

EXECUTIVE SUMMARY

Closing the Gap: Financing Affordable Housing in the Chicago Area

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Across the nation and in the Chicago area the supply of housing affordable to lower-income families has decreased. Overall, there is less rental housing in the Chicago area and the demand for low-cost rental housing far exceeds the supply. The shortage is expected to increase as about 18,000 units of Chicago public housing is being demolished with only a fraction of replacement housing intended for the very poor. In Illinois, between 30-39 percent of the population cannot afford fair market rent for a two-bedroom apartment. The poorer the family, the greater the problem, with the majority of extremely low-income families having to apply more than 50% of their income to rent. With the dramatic increase in demand for affordable housing in the past ten years, why is the production of affordable units so low?

This paper addresses the challenges that developers face when they attempt to construct affordable housing. A financing “gap” occurs when either for-profit or not-for-profit developers of affordable housing attempt to finance projects using traditional financing sources. These “traditional” financing sources—such as market-rate mortgages—don’t provide enough financing for developers or nonprofit community development corporations (CDCs) to complete an affordable housing project.

The main reason that market-rate tools fail to address the financing gap is the low incomes of the families for whom the housing is produced. The rents they can afford to pay mean low rental income from the proposed project. The problem is, then, most acute in building housing affordable for the lowest income families, the population suffering the greatest need for affordable housing in the Chicago area.

Constructing any type of affordable housing requires numerous subsidies. It is not unusual for a developer to utilize more than seven different sources of funding -- sometimes referred as the “layered” or “lasagna” method of completing financing of a project. This layering of subsidies is common in affordable housing and necessary to close the financing gap. Most developers currently combine federal money disbursed through local and state governments, a housing block grant program (HOME), and the Low Income Housing Tax Credit (LIHTC). The current system’s complexities are the direct result of changes in housing policy that occurred in the 1980s and early 1990s.

Background of current affordable housing financing policies

Previous affordable housing programs emphasized public housing as a solution to the affordable housing problem, or relied on federal appropriations and planning for production-based models. These federal programs began to fall out of favor for two

important reasons: (1) they tended to be expensive; and (2) fiscal control of the programs remained in the hands of the federal government.

Although the seed of change in housing policy occurred prior to the 1980s, the most substantial changes occurred under the Reagan and subsequent Republican administrations. The Republican administrations favored policies that increased the public-private partnership and shifted monetary control from the federal government to the state or local authorities. One result of this shift was a focus on Section 8 vouchers, which allow low-income families to find private-market housing on their own while the federal government pays the difference between the cost of a Fair Market rent and what the low-income family can pay. Although this program helps low-income people to pay more for a rental unit thereby making more housing choices available to them, it does not help to *produce* more housing in a city that already faces an affordable housing crisis.

Another policy change during the Reagan administration was the implementation of the Low Income Housing Tax Credit, which exemplifies the public-private partnership. These tax credits provide a dollar for dollar offset against future taxes. Developers often utilize third parties, or syndicators, who sell these tax credits to companies searching for tax shelters. In this way, the sale of the tax credits is converted into equity that developers can use to help finance low-income housing. Since the LIHTC is a tax credit, it tends to escape federal budget cutting as the credit represents income that the government never collects. The LIHTC remains “invisible” since monies need not be allocated from the federal budget.

The third major change that occurred in the last fifteen years is the creation of the HOME program, which directly allocates funds to state and local governments, thus giving the local authorities the power to decide which affordable housing proposals to support. This allows the local government to choose which projects are most feasible and allows them to partner with private developers and not-for-profit community development corporations.

While this process has its advantages—in particular more control by local governments and less “interference” by the federal government—one of the difficulties of the current system is its extreme complexity. Developers must apply to several agencies (state and local) in order to achieve total financing for their project. In addition, competition for funding is fierce, especially considering the expertise needed to complete a deal. Although there are few (less than 20) developers who primarily produce affordable housing in Chicago, proposals for funding outstrip funding sources by a three to one ratio.

The Illinois Housing Development Authority and the Chicago Department of Housing rank the allocation of subsidies. These agencies allocate scarce subsidies among developers based on their previous work with affordable housing, project feasibility and local political approval. For newcomers to affordable housing development, navigating the approval process is complex, especially since funding for subsidies is limited.

Recommendations for easing the affordable housing financing gap

In order to close the financing gap and help ease the affordable housing crisis, we offer these recommendations:

- Streamline the financing process. A new public or non-profit agency is needed to serve as an information clearinghouse to help developers and community development corporations package deals and to educate them in their financing options. Streamlining the process is not enough, however.
- To close the financing gap in affordable housing, funding for each program subsidy must be increased.
- Focus attention on the needs of extremely low-income renters where the need is greatest and the supply most wanting. Target some of the Low-Income Housing Tax Credits, the largest housing subsidy program, to this group.
- In addition, provide increased funding directly to CDCs, who may lack sufficient resources to compete with for-profit developers. Adequate program and subsidy funding is essential for developers and community development corporations to access the subsidies that are clearly needed in order to finance affordable housing in Chicago.

This paper addresses the challenges that developers face when they attempt to construct affordable housing. A financing “gap” occurs when either for-profit or not-for-profit developers of affordable housing attempt to finance projects using traditional financing sources. These “traditional” financing sources—such as market-rate mortgages—fail to provide enough financing for developers or Community Development Corporations to raise enough funds to complete an affordable housing project.

The main reason that market-rate tools fail to address the financing gap is the income of the families for which the housing is produced. The lower the income level, the less rent the individual or family can afford to pay. Low rent lowers the rental income of the proposed project. The problem is, then, most acute with respect to building housing affordable for the lowest income families, the population suffering the greatest need for affordable housing in the Chicago area.

Numerous subsidies are required to build any type of affordable housing. It is not unusual for a developer to utilize more than seven different sources of funding. Some developers have referred to the number of subsidies needed in order to reach total financing as the “layered” or “lasagna” method of financing. This method of layering subsidies is common in affordable housing and is necessary in order to help close the financing gap. Most developers currently use a combination of federal money disbursed through local and state governments, a housing block grant program (HOME), and the Low Income Housing Tax Credit (LIHTC). The current system’s complexities are the direct result of changes in housing policy that occurred in the 1980s and early 1990s.

