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

Benson F. Roberts
Local Initiatives Support Corporation

F. Barton Harvey III
Enterprise Foundation

Abstract

The Low-Income Housing Tax Credit (housing credit) that Cummings and DiPasquale portray is effective, efficient, and healthy. However, rapid changes in the industry have turned some of their data stale, and the absence of suitable context and information invalidate some key analyses and findings. Moreover, the researchers sometimes seem to see the glass as 10 percent empty instead of 90 percent full. A practitioners' perspective is more positive.

The housing credit generates an array of public benefits while harnessing private investors' business discipline. Genuinely low-income tenants occupy the housing. The housing revitalizes low-income communities. Properties are in good financial and physical condition. The housing credit is also cost effective. The economic fundamentals of producing low-income rental housing, not the housing credit, necessitate substantial subsidies. A remarkably high proportion of the federal tax-credit subsidy goes into the housing, and investor returns are modest. Nonprofit-sponsored production appears to cost more because nonprofits are prominent in high-cost locations and for other similar reasons, not because nonprofit developers are inefficient.

Keywords: Low-income housing; Multifamily; Tax policy

Introduction

Since its enactment in 1986, the Low-Income Housing Tax Credit (LIHTC or housing credit) has become more than just the latest in a long line of tax incentives for investment in affordable housing. It has become the linchpin of a whole generation of affordable housing production and low-income neighborhood revitalization. As such, the LIHTC has some advantageous features: incentives for private participants to serve public interests; the flexibility to meet local needs; the power to assemble working collaborations among developers, communities, investors, lenders, and government at all levels; state administration; and adaptability to changing market conditions. But the housing credit is not infinitely mutable. It is, after

all, a capital subsidy, subject to the economics of affordable housing production and the constraints inherent to capital subsidies.

Our organizations are two of the four that provided data for Jean Cummings and Denise DiPasquale's research. Local Initiatives Support Corporation (LISC) and the Enterprise Foundation are both nonprofit organizations with broad community development and affordable housing missions. Our affiliates, the National Equity Fund (NEF) and the Enterprise Social Investment Corporation (ESIC), respectively, are among the nation's largest and most experienced organizations at using the LIHTC to raise, deploy, and manage private capital. All of our work is through nonprofit sponsors, predominately in low-income communities. As such, we are very familiar with many of the properties in the database and the nuances of how the tax credit actually works in practice.

The tax credit that Cummings and DiPasquale portray is effective, efficient, and healthy. It is serving low-income tenants and helping to revitalize troubled urban neighborhoods. It is delivering ever more investment capital for each dollar of federal tax expenditure. Public, private, and community interests alike are eager to use the housing credit, and have found ways to do so collaboratively.

The authors also provide some useful data on the LIHTC through 1996. Rapid changes in the industry have turned some of the data stale, however, and the absence of suitable context and information invalidate some key analyses and findings. Moreover, in several instances, the authors appear to see the glass as 10 percent empty instead of 90 percent full. Our practitioners' lens provides a sharper focus on the tax credit's performance.

Reconciling private risk and public benefit

A good example of how our perspective differs from Cummings and DiPasquale's arises at the start of their article. The authors appear to challenge, without supporting data, a fundamental premise—indeed, a demonstrated strength—of the housing credit as a policy instrument: that public benefits and private market discipline are compatible.

One of the article's opening statements is that "government officials and advocates for the poor often have policy goals that may be viewed by private participants as bringing *too much* additional risk" (emphasis added). The authors cite tenants with special needs, social service requirements, very low income tenants, underserved (low-income) neighborhoods, and nonprofit sponsors as being perceived as inherently too risky for investors.

While it is true that a variety of factors can complicate housing, sponsors have learned how to manage the risks. Projects with special public benefits (and, for that matter, more conventional properties) sometimes have been poorly structured, especially in the earlier years of the program. More policy objectives can be loaded onto a given project than are prudent. But the housing credit's track record in balancing public benefit with private market discipline is overwhelmingly positive. Indeed, it is important to recall that when the LIHTC was enacted, the common market perception held that all low-income housing was extremely risky unless backed by project-based rental subsidies. The tax credit's outstanding performance, including properties that meet challenging public policy objectives, has improved dramatically the market's comfort level.

