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Comment on Jean L. Cummings and Denise DiPasquale's "The Low Income Housing Tax Credit: An Analysis of the First Ten Years": Lifting the Veil of Ignorance

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Abstract

Although the Low-Income Housing Tax Credit is the largest low-income housing production program in the country, we know very little about it. Even basic questions remain, such as who owns tax credit developments or how much do they cost? We do not even know if tax credits foster income mixing, or reinforce existing patterns of economic segregation. We need more information, not less, which is why the research performed by Cummings and DiPasquale is so important.

The competition for the tax credit has increased and states are using it as a general social service tool. Some states, such as Florida, Maine, and Rhode Island, now favor the use of tax credits to help finance service-enriched housing for seniors. States also are trying to anticipate the likely outcome when the tax credits expire. The Washington State Housing Commission received funding last year to study early tax credit projects with expiring affordability requirements, while California will start a study in 1999.

Keywords: Low-income housing; Multifamily; Tax policy

Introduction

Although the Low-Income Housing Tax Credit (LIHTC) is the largest low-income housing production program in the country, we know very little about it. Who owns tax credit developments, and how much do they cost? Who is served by the program, and at what rent burdens? Does the tax credit foster income mixing, or reinforce existing patterns of economic segregation?

I think there are two main reasons for our relative ignorance. First, since the LIHTC "program" is a kind of capped entitlement that is financed by tax expenditures rather than by direct congressional appropriations, no annual budget justifications or program analyses are needed to keep it going. Neither has the Internal Revenue Service (IRS) shown much interest in the LIHTC's effectiveness at producing affordable housing, save for matters having to do with tax compliance.

Second, and more important for the purposes of this discussion, is the role the affordable housing community has played in helping to preserve the veil of ignorance. For any number of reasons, including the vulnerability of all supply-side subsidies to political attack on cost and other grounds, the affordable housing community has been reluctant to support the kind of independent evaluations of the tax-credit program that have characterized virtually every other major subsidized housing program of the past 50 years. This is partly because of the tumultuous birth of the LIHTC in the Tax Reform Act of 1986, which wiped away virtually all other affordable housing tax preferences. At the U.S. Department of Housing and Urban Development (HUD) in 1994, where I served as Assistant Secretary of Policy Development and Research, we attempted to create the first national database of tax-credit projects. I still vividly recall the housing community's cool response and concerted efforts to discourage state housing finance agencies from participating in our initiative. Because of the tax-credit program's decentralized nature, it is both difficult and costly to conduct systematic and generalizable assessments of it without a national database.

This is why congratulations are in order to Jean Cummings and Denise DiPasquale for their outstanding analysis of the first 10 years of the LIHTC—as well as to the cooperating firms and organizations, for having enough confidence in the authors' integrity and independence of judgment to share proprietary information with them. Their excellent article is one of the first to systematically explore LIHTC financing and operating issues, and when coupled with recent work by the U.S. General Accounting Office (GAO) and other available information, provides important insights into how well the program is doing, and the challenges that lie ahead.

Clearly, those who ideologically oppose supply-side housing subsidies of any kind and those who value efficiency above all else will find in Cummings and DiPasquale's work ammunition for taking pot shots at the LIHTC. And the affordable housing and community development communities, in keeping with their overly protective tendencies, no doubt will be troubled by some of Cummings and DiPasquale's findings—especially those regarding the size of public subsidies, the higher costs (about 20 percent more per unit) of nonprofit development, and the differences in the program between big cities and the suburbs. The authors report, for example, that in major central cities the LIHTC program is much more often used to provide better housing in poor neighborhoods than affordable housing in higher-income neighborhoods, while in the suburbs the reverse is more often true.

While these are important issues worthy of more careful analysis, I think they distract from the main story line, which I believe is over-

whelmingly positive. As a long-term student and participant in the policy process, I think that Cummings and DiPasquale show, and related program information corroborates, that *10 years after the program's inception, a mature, sophisticated housing delivery system—driven principally by the private sector—has grown up around the Low-Income Housing Tax Credit.* This is why I believe the LIHTC, though not necessarily in its present form, should continue to be the core of the country's low-income housing production system well into the 21st century.

My comments on Cummings and DiPasquale's article are in three parts. First, I briefly discuss some of the developments that reflect and contribute to the tax credit's increasing effectiveness. Then I address some of the most important challenges to the program's future that are raised by Cummings and DiPasquale, none of which can be addressed without more of the kind of project-level information that Cummings and DiPasquale analyze so well. I conclude with a few comments on future policy options.

Spawning a sophisticated housing delivery system

Cummings and DiPasquale properly emphasize the importance of the LIHTC's flexibility and decentralized character. As it has matured, the tax credit has not only become the centerpiece of a sophisticated and increasingly efficient low-income rental housing production system, but it also has provided critical financing for a broader segment of the multifamily market. Trade publications confirm, for example, that in high-cost markets such as Los Angeles and in places such as upstate New York, where tenant incomes are low relative to building costs, the LIHTC is what makes new construction of any kind economically feasible (*Affordable Housing Today* 1997, 8). While the tax credit's market role might be problematic for housing advocates, this feature probably bolsters considerably the political support from the mainstream development community.

As the tax credit has matured, so too has the housing delivery system it spawned, bringing with it enormous gains in efficiency. Competition for tax credits has increased; in California's first allocation round for 9 percent tax credits in 1998, for example, demand outstripped supply by about four to one (*Affordable Housing Finance* 1998c, 76). Competition has caused prices to rise; according to Cummings and DiPasquale, the average price per tax-credit dollar increased from about 47 cents in 1987 to 62 cents in 1996. More recent data suggest that prices have continued rising to current levels of between 70 to 75 cents (Cummings and DiPasquale 1999; Shashaty 1997, 4). As a result, investor returns have been driven

down from the high twenties in the early years of the tax credit to single digits today. This means that a growing portion of every tax-credit dollar is going into building affordable housing rather than to paying syndication costs or higher investor returns. The private sector now provides a wealth of financing options, including "one-stop shops," where developers can secure both debt and equity, thereby reducing processing time and the need for investor cash ("One-Stop Shops" 1998, 18), and specialty syndicators that make pay-in flexibility their hallmark ("Fund Emphasizes Flexible Cash Calls" 1998, 6).

From this growing competition for new tax credits, rising equity prices, and falling yields has emerged an active secondary market for low-income housing tax credits, which should produce additional efficiency gains. This new market has yet to be studied systematically, but trade reports suggest that more investors are buying in the secondary market because, among other reasons, construction and leasing risks are eliminated, a project's operating history helps in pricing, and investors can "see what the debt coverage has been, how well occupancy has been maintained, and whether reserves have been drawn on" ("Developers Capitalize on Resale Market" 1998, 95).

Although not a major player, HUD is doing its part to increase system efficiency by delegating the subsidy layering review to state housing finance agencies when a project uses both tax credits and Federal Housing Administration (FHA) insurance. Through four recent rulings, the IRS and federal financial regulators have done even more to strengthen the tax-credit housing delivery system:

1. A final rule published by the IRS in September 1997 to facilitate HUD's mixed-income, mixed-finance HOPE VI public housing transformation program confirmed that Section 8 rental assistance and public housing operating subsidies would not be treated as federal grants under the LIHTC and therefore would not reduce a tax-credit project's eligible basis (*Affordable Housing Finance* 1997, 1).

2. Interpretive Letter 800, issued jointly by federal bank regulators in 1998, stipulates that under Community Reinvestment Act (CRA) regulations banks are not required to invest directly in low-income housing tax credits but instead can receive equal credit by investing in pooled funds ("Ruling Clarifies CRA Treatment" 1998, 66).

3. IRS revenue ruling 98-15, issued March 4, 1998, contains long-awaited guidelines for nonprofits on preserving their tax-exempt status when entering into joint venture partnerships

with for-profits. The essence of the ruling, which directly addresses health care partnerships, is that operating partnerships must be structured in such a way as to give the nonprofit a critical element of control, thus enabling it to carry out its charitable mission (*Affordable Housing Finance* 1998b, 1).

4. A private letter ruling (PLR 9822026) by the IRS in May 1998 gave learning centers and other social service programs a boost by allowing the eligible basis of a tax-credit project to include a community building for day care and Head Start classes "even if the services were available to nonresidents, as long as the size and scope of the building's services didn't exceed those necessary to meet the requirements of project residents and the services were commensurate with the project's character" ("Learning Centers Improve Operations" 1998, 332).