Previous affordable housing programs emphasized public housing as a solution to the affordable housing problem, or relied on production-based models, which were based on federal appropriations and planning. These federal programs began to fall out of favor for two important reasons: (1) they tended to be expensive; and (2) fiscal control of the programs remained in the hands of the federal government.

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In order to close the financing gap, and help ease the affordable housing crisis, it would be useful to streamline the financing process. A public or non-profit agency needs to be developed that would serve as an information clearinghouse to help developers and CDCs both package deals and educate them in their financing options. Streamlining the process is not enough, however. In order to close the financing gap in affordable housing, funding for each program subsidy must be increased. In addition, increased funding must be provided directly to CDCs, who may lack sufficient resources to compete with for-profit developers. Adequate program and subsidy funding is essential for developers and Community Development Corporations to access the subsidies that are clearly needed in order to finance affordable housing in Chicago.

What is affordable housing?

For the purposes of this analysis, the criterion for whether housing is affordable is that the cost of housing (including utilities) is no more than 30 percent of a low or moderate-income family’s gross earnings. This criterion is used when determining loan underwriting and provides a useful and commonly accepted definition for affordability in housing.

Across the nation, the availability of affordable housing has decreased. In twenty-one states, between 40 percent and 49 percent of the population can no longer afford the fair market rent (as determined by HUD) for a two-bedroom apartment. Illinois is one of one of twenty-seven states in which 30 percent to 39 percent of the population cannot afford the fair market rent for a two-bedroom apartment (Joint Center for Housing Studies 2001:23).

The federal government determines what families qualify as low-income, very low-income and extremely low-income. These definitions are based on the area median income. Low-income families earn 80% of the area median; very low-income families earn about 50% of the area median, while extremely low-income families earn about 30 % of the area median. For families across the country who are considered extremely low-income, the likelihood of paying *more* than 50 percent of gross income for housing is extremely high. About sixty-five percent of families across the nation who qualify as extremely low-income—that is they earn *less* than 30 percent of area median income—are considered severely rent burdened. Over 80 percent of extremely low-income households are severely or moderately burdened by housing costs. These families pay between thirty and fifty percent of their income for housing (Joint Center for Housing Studies 2001:22).

For low-income households, rent burdens are not as severe as those affecting extremely low-incomes, but serious rent burdens affect more than thirty percent of this population. Single parents, minorities and the elderly are more likely to be rent-burdened than the rest of the population. Seventy percent of households defined as very low-income are likely to be either severely or moderately rent burdened (Joint Center for Housing Studies 2001:22).

Of course, the lower the income, the less money people have available for rent, which increases the probability that a household will be rent burdened. For example, a family that works at minimum wage jobs and has only one wage earner would have to work 110 hours to afford a two-bedroom apartment in Chicago. For a household that lives in Illinois, but not in the Chicago Metropolitan Statistical Area, the same family would have to work 98 as opposed to 110 hours — still an enormous cost for housing. Even if the family has two wage earners, each earner would have to work an additional 15 hours of overtime a week in order to pay the rent (Chicago Rehab Network 2000).

In the above hypothetical scenario, the two-income family will earn just over \$20,000 a year if each wage earner works full-time. If they are able to find housing that is “affordable” they will be able to pay \$500 a month (including utilities). In the hypothetical, with only one family member working full-time, the amount they will be able to pay in rent is only about \$250 a month. Exceeding this limit would cause the family to be defined as “rent burdened.”

Unfortunately, the average rent in the Chicago area is well over \$700 a month for a two-bedroom apartment (HUD). In order for a hypothetical one-wage earner family to earn enough to pay for rent (without becoming rent burdened), the working member must

increase his/her wages to \$12.58 an hour to afford housing. (Chicago Rehab Network 2001). Even so, this family would only earn just over \$26,000—well below the \$70,500 median wage for the Chicago area. This family, even when they are able to raise their wages to the aforementioned level, still would earn well below fifty percent of the median income. As defined by HUD, this family would still be included in the *very* low-income category.

Low-Income Definitions

Definition of low-income families is dependent on the area median income level (AMI). Currently, the AMI for the Chicago metropolitan area is \$70,500 for a family of four. The Department of Housing and Urban Development categorizes low-income families or individuals as earning 80 percent or below the median income--\$56,000 for a family of four. Very low-income families earn about \$35,250 a year (50 percent of the area median income or AMI). Extremely low-income families earn about \$21,150 a year and are designated extremely low-income because they earn only 30 percent of the AMI. Each of these definitions is based upon a family of four, but adjustments are made for larger and smaller-sized families. The low-income family that earns \$56,000 a year can afford to pay rent of about \$1,500 a month without becoming “rent burdened.” Since the average rent in Chicago for a two bedroom apartment is well below this level, the low-income family (or moderate-income family) will not have a problem finding a unit that is “affordable”.

On the other hand, the very-low or extremely low income family will have a more difficult time securing housing because of two factors: (1) they can afford to pay substantially less for their unit; and (2) there are fewer units available for the very-low and extremely low-income family in Chicago at the present time.

Availability of Units

Although the Chicago metropolitan area population has increased by nearly half a million over the past ten years, rental unit stock decreased by 52,000. This shortfall is exacerbated even more highly in the case of very low-income affordable housing. A recent study by the Metropolitan Planning Council found that, for very low-income families, the demand in the Chicago-land area for affordable housing was much greater than the supply. The MPC discovered that there were 308,200 low-income¹ renters and only 125,700 available units. The gap in low-income housing is about 182,000 units (MPC 1999:32).

Since demand for affordable housing has increased dramatically in the past ten years, why is the production of units so low? If market factors worked (absent subsidies or incentives), one would expect that the supply would rise to meet the shortfall in demand. But the supply of affordable units has not increased. In fact, the Chicago area faces an even greater demand for affordable housing in the next five to ten years, as immigration

¹ In the MPC study, different criteria were used to determine low-income families. MPC defined low-income as 30 percent of AMI, at the time \$20,000 a year.

and the demise of public housing drive up demand to even larger numbers. Over the next five years 18,000 units of public housing will be demolished and this will only aggravate the housing shortage, especially among the poorest of the working poor.

