

ORER Letter

Published by the Office of Real Estate Research at the University of Illinois at Urbana-Champaign

Inside This Issue...

| | |
|--|----|
| <i>HUD Response: Don't Underestimate New Consensus on Ownership</i> | 5 |
| <i>Privatization of Public Housing in the U.K.</i> | 6 |
| <i>Career Stage and Job Performance of the Real Estate Salesperson</i> | 8 |
| <i>Czech Scholar Discusses Freeing the Real Estate Markets</i> | 10 |
| <i>The Economics of Accelerated Principal Repayment</i> | 14 |
| <i>Privatization of Illinois Land: A Historical Note</i> | 16 |

Privatization of Public Housing in the U.S.

Peter F. Colwell and Michelle A. Mahue

In September of 1990, the 464 unit Kenilworth-Parkside housing project in Washington, D.C. was sold to its resident management corporation for the modest sum of one dollar. While ownership of the units will be transferred gradually as renovations are completed, the entire project eventually will be owned as a cooperative under the direction of this private management body. The sale of Kenilworth-Parkside to the tenant group represents the culmination of nearly ten years' effort by the resident management corporation to assume ownership.

During the 1980s, Kenilworth-Parkside emerged as a model for tenant management. As more managerial responsibilities were placed in the hands of residents, their quality of life improved dramatically. Moreover, it is estimated that the sale of this project alone will save the government \$6 million in the first ten years, with savings growing to \$26 million over forty years. These results indicate that tenant ownership can be a favorable alternative for taxpayers and residents alike. Although it may not be the case in every situation, most tenant managed and tenant owned projects have enjoyed some degree of success.

The concept of privatization, the transfer of government activity to private control, has slowly gained popularity in the U.S. in recent years. Two frequently cited examples of privatization measures are contracting out public services and selling government assets. Much recent debate in the U.S. has focused on the potential benefits of selling to the private sector such government-owned real estate assets as undeveloped Western land and urban public housing projects.

Public housing is a topic of concern among lawmakers, because its sale has public policy implications for both the government and the buyers (occupants of the units prior to the sale). Evidence to date indicates that buyers of public housing can reap abundant benefits; projects sold to their tenants have displayed not only improved maintenance and management, but significantly less crime, drug usage, and teenage pregnancy as well. Resident ownership increases dwellers' stakes in the properties where they reside, thereby providing them with incentives to improve their living environment. A natural response, therefore, is to question why privatization of public housing has not become more popular.

ORER News

Generous Contributors

U of I alumnus Robert Levin of Chicago has made a significant financial contribution to ORER. Mr. and Mrs. Howard Buita have done so as well. Both Mr. Levin and the Buitas have been regular contributors for several years. The generous support of alumni and others helps the Office to meet its mission of promoting education, research, and public service.

Alumni Luncheon Scheduled

ORER is scheduling a Spring 1991 luncheon for University of Illinois alumni working in the real estate field. The date of the event will be April 26; the featured speaker is yet to be announced. Alumni luncheons are open only to alumni of the University and their guests. The Office of Real Estate Research will send registration notices to individuals on the mailing list who have identified themselves as U of I alumni.

Cannaday National President

Professor Roger Cannaday has been elected national President and National Executive Council member for Rho Epsilon. He is the faculty advisor to the U of I chapter. An article on the chapter's recent activities will appear in the Spring 1991 *ORER Letter*.

ILD Proposals Adopted

President Alberto Fujimori of Peru has enacted several initiatives based on Institute for Liberty and Democracy policies discussed in "The Creation of Property Rights in Peru" (*ORER Letter*, Summer 1990 issue). Among these policies, described for *ORER Letter* readers by *ILD* president Hernando de Soto, are the business registry and property registry, and related anti-drug programs.

Winter 1991 - Volume 5, Number 1

ORER Letter is published quarterly by the Office of Real Estate Research at the University of Illinois at Urbana-Champaign. Copyright 1991

Subscriptions: \$16 per year.