Finally, with demand outstripping supply by considerable margins, housing finance agencies have begun to use their Qualified Allocation Plans (QAPs) more strategically to accomplish statewide housing goals—to steer rather than to row. Each year, states prepare QAPs describing how tax credits will be distributed, including the scoring system used to rank applications and any targeting criteria or set-asides used to favor particular kinds of developers, projects, market segments, or places. This is why, as competition for tax credits has intensified, it has become more important for all affordable housing stakeholders to have a say in what goes into their state's QAPs by participating in the public hearing and review process that accompanies the development of this strategic housing plan.

Although most QAPs for calendar year 1999 were still in process when these comments were submitted for publication, several states have made important decisions that are worth noting. For example, some seem to be intending to reduce preferences and set-asides for applications from nonprofit sponsors. A survey of 1999 plans by *Affordable Housing Finance* magazine found that only 15 percent of allocating agencies are planning to set aside more than the federally required 10 percent for nonprofits, which is an apparent reduction from previous years ("Tax Credit Allocation Priorities" 1997, 38). Many state agencies also seem likely to continue ramping up their use of tax credits as a tool to preserve older assisted housing, including both privately owned projects and public housing. In its last funding round in 1997, Massachusetts allocated virtually all of its credits to the Boston Housing Authority for redevelopment of public housing into mixed-finance, mixed-income housing and will continue to emphasize preservation in the future. Among other states, Illinois, Michigan, Connecticut, and Rhode Island are planning to do likewise ("Tax Credit Allocation Priorities" 1997, 38).

Some states, such as Florida, Maine, and Rhode Island, are beginning to favor the use of tax credits to help finance service-enriched housing for seniors (*Affordable Housing Finance* 1998d, 22). Maine is targeting bonus points to assisted-living projects as well as setting aside $500,000 of tax credits for projects that include a service commitment from the Maine Department of Human Services ("Tax Credit Allocation Priorities" 1997, 38). In the immediate future, tax credits are also more likely to be targeted geographically to meet the most acute housing needs. In 1998, for the first time, the bulk of California's tax credits were allocated proportionately to all 11 counties where 80 percent of the state's rent-burdened households live ("Tax Credit Allocation Priorities" 1997, 38). In addition, Ohio's 1999 QAP creates geographic funding pools for the first time ("Tax Credit Allocation Updates" 1999, 1), and targeting is on the rise in North Carolina and Missouri ("Allocation Limits" 1998, 331).

Challenges to the future of the LIHTC

In their empirical analysis of more than 2,500 tax-credit projects, Cummings and DiPasquale address important policy issues, including who is served by the tax credit. They estimate the average rent for tax-credit units ($436 in 1996 dollars) to be just 9 percent lower than the national average; although LIHTC projects serve low- and moderate-income households, rents are beyond the reach of many poor households without additional subsidy. A GAO study shows that the average income of tenants assisted under the LIHTC program was 37 percent of area median income. This is far less than the statutory minimum of 60 percent of median, but still much higher than the income range where the most acute housing needs are concentrated—below 30 percent of area median income.

HUD data show that in 1990 there were 1.9 million more renters with "extremely low" incomes than there were units affordable to them, and 31 states had fewer units than needed for renters in this income range. Since 1990, these shortages have worsened. Between 1989 and 1995, the number of extremely low income renters rose by 800,000, but the number of units affordable to them dropped by 900,000 (Nelson 1998). Moreover, according to HUD, "this portion of the affordable housing stock is even more vulnerable than these net losses suggest. Tracking the same housing units twice over four-year periods from 1985 to 1992 in 41 metropolitan areas indicates that only 33 percent of the original units remained both in the stock and in the lowest rent category." The result is that shifts in the extremely low rent stock are forcing poor families that do not receive rental assistance to live in metropolitan neighborhoods characterized by higher rates of poverty, older housing, and greater racial segregation (Housing Market Dynamics, 3). Therefore, if the LIHTC

is to remain the centerpiece of our subsidized production system, we need to find ways to enable the program to serve lower-income households without further straining the operating economics.

