

LIMITED-EQUITY COOPERATIVES FOR LOW-INCOME HOUSEHOLDS: A REVIEW OF IMPLICATIONS

Marc T Smith

Abstract

This study provides a dialog on the implications of limited-equity cooperatives as a home ownership option for low-income households. Recent changes in several market factors have contributed to an increased interest in such options. Among them are the Tax Reform Act of 1986, federal cutbacks in housing programs, and the potential for lost housing stock through expiration and foreclosure of rental subsidies. Congress, the Presidents Commission on Housing (1982), and the National Housing Task Force (1988), have all encouraged such alternatives. The data indicate that from a cash flow perspective households that are both high-income and high-tax bracket should be owners while low-income households should be renters. Through the use of a hypothetical model, the financial considerations for both owners and renters are examined as well as the household benefits of converting a multifamily dwelling into such a cooperative. The cost differences relate primarily to taxes and the investment assumptions of the cooperative. The prospects of ownership conversion would improve if equal access to capital markets were assured by the government. For cooperative members short-term savings are obtained by a more stable tenant population and by taking on more of the maintenance than would a renter. Long-term benefits are garnered through a marked decrease in finance-related expenditures which roll back member enrollment costs in the long run.

Introduction

A large number of low- and moderate-income households are renters. This is in part because federal housing subsidy programs have predominately supported the construction and occupancy of rental housing. Yet, interest in low-income home ownership has increased recently. Home ownership opportunities for public housing occupants have received particular attention through bills introduced in Congress and under the aegis of the President's Commission on Housing (1982). Articles in the popular press (Noble, 1987; Wooster and Fund, 1987; Lublin, 1985) have highlighted successful experiments in tenant management of public housing. The Kenilworth Parkside development in Washington, D.C. is one example. These articles focused on legislative attempts to sell such alternatives. Also noteworthy is a Department of Housing and Urban Development demonstration program in which some 20 housing authorities are exploring the feasibility of converting public housing units to owner occupancy. Interest in home ownership opportunities is not limited to the public housing stock. In 1988 the National Housing Task Force recommended examination of the potential for low-income home ownership:

The Task Force further recommends that particular attention be devoted to enabling low-income families to buy homes and to assist low-income owners in preserving and rehabilitating their dwellings. Government expenditures in support of low-income home purchase constitute a sound investment in families and communities. Rehabilitation assistance to low-income home owners can reduce substandard housing and contribute to neighborhood preservation efforts (p. 71)

Marc Smith is an Assistant Professor in the Department of Finance, Insurance, and Real Estate at the University of Florida in Gainesville.

This interest in low-income home ownership has occurred at the same time that new authorizations of rental units under federal subsidy programs have been cut back. Various housing agencies have been examining alternative programs as a result.

Within the subsidized housing stock there is a substantial inventory of publicly-assisted but privately-owned units. Many of these may be lost to the low- and moderate-income housing inventory over the next 15 years. For some of these, conversion might be an alternative. Since 1961 some two million units have been built by private and non-profit entities through below-market interest rate loans and other subsidies (National Low Income Preservation Commission, 1988). A number of owners of these units become eligible to prepay their mortgages over the next 15 years. The peak should occur between 1991 and 1995. These units will no longer be restricted to low- and moderate-income occupancy and may become free-market units. Other units may be lost to the low- and moderate-income inventory due to expiration of rent subsidies, foreclosure, and other factors.

In addition, changes in the tax law in 1986 reduced the advantages of rental property ownership for investors. The ensuing increase in rents is likely to make ownership a financially viable alternative for more households (Hendershott, 1987).

One form of ownership is the limited-equity housing cooperative. Ellenbecker and White (1987) considered the question "Can limited-equity housing cooperatives be an acceptable home ownership alternative for moderate-income people unable to purchase conventional fee-simple units?" Their conclusion was yes. Implicit in that study is the assumption that home ownership is preferred to rental occupancy.

Limited-Equity Cooperatives

Advocates of cooperative housing cite several positive life-style changes that may result from participation in a limited-equity cooperative. These include advantages such as control of a housing unit, security of tenure, and potential cost reductions in operation and maintenance (Martineau and Smith, 1986). A limited-equity cooperative does not treat the ownership interest as an investment (Kirkpatrick, 1981). Instead, it limits the appreciation that shareholders can realize from the sale of their units so that units remain affordable to future low-income owners (Shabecoff, 1987).

