Investors, Developers, and Supply-Side Subsidies: How Much is Enough?

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Abstract

This paper examines the recent history of supply-side subsidies. The first section describes the programs that have had a major impact on the supply of low-income housing over the last 20 years. The second section looks in some detail at the recent history of tax subsidies to low-income housing and attempts to quantify their magnitudes. The third section presents some data on recent syndication deals to shed light on the return rate that seems to have been required in recent years to attract private investors into low-income housing. The final section turns to the literature on rent-seeking behavior and proposes a more efficient way to subsidize low-income housing production.

Supply-side housing policy since 1970

The first major federal effort to improve housing conditions was, of course, the low-rent public housing program established in 1937. The program was aimed both at poor housing conditions and at a depressed economy and construction industry. Until 1969, essentially all capital financing under the program came from the federal government in the form of loans, outright grants, and long-term debt service payment contracts. Operating expenses, with a few exceptions, had to be met by local housing authorities out of rent receipts. After 1969, the federal government began to pick up any excess of operating expense over rent, providing little incentive for efficient operation.

Beginning with the "turnkey" project in 1965, the private sector participated in the public housing program, but that participation was limited to contracted construction or management services. Private investors always participated to the extent that they bought tax-free bonds to finance projects, but those bonds were, and are, essentially risk free. Since the local issuing authority entered into a long-term agreement with HUD for interest and amortization, local housing authority bonds were virtually as secure as U.S. treasury bills.

The first program designed to attract private investor/developers was enacted as Section 221(d)(3) of the Housing Act of 1961. The act provided for below-market loans to nonprofits, limited dividend corporations, or cooperatives for the construction of modest housing for lower-middle-income households. The idea was that the subsidy would be split between the landlord/developer, who bore a somewhat higher risk by investing in lower income housing, and tenants, who paid lower rents.

Section 221(d)(3) was eventually replaced by two new programs, a rental assistance program (Section 236) and a homeownership program (Section 235); both were added to the housing law in 1968. Under Section 236, the developer obtained a mortgage loan at market rates, and HUD contracted with the landlord to pay a monthly rent subsidy equal to the difference between costs (operating, debt service, and amortization) and either 25 percent of tenant income or a "basic rent" (operating costs plus debt service and amortization on a 1 percent mortgage). In essence, the developer financed the project with a 1 percent mortgage and passed on the savings to tenants. Section 235 was similar except that the units were owner occupied, and the subsidy was paid to help defray the carrying costs of a conventional mortgage.

In 1974, Congress added the Section 8 program that has been the centerpiece of federal involvement in housing ever since. On the demand side, eligible households (essentially households with incomes below 50 percent of the area median) received a certificate that entitled them to approved housing in exchange for 30 percent of their incomes. Participating private landlords received the difference between that amount and "fair market rents" from the government. Fair market rents were set by HUD.

While Section 8 is essentially a demand-side program, there were plenty of incentives for private landlords to participate. Originally, Section 8 was made up of three separate programs: existing, new construction, and substantial rehabilitation programs. Developers who contracted to build or rehabilitate a project received a guarantee of virtually 100 percent occupancy at a fair rent as well as some ability to choose tenants. Since Section 8 was never an entitlement program, recipients queued for certificates. However, the real key to participation on the supply side lay imbedded in the U.S tax code, the subject of the next section.

The Section 8 new construction and substantial rehabilitation programs have now been cancelled, and more transportable vouchers have been introduced that can be used to help pay for housing rented by voucher recipients in the private market.

Also enacted in 1974 was Section 11b (part of an amendment to the 1937 National Housing Act). Section 11b authorized local housing authorities "or their instrumentalities" (housing finance agencies, in most states) to issue tax-exempt notes and bonds to finance low- and moderate-income housing projects. Tax-free financing has made it possible for agencies to offer mortgages at rates that have varied between 65 and 80 percent of the market rate.[1]

While all these programs played a role on the supply side of the low-income housing market, another key ingredient was the income tax code. Virtually all privately financed housing for low- and moderate-income families over the past two decades has received a substantial subsidy through the tax system.

