

A Property Rights Approach to Preserving Subsidized Multifamily Rural Housing with Cooperatives

Bruce J. Reynolds
USDA/RD/Cooperatives Programs

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A major challenge for the Rural Housing Service (RHS) is to preserve the stock of affordable multifamily housing in its 515 program. Most of these apartments were built during the 1970's and 80's. In general, government programs for low-income family housing have proven to be more effective in producing an available supply than in maintaining it over the long-run. Over the life of the program 527,089 apartment units were produced. New production has been very slight during the past decade while the supply of apartments affordable to rural low-income families is declining, as is evident by the fact that about 431,000 units remain. Without effective preservation programs, RHS's 515 stock of housing will continue to decrease, and many families will be displaced from the homes they rent in the coming years.²

The term "preservation" is used by RHS and affordable housing advocates to mean preventing 515 properties from becoming either market-rate rental apartments that displace low-income families or tear-downs for alternative uses of the land. The disappearance of low-income housing typically happens when the investor syndicates that developed the 515 buildings seek to get out of the program by prepaying their loans, or ultimately when their 40- or 50-year loans are fully amortized. In other words, preservation refers to retaining properties for low-income housing, whether preventing either conversions to market-rate rental units or losses due to physical deterioration.

Conversions have been a more prevalent source of decline in the 515 stock but physical deterioration is projected to be an increasing problem due to insufficient long-term maintenance and inadequate financial reserves for rehabilitation.³ Some of the investor syndicates are caught in a situation where they cannot afford to prepay because of high exit taxes, so they stay in the program without economic incentives and financial resources for either preventive maintenance or rehabilitation of apartment buildings.⁴

When a resource is insufficiently maintained, economists often look for an explanation in flawed delineation of property rights. Many types of property have attributes that can be delineated by a bundle of rights. Barzel points out how an initial allocation of all rights to one owner, perhaps a buyer or developer, will become unbundled and assigned to other stakeholders when their utilization and care of corresponding attributes of the total property can be more efficient.⁵

¹ The author's opinions expressed in this paper do not represent or reflect USDA views or policies.

² Leslie Strauss, "Overview of the Section 515 Program," *Preservation of Affordable Rural Housing: A Practitioner's Guide to the Sec. 515 Program* (henceforth referenced as LISC), Local Initiatives Support Group, Washington, DC, 2004, 1-7. (www.lisc.org).

³ ICF Consulting, *Rural Rental Housing- Comprehensive Property Assessment and Portfolio Analysis: Final Study Report* (henceforth referred as *Property Assessment*, November 2004 (www.rurdev.usda.gov/rhs), and Lindley Higgins, LISC, "Keeping Section 515 Properties Affordable: Challenges and Possible Solutions," 8.

⁴ Ibid, 12-13, and Robert A Rapoza and Cornelia Tietke, "Preserving Rural America's Affordable Rental Housing: Current Issues," Housing Assistance Council, *Rural Voices*, Winter 2004-2005 (henceforth referenced as HAC), 4-5 (www.ruralhome.org).

⁵ Yoram Barzel, *Economic Analysis of Property Rights* (New York: Cambridge University Press, 1997), Chapter 4, "Divided Ownership", 55-64.

In dealing with public housing programs, proponents of privatization might argue that the problem is the unbundling, specifically, the regulation of certain rights by government. Full privatization of 515 properties would likely improve their long-term maintenance but they would not be preserved for use as affordable housing. Hence, some optimal reassigning or reconfiguring of property rights to the 515 portfolio can improve the trade-offs between preserving affordability and preserving the value of multifamily housing by maintaining or improving their physical condition.

Such a proposal involves assigning more of the bundle of rights in 515 apartments to the people who live in these places. Especially important is the right to capture transfer value, which can be coordinated and managed by cooperatives. The underlying idea is to provide opportunity for some increase in wealth for low-income families as an incentive for them to pursue property improvement and long-term maintenance. Note that this strategy is not appropriate for the lowest-income families who are in some cases operating only with rent subsidies. This paper outlines a strategy of converting ownership in 515 projects from a landlord system to housing cooperatives.

Limited equity cooperatives (LECs) have been the form of cooperation used for affordable housing policy. This paper departs from that tradition by proposing the use of the market-rate cooperative (MRC) as having the property rights assignment needed to achieve efficient long-term maintenance of 515 properties. LECs vary by the extent to which they pass on increases in share value for a transfer of membership and turnover in apartments.⁶ But the LEC model involves costly appraisals and complicated calculations of a neighborhood's affordability-constrained share price. By contrast, an MRC uses the market price. The market provides a clear signal to the membership, rather than having the value of their membership share subject to uncertain adjustments with price or cost indices.

