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REFORMING PUBLIC HOUSING: AN EARLY ANALYSIS OF THE ADMINISTRATION'S 1983 PROPOSAL

by

Raymond J. Struyk

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INTRODUCTION

The President's 1984 budget proposes a thorough-going reform of the way in which subsidies for operations and modernization are distributed to some 1.2 million dwelling units run by local public housing authorities (PHAs). The present patch-work system has evolved piece-meal over the past fifteen years, mostly in an era when double digit inflation was unthinkable. It is hardly surprising, therefore, that this multifarious funding system has not weathered the past stormy decade without criticism.

Indeed, both the Administration and the Congress have been moderately dissatisfied with the present system since at least the beginning of the Carter administration. At that time, the Department of Housing and Urban Development (HUD) undertook an intensive evaluation of the Performance Funding System--the system used to calculate the level of operating subsidies needed by individual PHA's.[1] In 1981 Congress asked HUD to prepare a report on options for improving the administration of the operating subsidy system and for improving the incentives for good management embodied in the system. This report was duly delivered in the spring of 1982.[2] In the same year the Senate authorizing committee gave thoughtful consideration to modifying the funding system, but its counterpart committee in the House failed to address the issue.

1. The findings are reported in Merrill et al. (1980).
2. U.S. Department of Housing and Urban Development (1982).

Successive administrations have been plagued by the seemingly inexorable growth of subsidy levels, pages of regulations, and administrative effort. Yet, despite the substantial resources devoted to the resolution of these problems, there has been precious little visible progress. In fact, some of this effort has actually contributed more to the problems facing PHA directors than to their solution. Today, a sense of frustration, even miasma, about public housing has infected many in the housing field.

Thus the stage has been well prepared for a debate on the future of public housing as an important national resource enabling low-income households to live in decent and affordable housing. Through inclusion of this reform in its budget proposal, the Administration has asked that serious attention will be given to the operation of the public housing program.

This paper offers a limited but early discussion of the proposal advanced by the Administration. It is limited in at least three ways. First, it assumes that the reader has a good working knowledge of the present public housing system--the way funds are allocated and the almost amazing diversity among authorities (even of the same size) in management style, financial health, condition of the projects, and profiles of occupant families. Second, only partial information is now available about the specifics of the newly proposed system. Third, the critical question of how individual Authorities might fare in the shift from the old system to a new one is only dimly perceived now, in part because of the lack of information on the specifics of the new system.[1]

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1. It is our understanding that the Congressional Budget Office will prepare such estimates as soon as the necessary details are in hand.

Nevertheless, the general form of the proposed system is known. Thus it is possible to consider its logic and coherence before the air is saturated with numbers. The purpose of this presentation is to outline the new system--the Fair Market Rent System, as it is known[1]--and then to analyze its parts, offering advise about their reasonableness and suggesting ways to help ensure the effective implementation of the system, if it is adopted by Congress. In particular, the following areas deserve special scrutiny:

- The level at which the FMR is set, and whether it should indeed be set at the same level for public housing and the Section 8 Existing program;
- The HUD-proposed limit on the funds available to PHAs who stand to gain under the FMR-system;
- The formulation of the procedures for providing "transition modernization funds" to PHAs;
- The lack of explicit linkage between the shift to new funding system and upgrading badly distressed authorities;
- Ways to insulate the funding that should be provided by the system from capricious attacks by tight-fisted Administrations looking for "easy" budgetary savings.

The structure of the paper mirrors its purposes. The next section sketches the Performance Funding System and its problems. Then the FMR system, as proposed, is described. The final section offers the analysis and observations about it.

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1. The official name appears to be the Fair Market Rent-Based Public Housing Funding System.

A final introductory remark is in order. In 1980, the author of this paper sketched a system very like the FMR system (and of the same title) in a book on public housing. The proposed system still in principle appears to be superior to what exists today. However, it is a system, and to be successful must be adopted in its entirety. Moreover, as suggested, some elements of the version proposed by the Administration need reconsideration.

THE PERFORMANCE FUNDING SYSTEM

The PFS is a formula-based system that determines the aggregate operating subsidy requirements for public housing and the allocation of funds to individual PHAs. It was implemented in 1975 in response to a requirement of the Housing and Community Development Act of 1974. A key feature of the PFS is that it attempted to establish initial payment levels with reference to the cost of providing services at a "well-managed" Housing Authority.[1] It also tried to establish how the cost of such an Authority would vary with operating conditions such as regional wage levels, age and type of projects, and the like. Only the essentials of the system are sketched here.

The best way to grasp the operation of the PFS is to consider it from the individual Authority's perspective. An Authority's subsidy is the difference between "total permitted expenses" and its operating revenues, which are mostly rent receipts. There are two major elements among the "permitted expenses." One is the allowable expense level (AEL), the amount of operating expenses exclusive of utilities set for the first year the system operated as the cost to operate a similar well-managed Authority. In subsequent years the base AEL has been updated for inflation and, to a much lesser extent, for changes in the

1. In the development of the PFS, 129 Authorities were divided into high- and low-performing groups on the basis of their scores of two dozen areas of operations and attitudes of tenants, authority staff and management.

PHA's operating circumstances. The other element in the permitted expenses is a utility allowance computed as the product of base period consumption (e.g. gallons of oil) and current fuel prices. All computations are on a units-months-available; the Authority should only receive payments for units available for occupancy.

To determine future funding requirements for the system as a whole for use in HUD budgets, assumptions are made about future increases in tenant incomes, fuel prices, inflation in non-utility inputs, and the number of units to be subsidized. The assumptions are applied to existing data for 133 PHAs, and when properly weighted, the simulated scenario gives a prediction of future funding levels.

What are the Major Problems With the PFS?