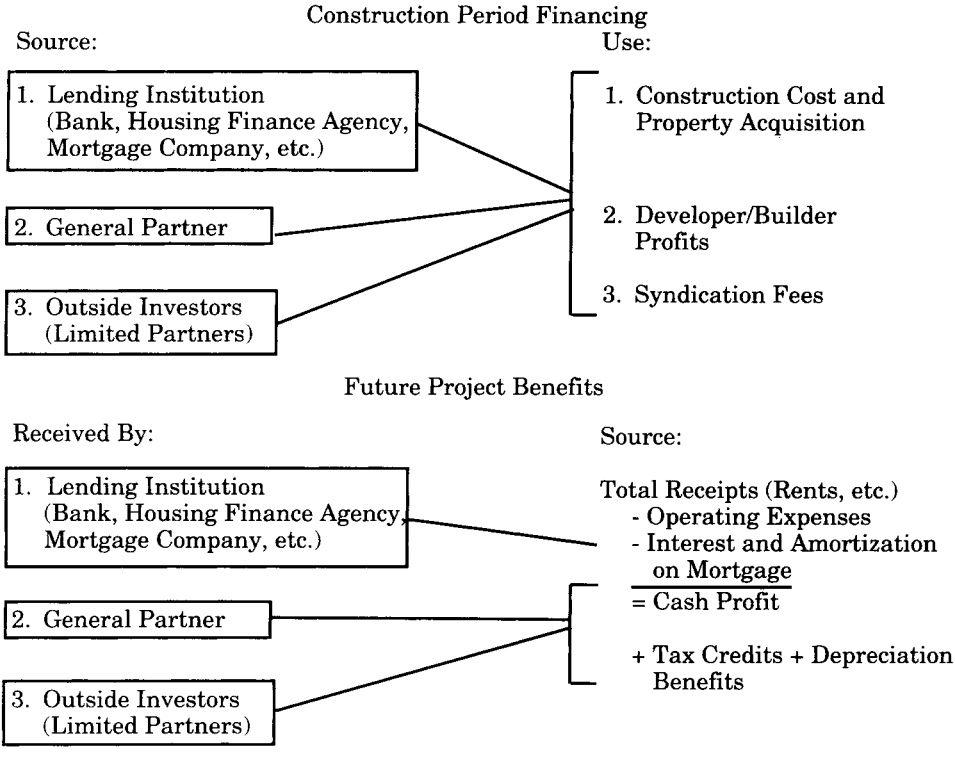
The tax code and private investment in low-income housing

The recent history of tax code provisions affecting returns to investment in low-income housing can be broken into three periods: (1) prior to the Economic Recovery Tax Act (ERTA) of 1981; (2) between ERTA and the Tax Reform Act (TRA) of 1986; and (3) since TRA. While the treatment of such investments was very different during the three periods, the tax code was very generous during all three. When combined with other subsidies, the tax provisions have for many years produced extraordinary returns.[2]

Over the past two decades, virtually all private investment in low-income housing has been through limited partnerships. The typical project is conceived by a developer, who puts together a plan. The bulk of the financing generally comes from a bank or other institution in the form of a fixed-rate mortgage (fig. 1). The lending institution may be a private bank, savings and loan, or finance company, or it may be a public body, such as a state housing finance agency. In some instances the mortgage is written at below-market rates. The remainder of the private funding comes from the sale of ownership shares to limited partners to whom the project's tax benefits are passed. The partners generally end up with a small positive cash flow and the ability to shelter ordinary income from taxation by using tax credits or depreciation deductions. In 1983 and again in 1984, over $50 billion was invested in tax shelters.

