

Joint Center for Housing Studies

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Federally Sponsored Rehabilitation Activity

Mark Duda

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Abstract

Each year the federal government spends approximately \$6 billion to rehabilitate the housing stock, which leverages a similar amount of spending from the private sector and state and local governments. The bulk of this spending is not captured in remodeling expenditure statistics. Today's largest programs take the form of block grants, tax credits, and support for improving public housing, though residual insurance programs exist. Over time, federal rehab support favored light then substantial rehab, and has recently shifted back in the direction of smaller projects as administrative control over most federal spending is now devolved to states and localities. Many of the projects supported blend subsidies from multiple federal sources in order to achieve the depth of subsidy necessary to provide affordable units to those with low incomes. This working paper describes current levels of activity, briefly characterizes the evolution of federal policy, and reviews the primary existing programs.

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Executive Summary

Each year the federal government spends roughly \$6 billion on the rehabilitation of the existing housing stock. These funds leverage additional money from the private sector, from not-for-profit groups, and from state and local governments, to support the rehabilitation of over 40,000 units annually. Yet, because statistics measuring remodeling activity are based on homeowner surveys, they miss virtually all government-sponsored activity. Additionally, government rehab is different in character than most private activity because it largely benefits those with low incomes, and because the financial complexities of these projects insure that they are often undertaken by specialist or non-profit developers. This working paper takes stock of the largely unexamined area of rehabilitation activity that is government-sponsored by briefly characterizing the evolution of federal policy and reviewing existing programs.

The federal government began supporting housing rehabilitation in the 1930s with rehabilitation loan insurance guarantees. The Federal Housing Authority's (FHA) first insured loan was, in fact, for rehabilitation, rather than for home purchase. Over time, policy moved from light to substantial rehab and from an insurance to a subsidy basis, including direct subsidies in the 1950s and tax credits in the 1970s, as private companies gradually assumed much of the government's role in rehab insurance. Broadly, the trend in housing rehabilitation policy since the 1960s has been a shift away from categorical assistance to block grants, from general tax incentives to targeted tax credits, from large-scale loan guarantee programs to more niched activities, and from support for substantial back to light rehab but delivered through a more decentralized structure than in the early years.

Though the federal government has funded dozens of programs to facilitate housing rehabilitation since the 1930s, the bulk of current rehab expenditures are channeled through just a handful of programs. Today's primary direct subsidy programs supporting rehabilitation are the Community Development Block Grant (CDBG) and the HOME block grant. The principal remaining tax incentives for rehabilitation are the Low Income Housing Tax Credit (LIHTC) and the Historic Rehabilitation Tax Credit (HRTC). The LIHTC replaced depreciation schedules and treatment of losses that once provided powerful incentives for construction and rehabilitation of rental property with a more targeted and contained program. The primary insurance programs

that remain active are FHA's Title I, which insures single-family home improvement loans, and the Section 203(k) program, which insures combined acquisition and improvement loans for one-to-four unit properties. Additionally, the government continues to provide direct subsidies for the rehabilitation and "modernization" of public housing through programs like HOPE VI and the Comprehensive Grant Program.

Currently, the largest federal programs direct billions to rehabilitation annually. Figure 1 summarizes the average annual production levels under the rehabilitation components of the CDBG, HOME, LIHTC, and HRTC programs. The figure indicates that the federal government commits funds that obligate it to support about \$3.6 billion on rehabilitation annually. An unknown but not insignificant part of these funds covers the acquisition costs of buildings that are being renovated. The numbers of units supported by each program are not additive because there is a significant degree of overlap among them. Tax credits and grants are often co-mingled to achieve the deep level of subsidy required to make rehabilitated housing affordable to very low-income households. Therefore, the number of units renovated with direct or tax credit support amounts to less than the 114,430 suggested by adding up production under the four programs but more than the number of units produced using funds from any one program.

Federal contributions to rehabilitation are typically well below total project costs due to contributions by state and local governments, and funds leveraged from the private sector. Figure 1 also uses leverage ratios to estimate the additional private funds directed to housing rehabilitation through federal government programs. Again, because the degree of overlap among programs is unknown, the leveraged investment under these programs is less than the \$8.5 billion suggested by adding the funds leveraged by each program. In addition to the \$3.6 billion that directly supports rehabilitation of the privately owned stock, the federal government also provides in excess of \$2.5 billion to local housing authorities annually to modernize public housing. All told, therefore, the annual federal contribution exceeds \$6 billion, which likely leverages as much or more in private investment.

Figure 1: Annual Averages 1997-99 for Primary Block Grant and Tax Credit Housing Rehabilitation Programs

Program	Total Funding (\$ mil.)	Share Allocated to Rehab	Total Rehab Funding (\$ mil.)	Leverage Ratio	Leveraged Rehab Funding (\$ mil.)	Total Directed to Rehab	Units Receiving Rehab Funds Annually
HOME¹ (1997-1999)	1,177.6	0.484	570.0	2.45	1,396.4	1,966.4	23,846
CDBG² (1997-1999)	4,243.8	0.219	928.1	2.31	2,143.9	3,072.1	43,362
Historic Credit³ (1996-1998)	1,648.0	0.485	799.3	4.00	3,197.1	3,996.4	13,404
LIHTC⁴ (1997-1999)	5,262.8	0.239	1,257.8	1.40	1,760.9	3,018.7	33,818

Notes: Leveraged funding totals and units rehabilitated annually are not additive because many projects use multiple federal funding sources.

1. Annual average “activity” for 197-99 reflects some projects funded in previous years. Likewise some projects funded during the 1997-99 period were not completed over the period. Source: *HOME Production Report*.

2. CDBG share going to rehab is calculated by multiplying the 27% share of CDBG that goes to housing by the 81% share of CDBG funds allocated to housing that go to rehab. Units rehabbed annually is based on 1999 HUD estimate. Source: *CDBG 25th Anniversary Fact Sheet*.

