 3 Estimating the Costs: Perspectives on Preservation of the Nation's Lower-Income Housing Stock

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The papers in this section pose a series of important issues and questions. In a fundamental sense, they get to the very core of the current debate over preservation of America's lower-income housing stock.

If there is agreement on the basic principle that the existing owners of prepayment-eligible Section 221(d)(3), Section 236, and other projects — as well as owners of Section 8 projects with soon-to-expire contracts — have the legal right to some "fair" compensation for the loss of their contractual abilities to dispose of their projects, and if there is agreement that those rights need to be balanced with the rights of their low-income tenants to decent shelter, then how can these questions be answered?

1. How much compensation is "enough" to prevent the loss of units? What indeed is "reasonable" and "fair" compensation?

2. How does one calculate reasonable and fair compensation for preservation of projects, when the very structures of ownership entities and the income and tenant profiles vary so widely, and the physical needs of individual properties differ so dramatically? How does one fashion compensation that attracts project owners who face severely negative tax situations in the wake of tax reform, and yet also attract and compensate ownership entities that are not tax motivated, but instead are prepayment motivated (they went into the deal expressly to prepay, sell, or convert to higher yielding rental or condominium status)?

3. Does "enough" imply the lowest possible costs in public funds — not a dollar more than necessary? If so, how should those costs be apportioned among the several levels of public funding authorities that might bear them?

4. To begin to answer that elusive question — what is enough — is there agreement on what forms compensation should take? Is it tax-exempt bond financing for acquisitions or refinancings? Is it capital gains tax forgiveness or reduction? Is it capital grants? Is it regulatory changes allowing access to reserve accounts? Is it all of these, plus more, or is it a plain-vanilla approach with little variation or project-by-project discretion allowed?

5. Once the forms of compensation are defined, how are they to be administered? How does this program work in practice — including the role of the U.S. Department of Housing and Urban Development (HUD), HUD's discretion, and the possible involvement of others?

6. Should the program tag on, in effect, to the existing statutory authority — particularly the bits-and-pieces, creative-finance layering approach common in the low-income housing tax credit program? Is creative financing, with all the variations it implies, a solid enough base for preservation policy, as well as a proper model for future production programs?

7. Indeed, do the answers to the questions above begin to suggest some of the outlines of a new federal approach to both preservation and production? In the future, are there ways to build responses to prepayment while designing newer and better programs to produce lower-income housing?

The three papers in this section discuss these key issues.

Several of Anthony J. Blackburn's concepts in his paper, "Tax and Direct Expenditures," are helpful and insightful, particularly the idea of seeing the right to prepay federally assisted financings as an *opportunity,* to be priced and sold up front to developers or sponsors. In addition to its value for future program design, I think it has relevance for the only major program today, the tax credit program, which after all has its own built-in time bombs, expiration dates just over the horizon.

In his approach to answering the basic question — how much compensation is enough? — Blackburn suggests establishment of a uniform standard, a maximum price beyond which the federal government should not go simply to preserve a particular project.

The idea of a maximum or "upset" price is one that I believe will be incorporated into legislation in some form this year. Blackburn's formula suggests that the maximum price the government should be willing to pay any owner would be the discounted cost of a 20-year housing voucher less the discounted cost of the remaining 20 years of the interest subsidies the government would otherwise have to pay.

The Bush Administration, via HUD Secretary Jack Kemp's HOPE (Home Ownership for People Everywhere) legislative package, agrees with the concept of a formula-based, maximum buy-out price, but computes the maximum dollar amount by using two different equations. Compensation could be either (1) the lesser of the discounted present value, over the life of the mortgage, of the difference between current project income and 90 percent of area fair market rents, or (2) 80 percent of market value (based on current rental use) less the amount of any outstanding principal balances under HUD-insured loans.

Both the HOPE concept and Blackburn's proposal seek to mechanize the preservation effort at least to a degree: By having a formula-derived dollar maximum, along with new appraisals of the highest and best alternative uses of the project, negotiations between the federal government and the current owners could be greatly simplified. If owners knew in advance that their maximum compensation totaled a specific dollar amount, and if that figure was insufficient to dissuade them from prepayment, then both sides would avoid lengthy, fruitless negotiations.

