

Impact

A regulatory impact analysis must accompany every economically significant federal rule or regulation. The Office of Policy Development and Research performs this analysis for all U.S. Department of Housing and Urban Development rules. An impact analysis is a forecast of the annual benefits and costs accruing to all parties, including the taxpayers, from a given regulation. Modeling these benefits and costs involves use of past research findings, application of economic principles, empirical investigation, and professional judgment.

Impact of the Rule on the Use of Public Housing Capital Funds for Financial Activities

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Abstract

This article assesses the benefits and costs of a rule that enables some housing authorities to pledge capital funds for debt-service payments incurred for the modernization and development of public housing (including public housing in mixed-financed developments).¹ At the outset, the implementation of the rule would not affect the federal budget but, over time, would have the potential of creating substantial financial flows and transfers for housing authorities and local economies. Although it is difficult to quantify the tangible benefits to the various stakeholders, it is possible to identify and quantify most of the costs.

¹ Published in the *Federal Register* as a final rule on October 21, 2010. 75 Fed. Reg. 203.

Background and History of the Capital Fund Financing Program

The Capital Fund Financing Program (CFFP) is best understood in the historical context of the public housing program.

- The U.S. Housing Act of 1937² established the public housing program to provide low-income housing to eligible families. In the early years of public housing, developments were built with tax-exempt bonds issued by a local public housing agency (PHA), with the debt being paid by the federal government's annual contributions contract, and PHAs funded repairs and improvements from the operating funds.
- In 1968, the U.S. Department of Housing and Urban Development (HUD) began providing funds for repairs and renovations under the modernization program and PHAs were allowed to borrow money for specific repairs as needed.³
- In 1980, the Housing and Community Development Act established the Comprehensive Improvement Assistance Program (CIAP) that focused on the comprehensive modernization of public housing developments. CIAP was a competitive program under which PHAs annually submitted applications for funds.
- The Housing and Community Development Act of 1987⁴ authorized the Comprehensive Grant Program (CGP),⁵ which provides formula funding to meet the needs of larger PHAs (250 or more units of public housing), rather than forcing those PHAs to compete for funds. CGP also gave larger PHAs a steady and predictable annual source of funding to better plan modernization of the aging inventory. PHAs receiving CGP funding had to develop comprehensive plans that identified existing physical and management needs and to establish a 5-year action plan that prioritized those needs. Small PHAs (those with fewer than 250 public housing units) had to continue to compete for funding under the CIAP.
- The Quality Housing and Work Responsibility Act (QHWRA) of 1998 combined and streamlined the existing public housing modernization programs, including the CGP, CIAP, and the Public Housing Development program⁶ into a new Capital Fund Program (CFP).⁷ The CFP provides financial assistance to PHAs to make improvements to existing public housing and to develop new public housing, including mixed-finance developments that contain public housing units. Allocation of CFP funds is governed by a formula developed through a negotiated rulemaking process. The formula uses information from a study by Dixon Bain et al. (1988).

² Public Law 412 (codified as amended at 42 U.S.C.A. 1437 et seq).

³ Public Law 90-448.

⁴ Public Law 100-242.

⁵ 24 CFR Part 968.

⁶ 24 CFR Part 941 (Congress stopped funding the Public Housing Development program in 1999).

⁷ Final rule published on March 16, 2000 (65 Fed. Reg. 14422).

⁸ Existing modernization needs are costs of repairs and replacements beyond ordinary maintenance required to make the housing decent and sustainable with modest amenities.

The CFP formula allocates capital fund grants to all PHAs. Of the total funding, 50 percent is based on estimated modernization backlog needs⁸ and 50 percent is based on estimated accrual needs.⁹ The QHWRA also allowed for the use of public housing capital funds for repaying debt incurred to finance the rehabilitation and development of public housing. The statute also gave the Secretary of HUD the authority to establish guidelines and develop regulations.

Major Provision of the Rule

Although QHWRA allowed for the use of public housing capital funds for repaying debt, HUD did not issue a proposed rule enabling the PHAs to make use of this provision until July 18, 2007. As implemented in 2010, the final CFFP rule establishes program and submission requirements and an approval process for PHAs to request authorization from HUD to pledge capital funds for debt-service payments.¹⁰

The main provision of the rule permits PHAs to pledge up to 33 percent of their capital funds and up to 100 percent of their Replacement Housing Factor (RHF) funds¹¹ for debt service, provided that such pledge constitutes no more than 50 percent of the PHA's combined future capital funds (that is, formula funds plus RHF funds).