In order to understand why the market does not meet the demand for very low-income affordable housing units it is important to understand how affordable housing is financed. Simply put, since the low-income renter has less money to spend on rent, the rental income anticipated by a developer is not enough to secure loans to create the units. A unit may cost \$150,000 to build. A low-income renter may only be able to pay \$400 a month or \$4,800 a year. Even without interest, tax, and other operating expenses, it is clear from this example of the low-income renter that the developer could not *raise* enough money from rents alone to pay off the mortgage on the property—in the unlikely event that a mortgage was obtainable. How does the developer raise the money to make a project feasible and still provide affordable rents? The difference between what the project costs to build and the income derived from the property can be viewed as the first step of the “financing gap.”

The Financing Gap

Since the low-income property will not generate enough income for the developer to pay for the development, the problem of how to finance the property becomes more complicated. Suppose developer ABC has decided to build an extremely low-income rental building with 20 units—all of which are targeted toward families earning approximately twenty-five percent of the AMI (\$17,635 for a family of four). The units cost \$150,000 each to build and develop (excluding land). The “soft” cost of developer’s fees, architects, and other professionals are also calculated into the cost per unit. The family that earns 25 percent of AMI can afford to pay thirty percent of their gross income for rent without becoming rent burdened. This figure amounts to \$4,800 a year or \$400 a month. In addition, the developer must subtract the operating expenses (taxes, insurance, maintenance, etc) from the anticipated cash flow from rents. Assuming that the building is entirely geared toward those families who earn 25 percent of AMI, then the income generated from a single unit can be illustrated as follows:

Total Income From Rent (per unit) for Family Earning 25 % AMI

Rent per Year	4,800 (\$400 a month x 12 months)
Net Operating Expenses per year	(4,600)
Rental Income (Net Operating Expenses) per year.	200

As the chart indicates, the rental income is practically non-existent when operating expenses are deducted from rents collected in any given year. The developer must borrow the money in order to finance the unit. A bank will generally assume a debt coverage ratio of 1 to 1.25—this means that only about 80 percent of the income generated from rents can be amortized over the life of the loan. Since the bank will only amortize 80 percent of the \$200 dollar income or \$160 (on the unit each year), the bank will loan the developer \$1,945 per unit (assuming an 8 percent interest rate). If we look at the cost of

construction again and the amount of money that can be conventionally financed, it becomes quite clear where the financing gap occurs.

Traditional Financing Structure with Family earning 25 percent AMI

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 1,945 ²
Gap	\$(148,055) Subsidies needed to finance project

Even if the developer uses 20 percent of his own equity, (which is not uncommon for market rate developments), this amount of equity will still not close the financing gap since the shortfall is so large. In addition, the developer would not choose to invest his/her own capital into a low-income housing development because there is very little likelihood of ever regaining the capital investment.

Traditional Financing Structure with Developer Equity

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 1,945
Developer Equity at 20 percent	\$ 30,000
Gap	\$(118,055)

It is clear from this chart that the financing gap is still very large. In fact, without subsidies, the developer would never find it feasible to build this unit—or any kind of affordable housing--simply because the income from rents is so low that there is not enough income to leverage a mortgage which comes close to covering the construction costs. Even with a \$30,000 investment of the developer’s own capital, no traditional bank will lend the developer the funds needed to build the project. The project is simply not economically viable unless there are sources of funds which can *subsidize* this large gap.

This is true even if the wages of the family are substantially higher. If a developer targets his/her low-come development to those individuals making at least 50 percent of AMI (approximately \$35,000) the financing gap is less because the family can afford to pay more for rent. The gap, however, is still quite substantial.

Total Income From Rent (per unit) for Family Earning 50 % AMI

Rent per Year	9,600 (\$800 a month x 12 months)
Net Operating Expenses per year	(4,600)
Rental Income (Net Operating Expenses) per year.	5,000

² Under current banking practices, *current* income is used to determine amortization rates. Although in some aggressive banking circumstances inflation may be added to income and operating expenses, the most conservative strategy is to use the current anticipated income stream.

When a family earns 50 percent of AMI (only *twice* as much as the family earning 25 percent of AMI), the rental income per unit is much higher—over *twenty-five times higher*—because operating expenses are fixed. Since the unit produced \$5,000 in income per year, traditional financing sources will lend the developer more money. For example:

Traditional Financing Structure with Family earning 50 % AMI

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 48,633
Gap	\$(101,367) Subsidies needed to finance project

This assumes that the bank will amortize \$4,000 (1 to 1.25) at eight percent interest for a thirty-year period, a loan amount that totals \$48,633. Even with a rental income that is twenty-five times higher than the family able to pay only \$400 a month, the financing gap is still substantial—over \$100,000.

Even with the added equity of the developer, the financing gap still remains high. Assuming the developer invests 20% of his/her own capital, the gap will only be reduced by about 30 percent. The monies needed to complete the project will still be substantial.

Traditional Financing Structure with Developer Equity

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 48,633
Developer Equity at 20 percent	\$ 30,000
Gap	\$(78,633)

Even after developer equity is invested in the project, as well as a reasonable income derived from rent, the gap is still about half of the total per unit cost. Deep subsidies will still be required to fill this financing gap, so that the project can be built.

After looking over the numbers of development costs, and the income that affordable rents can provide, it becomes quite clear that the market does not support the building of affordable housing units. The approach the developers—both for-profit and not for-profit—currently use requires working with a combination of subsidies to provide funds to close the financing gap. How these subsidies have worked has changed dramatically over the past thirty years. Programs have been created, dismantled, and re-created or changed completely. The following section will offer a brief history of affordable housing programs, along with the current status of subsidy programs and other financing tools that have been created to fill the affordable housing “financing gap”.

1949 To 1973 Federal Government Controls the Money and Means

When Congress passed the Housing Act of 1949 it declared the goal of, “a decent home and a suitable living environment for every American family.” These words were more a

basis for rhetoric than action during the next several years. No mention was made of helping to house the poor or low-income families. Instead the Act was put in place to create more housing in order to ease the post-war housing shortage and to clear away blighted areas and “slums”. The part of the Act that refers to clearing away “blighted areas” led the way for the disastrous urban renewal programs of the 1950s, which destroyed more housing than it built (Orlebeke 2000: 492).