3. “Total funding to program” is the total “Estimated Investment” dollars which differs from actual or “Certified Investment” dollars because of the lag between estimation and certification. “Estimated” figures reported here reflect increased program activity over the period. Since all projects using the Historic credit are rehab projects, but not all projects using the Historic credit involve housing, “share to rehab” is midpoint of the distribution of the share of projects including housing over the 1990s. Source: Personal communications with Park Service personnel.

4. Share to rehab and units rehabbed include “substantial rehab” and “acquisition plus rehab” categories, remaining 76.1% is new construction. The leverage ratio is based on both volume cap bonds and direct LIHTC projects. Total annual funding is nominal value over ten year life of the credit. Source for share allocated to rehab is *State HFA Fact Book: 1999 NCHSA Annual Survey Results*. Other LIHTC figures are estimates by Dave Smith, Recapitalization Advisors, Inc.

In addition to these programs, FHA insures a total of 30,000 home improvement loans annually under the Title I and 203(k) programs. It is difficult to judge how much of this activity would occur in spite of in the absence of these programs but evidence suggests that Title I is, to some extent, a niche product with the majority of its funds serving low-income borrowers.

Although current levels of federally supported rehabilitation are well below historical peaks, there are few efforts to rehabilitate low-income housing that do not depend in whole or in part on federal tax credits, grants, or other federal forms of federal government participation, often in combination.

I. Introduction: Federal Housing and Rehabilitation Policy

Federal involvement in housing rehabilitation dates back to the National Housing Act of 1934, which initiated the era of federal housing policy. In the 65 years since, the federal government has supported rehab primarily with three forms of assistance: Mortgage insurance, direct subsidies, and tax incentives. Despite some well-publicized shortcomings, federal rehabilitation policy has generated innovative programs and practices, some of which were subsequently imitated by the private sector. Rehab policy has also responded to changing social and political environments, as seen most recently in the trend toward devolution of responsibility for distribution and oversight of federal rehabilitation funds to states and localities. Over time, program stipulations have consistently allowed or encouraged layering of multiple subsidy sources, reflecting policymakers' recognition of the depth of subsidy often necessary to provide rehabilitated housing to those with low incomes.

FHA's Title I mortgage insurance program marked the federal government's first efforts to support housing rehabilitation. Mortgage insurance provides protection to lenders in the event of default by a homeowner or investor on a housing rehabilitation loan. As a Depression-era policy, Title I was designed to stimulate private sector lending and residential construction. Providing lenders with assurances against losses in the event of borrower default delivered much-needed liquidity to an important part of the economy with considerable spillovers to other sectors. At its peak from the late 1940s through early 1960s FHA insured over one million home improvement loans annually, as the Title I program successfully demonstrated the commercial appeal of rehabilitation loans. Current levels of Title I are drastically lower, as the government has largely removed itself from the business of mortgage insurance in deference to the efforts of private providers. Similarly, much of the lending that once took place only with an FHA guarantee is today perceived as commercially viable and is conducted without government involvement. This is due, among others things, to innovations in mortgage products and technology, stiff competition in the lending industry, as well as to the demonstrated effect of decades of federal sponsorship of successful small-scale rehabilitation loans.

Rehabilitation took a back seat during the "urban renewal" period of the 1940s and 1950s during which federal policy emphasized demolishing older buildings. Subsequently, however, FHA, and later HUD, began an explicit focus on rental housing that included programs to provide affordable housing through both new construction and substantial rehabilitation of older structures. The Housing Act of 1954 introduced federal direct subsidies for housing rehabilitation, and was followed by efforts to spur rehabilitation of existing structures to provide low-income housing via below-market interest rate loans, capital grants, soft-second mortgages, and rental subsidies. Initially, categorical aid was provided in the form of below-market interest rates and capital grants in combination with FHA mortgage insurance under FHA's Section 220 and 221(d)(3). Though not intended primarily as rehab programs, they in part supported housing rehabilitation until later superseded by the Section 236 program. Created in the Housing and Urban Development Act of 1968, Section 236 provided generous interest subsidies for multi-family property acquisition and renovation. At the same time Section 312 loans and grants were providing rehab activity with substantial support. Collectively, these programs produced thousands of multifamily units. By the late 1960s, upwards of 40,000 units were being rehabilitated annually after an eight-year period from 1954-1962 in which fewer than 14,000 total multi-family units were rehabilitated (Listokin 1983).

During the 1970s, categorical aid shifted to project-based rental subsidies and block grants under the Section 8 and CDBG programs following the Nixon administration's wholesale moratorium on housing assistance programs in 1973¹. The Housing and Community Development Act of 1974 introduced Section 8 Rental Subsidies and Community Development Block Grants (CDBG). Section 8 was a project-based,² substantial rehabilitation or new construction program incentivizing developers to house those with low and very low incomes via guaranteed monthly payments over the life of contracts ranging from 20 to 40 years. Financing for Section 8 was provided through FHA or Farmer's Home Administration (now Rural Housing Service) loans in a relatively early example of subsidy layering.

¹ Nixon suspended the programs in response to charges of fraud, poor management, and concerns that rising energy costs had exacerbated the financial troubles facing many FHA-insured, BMIR loan projects.

² In the early 1980s Section 8 was reoriented from a project to a tenant (vouchers) basis in response to the determination by the President's Commission on Housing in 1982 that affordability, not poor quality, was the primary problem faced by low-income households.

CDBG altered the administrative and delivery structure of a large portion of federal housing funds and, unlike categorical grants that funneled money into specific programs or projects, gave discretion to local governments to allocate funding within broad guidelines. The programs proved popular with state and local jurisdictions, and, because of the continued success of block grants in the eyes of "Entitlement Communities" and states, as well as with politicians, HUD now directs much of its overall aid to rehabilitation, and to housing generally, through the CDBG and HOME block grant programs. Although the number of incremental units receiving direct assistance has fallen since peaking in the late 1970s, nearly \$1.5 billion in federal block grants is committed each year through states and Entitlement Communities to residential repair and renovation efforts. These governments could commit an even larger share of their roughly \$5.4 billion combined annual CDBG and HOME appropriations to residential renovation if they chose to do so.