In rural real estate markets, MRCs for low-income families are unlikely to cause rapid price escalation as is more likely to occur in urban markets. A 515 MRC would operate under Federal Government regulations. For example, members of the cooperative would not be allowed to immediately vote for a sell-out to a for-profit developer. Other regulations that would need to accompany a 515 MRC are considered in the last section of this paper. Under current 515 regulations, only LECs that strictly maintain affordability are permitted, and therefore no real returns on member shares are allowed.⁷

The alternative proposed in this paper would in the long-run make the affected apartments unaffordable for new tenants who are in the lowest income status. But more affordability for other low-income families would occur by gaining improved quality and maintenance of the housing stock, even though particular units may not stay committed to serving the very lowest income strata. However, the total savings of this process would justify new funding for those families in the lowest income status.

Another benefit is that returns on housing cooperative equity, paid only for appreciation derived from property improvements, are a superior method for personal savings. Property appreciation often functions better than other savings methods that require individuals to make continuous saving versus spending decisions. Cooperative

⁶ Herbert H. Fisher, "The Role of Limited Income Maximums," *A Collection of Articles from the Cooperative Housing Bulletin and Cooperative Housing Journal*, National Association of Housing Cooperatives (undated).

⁷ *Loan Origination Handbook*, HB-1-3560, USDA/Rural Housing Service, Chapter 11, 27 (www.rurdev.usda.gov/regs/hblist.html)

housing equity can be an effective institutional mechanism for personal savings, and at the same time accomplish physical preservation of low-income housing.

Some background on RHS's 515 program, its preservation problems, and the methods used to solve them are described. A restricted MRC model, based on the economics of property rights is presented, along with a discussion of how these ideas could be implemented in the 515 program.

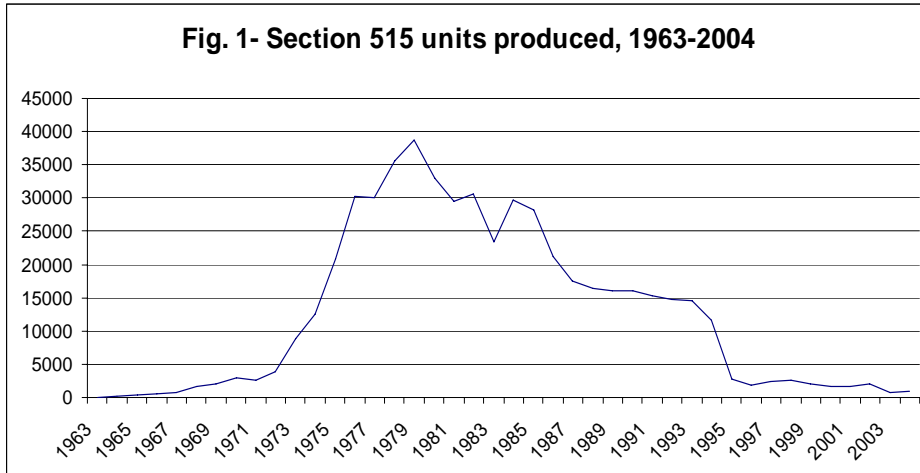
Review of the 515 Program

The involvement of USDA in housing goes back to the New Deal era, but while the commodity price support programs were sustained, most rural development programs were terminated for several years before gradually reemerging. In the Housing Act of 1949, which initiated much of the public housing programs in the U.S., Title V established the 515 multifamily housing loan programs for use by farmers and administered by the Farmers Home Administration (FmHA). In 1961, Title V was amended to allow non-profit organizations and state and local public housing agencies to receive 515 loans. Similar to FmHA's lending practices to farmers, these agency borrowers have to show that loans could not be obtained elsewhere. Furthermore, borrowers were encouraged to refinance in the future as other credit opportunities developed for them, so that they would graduate to more financial independence in the commercial market.⁸

Public subsidization of rural multifamily housing became significant with the Housing Act of 1968 that offered 515 loans at 1 percent for 40- and in some cases 50-year terms with only 5 percent equity or down-payment required. In addition, since 1978 the 515 program has been supplemented by a rent subsidy for low income tenants who would otherwise pay more than 30 percent of their income for housing. The RHS rent subsidy is similar to the section 8 program provided by Housing and Urban Development (HUD). In other words, the housing project loan is subsidized, as well as the cash flow from tenants' rent subsidies to pay back the loan and operating expenses. Subsidies have provided a way to get this public service produced, but long-term preservation of these homes for low-income families has been a different and more difficult challenge.

Preservation problems in regard to 515 loan prepayments only developed once the program was opened to for-profit developers in 1972. Changes in the tax code had already created opportunities for tax syndicates or partnerships to participate in programs like the 515. The broadened participation in 515 was successful in increasing the supply of affordable housing to low income families in rural areas. In fact, program volume increased from \$40 million in 1972 to \$105 million in the following year and reached \$881 million by 1980. Figure 1 shows this expansion in terms of units produced.