The fact that most projects are syndicated to limited partners through financial markets means that it is possible to determine the rates of return required to secure private investment by analyzing data on partnership sales. Specifically, the way the market

Figure 1. **Sources and Uses of Funds in a Typical Privately Financed Low-Income Housing Project**



operates is that developers and syndicators will first prepare a project pro forma, or business plan, projecting cash requirements, development costs, cash income flows, deductible losses (from depreciation), and tax credits available to investors, all on a share basis. The price of a share is then fixed at a level that provides investors the minimum return required to induce them to participate, given the risks associated with the deal. The shares are then marketed; they are made publicly available through an underwriting broker, or they are privately placed by the syndicator. If the subscription is not sold out, the price will drop, increasing the implicit return to the buyers until all shares are sold. If all shares sell out immediately, the next syndication is likely to carry a higher price.[3]

The required rate of return thus determines the price of the limited-partnership shares, and the price of the limited-partnership shares determines the size of the syndication proceeds. In essence the shares are auctioned, and the auction price determines the share of

project benefits that go to the limited partners and the rate of return they earn. Evidence on these rates of return is presented below.

The remainder of the benefits accrue to the developers and syndicators who put together the deals. The returns to these players are substantial, but they are difficult or impossible to quantify. In most cases, the projects are fully funded with the mortgage proceeds and the money raised by the syndication. Thus, the return to developers and the general partner is a return on the organizational skill and time spent in putting together the deal. It may include a return on political capital as well.

Perhaps surprisingly, the rewards to investment in low-income housing were sharply increased in each of the three periods despite the fact that developers have been queuing to take advantage of them for more than a decade.

Prior to 1981. While the tax changes in 1981 made tax shelters even more attractive than they were before, they were very popular well back into the 1970s. The key to a low-income-housing tax shelter was the ability to convert ordinary income into capital gains, which were afforded preferential treatment.

Under the rules in effect prior to 1981, owners could depreciate the full cost of a development over 40 years by using accelerated depreciation rules. As long as maintenance and repair expenditures were adequate, buildings did not actually lose value. In fact, in many instances projects appreciated in value.

In table 1, the present value of depreciation and tax credits available for each $10,000 of total project value is computed under the rules in place prior to 1981. Since the value of credits and deductions is a linear function of project value, the results apply to projects of any size.

The calculations in table 1 make a number of assumptions. First, the project is depreciated over 40 years using a 200 percent declining balance. That implies a deduction of 5 percent of the remaining basis each year. Second, it is assumed that the project is sold for the original development value at the end of year seven. That is, the market value of the project remains constant in nominal terms, a fairly conservative assumption. There is, of course, an optimal holding period for such a project that will depend on a large number of factors, including the depreciation rules in effect and so forth.

It is also assumed that recapture provisions do not apply. This means that at the time of sale, the selling price minus the remaining basis is taxed as a capital gain rather than as ordinary income. Under the law at the time, any such gains on the sale of machinery and equipment were taxed at ordinary rates. For most real property, only the excess of accelerated over straight-line depreciation was subject to recapture, or taxation as ordinary income, but low-income housing was exempt.

The value of deductions sold to limited partners depends on the marginal tax rate of the marginal buyer. The top marginal tax rate in force during the 1970s was 70 percent. Thus, the calculations in table 1 assume that limited partners face a 70 percent marginal rate. However, an important study done by the Congressional Budget Office (CBO) in the mid-1970s[4] estimates that tax shelters had to be sold at a price low enough to attract buyers in the 50 percent bracket simply because there were not enough filers in the top tax bracket to clear the market.

Table 1. **Pre-1981 (ERTA)**
Present Value of Tax Benefits: $10,000 Investment

End of year	Basis	Depreaciation (double declining balance (DDB), 40 years)	Present value (r = .15)
1	10,000	500.00	434.78
2	9,500	475.00	359.17
3	9,025	451.25	296.71
4	8,574	428.69	245.10
5	8,145	407.25	202.48
6	7,737	386.89	167.26
7	7,351		1,705.50
	Capital gain 2,649 x .40		-398.34
			1,307.16 x .70 = $915
Limited recapture would reduce the present value at the .50 marginal rate by: [2649-(6 x 250)] x .6 x .5/(1.15)[7] or a total of $129.59.			1,307.16 x .50 = $654

Finally, the present value calculations assume a discount rate of 15 percent. This is based on after-tax internal rate of return calculations done on recent low-income housing partnerships and reported in *The Stanger Report*[5] and on analyses of ten Massachusetts developments presented below. The CBO study assumes a slightly higher discount rate, but it seems to be a fairly arbitrary number, and no documentation is presented to defend it. A 15 percent rate implies that investors demand a significant risk premium.

