# Does Housing Affordability Argue for Subsidizing the Construction of Tax Credit Projects?

Ed Olsen
Department of Economics, University of Virginia
Visiting Scholar, American Enterprise Institute

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The Low-Income Housing Tax Credit (LIHTC) is the largest and fastest growing low-income housing program. It subsidizes the construction and renovation of more units each year than all other government programs combined. The tax credits themselves involved a tax expenditure of about $6 billion in 2015 and new commitments of about $7.5 billion. However, these projects receive additional development subsidies from state and local governments, usually funded through federal intergovernmental grants, accounting for one-third of total development subsidies (Cummings and DiPasquale 1999). Therefore, the total development subsidies associated with the new commitments were about $11 billion. Furthermore, many tax credit projects involve substantial renovations of older HUD and USDA housing projects that continue to receive deep subsidies from the programs involved, and many tax credit units are occupied by households with tenant-based housing vouchers that provide owners with additional revenue. GAO (1997) found that owners of tax-credit projects received subsidies in the form of project-based or tenant-based rental assistance on behalf of 40 percent of their tenants. More recent evidence for ten states suggests an even higher fraction (O'Regan and Horn 2015). To the best of my knowledge, the magnitude of these subsidies has never been documented. If their per-unit cost were equal to the per-unit cost of tenant-based housing vouchers in 2015, they would have added about $7.5 billion a year to the cost of the tax-credit program. A program of this magnitude merits much more critical scrutiny than it has received to date.

Proposed legislation in the Senate would greatly expand the tax credit program, indeed, increase its cost by 50 percent. This is billed as a solution to a housing affordability problem described in terms of the many households that devote a large fraction of their income to housing. The report that attempts to justify the expansion also argues that the expansion is necessary to house the homeless who clearly have a housing affordability problem. Neither argument holds water.

Building new projects is a very expensive solution to the housing affordability problem described. We don't need to build new housing projects to help households that spend a large fraction of their income on housing. They are already housed. If we think that their housing is unaffordable, the cheapest solution is for the government to pay a part of the rent. HUD's housing voucher program does just that at a much lower cost than the tax credit program.

Furthermore, it's neither necessary nor desirable to construct new units to house the homeless. The number of people who are homeless is far less than the number of vacant units—indeed, far less than the number of vacant units renting for less than the median. In the entire country, there are only about 600,000 homeless people on a single night and more than 3 million vacant units available for rent. Even if all homeless people were single, they could easily be accommodated in vacant existing units, and that would be much less expensive than building new units for them. The reason that they are homeless is that they don't have the money to pay the rent for existing vacant units. A housing voucher would solve that problem. A major HUD-funded random assignment experiment called the Family Options Study compared the cost and

effectiveness of housing vouchers and subsidized housing projects for serving the homeless. Short-term housing vouchers were as effective and much less expensive than transitional housing projects.

The evidence indicates that the tenant-based housing voucher program is by far the most cost effective approach to delivering housing assistance.[1] The best study of HUD's largest program that subsidized the construction of privately owned projects indicated the total cost of providing housing under this program was at least 44 percent greater than the total cost of providing equally good housing under the housing voucher program (Wallace and others 1981). This translated into excessive taxpayer cost of at least 72 percent for the same outcome. It implies that housing vouchers could have served all the people served by this program equally well and served at least 72 percent more people with the same characteristics without any increase in public spending.

We don't have a cost-effectiveness study of this quality for the LIHTC program. The best evidence available suggests that tax credit projects cost 16% more than the voucher program to provide units with the same number of bedrooms in the same metro area (GAO 2001). This is almost surely an underestimate because it omits some of the public subsidies to developers of tax credit projects such as land sold to them by local governments at below-market prices, local property tax abatements received by some developers, and later subsidies for renovating the projects.

The best evidence available also indicates that occupants of tax credit projects capture a small fraction of the subsidies provided to developers. Burge (2011, p. 91) finds that the present value of the rent saving to tenants (the difference between the market rent of the unit and the rent paid by its tenant) is only 35% of the present value of the tax credits provided to developers. Combining this result with Cummings and Di Pasquale's finding that tax credits account for about two-thirds of development subsidies for tax credit projects leads to the conclusion that tenants capture at most 24% of the development subsidies.

A recent PBS Frontline documentary called Poverty, Politics, and Profit illustrates one of the reasons for this outcome, namely, LIHTC fraud. A follow-up piece with NPR, Department of Justice news releases, and articles in the Miami Herald provide more details. One investigation of several developers revealed excess subsidies of $36 million for 14 projects. Because subsidies are proportional to development cost, developers have an incentive to overstate them. In the fraud uncovered in this investigation, the developer who was awarded tax credits persuaded contractors to provide inflated bids for their work on the projects combined with kickbacks to the developers. Due to the difficulty of determining true development cost and lax enforcement by state housing agencies, developers succeed in greatly overstating them. The documentary indicated that the developer of one project overstated its development cost by 16.6%. Because the fraud involved is difficult to detect, the few cases uncovered so far are surely the tip of the

[1] Olsen (2008, pp. 9-15) summarizes the evidence.

iceberg.[2] Recent investigations have uncovered fraud in Los Angeles, New York City, Dallas, and Maine, and other investigations are underway.

The reasons for the excess cost of tax credit projects go beyond fraud. The combination of programs that provide subsidies to them offer excess profits to honest developers (that is, much larger profits than can be earned in the unsubsidized market) and distortions in the combination of inputs used to provide housing (specifically, expensive new buildings that are built on inexpensive land and poorly maintained). The excess profits explain why many more developers submit proposals than can be funded with the tax credits allocated to the state. It's why developers of tax credit projects spend so much on their proposals. It's why almost all commit all of the units in their buildings to the tax credit program. It's why some pay bribes to get their projects approved. The layering of subsidies on tax credit projects makes it particularly difficult to prevent excess profits.