⁸ Arthur M. Collings, Jr., "Rural Rental Housing Preservation: The FmHA Experience," *Housing Policy Debate*, The Fannie Mae Foundation, V. 2, Issue 2, 1991, 559 and 562. (www.fanniemaefoundation.org/programs/hpd.shtml)



Source: USDA/RHS, and Housing Assistance Council,

There were two policy decisions with regard to the expansion of the program to for-profit syndicates that have proven to be costly.⁹ First, FmHA acted on its principle of encouraging a borrower to graduate to commercial sources of credit so that the right to prepay 515 loans was not restricted at that time. Second, FmHA did not place use-restrictions on prepaid 515 properties to forbid displacement of low-income tenants. Note that such restrictions had never been needed before 1972, when lending was unavailable to for-profit developers. Once the tax benefits begin to decline, syndicate partners have an incentive to get the 515 properties off their books because the return on their equity, their capital contribution, in these projects was limited to 6%, although in recent years it has been increased to 8%. After being prepaid, the apartment buildings can be converted to market based rentals, which drives out many of the low-income tenants.

By 1978 prepayments and tenant displacements were in full swing. In the following year affordable housing advocates were able to convince Congress to have 20- or 15-year use restrictions on future 515 loans initiated after December 21, 1979. It also retroactively applied use restrictions to apartment buildings with more than 10 units, which blocked prepayment plans of many investor partnerships on projects they had in the 515 program from the early 1970s. Predictably, in less than a year, housing developers convinced Congress to repeal the retroactive part of the 1979 public law.

The Housing and Community Development Act of 1987 (referred henceforth as the Preservation Act) restored the retroactive provisions for 515 loans prior to 1979 if it is determined that proposed properties for prepayment were located where housing markets for low-income families were already in short supply or would adversely affect housing opportunities for minorities. If either were the case, however, those requesting prepayment are offered additional incentives to stay in the program, such as generous equity loans or commitment to allow a higher rate of return when they exit the program at a later date. If these incentives are not enough, the Preservation Act requires investor partnerships to seek out transfers to either non-profit organizations or public housing agencies. If such transfer offers prove unsuccessful, then prepayment is approved.¹⁰

⁹ Ibid, 559.

¹⁰ Ibid, 563-564.

The 1987 Preservation Act essentially established the major ways to retain the stock of 515 affordable housing, either giving incentives to forestall prepayment or making transfers either to non-profits or local housing agencies. In 1989 Congress restricted payments on all 515 loans made after December 15 of that year. It was around that time that 515 expenditures were leveling out at around \$550 million, and have remained at or below \$100 million since 1995. Figure 1 shows this pattern in terms of units produced with 515 funds. But in 1992 in an effort to help the cause of affordable housing, new legislation applied the pre-1979 requirements of the Preservation Act to the mortgage loans initiated between 1979 and 1989. While affordable housing advocates would have liked to have had these restrictions from the start, they presumably believed that a retroactive imposition of regulations was better than none.

The U.S. Department of Agriculture (USDA) has been sued numerous times over the retroactive restrictions imposed by Congress on prepayment of 515 loans. Some of the court decisions have gone against USDA. Of course, many 515 prepayments occur entirely within the regulations. Many of them result in transfers of multifamily housing to non-profits or housing authorities that retain the tenants and maintain the affordability of these apartments. The failure of preservations due to transition to market prevailing rents typically occurs in rural markets that have a relatively high demand for multifamily housing.

The tax benefits that were syndicated in 515 partnerships were changed by the Tax Reform Act of 1986. The use of accelerated depreciation was restricted and this incentive for participation in 515 projects was replaced by the Low Income Housing Tax Credit (LIHTC). The LIHTC has helped to encourage investors to participate and stay in the 515 program. In fact, some non-profit organizations have developed creative ways to coordinate transfers of 515 properties from for-profit partnerships and use LIH tax credits to finance apartment rehabilitation.¹¹

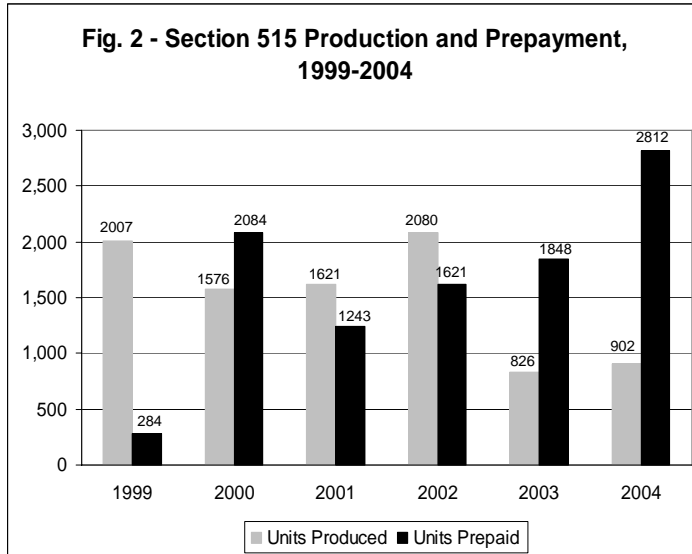
Figure 2 shows the difference between new 515 units produced and units prepaid from 1999-2004. Over this six-year period, units prepaid exceeded those produced by 880 and were especially lopsided in the past two years. But this difference does not precisely measure the status of preservation because some prepaids, though a small percentage, continue as affordable housing. More critical to the future of preservation are units not prepaid that are vulnerable to being lost when physical deterioration renders them uneconomical to rehabilitate.