The marketplace now readily accepts housing with high public benefits. The LIHTC has successfully mobilized substantial private investment in numerous properties with such characteristics. That the investments have performed well, that investors have increased their participation in such properties as well as the price they pay for them, and that even syndicators that previously shunned such properties now aggressively compete to invest in them, are all proof positive. The authors' own data show that the substantial rate of return premium investors had commanded for central-city and nonprofit-sponsored housing had all but disappeared by 1992.

The increased sophistication throughout the industry is one of the housing credit's signature achievements. The discipline required by private investors has been an important force in building this capacity in ways that meet and exceed public and community objectives.

Tenant income targeting

The Cummings and DiPasquale article raises some important public policy issues regarding the appropriate tenant income targeting of capital subsidies such as the LIHTC.

First, the housing credit clearly reaches genuinely low-income tenants, perhaps more than Cummings and DiPasquale can ascertain. Tenant incomes were not part of the database, but they were part of an extensive study by the U.S. General Accounting Office (GAO) (U.S. GAO 1997). The GAO found that the median income of tenants in LIHTC properties was only $13,200, or 37 percent of area median income. This is far below the 60 percent ceiling that applies to the great majority of properties. Some of the lowest-income tenants also received rental assistance. This is appropriate given both the limited ability of any capital subsidy alone to reach the very

poor and the insufficient availability of quality housing to tenants holding rental subsidies in many markets. The GAO found that the median income of tenants without rental subsidies was 45 percent of the area median, still well below statutory requirements—and lower than some skeptical observers previously had assumed.

That said, there are important policy concerns about the advisability of intensive low-income targeting in project settings, especially in a context of revitalizing low-income communities. Of course, serving the very poor is an important part of an overall national housing policy, but other tools such as tenant-based rental subsidies, in addition to capital subsidies, are available to address these needs. Although these issues lie beyond the scope of the Cummings and DiPasquale article, it is important to acknowledge that the deepest income targeting should not necessarily be the benchmark for measuring the success of a production program such as the LIHTC.

Low-income community development

Cummings and DiPasquale present important evidence that the LIHTC is contributing to reinvestment in low-income urban neighborhoods. While the tax credit serves a wide range of communities, including isolated rural areas and higher-income suburbs, we agree that its contribution to low-income community revitalization is especially beneficial. Cummings and DiPasquale find that in many neighborhoods included in their data, LIHTC projects represent the only new residential construction in recent years. "Ten percent of our LIHTC projects were built in census tracts where there was no residential construction of any kind in the five years preceding the 1990 census. Some 27 percent of the LIHTC projects in central cities are in tracts that had no new construction of *rental* housing in the previous five years" (emphasis in original). They also determine that in some central-city tracts, "LIHTC units are an especially important addition because those tracts simply lack rental housing. Overall, in 13 percent of the 1,820 tracts where LIHTC projects in our sample were built, tax-credit units represented more than 20 percent of the housing stock in 1990."

Moreover, tax credits are bringing private investment into poor communities. About 20 percent of the properties are located in neighborhoods where incomes are below 40 percent of the area median. In analyzing six major urban areas, the authors found it "striking how similar these metropolitan areas are in the extent to which the LIHTC projects are serving low-income neighborhoods. The portion of projects in tracts with incomes less than 60 percent of the area median income range [from] 60 percent in Boston to

89.6 percent in Chicago." Cummings and DiPasquale commend nonprofit sponsors as "important players in community development strategies" and for bringing "important community support and commitment."

Financial viability

Cummings and DiPasquale's discussion of cash flows suggests that a significant minority of tax-credit properties, and especially nonprofit-sponsored properties, lack sufficient cash flow to maintain long-term financial viability. Their finding does not accurately reflect the NEF and ESIC experience.

In fact, the NEF and ESIC portfolios, which include most of the nonprofit-sponsored properties in the database, are sound and steadily improving. With regard to NEF and ESIC, the Cummings and DiPasquale article uses 1995 data and includes only those properties placed in service at least five years ago. Older projects' conditions have improved because of management adjustments, and the financial soundness of more recent properties reflects more experienced underwriting. Some properties may show a small positive cash flow in one year and a small negative cash flow the next without encountering long-term problems. Current data from ESIC and NEF show that only 3 to 4 percent of their portfolios has substantial cash flow problems. NEF and ESIC have financed more than 1,000 nonprofit-sponsored properties, and less than 0.5 percent of them have failed.

