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Report to the Chairman, Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services, House of Representatives

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PUBLIC HOUSING

Converting to Housing Certificates Raises Major Questions About Cost

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Resources, Community, and
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The Honorable Rick A. Lazio
Chairman, Subcommittee on Housing and
Community Opportunity
Committee on Banking and
Financial Services
House of Representatives

Dear Mr. Chairman:

On May 1, 1995, the Department of Housing and Urban Development (HUD) submitted to the Congress proposed legislation entitled the "American Community Partnerships Act." If implemented, the act would transform how this nation has historically funded public housing. Federal assistance would no longer flow to public housing authorities, but instead would go to households in the form of housing certificates. These households would then have the choice of using their housing certificates to either stay in public housing or move to apartments available in the private rental market. HUD states that this shift in policy will result in significant savings and address several fundamental problems with the current public housing program, including (1) residents' lack of choice in housing, (2) the concentration of very poor people in very poor neighborhoods, and (3) a lack of discipline in the management of public housing because of its insulation from the marketplace.

In considering HUD's legislative proposal, you asked us to (1) describe the cost implications and the issues raised by transitioning from the current public housing program to one using housing certificates and (2) identify key factors that may affect HUD's plan to provide greater housing choice for the residents of public housing.

Results in Brief

After calculating the average costs of converting to housing certificates versus continuing the current public housing program, HUD concluded that the cost of using certificates will be less than that of funding public housing; however, these averages do not reveal the wide differences in the cost of these two options at individual public housing developments. For some developments, the current average cost to provide housing is less than half that of housing certificates. However, for those developments in the worst physical condition, the reverse in true. These wide variations in cost raise a number of important issues, including whether the federal government should pay for the rehabilitation of public housing developments when their rental revenues could finance it and whether housing certificates should be targeted initially to developments where they are clearly cost-effective. The actual costs of converting to housing certificates will depend on how these and other issues are resolved. But HUD has not performed the detailed analysis that would provide important information for deciding these issues.

Housing certificates by design are intended to provide public housing residents greater opportunity to select where they want to live. However, actual choice in housing depends on many factors, including the characteristics of the current tenants and their inclination to move, the availability of affordable housing, the willingness of private landlords to accept tenants with housing certificates, and the extent to which housing discrimination laws are followed and enforced.

Background

Approximately 3,300 public housing authorities own and operate about 13,200 public housing developments with about 1.4 million units. These housing authorities vary in size and condition. Over 2,400 authorities, or over 70 percent, are small, with fewer than 300 units. On the other hand, there are about 210 authorities, or about 7 percent, with more than 1,000 units. These large authorities account for about 63 percent of the total number of public housing units. By HUD's assessment, most of the public housing authorities are reasonably well managed; however, HUD considers 92 authorities, or about 3 percent, to be "troubled." Thirteen of the troubled authorities are large urban housing authorities, managing about 14 percent of the total public housing stock and most of the stock that is in the worst physical condition.

HUD plans to carry out the transformation of public housing in three stages and to complete it by 2002. During the first stage, which would begin in 1995, HUD would consolidate the amounts provided for the multiple public housing programs into two funds—one to pay for capital and management improvements of public housing authorities and public housing developments and another to subsidize the operations of these authorities and developments. To be eligible for funding, public housing authorities would be required, during this stage, to develop a strategic plan that, among other things, identifies the rehabilitation needed for their public housing developments and establishes a timetable for completing it. Under HUD's proposal, these improvements would be paid for by the federal government from the capital fund.

During the second stage, HUD proposes to replace the capital and operating funds established in stage one with a program of project-based assistance, which would be tied directly to units.[1] Project-based assistance, which would be authorized for 1 year, is intended to help public housing authorities gain experience in managing and operating their housing when they are dependent on the revenues generated from the properties' rents, rather than from capital and operating subsidies provided by the current system and continued during stage one. The rents set by public housing authorities for their properties during stage two would reflect the properties' market values and any services provided by and paid for by the public housing authority, such as child care, so long as the rents are not greater than the fair market rent[2] established by HUD for the area.

During the third stage, project-based assistance would be replaced by tenant-based assistance, namely, housing certificates provided directly to the assisted households. The public housing residents would then have the choice of either staying in their public housing unit or moving to privately owned rental housing that meets certain cost and quality standards. HUD's proposal recognizes that some public housing developments, even after they are rehabilitated, will still be located in modest neighborhoods and, because they were built in an earlier era, will still lack certain amenities offered in privately owned rental housing. These developments, therefore, will tend to have market values below their area's fair market rent. Consequently, in order to enhance the competitiveness of these public housing developments with other rental housing, HUD has proposed giving families a "shopping incentive" that would reduce their share of the rent by the same percentage that the market rent of the public housing unit is below the area's fair market rent.

Cost Implications of Replacing the Public Housing Program With Housing Certificates

The Secretary of HUD testified on April 6, 1995, before your Subcommittee that it cost $440 per month on average to house a family with a housing certificate, compared to an average of $481 per month in public housing. HUD used these averages to conclude that significant savings could result from converting the public housing program to one using housing certificates. However, these averages do not reveal the range of costs across public housing authorities and their developments resulting from differences in the age and condition of these developments, the efficiency

[1]To receive this assistance, a household must live in a designated unit.

[2]The fair market rent for an area is the amount that would be needed to pay the gross rent (shelter plus utilities) of privately owned decent, safe, and sanitary rental housing of a modest (nonluxury) nature.

of public housing management, and the housing markets in which these developments are located.