The goal to *produce* more housing was clarified by President Harry Truman, who authorized the building of 810,000 units of public housing over the following six years. Unfortunately, authorization of the building program meant little as Congress failed to appropriate money for the new units. The money appropriated for housing covered only the cost of construction of about 25,000 units. In addition, local authorities had to decide where to build the units, in most cases local battles ensued, and the housing was generally built in the poorest parts of town (Orlebeke 2000: 492-493).

In Chicago, the most noticeable housing produced by the federal government were the high-rise public housing projects. In the 1950s, construction began on many high-rise public housing developments with several public housing developments constructed well into the mid-1960s. These developments helped to concentrate public housing residents on cleared tracts of land, mainly in poor areas of the south and west sides. On the south side, construction of the Dearborn Homes, the Ickes residences, the Ida B. Wells extension, Stateway Gardens, and later the Robert Taylor Homes helped to create the infamous State Street Corridor. The State Street corridor represents an almost continuous thirty-four-block development of public housing, broken only by the Illinois Institute of Technology campus (Bowly: 1978). To many Chicagoans, affordable housing became equated with the monolithic high-rises built by the Chicago Housing Authority. These public-housing developments began to fall out of favor when the problems inherent to concentrating the city’s poor became apparent.

Although the 1960s resulted in high production in public housing in Chicago, the policy emphasis on the federal level was changing from public housing to subsidized housing. Legislation passed throughout the 1960s demonstrated this shift. The focus began to center around subsidies, which could either be augmented by the private market or simply supported by the private sector.

Under the 1961 Housing Act, Section 221(d)(3) was created to allow moderate-income families who didn’t qualify for public housing to qualify for subsidies. Basically, the 221(d)(3) program allowed for lower rents—between fifteen and twenty percent below the market rate—by guaranteeing loans for affordable housing at a three percent interest rate to qualified sponsors of affordable housing. In addition, under the 221(d)(3) program the federal government, under Fannie Mae (the Federal National Mortgage Association Board, a government agency in the business of providing FHA insured loans), bought out the mortgages and paid the banks the difference between the market-rate interest rate and the lower three percent subsidy. The program faced difficulties, however, both from the Treasury and the Budget Office since the subsidies directly impacted the Federal Budget through the buy-out of the below market-rate interest

program. In addition, potential legislative sponsors were not eager to embrace the program because of cost-constraints imposed by the government and a lack of available sites for building (Orlebeke 2000:493).

In 1965, President Lyndon Johnson attempted to rectify the problems of the 221(d)(3) program by initiating the Rent Supplement Program. This program, rather than supplementing interest rates, would provide directly to the project 25 percent of the monetary difference between the tenant's income and the Fair Market Rent to enable lower rents. The Rent Supplement Program targeted the same "moderate" income group as the 221 (d)(3) Program. Congress, however, did not embrace the Rent Subsidy Program, and made no appropriations in the program's first year. In 1966, the program received about half of the money requested by the President. After five years, the program had built only 31,000 units of affordable housing (Orlebeke 2000:493).

One change that indicated the future development of affordable housing occurred in the realm of public housing. Many Public Housing Agencies (PHA) in the central cities were losing population, and more units in the private rental market became available. Since the PHA lacked the authority to lease privately owned apartments, the PHA could not utilize these growing vacancies for low-income tenants. The new Section 23 Leased Housing program was introduced to allow PHAs to lease existing privately owned units and rent them to low-income families. The PHAs offered deep subsidies and for the first time the Public Housing Authorities became linked in a public-private partnership. This beginning would demonstrate the value of the public-private relationship into the future (Orlebeke 2000:494).

Attempts to Mobilize

In 1968, Congress attempted to redress the shortcomings of the 1949 Housing Act since its beginning—its lack of production. Congress wanted to build and build quickly, mobilizing to target 6 million units for construction for low and moderate-income families in the following ten years. The program would be funded through two new programs: Section 235 and 236. Administered by the Federal Housing Authority (FHA), the programs subsidized interest rates for both individuals (235) and developers (236) at an extremely low one percent.

Congress embraced the program, and perhaps even more surprisingly, so did the Nixon administration. It received both funding from Congress and the blessings of the new President. In 1969, 197,000 units began production. New starts for 1970 climbed even higher—to a total of 431,000 units. It was anticipated that new starts in 1971 would result in even more completed units.

While the FHA proved that it could produce units rapidly, after 1971 Presidential support for the program began to falter. Probably the largest concern of the administration was the escalating cost of the program. As more and more units came under production, the cost of subsidizing units began to spiral upward. FHA subsidized not only units currently in production, but every unit already built. For building to continue, the Authority had to continue subsidizing the mortgage rates. During the first year, the costs could be

absorbed without much difficulty. Increasing production of a program that entailed subsidies for the life of each of the loans required large amounts of available cash deducted directly from the federal budget. In addition to concerns about these large cash expenditures, some in the Nixon administration felt that production would not solve the affordable housing crisis. Too much emphasis had been placed on production alone, and not enough to quality, cost, administration of the programs, and the planning necessary to implement a purely production-oriented program.

Other problems also surfaced. Aside from the cost, concerned mayors, HUD officials and housing lobbies (the National Association of Home Builders, the Mortgage Bankers' Association, and the National Association of Real Estate Boards) found that many of the subsidized housing projects had become subject to the problems inherent in public housing. Claims of shoddy development, fears about lack of planning—particularly in large cities—as well as a failure to help low-income families *improve* their housing situation all became complaints around which reform could be targeted. Bi-partisan support for the subsidies waned, and a moratorium on housing starts began in 1973 (Orlebeke 2000:500-502).