Statistical Limitations. The way in which the AEL was established in the first year to represent costs incurred by well-managed Authorities is open to criticism, as is the inability to adjust the AEL adequately for changes in PHAs' operating conditions. Much more important in affecting the level and allocation of funds has been the inflation factor. One problem problem stems from the need to project inflation rates two years into the future to make budget estimates. Errors in such predictions are to be expected. These are ultimately handled with supplemental appropriations requests. More serious, however, is the one-year projection of inflation rates for individual PHAs. No adjustment is ever made when these errors have been recognized. HUD's latest treatment of inflation, which is designed to compensate partially for past errors and which was built into the FY1982

budget, continues this practice. Because of these incorrect adjustments over the years, the current AELs probably bear little relationship to what they were originally intended to measure.

Another limitation concerns the equation determining the relation between selected PHA attributes and the cost of running a good Authority. Because the data used in these estimates are for PHAs which receive PFS payments, the entire exercise has become a self-fulfilling prophecy; if PFS funds received by each PHA fall this year, thereby causing Authorities' expenditures to decline, the amount estimated by the equation will fall next year.

Management Incentives. The major incentive embodied in the PFS is that an Authority's subsidy is based on its "permitted," not its actual expenses. If it spends less than the permitted level, it can devote the remaining funds to taking care of deferred maintenance, adding services, or building up reserves. The strength of this incentive, however, has been badly undermined by the less-than-correct inflation adjustments. That is, nearly all Authorities have had day-to-day costs equivalent to the underestimated "permitted" amount.

A clear disincentive in the system has been the dollar-for-dollar reduction in subsidies for any increase in operating revenues. This must have reduced the willingness of the Authority to recruit higher-income tenants, or raise their rent schedules.[1]

Another salient deficiency in the system deserves mention. There is no routine way for HUD to deal with poor management performance. The responses that are available--withholding modernization funds or not

1. The latter is no longer permitted under the 1981 legislation.

approving the application for operating subsidies--have negative effects in the PHA. For this reason field office personnel are hesitant to employ them.

On the other hand, a positive incentive in the system has involved the treatment of utilities expenditures. If the Authority consumes a smaller quantity of energy (e.g., kilowatt hours) this year than it did in the multiyear base period, it keeps half of the savings (computed as the reduction in quantity times current prices). Likewise, the PHA pays half of any "over-consumption." Recently this feature was further strengthened by shortening the base period, and computing the base as a rolling average of recent years, so that consumption reductions are captured by the federal government more quickly.

The PFS and Other Funds. This point involves the relation between the PFS and funds available for modernization and for various HUD sponsored demonstrations. The allocation of funds from each of these sources is largely independent of the others. Thus, a hard-pressed PHA director can decide to solve some of his budget problems by reducing his maintenance activity to bare levels at a couple of projects. When deterioration becomes advanced, he applies for modernization funds to finance the rehabilitation. Clearly a strong disincentive exists against current maintenance, and the size of this disincentive has grown steadily in recent years as the modernization funds appropriated by the Congress have outstripped those for operating subsidies. Moreover, there is a great deal of discretion in the allocation of modernization funds, which makes the present system especially attractive to the more aggressive Authorities.

Another source of funds has been HUD demonstrations of superior management techniques.[1] These demonstrations have provided substantial modernization funds as well as additional funding for upgrading management systems. Not surprisingly, participation in these demonstrations is highly prized by PHAs. Those who have studied the results of these demonstrations generally characterize them as providing benefits to the Authorities selected to participate but of little value to other Authorities. Indeed, selection processes have time and again been inconsistent with any meaningful evaluation of the innovations being tested. Thus, these demonstrated programs are best thought of as rescue missions to Authorities that have sufficient political clout to be chosen as participants.

The Situation Today

One of the principal virtues of the PFS has been that it provided a reliable level of funding to the Authorities. Once a PHA filled out its worksheets and had its budget approved by the Area Office, the Authority could realistically count on receiving these funds. This virtue has been violated in the past several years, although it appears that in FY1983 Authorities are again guaranteed full funding from the beginning of the year.

The problem of underfunding has arisen from HUD inaccurate estimates of inflation generally and utilities expenditures in particular;

1. The Urban Initiative Program, announced in 1978, is the most recent of these.

thus aggregate PFS funding requirements have been underestimated. (More accurately, OMB has pressed hard for the use of unrealistic assumptions, and HUD has traded lower PFS levels against other program requests.) Congress has appropriated the PFS funds requested in the regular budget process. But, because of the underpredictions of utilities, HUD has repeatedly had to request supplemental appropriations for the PFS. In 1981, the supplemental request was withdrawn by the new Administration, and havoc ensued. Although Congress finally approved a supplemental appropriation, it was insufficient to cover the full amount under-predicted. A second supplement was initiated and ultimately passed by Congress. The main point, however, is that with this new precedent the amount of funds requested for the PFS will be more explicitly a discretionary item to OMB and the Hill. The willingness of all parties to proceed in this way is caused by the low regard in which the funding estimates associated with PFS are held--"My guess is as good as theirs."

A FAIR MARKET RENT-BASED PUBLIC HOUSING FUNDING SYSTEM

The FMR system has been formulated explicitly to overcome three perceived weaknesses of the Performance Funding System. The first is the relationship between the subsidy received by a PHA and its actual operating environment, given a standard of efficient operation. The PFS attempted to establish such a relationship on a crude basis, by limiting allowable expenditures to the actual expenditures of Authorities classified as "high performing" through a statistical analysis. Because of weaknesses in the methodology and data base, this classification was imperfect at the outset; over time the distinction between Authorities initially classified as high or low performing has gradually been eroded as all PHAs have been held to comparable budget constraints. The FMR-system, by contrast, assumes that the development of realistic and comprehensive standards against which to measure each PHA's performance would require a very large expenditure of research resources and may not in the end produce realistic results. Hence, the FMR system takes as its payment standard the rents charged for good housing in the local market.

The second weakness is the lack of proper management incentives embodied in the PFS. Stronger incentives are embodied in the FMR-system, arising primarily from the single payment for operating and modernization subsidies. The third weakness is the administrative complexity of the present system, a corollary of the attempt to hand-

tailor the size of the subsidy payment made to each Authority to fit its operating circumstances and to control very narrowly the utilization of modernization funds. By avoiding the tailoring, the FMR-system eliminates much of the present complexity.