In computing the costs of the current public housing program, HUD used the sum of the 1995 appropriations for operating subsidies, funding for the modernization of properties, and grants to eliminate drug use to obtain an average per unit monthly cost. This computation tends to skew the average cost of public housing upward because of the high costs associated with the relatively small percentage of the public housing stock that is in the worst physical condition. This portion of the stock requires a disproportionate share of the modernization funding and is likely to have higher than average operating costs. On the other hand, because HUD's analysis considered the capital costs of public housing as sunk costs, it made no attempt to add an imputed debt service charge[3] to the cost of public housing. After an adjustment for vacant units, the analysis showed an average per unit cost for an occupied unit of public housing to be $481 per month. In the calculation of the average per unit cost of housing certificates, the analysis used the fair market rent at the 40th percentile,[4] which resulted in an average per unit cost of $440 per month.

These averages do not disclose the wide variations in the costs of the programs among public housing authorities and their developments. The data used in HUD's analysis show that for some public housing authorities, such as the one in Buffalo, New York, housing certificates would cost about $500 per unit per month. This is about 40 percent less than the current $900 average cost to operate an occupied unit at this housing authority. Conversely, for other housing authorities, HUD's analysis shows just the opposite result. For example, in Los Angeles, California, HUD estimates the per unit cost of the certificate program to be about $1,100 per month, compared to $930 for public housing. For other housing authorities, the cost variations are even greater. For instance, in the case of McDonough, Georgia, housing certificates were estimated by HUD to cost about $700 per unit per month, compared to $240 for public housing.

Just as calculating aggregate averages for the two housing options obscures wide variations among public housing authorities, computing an average per unit cost across an entire stock of developments within a public housing authority does not recognize significant variations in costs

[3]The federal government has already paid for the construction of public housing. Accordingly, there are no mortgages on public housing developments nor any associated debt payments.

[4]A fair market rent set at the 40th percentile of an area's rental housing would reflect the fact that about 40 percent of the market area's rental housing can be obtained at this rent level.

among individual developments. To identify these variations and the issues they raise, we reviewed financial data on operating and rehabilitation costs for 40 developments located in nine public housing authorities across the country. From these 40, we chose 5 to illustrate the range of conditions we found in our review.[5] These five examples are discussed in detail in appendix I, along with the cost implications of using housing certificates and related issues.

These examples disclose a broad range in the cost of operating public housing and providing housing certificates. At one extreme, certain developments located in New York City, New York; Los Angeles, California; and Alexandria, Virginia, cost about half as much to operate currently as public housing as what they could be rented for in the private market.[6] Moreover, the operating costs for these developments are below the fair market rent in the area. If the public housing program is converted to use certificates, developments with these characteristics raise such questions as (1) whether the federal government should use the capital fund to pay for any needed modernization (which can run into the millions of dollars per development), as is contemplated in the proposed legislation, or whether these costs should be paid for out of revenues generated by the developments; (2) what, if any, restrictions should be placed on the use of the additional revenues such developments could generate for the public housing authorities, particularly as units become vacant and rents may no longer be restricted to the fair market rent; and (3) how the federal government will pay for the additional expenses caused by increasing rents from a level necessary to cover operating costs to the fair market rent. (See example 2 in app. I.)

At the other extreme are public housing developments whose operating costs after rehabilitation would be several times higher than the cost of housing certificates. These developments generally need extensive renovation, and while they can be found in housing authorities across the country, they are frequently associated with the large troubled urban authorities. Also, the market values of some of these developments is well below their operating costs. A critical question related to these developments is under what circumstances, if any, the federal government should use the capital fund to subsidize their rehabilitation. Another

[5]The 40 developments were identified by nine urban housing authorities nationwide in response to our request that they identify their more marketable and least marketable developments. We categorized these developments into five groups based on common characteristics. From these five groups, we chose five developments to present as examples.

[6]We defined operating costs to include current operating expenses and amortized costs for the rehabilitation of the property and funding of a reserve account for nonroutine expenditures.

question is whether to target these developments in a conversion to housing certiciates, since these developments represent the greatest opportunity for cost savings. (See example 5 in app. I.)

Between these extremes are developments with various relationships between their operating costs, market values, and fair market rents. These developments raise other issues. Among the more significant are (1) how the added cost of the proposed "shopping incentive" will be financed; (2) how the objective of the "shopping incentive," which in part is to make public housing developments more competitive with private rental properties, can be reconciled with one of the overall goals of HUD's proposal—reducing the concentration of very poor people in very poor neighborhoods; (3) whether the federal government should pay the additional costs of subsidizing families in public housing developments when the market values of these developments exceeds the fair market rents; and, (4) if current public housing residents move to higher-quality housing through the use of housing certificates, whether the additional costs will be paid for through increased federal subsidies or will be offset by housing fewer families. (See examples 1, 3, and 4 in app. I.)

The issues arising from our review of selected housing developments are largely unanswered by HUD's proposal. The answers will, of course, determine the actual costs of converting from the current public housing program to a program that uses certificates. But HUD has not done a detailed cost analysis, for individual housing developments, that takes into account their rehabilitation needs, operating costs, and market values and therefore would clarify the prospective costs for individual developments—critical information in deciding the issues on which overall costs depend.