With regard to income targeting, Cummings and DiPasquale discuss the pressure from housing advocates and state and local policy makers to use the program to serve more lower-income tenants. They report that even without deeper targeting, projects are tightly run, with revenues just covering costs for many projects. More than 20 percent of all projects in their study had negative cash flows in 1995, and operating expenses equaled or exceeded 115 percent of revenues for 10 percent of the sampled projects. Information from other sources confirms that a sizable number of older tax-credit projects are facing a cash flow squeeze and incipient deterioration. For example, E&Y Levanthal's review of tax-credit projects that had recently changed ownership found that 11 percent of the 120,000 units had occupancy rates below 90 percent and that some of the projects had operating expenses that were $300 to $400 more per unit than projections ("Equity Prices Show Small Rise" 1998, 13).

Thin operating margins also have implications for housing quality. Cummings and DiPasquale recognize that because the tax-credit program is just a dozen years old, most of this housing has not yet required major capital repairs or replacements. But it soon might, and the ability to meet these needs over time will determine the long-term financial viability of these projects and depends critically on funding reserves. Recent trade reports confirm Cummings and DiPasquale's concerns, suggesting that poor project underwriting continues to be a major concern among tax-credit investors. One recent article suggested that "as many as 20 percent of tax-credit projects may be unable to meet their debt service requirements" (*Affordable Housing Finance* 1998a, 1998b) while another reported that tax-credit reservations have been made recently for projects by sponsors with no liquid net worth, with rents higher than market rents, debt service coverage ratios as low as 1.0 to 1, and with operating expenses often underestimated by as much as $300 to $400 per unit (Shashaty 1997, 4). Fortunately, many owners have been able to take advantage of low interest rates to strengthen their project cost structures by refinancing the debt on their older tax-credit projects, which should help matters in the short run ("Equity Prices Show Small Rise" 1998, 14).

The above analysis suggests that a significant minority of existing projects will have difficulty remaining competitive in the marketplace and finding the necessary capital for systems renewal as they age. To prevent the same kinds of problems happening to new tax-credit projects, the National Council for State Housing Agencies, the de facto trade organization for the tax-credit community,

recently issued new guidance for state consideration. Among other things, the guidelines recommend that state housing finance agencies impose a minimum 1.15 debt service coverage ratio on tax-credit projects and require projects to maintain operating reserves equal to six months of operating expenses plus debt service payments and replacement reserves equal to $200 per unit per year for new construction and $300 per unit per year for rehabilitation projects (*Affordable Housing Finance* 1998c, 1).

Profitability and operating margins will factor into how owners decide to deal with the impending expiration of affordability use restrictions on their tax-credit projects. Cummings and DiPasquale address this important issue to the extent that their data allow. In just a few years, the 15-year low-income affordability requirement of the earliest tax-credit projects will expire, with the result that many of these units could convert to market rents, creating a problem similar to today's Section 8 contract renewal and expiring-use problem. While the future of individual projects will depend on many factors—chief among them market conditions—some portion of early tax-credit projects are likely to be converted to market-rent developments, especially in suburban, high-growth areas. Whether these conversions will significantly reduce the supply of affordable housing, Cummings and DiPasquale cannot say, because this will depend on the relationship between project rents and market rents—the narrower the gap, the smaller the impact.

Because neither HUD nor the affordable housing community has sufficient data to inform this issue, individual states have begun funding their own expiring-use studies. The Washington State Housing Commission, for example, received funding last year to study early tax-credit projects with expiring affordability requirements, while California will start a study in 1999 ("Loss of Affordable Housing Feared" 1998, 136–37). Arkansas already is considering providing financing for any rehabilitation that is necessary to keep projects affordable. While Cummings and DiPasquale can tell us little about where and how substantial the loss of affordable housing will be as a result of expiring affordability restrictions, their analysis of subsidy layering suggests that cities may be more at risk than suburbs. At least, this is how I interpret their finding that "suburban projects use virtually no soft loans or grants and have little concessionary financing," while in most cities and rural communities it is necessary to piggyback other subsidies on top of the tax credit to make projects work. This suggests that the expiration of use restrictions on suburban projects with near-market rents would have little impact on existing tenants. Because most urban and rural projects come onto the market at rents significantly below prevailing rents for new construction, the expiration of use restrictions for more big city projects could significantly displace low-

income households, depending on neighborhood market conditions at the time.