Even under the pre-1981 rules, the value of the implicit tax subsidies was extraordinary. A conservative estimate of the present value of tax benefits from each $10,000 of total project value is $654, Thus, the total package is equivalent to a 6.54 percent investment tax credit (ITC). On a $10 million project, syndication proceeds would amount to $650,000, and this assumes that *none* of the cash-flow is passed on to limited partners.

Table 1 also calculates the reduction in value that would result from application of the recapture provisions that applied to most real property. If the excess of accelerated depreciation over straight-line depreciation were taxed as ordinary income, the value of the tax package would fall by $129 per $10,000 of project value. Thus, the total would drop to $525 per $10,000.

Changes in 1981. The ERTA brought with it a significant number of changes that had a dramatic effect on the size of the implicit subsidy to developers of low-income housing.

First, ERTA included adoption of the Accelerated Cost Recovery System (ACRS), which reduced the depreciable life of virtually all assets, including real property. Under ACRS, all property was classified into one of four categories: 3-, 5-, 10-, or 15-year property. Low-income housing was classified as 15-year property. At the same time, the new law permitted the use of a 200 percent declining balance, and low-income housing was exempt from recapture provisions. All of these changes had a dramatic effect on the value of depreciation deductions.

Second, ERTA reduced marginal rates. The rate reduction, initially proposed as the Kemp-Roth Bill, was phased in over three years, with the top rate dropping to 50 percent from the beginning. Since the number of filers in the top marginal bracket was dramatically larger by 1982 than it had been a decade earlier, the calculations below assume that the marginal tax shelter investor faces a 50 percent marginal rate.

The calculations in table 2 that apply to the period between 1981 and 1986 and are based on the same assumptions as those previously discussed. The only difference is the depreciation rule in effect. The present value of the tax subsidies on each $10,000 of initial project cost jumps to nearly 15 percent of the total project cost. The developer of a $10 million project could sell the depreciation, again without considering any positive cash flow, to the limited partners for $1.489 million dollars. Little wonder tax shelter activity boomed from 1983 to 1985.

Table 2. **Post-1981 (ERTA)**

End of year	Basis	Depreciation (DDB, 15 years)	Present value (r = .15)
1	10,000	1333.33	1,159.41
2	8,666	1155.55	873.76
3	7,511	1001.48	658.49
4	6,510	867.95	496.25
5	5,642	752.22	373.99
6	4,889	651.93	281.85
7	4,238		3,843.75
Capital gain 5,762 x .40			-866.46
			2,977.30 x .50 = $1,488

Although ERTA was in place in 1982, the economy was still in recession and feeling the effects of extraordinary interest rates. But by 1983, the construction industry was in full swing. For figures on single- and multifamily housing starts annually between 1975 and 1989, see table 3. The major changes in tax law in both 1981 and 1986 had their biggest impact on the rental market. The tax treatment of owner-occupied housing did not change dramatically during the period. While it is true that rental housing is not the same as multifamily housing, there is no doubt that the multifamily starts figures had a lot to do with the tax laws.[6]

Table 3. **Housing Starts in the United States 1975-89**

Year	Single family	Multifamily
1975	897	269
1976	1,167	369
1977	1,437	525
1978	1,418	582
1979	1,172	546
1980	855	445
1981	711	386
1982	663	394
1983	1,065	641
1984	1,098	668
1985	1,071	671
1986	1,182	630
1987	1,156	477
1988	1,088	407
1989	1,009	377

Source: F.W. Dodge Corporation, Lexington, Mass.