Evolution to Local Control and the Public-Private Partnership: Section 8

After the demise of the large, production-based programs of the late 1960s and early 1970s, a policy shift occurred that promoted the public-private partnership. In addition, the shift in policy began to enable local governments to exert more financial control over subsidized housing. One of the first programs signed into law under the 1974 housing act was the Section 8 Program (often referred to as Project-based Section 8), which provided subsidies for construction and substantial rehabilitation of existing structures directly to the owner or developer. In essence, the developer, private or not-for-profit, would build or substantially rehab a multifamily building for low-income tenants. The federal government subsidized the difference between what the family could pay (at that time 25 percent of gross income) and the cost of a HUD-determined Fair Market Rent. Because the subsidy was tied to the project, rather than to the family, the developer could use the subsidies to qualify for financing. The system of Project-based Section 8 allowed for a funding stream that generally could be applied to the life of the mortgage because HUD required the property to be kept low-income for 20 to 30 years. Section 8 enabled the developer to bring the income generated by rents up to a market level, thus qualifying the project for financing, which was generally provided by the FHA.

Developers found it easy to use and qualifying the property to HUD standards was not overly cumbersome. Developers also found the process uncomplicated and the relative ease with which the subsidy could be used helped to facilitate new unit rehabilitation and construction.

The Section 8 Program, in addition to the Project-based funding, included a component resembling the “voucher” system currently in use. Under this program, a low-income family received a certificate that allowed it to find housing in the private market. The family (or tenant) paid 30 percent of their gross income for rent. HUD paid the balance between the cost of the apartment (up to the Fair Market Rent) and what the tenant could

afford. This “voucher” or “certificate”-based Section 8 is one of the only vehicles today that allows a family to “pay” more for rent.

The production programs for Project-based Section 8 were strictly curtailed under the Reagan administration. The new administration wanted to curb social spending and encourage the use of the “voucher”-based Section 8 Program, which had proven to be less expensive than the production or project-based programs. Unfortunately, the movement from a combination voucher/production program to one which only provided vouchers did not expand the supply of affordable housing. It did, however, allow extremely low-income people to “pay more” on the private market. This ability to “pay more” increased the supply of affordable housing to those families who received vouchers. In recent interviews, Chicago-area developers indicated that, Project-based Section 8 is needed, but except for project renewals, the program no longer exists to *produce* rental units.

Community Development Block Grants

The 1974 Housing Act also contained a new program--the Community Development Block Grant--that enabled local governments to have more control over federal funds. Community Development Block Grants provided the first opportunity to allow local governments to decide how to spend federally allocated money. The program consolidated seven programs for urban development into a single block of funds. Unlike previous programs—like urban renewal—which required the federal government to approve a particular local plan, funding under CDBG was automatic (under a formula based on population, poverty rates and other factors). CDBG money could be used for a variety of purposes such as slum clearance and relocation, funds for displaced persons, rehabilitation of housing, and other public services. In addition, CDBG funds had to meet one of the following “national objectives”: (1) benefit people with low or moderate incomes; (2) aid in the prevention or elimination of slum or blight; (3) meet an urgent need (e.g. flood or disaster relief). As long as these objectives are met, the money could be used in a variety of ways as determined by the local government (HUD: 2000).

Eighties Subsidies—End of the Traditionally Structured Subsidy

Two important programs would emerge from the 1980s. The first was the aforementioned Section 8 voucher, and the second the Low Income Housing Tax Credit. While the housing vouchers operated in the same way as they had in the 1970s, the Low Income Housing Tax Credit was a new program without a prototype. Both programs indicated the Reagan Administration’s objective to decrease the role of the federal government and to stimulate the private market for the “common good.”

The Low Income Housing Tax Credit (LIHTC) was enacted in 1986 after changes were made that rescinded the 1981 tax code. The 1981 tax code included changes designed to stimulate growth in a sagging economy, and in the housing market in particular. These changes to the tax code allowed for shortened depreciation schedules for multi-family housing. While the changes in the tax code increased housing production, the shortened depreciation schedules eventually caused a glut in production and led to the later S&L

crisis of the late 1980s. When the tax code was again changed in 1986, many developers of low-income housing were concerned about the future of affordable housing. The LIHTC attempted to give developers an incentive to develop low-income housing, since the new tax code lacked incentives like the shortened depreciation schedules that had spurred the building and rehabilitation of low-income housing. LIHTC attempted to encourage low-income housing production, but used radically different tools than subsidies of the past.

The LIHTC is different than other subsidy programs. First, since it is a tax *credit*; the subsidy does not come out of the federal budget, because it is an *indirect* federal resource. The tax credit represents revenue that the treasury will never see, which has the political advantage of keeping the amount of money funding tax credits out of budget allocations. In this sense, the LIHTC money remains “invisible,” since funding comes from a tax credit rather than from the federal budget.

The LIHTC

The Low Income Housing Tax Credits provide a way of “capturing capital,” so that the developer will have to borrow less in order to close the financing gap associated with affordable housing. The credits are syndicated either by a non-profit (like the Chicago Equity Fund) or by a for-profit syndicator, such as a developer, in order to create equity for the development. The syndicator “sells” the credits to a company that needs the tax shelter. Companies purchasing tax credits, which are a dollar for dollar offset against taxes, use them over a period of ten years. The company invests a very small amount into the development and purchases the tax credit from the syndicator. The tax credits are then converted into equity—the present value of the tax credits over ten years is first calculated and then paid to the developer, which the developer will use to help finance the project.

In order to qualify for the LIHTC, each property must either rent twenty percent of its units to families earning at or below 50 percent of the AMI; or forty percent of the units must be rented to families earning at or below 60 percent of the AMI. The rents charged cannot be more than 30 percent of the individual or family income. In addition, the properties must stay low-income for at least fifteen years or refund the equity (in addition to other penalties). In reality, since the equity produced by the LIHTC is quite large (typically between 50 percent and 60 percent of total project costs), most developers find it easier to target the entire development toward those renters who earn 60 percent or less of area median income, because then each unit will qualify for tax credits. The more units that qualify for tax credits, the more equity the developer will receive from syndication.

Since the tax credits are syndicated, the value of the tax credit to the developer is dependent on the market for tax credits. For example, in 1986 the first year in which the LIHTC was established, the value of a tax credit syndicated through the Chicago Equity Fund (CEF) was only \$.40 on the dollar. In 1998, CEF’s value of equity for the same tax credit had risen dramatically to over \$.80 on the dollar (Chicago Equity Fund Annual Report 1999). In essence, this trend of higher equity values per tax credit means that the

LIHTC is working better now than at its inception, when low-income housing only received 40 percent of the value of the tax credit.