Another consideration key to the development of the FMR-system is the lack of reliable information on the actual expenditures of Authorities in providing housing services. One problem is "partial" bookkeeping. Some sources of assistance—CDBG modernization funds—are excluded from budgets submitted to HUD. Moreover, the amount of in-kind services provided by cities to their Authorities varies dramatically and its value is excluded from budgets.

These factors together led to the conclusion that the proper standard for determining the cost of Authorities providing housing services is the cost of providing these services in the market. Because HUD has already established the rent of adequate housing in every housing market as part of the operation of the Section 8 Existing Housing program, these rents--the Fair Market Rents—could be used with a simple payment formula to calculate subsidy levels.

The remainder of this section provides an overview of the FMR system as it is known to us at this stage. It describes in sequence the funding formula, management incentives, administrative feasibility, and transition issues.

Funding Formula

The heart of the FMR system is the replacement of the present method of allocating operating and modernization subsidies with a single

payment is based on household incomes, size of public housing units, and the cost of providing housing services in the area, i.e., the FMR. The most important feature is the use of the FMR as the payment standard. HUD's current proposal sets the FMR at the 40th percentile of the rent distribution for units that meet a minimum physical quality standard.

Under the proposed system, a PHA would receive subsidy payments computed for each family occupying a unit managed by the PHA. This is the type of formula used to calculate the maximum allowable subsidies in the Section 8 Existing program. In that program, the subsidy paid to the landlord by the local agency is computed as subsidy equals fair market rent minus an established percentage of adjusted household income. Because of the way Section 8 is administered, allowing several exceptions to the maximum FMR, subsidies vary around the FMR but on average reflect this formula. The proposed FMR-system for public housing will differ from Section 8 in that subsidy will <u>always</u> be equal to FMR minus a percentable of adjusted income. The fair market rent in each case is calculated for the local geographic area and dwelling unit size. Household income is adjusted for work expenses and other items just as under the Section 8 program.

The PHA is allocated the sum of the payments applicable to all the units it manages. However, this the aggregate subsidy payment will be reduced by the amount required for providing payments on the outstanding Annual Contribution Contracts (ACCs). These payments will be made directly to the bondholder by the federal government. The HUD proposal limits the deductions for ACC payments to a maximum of 20 percent of the FMR on the grounds that this is equivalent to the experience in the

private market.[1] Hence, the aggregate subsidy received by the PHA, S, is determined as

$$S = \sum^{k}(FMR - ay) - \min(ACC, .2FMR)$$

where the summation is over the k-occupied units, y is adjusted income, and a is the fraction of income mandated as the tenant's contribution.

Because the FMR reflects the cost of renting adequate housing in the marketplace, it offers an objective, if imperfect measure of the cost of providing public housing. Separate FMR schedules are produced by HUD for existing dwellings and for dwellings built or substantially rehabilitated under the program. Beginning in 1979, the FMRs for existing units have been set using data from the Annual Housing Survey, a large survey conducted yearly for the nation as a whole and on a rotating four-year cycle for 59 metropolitan areas. These data are, in fact, quite reliable and offer a realistic measure of housing costs at a point in time and changes in costs over time. The issue, addressed in the next section, is where in the rent distribution to set the FMR.

A PHA would use its aggregate subsidy payment for two purposes for operating and maintaining its projects and for funding necessary modernization activities. Modernization could be funded either by accumulating reserves or by making expenditures out of current budget accounts. The modernization program would cease to exist, at least after a transition period during which the current backlog of past modernization needs was taken care of. Overall, Authorities would be

1. Note, however, that below the 20 percent of FMR cap, the PHA will still be subject to variance in ACC expenses that result from changes in the cost of short-term borrowing on some of the notes supporting the PHAs' debt.

given much more latitude for the management of the funds available to them.

Each year adjustments for inflation would be made by the publication of new FMRs. This process would be identical to that now employed in the administration of the Section 8 Existing program.

While the foregoing describes the funding system in broad outline, the reader should note that it becomes significantly more complicated because for some PHAs the FMR-based total resources will be larger or substantially smaller than that under the PFS. The question, then, becomes how to establish the FMR for such PHAs. Two principles guide ought to the rules proposed.

First, there needs to be a gradual transition for PHAs who would have fewer resources under the FMR-system than under PFS, if the affected PHAs are to have a reasonable chance of continued operations. The objective is to insure that the shock of the switch-over is not so severe as to cause some PHAs to cease operations or close projects when the Authorities could have become viable with a longer lead time. The second principle is that no PHA should receive a massive increase in funding. Some Authorities have been efficient compared to their private market counterparts, and some may find themselves in a favorable situation because of recent federally funded modernization or a set of newly constructed projects. In essence, the new system should reward their good performance or good fortune reasonably, but not excessively.

HUD has defined three cases: one involving PHAs having more resources under the FMR system than under the PFS, two for the losers.

Beginning with the "winners" the rule is extremely simple. HUD proposes to cap the subsidy at a level providing resources for operations equivalent to those that would have been provided in FY1984 under the PFS plus an allowance for replacements and improvements. This allowance has been set at 20 percent of non-utilities operating expenditures. According to HUD this is based on the average investments of this type made by private housing providers.

Turning now to the "losers," the treatment in the HUD proposal depends on whether an authority has at least 95 percent of the resources with which to work as it did under the PFS plus the replacement reserve. Those Authorities suffering a substantial shortfall (more than 5 percent of the base) will have their subsidy levels reduced by 5 percentage points per year of the FMR level. Actually, each year the Authority receives the FMR-based subsidy as calculated in the normal way plus transition funds. After the transition, the Authority's payment consists only of the subsidy computed by the formula; none of the transition funding is built into the base. The length of the transition period is expected by HUD to be fairly brief--two or three years.

The other set of losing PHAs would receive funds during the first year of the FMR system of more than 95 percent of the PFS plus replacement but less than 100 percent. In subsequent years, they would receive the basic FMR amount as calculated.