If the recession years of 1980-82 are omitted, the shift is quite evident for the four-year average before and after ERTA. Multifamily starts increased 29 percent from a four-year average of 505,000 (1976-79) to an average of 653,000 (1983-86). At the same time, single-family starts dropped 18 percent, from an average of 1.299 million to an average of 1.104 million.

While ERTA's effects on the real estate industry are hard to overestimate, the best was yet to come for low-income housing.

The Tax Reform Act of 1986. The Tax Reform Act of 1986 dealt a severe blow to the real estate industry. First, the preferential treatment afforded to capital gain income was dropped, with capital gains now treated as ordinary income. With the preferential treatment of gains went one of the cornerstones of the shelter industry. Second, the depreciation period for residential property was extended to 27.5 years. Third, the top marginal rate was dropped from 50 percent to 33 percent over a two-year phase-in period.

All these provisions dramatically reduced the value of the implicit subsidies to real estate investment, including low-income housing. The calculations in table 4 show that the present value of the tax advantages, which were $1,488 for every $10,000 of project cost under ERTA, drop to a mere $183 after the act. In essence, a 15 percent subsidy was reduced to 1.8 percent!

Table 4. **Post-1986 (TRA)**

End of year	Basis	Depreciation (straight line, 27.5 years)	Present value (r = .15)
1	10,000	363.64	316.21
2	9,636	363.64	274.96
3	9,273	363.64	239.10
4	8,909	363.64	207.91
5	8,545	363.64	180.79
6	8,182	363.64	157.21
7	7,818		1,376.18
	Capital gain 2,181.82		-820.22
			555.95 x .33 = $183

If this were not enough, the final blow was that with few exceptions passive partners could no longer deduct losses against ordinary income. Tax shelter losses could only be deducted if the partner was a material participant in the management of the property or if the losses were taken against passive income. It was predicted at the time that multifamily housing production would drop, and drop it has. From their 1983-86 average level, multifamily starts were off about 45 percent by 1989.

Somehow the preferential treatment afforded owner-occupied housing (exclusion of net imputed rent, mortgage interest, and property tax deductibility) survived the reformers' knife. While the value of these deductions fell with the marginal tax rate, increasing the price of housing, owner-occupied housing after TRA was one of the few remaining preference items left in the code. Single-family starts have only dropped about 10 percent from their 1983-86 average level (table 3).

In the final weeks prior to passage of the 1986 TRA, there was a panic on Capitol Hill about low-income housing. A coalition of members from the Northeast, with support from the construction industry and advocacy groups, was able to add a provision to TRA that gave a very lucrative tax credit to low-income housing development. Instead of accelerated depreciation, developers can market tax credits to passive investors. For conventionally financed,

mixed-income projects that receive no rent subsidies, the credit amounts to 9 percent of total construction costs per year *for ten years*. A set number of units in each project must be set aside for low- or moderate-income tenants.

If a developer acquires an existing apartment building that is at least ten years old, that was financed with a subsidized mortgage, or with tenants who receive rent subsidies (such as Section 8), the credit is 4 percent for ten years. If a building is substantially rehabilitated, the ten-year credit is 9 percent on the rehabilitation costs and 4 percent on the remaining basis.

Table 5 shows present value calculations on the two credits. The present value of marketable credits is $5,194 per $10,000 of development costs for the 9 percent credit. When added to the remaining benefits from depreciation and tax deferral, the total present value of the subsidy is $5,377.88 per $10,000. It is essentially equivalent

Table 5. **Post-1986 Tax Reform Act with Low-Income Housing Tax Credit**

Year	Credit	Present value (r = 15%)	Credit	Present value (r = 15%)
1	900	900.00	400	400.00
2	900	782.61	400	347.83
3	900	680.53	400	302.46
4	900	591.76	400	263.01
5	900	514.58	400	228.70
6	900	447.46	400	198.87
7	900	389.09	400	172.93
8	900	338.34	400	150.37
9	900	294.21	400	130.76
10	900	255.83	400	113.70
		$5,194.41		$2,308.63
		183 46		183.46
		$5,377.88		$2,492.09

to a 54 percent ITC. The present value of a 4 percent credit over ten years when added to the benefits of tax deferral from depreciation comes to $2,492.09.