The final method that the federal government has used to support housing rehabilitation is tax incentives. Unlike tax deductions, which simply reduce the level of taxable income, tax credits directly reduce tax liabilities. In almost all cases, tax credits are sold to investors to raise equity and lower debt payments on rehabilitated properties. The National Park Service's Historic Rehabilitation Tax Credit, introduced in the Tax Reform Act of 1976, was the first targeted tax incentive for rehabilitation. It allowed accelerated depreciation of historic buildings and later, credits for a portion of rehabilitation expenses. Through the early- and mid-1980s, the tax code provided powerful additional incentives for construction, rehabilitation, and ownership of all rental properties. These incentives included favorable depreciation provisions and rapid deduction of construction-period interest and taxes. From 1981 to 1986, tax incentives for building and owning rental housing were particularly potent and stimulated an apartment construction boom.

Beginning in 1987, tax policy shifted from broad-based incentives for all rental housing (with marginally better treatment for constructing new low-cost rental housing during some periods) to targeted tax credits for low-income (below 50 or 60 percent of area median) households via the Low-Income Housing Tax Credit (LIHTC). The credit enables recipients to raise capital by selling tax credits to outside investors and/or to use tax savings to subsidize their investment in the project. Low-income tenants' rents are capped at 30 percent of the project's

income ceiling. Though buildings may mix affordable and other units, the majority of units in placed projects qualify as low-income. According to an evaluation of the program, LIHTC was involved in 40 percent of all apartments built in the first ten years following its inception (Ernst & Young 1997). Competition for a limited supply of low-income and housing preservation tax credits is intense, suggesting that the demand for them outstrips supply.

The federal government, in addition to the contributions it makes to privately rehabilitated housing, provides more than \$2.5 billion annually in direct assistance for the rehabilitation of public housing for low-income renters through three programs: HOPE VI Revitalization Grants and two "modernization" programs, the Comprehensive Improvement Assistance Program and the Comprehensive Grant Program which serve public housing authorities (PHAs) operating small and large portfolios of units respectively.³ While little of HOPE VI funds are earmarked directly for demolition-only projects, a substantial portion of HOPE VI "revitalization" funding, which totaled \$514 million in 2000, goes to demolition and new construction expenses making the exact share devoted to rehab impossible to calculate. In contrast, all "modernization" funds, which were roughly \$2.5 billion annually in 1997-98, are used for rehabilitation.

Since the energy crisis of the early 1970s, the federal government has also supported rehabilitation for the purpose of energy conservation through the Department of Energy's (DOE) Weatherization Assistance Program. The program has helped minimize heat loss, and repair or replace inefficient lighting, heating and cooling systems in five million single-family, multi-family, and manufactured homes over the last quarter century. Modifications are made by local weatherization agencies, following computerized energy audits of the unit. The program serves an almost exclusively very low-income clientele, with two-thirds of recipient households earning below \$8,000 annually.

Current policy on federal housing rehabilitation blends the longstanding theme of subsidy layering with the more recent movement toward devolution. Policy has consistently allowed the blending of financing from multiple sources and current programs typically permit or encourage subsidy layering, sometimes mixing supply side incentives like tax credits with demand side

³ The Comprehensive Improvement Assistance Program awards grants on a competitive basis to PHAs that manage fewer than 250 units and the Comprehensive Grant Program uses a formula to allocate grants to PHAs with more than 250 units.

programs like Section 8 rental vouchers. Because of their versatility and the discretion they allow state and local jurisdictions in spending funds, block grants are particularly amenable to layering. The stipulation requiring recipients of HOME block grants to match at least 25 percent of funds from local sources is often met in practice with grants from state level housing programs. More than one-third of tax credit properties received subsidized loans or grants from federal sources, such as CDBG and HOME, and state and local governments. One recent recipient of HUD's Blue Ribbon Practices in Community Development award, for example, combined funding from nine different public and private sources (US Dept. of Housing and Urban Development 1999a). In approximately one-third of cases, Historic Credits are combined with LIHTC, and seven states⁴ offer historic rehabilitation credits that can be blended with federal ones.

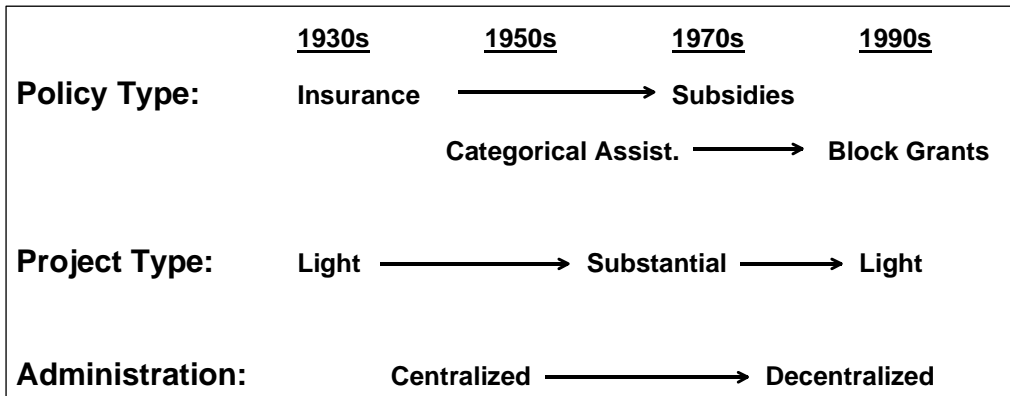
The migration toward block grant and tax credit programs distributed by formula to states and localities, which then allocate these funds according to local priorities, is in keeping with the trend toward devolution of federal housing rehabilitation policy. More than two thirds of CDBG funds bypass states, going directly to localities. Additionally, the core of the Cranston-Gonzalez Affordable Housing Act of 1990, was the creation of HOME, a new formula-based, block grant for states and localities consolidating a variety of more centrally-administered rehabilitation programs.⁵ States and localities also receive funds directly through the LIHTC program and choose how they can best be directed to achieve priorities including the provision of affordable housing for very low-income people through rehabilitation of existing units.