Tax credits are allocated to the states based on the state's population. Currently, the per capita value of tax credits is \$1.50, which means that the state receives \$1.50 in tax credits for each resident of the state (or \$1.50 times the state's population). When the LIHTC was first introduced, the limit was \$1.25 per capita and remained at that level for fourteen years. In 2002, the volume limit will be increased to \$1.75 per capita, thus allowing more tax credits to be used to finance low-income housing. Even so, the demand for housing credit far exceeds the supply. Most estimates of the demand for tax credits are higher than a two to one ratio, and many experts in the field of affordable housing believe that the current ration is closer to three to one.

Since there exists competition for tax credits, developers must compete in order to be awarded tax credits. In order to be awarded tax credits, developers must go through a competitive ranking system where either the state or local financing authority awards points based on previous tax credit allocations, as well as project feasibility.

The HOME Program

The National Housing Act of 1990 created the HOME program. The program is a form of block grant. In Illinois HOME funds may be spent in several ways. These include: 1) rehabilitation and new construction of affordable, multi-family housing; 2) purchase and rehabilitation assistance for homebuyers; 3) rehabilitation of single-family, owner-occupied homes; 4) rehabilitation of rural small rental properties; and 5) rehabilitation and new construction of supportive housing for the homeless. In addition the HOME funds require that state and local governments set aside 15 percent of the money for community-based nonprofits.

Financing Affordable Housing in Chicago

Since the inception of the LIHTC, HOME funds, and Section 8 vouchers, little has changed in the financing of affordable housing. The LIHTC and HOME programs are the primary tools available to developers to fill the financing gap when low-income housing is either built or substantially rehabilitated. Since Section 8 vouchers are portable—the holder of the voucher can choose to move, thus taking the subsidy with them—they cannot be used in the financing of new affordable housing because they provide neither an income stream nor project equity. The other programs that help to subsidize the cost of affordable housing are basically local programs. Together with the LIHTC, HOME monies, and local programs, developers find ways of layering financing options, combining traditional mortgages with subsidies from local authorities, along with the equity from tax credits.

In Chicago, the principal means of financing are derived from HOME funds, LIHTC, and other local programs. The Illinois Housing Development Authority (IHDA)—a state financing agency—generally allocates the *state's* share of HOME funds as well as other programs, including the State Affordable Housing Trust Fund. The State Affordable Trust Funds consist of monies from the real estate transfer tax. A small portion of this tax

is collected by the state and set aside for the development of affordable housing. The Chicago Department of Housing determines who will receive the city's share of tax credits and HOME funds.

Illinois Development Housing Authority

Each state has a financing agency similar to IHDA. IHDA differs from other state agencies in several respects. First, IHDA can issue debt, generally in the form of bonds. These bond funds are made available to participating mortgage lenders, which provide financing (generally at below-market rates) for private and non-profit developers of affordable housing. Second, IHDA is not funded by tax dollars; instead it must generate its own revenue in order to remain solvent. IHDA generates revenue through the selling of bonds, origination of loans, and fees for services in connection with programs like HOME. Although IHDA receives no tax funding, it is still required to support state affordable housing policy initiatives. In addition, the premise behind IHDA is that the agency functions like a corporate entity, making decisions on projects based on the project's ability to tap into private capital, the developer's ability to maintain the project for the long term, and ensuring that properties (whether for-profit or non-for profit) are privately-owned. IHDA can be viewed as a symbol of the public-private partnership and the evolution to local control that has shaped the terrain of the affordable housing landscape.

Competition for IHDA funds is fierce. Several developers as well as IHDA representatives have indicated there are at least three developers competing for every dollar that IHDA finances. Since IHDA prefers to spread its funding over several projects, providing some gap financing—rather than filling the gap completely—most developers must find additional sources of financing. These might come from agencies like the Chicago Department of Housing, which has other local programs that help to subsidize the financing gap. The end result of spreading financing throughout many projects, rather than fully funding a few, is that the financing process becomes more complicated. IHDA believes in the philosophy of having at least three legs of financing—first, a traditional mortgage, LIHTC equity, and then IHDA funds. In reality, however, most developers must look for additional sources of subsidy to close the financing gap.

The Chicago Department of Housing

Another source of funding in Chicago is the City of Chicago's Department of Housing (DOH). While the Department of Housing has an array of different sources of funding, competition for funds remains intense. One of the programs administered by the DOH is the Affordable Rents for Chicago Program (ARC). ARC supplies an interest-free, forgivable loan that can replace up to 50 percent of a developer's private loan. Savings from this program are used exclusively to subsidize families that earn no more than thirty percent of the median income. DOH offers other programs; generally these are similar in nature to IHDA's. One difference is DOH's ability to provide land acquisition at no cost for community development corporations or developers who are interested in building affordable housing. The Department of Housing also may approve parceling of vacant land for acquisition, and provide free demolition of blighted properties. The City's Department of Housing has other tools which it may use to help lower the cost of

financing affordable housing such as Tax Increment Financing (TIF) funds and Enterprise Zone funds. Both TIF and Enterprise Zone funds are available only if the developer or community development corporation builds in an area that is either designated as a Tax Increment District or an Enterprise Zone.

Closing the Financing Gap

For many developers who either rehabilitate or build affordable housing, the only solution to the financing gap is to try to locate all sources of money available. This makes the process complicated and most developers who enter into the affordable housing business find that they need to hire a consultant to navigate the terrain of financing options. Even if the developer or CDC proposes to use every potential funding source available to them, there is no guarantee that the various organizations that control funding—IHDA or the Department of Housing—will approve the development. As mentioned earlier, the competition for subsidies is fierce and even application for Low Income Housing Tax Credits does not mean that a developer will be automatically approved (they are more likely to be declined). In addition, the developer must pay attention to the political environment of the development. If political support is lacking, the project may not receive subsidies.