Because Congress understood from the beginning that these credits were lucrative, restrictions had to be placed on their use. Developers who wish to use the credit submit proposals to state agencies charged with administering the program.[7] Each state was originally given an allocation of $1.25 worth of credits per capita. Legislation extending the credit for one year was passed in December 1989, but it reduced the allocation to $.9375 per capita. Several times each year, states circulate a request for proposal from developers, and there is a strong response.[8]

Some other important limitations apply to the current low-income tax credit. Initially the credits were made available only to individuals with incomes below $250,000, and each taxpayer was limited to credits of $7,000 per year. However, corporations were not restricted in their use of the credit, and most projects were marketed to corporate investors. While the $7,000 limit remains in place, the $250,000 cap on income was dropped in the 1989 extension bill.

Developers are willing to spend large sums of money to compete for these credits. That fact by itself indicates that the *full* rate of return is significantly in excess of the return required to secure private financing.

Required rates of return to secure private financing

The return on investment in virtually all private low-income housing development accrues to three parties. First, most projects are heavily leveraged, so a portion of the return goes to debt service. Most projects have been financed with subsidized mortgages, usually through state housing finance agencies that can issue tax-exempt bonds (sec. 11b). Sometimes other programs bring rates down even further.[9] Even when conventional financing is secured, projects are nearly always required to purchase mortgage insurance. Since the mortgage holder is either insured or holds a first lien on the property, there is little risk, and the debt service is written at either subsidized or competitive rates.

The second part of the financing comes from the limited partners to whom the project is syndicated. These investors bear limited risk. They are, in essence, like shareholders in corporations. If the project fails, they can lose their investment, and they could be

responsible for a tax liability if the project does not work out as projected. In some instances limited partners have been forced to invest further in a project to save it from collapse.[10] Fortunately, since partnership shares are sold in a competitive market, analyzing individual share prices along with existing pro formas on specific projects provides evidence on the returns required to secure such investments.

The third component of return on the project is a residual, usually split between the developer and syndicator. Developers generally keep at least half of any positive cash flow as well as a good portion of the syndication fees. In essence, if the project generates greater than normal returns, those returns accrue to the developer who wins the right to build the project. To reiterate, it is virtually impossible to measure the extent of the returns to developers. Often, they put no money of their own into the project. Also, the real return to a developer depends on the time and effort given to the project. It is clear that some projects are so complex and cumbersome that the returns to the developer/syndicator do not justify the project. But the enthusiastic competition for HUD contracts and tax credits suggests that the real returns are high.

The evidence. It is impossible to calculate the return required to obtain private financing on a program-by-program basis. Most syndicated projects involve many different sources of program subsidy. To cite an extreme example, one of the projects examined in detail in Massachusetts involved (1) Massachusetts Housing Finance Agency below-market financing, (2) Boston Redevelopment Authority "linkage funds," (3) a Housing Development Action Grant from HUD, (4) a Community Development Action Grant, (5) funds from the Massachusetts State Housing Assistance for Rental Production Program, and (6) syndication proceeds.

For the purpose of this paper, an after-tax internal rate of return was calculated from pro formas on ten separate syndication projects marketed between 1985 and 1989 in Massachusetts. The projects were from three separate developer/syndicators. The low return was 14.5 percent; the high return was 21.6 percent; and the median return was 16.3.

A similar set of calculations based on pro formas was obtained by *The Stranger Report* from National Partnership Investments, a prominent Los Angeles-based sponsor of low- and moderate-income housing tax credit partnerships.[11] The after-tax internal rate of return on new construction was 12.2 percent; on existing projects, 16.2 percent; and on rehabilitation projects, 15 percent.