Benefit-Cost Analysis

For the investment to have a positive net present value, the expected value of the future stream of benefits would have to outweigh the expected value of the costs of debt, which include both upfront costs and interest costs.

Potential Benefits of the Rule

The primary argument for incurring interest costs to debt-finance a large investment is that economies of scale exist in making large-scale housing improvements. If the average cost for improving a unit fell as the number of units improved increased, then it would make economic sense to increase the number of units improved. The following specific arguments support the rule.

- The lump sum of loan proceeds will make large-scale improvements possible at the PHA's biggest sites that could not be undertaken on the basis of annual CFP allocations—large-scale repair work will diminish the backlog of units with failed structural systems at key sites now, saving future CFP dollars and better securing the portfolio for the future.

⁹ Accrual needs are the costs needed each year to cover expected ongoing repairs and replacements beyond ordinary maintenance, assuming that existing modernization needs are met.

¹⁰ These payments may include customary financial costs. The debt-service payments must be incurred for the modernization and development of public housing; the latter may include public housing in mixed-finance development.

¹¹ PHAs that have a reduction in the number of units attributable to demolition or disposition of units that lowers the formula unit count for the Capital Fund Formula calculation qualify for application of a RHF. The RHF is added where applicable for the first 5 years (first increment) after the reduction of units, and for an additional 5 years (second increment) if the planning, leveraging, obligation, and expenditure requirement are met. Because prior condition of a PHA's receipt of additional funds for replacement housing provided for the second increment, a PHA must obtain a firm commitment of substantial additional funds other than public housing.

- Making repairs now, using loan proceeds, should result in lower future operating costs. This strategy would link capital investment with the need for properties to stand on their own financially under HUD's new subsidy and asset management rules.
- Allowing more financial flexibility permits PHAs to take advantage of economic trends. Optimal financial decisionmaking depends not just on current values but also on expected future values. For example, if the manager of a PHA observes that construction costs are rising faster than interest rates, there would be a reason to invest more sooner than if construction costs were falling. This rule allows for that flexibility.

Potential Costs of the Rule

Notwithstanding the benefits outlined above, for the investment to have a positive net present value, the expected value of the future stream of benefits would have to outweigh the expected value of the costs of debt, both upfront costs and future interest payments.

Interest Payment

Assuming a \$2.5 billion annual appropriation for CFP and assuming every PHA participated in the program and maximized its borrowing, the associated maximum debt service would be approximately \$825 million annually (33 of the appropriation).¹² If we assume further that every PHA participated and maximized its borrowing, the maximum amount that could be borrowed would be approximately \$10.281 billion—assuming a 5-percent annual interest rate and a 20-year term (present value). During a 20-year period, about \$6.219 billion would be paid in interest on the loan.

Upfront Costs

Data from HUD's office that manages the CFFP also show that the cost of issuance for CFFP transactions approved in 2008 and 2009 were, on average, 1.2 percent of the amount approved. These upfront costs are paid once, at the time the debt is issued.

Additional Considerations and Externalities

HUD recognizes that it is not appropriate within the context of a regulatory impact analysis to count the secondary profits from a rule as part of the benefits of a rule. For consistency, the secondary losses would have to be counted as well. It is worthwhile, nonetheless, to consider the expansionary effect of a larger investment on local government revenues.

It is often argued that borrowing funds in the short term to accelerate capital improvement needs would be a stimulus to the local economy. In addition to actually addressing the capital improvement needs of public housing projects, the leveraged funds would generate jobs, wages and salaries, taxes, and business owners' income.

¹² As of December 2009 and since 2000, HUD had approved \$3.653 billion under the Capital Fund Financing Program for 206 entities. The total amount of debt service scheduled to be paid to cover the CFFP loan, as of 2009, from the capital fund grant, amounted to \$183.4 million.

Applying an input-output model to a sample of nine representative PHAs, Econsult Corporation, under contract with the Council of Large Public Housing Authorities, estimated that each dollar of PHA spending on capital and maintenance projects generates \$2.12 in total regional spending (Econsult Corporation, 2007).