The 515 loans that are eligible for prepayment but not prepaid are staying in the program because of an exit tax.¹² Prior to the 1986 tax reform, accelerated depreciation allowed properties to be fully depreciated. A syndicated partnership is liable for exit taxes when more depreciation has been claimed than is available in equity.¹³ These cases are a lost opportunity for ownership turnover that would accomplish rehabilitation to preserve affordable housing.

¹¹ LISC, 10 and 17.

¹² LISC, 12, and Colleen M. Fisher, "Preservation and the Aging Portfolio: The Owners' Perspective," HAC, 19.

¹³ General Accountability Office, *Multifamily Rural Housing: Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties*, GAO-02-397, May 2002, 10, and HAC 4-5.



Source: USDA/RHS and Housing Assistance Council

Prepayment controversies and the related issue of preservation strategies have been extensively debated and studied. Various solutions such as debt forgiveness and exit tax relief are being advocated. A more recently emerging concern is the potential cost of physical deterioration of the 515 portfolio. RHS contracted with a consulting firm to do a property assessment and its findings and recommendations were completed in the fall of 2004.¹⁴ This study found that many properties were on the verge of needing significant rehabilitation but lack sufficient current reserves and provision for future reserves to finance the impending physical upkeep. RHS responded with an Administrative Notice, AN 4036, to provide combinations of debt relief, RHS loans, and third party financing for revitalization demonstration projects that will serve as a guide to future programs for rehabilitating the 515 portfolio.

A strategy of organizing housing cooperatives to preserve the affordability status of multifamily housing has not been officially proposed as a part of government, RHS, strategy for its 515 portfolio. Participation by cooperatives was permitted in the 1961 revisions of 515. However, many of the weaknesses in the 515 program that have limited cooperative involvement were studied for RHS in 1999, but no actions have been taken to make revisions.¹⁵ Yet, a mutual housing association model for collecting a significant portfolio of 515 properties for preservation is being pursued by the National Cooperative Bank (NCB). The use of mutual housing systems with more flexibility in the transfer value of member equity is one of several regulatory revisions that might increase cooperative involvement in the preservation of the 515 stock of multifamily housing.

Housing Cooperatives

The proposed strategy for preserving affordable housing in the 515 program combines two institutional mechanisms: (1) property rights reassignment, and (2) housing

¹⁴ *Property Assessment.*

¹⁵ Anne Reynolds and Hugh Jeffers, *An Assessment of Loan Regulations for Rural Housing Cooperatives* (research conducted for USDA/RD/Cooperative Programs), September 1999. (www.wisc.edu/uwcc/info/i_pages/house.html)

cooperatives. A reassignment involves some government de-regulation so that individuals may hold unencumbered rights that create incentives to prevent the gradual physical deterioration of property over a long-term horizon. Specifically, restrictions on paying returns on share equity of departing members might be revised to this end. Both cooperatives and property rights have self-regulatory mechanisms that can be more flexible substitutes for some government rules. However, either mechanism by itself is not as effective for the goal of affordable housing preservation as they are if working in combination.

The proposal in this paper calls for a form of regulated MRC; however, the role of cooperatives in the housing affordability movement has entirely involved LECs, located primarily in big cities. A review of LEC policy provides a guide and rationale for developing new policies for a regulated MRC.

The LEC is designed for implementing affordable housing policies, whether under the regulations of government programs or independent of them. LECs that are not participating in the RHS and HUD affordable housing programs voluntarily limit the transfer value of member equity when there is turnover in family housing units. Yet, these independent LECs often raise the price on sales of new membership shares in accordance with their determination of affordability levels in their neighborhood. Many of these independent LECs would also be out of compliance with other RHS regulations in regard to policies for member selection and approval. These regulations inhibit the self-regulatory functioning of housing cooperatives.¹⁶

The general model of housing cooperatives is based on members owning shares in a cooperative that entitle them to the rights of occupancy of apartments. A blanket mortgage for financing all individual units is held by the cooperative. New members buy equity shares in the cooperative and are assessed a monthly carrying charge for operating expenses and their proportionate share of the blanket mortgage payment, including property taxes. Members are eligible to deduct their share of mortgage interest and property taxes from their individual income taxes. Also, similar to a home equity loan, cooperative members can receive share loans and deduct interest expense from their taxable income.