Peter F. Colwell, Editor
Joseph W. Trefzger, Associate Editor
Michelle A. Mahue, Staff Writer

Address correspondence to:

Brenda L. Bishop
304-D David Kinley Hall
1407 W. Gregory Drive
Urbana, IL 61801
Phone (217) 244-0951

ORER Advisory Committee

William R. Bryan
Director, Bureau of Economic and Business Research
Professor of Finance, University of Illinois at Urbana-Champaign

Gary L. Clayton
Executive Vice President, Illinois Association of Realtors®

Peter F. Colwell
Director, Office of Real Estate Research
ORER Professor of Real Estate
Professor of Finance, University of Illinois at Urbana-Champaign

Lydia T. Franz
Senior Vice President, Koenig & Strey

Charles M. Hill
Executive Vice President, Federal Home Loan Bank of Chicago

Gerald N. Perlow
President, Illinois Association of Realtors®
President, Property Valuation Services

David A. Rittmiller
Director, Illinois Real Estate Educational Foundation
Sales Associate, RE/MAX of Peoria

Albert M. Suguitan
Real Estate Commissioner, State of Illinois

Donald J. Ursin
Director, Illinois Real Estate Educational Foundation
Retired President, Coldwell Banker Residential Real Estate Services of Illinois

Successes Overseas

Although many other countries have adopted some privatization measures, none has been more vigorous in its pursuits than has the United Kingdom (see accompanying article on page 6). Britain's programs have served as models for privatization around the world, while the U.S. has lagged behind many less-developed, and even previously communist, countries in privatization activity.

As even the British experience has shown, however, bureaucratic sluggishness is likely to greet any serious efforts to promote or implement tenant ownership. Little was done to foster this form of privatization in the U.S. until 1987, when the Housing and Community Development Act, engineered by then-Congressman Jack Kemp, outlined "right to buy" procedures for tenants. While the Reagan administration had given a nod to tenant management, it was not until this legislation was passed that tenants' rights were broadened to include ownership. The legislation eliminated many of the legal barriers to resident control and provided funds for tenant groups.

Some observers feel that privatization has not become more widespread in the U.S. because of political opposition. Thatcher was able to counter opposition to British privatization by unifying and mobilizing those parties that would stand to benefit from the programs. U.S. proponents, on the other hand, have failed to organize a coalition among the parties affected by potential changes. By ignoring these parties' existing interests, proponents may have frightened and alienated bureaucrats and program participants alike. Although Kemp has emerged as a champion of privatization, the multitude of requirements that tenant groups must satisfy is evidence that bureaucratic foot-dragging continues.

Steps to Resident Ownership

The literature describing the Department of Housing and Urban Development's privatization procedures is filled with rhetoric addressing the need for tenant organization and mobilization. The proper post-sale environment, HUD apparently feels, depends primarily on the tenants'

being forced not only to join together, but also to work together. Indeed, HUD procedures and requirements place on tenants significant burdens to prove that they are capable of managing the dwellings they own.

Under HUD requirements, a tenants' leadership group must complete a 12 to 18 month training program covering such areas as organization, management, development, and ownership before it is "prepared" to negotiate a possible purchase. Only after completing the prescribed training can the group contract with the local Public Housing Authority (PHA) to determine the responsibilities and fees to be borne by each of the two parties. Given that an Illinois real estate salesperson is required to complete only 45 hours of training before assisting others with real estate transactions, HUD's 1,000 hour classroom requirement for public housing tenants who will represent their own interests appears onerous.

After at least three years of successful management experience, the tenants' group, called a resident management corporation (RMC), is permitted to purchase the property. While the property may, in theory, be run as either a cooperative or a condominium, HUD's housing policies are structured such that cooperative ownership is the preferred choice. HUD's bias toward the cooperative form is demonstrated by its policy that rent subsidy certificates may be applied toward mortgage loan payments only for projects managed as cooperatives.

Of course, public housing tenants do face maximum income restrictions, so it may be easier for a tenant group to secure a loan on an entire complex organized as a cooperative than for individuals to finance their units. Yet the financial and managerial problems associated with cooperative ownership are well known. Cooperatives, so frequently unsuccessful in private markets (there was no co-op boom during the condo boom), are even more unlikely to succeed in a semi-regulated market in which the interests of HUD, the local PHA, and low income tenants must all be served.