Figure 2 summarizes the evolution of federal rehabilitation support since the 1930s. The following sections build on this introductory section, discussing the current state of policy and describing the primary provisions of the four types of existing federal rehabilitation programs: Insurance, Grants, Tax Credits, and Public Housing.

⁴ Virginia, Maryland, Colorado, Rhode Island, New Mexico, Wisconsin, Vermont.

⁵ Section 17 Rental Rehabilitation Grants, Section 312, Section 8 Moderate Rehabilitation subsidies, Urban Homesteading, and Nehemiah Housing Opportunities Grants.

Figure 2: Summary of the Evolution of the Delivery System for Federal Government Support of Rehab



II. The Nature and Scale of Current Federal Housing Rehabilitation Programs

Insurance Programs

Two programs, Title I and Section 203(k) Rehabilitation Mortgage Insurance, both of which overwhelmingly insure owner-occupiers, have dominated federal mortgage insurance for rehabilitation. Through several other programs, however, FHA and HUD have also supported rehabilitation projects tailored to those with special needs, including the Section 202 and Section 811 programs, which fund rehabilitation of units with supportive services for the very low-income elderly and the very low-income disabled, respectively.⁶ The discussion below focuses only on Title I and Section 203(k).

⁶ Funding for FY1999 for Section 202 was \$660 million, Section 811 was \$194 million. (National Low Income Housing Coalition. 1999).

Title I Loan Guarantees

Title I insures private lenders against borrower default on loans for moderate improvements to single- or multi-family properties, manufactured homes, or for the construction or rehabilitation of nonresidential structures. In practice, the majority of Title I loans are made to improve single-family structures. Title I lenders must be approved by HUD, but all loans meeting program specifications, and consequently virtually all borrowers are eligible. The program's primary underwriting restriction is that borrowers' total monthly fixed expenses must not exceed 45 percent of their gross monthly income.

Customers may either own or lease the property they are improving. Though loans need not be collateralized with home equity, projects totaling \$7,500 or more must be secured by a recorded lien on the property and have an on-site inspection by the lender or its agent. Borrowers are typically recent, middle- to low-income homebuyers who paid low down payments on their mortgage. Title I borrowers may also tend to be those with few other financing options. They are not in a position to receive home equity loans and typically have credit records that are sufficiently blemished to exclude them from funding rehab through conventional loan products (Price Waterhouse 1997).

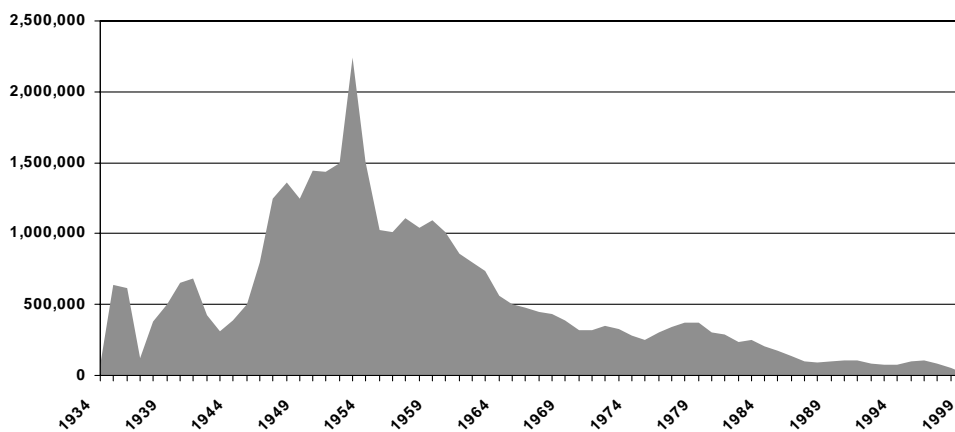
HUD insures lenders for 90 percent of the value of a loan⁷ for which the borrower pays annually 50 basis points on the original loan principle. This premium is typically incorporated in to the interest rate on the loan. Loans for single-family units or for building/improving nonresidential structures on the property are limited to \$25,000. Multifamily structures are limited to \$12,000 per unit and a total of \$60,000. Loans for manufactured homes qualifying as real property are capped at \$17,500, while those designated as personal property are limited to \$5,000. Loans, made at fixed, market rates, may be either "direct," in which funds are disbursed to the borrower who is responsible for monitoring all work and controls all funds, or "dealer." In

⁷ However, HUD will cover only up to 10 percent of a given lenders' Title I portfolio.

dealer loans, funds are disbursed by the bank to the contractor, or jointly to the contractor and borrower. As of 1998, 60 percent of loans were direct and 40 percent were dealer.

Figure 3: Title I: Novel But Waning

Loans Guaranteed Annually under Title I: 1934-1999



Under Title I, FHA has insured millions of loans worth over \$40 billion since the 1930s but, as Figure 3 indicates, current production is well below historical levels. More than one million loans were insured annually from 1947 to 1960, and over 2.2 million loans were insured in 1953 alone. In contrast, 1996 saw FHA insuring 107,000 loans, a figure that fell to 17,000 loans in 1999.⁸ Over time, private insurers have taken up much of FHA's original market share, leaving the government as a somewhat niched player, serving owners with little equity and the less credit-worthy segment of the market.

Section 203(k) Rehabilitation Mortgage Insurance.

Section 203(k) fully insures lenders against default by borrowers who are purchasing and rehabilitating, or refinancing and rehabilitating their property simultaneously. The program is designed to help borrowers avoid the costly and time consuming process of taking out a loan to purchase the property, a second to finance its rehabilitation, and then a new loan, reflecting the improved value of the property following rehab, replacing both of the first two. Under the program, rehabilitation is defined liberally to include everything from minor repairs, as long as they are permanent, to razing and reconstruction, providing the original foundation is preserved.

