



The market price of Low-Income Housing Tax Credits

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ABSTRACT

The Low-Income Housing Tax Credit (LIHTC) program awards a subsidy to private developers who construct and operate housing units with income-targeted rent controls for at least 15 years. The program allocated \$6.6 billion to developers in 2006, and over 1.6 million units have been subsidized under the program since its inception in 1987. A historical literature suggests place-based housing subsidies, such as the LIHTC program, will be more expensive in providing the same level of housing support to the poor than tenant-based strategies (i.e., housing vouchers). This paper uses an administrative data series of LIHTC subsidized properties in California to show the program encourages developers to construct housing units that are an estimated 20% more expensive per square foot than average industry estimates. It is additionally shown that due to liquidity constraints faced by LIHTC primary developers in how the subsidy is allocated, virtually all developers sell the tax credits at a substantial discount below their statutory value immediately after construction. This price is estimated to be \$0.73 per \$1 of tax credit, or \$1.8 billion annually, as compared to alternatively allocating a lump sum grant to developers.

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1. Introduction

The Low-Income Housing Tax Credit (LIHTC) Program is the nation's largest affordable housing construction subsidy (Eriksen and Rosenthal, 2008; Desai et al., 2008). The program allocates a subsidy (up to 91% of construction costs) to private developers who agree to impose rent controls on newly constructed or rehabilitated rental housing units for at least 15 years. Over 1.6 million housing units have received a subsidy under the program since its inception in 1987, accounting for approximately one-third of recent rental housing constructions (NCHSA, 2007; Census, 2007). This paper uses a project-level data series to illustrate that the current program is an expensive method to provide housing support for the nation's poor and other options to expand the supply of low-cost housing should be explored.

A place-based subsidized rental housing program, such as the LIHTC, being an expensive option to provide support to the poor should not come as a surprise to many economists. A heated debate and one of the nation's largest social experiments during the 1970's ultimately showed that housing subsidies given directly to low-income households were a more cost-effective solution in providing the same level of support than subsidies allocated to the suppliers of housing units these households typically occupy (see Olsen, 2000; Quigley, 2000; Orlebeke, 2000). These arguments

eventually led to an almost total reversal of federal policy away from place-based subsidies (primarily the public housing program) to tenant-based (housing vouchers) during the late 1970's.¹ Within this historical context, the LIHTC program was enacted as Section 42 of the US Tax Code in 1986 and has subsequently grown to be the nation's largest ever place-based subsidized program measured on a per unit basis (Eriksen and Rosenthal, 2008). More recently, annual allocations under the program have increased by 70% from 2000 and 2006, with over \$6.6 billion allocated in 2006 (see Table 1), with an additional 10% increase in allocations scheduled to begin in 2009 (Roberts, 2008).

This paper illustrates two potentially expensive features of the current LIHTC program using an administrative data series of subsidized projects in California.² The first is the program's premise of allocating tax credits as a fixed percentage of construction costs, up to 91%, to private developers who agree to impose rent controls on the subsidized units for at least 15 years. This leads developers to increase construction costs by an estimated 20% per square foot as compared to average quality unsubsidized properties as they substi-

¹ Although new public housing units have not been constructed since the early 1980's, over 1 million units were still operated under the program as of 1998 and recent efforts have been taken to demolish the least performing.

² See (Table 2) for descriptive statistics about the assembled data series of LIHTC Projects. The series contains information on 369 subsidized projects containing 26,563 housing units allocated tax credits from 1999 to 2005 in California, representing \$4 billion in development costs.

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Table 1
National low-income housing tax credit allocations ^a.

Year	Total annual allocations (\$) ^b	Number of subsidized units ^c
1987	980,533,493	34,491
1988	3,140,987,971	81,408
1989	4,387,952,511	126,200
1990	2,888,647,156	74,029
1991	5,207,469,242	111,970
1992	4,255,013,370	91,300
1993	5,205,992,598	103,756
1994	5,915,192,114	117,099
1995	4,892,206,044	86,343
1996	4,277,723,133	77,003
1997	4,225,625,522	70,453
1998	3,999,808,231	67,822
1999	3,983,473,499	62,240
2000	3,895,882,268	59,601
2001	4,624,992,306	67,261
2002	5,162,994,677	69,310
2003	5,507,541,467	73,877
2004	5,680,347,051	75,600
2005	5,556,042,690	70,630
2006	6,668,538,964	74,278
Total	90,456,964,308	1,594,671

^a Data compiled from National Council of State Housing Agencies (2007).

^b Calculation made assuming 3% annual inflation and allocated tax credits are claimed for the 10 years immediately after allocation.

^c Does not include market rate units included in LIHTC subsidized properties.

tute away from other inputs in their housing production (primarily land acquisition and future maintenance expenditures).