HUD also requires the completion of a number of administrative procedures

before any transfer of ownership is possible. For example, the PHA must prepare a plan meeting a requirement that a new dwelling unit be built to replace each unit privatized. In addition, the tenant group must submit an economic and financial feasibility study to support its ownership plans. Furthermore, to meet minimum housing quality standards, significant investments in renovation and rehabilitation are required, virtually necessitating that the RMC secure a mortgage from a commercial lender. Specifically, HUD requires a minimum investment of \$1,000 per unit in order for tenants to convert rent subsidy certificates to mortgage subsidies.

There is, however, no economic rationale for this minimum. Policy makers evidently feel that a tenant will not recognize his stake in a project's success if he is not forced to assume some financial responsibility for improvements. In mandating a required investment, officials appear to have underestimated the incentives that tenant control provides. A mortgage loan should be made only if the value added by rehabilitation meets or exceeds the cost of the loan. Certainly public housing tenants can understand that funds are lost otherwise.

Once an RMC has jumped through HUD's procedural hoops and finally is permitted to purchase the property, the group faces even more ill-conceived restrictions. For example, the RMC is encouraged to employ tenants as maintenance workers and in various other staff positions. While this practice may initially reduce local unemployment, it sets the stage for favoritism and waste. Similarly, public housing tenants are not permitted to hire professional management. While arguments may be made that such services are beyond the budgets of low income housing projects, basic economic theory supports the claim that the party with the comparative advantage should be chosen as the supplier. No other private condominium or cooperative owners must fulfill requirements even remotely comparable to those placed on public housing dwellers. In light of this inequality, HUD regulations appear to be excessive obstacles to privatization.

Why Privatization Can Work

A tenant's economic stake in a unit he can purchase is a function of the value of the property. A low income tenant, whose equity is likely to be limited, realizes a high return on dollars invested if his property appreciates in value. Conversely, since he has little equity to lose, downside risk is small. HUD's literature regarding tenant control emphasizes potential social improvements rather than the more obvious economic incentives, yet social betterment follows from economic incentives. Given the ability to realize gains, the tenant will monitor the environment to protect his investment.

Some who argue that privatization is not economically viable assume that other government institutions cannot accommodate tenant ownership. For example, if rent subsidies may not be applied to the purchase cost of a dwelling, then a tenant at the margin truly will find it more costly to buy and maintain his dwelling than to continue renting. It has also been argued that comparing successful housing privatization programs in Britain with tenant control in the U.S. is inappropriate, given differences in the markets served in the two countries. When Thatcher took office, nearly a third of all British families occupied public housing, while just over one percent of American families lived in government units.

One may surmise from these figures that many of those living in Britain's public housing earn incomes close to the national median. In contrast, a U.S. public housing dweller is typically from the poorest segment of society, earning only a small fraction of the nation's median income. American public housing residents, so the argument goes, would therefore tend to face much more difficulty in purchasing housing than do their British counterparts. There are, of course, cases in which it does not pay tenants to purchase their dwellings. If, however, the tenant may realize the appreciation in the property's value, as well as any equity build-up accruing from loan amortization, then there is as much economic justification for poor American renters to purchase as there is for wealthier British public housing dwellers to do so.

New ORER Paper

Another paper has been added to the ORER Working Paper Series. "Valuing Long-Term Leases: The Option to Redevelop" by Dennis R. Capozza and Gordon A. Sick is the 84th entry in the series. A single copy of any paper in the series is available free of charge from ORER.

Scholarships Awarded

University of Illinois seniors Lisa Ludwig (from Westchester) and Chris Tierney (from Bartlett) have been awarded scholarships by the Chicago chapter of the Society of Industrial and Office Realtors®. They were chosen by a faculty committee as the outstanding U of I undergraduate real estate students for the 1990-91 academic year.

Outlook Day

The Office of Real Estate Research conducted its Real Estate Outlook 1991 program on January 8 at the Hyatt Regency Oak Brook. Approximately 50 representatives of the brokerage, development, lending, regulatory, and academic communities heard four prominent speakers' views on issues affecting real estate markets in Illinois and the country.

William Bryan, Director of the University of Illinois Bureau of Economic and Business Research, spoke on the state of the the economy and its likely impact on real estate. John Weicher, Assistant Secretary for Policy Development and Research with the U.S. Department of Housing and Urban Development, discussed the impact of thrift reform on the housing sector. RESCORP president Norman Katz, a Chicago developer with experience in revitalizing troubled properties, spoke on affordable housing. Terry Alexander of Boelter Environmental Consultants in Chicago discussed recent legislation and other activity in the environmental area.