The operation and perceived advantages of limited-equity cooperatives were detailed by Gilderbloom and Applebaum (1988) as follows:

Cooperatives with resale restrictions offer a useful example of attractive multifamily community-based housing, since they provide many of the guarantees ordinarily associated with home ownership. These guarantees include protection against rising capital costs, equity accrual, tax advantages such as interest deduction, eviction protection, reduced maintenance costs, lowered turnover, and –perhaps most importantly– a community sense of "we-ness." As a result upkeep is typically superior to ordinary rentals, while the incidence of crime is typically lower.

Cooperatives are operated through a nonprofit corporation which holds a single mortgage on the property. The corporation is democratically run, with an elected board of directors. Under typical arrangements, each new owner purchases a share for a minimal down payment. Monthly payments include each owner's share of the common mortgage, plus a fee for maintenance and operating expenses. When an owner wishes to move, she or he sells the share back to the cooperative, which resells it to a new owner. Since the whole process takes place within the cooperative corporation, no new financing or real estate fees are involved.

The cooperative is termed "limited-equity" because appreciation in the value of each member's share is limited by common agreement to a low level. Cooperative members cannot sell their shares for what the market will bear. In this way, the sale price of units quickly falls below the market price for comparable housing. While a typical home or condominium is sold and refinanced at ever-inflating prices many times over its life span, a limited-equity cooperative is never sold. The

original mortgage is retained until it is fully paid off, at which time the monthly payments of the owners decrease to the amount necessary to operate and maintain the units (p. 188).

Thus, the fees paid by a cooperative occupant include the prorated share of mortgage payments and operating expenses. Consistent with arguments in favor of home ownership, cooperatives are viewed as creating a sense of pride, security, and community. When coupled with the assured tenure and the ability to control costs which are directly passed through to members, the result may be reduced maintenance costs, lower turnover, and lower crime rates. Limited-equity implies that the value of a member's share is limited to a level or index by agreement, which insures affordability for future purchasers.

A Cash Flow Approach

A simple, cash flow approach may be used to examine whether a household might benefit financially from participation in a limited-equity cooperative as compared to rental tenure. The process considers income and operating expenses, taxes, and equity and mortgage financing.

Income and Operating Expenses

In a rental building, the rental rate of a given unit must be high enough to meet all expenses and assure a minimum profit to the building owner. In the limited-equity cooperative, shareholders receive a limited, one-time return on investment. In both cases vacancies reflect unit turnover and the demand side of market conditions. Operating expenses for both systems include such elements as property taxes, insurance, utilities, advertising, management fees, maintenance, and repairs. Here, a cooperative may provide cost savings through a reduced turnover rate. That is, fewer maintenance and repair expenses may result from decreased turnover and, consequently, lower the overall cost of upkeep and maintenance for the property.

Henderson and Ioannides (1983) developed a theoretical framework for analyzing the own-versus-rent decision. It initially excludes consideration of taxes and other institutional factors. They show that an externality exists in rental housing which results in the preference to own over renting at all income levels. This externality results from a landlord being unable to charge a tenant directly for the wear and tear of their occupancy. This necessitates a high rate of utilization for the property.

Linneman (1985, 1986), however, finds that landlords may have certain economic advantages. He defines the concept of relative landlord efficiency:

Relative landlord efficiency may derive from superior credit ratings, greater political influence which yield lower tax assessments, maintenance cost efficiencies, or economies associated with processing a landlord's credit application versus that for a home owner. Particularly in multifamily structures and dense neighborhoods landlord production costs may be substantially lower than those of home owners due to the fact that landlords can solve a number of free rider problems (p. 233).

Several empirical studies have examined the home maintenance investments of both owner occupants and renters. Ozanne and Struyk (1976) compare owner-versus-renter occupancy for the existing housing stock. They cited the common arguments of owner advocacy: owner-occupants can screen themselves as good or poor tenants, they know their future demand for housing, and they can make investment and management decisions based on this knowledge. Owner-occupants can also purchase their own labor at below-market rates. On the other hand, investor-owners have greater ability to bear risk, can purchase some items at discount, and have professional management expertise and skilled workers.

Ozanne and Struyk find little difference between the level and quality of maintenance attained by owners and renters. However, owner-occupants who had incomes below \$7,500 in 1972 assumed more of their own maintenance than tenants of the same income. In discussing policy implications, the authors argue that though low-income households may benefit from owner-occupancy, providing such housing would be

more costly to the government than present rental options. Struyk (1977) finds that though the case for government intervention to encourage home ownership is not strong, there are benefits. The primary benefit of home ownership for low-income households is from superior maintenance. Other benefits include neighborhood stability and community involvement as demonstrated by political activity.