Promoting Greater Choice in Housing

A key element of HUD's plan is to give the residents of public housing greater choice in deciding where they will live. Under the plan, public housing residents who are not satisfied with their housing will be able to use their housing certificate to rent another public housing unit or a privately owned apartment. To the extent that current residents exercise their choice by moving out of very poor neighborhoods, a basic goal of the plan will be achieved. However, the outcome depends on several issues, including (1) the extent to which tenants desire to move, (2) the availability of affordable apartments in the neighborhoods that tenants choose, (3) the willingness of landlords to accept tenants with housing certificates, and (4) the extent to which laws intended to prevent discrimination are followed and enforced. Since these factors tend to be locally determined, the degree of choice and the related issue of the extent to which very poor people are concentrated in very poor neighborhoods will probably vary from one housing authority to another.

Tenants' Desire to Move Will Vary

The decision to move is often a very personal one, motivated not only by the quality of a person's present housing but also by the proximity to work, the availability of shopping and medical care, the location of family and friends, and the level of security. Officials of housing authorities we visited in New York, New Jersey, Virginia, and California stated that it is unlikely that many elderly tenants will move, because they are satisfied with their current housing. In addition, we observed a variety of housing developments, serving families with children, that were in good condition and in desirable locations, where tenants' choice to move would not likely be based on their dissatisfaction with their current housing.

The elderly population represents a significant percentage of the people in public housing. HUD estimates that more than a third of the 1.4 million units of public housing are occupied by the elderly. It is generally recognized by public housing officials nationwide that this housing tends to be in reasonably good condition. Also, while public housing developments serving families have frequently been depicted as distressed, crime-ridden, and poorly located, in fact, many provide decent, safe, and sanitary housing.

Availability of Affordable Units Affects Choice

A key factor in any plan to bring the forces of the market to bear on public housing is the availability of alternative housing that is affordable to public housing residents. Recent data show that the national vacancy rate for rental apartments has exceeded 7 percent. However, this average figure does not reflect significant variations among housing markets throughout the country. Generally, the lower the vacancy rate in an area, the more difficult it will be for assisted households to find alternative housing. In the New York City housing market, for example, where about 11 percent of the nation's public housing stock is located, the vacancy rate is less than half the national average, making alternative housing more difficult to find.

Landlords' Acceptance of Housing Certificates Impacts Choice

The ability of public housing tenants to exercise choice in their housing decisions depends not only on the availability of affordable housing but also on the willingness of private landlords to accept their housing certificates. Landlords electing to accept tenants with housing certificates do so voluntarily and, in so doing, also agree to the program's requirements. Identifying ways to improve landlords' willingness to accept housing certificates was the subject of a study commissioned by the National Multifamily Housing Council.[7] To achieve this objective, the study recommended that housing certificates operate as much like the regular market as possible, though it was recognized that in some areas, eliminating all government involvement would be unwise.

Under the American Community Partnerships Act, HUD has proposed provisions that would make housing certificates more consistent with the operation of the regular market. These provisions are aimed at attracting additional owners of private-market rental housing to rent to families using housing certificates. HUD has proposed changing requirements that have discouraged landlords' broader participation in the current housing certificate and voucher programs. Key provisions that would facilitate private landlords' acceptance of housing certificates include

- eliminating the "take one, take all" requirement, and replacing it with the requirement that owners must lease a "reasonable" number of units to certificate holders;
- making it easier for owners to terminate the lease of a certificate holder, in accordance with state and local law (e.g., for not paying rent; for repeated, serious violations of the lease; for any criminal or drug-related activities, etc.); and
- clarifying that owners can screen and select families for admission according to the owners' standards (but following the Fair Housing Act's requirements).

Housing Choice Affected by Discrimination

Discrimination in the rental market is an issue that is difficult to quantify. However, to the extent that it exists, whether it be against female heads of households, families with children, or members of particular races, it would negatively affect residents' choice in housing. Conversely, of course, to the extent that housing discrimination laws are followed and enforced, residents' choice would be encouraged.

Conclusions

HUD's recommendation to transform public housing to a tenant-based housing certificate program is a fundamental shift in federal housing

[7]Abt Associates, Inc., Final Report on Recommendations on Ways to Make the Section 8 Program More Acceptable in the Private Rental Market, (Cambridge, Mass.: Mar. 1994).

policy that has significant implications for public housing authorities, their residents, and the federal government. To date, HUD's cost analysis, used in part to support the recommendation, has relied on average costs and does not reveal the wide differences in the costs of the two approaches for individual housing developments. For some public housing developments, the cost of operating is about half of what the government would have to pay once it provided tenants with housing certificates. For other developments in the worst condition, rehabilitation expenses plus operating costs are several times higher than what certificates would cost. With such divergent cost implications, a transformation from the public housing program to one using housing certificates raises issues that are largely unanswered in HUD's proposal. Therefore, the ultimate cost of converting to housing certificates is not known.

HUD has not required that public housing authorities do a detailed cost analysis of individual housing developments, which would provide critical information in deciding these issues, though the Department is planning to require that housing authorities collect some of this information during stage one of the transformation. If such an analysis took into account individual developments' rehabilitation needs, operating costs, and market values, it would reveal the cost implications for individual developments and public housing authorities. It would also provide the data necessary to assess the other issues raised in this report. In doing so, it would clarify the choices available to the Congress in allocating housing funds.

Agency Comments

We discussed the contents of this report with HUD's Assistant Secretary for Policy Development and Research and with other senior Department officials. These officials neither agreed nor disagreed with the manner in which we characterized the cost implications and other implications of converting to housing certificates. However, they acknowledged that converting to housing certificates would have different cost implications for various housing developments. They also stated that HUD's proposal to transform public housing was never intended to focus on individual developments or public housing authorities. Rather, HUD's intention was to present a major shift in housing policy that was revenue neutral and focused on the benefits of individual choice.