The second expensive feature of the program is the complicated method the subsidy is allocated to developers. More specifically, the subsidy enables owners of LIHTC projects to subtract a nonrefundable portion of their federal income tax liability for 10 years immediately after the project is completed. For a variety of reasons, including the possibility that a subsidized project will never create any federal tax liability due to imposed rental restrictions or non-profit status, virtually all primary LIHTC developers sell the equity of their projects bundled with the tax credits immediately after construction (Case, 1991). Paying special attention to the annuity feature of these allocations and that investors may receive financial benefits beyond the tax credits, it is estimated across a sample of LIHTC developments in California that LIHTC developers received on average \$0.73 per \$1 of allocated tax credit from 1999 to 2005. This estimate is significantly below prior estimates of the same time period because of a failure to previously recognize secondary market investors receiving income benefits beyond the allocated tax credits (e.g., net rents, capital gains, tax deductions) through the transaction (Ernst and Young, 2005).

The gap between the market price of a tax credit and its statutory value of \$1 adjusted for inflation partially represents the costs of future owners to remain compliant with, and then subsequently illustrate to the IRS, the program's mandated rent controls.³ Supporting evidence for the importance of these compliance costs is found in the variation in prices observed in the secondary market accordingly to individual project characteristics. More specifically, projects are found to earn 7¢ less per tax credit (p -value = 5%) if they are located in Census Tracts where the average housing rent exceeds the maximum allowable LIHTC rent. Considering the average subsidized project in the sample was allocated \$8.5 million tax credits, this estimate is economically large as it implies these primary developers earned approximately \$595,000 less per project holding other characteristics constant. Arguably these projects face higher compliance costs since the property must attract a sufficient number of in-

come-eligible households as residents or face a stiff penalty imposed by the IRS.⁴

Altogether, the current LIHTC program is an expensive method to provide housing support to the poor and the paper concludes with offering three recommendations in regards to the current program. First, since a justification for the program is to expand the supply of low-cost rental housing, restrictions should be made to limit construction costs per square foot. At a minimum, no further subsidies should be allocated to developers who voluntarily elect to construct higher quality units. Such a restriction would serve to lower the subsidy cost per unit and subsequently increase the number of units constructed under the program annually.

Second the subsidy should be delivered to LIHTC developers in a more liquid asset form than through a 10-year nonrefundable reduction in their federal tax liability. This would serve to lessen any potential liquidity constraints faced by developers in financing initial construction costs. Last, a less targeted policy that provides a subsidy to all suppliers of low-cost rental housing units should be explored. A program, such as the LIHTC, that subsidizes private developers to construct above average cost housing units and subsequently offer them to tenants at below market rents creates uncertainty in unsubsidized rental housing markets, which ultimately leads to crowd out of privately supplied housing units. Previous estimates of crowd out arising due to the subsidized units are substantial and range from 55% to 100% (Malpezzi and Vandell, 2002; Sinai and Waldfoegel, 2005; Eriksen and Rosenthal, 2008). Furthermore, such a subsidy structure mandates expensive compliance requirements on a property's owners, since in the absence of such requirements all developers would immediately renege on the terms of subsidization and offer units at market rates. Estimates reported in the paper suggest a less targeted alternative program that relied on lump sum grants would be far more cost effective (up to 40%) in increasing the nation's supply of affordable rental housing than the current LIHTC program.

2. Historical context

As mentioned in the Introduction, there is a long-standing debate among economists and policymakers about the merits of place- versus tenant-based housing assistance for low-income households.⁵ Generally speaking, place-based housing programs subsidize the construction and operation of buildings low-income households occupy, whereas tenant-based alternatives provide the subsidy directly to low-income households and allow them to select their housing from a set of approved housing options. The Federal Government first provided housing assistance to the poor in 1937 through a place-based mechanism by directly locating, constructing, and operating the units, a method of subsidization typically generalized as the public housing program.⁶ These "projects", as they became known, dominated low-income housing policy for the next 37 years with over 1.3 million units constructed through the program over this time span (Quigley, 2000).⁷

After a moratorium on newly initiated public housing projects by Nixon in 1972, the Government looked for alternative methods to provide housing support for the poor (Orlebeke, 2000). After

⁴ Projects located in high poverty Census Tracts (greater than 30% of households) and with below average construction costs are also founded to earn 3.5¢ and 5.7¢ less per tax credit, respectively.

⁵ See Olsen (2000), Quigley (2000), and Orlebeke (2000) for surveys on the debate of place- versus tenant-based subsidies.

⁶ There is not a single federal public housing program, but at least 36 different federal programs that share these general characteristics (Olsen, 2003).

⁷ Eriksen and Rosenthal, 2008 provide a timeline of public housing construction from 1937 until 2000. The US Office of Management and Budget (2004) estimated over \$5 billion would be spent maintaining and operating the remaining 1.3 million public housing units in 2006.

³ Other reasons for gap between the effective and statutory value are discussed in Section 4.

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