Problems With Low-Income Housing Tax Credits

Statement of

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Chairman Grothman and ranking member Krishnamoorthi, thank you for inviting me to testify at today's hearing on "Examining the Growth of the Welfare State." My testimony focuses on federal subsidies for affordable housing.

Policymakers are rightly concerned about the high costs of housing for moderate-income families. One federal response to the problem is the low-income housing tax credit (LIHTC), which provides income tax benefits to investors in multifamily housing.

The LIHTC has had substantial bipartisan support, but it is a complex and inefficient solution to housing affordability. The tax credits raise the costs of housing projects and partly displace market-based housing. They generate fraud and corruption in some places, and only a portion of the tax benefits go to tenants. Market-based housing reforms are a better policy option.

Congress took steps to simplify the tax code with the Tax Cuts and Jobs Act. In renewing the TCJA this year, Congress should aim to reduce tax loopholes, and the LIHTC is one provision lawmakers should consider repealing.

A better way to reduce housing costs is through tax and regulatory reforms. The states should reduce barriers to multifamily housing investment by cutting property taxes and liberalizing zoning and building regulations. Congress should reform depreciation provisions to increase returns to multifamily housing investment.

Complexity

The Internal Revenue Service (IRS) will provide about $14 billion in LIHTCs this year to support multifamily housing investment. The IRS distributes the credits to the states, which award them to developers to cover part of the costs of constructing and rehabbing apartment buildings. In return, developers must cap rents for the units they set aside for low-income tenants.

Developers who receive the credits usually sell them to investors, often using syndication firms as intermediaries. This provides cash to developers for construction and gives investors equity in the projects and credits to use on their tax returns over a 10-year period.

The Congressional Research Service says that the "process of allocating, awarding, and then claiming the LIHTC is complex and lengthy."[1] Indeed, the credit has spawned a large industry of law and accounting firms to administer it because it is so complex.

The LIHTC statute and related IRS regulations are 442 pages in length.[2] The IRS auditing guide for the LIHTC is 344 pages.[3] An IRS guide for LIHTC building compliance is 214 pages.[4] State compliance manuals for LIHTC building owners can run 145 pages.[5] A standard industry guidebook for the LIHTC is 1,942 pages.[6] All these rules and instructions are for a single tax credit!

The federal government apportions housing tax credits to the states, which issue Qualified Allocation Plans (QAPs) for developers. QAPs are like central planning documents and can be more than 100 pages in length. They micromanage apartment building construction through mandates and point systems. QAPs specify such items as favored neighborhood locations, demographics of project contractors, and the details of light fixtures, faucets, shower heads, energy sources, materials, USB charging ports, and many other things.

After LIHTC projects are constructed, there is more bureaucracy. Building owners must generally adhere to rent caps and tenant income limits for 30 years. Owners must keep records for the residents of each unit for income, assets, family composition, and other characteristics.

In sum, there is a large bureaucratic overhead in the program. The LIHTC is not a simple tax cut.

High Costs

LIHTCs raise the construction and financing costs of multifamily housing projects.

Construction costs are often higher than market-based projects because of state QAP rules and local design requirements. The top-down rules for affordable housing projects can prohibit innovations in building techniques, such as manufactured and modular housing.[7]

The financing costs are high because LIHTC projects usually include a complex array of government subsidies, each having different rules. A State of Washington study on affordable housing found that "it generally takes twice as long to assemble the financing as market-rate projects," and LIHTC projects have "higher legal, development, and financing fees."[8]

The State of Washington report further noted that once a tax credit allocation is made, "there are limited incentives to reduce development costs because doing so would mean not using the full appropriated federal low-income housing tax credits issued for the project."[9]

A 2024 article in *Crain's Chicago Business* discussed recent local LIHTC projects, which have had costs up to $898,837 per unit.[10] The piece noted, "Costs are driven by the byzantine rules of the federal tax credit system that require builders to assemble a capital stack of funders, each with sets of fees and requirements. On top of that comes ever more rigorous government standards for accessibility, sustainability and design. Developers and their architects win points from public agencies awarding the projects by striving for net zero carbon emissions by using materials such as solar panels, triple-pane windows and upgraded insulation."[11] Pointing to one LIHTC project, the article said, "It took nearly four years to get the project financed. Legal fees are more than $600,000, three times the cost of a market-rate apartment tower."[12]

A 2023 article in the *Wall Street Journal* profiled a Los Angeles low-income apartment project subsidized by the LIHTC and other programs.[13] It took 17 years to complete and cost $700,000 per unit because of neighborhood opposition, lawsuits, zoning and environmental rules, and politically mandated amenities. The article also pointed to San Jose, where subsidized projects now cost, on average, "$938,700, or roughly what it costs to buy a three-bedroom bungalow" in the city.[14]