A final complication proposed by HUD is that the FMRs for high-rise family projects (of six or more stories) will have their FMRs set at 118

percent of the regular FMR to account, it is said, for the unusual costs associated with such structures.[1]

Thus, the funding system proposed lacks the elegance of simply applying the Section 8 formula. Each complication has an arguable justification, but certainly any further attempts at fine tuning will pave the way to a system as awkward as the one being replaced. Moreover, some of the justifications for fine tuning are open to question, as discussed below.

Management Incentives

The FMR funding system in principle contains several incentives for a PHA to conduct its operations efficiently. Some stem from the joint funding of operating and modernization activities, some from the effects on the allocation of the time of top management, and some from the treatment of vacancies in the funding formula.

The incentive for linking the funding of operations and replacements modernization is clear: any savings from day-to-day operations are clearly available for modernization.[2] Furthermore, the value of keeping current with routine maintenance rises sharply--and hence the amount of rehabilitation and replacements required falls—because there is no additional funding source available for modernization. If the principles just enunciated for an Authority were effectively transmitted directly to individual projects through a capital-and-operations

1. The 118 percent figure appears to be based on an adjustment factor used in the PFS.

2. In theory, modernization funds cannot now be used to handle deferred maintenance but in practice these are the only funds available and they are used for this purpose.

project-based budgeting system, the effects on Authority efficiency could be very substantial indeed.

An additional incentive for efficiency arises by eliminating the [illegible]rent modernization system. This system generates annual funding [illegible]s to individual PHAs on a highly irregular basis in accordance with [illegible]rly articulated principles. The revised system provides greater certainty regarding future modernization funding, as well as almost total f[illegible] the Authority to use its funds as it thinks best. This elimi[illegible] paperwork between the PHA and area office, frees the Autho[illegible] numerous re[illegible]tions on how it spends its funds, and should foster comprehen[illegible]ernization planning and plan implementation.

The incentive for conserving on utilities is also strengthened, since an Authority would pay for 100 percent of any increase in consumption, compared with 50 [illegible]nt in the PFS. Of course, PHAs would also retain all the [illegible]ngs from reduced energy consumption. Gi[illegible] this incentive, one expects energy retrofit to receive high priority in Authorities' use of the funds available under the FMR sytem, including transition modernization.

A fourth effect of the consolidated funding is to give top management more time to deal with actual management of an Authority's operation. This contrasts with the present situation in which much top staff time is spent hunting for funds--dealing with the HUD area office to secure modernization funds, filling out forms for competitions sponsored by HUD to select PHAs to participate in demonstrations, or lobbying HUD or Congress for supplemental PFS appropriations. Relief from some of

the "hustling" burden may even make senior management positions in public housing more attractive to qualified individuals. Of course, some of this activity will continue to exist, and PHAs that receive lower subsidies under the FMR may increase their efforts, at least over the initial period. Likewise, PHAs will be active in making sure FMRs are accurately set for their areas.

A final incentive for good management embodied in the proposed system concerns the speed with which vacancies are filled. The FMR system would not make payments on vacant units, paralleling the situation in the private market.[1] Payments are resumed when the unit is reoccupied. This treatment contrasts sharply with that under the PFS, where in some cases subsidies are paid on vacant units. Also, paralleling the treatment in the PFS, the tenant's contribution to rent used in the formula is calculated assuming full collection efficiency; if the Authority has poor collection performance it has correspondingly fewer resources at its disposal.

Administrative Simplicity

After the transition the FMR-system would, compared to the PFS, be simple to operate. A good deal of the simplification stems from the fact that in the FMR-system one is not going through elaborate procedures to update the allowable expense levels of the PFS. Rather, one starts "fresh" each period. The computation of the aggregate subsidy

1. This treatment is less generous than that under Section 8 Existing, in which partial payments are made for 60 days. These payments are contingent upon the unit not being vacant because the owner has violated the lease; also the owner must be taking "all feasible action" to fill the vacancy. For details, see 24 C.F.R. par.882.105.

requirement for use by HUD in proposing forward-year budgets would require projections of only the FMRs and public housing tenant incomes. The FMR projections are already done for the Section 8 Existing program as part of the budget process,[1] and the projection of incomes is already part of the PFS.

To the extent that the projections of the FMRs or tenant incomes caused the subsidy requirements to be understated, a supplemental appropriation might be required or it might be possible to incorporate the reconciliation into the next year's appropriation of PHA funding. This, of course, applies to any system, because of the advanced planning of the federal budget process. However, the variance in prediction error should be much smaller under the FMR-system because the most volatile element, utilities, is part of the broader FMR prediction done for a whole market, not for specific PHAs.

The role of the area offices in this system is minimal: checking over the calculations in the budgets proposed by the PHAs and monitoring the Authorities' income data. The PHAs would enjoy relief from negotiating dozens of entries in their proposed budgets with HUD staff. In general, the level of HUD "oversight" would be diminished. More positively, shifting to the FMR should mean that the HUD field staff will be free to spend a greater share of its time identifying management problems and working with Authorities to develop solutions to them.

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1. A PHA who thought the FMR was incorrectly set for his area would have the right to demonstrate this with survey data during the comment period on the published FMRs.

Transition

Two significant transition problems must be addressed. The first, already discussed, is how to treat those Authorities whose total financial resources, including subsidies, under PFS differ substantially from those provided under the FMR system. The second major issue is the deferred maintenance and modernization backlog.

The approach proposed by HUD to deal with the modernization backlog is to provide funding to bring all projects up to a common minimum physical standard. The upgrading is consistent with the idea of placing the Authorities in a competitive position before cutting them free from a more hand-tailored system of support. The standard selected is unclear at this point, but apparently it is somewhere between a minimum health-and-safety level and HUD's minimum property standard. Nor has the program for carrying it out been specified. One point that is clear is that all the initial catch-up work is to be funded outside the new FMR payment scheme; that is, these ACCs would be paid for directly by the Authorities through the traditional process.

The total cost of the transition modernization has not been yet stated. Nor has the number of years over which funding is to be spread. These are key parameters that are discussed further in the next section.