Moreover, Cummings and DiPasquale do not discuss other factors that routinely mitigate cash flow problems. First, NEF and ESIC provide a range of reserve structures to protect nonprofit-sponsored properties and their investors. In some cases, property-level reserves are augmented by a second, reserve pool that can be deployed among properties as needed. We believe these reserves are sufficient to meet the need. Second, nonprofit sponsors frequently set rents lower than required to maximize affordability. If the resulting cash flow becomes too tight, there is room to raise rents modestly (usually as units turn over) to strengthen cash flows. Sometimes that adjustment takes a while to execute, but the property is fundamentally sound.

That is not to dismiss the need for continuing vigilance. Problems are bound to arise in all kinds of real estate, let alone low-income rental housing in tough neighborhoods. That is why syndicators such as NEF and ESIC that specialize in such housing maintain early warning asset management systems and move quickly to head off problems that may arise. Abrupt changes in public policy also

can destabilize otherwise sound housing, at least until adjustments can be made. That explains Cummings and DiPasquale's finding that Los Angeles properties, many of which serve homeless individuals dependent on state aid, tended to have cash flow problems. The sudden curtailment of that state aid did adversely affect those properties.

Contrary to what Cummings and DiPasquale imply, the strong and improving financial condition of nonprofit properties shows that the LIHTC is working as intended to benefit from the discipline of the market. It also shows that nonprofits are excellent sponsors, in part because of their tenacity and ability to adjust and learn from early experience.

Total subsidy costs

Cummings and DiPasquale cite as one of their major findings the fact that housing credit properties receive deep public subsidies—purportedly 79 percent of development costs. That deep subsidies are required has little to do with the tax credit itself. Indeed, it is axiomatic within the field that producing low-income housing inevitably requires deep public subsidy. Affordable rents cannot carry a market-rate mortgage large enough to cover even half of the cost of construction in most places, especially in low-income areas. The lower the rents, the deeper the subsidy that will be necessary. That has been a constant fact affecting the LIHTC and every other housing production program. Congress explicitly recognized this reality when it created the LIHTC. We are at a loss to understand why the authors consider this to be a noteworthy feature of tax-credit properties. The result, however, is that those outside the field may mistakenly associate the housing credit with unnecessary or wasteful public subsidies.

There are also several specific problems with the Cummings and DiPasquale analysis of subsidy costs. First, the LIHTC today generates substantially more investment per dollar than during most of the study period. That means that less total subsidy is currently required than was the case during the study period.

More technically, the authors substantially overestimate the subsidy costs of depreciation allowances. Tax-credit properties receive the same depreciation allowance as any other rental housing. This allowance is not a subsidy at all, but rather a standard tax policy mechanism for recognizing that physical assets wear out over time. The federal government will get back in taxes upon sale every dollar it provides as tax expenditure for depreciation. From a public subsidy perspective, these depreciation allowances function like an

interest-free loan extended gradually over the property's operating period and repaid upon disposition, presumably after 15 years in the case of tax-credit properties.[1] The government's cost is based on the fact that it is "forgoing interest" on these "loans," so it must borrow more through capital markets to compensate.[2] Calculated this way, the present value cost to the government of depreciation allowances is about 4 percent of construction costs, not the 14 percent that Cummings and DiPasquale estimate. This change alone substantially reduces the total subsidy share from 79 percent to 69 percent.

In addition, Cummings and DiPasquale may overestimate the depth of a subsidy if they do not include reserves in the total cost of housing. In some cases, such as housing for the homeless and in New York City, these reserves are substantial. The difficulty of supporting any private mortgage—combined with the researchers' use of old data that do not reflect the efficiency of the LIHTC today, overestimating the subsidy cost of depreciation and not including reserves in total costs—explains why subsidies on the New York City properties are inevitably very deep.

We further disagree with the statement that "the overall structure of the LIHTC program, with its dependence on many sources and types of subsidy, can make it expensive." While the layering of subsidies certainly has its drawbacks and should be made easier, the adverse effect on costs is overstated. As funders of tax-credit properties have become more experienced, these inefficiencies have diminished over time. Layering of subsidies also has some useful functions, allowing the LIHTC to address the different objectives of the various subsidy providers and adding more scrutiny and stakeholders in the success of housing developments. Although we all have seen some deals with so many funders that efficiency is compromised, the participation of a modest number of subsidy providers builds commitment among all the funders.