Scope and Methodology

In addition to discussing with HUD officials the proposal to transform the public housing program and reviewing the agency's documents and reports on the costs of public housing and the estimated costs of the housing certificate program, we judgmentally selected and contacted nine public housing authorities throughout the country. We asked that they identify their more marketable and least marketable developments. We obtained both general and detailed information about the individual housing developments—for both elderly people and families—that these authorities manage, their actual costs of providing public housing, and their costs related to the proposed certificate program. Specifically, we obtained detailed data on 40 developments managed by the nine authorities in the following locations: Alexandria, Virginia; Baltimore, Maryland; Chicago, Illinois; Cleveland, Ohio; Jersey City, New Jersey; Los Angeles County, California; City of Los Angeles, California; New York, New York; and Seattle, Washington. These data included developments' operating incomes and expenses, the costs to rehabilitate these developments to market standards, estimates of rents that could be charged for the rehabilitated units, and other pertinent information. We then categorized developments with similar characteristics into five groups, from which we then chose five examples to highlight the kinds of issues HUD's proposal raises. HUD officials agreed that our grouping of projects was reasonable for the purpose of illustrating these issues. Our sample size and selection criteria were not intended to allow for projections of how many public housing developments fall within each group, nor were our five examples intended to be all-inclusive. These examples are presented in appendix I.

We also visited four of the housing authorities to discuss the implications of the data we collected in greater detail and to obtain their input on key factors affecting housing choice for the residents of public housing. We also reviewed recent reports pertaining to national vacancy rates and factors affecting the mobility of assisted renters.

We conducted our work between March and May 1995 in accordance with generally accepted government auditing standards. We did not independently verify the financial data on operating costs nor the estimates of rehabilitation needs of the public housing developments used as examples in this report.

We are sending copies of this report to the appropriate congressional committees, the Secretary of Housing and Urban Development, and the Director of the Office and Management and Budget. Copies are available to others on request. If you or your staff have any questions, please call me on (202) 512-7631.

Sincerely yours,

Judy A. England-Joseph
Director, Housing and Community
Development Issues

Cost Implications of Transforming Public Housing

The Department of Housing and Urban Development's (HUD) plan to transform public housing to a market-driven, certificate-based system will present different and wide-ranging cost implications for the nation's 3,300 public housing authorities. For some, but currently unknown, number of these authorities' 13,200 developments, the cost comparisons will show the real housing value that public housing units deliver. For other developments, the cost comparisons will highlight the questionable value—from a cost perspective only—of continuing to overpay for public housing when viable, less costly private rental apartments are available.

The following examples illustrate the range of cost implications that HUD's plan could have for housing developments. These examples are for illustration only and should not be used to project overall costs of the plan. To control for tenants' income and for purposes of consistency, each example assumes that assisted households would make no contribution toward their rent.

Four costs are presented in each example. The first is the property's current per unit operating cost. These can vary widely depending on such variables as the property's location and amenities and the extent to which maintenance and modernization expenses have been deferred. Also, according to HUD's Director, Office of Assisted Housing, current operating costs are somewhat understated because they do not adequately account for the costs of employee benefits, solid waste disposal, services such as child care and tenant counseling, and security. The second cost—the revised operating cost—presented in each example, is the sum of current operating costs; the rehabilitation and modernization expenses necessary to put the unit in a market-ready condition, as estimated by the housing authority; and a reserve for future nonroutine expenses. The third cost is the market value of the unit. This is the approximate monthly rent that the unit could bring in the private market, according to the opinions of and surveys made by housing authority officials and local real estate agents. The fourth cost—the fair market rent—is the maximum monthly rent that HUD would pay for households using housing certificates.

Example 1

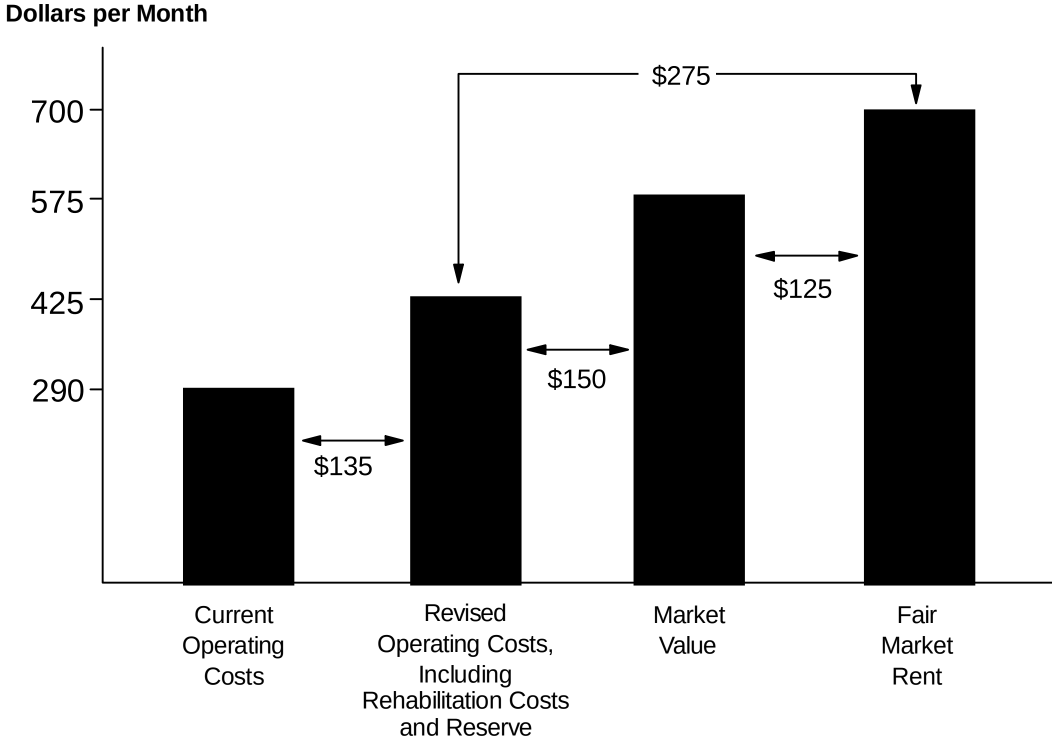
As shown in figure I.1, this development has the following monthly per unit costs: current operating costs of $290, revised operating costs of $425, a market rental value of $575, and a fair market rent of $700.