OBSERVATIONS ON THE FMR SYSTEM

The system just sketched has a veneer of simplicity that overlays successive layers of complexity. Understanding it well enough to think creatively about its design requires that each part be clear as well as the relationships among them. There is one critical point, however, about legislating the FMR-system that is largely independent of the details. The PHAs have good reason to be skeptical about any funding system, including the PFS. During the past several years, funding levels for both operating and modernization subsidies have been capriciously set and revised. In this environment, the *sine qua non* of a new system is that the legislation be written so that there is *no* discretion left to the Administration in establishing annual funding levels; in essence much of the latitude that would normally be invested in HUD's regulatory authority must remain with the Congress. It is indeed unfortunate that such reservations must be imposed; if they are not, however, there is little incentive for PHAs to shift systems. Indeed, the malleability of the funding levels over the past few years—with the Authorities gradually learning to be extremely effective lobbyists and securing generous funding--is a fundamental impediment to reforming public housing in the near future.

The balance of this section divides the discussion into five parts. We begin with the basic question as to whether market rents provide the correct standard for public housing. The second part then

deals with key funding parameters, i.e., those decisions that determine funding levels over the long-term. The third part deals with modernization funding during the "transition period." The fourth focuses on management improvements, especially for the badly distressed Authorities. The final part gives a concluding observation.

Is the FMR the Right Standard?

How strong is the case for using market rents as the basis for establishing subsidies for public housing? The general logic has already been suggested: the federal government should assist poor households to obtain decent and affordable housing at the lowest cost to the government; leasing units in the open market is the least costly option presently available so it is the standard against which other options must be measured. Of course, to the extent that other objectives are emphasized, such as adding new units to the stock to stimulate the economy, other criteria must also be employed. But several more specific questions can be asked about the applicability of a market standard to public housing.

One such question stems from the fact that FMRs are market determined, that is, they depend on both the cost of providing services and the demand for them. It is neither a purely cost-based or demand-based standard. Over the long run, under competitive market conditions rents should be close to costs. In the short run, however, considerable deviations can exist--with the market setting either excessive or insufficient profit rates. Moreover, extra-market factors--especially rent controls--can yield situations in which rents are sustained at a

level below that necessary to make housing a profitable investment. Under this condition some public housing projects that would be viable under a cost-based system will leave the stock of assisted housing under the FMR-system.

The logical response to this situation under a market-oriented system is to say that publicly assisted housing should not be insulated from the market. If some public housing projects are the marginal housing in an excess supply situation, they should be those withdrawn from the stock.[1] Such a policy would attenuate the burden of market adjustments placed on private producers, and probably increase local pressure to drop rent controls. At the same time, since FMRs are set on an SMSA-wide basis, some relief for PHAs in jurisdictions with rent controls is available, especially if rents paid by "recent movers" are the basis for setting the FMR.[2]

Another issue concerns differences in the cost of capital and property taxes confronted by private owners and PHAs. On the one hand, PHAs have received favorable treatment under the income tax system because they have been able to finance their capital cost through bonds whose return is exempt from federal income taxes. Additionally, PHAs pay no federal or local income taxes or local property taxes; instead, they make payments in lieu of local property taxes (PILOT), which are

1. Under the FMR system, Authorities should have the right to remove units; tenants would receive Section 8 certificates. The provisions for this in the HUD proposal are not clear, although some "deprogramming" is expected and encouraged.

2. One might expect this policy to push for rent deregulation, especially where sustained rent control has had the effect of restricting housing supply so that the loss of public housing units would work a serious hardship on the community.

substantially less than the rates applicable to private owners of rental property. On the other hand, private owners enjoy significant breaks under the federal tax code. These have traditionally included accelerated depreciation, the expensing of construction period costs, and the deduction of operating expenses--including mortgage interest and property taxes--from income in computing their tax liability. Finally, the length of the mortgage period and the holding period for private owners are shorter than for public housing.

In order to assess the relative tax advantages of PHAs and private owners it is necessary to conduct an analysis of the cumulative effect of these advantages over time, making strong assumptions about the similarity of other conditions faced by the two groups. The analysis presented here makes use of a dynamic model of rental housing developed by Hendershott and Shilling (1980). In particular, their model can be solved for the real user cost of capital, which is defined as the real (i.e., net of inflation) rental rate that one would pay to rent a unit of capital. In a world without taxes and inflation and with perfect capital markets, the user cost would be "the" rate of interest plus the depreciation rate.

Our approach has been to solve the Hendershott-Shilling model twice, once for the values of the parameters appropriate to public housing and once for the values appropriate to private owners. These calculations assume the federal income tax regime in place in 1980.

The results show public housing on net to be in an advantageous position compared to private owners, even under assumptions about the spread in interest rates and the share of applicable property taxes made

in PILOT payments that are somewhat unfavorable to the PHA.[1] In brief, there appears to be no justification for increasing the payments in the FMR-system on the presumption that PHAs have been disadvantaged in their cost of capital compared to private owners.

A third question about the applicability of market rents to public housing involves the extra cost imposed on PHAs by a host of federal regulations and reporting requirements. No one has any accurate idea of the magnitude of the direct, not to mention indirect, costs of such requirements, but they are certainly nontrivial. As part of the reform discussion, the public housing interest groups and Congress should identify the most onerous regulations which have little to do with effective operation of the program and delete them. In this regard, the HUD proposal does not place a sufficient emphasis on increasing the flexibility available to PHAs to conduct their own affairs.

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1. The basic results can be illustrated for the following case: a 7 percent rate of inflation, a market mortgage interest rate of 9.86 percent and the public housing borrowing rate of 70 percent of the private rate, public housing making PILOT payments equal to 30 percent of full property tax payments, and private properties being held for 13 years (with a 20-year mortgage) and public housing 40 years, private owners are in the 50 percent tax bracket and are able to shelter other income with excess tax deductions. All costs are expressed on a discounted present-value basis. The cost of annual capital, experienced as a percentage of the purchase price of structure, is 11.9 percent for a private unit and 4.5 percent for public housing. (It is the discounting procedure that drives the real cost below the nominal interest rate in the case of public housing; note also that the real rate of interest paid by PHAs in this scenario, based on historic data, is approximately zero.) Much of the divergence between the two housing producers stems from differences in the length of the holding period. The real cost of capital (on a present-value basis) for private owners falls to 7.5 percent on a 40-year mortgage and holding period, due in part to lower real interest cost in the out years and growth in the resale value of the property since inflation rate is greater than depreciation rate. Of course, the best holding period for the investor depends on profits, not just the cost of capital.

