

June 25, 1992

## TIME TO LET THE LOW-INCOME HOUSING TAX CREDIT PROGRAM EXPIRE

### INTRODUCTION

Congress soon must decide whether to continue the biggest tax incentive for builders of low-cost housing in America. Enacted as part of the 1986 Tax Reform Act, this incentive, the Low-Income Housing Tax Credit (LIHTC), finances the construction and rehabilitation of low-cost rental housing. Under this program, individuals and corporations may receive a credit against their income tax for investments in certain rental housing. The LIHTC incurred a loss to the federal Treasury of about \$600 million last year. If permanently reauthorized, it eventually could incur an annual revenue loss of some \$3 billion.

The program has been reauthorized by Congress three times on a temporary basis, most recently for the six-month period ending this June 30. One bill (H.R. 5150), sponsored by Representative Charles Rangel, the New York Democrat, would make the program permanent. Two other bills, one in the House (H.R. 5240), sponsored by Representative Frank Guarini, the New Jersey Democrat, and another in the Senate (S. 2773), sponsored by Senator John Danforth, the Missouri Republican, would extend the LIHTC for another eighteen months.

Instead of extending the credit, however, Congress should end it.

Supporters of the LIHTC claim that tax credits make rental housing more affordable for a great many low-income families. They note that the program thus far has financed some 420,000 rental units over the past five years, an average of over 80,000 annually.<sup>1</sup> But the claim is misleading, since much of the housing would have been built anyway. More important, the LIHTC is an inefficient way to enable low-income families to obtain decent, affordable housing. The Congress-

---

1 Jacqueline L. Salmon, "Housing Groups Plan Push for Tax Breaks," *The Washington Post*, April 25, 1992; Salmon, "Low-Income Tax Credits Draw Criticism," *The Washington Post*, June 13, 1992. Some claim that the figure is even higher. The American Planning Association, which strongly supports the program, says that the LIHTC has made possible 120,000 low-income rental units annually, or 600,000 units during 1987-1991. See "Low-Income Housing Tax Credit Nearing Deadline," *Planning*, May 1992, p. 6.

The LIHTC was intended to remedy these shortcomings. The program allows an investor to reduce his income taxes by a certain percentage of the amount invested in an eligible project. Specifically, individuals and corporations are able to invest in rental housing construction or rehabilitation, and take as a tax credit the portion of the building or the project value reserved for occupancy by low-income households.

The main features of the LIHTC include:

**State administration.** While the Internal Revenue Service (IRS) formally is in charge of the program, the IRS designates a housing agency within each state to determine eligibility for the credits, and to monitor compliance with federal rules governing income eligibility and financial accountability on the part of the developer. It is the states that decide whether a rental housing development qualifies for a credit, and how large the credit will be. States have a total annual allocation of credits, according to a federally designated formula. The allocation is based on a per capita rate that applies to all states—currently \$1.25—times its total population. For example, a state with a population of 4 million would receive \$5 million worth of annual credit authority.<sup>7</sup>

**Federal determination of the duration and size of the credit.** A private investor receives a tax credit over a ten-year period on low-income rental dwellings that are constructed, rehabilitated, or purchased for rehabilitation. While corporations in most instances do not face an annual limit on the total value of credits they can receive, individual investors do face a limit equivalent of a \$25,000 tax deduction. Thus, a person in the 28 percent tax bracket can obtain up to \$7,000 worth of credits each year.<sup>8</sup>

**Federal rent restrictions.** A household living in a rental unit assisted under the program pays 30 percent of its income toward rent. This requirement is similar to other federal housing programs, such as public housing, and the Section 8 rent certificate and voucher programs. LIHTC dwellings must be available for occupancy by low-income tenants for thirty years.<sup>9</sup> After fifteen years, the owner may terminate his commitment to keep units affordable to low-income households only, but must offer the project for sale at a price no greater than his original price, adjusted for inflation. Any new owner must agree to operate under the same restrictions on rents. If the state housing agency cannot find a buyer willing to accept these restrictions, the project may be converted to non-low-income use, but tenants can remain in their dwellings with restricted rents for at least three years.

---

7 Additional credit authority is available for projects financed with tax-exempt bonds. The 1989 reauthorization lowered the per capita allocation to \$.9375. The 1990 reauthorization, however, restored the rate to \$1.25.

8 Projects generating more than this amount per person in credits are typically syndicated. Under syndication, a person sells part of his interest in a property to outside investors.

9 Originally, the minimum period was fifteen years. Pressure from housing advocacy groups resulted in Congress lengthening the period to thirty years.