The result of the public-private partnership is extremely complex financing. To fully finance an affordable housing project, the developer must layer as many levels of subsidies as possible – sometimes from six or more financing sources. This adds to the complexity of closing the financing gap as proposals must be submitted to several sources in order to receive financing. Currently, no agency exists that acts as a “clearing house” for affordable housing financing—although organizations like the Local Initiatives Support Corporation will aid community development corporations in packaging their deals so that their proposals will more likely be accepted.

To illustrate how these subsidies work to close the gap, we return to the chart demonstrating the need for subsidies for a family earning 50 percent of area median income.

Traditional Financing Structure with Family earning 50 % AMI

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 48,633 (\$4,000 rental income per year amortized for thirty years at 8% ³)
Gap	\$(101,367) Subsidies needed to finance project

In the above chart, conventional financing provides almost thirty percent of the cost per unit. LIHTC credits generally provide about 50 percent to 60 percent of the project’s cost, substantially narrowing the gap.

³ This figure assumes \$800 a month rent minus operating expenses. Annual income derived from rents after operating expenses is \$5,000, bank will amortize \$4,000 based on 1:1.25 debt coverage ratio.

Financing with LIHTC and Conventional Mortgage with Family Earning 50% AMI

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 48,633 (\$4,000 amortized for thirty years at 8%)
LIHTC Equity	\$ 78,266 ⁴
Total Financing Sources	\$ 126,899 (\$ 48,633 + \$78,266)
Financing Gap	\$ (23,101)

In order to close the balance of the financing gap, the developer must find additional sources of funding. Generally these must be at a reduced or zero percent interest rate because the income derived from rents will be used to pay the first mortgage. The IHDA loans require no interest payments. Additionally, these kinds of loans generally are repaid after the thirty-year term, with the “balloon” payment paid out of the proceeds of either sale or refinancing. Mortgages of this kind are generally referred to as “soft” mortgages—meaning that foreclosure on the property for lack of payment is unlikely.

Another financing structure follows.

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed (1 st Mortgage)	\$ 48,633 (\$4,000 amortized for thirty years at 8%)
IHDA Affordable Housing Trust Fund (2 nd Mortgage)	\$ 25,001 (0% for thirty year term)
General Partner Capital	\$ 100
LIHTC Equity	\$ 78,266
Total Financing	\$ 150,000

This financing structure requires only four layers to close the financing gap because the income derived from rents is relatively high, thus increasing the amount of the first mortgage. In addition, the developer did not locate the property in a TIF district or an Enterprise Zone, which lowered the number of financing layers. Also, the developer could not call on several programs aimed at extremely low-income families because the property was developed for those earning 50 percent of the median income. The primary reason why the financing required only four layers is that the financing gap was relatively small.

Closing the financing gap becomes more difficult as developers attempt to target extremely low-income families. The chart below demonstrates that the amount conventional lenders would loan offers very little capital towards closing the gap.

Traditional Financing Structure with Family earning 25 percent AMI

Construction/Rehabilitation cost per	\$(150,000)
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⁴ Assuming a nine percent tax credit, each credit net value \$.80 on the dollar for ten years. This number represents the present value of the ten-year funding stream converted into capital.

Unit	
Amount Conventionally Financed	\$ 1,945 (\$200 rental income per year amortized for thirty years at 8% ⁵)
Gap	\$(148,125) Subsidies needed to finance project

In this hypothetical the subsidies required to finance the project are very close to the actual cost per unit because the income from rents is practically negligible after operating expenses have been deducted. In order to close the financing gap on a project with so little rental income the developer must utilize every program available for extremely low-income individuals. In the hypothetical, it is possible to close the financing gap even for extremely low-income families. But the reality of obtaining financing is less certain since deeper subsidies are required and the complexity of layering these subsidies makes financing the project much more difficult. Every agency that the developer or community development corporation applies to for funding must approve the deal. Since funds are limited, it is very challenging to finance the affordable housing deal for those who make 24 percent of area income. In addition, IHDA and the Department of Housing weight their formulas to favor mixed-income developments.

If the LIHTC are granted, then there exists a chance for this hypothetical scenario to be financed. The tax credits will provide between fifty and sixty percent of the project's costs, just as they did with the family earning 50 percent of the area median income.

Financing with LIHTC and Conventional Mortgage with Family Earning 25% AMI

Construction Cost per Unit	\$(150,000)
Amount Conventionally Financed	\$ 1,945 (\$200 amortized for thirty years at 8%)
LIHTC Equity	\$ 78,266 ⁶
Total Financing Sources	\$ 80,211 (\$ 1,945 + \$78,266)
Gap	\$ 69,789

Here the financing gap has been reduced. It is clear, however, that much deeper subsidies are required to close the financing gap for the family who earns 25 percent of the area median than for the family who earns fifty percent of AMI. Some Chicago programs are targeted at families earning less than 30 percent of the area median. Following are the programs that could help to fulfill the financing gap in the above hypothetical scenario.

Total Subsidies Required per Unit Targeted Towards Families Earning 25% AMI

Construction/Rehabilitation Cost per Unit	Position	Term	\$(150,000)
Amount Conventionally	1st	30	\$ 1,945 (\$200 amortized for

⁵ This figure assumes \$400 a month rent minus operating expenses. Annual income derived from rents after operating expenses is \$200, bank will amortize \$160 based on 1:1.25 debt coverage ratio

⁶ Assuming a nine percent tax credit, each credit net value \$.80 on the dollar for ten years. This number represents the present value of the ten-year funding stream converted into capital.

Financed		year	thirty years at 8%)
DOH/ARC funds			\$ 7,431
DOH (HOME funds)	2nd	30 year	\$ 35,484
IHDA (Affordable Housing Trust Fund)	3rd	30 year	\$ 24,193
DOE/Com Ed (energy)	Grant		\$ 2,581
General Partner Capital			\$ 100
LIHTC Equity	Equity		\$ 78,266 ⁷
Total Financing			\$ 150,000

In the above hypothetical scenario, seven layers of financing were required to close the financing gap. The developer had to deal with four separate agencies: (1) the Chicago Department of Housing; (2) the Illinois Housing Development Authority; (3) the Department of Energy; and (4) the Equity Syndicator. In order to achieve total financing for the project, the developer had to assure each agency that the project could be adequately financed, that need existed in the purposed project area, that the developer had a reputation for working with affordable housing programs in the past, and guarantee that the project would be built in a timely and cost efficient manner. In addition, the developer had to have the consent and political support of the alderman, the community, and other interested parties.