In this example, the federal government is currently subsidizing that portion of the public housing authority's current operating costs

($290) not covered by the tenant's rent contribution. If the federal government pays for the modernization of this 100-unit property out of grant funds, it will cost about $850,000, or about $8,500 per unit. Conversely, if the federal government either makes a direct loan or insures a private loan for the modernization costs and requires a reserve for nonroutine expenses, the revised operating costs will be about $425 per month. Once this modernization is completed, as called for under HUD's proposal, the public housing authority would be able to charge a market rent of $575, or $150 more than the revised operating costs. Last, if a household chose to use its housing certificate to move to private rental housing, it could receive a subsidy up to the fair market rent of $700. This is $125 more than the market rent of the public housing unit.

For this example, the federal government minimizes its cost by retaining the development as public housing. If the housing is rehabilitated and maintained as public housing, it has a monthly per unit cost of $425. This can be considered a good value for the federal government, since the unit's market value of $575 exceeds the monthly revised operating costs by $150.

Figure I.1: Example in Which Unit's Market Value and Fair Market Rent Exceed Operating Expenses



HUD's plan raises the following issues concerning the costs of this development.

- Should the federal government pay to rehabilitate public housing properties when these properties could generate sufficient revenues to pay for these expenses? In this example, under the proposal the federal government would pay the $850,000 in rehabilitation costs. Alternatively, these costs could be financed by a loan that could be paid back through the additional revenues generated at the property's market rent. If the federal government pays for the rehabilitation costs, the public housing authority would still have operating costs of about $290, plus an amount set aside for reserve, yet be able to rent the unit for $575, thus generating about $285 in additional revenues for the public housing authority. Conversely, if the federal government required that the rehabilitation be finance through a loan, the public housing authority's revised operating costs, including funding for a reserve, would be $425. This would generate $150 in additional revenues for the public housing authority.

- Should the federal government subsidize public housing units at market rents, as proposed in stages two and three of HUD's proposal, when these rents exceed the public housing authorities' operating expenses? If yes, should any federal restrictions be placed on public housing authorities' use of the additional revenues that would be generated?
- How, under the proposal, will increases in federal subsidies resulting from converting to housing certificates be paid for? In this example, these increases could result from (1) subsidizing the public housing authority at the market value of its units, versus its operating costs; (2) providing public housing residents with a "shopping incentive," since the market value of the unit is less than the fair market rent; and (3) providing tenants with housing certificates enabling them to move to a unit with a monthly rent at or near the $700 fair market rent. Possible alternatives for paying for these costs include increased spending by the federal government or a reduction in the number of families assisted.

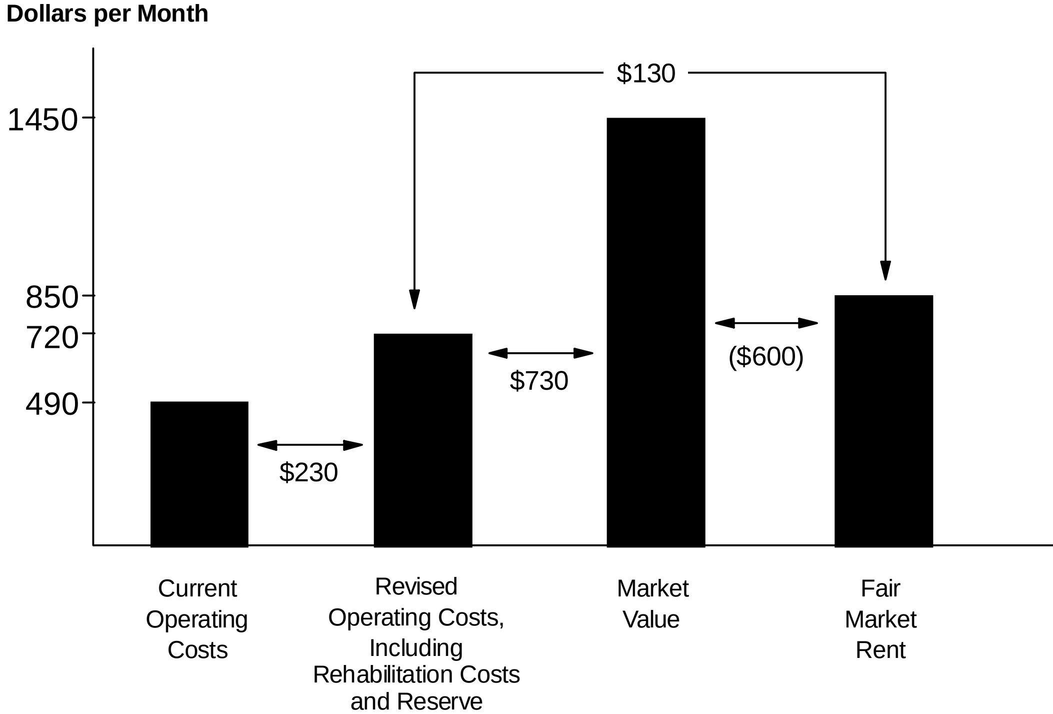
Example 2

Figure I.2, highlights the characteristics of our second example. As shown in the figure, this development has the following monthly per unit costs: current operating costs of $490, revised operating costs of $720, a market rental value of $1,450, and a fair market rent of $850.