**Federal eligibility standards for rental projects.** To qualify for the credit, a rental project must meet one of two criteria. At least 20 percent of the dwellings in the project must be rented to households with incomes below 50 percent of the area median income. Or, at least 40 percent of the dwellings in a project must be rented to households with incomes below 60 percent of the area median income. Area income standards are based on Census Bureau figures. The tax credit is available only for the low-income units in a project, although frequently all units in a project will qualify.

**Federal rules governing the portion of project costs eligible for credits.** For construction or renovation costs borne by the developer, credits are available to the investor for up to 70 percent of the capital cost—or present value—of the eligible property. When the developer purchases existing rental housing for renovation, or buys certain rental housing already receiving a federal subsidy, the credits are available for up to a maximum of 30 percent of the property's present value.

The Low-Income Housing Tax Credit thus should be seen as a federal-state partnership that uses the federal tax code to compensate people for investing in projects to build or renovate housing for low-income households that otherwise might be financially unattractive. In one major sense, it is like HUD rent subsidy programs. It reserves housing over long periods of time for households whom HUD deems too poor to afford it.

Supporters of the program want to tie it as much as possible to rent subsidies. For example, a 1989 report from a congressional task force headed by Senator George Mitchell, the Maine Democrat, and Senator John Danforth, the Missouri Republican, called for tenant assistance to be given on top of these tax credits wherever possible. The Mitchell-Danforth task force saw the LIHTC as especially useful in preventing the conversion of projects reserved for low-income families into projects available to families with higher incomes. That report alleged that a diminishing stock of affordable housing justified the credits.<sup>10</sup> The report was very influential in the federal government expanding the states' authority in running the program.

## PROBLEMS WITH THE LIHTC

Supporters of the Low-Income Housing Tax Credit program claim it to be both successful and necessary. Argues St. Paul, Minnesota, Mayor James Schiebel, "For the production of housing, the only tool we are receiving from the federal government is the LIHTC. This isn't just something we like; this is something we need."<sup>11</sup> And according to F. Barton Harvey III, co-chief executive officer of The Enterprise Foundation, a nonprofit homebuilding organization, "There is no good reason for this program not to be extended."<sup>12</sup>

---

10 *Report of the Mitchell-Danforth Task Force on the Low-Income Housing Tax Credit*, prepared for Senator George J. Mitchell (D-ME), and Senator John C. Danforth (R-MO), January 1989. See pp. 3-7.

11 Quoted in Joseph A. Haas, "Despite Strong Support, Low-Income Housing Tax Credit Extension Seems Unlikely This Year," *Housing and Development Reporter*, October 14, 1991, p. 459.

The National Association of Home Builders, meanwhile, projects that continuing the credit would result in the construction or preservation of 1.25 million affordable rental units over ten years.<sup>13</sup>

A report completed in 1991 for HUD by ICF Incorporated, a consulting firm based in Fairfax, Virginia, gives the most comprehensive available picture of the program.<sup>14</sup> The report, which evaluated the first two years of the program's operation (1987 and 1988), consisted of two separate surveys. The first described the characteristics of rental properties financed with credits. The second survey examined the financial characteristics of developers using credits.

ICF found that the availability of credits enabled investors to earn after-tax investment returns averaging 17 percent for individuals and 19 percent for corporations on LIHTC dwellings.<sup>15</sup> Without the credit, ICF calculated, only 12 percent of all assisted dwellings would have produced returns over 15 percent, and some 60 percent of assisted dwellings would have lost money.

Supporters of the program use this finding to argue that it significantly contributes to the availability of low-cost rental housing. However, supporters overlook several problems with the LIHTC.

**First**, other subsidies are usually layered on top of the LIHTC, so the cost of the program in practice is much higher than the tax credit itself. According to the ICF study, when all sources of funding are counted, the average LIHTC-subsidized dwelling incurs a public cost of \$37,627 over a fifteen-year period (about \$2,500 annually). But the tax credits make up only \$11,739, or about 31 percent of this total.<sup>16</sup> Long-term federal rent subsidies usually are needed if the project is to comply with IRS requirements that units are within reach of the poor renters. Some 46 percent of tenants in LIHTC-supported units received either Section 8 rent certificates or vouchers.<sup>17</sup> In fact, about four of every five LIHTC rental units require a rent subsidy from some federal, state, or local program.<sup>18</sup>

**Second**, the program has "created," through construction or rehabilitation, housing units that in large measure would have been created anyway by the unsubsidized private sector. According to the Congressional Budget Office (CBO),<sup>19</sup> the LIHTC and other production programs do not so much create housing as "crowd

---

12 Quoted in *ibid.*

13 *Ibid.*

14 U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Evaluation of the Low-Income Housing Tax Credit: Final Report*, prepared by ICF Incorporated, Fairfax, Virginia, February 28, 1991.