Finally, no program can be 100 percent efficient, and any fair analysis would compare the LIHTC with other large-scale production

[1] Cummings and DiPasquale assume a 20-year holding period, which inflates the estimated cost to the government but is longer than industry expectations. They also assume that investors pay an average state income tax rate of 5 percent, so the subsidy value of depreciation reflects some benefits here. However, some investors, including two of the largest, Fannie Mae and Freddie Mac, do not pay state income taxes on tax-credit investments, so it is hard to estimate the size of state income tax depreciation deductions, or whether they are significant.

[2] The appropriate discount rate for this analysis is the federal government's borrowing rate, charted monthly by the U.S. Treasury as the applicable federal rate. The March 1999 long-term rate was 5.3 percent.

subsidy programs. As just one illustration, the housing credit pays investors only for *successful* housing. In other words, the housing must be built on time and serve qualified tenants at qualified rents for at least 15 years, while remaining in decent condition, or else the tax credits are recaptured. In effect, the tax credit also confers the resulting benefits of these requirements on the other subsidy programs that contribute to LIHTC properties. That, too, should be part of an efficiency analysis.

The LIHTC's efficiency

Cummings and DiPasquale substantially underestimate the efficiency of the LIHTC in raising equity because the measure described is flawed. They measure efficiency by comparing how much net equity is invested at the start of a project with the tax credits claimed over 10 years. Unless this 10-year stream of tax credits is discounted to a present value, it is plainly wrong to use the resulting fraction (e.g., 70 percent) as representing the portion of each tax-credit dollar spent by the federal government that actually ends up in housing. In fact, when a discount rate equal to the Treasury's long-term applicable federal rate (5.3 percent for March 1999) is applied, the present value of a dollar of tax credits drops to 76 cents. Adding the federal government's cost of depreciation allowances (described above) raises the present value subsidy to 80 cents. Using today's typical 75-cent net equity contribution as the denominator, it is more accurate to say that 94 percent of each tax-credit dollar spent by the federal government actually ends up in housing. From a governmental perspective, this is a remarkably high rate of efficiency.

We agree with Cummings and DiPasquale that the housing credit has become substantially more efficient over time, as investors have become more confident in the quality of the low-income housing produced. However, we disagree with the caution that higher prices may reflect longer periods over which investors pay their investments into syndication pools. The prices quoted represent net equity, which means the amount paid to housing sponsors at the start of a project. A change in investor pay-in periods would not distort net equity contributions.

Rates of return to investors

Cummings and DiPasquale's analysis of rates of return to investors is flawed, in part because the tax-credit investment market has changed substantially since the study period ended in 1995. The authors also measure rates of return in a way that the industry has

since discarded because it is unreliable. Finally, the regression model they use explains relatively little (23 percent) of the variation in investor returns among projects.

Rates of return have dropped sharply since 1995, to below 8 percent—a fact Cummings and DiPasquale do not mention—and investors now compete aggressively for projects that many would have shunned before. Our experience shows little or no current price differential for nonprofit-sponsored properties. The Cummings and DiPasquale article is somewhat confusing on this point, asserting that rates of return were generally higher for nonprofit-sponsored housing over the study period but that this differential had "virtually vanished" by 1992.

It is also a mistake to analyze rates of return based on an 8-year investment schedule. The investment community does not consider such calculations reliable because minor variations in timing can produce wide swings in rates of return. Unleveraged rates of return (based on up-front investments) are now the industry standard because they provide a better basis for comparison.

The cost of nonprofit-sponsored housing

Cummings and DiPasquale construct a cost estimation model that suggests that nonprofit-sponsored properties are 21 percent more expensive than those sponsored by for-profit developers. However, the cost of nonprofit-sponsored properties appears to be inflated because their cost estimation model has limited explanatory power and does not consider important characteristics of nonprofit-sponsored properties. Indeed, a new analysis of this question by the GAO found no statistically significant difference in costs among nonprofit and for-profit sponsors:

> While tax credit units built by nonprofit developers cost more, on average, than units built by for-profit developers, *nonprofit developers' costs were not necessarily higher when differences in the units' characteristics were taken into account.* We identified four characteristics that both increased average costs and were more likely to be associated with units built by nonprofit developers. These characteristics were (1) location in areas with high poverty and unemployment rates, (2) location in areas eligible for additional tax credits (because the costs of development were high relative to incomes in these areas), (3) large units, and (4) units in the Northeast or Pacific regions (U.S. GAO 1999, 1–2, emphasis added).