Clearly, Congress should not authorize the expansion of the tax credit program unless existing evidence on the cost-effectiveness of the tax credit program is far from the mark. If Congress wants to serve additional households, it should expand the much more cost-effective housing voucher program. Furthermore, given the large current public spending on tax credit projects, Congress should insist on, and appropriate the money for, independent analyses of the highest quality that compare the cost-effectiveness of housing vouchers with the various types of tax credit projects, including ones that renovate private and public housing projects built under HUD and USDA programs. The cost of these studies would be trivial compared with public spending on tax credit projects.

It's often argued that the large expense of subsidizing the construction of new tax credit projects is justified by low vacancy rates that prevent potential recipients from using housing vouchers. Table 1 shows that the location of new tax credit projects is inconsistent with this justification. The construction of tax credit projects is not focused on metro areas with low vacancy rates. Over the past decade, the majority of tax credit units were built in metro areas with vacancy rates in excess of 8%. Almost 40% of all tax credit units were built in metro areas with vacancy rates in excess of 10%. The location of tax credit projects indicates that market tightness is not a serious argument for the tax credit program.

Furthermore, there are good reasons to expect that subsidized construction will work poorly in tight housing markets because it crowds out unsubsidized construction to a considerable extent. When vacancy rates are low in a market, rents will be high. This is when unsubsidized construction will be most profitable. In the absence of subsidized construction, unsubsidized construction would be high, and unemployment among construction workers and equipment would be low. Subsidized construction would divert workers and equipment from unsubsidized construction.

The evidence indicates that subsidized construction largely crowds out the unsubsidized housing stock to a considerable extent (Murray 1983, 1999, Malpezzi and Vandell 2002, Sinai

[2] Since LIHTC has subsidized the construction and renovation of more than 40,000 projects, it is reasonable to believe that fraud has accounted for a substantial sum over the program's history.

and Waldfogel 2005, and Eriksen and Rosenthal 2010). In tight markets, it mainly crowds out unsubsidized construction. In markets with high vacancy rates, it mainly results in the withdrawal of existing units from the housing stock.

It's reasonable to believe that all subsidized housing programs lead to some increase in the number of dwelling units by increasing the demand for distinct units. The offer of housing assistance of any type induces some individuals and families living with others to live in their own units. Abt et al. (2006, pp. 23, 76) indicate that about 26 percent of the families on the housing voucher waiting list were living with friends or relatives and 2 percent were living in a homeless shelter or transitional housing, and voucher usage resulted in corresponding decreases in these numbers. Since doubling up and homelessness are more common among the poorest households, the programs that serve the poorest households will have the greatest net effect on the number of housing units. The voucher program serves somewhat poorer households than public housing and much poorer households than privately-owned subsidized projects as judged by per-capita household income (Picture of Subsidized Households). Consistent with this explanation, Sinai and Waldfogel (2005) find that tenant-based vouchers lead to a larger increase in the housing stock than construction programs. This phenomenon also explains Eriksen and Rosenthal's finding of almost complete crowd out for the LIHTC. This program serves families with much higher incomes than the other programs.

Contrary to popular perceptions, housing vouchers work reasonably well in tight housing markets. Many families offered vouchers already occupy apartments meeting the program's standards. We don't need vacant apartments for these families. They can participate without moving. Other families offered vouchers live in housing that doesn't meet program's minimum housing standards, but their landlords are willing to repair them to meet the standards. Similarly, vacant apartments that do not initially meet the program's standards can be upgraded to meet them. About half of the units occupied by voucher recipients were repaired to meet the program's minimum housing standards (Kennedy and Finkel 1994). The tenant-based voucher program substantially increases the supply of apartments meeting minimum housing standards without building new units for the households involved.

The Housing Assistance Supply Experiment of the Experimental Housing Allowance Program (EHAP) provides additional evidence on the ability of tenant-based vouchers to increase the supply of apartments meeting minimum housing standards even in tight housing markets.[3] The Supply Experiment involved operating an entitlement tenant-based housing allowance program in two metropolitan areas for ten years. During the first five years of the experiment, about eleven thousand dwellings were repaired or improved to meet program standards entirely in response to tenant-based assistance (Lowry 1983, p. 24). This represented more than a 9 percent increase in the supply of apartments meeting minimum housing standards.

Given the available evidence on program performance, we should certainly not expand the tax credit program. The existing evidence argues for terminating it or phasing it out. If we want to serve additional households, we should expand the much more cost-effective housing

[3] Olsen and Zabel (2015, pp. 903-904) provide a brief account of the experiment and its main results.

voucher program. If the tax credit program is retained, Congress should insist on independent analyses of the highest quality that compare the cost-effectiveness of housing vouchers with the various types of low-income housing tax credit projects.

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Table 1

Tax Credit Units v. Vacancy Rates
75 largest metro areas, HVS vacancy rates, 2005-2014

| Vacancy Rate (%) | Tax Credit Units Placed in Service | Tax Credit Units as % of Occupied Rental Units |
|---|---|---|
| 2.0-3.9 | 13,931 | 0.24 |
| 4.0-5.9 | 117,729 | 0.20 |
| 6.0-7.9 | 145,076 | 0.27 |
| 8.0-9.9 | 84,894 | 0.21 |
| 10.0- | 223,220 | 0.25 |
| Total | 584,850 | 0.24 |

Note: Each observation refers to a single metro area in one year.
Sources: Vacancy rates, https://www.census.gov/housing/hvs/data/ann15ind.html
Tax credit units placed in service, https://www.huduser.gov/portal/datasets/lihtc.html
Occupied rental units, http://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml