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Publication Date

1998-06-01

Peer reviewed



Institute of
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Economic Research

University of
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Berkeley

FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS

WORKING PAPER SERIES

WORKING PAPER NO. 99-264

THE ECONOMICS OF HOUSING SERVICES IN LOW INCOME NEIGHBORHOODS

By

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**THE ECONOMICS OF HOUSING SERVICES
IN LOW INCOME NEIGHBORHOODS**

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Working Paper No. 99-264
June, 1998

The Economics of Housing Services in Low Income Neighborhoods

The United States has, for the past 60 years, been committed to the goal of providing a "decent home in a suitable living environment" for all Americans. While the "goal" is far from being reached, much progress has been made. National housing policy, along with a robust private market, has succeeded in vastly improving the nation's housing stock over the past six decades. The quality of the housing stock has greatly improved, with the supply of structurally inadequate units falling from 38% of the stock in 1950 to 1% of the stock in 1990.

Another indication of the "success" of the U.S. housing market in the past six decades is that the proportion of homeowners in the population has risen from 45% in 1940 to nearly 65% in 1995. Many analysts view homeownership as the best way to meet our societal housing goals.

There is no question that, in the aggregate, our primarily private housing market (with the help of federal tax policies and subsidized mortgage credit policies) has met our national housing goals for the vast majority of Americans. At the same time, there are a substantial number of low and very low income Americans who have not fully participated in this general improvement in housing market conditions. The focus of this paper is to document what we know about the low income housing problem in Urban America. In particular, we will focus on both past and existing public policies towards housing and the urban poor. A special emphasis of this paper will be an examination of a neighborhood based housing delivery system which has emerged in the past decade as an alternative housing production system in a time of massive cutbacks in federal housing programs for the urban poor.

The core of the neighborhood based housing delivery system that has primarily arisen in the past decade are the community development corporations (CDCs). These nonprofit community-based housing sponsors or developers are now the major link in the neighborhood revitalization process in low income urban areas of our center cities. The CDCs make use of a "creative financing" system that puts together a patchwork of tax incentives, tax exempt bonds, CRA (Community Reinvestment Act) related loans and state, local, and philanthropic supports to produce low income housing. Three national intermediaries, Local Initiatives Support Corporation (LISC), the Enterprise Foundation, and the Neighborhood Reinvestment Corporation (NRC) have provided critical technical assistance and capital support to the CDCs. These intermediaries have had an important capacity (human and technical) building impact on the CDCs.

Before analyzing the CDC based housing delivery system, we will briefly review the dimensions of the low income housing problem and previous federal policies toward low income housing.

The Dimensions of the Low Income Housing Problem.

The best measure of the current condition of the nation's housing problem is provided by The State of the Nation's Housing (1996) prepared by the Harvard University Joint Center for Housing Studies. Despite the massive overall improvements in the housing market, the Joint Center analysis documents that renter households with "worst case needs" have increased by two-thirds between 1974 and 1993. "Worst case needs" as defined by HUD include households living in structurally inadequate units and those rental households with income less than 50% of area median paying more than 50% of their in-

come for housing. According to the Harvard compilation, 3.6 million renters with extremely low income (less than 30% of area median) paid more than half their income in rent and another 800,000 lived in structurally inadequate units. Thus, 37% of extremely low income households are facing "worst case needs" housing conditions. For very low income households (30-50% of median), one quarter of those in adequate housing without subsidies face an excessive rent burden, and 11% live in structurally inadequate units. In addition, the incidence of structurally inadequate housing for very low income blacks and Hispanic households is more than 100% and 50% higher respectively than that of very low income white households.

The Joint Center study concludes "that a record number of very low income households now face extreme housing cost burdens and/or live in structurally inadequate units." Severe payment burdens is the primary housing problem facing low income renters. Impending cut-backs in federal housing assistance programs and welfare payments will exacerbate the already intense shortage of affordable and structurally sound housing available to low-income families.

While the careful compilations of the Joint Center from The 1993 American Housing Survey may appear to quantify the "population at risk" in the housing market, it may in fact, understate the housing problems faced by the urban poor. It is estimated that on any given night between 500,000 and 1.5 million individuals are homeless. (Burt (1992), Jencks (1994), Cordray and Pion (1991), O'Flaherty (1995)). Furthermore, it is estimated that perhaps two-thirds of the homeless have mental health or substance abuse problems and thus improving conditions for the majority of the homeless will require intensive social

services, as well as housing. While this paper will not deal at all with the homelessness issue, it is essential that the national shame of this "extreme worst case" housing problem of the country be recognized.

Finally, the compilation of the American Housing Survey, for the most part, cannot capture the often inadequate and marginal housing condition occupied by a substantial number of new legal and illegal immigrants to the United States. A recent New York Times series, "Behind Hidden Walls" (1996) documents that there are hundreds of thousands of people living in undocumented (illegal) units where appalling conditions approach those of the early 1900s slums. While this paper will also not deal directly with this problem, the illegal units are symptomatic of our inability and unwillingness to encourage a "legal" supply of low cost, safe, and sanitary housing in many of our larger metropolitan areas. It is clear that a significant portion of our illegal and legal immigrant population, as well as our own urban poor, are living in marginal housing conditions.

Federal Policy Towards Low Income Housing.

Since the passage of the U.S. Housing Act of 1937, which initiated the public housing program, the federal government has created a series of programs aimed at providing affordable housing for low income households. While it is not the intent of this paper to examine in detail the range of programs used in the past, it is useful to a potential assessment of present programs to briefly review the legacy of the past 60 years.

We begin this review by examining the stock of publicly subsidized housing in place today. Table 1, taken from an article by, James Wallace (1995),

shows that the first federal housing program, public housing, still houses more households than any other program, approximately 1.4 million households, representing nearly 4 million people (Vale, 1993). At its initiation, public housing was conceived as temporary housing for the working poor. While the federal government advanced the capital costs of the housing, households had to be able to pay enough rent to fund the annual operating costs of the housing.

Table 1
Federally Assisted Housing Units

	<u>Total</u> <u>Units</u>	<u>Percent Below</u> <u>50% of Median</u> <u>Income</u>	<u>Percent</u> <u>Nonprofit</u>
Public Housing	1,400	81%	Public
Privately Owned Rental Housing			
Section 202 Elderly	237	65%	100%
Older Assisted Programs - 221(d)3, 236	794	77%	22%
Project Based Section 8	362	90%	---
Low Income Housing Tax Credit (LIHTC)	335	28%	27%
Tenant-based Assistance (Section 8)	1,400	100%	---

Source: Wallace (1995)

In the 1960s, Congress changed the public housing mandate to allocate scarce federal resources to house the neediest families. As a result, the well meaning attempt to serve the neediest population led to a concentration of very low income families in public housing. Public housing became housing with a high concentration of welfare income single mothers. As of 1990, 81.7% of all public housing authority recipients were non-white, and 42.9% were single parents (Lane (1995), National Commission on Severely Distressed Public Housing, (1992)). As a result of this major change in the public housing mission, in many buildings the rent collected from residents dropped below the amount needed to pay for annual operating costs, much less to fund capital reserves

needed for periodic expenses such as new roofs, boilers or elevators. Given the drop in tenant rent collected because of the new federally imposed housing mission, the federal government began to provide an annual operating subsidy to local public housing authorities. Currently in some of the larger cities, residents' rent covers only half of the annual operating costs, and a federal operating subsidy provides the balance.

Recognizing the dreadful physical and social condition of many urban family public housing developments, in 1996, President Clinton stated a goal of demolishing 100,000 units of the 1.4 million public housing units over the next few years. Earlier, Secretary Cisneros of HUD proposed that the entire public housing program should be restructured by changing it from a "supply side" program (i.e., providing physical housing units) to a "demand side" program (i.e., providing households the funds to enable them to choose units in the private or public rental market). The proposed restructuring would result in providing all existing public housing residents a "voucher" which they could use at either their existing public housing unit or at some private sector unit. If such a program of individual household choice were adopted, it is conceivable that many public housing developments would not be able to compete for residents and would be abandoned.

Given that, on average, it will take a minimum of \$100,000 to replace each family public housing unit demolished, demolishing 100,000 units, as the President is recommending, would require \$10 billion for replacement. In order to regain credibility with Congress and with the taxpayers who have funded public housing, a major effort should be made to better understand what went

wrong so that the same mistakes are not repeated.

The second set of major programs that represent about 1.2 million subsidized units built with project based supply programs 236, 221(d)3, and Section 8, in the 1960s, 1970s, and 1980s. These units were primarily built by private for-profit developers using below market interest rates and, in the case of Section 8, rental subsidies. Most of these units had a 20 year affordable "use horizon" (15 years in the case of Section 8). After 15 or 20 years, they could be converted to non-subsidized market rate rental housing by prepaying mortgages (in the case of the 1960s and 1970s programs). This problem of conserving the existing subsidized stock was addressed by the National Low-Income Housing Preservation Commission (1988) and subsequent legislation that allows nonprofits to buy these units with the for profit project developer getting an equity take-out. In the past year, \$700 million was allocated for the preservation of this low income housing stock. Thus, the units bought by the nonprofits will remain permanently in the affordable stock. The Section 8 project based program, of course, will require billions of dollars to renew contracts with the for-profit developers which expire after 15 years. Without adequate funding, it is possible that many subsidized units could leave the affordable low income housing stock. This may be the biggest issue facing the low income housing sector in the next few years. A related issue is the fact that, perhaps 700,000 apartments on which the federal government provided mortgage insurance are financially troubled (Wallace, 1994). The resolution of these distressed situations will be extremely costly and will crucially influence the supply of subsidized stock available to low income households.

A final supply side program, Section 202, provides housing for the elderly and, most recently, handicapped households. This program is restricted to nonprofit sponsors. Originally financed by below market interest rates loans, since 1990 this program has been funded by capital grants and annual operating subsidies. Section 202 has produced nearly 250,000 units since its inception.

In addition to this set of supply side programs, the Section 8 demand side program or "tenant based" program was initiated to provide households a more flexible subsidy alternative. This tenant based assistance program provides vouchers or certificates directly to households. In a household or tenant based subsidy, the household with a subsidy can move into any privately or publicly owned building whose rent is at, or below, federally defined fair market rent. The household pays 30% of its income towards rent with the government making up the gap between fair market rent and the household rent payment. This program currently funds 1.4 million households. Many housing analysts, such as Struyk (1991) believe that the "primary housing problem is one of affordability and that the most efficient way to deal with this problem is through housing allowances or vouchers."

With this macro context in mind, we now turn to an analysis of the current housing production and finance system for low income neighborhoods.

Current Housing Production and Finance System for Low Income Housing.

The current housing production and finance system is a product of the massive cut in federal housing subsidy programs over the last decade. The present system can best be described as a “creative financing” alternative that has put together a patchwork of tax incentives, tax exempt bonds, and state, local and philanthropic supports to try to fill the void left by the curtailment of the federal subsidy programs. Figure 1 provides our schematic of the low income housing production system.

The key elements of the “creative financing system” are the low income housing tax credit (LIHTC), tax exempt mortgage revenue bonds (MRBs), community reinvestment (CRA) funds from private financial institutions, and an accelerated role of the nonprofit sector, especially community based development corporations (CDCs), and non-CDC nonprofit housing developers, and local and regional housing partnerships. National intermediaries, LISC, Enterprise, and NRC, funded primarily by foundations, have provided critical technical assistance and capital support to the newly emerging nonprofit housing production system. The federal government provides block grants to local governments for low income housing support through the HOME and CDBG programs. In many situations, state and local governments provide critical additional subsidies to this sector.

Low Income Housing Production System

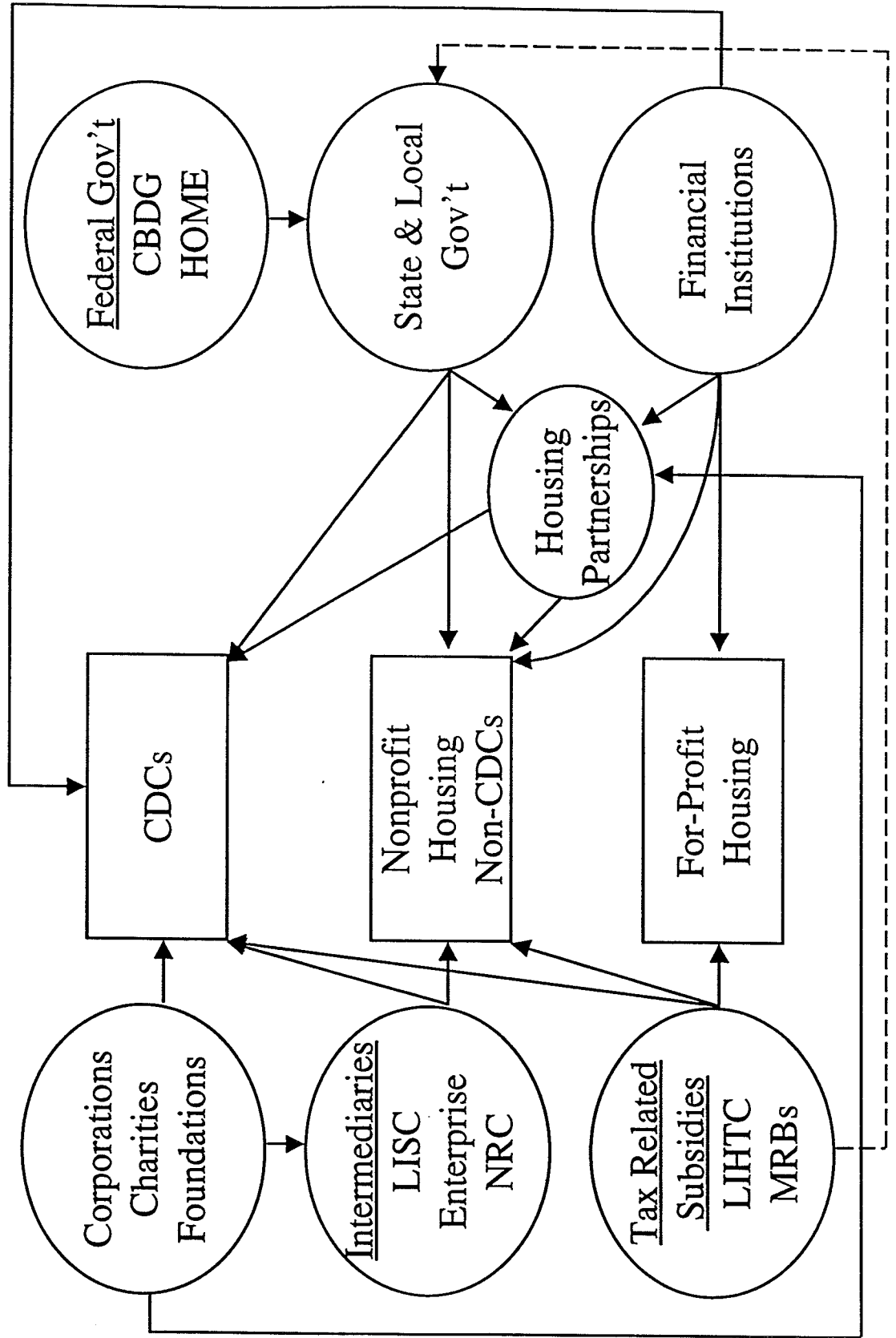


Figure 1.

Table 2, again taken from Wallace (1995), shows current production of federally assisted housing units. With this background, we now will describe each element in the community based "creative finance" housing production system.

	<u>Units (000)</u>	<u>Percent Nonprofit</u>
Public Housing	5.0	Public
Section 202	7.3	100%
HOME Program	8.3	---
LIHTC	44.4	27%
Urban Homeownership (HOME)	7.0	100%
Source: Wallace (1995)		

Emergence of a Third Sector: The Community Development Corporations (CDCs)

The massive cutbacks in direct federal housing subsidies combined with the growth in community reinvestment has occurred at the same time that a third sector has emerged in the housing production process: the nonprofit housing developer. Some of the best research on the community based housing development system and their role in neighborhood revitalization has been done by Christopher Walker (1993, 1995). "The majority of nonprofit organizations consist of community development corporations (CDC's) defined as nonprofit community-based housing sponsors or developers" (Walker 1993). They usually

restrict themselves to a set of neighborhoods and are involved in a number of ancillary roles other than housing that are critical to the success of neighborhood revitalization. Walker believes that “the nonprofit advantage lies in linking housing production and preservation to community development” (Walker 1993). Under what conditions this relationship actually improves a neighborhood has yet to be empirically confirmed.

There are also very successful regional nonprofit housing developers such as BRIDGE Housing Corporation and Ecumenical Association for Housing in the San Francisco Bay Area, and Community Builders in New England. While not neighborhood based, these organizations have produced large numbers of low and moderate income housing and may be both complimentary and competitive with CDCs.

Nonprofits run the full gamut of housing development from the building of new units to rehabilitation of existing units. They build housing for the elderly, supportive housing for the mentally ill, and transitional housing for drug treatment programs. They often have programs to encourage home ownership. They are involved as sponsors, developers and property managers.

The CDC based production system is marked by “extreme concentration of capacity”, with 2% of the CDC’s producing one-fourth of all production, and with 10% producing one-half of all housing unit production.

Few CDC’s would describe themselves as only housing developers. Rather, community revitalization is their principal goal. Many emerged as community advisory groups dealing with local banks and savings and loans to get community reinvestment funds. Thus, they are often characterized by strong

advocacy and community education programs, the provision of a range of social services, as well as housing development programs.

In terms of the role CDC's play in the housing delivery system, Walker (1993) has produced a table based on a NCCED survey. Table 3 illustrates the wide and comprehensive range of functions performed by the CDC's.

Development Types	<u>% of CDCs</u>
Rehabilitation	76.6%
Acquisition	65.3%
New Construction	56.3%
Weatherization	42.4%
Development Functions	
Property Management	53.5%
Construction Management	36.7%
Loan Packaging	27.8%
Administer Revolving Loan Fund	27.0%

Source: Walker (1993), Original data from Urban Institute based on data obtained from NCCED Survey.

In terms of funding, the CDC's are the major consumers of the "layered creative financing" system described in this paper. They use multiple sources of funding including: the LIHTC, community development block grants (CDBG), state and local funds, foundation and other philanthropic contributions, funds from local and national financial intermediaries, loans from financial institutions, and grants and tax credit sales to corporations. This patchwork nature of financing, which typically involves five to seven sources of funds for each project, is complex and typically takes a substantial amount of time to arrange.

This added complexity and time appears to have increased the cost of pre-development (Abt, 1992). Table 4, also from Walker (1993), shows the sources of funds for CDC's.

	<u>% of CDCs</u>
Federal	
LIHTC	94.3%
CDBG	55.3%
Rental Rehab	15.1%
McKinney Act	14.1%
State Government	54.9%
Local Government	36.0%
Private Sector	
Foundations	40.8%
Banks	37.6%
Local or National Intermediaries	22.5%
Corporations	20.8%
Religious	15.4%

Source: Walker (1993)

While this creative financing is complex, the network of community based nonprofits have, with the aid of the national intermediaries, become sophisticated packagers of these financial structures and have become important providers of housing services in low income neighborhoods. While there has been criticism that too much energy is expended on financial packaging and "they should not be held up as replaceable models," (Stegman, 1991), until there is another source of financing, this system is the only alternative available to CDCs.

With the growing importance of the CDC's as providers of low income housing development, the research question arises as to their effectiveness. The one obvious question asked of CDC housing is what does it cost. Abt Associates (Hebert, et. al, 1993) has produced an elegant methodology that accounts for all

known costs of producing housing by the CDCs. This methodology was tested in 15 developments by experienced CDCs in five metropolitan areas. This best case study showed that construction cost by the experienced CDCs was not out of line with for-profit constructions costs. Since both nonprofit and for-profit firms use the same contractors, comparability of construction cost for the same product is understandable though reassuring.

The Abt study suggests that the CDC costs during the pre-construction period appears to be higher than in comparable for-profit developments. Though all too often there really is not a true “comparable” for-profit development. The CDC multiple funding sources makes the process more complex and more time consuming. Often the CDC proposals are strenuously opposed by the potential neighbors which results in both further delay and in costly design changes. There may be more rewards for a CDC to take the time to try to mediate the entitlement opposition than to try to proceed to development as quickly as possible. Given the same degree of opposition, a for-profit developer will look for another site while a nonprofit CDC, committed to a particular neighborhood, is there to the bitter end. In fact, there may be situations in which a CDC believes that “fighting” the opposition is an effective way to “organize” the neighborhood.

While potential neighbors often oppose proposed CDC developments on the grounds that such housing is inappropriate or would lower the value of surrounding property, no one has been able to show that the existing nonprofit housing, the existing 400,000 units, has had a negative effect on surrounding property values. Probably the opponents are, understandably, confusing the proposed nonprofit housing with existing distressed public housing.

Another advantage of the CDC centered housing production system is that it brings a development perspective that identifies more closely with the potential subsidized residents. While this closer identification may be useful during the entitlement process, it may lessen once a development is built and must be managed. Sullivan (1993) points out: "The problems that have beset other housing sectors do not disappear once a CDC has completed a development. CDC residents are primarily low-income, usually unable to support the costs of maintaining the housing on their own. The stresses of poverty on residents can also be associated with personal problems that can lead to high rates of wear and tear on the buildings and each others' nerves. Most CDC housing developments for families, for example, have high rates of households headed by single mothers and high concentrations of children and teenagers. The surrounding neighborhoods continue to encroach on the micro-environments of CDC buildings through vandalism, graffiti, drug traffic, and gang fights. Finally, the CDC's themselves remain relatively small organizations that are undercapitalized and often under funded, even with the help of grants and subsidies. In short, "these CDC's are addressing some of the most critical housing problems in the country, problems that have not proved amenable to other solutions". (Sullivan, 1993).

CDCs have the same basic management problem as for-profit firms: how does one select residents and when does one evict residents? Sullivan suggests that CDCs "go through an evolution of wide-eyed optimism, to cynical landlord, to realistic and compassionate" .

Being responsible for maintaining a building may make the nonprofit and responsible for-profit behave in very similar ways. Briggs, Mueller, Sullivan

(1996) detailed study of three CDCs confirms the tension between property management and understanding the cause for resident problems. The evidence seems to be suggesting that CDCs are responsible property managers.

What is not known at this time is whether the CDCs are establishing adequate building reserves. Since most of the CDC housing is of relatively recent construction, the lack of adequate building reserves may not yet be apparent or there may be adequate building reserves. Without such reserves or another source of funding capital replacement items, the CDC buildings could, over time, repeat some of the problems of public housing. Therefore, it is necessary to look at long term financial operating policies of CDC housing.

One of the major hopes of the CDC developments is that they will stabilize or improve the surrounding neighborhood. Briggs, et. al (1996), looking in detail at the developments of three "best case" CDCs could not find unambiguous neighborhood improvements due to the CDC housing. The relationship between any one development and a neighborhood may be too complex or too subtle to see at this time.

Part of the ideological perspective of many CDCs is to "involve" the residents in the day to day operations and thereby to obtain some sort of social "buy-in." Briggs reports, "our data provide strong evidence that the notion that residents' associations can be largely self-sustaining is a myth, especially in buildings with very diverse resident populations (in terms of life-stage, employment status, and the presence of children, not just race/ethnicity), substantial resident turnover, and frequent changes of management staff." It must be remembered that most market rate residents are not involved in day to day opera-

tions of their buildings. In fact, tenants in for-profit buildings organize when they want to fight an owner.

At this time, the case that CDC buildings have a long term positive effect on a neighborhood has yet to be made in a convincing manner. If the case cannot be made, one might find that the long term maintenance cost of a building would be lower in less impacted neighborhoods. While one does not want to lightly "give up" on certain neighborhoods, one has to ask if spending large public sums in neighborhoods that many individuals want to leave is the best possible public policy. At this time, not even a tentative recommendation can be made and the CDC building in distressed neighborhoods should be viewed as a very important publicly funded experiment. Measuring the positive spillover impacts on neighborhood revitalization is an important area that needs research.

For many, the fundamental question of subsidizing CDC housing is what long term difference the housing makes in the behavior and relative status of the households subsidized. The evidence at this point is inconclusive.

Low Income Housing Tax Credit (LIHTC).

The CDC based housing production system that we have just described relies heavily on a creative financing system in which the Low Income Housing Tax Credit (LIHTC) is the most important element. The LIHTC was created by the Tax Reform Act of 1986 to replace the tax benefits that were otherwise reduced for real estate (including low income residential projects) investments. The LIHTC provides federal income tax credits to private investors who provide equity capital for affordable housing. The LIHTC is a tax credit of 9% per year

for ten years for new construction or substantially rehabilitated units. The credit applies to the proportion of units occupied by eligible low-income households. Eligibility is determined as follows: 20% of the units must be occupied by tenants whose income is less than 50% of the area's median income, or 40% of the units must be occupied by tenants whose income is less than 60% of the area's median income. In fact, our discussion with tax credit users indicates that 100% of units are occupied by eligible households so that the value of the tax credit can be maximized. Whether it is good public policy to create buildings that are 100% subsidized is an area that needs research. These occupancy restrictions have a 15 year life even though a number of states, including California, require a 54 year life so as to avoid the future expiration problem encountered by earlier production programs which had limited periods of affordable requirements. In addition, for-profit owners must give states one year after the use restriction is up to find a nonprofit buyer for the project. If these occupancy restrictions are violated, the private investors face a "recapture event".

If the LIHTC is used in conjunction with below market government provided tax exempt financing, then only a 4% annual tax credit can be taken. The aggregate amount of 9% tax credits provided nationally is allocated to each state on the basis of \$1.25 per state resident. The Housing Finance Agency or its equivalent in each state then allocates the credits to individual projects. Allocated tax credits not utilized after two years go into a national pool administered by the Treasury Department and can be claimed by states that have used up their existing allocation. Since the 4% tax credit is not subject to the state by state cap on credits, there is no allocation process for these benefits. Table 5 shows the volume of tax credits authorized in the past 9 years.

Table 5
Low Income Housing Tax
Credits

<u>Year</u>	<u>Total Authority</u> (Mill)
1987	313.1
1988	311.5
1989	314.2
1990	317.7
1991	497.2
1992	488.5
1993	546.4
1994	522.6
1995	432.3

Source: National Council of State
Housing Agencies

The profit or nonprofit developers of rental housing nearly always “syndicate” the tax credit to obtain up-front equity from investors. Individuals are limited to utilizing \$7,000 of tax credit per year, while corporations can make unlimited use of the credits. Typical syndication and transaction costs run between 25% to 30%. In addition, corporations and investors typically want a competitive investment return in the 12% to 20% range. As a result, Case (1991), Stegman (1991), and Ling (1991), estimate that only between 50% and 60% of the value of the credit actually gets captured by the low income housing developer. The market for LIHTC has become substantially larger and more competitive in recent years. Nonprofits, in addition to selling tax credits through the National Equity Fund, an affiliate of Local Initiatives Support Corporation (LISC), have been able to sell tax credits directly to corporations. Recent estimates are that as much as 70% of the tax credit is now received by nonprofits. A study in

progress by DiPasquate and Cummings (1996) may provide more data on recent experience with this program.

One supposed advantage of the LIHTC is that it is independent of HUD or similar bureaucracies. In fact, a shortage of tax credits has led to a highly political process that determines the allocation of tax credits. Another purported advantage of the LIHTC is that in the nonprofit transactions, the corporations buying the credit have a strong desire to make sure that the project is successful and does not violate any of the use restrictions. "The LIHTC brings large scale corporate investors into the nonprofit orbit. These corporations develop sizeable stakes in the housing portfolios of the nonprofit organizations and face significant financial losses if this housing falters" (Keyes, et al, 1996). As a result, there is a continual auditing and monitoring function performed by the corporation buying the credits. The argument is that this oversight by the corporate investor which faces potential recapture of all benefits if a problem arises will be more complete than oversight by government officials with no personal financial stake in the project. This hypothesis needs further investigation.

While the LIHTC is the lynch pin of the new assisted housing delivery systems, and is currently critical to the ability of nonprofit and community based housing groups to develop housing, it is not sufficient by itself to deliver affordable rental housing. In most cases, between 5 and 7 additional sources of equity and debt financing are required to produce housing for very low income households. This layering of subsidies on top of the LIHTC base is the mechanism by which the community based nonprofits are delivering affordable housing.

The criticism of this creative financing system with the LIHTC as a mainstay of financing is substantial. Michael Stegman (1991), one of the most thoughtful analysts of housing policy, takes a much more negative view of this creative financing system. He views this system as "highly inefficient, costly, and a labor-intensive means of producing low income housing that evolved in the 1980s as an ad hoc, emergency response to.....the withdrawal of the federal government from the subsidized housing market." He goes on to say that "high transaction costs, inappropriate targeting of benefits, and insufficient monitoring are among the problems with the LIHTC." He is especially critical of the "excessive" profits made by the for-profit developers using the LIHTC. His criticism is echoed by Ling (1991) whose study of the LIHTC in Florida supports the view that the credit may be too generous in some geographic areas. Stegman concludes that "the use of creative financing to preserve and produce low-income housing should be viewed as a system whose time should never have come."

While housing economists have been fairly critical of the LIHTC on efficiency grounds, they have not provided a politically feasible alternative to the LIHTC anchored production system. Our discussions with regional and community based nonprofit developers indicate that the LIHTC is the key element in their raising of equity for their affordable housing projects. They have become quite adept at packaging and selling these credits. Now that the LIHTC is ten years old, it is time for a comprehensive review of the costs and benefits of the program. The tough legislative battle in 1996 to reauthorize the LIHTC indicates that studies showing its vital role in the neighborhood based housing production system could be important to its continued use.

Tax Exempt Mortgage Financing (MRBs).

Historically tax-exempt bond financing has been used for the development of publicly owned facilities. In 1974 the use of tax-exempt based financing for low and moderate income housing owned by private entities was authorized. The 1986 tax reform act placed strict limits on the amount of tax exempt "private activity" bonds that can be issued by a state and its localities. Since 1986, each state may annually issue \$50 per capita of private activity bonds for housing, economic development, etc. Unused portions of the allocation can be carried forward up to three years.

As in the case of tax credits, the states are responsible for allocating the issuance of private activity bonds among competing users. Mortgage credit certificates used to encourage homeownership among low income households are part of the same allocation process. Typically state housing and local housing finance agencies issue and allocate the bonds. MRBs can be issued in conjunction with the reduced (4%) LIHTC. The 4% LIHTC is not subject to the per capita on limit LIHTC so there is a strong demand from private sector developers.

In a market with a strong effective unsubsidized demand, i.e., a market in which rents are increasing and are high enough to cover the cost of new construction, the use of tax exempt bonds is a relatively inexpensive way to encourage the creation of housing for low income households. In such a strong housing market, reducing permanent financing through tax-exempt bonds in a mixed income development can be a very attractive program for developers. Under current federal rules, a developer can obtain tax-exempt permanent financing

several hundred basis points below the private market interest rate (i.e., if a conventional, market rate mortgage were 8.5%, a tax exempt, low floater mortgage would be in the 4-6% range) in return for restricting the occupancy of 20% of the units so financed to households having adjusted annual cash incomes no greater than 50% of the areas median income or 40% of the units for households at 60% of the median income and restricting the rents of these units to no more than 30% of the households annual cash income. In many situations such "80-20" buildings with tax-exempt financing can generate a return higher than a 100% market rate building with conventional financing. Competition for the limited allocation of these bonds is fierce in many jurisdictions.

There are several concerns with the MRB program. First, the restriction on occupancy and rents is for a specific period of time, say 20 years or the term of tax-exempt financing. Therefore, there is an "expiring use problem" when the restricted units become unrestricted. When the restriction term ends, the government has to "purchase" an extended restriction by offering some new economic incentive to the owner, or has to give the existing subsidized household some type of voucher to enable that household to continue to receive subsidized housing in the existing building or in another building, or let the existing subsidized household and existing owner fend for themselves. Given the large number of such for-profit subsidized units created in the 1970s, there are several hundred thousand such "units at risk" occupied by low income households that will shortly reach the end of the government imposed restrictions. One of the major challenges facing the government at this time is how to minimize the social problems associated with the end of the restricted use.

The second concern with such for-profit "mixed income" supply side interest subsidies is that these buildings may not be built in distressed neighborhoods. The economics of a mixed income subsidized building is such that it must be located in a neighborhood that can attract the necessary market rate residents. "Most private sector LIHTC housing has been developed in suburban areas, not inner-city communities" (Keyes, et al, 1996). Most developers tend to believe that only in very unusual cases, say very tight housing markets, will market rate households voluntarily move into distressed, low income neighborhoods. Without the internal project subsidy created by market rent units subsidized with below market interest rates, more extensive subsidies are needed to attract for-profit developers to build housing for low income households.

A third concern with such programs is that the households being subsidized may not be those most in need. The "80-20" housing effectively builds housing for those in the 40-60% of median income ranges with only one-fifth of the financing actually creating units for households in that income range. The remaining units that are created are for market rate housing without income restrictions.

Overall, the MRB program is one of the more effective programs at stimulating housing production with a minimum of bureaucracy. However, it is time for a complete research review of the program. Questions that might be asked include: (1) is the 80/20 mix correct, or should it be 70/30, or 60/40?; (2) is there a way to target the program to distressed neighborhoods or to give the nonprofit developers some advantage in the allocation process?; and (3) should the \$50 per capita limit be raised, and perhaps be allocated based on the number of households in poverty or are in need of affordable housing?

National Low-Income Housing Finance Intermediaries.

A third key element in the success of the CDC based housing development system is the rise of a set of national intermediaries that have funneled capital and technical expertise to the local nonprofit developers. "At the national level, the rise of intermediaries to mobilize capital, provide technical assistance, and help create a local nonprofit housing production system has dramatically improved the capacity of the nonprofit sector to undertake housing and community development projects." (Walker, 1993) Three national intermediaries that have had substantial impact on urban housing include: Local Initiatives Support Corporation (LISC), the Enterprise Foundation, and the Neighborhood Reinvestment Corporation (NRC). Intermediaries are a key element in the development of the technical and financial capacity of the nonprofit housing sector. They have provided three key functions: (1) mobilized capital for operating support, projects and pre-development financing; (2) provided technical assistance in packaging projects, assessing projects, and in community building; and (3) legitimized CDCs in the eyes of the funders, especially by improving technical competence.

Local Initiatives Support Corporation (LISC) targets community development corporations (CDCs) committed to comprehensive residential and commercial development. They also have helped build local and regional intermediary support for CDCs. The National Equity Fund, an affiliate of LISC is the largest syndicator of federal housing tax credits. LISC has raised over \$1.6 billion for affordable housing. Equally important as its funding is the dissemination of

technical expertise to local CDCs and the building of human capacity in the low income housing production system.

The Enterprise Foundation was founded in 1981 by the real estate developer, James Rouse. Its focus is on community development corporations specializing in very low income housing and emphasizes the linkage to needed social services. The argument is that housing without social services is not sufficient to improve the conditions of low income households.

The Neighborhood Reinvestment Corporation (NRC) and its related entity (NHS) supports neighborhood based CDCs and encourages partnerships among households, the public sector, lenders, and corporations.

All three of these intermediaries obtain substantial contributions from charitable foundations. Much of the funding from this source goes to support the operating budgets of CDCs which are, for the most part, not self-sustaining. Only 1/4 of the money from foundations goes directly to projects. Most foundations prefer using the intermediaries funding route as the intermediaries perform important screening and performance judgements. Also, the intermediaries are strongly oriented toward building up the technical and human capacity of the nonprofit housing sector. There is no question that the intermediaries have very effectively helped the nonprofit sector become an important third force in the low income housing production system. Again it is time for a thorough research review of the successes of the low income housing finance intermediaries.

Community Reinvestment.

A fourth vital element in the low income housing finance system is the strong demand by community groups for community reinvestment by financial institutions in the past two decades. The community reinvestment movement began with the Home Mortgage Disclosure Act of 1975 (HMDA) and the Community Reinvestment Act of 1977 (CRA). The Community Reinvestment Act states that regulated financial institutions "have a continuing and affirmative obligation to help meet the credit needs of local communities in which they are chartered.....consistent with safe and sound operation of such institutions" (Squires, 1992). The Community Reinvestment Act is intended to insure that every community has adequate credit to help meet its needs (U.S. House Banking Committee, 1994). These acts were passed only with the strong lobbying of community groups lead by Gale Cincotta. By mandating financial institutions to disclose home mortgage lending by census tracts, this legislation hopes to encourage nondiscriminatory lending activities. The CRA legislation was further strengthened in 1990 when it was extended to independent mortgage bankers and when it required all lenders to disclose the race, gender, and income of all mortgage loan applicants, as well as the final disposition (accepted, declined, withdrawn) of each application. In addition, after 1990, the CRA rating of each institution is made public. The importance of CRA in stimulating the flow of private credit to low income housing should not be underestimated. Prior to the 1970s it is now generally admitted that "redlining" of low income neighborhoods was prevalent. "Redlining is a process by which goods or services are made unavailable or are available on less than favorable terms to people because

of where they live regardless of their relevant objective characteristics.”

(Squires, 1992) In the name of “risk control” racial discrimination was an integral part of the appraisal and underwriting process. Until 1948 racial biased lending was actually encouraged by the FHA. “A change in social or racial occupancy generally contributes to instability and a decline in property values” (Squires, 1992 from FHA manual, 1938).

While the legal underpinning for redlining was eliminated in the 1960s, it was not until community groups utilized CRA in the 1980s and 1990s that major financial institutions began to reexamine their lending practices. The surge in bank merger activity has allowed community groups substantial leverage to extract CRA lending promises in return for not challenging bank mergers on CRA grounds. The CRA issue has encouraged the formation of a number of “housing partnerships” between lenders, community groups, corporations, and local governments to stimulate lending in distressed neighborhoods. These partnerships, like the national intermediaries mobilize capital and technical expertise. To our knowledge there has been no systematic analysis of the impact of CRA on neighborhoods or on the loan quality of the financial institutions. Given the magnitude of funds involved (nearly \$50 billion) and the importance of these funds to the communities and institutions involved, research in this area is critical.

There, however, has been some considerable research on racial disparities in home mortgage lending. “While the severity of racial disparity varies, a consistent finding across the vast majority of research on mortgage lending and race, demonstrates significant racial disparities in access to loans-disparities that

do not disappear when relevant socio-economic factors are taken into consideration" (Squires, 1992). Some of these differences can be explained by the failure to take into account credit records, other indebtedness, down payment requirements, and specific conditions of properties (Canner and Smith, 1991), but still the disparity is disturbing. More research needs to be done on this issue to see if there is an unintended bias in underwriting rules or perhaps an absence of minority lending officers that causes these disparities to exist. Further analysis of CRA data and supplemental data and research will be required to answer these types of questions.

HOME

A final element in the financing of the CDC based development system is the HOME program. The National Affordable Housing Act of 1990 initiated the HOME program, the first Federal block grant designed exclusively to address affordable housing needs (HUD, 1995a). In the HOME program, federal dollars are allocated by formula to local and state governments who then reallocate them to appropriate projects. The formula is based on a community "distress index" which allocates 57% of its funds to the 20% of the cities in most need. The funds can be used in a broad array of housing activities. Fifteen percent of the HOME funds are set aside for community-built, nonprofit housing development organizations (CHDOs), and specifically aimed at stimulating the nonprofit sector. As of August 1994, \$419 million (27.7%) HOME funds were committed to nonprofits (Walker, 1995).

Private Non-Subsidized Low Income Housing Services

While we have spent most of this paper discussing the subsidy programs for low income households, we have neglected to review the role of the unsubsidized sector in providing low income housing services. Nearly three-fourths of low income households live in private non-subsidized housing. "Too little attention is being paid to preserving the stocks of unassisted units affordable by low income families" Struyk (1991). The dynamics of the unassisted low income housing stocks have received far too little attention and research. The growing imbalance between supply and demand in the low income stock is, in part, due to destruction of a significant part of the low income housing stock. Struyk (1991) offers the following example to illustrate how little we know about the dynamics of low income housing stock and low income households. "Of the units occupied in 1974 by households in the lowest 25% of the income distribution, 20 percent had been destroyed or were vacant by 1983, and 38% were occupied by higher income families. On the other hand, 41% of units occupied by the lowest income households in 1983 had been occupied by higher income groups in 1974." (pg. 394). Clearly we desperately need a good empirical study of the "filtering" process.

Downs (1991) takes the argument about the importance of the privately produced low income housing stock a step further. Downs contends that regulatory barriers unnecessarily raise the cost of low income housing. "Well over half the cost of building new housing in the average U.S. community is a direct result of local government regulations rather than of any minimum requirement truly necessary for the occupants' health and safety." Restrictive zoning in particular

causes a concentration of the poor in old deteriorating neighborhoods with restricted access to high quality jobs and education.

In terms of the current stock of low income housing, Downs contends that small lower quality units are, in fact, in widespread use through illegal use of the existing stock. The recent New York Times article entitled "Behind Hidden Walls" (1996) strongly supports this view that thousands of poor households, especially immigrant households, are in illegal accessory apartments in garages, attics, and basements. There is no definitive research on this topic, but press articles indicate that the number of such units in "gateway" cities may be very substantial. As Downs states, "People who are too poor to pay for legally required minimum housing standards will quite reasonably live illegally in smaller or overcrowded quarters rather than become homeless."

"Current housing quality and density standards in many communities are set unrealistically high in relation to the true economic capabilities of millions of American households." Downs contends that "legally required standards of housing quality should be lower in poor neighborhoods than in wealthier ones." In fact, today we have de facto differential enforcement of codes. (New York Times, 1996). Along these lines, Downs would encourage the preservation and construction of SRO hotels, and accessory or "Granny flats" in garages, basements and attics. While we need minimum safety requirements, Downs correctly points out that we need to encourage innovative ways to meet the need for low cost housing in our neighborhoods.