Returning, however, to the costs imposed by the remaining regulations, one point is especially germane. The energy retrofit that will be accomplished during the transition will give the Authorities a dramatic cost advantage compared to their private counterparts for a number of years. While this is clearly an offset, the FMR could be set so as to easily accommodate a realistic adjustment for excessive costs associated with meeting various regulations but only if a reliable basis for such adjustments is available.

If the various arguments advanced above are accepted, and the cost of decent housing in the private market is taken as the relevant standard, one must still confront the anomalous fact that HUD's proposal rejects the FMR standard for those PHAs which would receive more funds under the FMR-system than under the PFS plus the replacement and improvements reserve. There are, to be sure, several arguments against the cap as proposed. Some Authorities had their "base year" in the PFS set at too low a level because of poor methodology. Other Authorities have received systematically smaller inflation adjustments over the years than they should have, thereby keeping subsidies unrealistically low.[1] Likewise, the 1984 PFS levels to be used in establishing the cap will embody each PHA's actual utility bills as of the early 1980s. Freezing at this level will penalize those who have been most efficient as well as capping those with low utilities due to energy modernization expenditures. Thus, the capping proposed appears expeditious and disingenuous.

1. Struyk, Malpezzi, and Wann (1980).

To be strictly consistent with the principles of the FMR-system every PHA would receive full funding and pay for its full debt service ACCs. But because of the vagaries of history and the incentives embodied in past funding methods, the transition to this unconstrained system would be quite destructive. HUD's proposal cushions the losers by capping the ACC deduction from the potential subsidy and pays for this with funds captured from the "winners."

The capping proposed for application to the winners is too draconian. But some limitation is inevitable. The figures in HUD's report to the Congress suggest that under an unconstrained FMR system on the order of 15 percent of all public housing units would experience increases of over 30 percent above the PFS plus the replacement reserve. About half of these would be greater than 50 percent. And these calculation did <u>not</u> limit the ACC offset.[1] Increases of these magnitudes are very hard to swallow for any system.

In summary, a market-based standard does appear reasonable for public housing. Unfortunately, the inherited funding of individual Authorities under the PFS precludes a straight-forward application of a "pure" FMR-system. Protections for losers and limitations on winners are required to compensate for past inequities and to restrain them in the future. The next section discusses establishment of funding levels in greater detail.

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1. U.S. Department of Housing and Urban Development (1980), p. 319.

Key Funding Parameters

Four preliminary comments are in order before turning to the specific parameters that drive the amount of funds received by an individual Authority. First, the parameters must be considered as a group. Obviously, together they determine how much Authorities receive. There is a considerable range of combinations of parameter values that will generate the same aggregate funding, while changing the distribution of funds among Authorities in potentially fairly drastic ways.

Importantly, it appears that of these parameters--FMRs, "cap" on debt service to be deducted, the level of the replacement reserves, and the "high rise" adjustment factor is--only one is under the Authority's control to even a limited degree. The exception is future ACC levels. Those Authorities with 1984 debt levels less than the level at which the cap takes place (20 percent of FMR in the HUD proposal), may weigh higher ACCs against the level of modernization they are willing to undertake during the transition. In general, however, variation in the combination of parameter values chosen will not create systematic differential behavioral responses by the PHAs. This means that there is room for considerable experimentation among parameter combinations. Having said this, it seems wise to study the merits of the values proposed by HUD as a starting point.

The second preliminary observation is that comparisons of the funding levels that a PHA would receive under the FMR system with those under PFS plus modernization is more complex than one might at first imagine. The allocation of modernization funds has been driven by grantsmanship, the predilections of area office staff, and HUD policies,

as well as by objective criteria. Thus, it is extremely difficult to estimate how much modernization funding a particular Authority would receive if the current regime was continued. Presumably, PHAs receiving high levels of these funds in the past (on a per unit basis) should have lower needs in the future. However, it is doubtful that past funding is a good guide to a "just distribution" of these funds. Another and perhaps more important problem is that transition modernization funds will reduce operating costs significantly by achieving important energy consumption reductions. Thus, current operating expenses and subsidy levels are unsatisfactory standards for comparison as well. Because of the diversity of Authorities, it is hard to predict with much precision the situation of any PHA under the FMR-system compared with the PFS cum modernization. Generally, however, because of transition modernization expenditures, current operating expenses should be considered the upper limit of operating cost levels faced by PHAs under the proposed FMR system.

The final preliminary observation is simply that under the FMR-system, like the PFS, Authorities are permitted to pool their resources across projects. Projects with surpluses can be used to cross-subsidize those with deficits. There is an important question, however, which is addressed later about the linkage between the expenditure of transition modernization funds and retiring grossly expensive projects.

The Fair Market Rent. There are two distinct issues involved in this point: establishing the correct FMR for the Section 8 program, and determining whether public housing should be governed by the same standard.

In principle HUD can establish the FMR for the Section 8 Existing program at any point in the distribution of rents of units meeting certain standards. FMRs should be set at a level is consistent with the effective operation of the program. Let us define effective operation of the program as the situation in which (a) would-be participants can find qualifying housing in a wide range of neighborhoods, including racially integrated ones, with reasonable search effort; and, (b) the incentives embodied in the program are sufficient to induce a substantial share of eligible households currently living in deficient units to participate in the program, thereby improving their housing situation. In the past, the debate on where to set the FMR has concentrated on the first point, i.e., on the so-called "penetration rate." This focus was appropriate as long as other key factors determining the level of subsidies received by participants--the tenant's contribution and the definition of income--were held constant. But 1981 legislation and 1982 and 1983 proposals by the Administration change and would further change these other parameters. Indeed, the reduction in benefits is so great under these changes--40 to 50 percent--that it is doubtful that the "voucher" program will be capable of accomplishing the second basic objective. In other words, most new participants in the program will be those already living in standard housing,[1] and little upgrading in housing quality will occur. Stated alternatively, if the subsidy levels are set so low that poor families living in substandard housing will not participate because the reward is too small compared with the effort of searching for and moving to better housing, the

1. Zais, Struyk and Thibodeau (1982), Chapter 6.

program is simply an income transfer to those already in decent housing. The choice of neighborhoods is secondary.