Loans may also be used to convert properties of any size into 1-4 unit structures, to move existing structures to new foundations, and to address health and safety hazards in homes. Section 203(k) is often combined with other mortgage insurance programs tailored to specific groups, design specifications, or financing arrangements. Homes must be at least one year old, have between one and four units, and meet basic energy efficiency and structural standards. Loans must exceed \$5,000 and be on homes whose values fall within the FHA mortgage limit for the area.⁹ Coops are excluded and condos must meet specific requirements to qualify. There are no income restrictions for individuals, but owner-occupied properties worth less than \$50,000 can receive insurance on loans up to 97 percent of the expected property value after rehabilitation; those valued above \$50,000 may receive only 90 percent of the expected value. Lenders must be FHA-approved, and mortgage companies as well as banks, and savings and loans are eligible.

Formerly, there were three types of 203(k) borrowers: owner-occupants, nonprofit organizations, and investors. Owner-occupants have traditionally been responsible for 80 percent of all loans, nonprofits three percent (usually to purchase and rehabilitate homes for resale to low-income homebuyers) and, investors 15 percent. A report by the Inspector General (US Dept. of Housing and Urban Development 1997), however, resulted in a moratorium on investor loans beginning in 1996 that is ongoing.

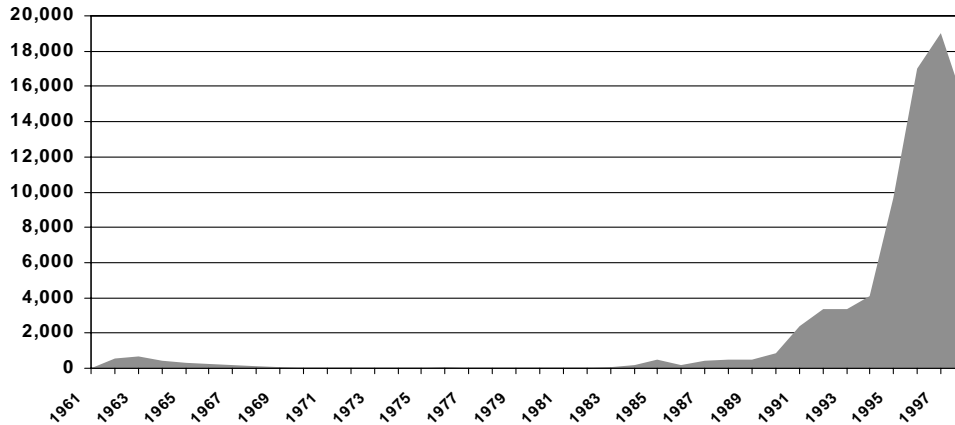
Access to 203(k) has changed over the years as a result of FHA's efforts. Created by the Housing Act of 1961 and amended by the Housing and Community Development Act of 1978,

⁸ Part of the decrease in Title I volumes during the 1990s has resulted from conventional lenders increased willingness to make loans for manufactured homes over the decade.

⁹ For the purpose of determining eligibility, home value is the lesser of 110 percent of appraised value after rehabilitation or the pre-rehabilitation value plus the cost of the repairs. FHA loan limits for 1-4 unit properties for 2000 were: \$121,296; \$155,232; \$187,632; \$233,184. Limits in "high cost areas" were: \$219,849; \$281,358; \$340,083; \$422,646.

the program insured only a handful of loans in its first two and one-half decades as Figure 4 indicates. Between 1991 and 1999, however, over 74,000 of these loans were originated, with recent years seeing the highest volumes. From a lenders' perspective 203(k), while desirable for its "one-stop shopping" quality, is more complicated than a simple mortgage, requiring the skill to evaluate the feasibility of rehabilitation projects and estimate post-rehab, on top of the viability of the mortgage itself.

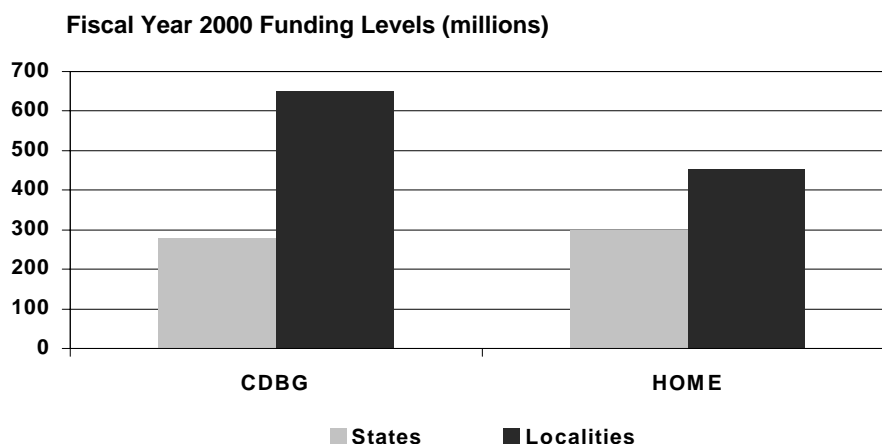
Figure 4: Loans Guaranteed Annually Under Section 203(k), 1961-1998



Grant Programs

HUD has used block grants since 1974 to allocate federal money to state and local jurisdictions with relatively few limits on how and where it should be spent. The two largest programs, CDBG and HOME, fund several activities, including new construction, but manage together to direct nearly \$1.5 billion in federal funds annually to rehabilitation of the existing housing stock. The flexibility of both programs makes them highly amenable to layering with other federal funds. As Figure 5 shows, these programs are highly decentralized with the majority of both programs' funds allocated by local governments.

Figure 5: Majority of Block Grant Funds for Rehab Go Directly to Localities



Note: Funding levels based on rehab shares of total program funding of CDBG: 21.9% and HOME: 48.4%.