Again in this example, the federal government is currently subsidizing that portion of the current operating costs ($490) not covered by the tenants' rent contribution. Modernization costs for this almost 1,100-unit project are estimated at over $17 million, or about $15,500 per unit. The federal government, as in the first example, could either pay the $17 million in the form of a grant, or it could make a direct loan or insure a private loan. If modernization costs are financed through a loan and this cost together with a reserve for nonroutine expenses is added to the current operating costs, the revised operating costs are about $720 per month. This is still well below the fair market rent ($850), which the housing authority would be permitted to charge current residents under HUD's proposal. Moreover, the revised operating expenses are less than half of the unit's market value, which the housing authority conceivably could charge new tenants as units become vacant unless the rents are capped to ensure that lower-income households continue to be served by the property.

For this example, as was the case in the first example, the federal government minimizes its cost by retaining the development as public housing. This unit provides a good value for the federal government, since the unit's revised operating costs of $720 are $130 below the $850 fair market rent permitted under HUD's proposal. Moreover, the unit offers the residents an excellent value since the unit's market value of $1,450 is double the revised operating costs ($720) and $600 above the fair market rent.

Figure I.2: Example in Which Unit's Market Value Exceeds Both Operating Costs and Fair Market Rent



HUD's plan raises the following issues concerning the costs of this development.

- As with example 1, a question is raised over whether it is prudent to adopt housing certificates for properties where the federal government is getting substantially more housing value than it is currently paying for.

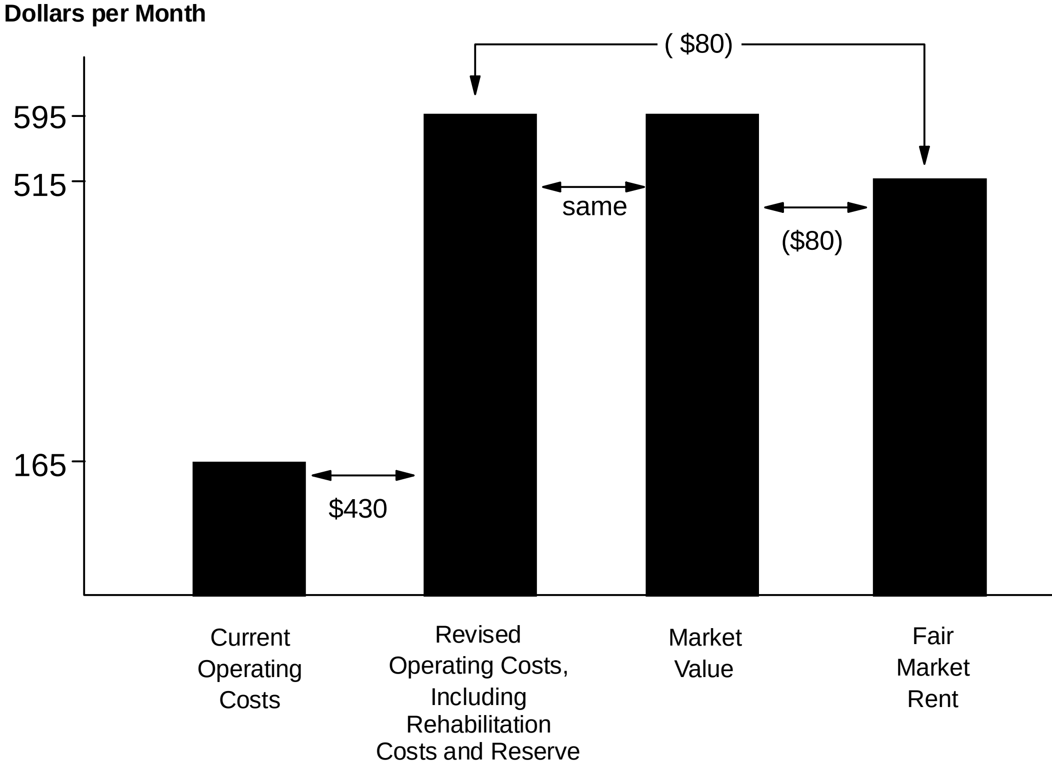
- Second, as with example 1, should the federal government pay to rehabilitate public housing properties when these properties could generate sufficient rental revenues to pay for the rehabilitation? In this example, these costs are estimated at over $17 million.
- Third, and again as with example 1, a question is raised over whether any federal restrictions should be placed on the increased revenues that the public housing authority could generate when the revised operating costs are below both the fair market rent and the market value of the property. In this example, the public housing authority could theoretically receive an additional $130 per unit per month ($850 minus $720) for current residents and an additional $730 per unit per month ($1,450 minus $720) if vacant units were rerented at their market value.
- Finally, like our first example, this example raises the question of how additional federal subsidies would be paid for if the public housing authority is permitted to charge the fair market rent and tenants would receive that amount.