Similar to owners of a residential unit in a condominium, cooperative members have bought rights to participate in the democratic governance of the association and to be bound by its rules. Members can be involved through a democratic process with, for example, developing and implementing ideas for improving the commons area. They also have a vote and voice through their board of directors regarding actions that have some affect on operating costs, and hence their monthly charges. These rights are a part of the bundle that is assigned to members that is unavailable to rental tenants.

The affordability of cooperative housing is determined by the price of an equity share and the monthly carrying charges. LECs are committed to keeping housing affordable for low income families in their communities. Limited equity means that even when housing properties rise in value, which is captured in a cooperative's equity, the offering of a new share price may only adjust in line with some type of affordability index for low income families.¹⁷ LEC provision of affordable housing is an example of

¹⁶ Ibid, 17-25.

¹⁷ Herbert H. Fisher, *op cit.*

cooperative principles, functioning as a constraint, to produce a local public good.¹⁸ This capability forms a natural alliance with the housing objectives of RHS and HUD.

LECs have the potential to not only keep housing affordable, but also to provide excellent care and maintenance. In other words, there are numerous examples, mostly in urban neighborhoods, of LECs that successfully reconcile the potential goal-conflict between affordability and long-term physical preservation of apartments. However, their efficacy in this regard is dependent upon having a core majority of members who want long-term residency and strong community ties. In fact, the focus of the LEC is the resident community, the members who stay for a long time, and no incentives are created to depart.

The difference between the rationale of the proposal in this paper and traditional LEC policy hinges on the definition of “member.” In an LEC, the user-benefits principle is at work. A departing member is paid slight, if any *ex post* rewards for *ex anti* contributions or improvements to the cooperative property. Member benefits are predominantly confined to current users, and to future users in regard to having housing affordability maintained for them. Sound fiscal management for an LEC is described by one of the leading experts in housing cooperatives as follows. “...the cooperative can usually build its income or reserves by charging incoming members something more than it pays outgoing members because the increases in value of the shares are due at least in part to the efforts of the cooperative and its members.”¹⁹

The above quotation points out that efforts made by departing members to increase the value of shares are not fully, if at all, compensated. The members who matter are the members who continue to reside in the cooperative. By contrast, the proposal of this paper assumes that an MRC, requiring a minimum period of residency before departing members are eligible to receive a return on equity, would provide an intertemporal incentive. The latter is defined as an incentive for current members to increase their efforts to improve the housing cooperative for the future, even when they are not planning to have long-term residency.

Cooperative Equity Incentives

The idea of using returns on equity as incentives for cooperative members emerges whenever a long-term maintenance issue is viewed through the lens of property rights economics.²⁰ From this viewpoint, overt government regulations will often not be fully successful in accomplishing tasks such as care and upkeep of subsidized housing. The history of the 515 program would not contradict such predictions.

¹⁸ Bruce J. Reynolds, “Cooperative Principles as Constraints for Public Goods Production,” NCR-194, December 2000 (www.agecon.ksu.edu/accc/ncr194/ncr%20publications.htm).

¹⁹ Herbert J. Cooper-Levy, “An Introduction to Limited Equity Cooperatives,” *A Collection of Articles from the Cooperative Housing Bulletin and Cooperative Housing Journal*, National Association of Housing Cooperatives (undated).

²⁰ Thomas J. Miceli, Gerald W. Sazama, and C.F. Sirmans, “The Role of Limited-Equity Cooperatives in Providing Affordable Housing,” *Housing Policy Debate*, The Fannie Mae Foundation, V. 5, Issue 4, 1994, 479 (www.fanniemae.foundation.org/programs/hpd.shtml), and Gerald Sazama and Roger Wilcox, “An Evaluation of Limited Equity Housing Cooperatives in the United States,” University of Connecticut, Department of Economics Working Paper Series, Working Paper 1995-02, 1995, 26 (www.econ.uconn.edu)

Long-term maintenance of residential buildings is subject to a host of local, state, and federal government regulations. A replacement reserve account is established as a source of funding long-term maintenance in underwriting 515 or any other multifamily housing project. The standard RHS policy for setting-up a reserve is to make deposits of 1% of the total development cost until a 10% amount is reached, but recent revisions specify other adjustments in this amount to be based on life-cycle or special appraisals.²¹

Yet, for all the regulations on long-term maintenance, the recent property assessment of the 515 portfolio reports that, “No property has sufficient current reserves, or provision for future reserves, to address physical needs over time.”²² This report also notes a general condition of deferred maintenance in these buildings. The encumbrance of property rights by limiting equity returns renders this outcome inevitable. As observed by the executive director of the trade association of section 515 for-profit developers, “With a limited return on equity, this limits the owner’s ability to maintain the property sufficiently.”²³ From a property rights perspective, there is no compelling reason to expect different results with LEC ownership of a 515 property other than under the special conditions of having a significant majority of members who are committed to long-term residency.