The National Association of Home Builders (NAHB) reports that a 100-unit multifamily housing unit built in Average City, USA, would result in an estimated \$822,000 in tax and other revenue for local governments in the first year and \$384,000 annually after the first year (NAHB, 2004).

Assuming total development costs (TDCs) of \$150,000 per multifamily unit, a 100-unit multifamily housing project would necessitate an investment of \$15,000,000. Using NAHB's assumptions, it can be estimated that each dollar invested in public housing revitalization has the potential to generate 5.5 cents in additional tax revenue to the local government the first year and 2.6 cents each year thereafter. These tax revenues are a windfall to the local government.

Transfers

The rule in itself does not add any new cost to the program. There would, however, be a time shifting of the provision of housing services by those PHAs that choose to hasten their investments as a result of the rule. More units or higher quality units would be provided sooner, which would create positive transfers to the residents of PHA units. The time-shifted investment would also add positive externalities in the local economies, as described previously.

Alternatives

As an alternative to publishing a rule on the CFFP, HUD could continue to implement the CFFP on a case-by-case basis without publishing a rule, as it has done since 2000. The rulemaking process enables HUD to solicit comments from the public on the proposed rule, however, and to incorporate changes into the program based on those comments, to the extent feasible. A final rule published in the Federal Register also serves to establish rules of general applicability and to make those rules accessible to the public.

Another possible alternative would involve changing the terms deemed approvable in a CFFP transaction. For example, HUD could allow a PHA to pledge more than 33 percent of its capital funds or borrow for a period in excess of 20 years. HUD experience from implementing the CFFP on a case-by-case basis since 2000 suggests that 33 percent appears to be an appropriate debt coverage ratio. At that ratio, PHAs can borrow a sufficient sum to enable them to address a substantial scope of work; at the same time, leave a sufficient amount of capital funds after the payment of debt service to cushion possible reductions in appropriations and to address accrual needs.

Changing the number of years for which a PHA could borrow funds would have both benefits and costs. Extending the period would increase borrowing capacity, but it would greatly increase the amount of capital funds used to pay interest costs. In the end, HUD decided that synchronizing the term of the CFFP with the term of the Capital Fund Annual Contributions Contracts (ACC) amendment PHAs sign each year when they receive Capital Fund Grants provided consistency between the financing program and its intended funding source.

Sensitivity Analysis

In this article, we assumed a \$2.5 billion annual appropriation. If we assumed instead a reduction in the level of congressional appropriations and retained the assumption of maximum borrowing by PHAs, the total amount of debt service required to cover a CFFP loan could be above the 33-percent limit. Conversely, if the level of appropriation were to increase, the debt ceiling could also be raised.

Conclusion

Benefits and costs are summarized in exhibit 1. A PHA undertakes a diversity of investment activities: new construction, major renovation and rehabilitation, and maintenance activities. The optimal allocation of investment activity over time is one that minimizes the costs of providing housing services during the lifetime of the housing stock. The intertemporal allocation of additions to the housing capital will vary depending on the depreciation rate, the growth of demand, and the cost of adding capital. The primary argument for incurring interest costs to debt-finance a large investment is that economies of scale exist in making large-scale housing improvements. If the average cost for improving a housing unit fell as the number of units improved increased, it would make economic sense to increase the number of units improved. These benefits may warrant undertaking the costs of interest expenses and the other costs of debts. In this case, the optimal investment pattern would be one of large investments timed at long intervals as opposed to small investments at short intervals. Limiting a PHA by not allowing it to debt-finance would force it into a less than optimal investment strategy. Thus, a reduction in the cost of capital is expected to be the primary benefit of the rule.

Exhibit 1

Benefit-Cost Summary Table

	Amount	Beneficiaries
Benefits		
Economies of scale in making large-scale housing improvements		PHAs and residents
Lower operating costs because of a reduction in the backlog of deteriorated sites		PHAs and residents
Economic stimulus		Local economy
Higher quality housing units and reduced vacancies		PHA residents
Costs		
Transaction fees	Up to 2% (one time)	Incurred by PHAs
Debt-finance interest costs	Up to 5% (annually)	Incurred by PHAs
Transfers		
Transaction fees		Financial institutions
Interest payments		Financial institutions
Increased housing quality and benefits		PHA residents
Positive externalities		PHA residents

PHA = public housing agency.

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