Home Ownership and the Community Development Corporation

While most of the literature we have reviewed concerns the impact of CDCs and the creative housing finance system on affordable rental housing, there is a renewed interest in the impact that homeownership has on low-income neighborhoods. Articles by Galster (1987), and Rohe and Stewart (1996) are supportive of the view that homeownership improves neighborhood stability by increasing property maintenance and property values, and increasing length of tenure. There is more mixed evidence concerning the impact of homeownership on other measures of neighborhood health (Rossi and Webber, 1996).

The role of non-profits in stimulating homeownership by low income households is less well documented. The importance of community reinvestment efforts which have shown banks that affordable housing is sound lending has been especially valuable. NHS has had a large role in this effort. Also, homeownership counseling programs (Quercia and Wachter, 1996) is a vital element in assuring the longer term viability of low-income homeownership. Clearly much additional research on the potential for neighborhood revitalization through increased homeownership needs to be done.

Research Agenda

In order to understand the economics of housing services in low income areas, we first need a substantial amount of research on the dynamics of low income households and the low income housing stock. We need a series of longitudinal studies of households, buildings, and neighborhoods so that the

public policy interventions being proposed can be put in the context of a dynamic housing market.

Over the years the federal government has provided an ever changing menu of subsidized housing programs. The original public housing program was a subsidy to a building. With a building based subsidy, households who obtained permission to move in received the subsidy; if they moved out, another household obtains the building based subsidy. At the other end of the spectrum is the voucher program enacted in the 1970s as a subsidy to a household. In a household or tenant based subsidy, the household with a subsidy can move into any privately or publicly owned building whose rent is at or below a federally defined fair market rent. There are many who believe if the prime problem for the low income housing market is low income, then a voucher program is the most efficient way to reduce the low income housing crisis.

The federal government has also experimented with a number of geographic or place-based programs. The urban renewal program of the 1950s and 1960s, the Model City program of the 1960s and the Enterprise Zone proposals of the 1990s, while not housing programs, were federal efforts to improve neighborhoods with specific geographic areas. The difficulties of these programs have been well documented (Rothenberg (1967), Gruen (1963)). Anti-redlining efforts which resulted in the federal Community Reinvestment Act, encourages banks to invest in areas with high concentrations of low income and/or minority populations. In some programs, such as the federally authorized Mortgage Credit Certificate program for first time homeowners, cities often set different qualifying rules to try to encourage use of the program in certain low income neighborhoods.

A major policy question is whether federal subsidies should be concentrated at the building level, at the household level, or at a geographic level (i.e. census tracts with high numbers of low income households). To determine the relative merit of each program we need to analyze the impact of these subsidies on the long-run behavior and quality of life of the subsidized households. Currently the federal government is subsidizing about 25% of the very low income households that rent. Does subsidizing housing free up funds for better health care or other necessary expenditures? Over time, do individuals with subsidized housing obtain better jobs? Do children from subsidized housing have lower criminal records or fewer pregnancies outside of marriage? There is at present very little discussion of how we should theoretically evaluate the benefits of a subsidized housing program. Most evaluations to date have been concerned with the subsidy cost per unit, the income of the household subsidized, and with the external effects of a subsidized building on neighborhoods. And if we do not want to repeat past mistakes, these are important questions. But we need to begin to deal with the most complicated questions surrounding household mobility. By addressing some of the complicated questions, perhaps we can develop a "holistic" low income housing and neighborhoods' policy.

While the previous discussion sets a general long-run framework for the economics of housing in low income neighborhoods, there are a number of more limited research topics that can address the role of CDCs in the low income housing delivery system. Some specific targeted research could help improve the functioning of the system.

The first area we would suggest is to expand the research done on large CDCs to include each CDC with certificates of occupancy for at least 1,000 dwelling units. The intent of this type of study is to see what start-up or less successful CDCs could learn from the older successful firms. Each such CDC report would include the following: the annual cumulative production per year; the board make-up, particularly the presence of financial and real estate professionals; the compensation of the three highest paid employees; the career lines of the three highest paid employees, where did they come from, and where do they go; a ten year history of balance sheets, both corporate and individual development; the role of the sponsoring entity over time; a 5 year business plan, i.e., where do CDCs plan to be; and current resident selection and eviction policies. To complement the study of successful CDCs, we recommend case histories of CDCs that are at least ten years old that have not completed 1,000 units. What is the difference between those CDCs that produce units and those that do not.

Understanding the nature of residential mobility in CDC sponsored housing is an important research topic. For buildings open at least five years, we suggest tracking where residents come from and where they move to.

The role of mixed income housing is critical to any solution to the affordable housing problem. For a sample of buildings with project based Sec. 8 residents, tax credit residents, and unregulated residents determine under what conditions it is realistic to create intradevelopment subsidies. Is there some mix of income groups that negates the need for a construction subsidy. Is there a tipping point at which unregulated residents will not voluntarily live with Sec. 8 residents. Is the Sec. 8 resident mobility different in a mixed income building then in a building in which all residents are subsidized?

The potential role of CDCs in solving the public housing crises should be addressed. Under what conditions have or should CDCs take over the management of particular public housing units. Is there a different strategy for family units, for elderly units, and for handicapped units.

Another fruitful topic to be explored is, how do CDCs with Sec. 202 units that have 20 year operating subsidies plan to handle the end of these subsidies. How will the residents being subsidized in the 202 buildings pay their rent when these subsidies end.

A study of CDCs that have provided supportive housing would be of substantial interest. A comparison of costs and benefits by type of resident (elderly, HOPWA, homeless, mentally ill, drug treatment, etc.)

Finally for jurisdictions with a large number of CDC units, say 10,000 or more, what is the perception of CDC contribution to neighborhood quality of life. Is there any perceived effect by elected officials or by opinion makers that the existence of a large number of CDC units has any external positive or negative effect. At this time, such a study would be a series of case studies.

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