Each layer represents a different program. For example, the DOH program referred to as ARC—Affordable Rents for Chicago—is targeted at families earning less than 30 percent of the area median income. The IHDA-run Affordable Housing Trust Fund is targeted at low and very-low income families and is funded by a portion of the state real estate transfer tax, the tax collected when properties are bought or sold. HOME funding comes directly from the Department of Housing (but is financed by the federal government as housing block grant). The Department of Energy in combination with Commonwealth Edison grants money if the developer uses energy-efficient appliances and state-of-the-art heating and cooling systems. The tax credit equity is syndicated on the open market (but is not guaranteed until the DOH or IHDA awards them). This combination of different sources of funding and program subsidies is often referred to as “lasagna” or layered financing.

In actuality, complex deals may have even more layers than the seven listed in the above hypothetical. The array of financing options can be overwhelming and their combination is a daunting task for all but the most seasoned experts. Included in the array of financing options are tax-exempt bonds (which lower the amount of tax credit which can be allocated to the development if used in conjunction with each other), CHA housing loans, TIF funds, and an array of other tools. Some of these financing tools may be applicable only to a particular population such as the elderly, disabled, or even for extremely low-income TANF teenaged mothers. In addition, a pool of resources exists for developing

⁷ Assuming a nine percent tax credit, each credit net value \$.80 on the dollar for ten years. This number represents the present value of the ten-year funding stream converted into capital.

former public housing developments (HOPE VI), and these are generally used in combination with TIF monies and Chicago Housing Authority building and financing loans.

The complexity of developing and financing affordable housing is not the only reason why developers may be hesitant to delve into the affordable housing field. Aside from packaging the financing of the project, developers find that affordable housing is more expensive to build with less money to be made in an individual deal. In fact, many developers either defer their fees or write down their costs in order to finance an affordable housing development. Even so, competition for affordable housing subsidies remains high although more money can (currently) be made in market-rate developments as real estate prices in Chicago have been on a continual upswing for the last several years. Market-rate developments take much less time to build than affordable housing developments, since developers need not submit proposals to several governmental agencies in order to achieve total financing. Another factor that makes the financing and developing of affordable housing projects more difficult is the income verifications of tenants that developers must provide on a yearly basis. Many developers fear the long commitment that developing affordable housing requires—most subsidies require the development to meet the affordable housing commitments for at least fifteen, but more often, thirty years.

Mixed-Income Developments

At this juncture some funding agencies grant extra points to developers who propose to build mixed-income developments. These kinds of projects entail the highest degree of complexity since tax credits cannot be applied to the entire project, nor do the market-rate units subsidize the below-market units, some of which may be targeted at those earning less than 30 percent of AMI. Developers report that market-rate rental units in mixed-income developments must rent for *below* the actual market-rate in order to attract residents who earn median income or higher, particularly in the early stages of the development. In interviews some developers indicated that many high-wage earners may be anxious about living in a mixed-income development, particularly when it includes some former public housing residents, or if the development is located near a public housing development. In this case, the incentives used to attract the higher-income wages must come in the form of lower rents.

As mixed-income developments begins to flourish, and as nearby public housing high-rises are razed, more high-income individuals and families can be expected to be attracted to the new mixed-income developments. This is evidenced by the upward trend of townhouse pricing near the Cabrini Green public housing projects in Chicago. In addition to below-market rents, mixed-income developments must offer a desirable location in order to attract higher-income renters.

Financing Smaller Developments

The same problems cited in building (or rehabilitating) larger developments exist on the small scale. The complexity of financing options operates in the same manner as in

larger developments and, since financing small developments is just as costly and time consuming, most smaller developments are left to community development corporations. Currently, IDHA's ranking system does give additional points to non-profit community development corporations. If small developments were further encouraged, it would help to provide more choices for affordable housing and help to stabilize low-income neighborhoods.

Recommendations

Are Current Subsidies Enough?

The list of existing programs that subsidize affordable housing is lengthy, but do they provide enough money to fill the affordable housing gap? The answer to this question can be answered simply by comparing the number of units produced in Chicago to the current need. According to the Chicago Rehab Network, the Chicago Department of Housing built or preserved only 971 rental units during 2000, with 67 percent of these units created exclusively for seniors. The National Equity Fund estimates that IHDA created an additional 500 units in 2000. Between these sources the total is less than 1,500 units in the year 2000, 650 of which were designated solely for seniors. In order for extremely low-income residents to not be rent-burdened, nearly 150 *thousand* units must be available at much lower rents. (MPC 2000).

The shortage of housing for extremely low-income renters demonstrates the need for more funding to help house this group. Since the LIHTC provides the largest subsidy of any program by far (generally subsidizing between 50 and 60 percent of the development project's costs), it should target some of the tax credits exclusively towards extremely low-income people. This strategy makes sense when one considers there is a 23surplus of housing for those who earn around 60 percent of the AMI. An expanded LIHTC is more easily defended politically as it represents a tax expenditure rather than an additional outlay.

Streamlining the financing process is one of the necessary components in easing the affordable housing crisis. The complexity of closing the financing gap can be overwhelming, particularly to a developer or community development corporation that is new to affordable housing. A clearinghouse that could package deals and provide information on the financing options available to developers would help to make this complicated process easier. The clearinghouse would have to be either tax-funded or not for profit in order to reach the most potential clients—CDCs and developers.

Most important, additional funding is needed whether in formulating new programs or funding current ones. Simplifying the process would make it easier for more developers to enter the affordable housing field but, without an increase in funding, a clearinghouse would simply provide more competition among developers, rather than creating more units. In addition, many developers have stated that another Project-based Section 8 Program would help to spur low-income housing development. Another solution would be to increase the number of vouchers available to those who earn less than 30 percent of area median income. Since an oversupply of housing exists in the 30 percent to 80

percent AMI range, extra vouchers would allow the extremely low-income families to access this supply of housing that is currently out of their financial grasp.