A housing cooperative board of directors is responsible for planning and budgeting. Its decision-making has considerable discretion in the timing, extensiveness, and quality of long-term maintenance. Members not only elect the board, but also have some influence on their decisions. Members, especially those not considering long-term residence at the cooperative, may influence a policy of accomplishing some of the low carrying charges by means of deferred long-term building maintenance. In this way, a collective horizon problem is created. The horizon issue has been raised by economists, with some evidence in a 1992 Canadian study that cooperatives deferred long-term maintenance. Note that the authors who referenced this study believe that deferred maintenance is not typical of LECs.²⁴ Yet again, problems with deferred maintenance by LECs in Illinois have been reported by a HUD official.²⁵

The opportunity for member equity appreciation is an economic incentive that would contribute to solving the horizon problem of inadequate long-term maintenance. Solving this problem contributes to the supply of affordable housing even if some of the preserved supply were to become less affordable from a rise in price of new member shares. An MRC policy can be applied in rural areas because only modest increases in the value of shares are likely to occur but at the same time be sufficient to create incentives for long-term maintenance. Long-run savings for the government in physical preservation of buildings could then be allocated to help the very lowest income families with their housing affordability problems. A new cycle would begin but it would be upward in terms of improving the quality of housing, rather than the downward cycle of deteriorating properties with current policies.

²¹ *Asset Management Handbook*, HB-2-3560, USDA/Rural Housing Service, Chapter 4, 4-13 (www.rurdev.usda.gov/regs/hblist.html)

²² *Property Assessment*, 4.

²³ HAC, 18.

²⁴ Sazama and Willcox, *op cit*, 27 and 46.

²⁵ Larry Anderson, RHS program director, attended a conference of the National Council of State Housing Agencies in 2003, where this information was reported.

Equity Appreciation as a Savings Mechanism

Another advantage of using cooperative equity as an incentive to improve housing is to create a starting point for low-income families to accumulate wealth. This view has been advocated for over a decade or more as a way of transitioning low-income families to unsubsidized homeownership.²⁶

The argument for returns on equity has never had traction among housing cooperative advocates and such returns are prohibited in 515 regulations because they conflict with affordability policies. Furthermore, it is argued that financial benefits for members occur in the form of lower monthly carrying charges as compared to amounts paid by rental tenants. Proponents of LECs point out that this source of personal savings offsets the restrictions on member equity appreciation.²⁷ The evidence for lower carrying charges is briefly reviewed before discussing why equity is a better method of personal savings than low carrying charges.

A major source of savings in carrying charges is the blanket mortgage used by cooperatives, in contrast to individual loan financing of condominium units or single-family homes. Each time one of these latter properties changes ownership, new loans are made and a series of expensive real estate transactions occur. In contrast, membership turnover in a cooperative avoids these tremendous costs because no real estate is bought and sold. There is only a transaction in transferring a membership share. Rental tenants also incur a similar source of escalating costs from frequent changes in the ownership of apartment buildings.²⁸ Member turnover in cooperatives only affects a small part of the shares and the mortgage is unaffected. In regard to mortgage payments, LEC members who would be subject to Federal income taxes may deduct their share of interest payments.

Another source of reduced costs is in daily operations and the care of common areas of apartments. Cooperative members have more incentives for daily up-keep of properties, especially commons areas because their actions can help reduce carrying charges. Evidence for these efficiencies are found in comparative studies with other forms of subsidized housing where mortgage costs would be similar. In a study completed in 2003, the Co-operative Housing Federation of Canada compared the operating costs of LECs for low income families with those of other municipal or private non-profit housing. In this study, LECs cost 14% less to operate than other institutions that provide low-income housing.²⁹

Efficient operations of housing cooperatives can accomplish both low carrying charges and long-term maintenance without requiring trade-offs between the two. Yet, as pointed out in the previous section, some LECs have been known to defer long-term maintenance. The potential trade-off raises the point that even when carrying charges can be lowered without short-changing long-term maintenance, there are alternative opportunities to use the savings in operating costs for capital improvements rather than distribute them in lower carrying charges.

²⁶ Miceli, Sazama, and Sirmans, *op cit*, 479.

²⁷ Enterprise Foundation, "Alternative Financing Models – Hybrids of Homeownership, Limited-Equity Cooperative Housing (www.enterprisefoundation.org/resources/dss/large/lg&rin&rc&ucpsff3.htm), and Susan Saegert and Lymari Benitez, "Limited Equity Housing Cooperatives, A Review of the Literature," City University of New York Graduate Center & the Taconic Foundation, June 2003, 7.