Where I begin to depart from Blackburn's proposal is in the degree of "mechanization" he believes can be built into the process. He wants to keep HUD negotiators on a very tight leash and to present project owners with only two approved methods of compensation: recalculations of equity to increase distributions and equity takeout loans through secondary financings, along the lines of Section 241. But Blackburn rejects other forms of compensation that can be crucial to the overall arsenal the government brings to the table:

1. Reestablishment of the owner's depreciable tax base at the highest and best use appraisal value.

2. Use of the low-income housing tax credit in connection with preservation efforts.

3. Elimination of capital gains taxes on sales to public and non-profit entities.

Blackburn dismisses these as “blunt and undiscriminating tools.” He also suggests that “they could not be used by HUD to adjust the offer amounts to reflect the likelihood of prepayment.” Perhaps they could be adjusted by using a project-by-project “package” approach that is customized to the particular needs of an ownership entity and that remains within the “upset” dollar maximum.

Blackburn also criticizes these financial tools as more expensive than direct expenditures; he worries that they would further complicate the federal tax code. Here are two thoughts on that: First, it strains the imagination to envision a federal tax code more complex than it is at present. Second, if tax relief happens to be the key that unlocks the door to preservation of some low-income stock — and it unquestionably is — then failure to put tax relief on the table will result in greater loss of stock. Anyone who has examined the costs of *replacing* existing low-income stock with new units must agree that the potential direct costs far exceed the indirect costs of selective capital gains tax relief for projects that require it.

Blackburn’s take-it-or-leave-it approach to preservation — using only a small number of financial tools — would result in too many people deciding to “leave it.”

This line of discussion raises a central question: What is the goal in low-income housing preservation? I think it is *maximum preservation of stock at the minimum achievable costs.* But maximum preservation of stock — given the cost of the alternatives — has to be given greater weight in the equation. It is better to risk slight overcompensation or oversubsidy of a few owners than to pinch pennies, rule out tax relief, and lose thousands of units that could have been retained in the inventory.

Let me propose a set of principles for preservation policy that both Blackburn’s and Karl E. Case’s papers helped stimulate.

- Principle number 1. Prepayments of conversions will not be prevented unless the significant differences among ownership entities of lower-income projects are taken into consideration.

There are differences among Section d(3) and Section 236 projects that profoundly affect the financial needs of these projects. Is the current ownership entity the original? Was it syndicated by a large national syndicator using the typical two-tier structure? Does the local or project general partner derive current management fee income from the development, thereby affecting the partner’s potential interest in changes? Are some or any of the original partners in

the venture deceased, and have their partnership interests been "stepped up" under IRS Section 754? Did current owners purchase the project in the wake of the 1981 tax law liberalization hoping to reap huge benefits that now have been curtailed? Or did the investors purchase the project after the Tax Reform Act of 1986 with the knowledge that their tax advantages would be minimal but with the expectation that their gains from flipping the project to market rate would be substantial?

Anyone seeking insights into the critical differences in owner perspective that flow from these and many other situations should read the best recent study on the subject, *The Illinois Housing Preservation Study* (March 1990), conducted by the National Housing Trust.

- Principle number 2. A significant source of financial assistance to be incorporated in preservation packages is the estimated $2 billion available in project reserve accounts for residual receipts and capital improvement replacements. The residual receipts accounts have been generated by cash flows in excess of the 6 to 8 percent regulated returns. Under current federal rules, owners are allowed no access to these considerable funds. Yet opening up at least a portion of this capital could greatly assist in retaining low-income stock.

- Principle number 3. New federal legislation is needed to expand the financial tools available to the preservation effort. Among the legislative needs are the following:

1. New tax-exempt bond authority aimed exclusively at preservation of lower-income stock. If preservation truly is a critical national need — and this conference literally shouts to Congress that it is — then it is worth amending the tax law to allow financing for subordinated debt for equity takeouts, refinancings, and new financings of transfers without rehabilitation. There needs to be a separate bond volume cap for these financings and higher volume caps for tax-exempt bond issues for multifamily housing in general.