Source: Joint Center tabulations of data from <http://www.hud.gov/cpd/fy2000alloc.pdf>

Community Development Block Grants (CDBG)

Activities related to housing and economic development are eligible for CDBG, the eighth largest Federal grant program in the US. About 27 percent of CDBG funds go to housing, of which about 80 percent go to rehab. According to HUD, "the rehabilitation of affordable housing has traditionally been the largest single use of CDBG funds" (US Dept. of Housing and Urban Development 1999b). Using 22 percent as the share of CDBG devoted to rehabilitation, HUD spent an average of \$928 million annually between 1997 and 1999. Additionally, each CDBG dollar leverages an estimated \$2.31 from other sources, implying total spending over \$3 billion. A corollary to CDBG, the Section 108 program, allows state and local governments to borrow against their CDBG allocations with a federal government guarantee (lowering borrowing costs) to fund rehabilitation and other activities as part of revitalization and economic development strategies.

The majority of CDBG's annual budget is dispersed on a formula basis either to Entitlement Communities, of which there are almost 1000, or to states. Entitlement

Communities, receiving about 70 percent of CDBG money, are local governments with 50,000 or more residents, designated as central cities of metropolitan areas, or urban counties whose population, excluding entitled cities they may contain, exceeds 200,000. The other approximately 30 percent goes directly to 49 of the 50 states and Puerto Rico.¹⁰ Both states and Entitlement Communities distribute block grant funds among "eligible activities" determined by HUD.¹¹

States receive a share of the overall CDBG funds in a single block, based on a formula, and they must then distribute these directly to units of local government. They prioritize among the eligible activities and have discretion to determine which projects are funded based on applications from non-entitlement communities. However, 70 percent of CDBG spending must benefit low- and moderate-income people, defined as those making less than 80 percent of the area median income or those living in an area in which a majority of residents are low- and moderate-income earners.

For Entitlement Communities, the list of eligible activities and the income requirements of the beneficiaries are the same. The slightly different allocation procedure is based on one of two formulae that factor in the community's housing conditions, population, and poverty rate. Communities may use CDBG funds directly or distribute them to non- or for-profit groups for eligible projects.

The majority of all CDBG funds (88%) flow through line agencies in local governments, typically economic development agencies and city hall staffs.¹² While independent authorities or non-profits directly allocate a relatively small percentage of funds, approximately one-fourth of funds disbursed to local governments are subsequently distributed to subordinate organizations, most frequently non-profits and other city agencies (Urban Institute 1995). Much of the remaining three-quarters of the funds are passed on directly to homeowners and landlords in the form of partially subsidized loans.

¹⁰ Hawaii does not administer CDBG so HUD makes grants directly to non-entitlement communities.

¹¹ Eligible activities are: acquiring real property; reconstructing/rehabilitating property; building public facilities (streets, sidewalks, sewers, parks, etc.); helping people prepare for employment; assisting for-profit businesses doing economic development work; providing public services for youths, seniors and the disabled; assisting homebuyers directly; enforcing building codes; meeting planning and administrative costs of CDBG.

¹² These agencies are often also the distribution point for HOME block grant funds. Since 1995 agencies have had the ability to use one application, the Consolidated Plan, for both programs.

HOME Investment Partnership Program

The HOME Investment Partnership Program, begun in 1990, is intended to fund the production, rehabilitation, and ownership of affordable housing. It uses a formula to distribute block grants in the form of lines of credit to state and local jurisdictions. Nearly half of HOME funds support rehabilitation,¹³ and annual leveraged totals directed to rehab through the program over the 1997-99 period were slightly less than \$2 billion.

Each state receives at least \$3 million annually. Localities receive a minimum of either one-third or one-half of \$1 million depending on the level of Congressional funding that year.¹⁴ The formula awarding funds to jurisdictions is based on their housing stock, degree of poverty, and fiscal health. Each jurisdiction must have an approved Consolidated Plan describing how it will use HOME funds and must match 25 percent of its grant with non-federal sources. Political units unable to qualify under the criteria set out in the formula can formally join others in order to get funding directly from HUD, or can apply for state funds. Local governments may divide funds by use prior to distribution (*e.g.*, rehabilitation, rental assistance), distribute them on a project by project basis, or issue formal RFPs and hold competitions within HOME eligible activity areas. When supporting housing rehabilitation, HOME funds may cover costs of development, relocation during the period of the rehabilitation, acquisition, and costs related to financing, development or acquisition of housing.

In order to ensure that all funds benefit low-income residents, there are strict rules for HOME disbursements. To qualify for rental rehabilitation, units must all be occupied by low-income families (less than 80% area median) whose rents cannot exceed the lesser of Section 8 fair market rent for comparable projects, or 30 percent of adjusted gross income for a family with gross income of 65 percent of area median income. Owners with more than five HOME units must designate 20 percent for very low-income families (less than 50% area median) with rents limited to the lesser of 30 percent of adjusted family income or 30 percent area median income, adjusted for utilities. Further, rental property owners must maintain affordability levels for five

¹³ Communities are statutorily required to prioritize rehabilitation of existing substandard housing in administering their HOME dollars (Jacobs 1997).

¹⁴ If the HOME budget is \$1.5 billion or more the higher figure is used.

years in developments receiving less than \$15,000 per unit, ten years in those receiving between \$15,000-\$40,000 per unit, and fifteen years in those receiving more than \$40,000 per unit. Owner occupied properties qualify for HOME rehabilitation funds if the homeowner is low-income and if the post-rehabilitation property value is less than 95 percent of the median purchase price for that type of unit in that jurisdiction.

Ninety-six percent of residents of rental units, 82 percent of residents of owner occupied homes, and 53 percent of new homebuyers supported by HOME are below 60 percent of the median income for their metropolitan area. The matching requirement typically means that states will partner with other local groups in rehabilitation projects. Another requirement, that 15 percent of funds be set aside for community-based nonprofit housing groups, is designed to build capacity of actors with a local affordable housing agenda.

Tax Credit Programs

Using the federal tax code has become an increasingly popular method of directing private sector efforts and resources to federally determined priority areas. In housing policy, the tax code is now an important source of funding for both rehabilitation and new construction. Recipients of tax credits often sell housing tax credits to fund the start up costs of projects. Individuals and corporations use the credits, which are subtracted directly from income tax obligations, to offset their federal income tax liability.