Under these circumstances, either the 40th percentile FMR for all units is too low for the voucher program or the proposed tax rate on tenant incomes too high. In short, the parameters for the Section 8 or voucher program are wrong. A more reasonable figure--for the successful operation of the voucher program--is the 40th percentile rent for recent movers or the 45th percentile for all acceptable units.

Should the FMR be set at the same level for Section 8 and public housing? The answer is affirmative only if the FMR for Section 8 (in combination with the other parameters determining subsidies to households) is high enough. *Prima facie* equity would suggest the same figure. This treatment also has the advantage of making the same income available on average to both private and public landlords. Perhaps more to the point decoupling the two standards would make both more subject to *ad hoc* manipulation. Thus, the proper road appears to be to correctly establish the FMR in the Section 8 program; only if this route is impassable should a separate FMR for public housing be established.

The Replacement Reserve. The earlier discussion of the FMR-system showed that the role of the replacement reserve figure is critical only to setting the subsidy level in the first year. That is, the key comparison for setting the initial subsidy level is between the funds available to a PHA under the FMR-system and those available under the PFS plus the replacement reserve. Nevertheless, the replacement reserve is extremely important. HUD proposes to set the reserve at a level equivalent to 20 percent of non-utilities operating expenses. This

figure is supposed to be sufficient for both replacements typically financed out of reserves by private investor-owners and major improvements (roofs, etc.) that are often paid for when a privately owned property is refinanced.

How reasonable is this figure? The available information suggests that it may be defensible. Analysts at Abt Associaties documented the on-going investment in private rental properties at 8-15 percent of operating expenses less utilities.[1] Early findings from a project currently underway by another HUD contractor using more comprehensive data for 300 FHA-insured projects is said to indicate a figure in the 20 percent range. This new study must be thoroughly examined by analysts outside of the Administration, since long-run problems for the entire public housing inventory are inherent in setting reserves at an insufficient level.

The Cap on ACCs. Limiting the size of the debt service payments (per unit) subtracted from the FMR to determine the subsidy amount is an attempt to deal with the greatest source of disparity among Authorities and the one which is now largely beyond their control. The fact is that the per unit ACC payments vary dramatically among Authorities, and that there is no close relationship between the level of debt and the costs of project operations. Although one might expect newer and more recently modernized projects with higher ACCs to be in better condition, more energy efficient, and therefore more economical to maintain and operate, this is only loosely the case. Thus, it would be unreasonable

1. U.S. Department of Housing and Urban Development (1982), pp. 234-235.

to simply subtract actual ACCs from the FMR for every Authority. It would be equally unjust to lower the FMR by the same amount for all PHAs and ignore the actual ACCs in the subsidy calculations. This would penalize those PHAs which have an older inventory and have received fewer modernization funds over the years. Hence, the concept of a cap on the ACC deduction represents a reasonable compromise.

At what point, however, should this cap be set? To maintain compatibility with the private market one should set the maximum amount of debt service at the average value for comparable private properties. HUD claims that this figure is 20 percent of rents. Reliable information on this point is difficult to assemble; so one awaits the release of the basis for this figure with some anticipation.

We have suggested various interrelations among elements in the funding formula. This is a good place to catalogue some of these. First, raising the FMR level beyond that proposed, while still maintaining some cap on the first year's funding aids only those who are losers in the transition to the FMR-system; winners remain capped at the same level. Lowering the limit on the ACC deductions, i.e. from 20 to 15 percent of FMR, also makes PHAs who would be losers in the shift to the FMR system better off. Only those losing PHAs with old projects needing modernization, i.e. those with ACCs still below the caps are unaffected. Finally, note that raising the size of the replacement reserve, makes the winners bigger winners. It also increases the size of the loss of losers, which would raise the level of their transition subsidies but leave their long-term funding unchanged.

<u>The Family High-Rise Factor</u>. The HUD proposal includes a provision to multiply the FMR by some factor between 1.15 and 1.20 in computing the subsidy for units in projects over six stories high, with half or more of its units occupied by families. The argument is that even if such building exist in the private market, they receive insufficient weight in the FMRs. This raises a broader issue of whether the FMRs used in setting subsidies for each PHA should be more closely tailored for the specific Authority. Below, the high-rise factor is first discussed and then the more general question of tailoring.

There is certainly reason to sympathize with the managers of high-rise family projects, and the extremely high incidence of such projects among those classified as distressed suggests genuine management problems. At the same time, the precedent of granting bonuses for special conditions is worrisome. Next, we may have the "bad neighborhood" bonus. Before embracing a high-rise bonus, a fairly intense effort to find comparable experience in the private sector should be undertaken. Creative statistical manipulation of Annual Housing Survey data for the few SMSAs with a large volume of large apartment buildings is one option. Another idea is to compare the per unit cost of operating these large buildings with smaller ones within a well-managed Authority; New York comes readily to mind.

The theme here is to entertain the idea of the need for such bonuses with the greatest skepticism. Thorough, convincing documentation must be produced to support this one or any other.

A more systematic way to deal potentially with the types of buildings PHAs operate is to use separate FMRs for each building type.

Indeed, one of the salient criticisms of the FMR-system is that it is not closely enough tied to the kind of units managed by PHAs. In principle separate FMRs could be computed for alternative building types. Limited sample sizes in the AHS would probably mean that some inference through estimation of regression models (the so-called hedonic index approach) would be necessary. Still, separate computations could be done. For larger SMSAs, separate FMRs could be calculated for cities and suburbs. However, considerable caution is urged on the proponents of this approach. Much of the averaging in the HUD proposed average FMR approach is to the PHAs' advantage. For example, central city FMRs will probably be lower than surburban ones; hence, the big central city PHAs would lose funds through less averaging.[1] Likewise, analysis of the variation of rents with number of units in the structure and elevators indicates generally that PHAs will not realize higher FMRs from greater specifcity of this type.[2]

In general, it is the case the Annual Housing Survey will permit some greater tailoring in setting the FMRs. But it is clear that some PHAs will lose from such adjustments, and the identity of the losers is far from obvious.