Example 3

As shown in figure I.3, this development has the following monthly per unit costs: current operating costs of $165, revised operating costs of $595, a market rental value of $595, and a fair market rent of $515.

In this example, the federal government is currently subsidizing that portion of the current operating costs ($165) not paid by the tenants. If the federal government pays for the modernization of the 59-unit property out of grant funds, it will cost about $2.3 million, or about $39,000 per unit. Conversely, if the federal government either makes a direct loan or insures a private loan for the modernization costs and requires a reserve for nonroutine expenses, the revised operating costs will be about $595. Once this modernization is complete, the property would also have a market value of about $595. The fair market rent for the area in which this property is located is $515 per month, which is $80 below the property's projected revised operating costs. However, the property houses elderly people, who may have difficulty paying the additional rent and who generally are less likely to be able or willing to use housing certificates to move to alternative housing. If the property is rehabilitated, its market value of $595 would be a good value for its residents, since this is $80 more than the fair market rent. The federal government, on the other hand, is getting a market value equivalent to its housing subsidy cost. However, again, because this unit's value is above the fair market rent, the federal subsidy costs are greater than if the project's residents were provided housing certificates.

Figure I.3: Example in Which Unit's Market Value and Operating Costs Are Equal and Both Exceed the Fair Market Rent



HUD's plan raises the following issues concerning the cost implications for this development.

- As with the prior two examples, should the federal government pay for the cost of modernization through a grant when the property could finance the rehabilitation through rental income?
- As long as the current residents remain in this project, should the federal government continue to subsidize their rents above that which would be allowed with housing certificates?
- Finally, how will the added costs of subsidizing current residents in this property be paid for?

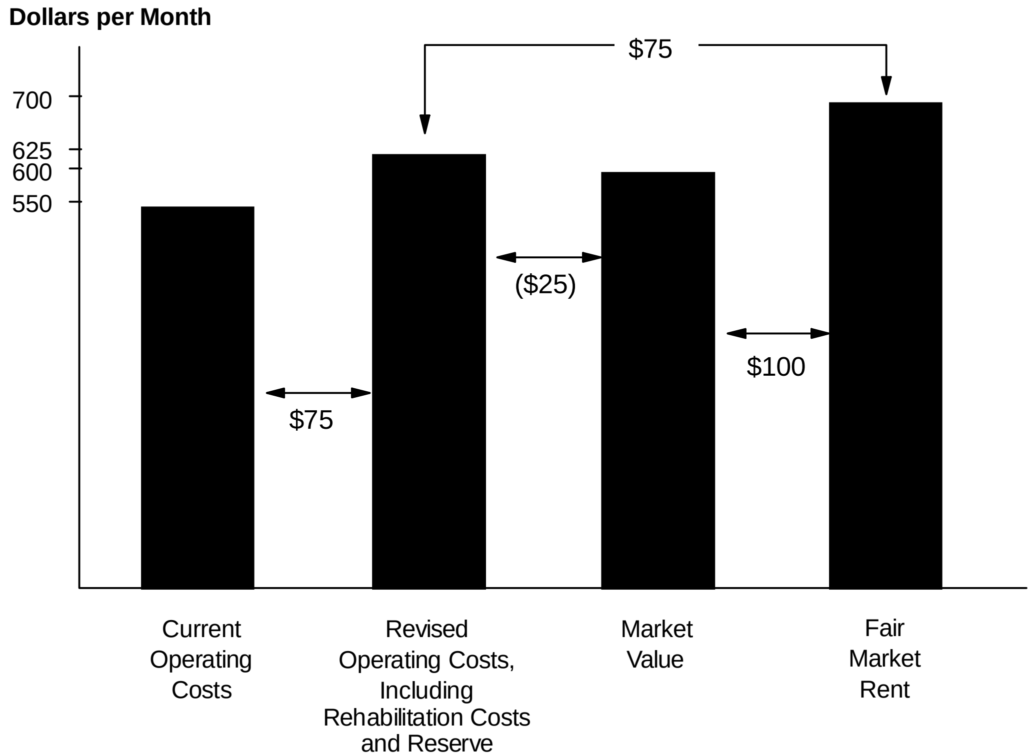
Example 4

Figure I.4 illustrates our fourth example. In this example, the development has the following monthly per unit costs: current operating costs of $550, revised operating costs of $625, a market rental value of $600, and a fair market rent of $700.

In this example, the federal government is currently subsidizing that portion of the public housing authority's current operating costs ($550) not covered by the tenants' rent contribution. If the federal government pays for the modernization of this 150-unit property out of grant funds, the cost will be about $340,000, or about $2,300 per unit. Conversely, if the federal government either makes a direct loan or insures a private loan for the modernization costs and requires a reserve for nonroutine expenses, the revised operating costs will be about $625 per month. Once this modernization is completed, the property would have a market value of $600 per month, or about $25 less than the cost to operate the property. Last, if a household chose to use a housing certificate to move to private rental housing, it could receive a subsidy up to the fair market rent of $700.

For this example, the federal government would have to subsidize the rent on the property at a level $25 per unit per month above its market value. However, the revised operating costs of $625 would still be $75 per month below the fair market rent.

Figure I.4: Example in Which Unit's Market Value Is Less Than Both Revised Operating Costs and Fair Market Rent



HUD's plan raises the following issues concerning the costs of this development.