15 *Ibid.*, pp. 14-15.

16 *Ibid.*, p. 16.

17 The ICF report also found that households receiving a voucher or certificate had an average income of \$5,981 compared to \$11,400 for qualifying households not receiving such assistance. Rents (including utilities) for both groups were low: \$347 and \$317, respectively. See *ibid.*, p. 8. Projects can be supported with state or local, as well as federal, rent subsidies.

18 *Ibid.*, pp. 6-7. The ratio in 1988 was three of every four units, a slight decrease.

19 Congressional Budget Office, *op. cit.*, p. 2.

out” unsubsidized housing that would have been created.<sup>20</sup> This is especially true for new construction. An analysis of the LIHTC by the Joint Committee on Taxation notes, “Subsidies to new construction could make it no longer economic to convert some . . . older properties to low-income use, thereby displacing potential low-income units.”<sup>21</sup> Some developers use the tax credit merely to enhance the profitability of a project that they would have undertaken in the first place. Example: Jack Y. Matthews, general partner of the Washington, D.C.-based W & M Associates, received a \$250,000 tax credit for a project he finished two years ago. Admits Matthews: “I was going to do the job anyway.”<sup>22</sup>

**Third**, the program is federal rent control by any other name. The rent restriction exists in order to limit “excessive” profits that developers could reap under the program. While the intent here may be laudable, two problems are created. First, tenants of LIHTC dwellings may not see them as attractive without the heavy rent subsidy. Argues the Congressional Budget Office study: “Landlords can still attract tenants because the rents are limited, but some tenants might leave the project for more convenient housing if rents were increased only slightly.”<sup>23</sup> Second, like local rent control, it reduces the supply of low-cost unsubsidized housing by restricting rents necessary for upkeep and maintenance.

**Fourth**, the program requires extensive regulation. State agencies must verify that all households in a project fall below income-eligibility ceilings. Preventing “excess profit” on individual housing projects requires state regulators to gather a large amount of information on rents, family incomes, and other household characteristics. Compliance by the Illinois Housing Development Authority with new IRS monitoring rules, for example, will cost an additional \$30,000 to \$40,000 in that agency’s annual operating costs.<sup>24</sup> These costs are typically passed on in the form of higher fees to developers of LIHTC projects, which in turn generate a demand for additional government subsidies.

Even with tougher regulation, verification of the compliance of builders and developers may be difficult.<sup>25</sup> Ironically, money spent on safeguarding against excess profits has offset much of the potential savings to low-income tenants. Concludes the CBO: “[T]he reforms may have converted excess profits into excess

- 
- 20 For evidence that this tendency generally has occurred in federal supply-oriented housing programs, see Michael P. Murray, “Subsidized and Unsubsidized Housing Starts: 1961-77,” *Review of Economics and Statistics*, Vol. 65, No. 4 (November 1983), pp. 590-97; John C. Weicher, “Private Production: Has the Rising Tide Lifted All Boats?,” in Peter D. Salins, ed., *Housing America’s Poor* (Chapel Hill, NC: University of North Carolina Press, 1987), pp. 45-66.
- 21 Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92) (Washington, D.C.: U.S. Government Printing Office, January 27, 1992).
- 22 Quoted in Christina Del Valle and David Greising, “Low-Income Housing: Is There a Better Way?” *Business Week*, June 22, 1992, p. 62.
- 23 Congressional Budget Office, *op. cit.*, p. 8.
- 24 See “State Agencies Seek Changes in Compliance Monitoring Rules,” *Housing and Development Reporter*, March 16, 1992, p. 849.
- 25 See U.S. General Accounting Office, *Rental Housing: Observations on the Low-Income Housing Tax Credit Program*, GAO/RCED-90-203, August 1990, p. 21.

overhead costs, with little or no increase in the overall efficiency of the housing credit.”<sup>26</sup>

Tax credits can be a sound instrument of public policy, especially if they are targeted directly to the consumers of services, and are not encumbered with excessive regulation. But tax credits turn out to be an inefficient way of making rental housing more affordable. They require higher federal outlays as well as tax expenditures; they substitute “affordable” public housing for housing that likely would have been produced by the private sector anyway; they take housing off the general market; and they impose regulatory costs and delays. Congress should recognize these shortcomings, and look for alternative measures.