For-profit owners of tax-credit housing already are preparing for this new phase of the tax-credit program. For example, Boston Capital, a participant in the Cummings and DiPasquale study, has set up a separate department to begin planning for the disposition of developments that received tax-credit allocations in 1987. A company spokesman reports Boston Capital has started looking at exit strategies for these 150 projects, representing as many as 8,000 units, in the company's portfolio.

Another Cummings and DiPasquale study participant, the Chicago-based National Equity Fund, structured its early tax-credit partnerships to give local community-based nonprofits the right of first refusal to purchase the properties for the outstanding debt plus exit taxes. Many other community development–oriented syndicators have done likewise, but preserving these projects for existing residents requires the nonprofits to have the financial wherewithal to buy the properties. Because of the importance of financing to the future use of tax-credit projects, housing finance agencies—most of which also serve as their states' tax-credit allocating agencies—will be key players in preserving tax-credit projects as lower-income housing ("Loss of Affordable Housing Feared" 1998, 136–37).

Conclusions

In closing, I argue that no housing program, including the Low-Income Housing Tax Credit, can prosper for long under a veil of ignorance. Because it took four or five years to ramp up production of tax-credit housing, the lack of project-specific data was not a major problem in the beginning. Perhaps the tax credit even benefited from anecdotal reports of program successes, which substituted for more systematic outcome assessments, during a period when there was very little political support for supply-side subsidies of any kind.

Ten years later, however, the tax credit is now our biggest production program, having created more than 700,000 units of affordable housing in thousands of projects in thousands of communities across the country. Cummings and DiPasquale illustrate how systematic empirical analysis of project-level data can demonstrate program strengths, show how the program adapts to different market conditions, identify areas of policy concern, and stimulate a national conversation about future directions and possibilities. This forum is a good way to start that conversation, because the 106th

Congress probably will act on bipartisan legislation to raise the amount of tax credits by 40 percent, from $1.25 per capita to $1.75 per capita. Since the tax credit has not been increased since the program's inception, the rationale for this legislation is that the increase is needed to offset the cumulative effects of inflation. Because their empirical study is so rich, it is reasonable to ask whether Cummings and DiPasquale's article has anything to say about this pending legislation. I would argue that it does.

While their article is full of policy implications, their most relevant analysis has to do with who is served by the tax credit and at what rent burdens. Because the most acute housing problems are suffered by those with incomes below 30 percent of median, and because the tax-credit program serves households with substantially higher incomes, it seems to me we should not increase spending on the tax credit unless the LIHTC addresses this problem. Therefore, I would argue that any legislation to increase the tax credit also should change the allocation formula and make it possible for the tax credit to reach more poor households. This could be done by permitting a bigger tax credit for projects designed to house poorer people.

In addition to a variable tax credit, I suggest that Congress and the tax-credit community consider a proposal originated by Kathryn Nelson, a career economist at HUD, who recommends changing the present tax-credit allocation formula to better reflect the actual need for low-income housing in a given state and enable more extremely low income families to live in tax-credit housing. According to Nelson, the 40 percent increase in credits could be better targeted if it were allocated according to each state's share of low-income renters, weighted by its relative shortage of units affordable to those renters (Nelson 1998). Each state would continue to receive its current dollar share of the credit, but both the 40 percent increment and any future increases for inflation would be allocated according to the number of low-income renters and the shortage of rental housing affordable to them.

Recognizing that most tax-credit units are generally not affordable to poor families unless the units are layered with additional subsidies, Nelson wants to increase tax-credit compatibility with other HUD housing programs. Rather than requiring that units be affordable to those with incomes at or below 60 percent of area median, Nelson recommends that maximum rents be set at the *lower* of HUD's Fair Market Rent or at rents affordable to households with incomes at 65 percent of area median. These are the same affordability requirements that Congress applied to HOME and other major federally funded housing production programs in 1990 (Nelson 1998). This change would ensure that all tax-credit housing is ac-

cessible to poor families with tenant-based rental assistance, which is how it should be.

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