Low Income Housing Tax Credit (LIHTC)

LIHTC's are intended to support both construction and rehabilitation of rental units affordable to low-income people. As part of the tax reform package passed in 1986, LIHTC replaced several tax provisions that support rental housing generally, including accelerated depreciation, expensing of construction period interest and taxes, rapid amortization of rehabilitation expenses, and reduced capital gains taxes. The goal was to incentivize developers specifically to produce low-income units and require them to dedicate a share of units to low-income renters, with properties having rent ceilings for the low-income occupants of these units.

LIHTC ensures affordability in two ways. First, either 20 percent of project units must be set aside for households making no more than 50 percent of the area median income, or 40

percent of units must be reserved for those making up to 60 percent of area median. The compliance period lasts 15 years with a mandatory additional 15-year agreement to maintain the building's "low-income character" after that. Developers must choose the income limit option up front and reach their goal within one year of placement or risk losing credits in subsequent years. Second, eligible tenants' gross rents (including utilities) are limited to 30 percent of the income ceiling for the project.

The authority to issue credits has been allocated to states at the rate of \$1.25 per capita from the program's inception through 2001,¹⁵ and 10 percent of each state's funds are set aside for projects by non-profits. State housing finance agencies review LIHTC applications and distribute credits. Both for-profit and nonprofit developers apply and, if approved, may sell their tax credits, often through syndicators that package the credits for sale to outside investors. Unallocated or returned funds may be rolled over for one year but must then be returned. Currently, demand is keen, with more than four investors competing for each available credit (White 1997).

There are two tax credit rates under LIHTC, one for projects combining LIHTC with other federal subsidies and another for those using only LIHTC.¹⁶ Credits for substantial rehabilitation projects not involving other forms of subsidy have a present value over 10 years equal to 70 percent of the qualifying portion¹⁷ of project's current value. Projects combining several federal subsidies or ones where existing projects are acquired are worth 30 percent of the qualifying portion of current value. Thus, annual credit values are approximately 9 percent for LIHTC-only projects and 4 percent for others. In the special cases of Qualified Census Tracts¹⁸ and Difficult to Develop Areas,¹⁹ the subsidy may be increased by a factor of 1.3 raising the value of 70 percent credits to 91 percent and 30 percent credits to 39 percent.

Combining LIHTC with other programs is common and one analysis found that while 68 percent of development costs in LIHTC projects were subsidized, only two-thirds of the subsidy comes from LIHTC itself (Cummings & DiPasquale 1999). In combination with HOPE VI, for

¹⁵ The rate was raised to \$1.50 beginning in fiscal 2002.

¹⁶ The US Treasury sets the value of the tax credit monthly at seventy-two percent of the average of the annual Federal mid-term and long-term interest rates, compounded annually.

¹⁷ The qualifying portion of costs (where "costs" are typically calculated as total development costs less land) is the cost of the low-income share of the overall project. Thus a project with 35 percent low-income units has a 35 percent qualifying portion.

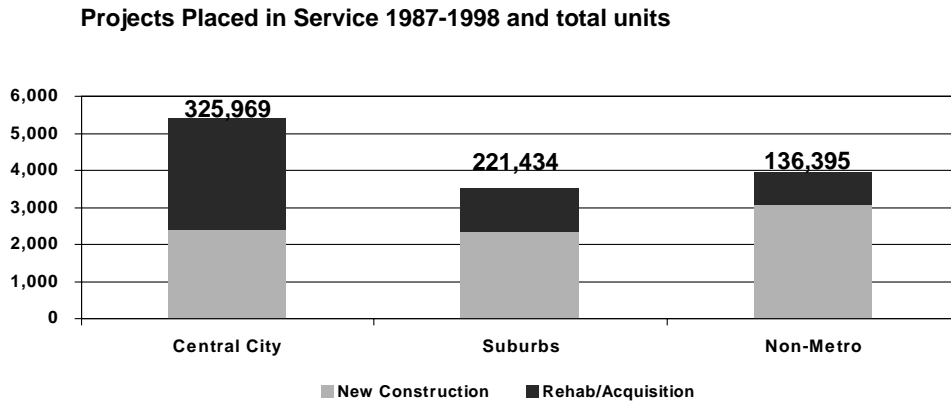
¹⁸ Tracts in which 50 percent of households have income less than 60 percent of the Area Median Gross Income.

¹⁹ Areas where construction, land, and utility costs are high relative to the median income.

example, public housing is being renovated with tax credits. According to White (1997), 32 percent of tax credit projects placed in service from 1992 through 1994 received Section 515 loans through the Rural Housing Service. Another 37 percent of tax credit properties received subsidized loans or grants from federal, non-RHS sources, such as CDBG and HOME, and state and local governments.

As Figure 6 indicates, the bulk (59 percent) of LIHTC rehab projects placed in service through 1998 are located in central cities. Over 60 percent of units rehabbed are in central cities as well. While the average number of units per project is about 50 in both central cities and suburbs, more than half of central city projects are rehab projects, compared to just one-third in the suburbs, and slightly more than one-fifth outside of metropolitan areas.

Figure 6: LIHTC Rehab Activity is Concentrated in Central Cities



Source: Joint Center Tabulations of HUD's LIHTC database.

The Historic Rehabilitation Tax Credit (HRTC)

Since 1976 the Federal Historic Preservation Tax Incentives program has supported rehabilitation of historic buildings for income-generating purposes including rental housing.²⁰ It is designed to engage the private sector in historic preservation and lessen federal responsibility for the upkeep of these structures. To date HRTC has spurred the rehabilitation of over 27,000

²⁰ The tax code had previously favored demolishing older buildings (NPS 1999a).

historic buildings and engendered more than \$18 billion in private sector investment. Of the housing units rehabilitated (149,000) and created (75,000) in historic structures using the Credit, 30,000 are for low- and moderate-income renters (National Park Service 1999).