A 2024 article in the *Wall Street Journal* compared subsidized and unsubsidized multifamily housing projects in Los Angeles.[15] One group of subsidized projects built in recent years cost $600,000 per unit, on average. By contrast, the article profiles a developer who is building a 49-unit project without any tax credits or other subsidies, and which is costing just $291,000 per unit. Executives with the developer said, "We believe there's a different way than using government money, which really becomes slow and arduous and increases cost," and by foregoing subsidies, "You're cutting out millions of dollars just in soft costs."[16]

A few statistical studies have compared LIHTC and non-LIHTC project costs. In a 2009 study, economist Michael Eriksen found for a large sample of projects in California that the construction costs per square foot of LIHTC projects were 20 percent higher than for average industry projects.[17]

The Minnesota state housing agency reports the average costs of projects that it subsidizes—both LIHTC and non-LIHTC projects. For new construction over the past 20 years, LIHTC projects in the Twin Cites cost 20 percent more per unit than non-LIHTC projects. For rehab projects, the LIHTC cost disadvantage was even larger.[18]

Some studies have compared the costs of aid through the LIHTC to aid through federal housing vouchers. A 2002 Government Accountability Office (GAO) study found that one-bedroom LIHTC units cost 19 percent more in metro areas and 44 percent more in non-metro areas than units subsidized through housing vouchers.[19] And in a 2005 statistical study, Lan Deng found that LIHTC housing is more costly than vouchers in the six major U.S. cities he examined.[20] The tax credit housing averaged 63 percent more costly across the cities, with a range from 2 percent more in San Jose to 133 percent more in Atlanta.

Fraud and Corruption

Economists Michael Eriksen and Bree Lang noted that the LIHTC "provides little to no incentive for developers to minimize the costs of development."[21] Indeed, developers have an incentive to inflate their reported costs to maximize tax credits. The GAO has found that few public housing agencies "have requirements to help guard against misrepresentation of contractor costs (a known fraud risk)."[22]

Florida has made headlines with LIHTC developer scandals. In one case, Biscayne Housing and partners stole $34 million from 14 LIHTC projects by submitting inflated construction cost data to the state.[23] In another scam in the state, a company owned by Pinnacle Housing stole $4 million from four LIHTC projects by the same method.[24]

Another problem is that the LIHTC can be a vehicle for state and local corruption because officials have discretion in handing out the lucrative credits. In some places, officials have taken either bribes or campaign contributions from developers in return for approving projects.

In California, a state treasurer steered millions of dollars in housing tax credits and bond financing to developers that donated to his political campaigns.[25] And a developer named ADI claimed inflated costs on many of the dozens of affordable housing projects that it was awarded in the state after showering officials with campaign contributions.[26]

In Dallas, two members of the city council plead guilty in 2019 to taking bribes for helping award housing tax credits and other benefits to favored developers.[27] And a decade earlier, the LIHTC was at the center of the "largest political corruption case in Dallas history."[28] Fourteen people were convicted of bribery, extortion, and related crimes, including developers, a state representative, a city council member, and the city planning commissioner.[29]

Such abuse may not be common, but we do not know the extent of it because the IRS performs little LIHTC oversight. The GAO has found that IRS oversight is "minimal," and that it rarely audits the state agencies handing out the credits.[30] In its defense, the IRS has been overwhelmed as Congress continues to add complicated breaks to the tax code.

Who Benefits from the LIHTC?

Statistical studies suggest that a substantial share of LIHTC benefits flow to investors and developers, rather than to tenants.

A 2010 study by Gregory Burge of projects in Tallahassee found that "the LIHTC program may significantly benefit project developers and owners," with just "one-third of the programs' cost going to low-income households in the form of rent savings."[31] The LIHTC program "is an inefficient mechanism for generating benefits to low-income households."[32]

A 2024 study by Evan Soltas using data from LIHTC projects across 40 states found that "households benefit from modest rent discounts on subsidized units, but developers capture around half of the subsidy in profits."[33] He found that housing vouchers create more benefits to renters at a lower budget cost than the LIHTC.

Similarly, economist Ed Olsen concludes that "the best evidence available also indicates that occupants of tax credit projects capture a small fraction of the subsidies provided to developers," and that vouchers are a more cost-effective method of aiding tenants.[34]

Crowd-Out

The LIHTC has helped finance many projects since the 1980s, but that does not necessarily mean that it has been effective. That is because LIHTC housing has partly displaced market-based housing, an effect called "crowding out."

The Congressional Budget Office noted in 1992: "The low-income housing credit, like other supply subsidy mechanisms, is unlikely to increase substantially the supply of affordable housing. Subsidized housing largely replaces other housing that would have been available through the private, unsubsidized housing market."[35]

Statistical studies have confirmed CBO's view. A 2002 study by Stephen Malpezzi and Kerry Vandell found "no significant relationship between the number of LIHTC units (and other subsidized units) built in a given state and the size of the current housing stock, suggesting a high rate of substitution."[36]

A 2005 study by Todd Sinai and Joel Waldfogel estimated that units financed by the LIHTC "raise the total number of units in a market, although on average one government-subsidized unit adds only one-third to one-half of a unit to the total housing stock."[37]

