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Location incentives in the low-income housing tax credit: Are qualified census tracts necessary?

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ABSTRACT

The low-income housing tax credit (LIHTC) is the largest project-based housing subsidy in the United States. Within the program, private developers receive a subsidy in exchange for constructing apartment units that rent for a predetermined affordable rate. Because the subsidy requires apartment buildings to charge a lower rental rate, the opportunity cost of developing subsidized housing in a location is the market rent that a developer could have charged if he had not received the subsidy. This study characterizes how profit incentives motivate location decisions within the LIHTC program by showing that opportunity cost causes more LIHTC development in locations with low market rent. This result implies that additional financial incentives, like the qualified census tract, may not be necessary to promote construction of subsidized housing in low-rent areas.

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1. Introduction

Since the creation of the low-income housing tax credit (LIHTC) in 1986, the program has become the primary source of project-based subsidized housing in the United States.[1] Under the LIHTC program, private developers propose apartment projects to government housing agencies. If the projects are selected, developers receive tax credits that partially fund construction and, in exchange, apartments are required to rent at a rate considered affordable to low-income families. Between 1986 and 2003, 28% of all multi-family housing built in the United States received funding from tax credits, building over 1.2 million low-income units (Schwartz, 2006; Malpezzi and Vandell, 2002). Currently, the LIHTC program "is the most important resource for creating affordable housing in the United States" (Abt Associates, 1996).

The location of LIHTC units has been an important topic of debate, primarily because a unique aspect of the program is that private developers propose the location of housing developments. Because developers propose locations, one expects profit incentives to play a role in the location of LIHTC housing. A number of studies have documented the effect of a specific location incentive called the qualified census tract (QCT), which provides additional funding for construction in designated low-income census tracts (Freeman, 2004; Hollar and Usowki, 2007; Baum-Snow and Marion, 2009; Oakley, 2008). The current study shows that, even after controlling for QCT designations, differences in the market rent level affect the location of subsidized housing. Specifically, developers are more likely to build subsidized housing in locations with low rent.

The economic reasoning that motivates this result is that developers must reduce the rent charged in apartment units in exchange for the subsidy. This implies that a developer will choose to construct subsidized units as long as the rent reduction is completely offset by the subsidy received. As the market rent increases, the amount of forgone rent increases, reducing the likelihood that the size of the subsidy is sufficient to make LIHTC development the most

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[1] The housing choice voucher program is the largest tenant-based federal subsidy program. This program provides individual tenants with funds that can be used at designated apartments to reduce the rent paid by the tenant.

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profitable decision. Therefore, subsidization is less likely to be profitable in locations with relatively high market rent because the opportunity cost of building subsidized housing is high in these locations.

The degree to which developers respond to differences in market rent has implications for the efficiency of the LIHTC program. First, if the LIHTC subsidies are constructed such that developers are already motivated to build in locations with low rent, offering additional subsidies for building in these locations may be redundant. Qualified census tracts are defined as low-income locations and the correlation between low-income and low-rent areas is substantial. Because the majority of qualified tracts are designated in the lowest part of the rent distribution, it is possible that rent-based incentives would already motivate construction in locations that are most likely to be designated as QCTs.

Additionally, if LIHTC housing is primarily located in low-rent locations, tenants within these buildings may not be paying significantly less than the rent in an equivalent unsubsidized building in the same area. Burge (2011) shows that only a small portion of the cost of the LIHTC subsidy is used to reduce rent for tenants and rent savings diminish over the lifetime of the apartment units. The outcome Burge demonstrates may be the result of incentives to build subsidized housing in locations where the rent is already low.

This study shows that market rent levels, absent of other location incentives, affect the number of LIHTC units built in a census tract. Empirical evidence suggests that LIHTC units are most likely to be constructed in locations with low rent, which is likely due to the profit incentives that developers face. If the LIHTC program structure attracts subsidized construction to low-rent locations, additional subsidies for construction in QCTs may not be necessary. The estimates from this study suggest that reducing or eliminating the QCT incentive from the LIHTC program would reduce costs without substantially altering the locations and quantity of LIHTC construction.

2. The low-income housing tax credit

The low-income housing tax credit (LIHTC) was established in the Tax Credit Reform Act of 1986 to motivate private investment in low-income housing. Although the program is federally funded, state housing agencies decide which projects will receive tax credits. Each year state agencies accept applications for potential projects and then allocate credits to those that are considered most viable and beneficial for the community. National regulations require projects to remain affordable for at least 30 years. Often the number of tax credits requested by developers outweighs the available supply, so many allocation agencies have systems to award tax credits to the developments that are considered the most beneficial.[2]

When a project is selected for the subsidy, developers do not immediately receive tax credits. Instead, credits are allocated over the ten year period after the building begins operation. To fund construction of apartments, developers sell the future stream of tax credits to investors in a process called "syndication". While syndication is not addressed in the current study, previous research finds mixed results on the efficiency of the syndication process.[3]

The number of tax credits that each project receives is directly related to the cost of construction, excluding land and other financing fees. Through the calculation process, a developer can alter the size of the tax credit with certain decisions. These decisions and incentives are most easily understood using an example. Imagine a proposed project that costs $12 million to develop. If the cost of land and financing is $4 million then the tax-credit calculation begins with $8 million. This is called the "qualified basis".[4]

The location of a project can influence the number of tax credits received. Developers can increase their qualified basis by a factor of 1.3 if the proposed project is located in a "difficult to develop area" or a "qualified census tract". Difficult to develop areas are counties and Metropolitan Statistical Areas (MSAs) that have high construction, land and utility costs relative to income. Qualified census tracts (QCTs) are tracts where the poverty rate is above 25% or at least half the households earn below 60% of median family income for the MSA or county.

The purpose of qualified census tracts is to motivate the construction of low-income housing in high-poverty areas. Consequently, studies cite this incentive as the primary reason for high-poverty clustering (Oakley, 2008; Hollar and Usowki, 2007; Jewell, 2005). Of the 800,000 units built between 1995 and 2003, about 40% were located in at least one of these geographies (Abt Associates, 2006). If the example building is located in a qualified census tract, the qualified basis is adjusted from $8 million to $10.4 million.

The final step needed to calculate the tax credit is to multiply the adjusted qualified basis by the current tax-credit rate.[5] In the example, if the credit rate is 8%, then multiplying $10.4 million by the credit rate yields $832,000. This is the number of tax credits the developer will receive each year for the ten years immediately after the project is completed. In the example, the total number of tax credits received is $8.32 million. Tax credits make up approximately 70% of the original $12 million of costs. The futures of these tax credits are then sold to investors

[2] Gustafson and Walker (2002) review the allocation plans for 47 states and find that in the year 2000, 43 states favored projects in targeted areas. In almost every case, targeted areas are low-income and the intent is to revitalize the areas with LIHTC construction.

[3] See Stegman (1991); Case (1991); Cummings and DiPasquale (1999); McClure (2000) and McClure (2006).

[4] This example assumes that 100% of units are rent-restricted. The "qualified basis" is adjusted based on the number of units in the building that are rent-restricted. If a fraction of units are dedicated to market renters, the number of credits the developer receives is reduced by that fraction. Although this option is always available, few mixed-income buildings are ever developed. Of all the tax-credit projects built nationally before 2002, 84% were entirely dedicated to low-income use (McClure, 2006; US Department of Housing and Urban Development, 2005).

[5] Projects with less than $3000 of development cost per unit or projects that receive certain federal subsidies are given the four percent credit. All other projects receive the nine percent credit. The names four percent and nine percent are labels only, as the IRS publishes the actual rate each month.

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