Oversubsidy and rent-seeking behavior

There is little doubt that the system of providing supply-side subsidies to increase the production of low-income housing has overshot the mark. The fact that developers have engaged in rough political competition for access to limited credits and Section 8 authorizations is prima facie evidence of oversubsidy. In competitive markets, entry will drive overall returns down to competitive levels. But under all the programs discussed, entry is blocked by budgetary limitations on subsidy use. Even the tax advantages are now rationed.

In essence, this is a classic example of what Ann Krueger christened "rent seeking behavior".[12] In a more recent piece, Jagdish Bhagwati added color to the notion in an article entitled, "Directly Unproductive, Profit-Seeking Activities."[13] The Krueger/Bhagwati model predicts precisely the kind of political problems that unfolded at HUD during the final days of the last Administration.

The efficient solution to the oversubsidy problem would be to auction the tax benefits to the developer who offered the highest bid. In fact, Congress moved in that direction when it included a set of instructions to state agencies regarding allocation of the low-income tax credit in the Revenue Reconciliation Act of 1989. Specifically, housing agencies are to give highest priority to projects with "the highest percentage of the housing credit dollars [used] for project costs *other than the cost of intermediaries"* (emphasis added). That means that awards should be made to projects that seem to generate low returns to syndicators and developers. In addition, individual projects do not need to be granted full access to the credit, and agencies are instructed to grant "no more than the amount of credit required to make the project feasible."[14] These two provisions taken together are an attempt to squeeze the excess returns out of projects and to push them closer to the hurdle rate required to secure private investment.

It seems strange that Congress would write a law that provided very generous benefits to participants in a program, and then instruct local agencies to restrict access to the credits to those willing to pay the least for it. It would be far better to have a generally available credit with returns closer to the minimum required rate. This would put less power in the hands of local agencies, but it would allow the market more freedom to choose among projects.

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Endnotes

1. Herman Leonard, *Checks Unbalanced: The Quiet Side of Public Spending* (New York, NY: Basic Books, 1986).

2. See, for example, Comptroller General, op. cit., and CBO, op. cit. It is important to note that extraordinary returns were and are available only to those selected to participate in various programs. For example, the current low income housing credit is not generally available; each state has the authority to award $.9375 worth of credits per capita in 1990. For Massachusetts, that translates into less than $5.5 million for the entire state. (See *Housing and Development Reporter,* November 27, 1989). Since credits are tightly rationed, the fact that they yield high rates of return does not mean that lots of housing is being produced as a result.

3. In recent months, the tight rationing of low income housing credits has meant that only very good (low-risk) projects are being funded. In addition, the Tax Reform Act significantly reduced the ways that taxpayers can legally shelter income from taxation. Anecdotal evidence from three syndicators suggests that share prices have been rising (required returns are falling) as a result.

4. Congressional Budget Office, "Tax Shelter Subsidies for Real Estate" (Mimeo, 1977).

5. *The Stanger Report* XI, no. 8 (August 1989).

6. As of 1983, 94 percent of all owner-occupied units were single-family detached units. In the same year, more than 83 percent of all units in multi-unit structures were occupied by renters. *See Statistical Abstract of the United States*, 1985, table 1134, p. 643.

7. In Massachusetts, the Executive Office of Communities and Development makes the allocations.

8. While the Executive Office of Communities and Development in Massachusetts would not reveal the fraction of proposals received that were funded, it is clear that a large majority go unfunded.

9. Such programs include the Fannie Mae credit enhancement program that collateralizes state bond issues with mortgage-backed securities, and the old Ginnie Mae Tandem plan that offered 7 1/2 percent mortgages to qualifying borrowers.

10. Comptroller General, General Accounting Office, "Evaluation of Alternatives for Financing Low and Moderate Income Housing," PAD-80-13. (Washington, DC: U.S. Government Printing Office, 1980).

11. *The Stanger Report* XI, no. 8 (August 1989).

12. Anne Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974).

13. Jagdish N. Bhagwati, "Directly Unproductive Profit Seeking Activities," *Journal of Political Economy* 90, no. 5 (October 1982).

14. *Housing Development Reporter* (November 27, 1989) 506.