²⁸ David H. Kirkpatrick, "Legal Issues in the Development of Housing Cooperatives," National Economic Development & Law Center (Berkeley, CA) 1981, 21.

²⁹ Co-operative Housing Federation of Canada, *just the numbers* (www.chfc.ca/eng/chf/about_1_2.htm).

Recent research in behavioral economics has bolstered the arguments in favor of housing equity as a means of increased personal savings. Since members of a housing cooperative can use share loans to spend their equity, that which remains unspent is savings. There are many alternative ways to create savings, but behavioral economists have tested and rejected the proposition that the amount a rational individual chooses to save is invariant with respect to different forms of savings used. In the words of Shefrin and Thaler: “If the wealth in their home is a good substitute for other savings, then one would expect homeowners to have less savings in other assets, holding everything else constant. However, just the opposite is true.” From survey data, those with the largest amounts of savings in the form of home equity also held more in other kinds of savings as compared to other individuals with comparable wealth and income.³⁰

Some of the increased savings is caused by the fact that home equity is not a perfect substitute in terms of access. Member equity in a housing cooperative is not as readily spent as is the increased revenues available each month to members from lower carrying charges.

In a property rights analysis, personal savings failures are an individual horizon problem in contrast to the “collective” horizon problem of deferred maintenance in multifamily housing. Cooperative housing, with a policy that pays returns on member equity, would contribute to remedying both types of horizon problem.

The economics of property rights have been applied to redesign the traditional model of farmer cooperatives into the new generation cooperatives. Returns on member equity are generated by transferable delivery rights in a closed cooperative. In contrast, savings on inputs or premiums on marketing products are the user-benefits of traditional farmer cooperatives.

Behavioral economists’ analysis of savings is applicable to a comparison of earnings from delivery rights with the same business operations organized as a traditional cooperative with annual distribution of earnings. Research has shown that members significantly invest more in new generation cooperatives than is by comparison invested by members of traditional cooperatives.³¹ Although not tested, similar behavior is expected in the case of housing LECs, where the gains for members of lower carrying charges are spent rather than retained for investment in their cooperative.

Implementing 515 MRCs

Ownership transfers of many of the 515 multifamily housing properties to cooperatives is economically infeasible without several major coordination and restructuring steps. The problem of exit taxes was discussed earlier, and that problem in part reflects the more general weakness of insufficient equity for financing significant rehabilitations that would predictably be needed.

Part of the financial obstacles for ownership transfers is the relative small size of 515 properties and their geographic dispersion. The average size of a property was 27 units in 2001, and many of them are separately owned by small property developers.³² In

³⁰ Hersh M. Shefrin and Richard H. Thaler, “Mental Accounting, Saving, and Self-Control,” *Choice Over Time*, George Loewenstein and Lon Elster, editors (New York: Russell Sage Foundation), 1992, 308.

³¹ Constantine Iliopoulos, *A Study of the Property Rights Constraints in US Agricultural Cooperatives: Theory and Evidence*, University of Missouri-Columbia, 1998, 190.

³² GAO, *op cit*, 5.

other words, the per-unit cost of transfer is high and a solution lies in achieving economies by bundling several properties into a single re-development process.³³

An innovative plan for financing 515 transfers to a “quasi-cooperative” form has been developed by Cooperative Community Works (CCW), a subsidiary of the NCB. The term “quasi” is used in this paper because membership rights and benefits are, by financial necessity, compromised in comparison to the model of a single, stand-alone housing cooperative, whether organized as an LEC or MRC. The CCW have adapted the system of mutual housing associations (MHAs) that are prevalent in some of the European countries.³⁴ An MHA can accomplish the bundling of several separately owned 515 properties for a new, consolidated ownership that can finance rehabilitation.

In the CCW plan, an MHA is organized as a 501(c)(3) non-profit. Since the bundling of properties would not cross state lines because of many distinctive regulations in the state offices of RHS, it is feasible to fund some of the rehabilitation with proceeds from the issuing of tax-exempt state bonds. Furthermore, an MHA can establish partnerships for syndicating tax credits for retiring the bonds after completion of rehabilitation. Additional new financing would be accessed and under recent regulatory change, the 515 loans can be subordinated.³⁵

Ownership would initially be shared by members of the tax credit partnership for a 15-year period, after which the housing properties would be exclusively held by the MHA. Residents would be members of the MHA with occupancy rights but without equity. After initial rehabilitation and its financing are completed, sole ownership would transfer to the MHA, and members would elect a board of directors.³⁶ From that point on, it would seem to be feasible to revise the by-laws to provide for a financial return to members as might exist in the future market value of a share. Such gain in value would be based in part on improvements to the property subsequent to the rehabilitation that could be attributed to the efforts of members.