Galster (1983) further explores the question of whether owners demonstrate a higher willingness to do maintenance. His study examined single-family, detached dwellings and found that owner-occupants had taken on more of the maintenance duties and had fewer housing problems. When stratified by income, the willingness of owner-occupants to do maintenance and the condition of the building was greater at lower income levels. Low income was defined as below the sample median of \$11,000 in 1975. Explanations advanced by Galster include: 1) a smaller opportunity cost for time spent in maintenance compared to professional labor, 2) status achievement, and 3) attachment to a neighborhood with its attendant peer pressure.

Porell (1985) studied owner-occupant landlords and the claim that they maintain units better than absentee landlords. Among the factors that may lead to better maintained units are greater awareness of problems, the deterrent effect of being on site, decreased value placed on personal labor services in an opportunity cost sense, pride of ownership, and a comparative advantage in tenant selection. His empirical work provides qualified support for favoring landlord residency in buildings of four or fewer units. The preference was primarily related to nonmechanical aspects in the quality of the facility.

Taxes

Shelton (1968), Buser and Sanders (1983), Litzenberger and Sosin (1977), Johnson (1982), Rosen (1979), and Hendershott and Shilling (1982), have examined the own-versus-rent decision in relation to the marginal tax bracket of the household. The general conclusion from these studies is that the tax advantages available to home owners and landlords provide strong incentives for ownership to households that are both high-income and high-tax bracket. Low-income households, because their tax bracket implies that they achieve little tax advantage from home ownership, should be renters. As renters they can capture the tax advantages passed-through to them by high-tax bracket landlords who take advantage of the deductibility of depreciation, interest, and property taxes. For example, Henderson and Ioannides (1983) find that taxes and capital-market constraints must be utilized to overcome the externality of rental property and explain rental tenure by low-income households.

An individual's marginal tax bracket, however, is not a perfect predictor of household tenure. Other factors may influence the choice to rent or own. These include a household's expected mobility, and their ability to repair and maintain a home. These factors may help to explain why some higher-income households might rent.

Changes resulting from the Tax Reform Act of 1986 have increased the advantage of home ownership because of reductions in the tax shelter benefits for rental property ownership. Hendershott (1987) finds that households that currently rent will find home ownership more attractive under the new law. Households in a \$13,000 to \$25,000 income range will find a 10 percent decrease in the cost of owning and a 10 percent rise in rents. Offsetting this increase in the advantage of ownership is a low-income housing tax credit for rental housing, as discussed by Carlisle (1987), Goldstein and Edson (1988), and Haight (1988). This program is limited to a statewide cap in credit dollars available. Without the low-income tax credit, tax advantages may be a less compelling reason for investors to provide rental housing for low-income households than in the past.

Equity and Mortgage Financing

Other than a security deposit, renters do not make a down payment on their units; nor do they directly pay debt service on a mortgage. Rental rates do indirectly cover these expenses of course. Thus rental rates are set to assure that the investors earn a fair return on the equity investment. At some point, the investor sells the property for a price reflecting the capitalized value of future cash flows. This price likely leads to a larg-

er mortgage, higher mortgage payments, and rent increases, providing the market will bear it.

While mortgage payments rise with the sale of a rental property, this type of increase is averted for a housing cooperative because the dwelling remains under the ownership of the cooperative. Further, the cooperative is a nonprofit organization. Consequently, monthly fees do not include an investor profit. Return on members' investments are derived from the sale price of their shares. Cooperative members must make a down payment in the form of a share purchase. This represents an expense in terms of an opportunity cost. And while less than in a home purchase, it is more than a renter pays as a deposit. Some members may need to finance their share purchase. Until recently, market constraints have made such financing difficult to obtain. These constraints existed, in part, because many lenders did not have experience in lending to cooperatives. Additionally, a cooperative share does not provide collateral for a loan in the same manner as privately-owned property. Another factor was that cooperative corporation mortgages took precedence over other mortgage financing should a member default (Martineau, et al., 1981). Finally, the mortgage interest rate for the cooperative mortgage may be higher than that available to the private investor. This may be due to a perception of higher risk. The risk is partially due to the fact that a delinquency by any member can force other members to pay higher fees for debt-service payments. The cooperative may maintain reserves to counteract part of this risk.

