Low-income housing credit

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Designed to encourage the acquisition, construction, and/or rehabilitation of housing for low-income families, this federal tax credit, which is criticized for its inefficiency and complexity, is one of the few mechanisms for low-income housing support.

This credit, enacted as part of the Tax Reform Act of 1986 and made permanent in 1993, replaced a variety of incentives for investment in low-income housing with a tax subsidy aimed more directly at lower-income households.

Overview

Under Section 42 of the Internal Revenue Code, qualifying individuals and corporations can claim a tax credit over a 10-year period equal to a percentage of the depreciable costs incurred to provide low-income housing. For new construction and costs of renovation on qualified housing that does not receive additional federal subsidies, the credits may have a present value of up to 70 percent of the depreciable basis in low-income units. A reduced credit with a present value of up to 30 percent is available for housing with other federal subsidies and for the cost of purchasing existing housing that is renovated. The corresponding maximum annual credit percentages were 8.7 percent and 3.7 percent, respectively, in June 1995.

To qualify for the credit, either 20 percent of the units in a housing project must be rented to tenants with incomes below 50 percent of the area’s median income, adjusted for family size, or 40 percent of the units must be rented to tenants with incomes below 60 percent of the median income. The rent on a low-income unit is limited to 30 percent of the qualifying income level, assuming a family size equal to 1.5 times the number of bedrooms in the unit.

Past tax credits are recaptured with interest if the project fails to comply with the rent limits and set-aside requirements during the first 15 years. The percentage of credits recaptured phases out in the 11th through 15th years. In addition, project owners must agree to provide low-income units for at least 30 years, although owners may terminate this commitment after 15 years under certain conditions.

State housing authorities authorize credits for housing projects. Credit allocations for each project are supposed to be limited so that investors and project organizers do not reap excessive profits. Each state may allocate up to $1.25 per capita for projects that are not financed with tax-exempt bonds. Total credits allocated for bond-financed projects are limited only by states’ authority to issue tax-exempt bonds (for a more detailed description, see Johnson and Schober 1994).

The Joint Committee on Taxation estimates that the tax expenditure on low-income housing credits will total $15 billion from 1995 to 1999. About two-thirds of the credits are claimed by individuals and one-third by corporations. The annual amounts are expected to increase from $2.2 billion in 1995 to $3.7 billion in 1999, because more and more projects qualify for the credits over time. Credits paid in 1999 will go to projects placed in service not just in 1999 but also during the preceding 10 years. Once the credit is fully phased in—around the turn of the century—the tax expenditure should increase at about the rate of growth of the population.

Analysis

The question “Is the low-income housing credit an efficient way to help poor people meet their housing needs?” can be dissected into two parts. First, how efficient are government subsidies to the supply of housing, compared with demand-based subsidies? Second, if supply subsidies are called for, how efficient is the low-income housing credit, compared with other subsidy mechanisms? The debate on both of these questions has been lively and remains unresolved.

Efficacy of housing supply programs

If the supply of low-income housing is very elastic in the long run, then production of limited amounts of subsidized housing will simply replace other housing that would otherwise have been provided. Housing supplied or subsidized by the government might increase the average quality of housing available to low-income tenants, but it would have little lasting effect on the quantity or price of housing available to poor people. (See Weicher and Thibodeau 1988 for a discussion of the effects of subsidized housing on the housing market as a whole.) Moreover, because new and substantially rehabilitated housing is expensive to produce, it is likely to be worth far less to tenants than an equal cash supplement, such as housing vouchers. (For a more complete comparison of housing vouchers with low-income housing credits, see Congressional Budget Office 1992.)

Advocates of supply subsidies argue that, in certain housing markets, the supply of housing is inelastic, even in the long run. Apgar (1990) argues
that shortages of decent low-rent housing have been getting worse over time. As a result, housing produced or subsidized by the government will permanently increase the stock of housing available. Moreover, because supply is inelastic, supply-based programs can be more efficient than demand subsidies because they generate pecuniary externalities. The augmented supply lowers the price of housing, generating benefits not only for the tenants in the new housing but for others in the market as well (Coate et al. 1994). In contrast, a program like housing vouchers, which expands the demand for housing without affecting the supply, raises the price, harming low-income tenants who do not have vouchers.

Supply is likely to be elastic in markets with high vacancy rates even in the short term, and vacancy rates are relatively high by historical standards. The vacancy rate for rental housing was 7.4 percent in 1994, according to the Commerce Department. By comparison, it was 5.9 percent in 1984 and 5.3 percent in 1970. Since the late 1980s, vacancy rates have been higher than at any time since the 1960s. In the 61 largest metropolitan areas, the average vacancy rate was 7.5 percent in 1993. Only four cities had vacancy rates below 4 percent.