Transition Funding for Modernization

There are several questions that must be fully considered in designing the transition modernization activity, which is intended to bring all public housing projects up to a minimum standard which the

1. Follain and Malpezzi (1980), Table 12.
2. Ibid, Table 6.

funding available in the FMR-system will sustain, assuming that the stock is reasonably managed. Close attention to this topic is essential, as the ultimate utility of the FMR-system and PHA acceptance of it both hinge on it.

The first question, naturally, concerns the standards to be employed. The information thus far available from HUD is not totally revealing. Reasonable standards would appear to encompass energy investments which are cost effective within five years as well as general upgrading sufficient to make projects conform with the minimum property standards in most areas.

Calculating how much it will cost to achieve these goals is tricky. One complicating factor is that the cost varies with the number of years over which the transition activity is spread, both because of inflation and because the projects will continue to deteriorate with each year.[1] Another factor is the relationship between recent modernization funding and new funding needed to achieve these standards. Because some of the very substantial amount of modernization funds appropriated over the past three years will be spent for improvements beyond these standards, it will not have taken care of work of the type to be done over the transition.

These facts point to the need for a full-fledged program for funding and accomplishing the transition modernization. The first step, of course, is to define the funds needed for 2, 3, and 4-year funding programs. Thus far, HUD has not provided this menu of costs. Next, the

1. Arguably, however, this deterioration should be offset by the funds made available as the replacement allowance which the PHA begins receiving in the first year.

Congress will probably have to establish a multi-year funding scheme to accomplish the modernization work if PHAs are to be convinced that the full program of upgrading in fact will occur.

A key aspect of the expenditure of the transition modernization funds is that Authorities ought to be given the widest possible latitude. Some projects can be upgraded beyond the standards; work on others can be deferred. The massive amount of red tape and HUD oversight should be laid aside. The major philosophical shift underlying the FMR-system is that PHAs are perfectly capable of making decisions about the relative allocation of resources between maintenance and improvements and can develop their own strategies for making needed improvements. Immediate implementation of this philosphical change will signal the determination of the Congress and Administration in this matter to the Authorities.[1]

One final aspect of transition modernization requires comment: the relation between it and retiring some public housing stock. The time for PHAs to make the decision to retire buildings or projects is before the investment of the modernization funds. The rational Executive Director and Board of Commissioners would calculate the post-transition-modernization operating and improvement costs of each project and consider retiring those few which will not be financially viable under the FMR-system, even allowing for some cross-subsidization. Tenants in deprogrammed projects would be given Section 8 certificates issued for this purpose. As an inducement to the PHAs to confront the difficult

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1. The treatment of poorly managed Authorities is discussed in the next section.

issue of shrinking their inventories, they should be permitted to keep the lion's share of the transition modernization funds allocated to these projects.

Management Improvements

The present HUD proposal is silent on the relationship between the shift to the FMR-system and the future of the few badly distressed Authorities that exist in the system. It seems essential not simply to hand these Authorities the modernization funds and hope for the best. Four years after implementation of the new system the same management problems will be evident in an even more acute condition. Restoring the badly distressed Authorities to sound condition is a several year process; shortcuts are merely wishful thinking.

Thus it is imperative to delay the provision of modernization funds to these few Authorities until the upgrading of management is well on its way, so that these funds can be deployed as part of an overall improvement strategy. There are perhaps a dozen large Authorities requiring a substantial overhaul. And these might be stretched over a two- or three-year period. Several ingredients are necessary for this process to yield satisfactory results. Transition modernization funds must be set aside and their purchasing power protected. For PHAs which would have reduced operating subsidies under the FMR-system, the subsidies must be maintained at the higher level until after the Authority is ready. Finally, funding for technical assistance and management improvements will have to be available. All of these elements, plus the criteria for identifying the distressed Authorities, should be part of

the legislation enacting the new system.[1] Attention must also be given to HUD's ability to oversee such a process, in both the field and central offices.

It is probably worthwhile to say a word about the relationship between the FMR-system and the Tier A - Tier B system proposed by the Senate in 1983 (S.2607). The distressed Authorities correspond to those in Tier B in that legislation. However, note that there is little correspondence between an Authority being in Tier B and being a winner or loser under the FMR-system compared to the PFS cum modernization. Some extra large, distressed Authorities will be at least as well off under the FMR-system. Thus, the proposed under Tier B is really for distressed PHAs, quite independent of their apparent fate under the FMR-system.

The Last Word

All of the above points to a few simple concluding observations about what it will take to make the FMR-system work for public housing. First, the legislation must be constructed to ensure that the complete funding system will come into being as a whole, and that the steady-state system will be as tamper-proof as possible. Second, the funding level in the critical base year needs to be correct both on average and in the distribution among PHAs. Thus, changes in funding from that proposed by HUD must be considered along both dimensions. The parameters in the system offer some genuine flexibility as to allocations. Still, it is hard to imagine that it will be possible to shift

1. One set of criteria is outlined in Chapter of Struyk (1980).

FMR-system without there being losers, if the principles undergirding the proposal are followed. Third, the FMR-based system has a wonderful allure of simplicity. Unfortunately the diversity of PHAs--caused in part by past federal funding patterns--precludes straight-forward application of the Section 8 Existing formula to public housing. Fourth, the Authorities deserve as much freedom in expenditures, management practices, tenant policies, and other areas as is consistent with the mission of the program. The question of how much latitude is appropriate should be re-thought along with the more tangible question of funding. Finally, nothing in this new system will reverse the mismanagement at the truly distressed Authorities; it is no panacea. A separate approach is necessary for these, no matter which funding system is employed.

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