Cooperative and Rental Costs: Illustrative Building

Haight (1988) analyzed the purchase of an existing low-income rental building and its occupancy. He assumed the property took advantage of the low-income housing tax credit set at four percent over 10 years and available since the 1986 Tax Reform Act. He found that the internal rate of return for a limited partner was over 23 percent. This rate of return was assumed to be sufficient to attract investment. Haight's assumptions about the building for calculating this return are in Table 1. Based on a 100-unit building, the calculated rent was \$321. I assume a 92 percent occupancy rate and that operating expenses were 40 percent of effective gross income. These assumptions were based on data from *Experience Exchange Report, Apartments* (1988).

Table 2 shows the monthly costs for a member in the same building as a limited-equity cooperative when operating expenses and mortgage terms are assumed to be the same for either a rental or cooperative building. For a 100-unit building purchased for \$2,700,000 with a \$2,000,000 mortgage, the initial investment would be \$7,000 per cooperative member. If, upon leaving, the cooperative only returns a member's initial investment, the cost of using those funds is comparable to the opportunity cost of alternative investment vehicles. Seven percent is assumed and is similar to a savings account.

Marcuse (1972) notes that home ownership as an investment for low-income households is characterized by low-quality properties, inaccessible information, high risk, loss of liquidity, and a consequent need for a high rate of return. Since the loss of liquidity for these funds may warrant use of a higher interest rate, a second case is illustrated at 12 percent. This rate may also be appropriate if the down payment is borrowed. In the study, members are assumed to be in a 15 percent tax bracket for the calculation of tax savings.

In this case cooperative home ownership only costs \$7 more per month than the \$321 rental rate. This amount could possibly be saved if vacancy, operating, and maintenance costs were reduced. Using the higher rate for down payment and closing costs, the difference becomes \$37 per month. If households are not able to take advantage of the available income tax deductions, then the difference increases by another \$31.19. Mortgage costs may be higher if the cooperative is unable to negotiate comparable mortgage terms to the rental investor. Offsetting these factors, and not reflected in the one-year expenses, are the long-term advantages that the cooperative enjoys by not refinancing the mortgage or increasing the equity investment required through the sale of the building. From a member's perspective, limited equity may imply that there is an indexed increase in the equity returned on the sale of the member's share to the extent

market conditions allow. This could reduce the opportunity cost indicated in Table 2.

Table 1. Assumptions for low-income rental housing project using tax credits

Cost of Apartment Complex (Land = 250,000)	2,500,000
Equity Contribution	700,000
Mortgage (10%, 30-year amortization)	2,000,000
Commissions, Fees, and Organizational Expenses	200,000
Net Operating Income, Year 1	212,000

Table 2. First-year expenses cooperative tenure

Expenses	Total	Monthly Per Unit
Operating Expenses	\$141,667	
Vacancy and Collection Losses	30,797	
Debt Service	210,613	
Subtotal	\$383,071	319.22
Down Payment and Closing Cost at 7 Percent	49,000	40.83
at 12 Percent	84,000	70.00
Tax Savings at 15 Percent		
Interest (\$199,500)	29,925	24.95
Property Taxes (\$50,000)	7,500	6.25
Total Monthly Expense at 12 Percent		328.86
		358.03

Summary and Implications

The analysis presented above is a simplified analysis of an existing 100-unit residential building. Assuming that no major rehabilitation expenditures are necessary to upgrade the building and that it is to remain accessible to low-income households, the case shows the difference between costs for an owner and a renter. Cost differences relate primarily to taxes and the investment assumptions in the case of the cooperative.

Other assumptions would obviously influence the divergence between owner and renter costs. If the building were to be newly constructed or substantially rehabilitated, for example, a large tax credit would be available for rental use. The need to set up a cash reserve for unanticipated expenses may warrant the slightly higher rates for members. Many other factors may affect the analysis. Among these are assumptions regarding the rate at which operating costs rise; appreciation in the value of the property, availability of below-market interest rate loans; down payment requirements; initial purchase price; vacancy rates; and the rate of return required on equity.

There are three potential advantages to this form of multifamily building ownership:

1. Interest in the nonfinancial benefits of home ownership for low-income households is growing.
2. Changes in tax law add incentive.
3. Urgency spawned by the potential loss of a number of units from the low- and moderate-income housing stock.

These potential advantages warrant a reevaluation of cooperative housing alternatives. Smaller buildings may provide the best opportunity for cooperative conversion because the potential income and operating benefits for these are the greatest. The nature of the tenants is also important with respect to maintenance and for tax and financing purposes. Governmental efforts to provide access to capital markets on an equal basis with rental investors and to equalize mortgages rates and terms could improve the prospects of ownership conversion.

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