## VOUCHERS: A PARTIAL SOLUTION FOR RENTAL AFFORDABILITY

While HUD Secretary Jack Kemp supports extending the LIHTC, he also agrees that housing vouchers are the best way of improving housing affordability for the poor. HUD’s own research staff recently concluded that while 90 percent of vouchers distributed to tenants in non-LIHTC units go to households with “worst-case” needs, only 25 percent of “free-standing” (unsubsidized by outside sources) LIHTC units go to such households.<sup>27</sup>

### Limitations of Vouchers

Vouchers reach more potential tenants than tax credits, or for that matter, other forms of housing subsidy, and so are preferable to the LIHTC. But vouchers raise two major concerns:

**First**, vouchers involve budget increases rather than tax reductions. To be sure, they make more efficient use of federal money than subsidies for new construction. Yet by requiring higher levels of HUD spending, the voucher program makes it harder to control total government spending and the federal deficit. Current projections show that HUD spending will go up sharply. In fiscal 1991, HUD outlays were almost \$22.8 billion. The Office of Management and Budget (OMB) projects this figure to be \$24.2 billion in fiscal 1992 and \$28.1 billion in fiscal 1993.

A voucher is good for five years, and subsidizes the difference between what HUD deems a “fair market rent” and what the household can afford to pay, assuming rent is no more than 30 percent of its income. The cost thus can be enormous in expensive rental markets such as New York City and San Francisco. The danger for taxpayers is that vouchers could become another open-ended entitlement program.

---

<sup>26</sup> Congressional Budget Office, *op. cit.*, p. 19.

<sup>27</sup> U. S. Department of Housing and Urban Development, Office of Policy Development and Research, *Priority Housing Needs and Current Housing Assistance Programs*, prepared for the Senate Committee on Appropriations, Subcommittee on VA, HUD and Independent Agencies, April 30, 1992, pp. 3, 7.

**Second**, vouchers can be as counterproductive as other welfare and income-support programs if their receipt is unconditional. Some supporters of vouchers want them to become entitlements; that is, once a poor household demonstrates financial need, it automatically gets a federal subsidy. Without imposing conditions on the receipt of these vouchers, such a policy could move America ever closer toward permanently subsidizing all the basic expenses of nonworking families at the expense of working families. Persons on welfare already have little incentive either to marry or seek full-time work. If vouchers become an entitlement, the situation will become worse.

If Congress wants to improve rental housing opportunities for those on welfare, it should extend the voucher program rather than the LIHTC. But receipt of a voucher should be conditioned on serious welfare reform measures, most important, a work requirement for able-bodied recipients. Such a policy should exempt the elderly poor and most mothers with pre-school children.<sup>28</sup> It should not, however, exempt any other type of household.

## WHAT CONGRESS SHOULD DO

If Congress wishes to make rental housing more affordable to households with low incomes, without imposing unnecessary costs on taxpayers, lawmakers should do three things, in order of preference:

- ✓ **Help working families with tax relief.** The best way to make housing affordable is to lower taxes for all working households, as outlined in The Prosperity Plan developed by Heritage Foundation scholars.<sup>29</sup> Among other things, the Prosperity Plan would eliminate income tax liability on working families with incomes below 120 percent of the current poverty threshold, or roughly \$16,000. This could increase the take-home income of these families making it easier for them to afford rents.
- ✓ **Allow the LIHTC to expire and use vouchers for poor renters.** Vouchers are a far more efficient alternative to the LIHTC. At the same time, receipt of housing vouchers should be made conditional on a work requirement. Under no circumstances should Congress make it into another entitlement program.
- ✓ **Allow renters to deduct a portion of rent from taxable income.** As an alternative to general tax relief, Congress should change the tax code to make rental payments tax-deductible up to a certain level, much as mortgage interest and property tax payments are tax-deductible for homeowners. This measure would reduce the after-tax cost of rent for families, and would encourage nonworking renters to find employment, since earned income, rather than welfare payments, incurs tax liability.

---

28 See Robert Rector, "Strategies for Welfare Reform," *Heritage Lecture* No. 378, January 31, 1992, p. 10.

29 Hodge, *op. cit.*

## CONCLUSION

Congress is under great pressure from developers and housing advocates to retain the Low-Income Housing Tax Credit. One House bill (H.R. 5150) would make the program permanent, while another House bill (H.R. 5240) and a Senate bill (S. 2773) would extend the program for eighteen months. But the credit program is a very inefficient method of making housing affordable for low-income families. Lawmakers instead should consider other ways of helping families who cannot afford decent housing, and allow the LIHTC program to expire.

Carl F. Horowitz, Ph.D.  
Policy Analyst

*All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.*