2. Preservation amendments to provide capital gains tax relief. It may be fashionable in academic circles to belittle project owners' needs for at least partial relief from their capital gains liabilities. But to the owners and partnership investors involved, the tax problems are very real, painful, and, most important to this policy discussion, can spell the difference between retention and loss of lower-income housing units.

- Principle number 4. In seeking to modify behavior, attention should be paid to what B. F. Skinner taught. National preservation policy needs to incorporate sticks — big sticks — along with all the carrots under discussion. There must be penalties for pulling units out of the lower-income stock. One penalty that is particularly needed would be heavy, long-term payments to the most vulnerable tenant populations — the elderly, handicapped, and very low income — displaced by conversions. For a negotiating process to be successful, there have to be believable, painful federal and local "negative reinforcements" waiting in the background. Perhaps there should be more sticks, not just carrots, in future discussions.

- Principle number 5. State and private-sector experts need to be brought into the process, rather than relying primarily on HUD. Personnel in state housing finance agencies know many of these projects inside and out. State and local officials also have an important stake in retaining lower-income units; after all, the loss of any project will have maximum impact at the local and state levels, not in faraway Washington, DC. Federal policy should, therefore, seek to make maximum use of state and local talent in devising preservation strategies for an area, for conducting analyses of the physical needs of projects, and for offering views on the types of financial incentives that could prove most effective in retaining specific projects in the lower-income stock. Regional overview panels with highly sophisticated private experts on housing matters — particularly accountants, attorneys, and others who helped structure many of these deals — could prove cost effective. These review panels would not need to know the specific identities of projects, nor would they examine projects they had worked on. But given accurate financial data on the tax and cash-flow characteristics of projects, panels of experts could come up with proposed buy-out or refinancing packages that would cost the federal government less than the maximum formula would dictate.

- Principle number 6. With all the focus on the present owners of lower-income projects, policy-makers should not neglect the ground rules for new buyers. To engineer a massive transfer of ownership of Section 236 and 221(d)(3) housing to nonprofits, for example, standards are needed to ensure that the new entities have the financial staying power to weather recessions, to manage the units competently for the foreseeable future, and to function as the organizational pillars of the nation's housing strategy for the next several decades. Such an elemental point cannot be ignored.

The following is a brief commentary on Karl E. Case's paper, "Investors, Developers, and Supply-Side Subsidies," and on Michael A. Stegman's presentation, "The Excessive Costs of Creative Finance," First, Case asks, "How much is enough?" and presents data implying that federal subsidies for housing developers and syndicators have been too much in the past. But unfortunately, nowhere does he answer his central question: "How much, indeed, is enough?" As a small-scale investor in residential real estate myself, I must confess that Case's figures of 12 to 21 percent internal rates of return do not strike me as wildly excessive given the risks to capital involved in lower-income housing. One of the risks involves loss of anticipated tax benefits — a nightmare possibility that has come true for a sizeable number of investors from the 1980s. Another risk is that the federal government will attempt to change the rules of the game while the game is underway. This risk is poignantly clear to those who own Section 236 and 221(d)(3) projects and who had planned to prepay in 1987 and 1988.

As a taxpayer, I share Case's desire to limit the amount of subsidy to the minimum necessary, but he is not precise about what that minimum is.

Regarding Stegman's presentation, who can disagree with the assertion that creative financing is a needlessly complex base for national housing policy? Who can disagree with the assertion that of all possible subsidy mechanisms for a production program, the low-income housing tax credit is nobody's choice for first prize? But those who criticize the credit have a responsibility to come up with a politically acceptable, fundable replacement. What is it? And who is going to convince the Bush Administration to support it? At the very least, the Administration appears willing to extend the tax credit once a year. Would Dick Darman and Company lobby Capitol Hill and twist arms to secure passage of a 20 percent capital grant program for lower-income housing? The Platonic ideal of a housing program — one that dispenses the minimum, necessary grant to the developers who will build and manage units best — works only in that earlier Republic. Meanwhile, we're stuck with reality.

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