- First, what criteria or parameters should be used for deciding when to rehabilitate a public housing unit when the revised operating costs exceed the unit's market value?
- Second, how should the rehabilitation expenses be paid for? For example, should the portion of the rehabilitation costs that cannot be financed through rental income be financed by the federal government through a grant? Such an approach might allow part of the rehabilitation costs to be financed at the property's market rent of $600 and the remainder to be paid for through a grant.
- Finally, as in the case of our other examples, a question is raised concerning how to pay for increases in federal subsidies resulting from converting to housing certificates. In this example, these increases could

result from (1) subsidizing the rehabilitation of the property at least partly through a grant, since the property's revised operating costs are above its market value; (2) providing public housing residents with a "shopping incentive," since the market value of the unit is less than the fair market rent; and (3) providing tenants with housing certificates enabling them to move to a unit with a monthly rent at or near the $700 fair market rent.

Example 5

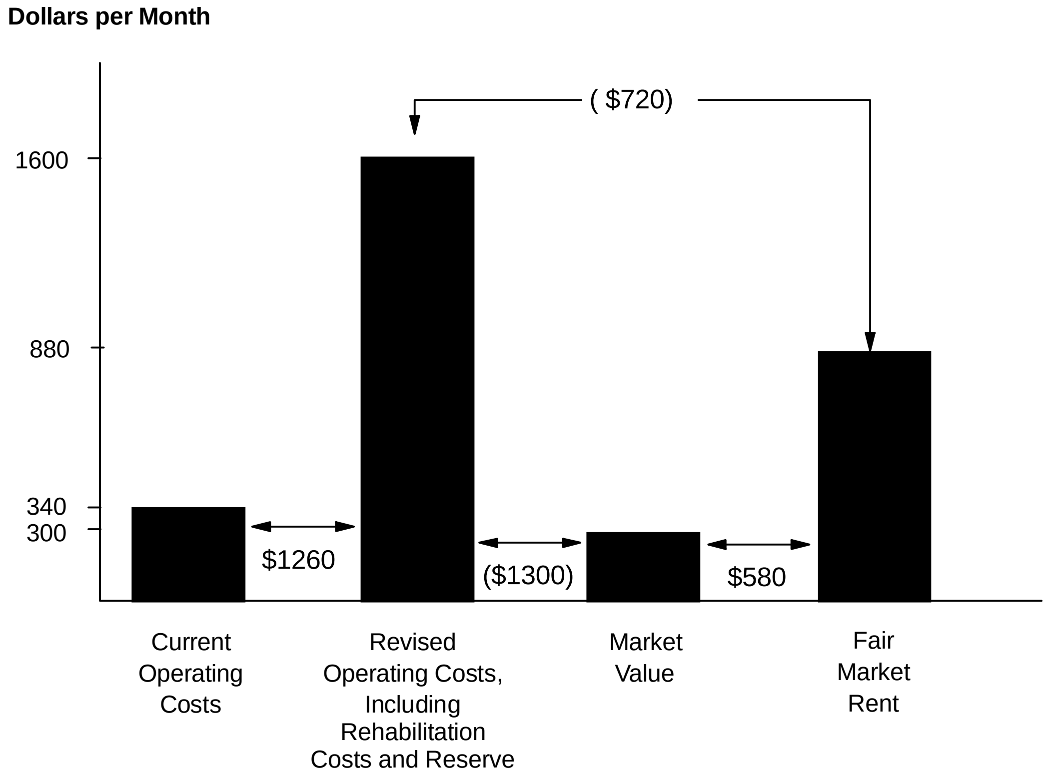
As shown in figure I.5, this development has the following monthly per unit costs: current operating costs of $340, revised operating costs of $1,600, a market value of $300, and a fair market rent of $880.

This example typifies properties that have fallen into very serious disrepair, for which the costs of extensive renovation cannot be justified on the basis of the market rents that the rehabilitated units could generate. In this example, the federal government is currently subsidizing that portion of the public housing authority's current operating costs ($340) not covered by the tenants' rent contribution. If the federal government pays for the modernization of this property with over 4,000 units out of grant funds, the cost could be over $500 million, or more than $125,000 per unit. Alternatively, if this rehabilitation is financed by a direct loan and a reserve is established for nonroutine expenses, the revised operating costs would be about $1,600. Once the rehabilitation is completed, the property's market value is about $300 per month. Last, if current residents were issued housing certificates and chose to move to private rental housing, they could receive a subsidy up to the fair market rent of $880.

From a cost perspective, rehabilitating the property in this example makes no economic sense. Specifically, the federal government would incur an inordinately high cost to rehabilitate the unit, after which its market value of $300 per month would be less than one-fifth the cost of operating the unit. Moreover, if the property is rehabilitated, tenants would be left in a unit whose market value is far less than the value of the housing they could obtain with housing certificates at the fair market rent of $880.

This example highlights the type of property that, because of its high rehabilitation costs, inflates the cost of public housing when compared to the cost of housing certificates. Assuming this property is located in an area where there is an adequate supply of rental housing to accommodate housing certificate holders, then the rational economic decision would be to provide residents with the certificates.

Figure I.5: Example in Which Operating Costs for Rehabilitated Housing Exceed Both Fair Market Rent and Market Value



HUD's plan indicates that upwards of 100,000 units of public housing would likely be demolished. Properties such as the one illustrated by example 5 would be likely candidates. However, this example still raises certain issues, including how rehabilitation should be paid for if the local government wants to retain all or a portion of this housing? For example, should the federal government be willing to subsidize the rehabilitation only up to the property's market value and require the local government to finance the remainder of the cost?

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