Although vacancy rates are lowest for very low-rent housing (which is the housing most likely to be demolished or abandoned if unoccupied), they are highest at the rent levels qualifying for low-income housing credits. Median family income in 1993 was about $37,000. Based on 60 percent of that income level, monthly rents in credit-eligible housing would average about $550. In 1993, 8.2 percent of housing renting for $500 to $599, and 8.6 percent of housing renting for $450 to $499, was vacant. Overall, two-thirds of the vacant units rented for less than $500. These vacant units—especially the inadequate ones—are likely to leave the stock if better-quality housing is supplied (Weicher 1990).

In the long run, the supply of unsubsidized housing is likely to be very elastic because housing investments have to earn rates of return competitive with other capital. Thus, even in tight markets, subsidized housing starts are likely to displace unsubsidized housing over the long run. However, adjustment to this long-run equilibrium may be slow. Thus, targeted supply subsidies might speed adjustment to equilibrium. For this reason, some analysts advocate supply subsidies as a complement to demand subsidies in tight housing markets (Struyk 1990).

Supply subsidies might also enhance efficiency if they mitigate market failures. The market for low-income housing might fail for several reasons. Lenders might be unwilling to lend to investors in neighborhoods where many poor people live because of class or racial biases (a form of discrimination often referred to as “redlining”). To the extent that discrimination in lending occurs, a capital subsidy might improve the allocation of capital.

In addition, when an area falls into decline, decayed housing creates a negative externality that discourages investment in housing on a small scale. A significant part of property value arises from the characteristics of the neighborhood (indeed, externalities are sometimes referred to as “neighborhood effects” in the economics literature). Thus, if all or most of the housing in a neighborhood were improved, it would be worth more per unit than would one or two improved buildings. As a result, government investment, directly or indirectly, might generate social benefits by improving a neighborhood.

Indirect evidence of such market failures might be the poor quality of housing available for rent to poor families. Harvard University’s Joint Center for Housing Studies reports that 22 percent of very poor households (incomes below 25 percent of area median income) lived in structurally inadequate housing in 1991. In rural areas, 31 percent of such households lived in substandard housing. The percentage of households in inadequate housing declines with income, and the income limits for the low-income housing credit are relatively high. Nearly 90 percent of households with incomes between 50 and 80 percent of the median lived in decent housing. In this income range, housing problems were not particular to any region, and cities and rural areas had only slightly more inadequate housing than suburbs. Thus, poor-quality housing is not pervasive. It derives from the inability of a poor household to pay for decent housing. In most housing markets, the primary problem seems not to be market failure, but affordability.

**Advantages and disadvantages of the low-income housing credit**

Suppose that policymakers decide that the government should build or subsidize the creation of affordable housing. How does the low-income housing credit compare with other available mechanisms for increasing supply? The credit has obvious political advantages. First, the private sector builds the housing, rather than state or federal governments.

Second, the program devolves almost total control over allocation of the credits to state housing agencies, a sterling example of how fiscal federalism (see Fiscal federalism) can be implemented through the tax code. Third, new spending done through the tax code (see Tax expenditures) is viewed as a tax cut, rather than increased government spending.
These advantages come at a high price. The equity capital raised for investment generally comes from syndicates of individual investors or from corporations. Syndicating limited partnerships is technically complex—and expensive. The General Accounting Office has estimated that these costs consume 27 percent of equity invested in low-income housing credit projects. Moreover, because the credit is very complex and risky to investors, who might become ineligible for credits and have to repay past credits with interest if their project fails to comply with the restrictions of the law, investors require high after-tax rates of return. Stegman (1991), using an estimated internal rate of return of 15 percent, estimates that housing produced by syndicates of individuals costs the government nearly twice what a direct capital grant to the project sponsor would cost.

Corporate investors do not have to form syndicates to raise capital, but their lower overhead costs may translate into higher profits rather than smaller subsidies. Lampert (1993), who calls the low-income housing credit “perhaps the last true tax shelter remaining—especially for the widely held corporation,” claims that “lofty internal rates of return, ranging from 15 percent to 25 percent, are possible in today’s market.”

The costs of the low-income housing credit include the costs of administration by federal and state housing agencies and by the Internal Revenue Service (IRS). Adequate monitoring by state housing agencies and the IRS would be expensive, but, without such monitoring, credits might be allocated to fraudulent claimants, to those who do not comply with the income or rent restrictions of the law, or to investors who earn above-normal rates of return. Public information on the administrative effort of state housing agencies does not exist, but Guttman (1995) reports that the IRS has no internal tracking mechanism to ensure that those who claim the low-income housing credit are eligible for it. As a result, the IRS estimates that $6 billion or more in credits might have been improperly claimed since the tax credit was enacted in 1986. Both the costs of non-compliance and the costs of administration must be added to the total cost of the tax credit approach.

**Additional readings**