The GAO model has substantially more explanatory power than Cummings and DiPasquale's, accounting for 76 percent of the varia-

tion in development costs compared with 46 to 49 percent. However, data limitations precluded both models from analyzing other characteristics more associated with nonprofit-sponsored properties that tend to increase development costs.

1. Nonprofit sponsors tend to take on rehabilitation projects involving more extensive improvements, because those properties are often crucial to neighborhood revitalization, while for-profit sponsors often prefer less difficult and economically more feasible properties requiring more modest rehabilitation.

2. Nonprofit sponsors are particularly active in the handful of central cities with especially high development costs, such as New York, Boston, Philadelphia, San Francisco, and Los Angeles.

3. Nonprofit sponsors more often build space for social service provision into their properties, and may provide for larger capital and operating reserve funds to protect the housing over the long term, and sometimes pay for tenant services.

4. A larger share of nonprofit properties is subject to Davis-Bacon Act requirements because they involve other federal capital subsidies. These requirements can add significantly to construction costs, depending on the local market.

Summary

While Cummings and DiPasquale do report some positive findings, they also make numerous unjustified negative inferences about housing credit properties that we summarize below:

1. The article states that "LIHTC projects can be expensive," but offers no basis for comparison with alternative low-income housing production costs. The cost data presented, the GAO's 1997 report, and routine reviews of individual property proposals by NEF and ESIC all confirm that development costs are reasonable and well within local market norms.

2. The article states that "nonprofits . . . *bring* additional costs" (emphasis added). As discussed above, while the properties that nonprofits sponsor have characteristics associated with additional costs, we see no basis for concluding that nonprofit sponsorship per se adds cost.

3. As discussed above, the criticisms about income targeting are unfounded. It is useful to note that, starting in 1990, states

have given priority in allocating tax credits to sponsors serving very low income tenants. We believe this priority has effectively countered financial pressures to charge higher rents to carry market-rate mortgages.

4. While we and others remain vigilant for the continued financial viability of tax-credit properties, we disagree with implications that substantial portions are not viable. Nor do we believe that the involvement of additional subsidies presents a major problem.

5. As discussed above, we disagree with the assertion that "the total cost to society of the LIHTC program is quite high." We find that some of these costs are overestimated, and that others reflect the cost of producing decent low-income housing generally, not the tax-credit program itself.

6. We believe the article overstates the threat to future affordability when it states that "In 5 to 10 years, many units could convert to market-rate units, creating a problem similar to the expiring-use problem of the late 1980s." In fact, Congress acted in 1989 to head off just such a problem. Virtually all LIHTC properties since then have been committed to serve low-income tenants for at least 30 years. ESIC and NEF underwrite properties to ensure affordability for the full period. NEF and ESIC also provide for nonprofit sponsors committed to permanent affordability to acquire the properties at the end of the 15-year investment period at a nominal price. While LIHTC properties, like all real estate, will indeed require recapitalization over time, we believe the challenge of obtaining the necessary subsidies can and will be addressed.

We conclude that the LIHTC has performed extremely well because of both sound design and responsible implementation. No program or industry is perfect, but the tax-credit program has demonstrated the capacity to encourage all participants to make appropriate adjustments as experience and changing market conditions and local needs indicate. In that respect, the housing credit offers important lessons for policy makers within and beyond the housing field.

Authors

Benson F. Roberts is Vice President for Policy at Local Initiatives Support Corporation. F. Barton Harvey III is Chairman and CEO of The Enterprise Foundation and Chairman of the Enterprise Social Investment Corporation.

Jeff Goldstein of Boston Capital Partners also contributed to this commentary.

References

U.S. General Accounting Office. 1997. *Tax Credits: Opportunities to Improve Oversight of the Low Income Housing Program*. GAO/GGD/RCED-97-55, Washington, DC.

U.S. General Accounting Office. 1999. *Tax Credits: Reasons for Cost Differences in Housing Built by For-Profit and Nonprofit Developers*. GAO/RCED-99-60, Washington, DC.