Members of MHAs are not as cohesive and community oriented as members of a local, single property ownership, housing cooperative. In fact, in the European experience there are frequent tensions and disagreements over cooperative policies between the members in different geographic locations.³⁷ Once ownership has been transferred to an MHA, more individual assignment of rights to each member would improve the care of properties. Given the potential for weaker member cohesiveness in MHAs, a LEC policy would result in members continuing to regard themselves as tenants who are occasionally asked to vote for a slate of candidates to the board. In other words, MRC policy of allowing members to transfer their shares at the market rate can compensate for weaker cohesiveness in accomplishing long-term maintenance and improvement of properties.

Whether developing a 515 MRC down the long road of an MHA or in a local housing cooperative, a few regulatory constraints would help accomplish a balanced trade-off between affordability and long-term care of property. These constraints would have to be studied and tested in pilot projects, and probably revised overtime. Three general restrictions are suggested:

³³ LISC 10.

³⁴ Kirkpatrick, *op cit* 40.

³⁵ Terry Lewis, “CCW Section 515 Model Rehabilitation/Conversion Program,” Virginia proposal, 2004.

³⁶ *Ibid.*

³⁷ Kirkpatrick, *op cit*, 41.

1. Members would not have the right to dissolve a 515 housing cooperative, or otherwise sell-out as a group to a developer.
2. A waiting period of 3-5 years or more would be established before departing members may receive an equity return on sales of their shares.
3. Departing members who receive rent subsidies would have the equity return on sales of their shares reduced to an extent that would try to minimize reduction of incentives to maintain and improve property. But a reduction in their return is justified as a pay-back for part of their past rent subsidies.

Restriction 1 would interfere with a members' pursuit of personal savings or wealth, but is justified on the grounds that public revenue was spent on these projects to accomplish affordable housing for current and future low-income families. The right of cooperative dissolutions and property sell-outs cannot be allowed because it would result in conversions to higher-priced housing that would be out of range for those intended to be served by affordability policy.

Restriction 2 was developed and applied to a non-515 conversion in Minnesota by a housing cooperative specialist with the Northcountry Cooperative Development Fund.³⁸ Northcountry has advocated a form of restricted MRC to be used in 515 ownership transfers as a necessary membership incentive for these projects to succeed. They have also communicated these concerns to RHS and the importance of revising many of the 515 program regulations that prohibit returns on member equity. As mentioned earlier, this and other issues that undermine cooperatives were identified in the 1999 study of the 515 program.

Restriction 3 touches several sensitive and complex topics. About 300,000 units in the 515 portfolio have rental subsidies, either RHS section 521 or HUD section 8. The Rent subsidies protect tenants from paying more than 30 percent of their income for housing. Those receiving the subsidy cover a range of income differences, with those at the lowest level having only the subsidy to use for rent payments. Many of the 515 properties have a mix of tenants with and without rent subsidies.

The amount of reduction in the return paid to rent-subsidized members for their shares in the housing cooperatives, should they depart, would lessen, but should not eliminate, incentives for property up-keep. Restriction 3 would effectively make some housing cooperatives have members under both an MRC and an LEC status. The prediction of property rights economics is that the more members in MRC status, the greater will be future improvements in the multifamily housing buildings and grounds.

Cooperatives and Property Rights

Cooperatives can be viewed as organizations for alternative re-bundling and assigning of rights to specific attributes of property. They can accomplish a more balanced trade-off between housing affordability and long-term incentives to maintain and improve property than any of the current methods of ownership and participation in the 515 program.

In a transfer of 515 multifamily housing to cooperatives, a part of the bundle of rights is assigned to tenants. Members of housing cooperatives receive a much stronger right of occupancy that offers far more protection from eviction than is held by rental

³⁸ Kevin A.S. Walker, e-mail message to Joe Folsom, USDA/RD, March 23, 2004.

tenants. In regard to LECs, they are designed to also produce a local public good of housing affordability. The first entrants or members are restricted from capturing real estate profits when they sell their shares. In much of urban and suburban U.S., housing affordability has recently been under severe stress from a large escalation of prices. An MRC in such markets would eventually sacrifice affordability policy.

Affordability is also a problem in rural areas of the U.S. and the available stock of 515 multifamily housing needs to be preserved. While such preservation has been under pressure from loan prepayments that have lead to conversions into higher priced housing, a looming threat is the gradual physical deterioration of buildings that have lacked a property rights system to ensure their proper long-term maintenance. Cooperatives, with their capability to distribute specific rights to large groups of individuals, can inject incentives for long-term maintenance into 515 properties.

The model of a restricted MRC, operating in rural real estate markets, can accomplish an effective trade-off between affordability and property preservation. Any declines in affordability due to implementing this policy in rural real estate markets would be predictably slight and spread-out over time. More important, declines in affordability would be off-set by creating conditions for low-income families to achieve modest increases in wealth, and by more prevention of physical deterioration of relatively low-priced multifamily housing.