The 1991 program was the 5th Outlook Day sponsored by the Office of Real Estate Research.

The Standard Criticisms

In a recent paper produced by the Heritage Foundation, John Scanlon analyzes the criticisms often directed against tenant ownership. He cites resistance from politicians who claim that ownership responsibility is beyond the understanding of public housing tenants, from local government officials and other bureaucrats who risk losing authority and autonomy, and from unions and labor organizations whose contracts (to provide maintenance for the publicly-owned properties, for example) are threatened.

The argument that public housing residents are incapable of handling

replace each unit sold to its tenants with a new unit of public housing. Scanlon maintains that this requirement, which was designed to address fears that privatization would reduce the stock of low income housing, actually exacerbates the problem of shortages by imposing an effective barrier to privatization.

Legitimate Concerns

The truly compelling arguments are not those critical of the privatization concept, but rather are those concerned with the restrictive manner in which privatization schemes are administered. For example, restrictions that HUD places on the resale

price than does similar privately owned property. If a tenant-turned-owner can realize only a portion of the value, he is less likely to maintain or improve his unit. Prices in such a system eventually converge; through reduced maintenance owners disinvest until their properties are worth no more than the controlled prices, or devices such as key money and bribes raise the effective prices of controlled units to market levels.

Conclusions

While some amount of training and supervision may be necessary for public housing dwellers who buy their units, HUD's requirements have proven to be more a hindrance to privatization than a catalyst. Government places a burden on public housing tenants unlike any faced by other prospective purchasers; wealthier individuals who lack the knowledge to manage property are not prevented from buying in private transactions. With the availability of professional management services, there is no reason why public housing tenants should be required to possess management ability in order to purchase their dwellings. Success is not dependent on tenant management; full ownership rights, including the unimpeded right to dispose, provide sufficient incentives to guarantee the success of privatization efforts.

Requiring replacement of privatized units and limiting resale rights may quell political fears of displacing the urban poor, but they also slow the growth of privatization programs. While there is a need to ensure health and safety when public housing units are sold to their tenants, privatization seems to be wrought with overregulation. Regardless of whether these standards are enforced to satisfy special interest groups or to satisfy those who feel that property ownership is beyond the capacity of the poor, the stifling results are the same. HUD's programs not only create a cloud of procedures that discourage tenant efforts; they also effectively obfuscate the economic benefits of home ownership, limiting public housing tenants from recognizing the units they live in as potential investments. ■

No other private condominium or cooperative owners must fulfill requirements even remotely comparable to those placed on public housing dwellers.

responsibility fails, however, in light of the successes of many tenant-managed housing projects. Such projects seem to be successful even when they are not characterized by the type of high profile leadership encountered in some early privatization undertakings. The argument that privatization requires excessively high rehabilitation costs fails to recognize the long-term cost saving that results from terminating government maintenance obligations.

Critics also claim that the real housing problem facing the nation's poor is a shortfall of available units, not a lack of ownership opportunities. They say that public policy should focus not on the sale of public housing, but on the construction of new low-cost dwellings. According to Scanlon, however, a closer analysis of the facts reveals that public housing projects carry high vacancy rates, with approximately ten percent of the units uninhabitable. Privatization actually adds to the housing stock, by rehabilitating otherwise undesirable units and by decreasing vacancy rates. It is unfortunate that politicians included in the 1987 Housing and Community Development Act the provision that HUD must

of privatized units assure that many of the potential benefits of privatization will not be realized. A unit purchased by its occupant may be resold only to another low-income tenant, to the RMC, or to the local PHA, and the price must be an administered price rather than the figure at which comparable privately-developed units sell. Such restrictions on the right to dispose of property significantly reduce incentives to the initial purchaser.

Nevertheless, some who claim to favor privatization offer arguments in support of resale restrictions. They contend that in Britain, where there are no restrictions on reselling public housing, privatization has created an affordability problem when public housing estates have been sold to developers and refurbished for resale to a more affluent clientele. Unless there are restrictions on development, however, supply adjustments should respond to these shifts in demand, alleviating any displacement problems.

Restricting the resale terms for a unit, like any other form of price control, creates its own market peculiarities. In the public housing situation, a dual price system is created, whereby formerly government-owned property sells at a lower