A 2010 study by Michael Eriksen and Stuart Rosenthal found that "nearly all LIHTC development is offset by crowd out of unsubsidized rental housing construction, although the confidence band around this estimate allows for more moderate effects."[38]

A 2015 study Matthew Freedman and Tamara McGavock found that "a sizable fraction of rental housing development spurred by the program is offset by a reduction in the number of new unsubsidized units in the same neighborhood. However, crowd out of private, unsubsidized investment in the rental housing stock does not appear to be complete."[39]

The 2024 study by Evan Soltas found that "the LIHTC has little impact on the overall size of the housing stock, as the LIHTC heavily displaces private development that would have otherwise soon occurred."[40]

Reforms to Boost Affordable Housing Supply

Proponents say that the LIHTC is needed because markets fail to supply enough affordable housing. However, state and local governments have undermined multifamily housing investment for decades with excessive taxes and regulations.

State and local governments should reassess zoning rules, land-use regulations, and permitting requirements that raise costs and slow construction, particularly for multifamily housing. Reforms should potentially include liberalizing rules for allowable density, minimum lot sizes, height restrictions, accessory dwelling units, parking requirements, environmental reviews, and bureaucratic delays in permitting.[41]

Many studies have found that excessive regulations boost housing costs. A 2005 study by Edward Glaeser and coauthors, for example, found that restrictive rules imposed a "regulatory tax" of about 20 percent or more on the price of housing in coastal cities such as Boston, Manhattan, San Francisco, and Los Angeles.[42]

A 2022 study by the Federal Reserve Bank of Boston found that local "density restrictions play a key role in limiting the multifamily housing supply. Relaxing density restrictions, either alone or in combination with relaxing maximum-height restrictions and allowing multifamily housing, is the most fruitful policy reform for increasing supply and reducing multifamily rents."[43]

A 2022 study by housing trade associations examined regulations on apartment building construction.[44] It found that high costs stem from frequent changes to building codes, affordability mandates, land set-asides, government delays, labor regulations, complex zoning approvals, unique development mandates, and developer fees. Overall, these barriers raise project costs by 41 percent, on average. The report concludes that "regulatory mandates discourage developers from building in the very marketplaces that have the greatest need for more housing."[45]

The negative effects of regulations appear to show up in construction productivity statistics. A 2023 study Austan Goolsbee and Chad Syverson found that while total factor productivity has trended upward in the overall U.S. economy over the decades, productivity in construction has stagnated since the 1970s.[46] Economists do not know why construction productivity has lagged, but one of the causes may be overregulation that stifles innovation.

In their discussion of the poor productivity data, Nathaniel Baum-Snow and Gilles Duranton note that "through building codes, city governments and construction unions promote inefficient and expensive work practices, mandate questionable improvements, and restrict cost savings," and they say that "building codes may prevent innovations in building technologies from diffusing or even happening in the first place."[47]

Another factor undermining affordable housing investment in some states is prevailing wage rules. The Terner Center for Housing Innovation at UC Berkeley studied the costs of housing projects in California in 2019 and found that the wage rules increased the average cost of building LIHTC projects from about $400,000 per unit to about $500,000.[48]

Another cost factor in multifamily housing is property taxation. Property tax rates on (unsubsidized) apartment buildings are much higher than on owner-occupied homes. In a survey of 50 U.S. cities, the Lincoln Land Institute found that effective tax rates on apartment buildings are 44 percent higher, on average, than on owner-occupied homes.[49] Those high tax rates should be cut to boost investment.

In sum, reducing state and local taxes and regulations can increase affordable housing supply. Federal tax credits are not needed, as the states have many reform options to tackle their affordability challenges.

The federal role in housing should be limited, but there are reforms that Congress should pursue. One option is for the federal government to transfer some of its massive land holdings to the states, which could then sell parcels for housing development.

Congress should also reform depreciation rules for multifamily construction. Currently, apartment buildings have a lengthy 27.5-year write-off period, which raises effective tax rates on investment. One reform option would be to provide "neutral cost recovery" for apartment building investment, meaning indexing depreciation deductions to maintain their real value over time.

Tax Foundation modeled such a depreciation reform and found that it would boost total apartment building construction by 2.3 million units in the long run.[50] An alternative reform would be to shorten the write-off period for apartment building depreciation.

Ironically, Congress enacted the LIHTC in the Tax Reform Act of 1986 to lessen the blow from that law's increase in the write-off period for apartment buildings from 19 years to 27.5 years. Studies have found that the change of depreciation rules damaged apartment building investment.[51] Congress should reverse that mistake and implement depreciation reforms.

Conclusions

With tax and regulatory reforms, markets would supply more housing for moderate income families. Market-based housing is less costly than the housing produced by the LIHTC program, and it also avoids long-term maintenance problems associated with LIHTC buildings.[52]

Congress should phase out the LIHTC program, but it should reform depreciation provisions in the tax code to increase returns to multifamily housing investment. At the same time, state and local governments should boost multifamily housing supply with regulatory reforms and property tax cuts.

Thank you for holding this important hearing.

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