The Historic Credit is jointly administered by the National Park Service (NPS), the Internal Revenue Service, and State Historic Preservation Officers. Although there are two credit levels, only the higher (20 percent) level applies to the rehabilitation of property for housing purposes. Applicants must own a Certified Historic Structure²¹ and be undertaking a Certified Historic Rehabilitation.²² Owners believing their buildings are eligible but that have not yet been certified can apply for certification and begin rehabilitation while the process proceeds under a "preliminary determination of significance," which does not, however, ensure eventual certification. Project results must be approved by NPS to insure that the building's historic character has been maintained. Other conditions require that rehabilitation cost is at least the greater of \$5,000 or the "adjusted basis" of the building (purchase price less cost of land, less depreciation taken, plus improvements already made). The building must also be fully certified and placed in service before the credit is taken. Owners must hold a renovated building and not make structural changes diminishing its historic value for at least five years or the credit is subject to recapture at the rate of 20 percent of the total for each year less than five.

Importantly for some investors, HRTC is subject to different passive loss provisions in the income tax code than typically apply. Ordinarily, taxpayers may not apply losses from "passive" sources, such as real estate limited partnerships, to tax liability from "active" sources like salaries.²³ Investors in historic rehabilitation earning less than \$200,000 can, however, use HRTC to offset tax owed up to \$25,000. This is phased out and then eliminated for individuals with incomes above \$250,000. (Corporations are generally not subject to passive loss restrictions.) Credits earned on a placed project not used in a given year may be rolled over indefinitely until they are exhausted.

²¹ Defined as a structure either: (1) listed on the National Register of Historic Places or (2) located in a Registered Historic District and NPS-certified as contributing to the historic character of that district.

²² Defined as rehabilitation of a Certified Historic Structure that is consistent with the historic character of the property and, where applicable, the district.

²³ Typically, taxpayers with incomes below \$100,000 *are* able to take up to \$25,000 in losses annually from rental property. Those earning below \$150,000 may take somewhat less, and those earning more than \$150,000 are prohibited from doing so.

Like other programs the Historic Credit is often layered. Approximately one-third of historic credits are combined with LIHTC (NPS 1996). Virginia, Maryland, Colorado, Rhode Island, New Mexico, Wisconsin and Vermont offer their own historic credits, worth up to ten percent of the project's cost, which can be combined with the Park Service's Historic Credit.

Public Housing

HUD funds rehabilitation of its public housing portfolio primarily through HOPE VI and the two “modernization” programs for large and small public housing authorities (PHAs), the Comprehensive Grant Program (CGP) and the Comprehensive Improvement Assistance Program (CIAP). HOPE VI is intended to “revitalize” and/or demolish severely distressed public housing and to CGP/CIAP rehabilitate it. All modernization funds, less a small amount for administrative costs, and a significant portion of HOPE VI allocations support rehabilitation. Levels for a specific year vary somewhat depending on funding allocation levels and the share of HOPE VI “revitalization” projects that support rehabilitation as opposed to demolition but together these programs have provided over \$2 billion for rehabilitation in recent years. Both programs reflect the trend toward flexibility that has characterized federal policy in the 1990s and both may be combined with other federal funds (including with each other).

Since HOPE VI began in 1993, 95 percent of the \$4.3 billion allocated under the program has gone toward “revitalization,” producing 61,000 revitalized units.²⁴ This picture is somewhat misleading, however, since “revitalization” projects typically contain substantial demolition and new construction components making the actual division of funding between the rehab and demolition difficult to establish. Funds allocated are for use primarily to cover the capital costs of projects. All PHAs are eligible and they submit applications for specific projects directly to HUD. Figure 7 breaks out the numbers of units, created, rehabilitated and demolished in revitalization projects during the last two years.

²⁴ The \$218 million spent under HOPE VI that has been spent on demolition-only projects has resulted in the removal of 97,000 “severely distressed” public housing units since these programs were first funded in 1996.

Figure 7: HOPE VI Allocations 1999-2000 (current \$)

Year	Revitalization			Demolition Only		
	Funding (mil.)	Units Rehabilitated	Units Developed	Units Demolished	Funding (mil.)	Units Demolished
1999	\$571.3	408	3,720	9,815	\$40.7	6,788
2000	\$513.8	1,394	10,128	6,778	\$50.0	8,098

CGP modernization program funds are issued according to a formula that considers the condition and needs of the housing stock owned by the PHA. Eligible activities must fall within the areas of capital improvements, major repairs, management improvements, and planning costs, but are quite flexible in practice. PHAs must own the housing, which must contain more than 250 units. Projects must be maintained so as to service low-income families for at least 20 years. The CIAP modernization program, for PHAs with less than 250 units, has similar requirements, the key difference being that funds are awarded on a competitive rather than a formula basis. In 1998, \$2.1 billion was allocated to modernization efforts under CGP and \$305 million through CIAP.

Given the number of distressed public housing units and the ongoing need to provide housing to the very and extremely low-income segments of the population, public housing will likely continue to receive a substantial portion of annual federal spending for housing rehabilitation.

III. Conclusion

Examining the last sixty years of federally sponsored rehabilitation and current programs supporting it points out several key issues. First, the trend over time has been from insurance to categorical aid and later to block grants and tax credits. Second, subsidy layering is common and has been practiced and/or encouraged throughout much of the period of federal support for rehabilitation of the housing stock. Third, a significant degree of control and oversight for federal spending on rehab has been devolved and now rests with state and local governments.

Fourth, mortgage insurance for owner-occupier home improvement loans has moved to provision by the private sector, and home improvement lending has largely come to be conventionally-provided, obviating much of the effort the federal government formerly committed to this purpose. Fifth, over time the emphasis of HUD programs shifted from light to substantial and back somewhat toward light rehab - with the key difference between the periods of light rehab being that earlier programs are centrally administered while later ones are run by states and localities. Sixth, through leveraging the federal government is able to guide far more to rehabilitation than the funds its programs contribute directly.

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