

# Comment on Jennifer Steffel Johnson and Emily Talen’s “Affordable Housing in New Urbanist Communities: A Survey of Developers”

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## *Abstract*

Johnston and Talen use survey data to investigate the experience of developers employing New Urbanist techniques. The authors conclude that for cases in which affordable housing has been included in New Urbanist projects, developers typically relied on complex arrangements or incentives to achieve this goal. Whether New Urbanist objectives and the promotion of affordable housing can be simultaneously incorporated in projects on a large scale remains an open question.

This comment identifies the incentives available for affordable housing and community development and notes the problems that ensue when these incentives are used together. Further, this comment examines the market-demand challenges faced by developers trying to construct affordable housing within a New Urbanist framework. The findings suggest that the most efficient way to further New Urbanist principles, where the market demands such techniques, is to increase the flexibility of tax incentive programs.

**Keywords:** Affordability; Low-income housing; New Urbanism

## **Introduction**

By using survey findings to investigate the experience of New Urbanist developers with respect to the production of affordable housing, Johnson and Talen provide an interesting perspective on the application of New Urbanist development strategies. This is an important topic for evaluating the merits of New Urbanist development, in part because of the movement’s emphasis on mixed-income communities as a planning element that enhances the livability of a neighborhood and generates long-run benefits for its resi-

dents (Jacobs 1961). It is important to note that the size and existence of such neighborhood effects is a topic of debate (Dietz 2002). Nonetheless, examining how mixed-income neighborhoods can be developed and how various aspects of public policy can help or hinder the creation of these neighborhoods is critical to understanding and perhaps estimating the benefits and costs of New Urbanism.

Johnson and Talen's analysis of survey data on the use of New Urbanism in the development of affordable housing poses two fundamental questions:

1. To what extent is affordable housing included in New Urbanist projects?
2. What policies promote the development of affordable housing within the New Urbanist context?

In surveying developers employing New Urbanist strategies, the authors find that a majority of respondents offer affordable housing units. However, these make up only 29 percent of all the units in the sample, with low-income units comprising 6.8 percent of the total. These data indicate that, indeed, New Urbanist-inspired housing units are more likely to be developed for higher-income households.

The authors also report that among developers offering affordable housing units, 78.6 percent did so to fill a community need, 47.6 percent acted because of a local government requirement, and 26.2 percent were encouraged by a financial incentive. Not surprisingly, among developers not offering affordable housing, "inappropriate mix" and cost were cited as common explanations for their development strategy.

As Johnson and Talen note, there is no strong consensus within the New Urbanist movement on how mixed-income communities should be developed. Because such developments tend to appeal more strongly to high-income households, in part due to the higher prices that necessarily accompany the benefits these communities are intended to provide (Tu and Eppli 1999), it is not clear whether New Urbanist goals and the promotion of affordable housing can easily coexist, let alone complement each other. On the one hand, proponents of New Urbanism want to reduce or eliminate zoning and regulations that decrease affordability by increasing the cost of housing. On the other, certain tenets of New Urbanism, if implemented as mandates, may act to decrease affordability via higher development costs. Indeed, Gyourko and Rybczynski (2000) report practitioners' survey findings demonstrating that New Urbanist developments are more expensive to

construct because of lost economies of scale and higher costs for engineering and transportation infrastructure.<sup>1</sup>

Johnston and Talen conclude by suggesting that the “inappropriate mix” reason for failing to include affordable housing could be a design issue; that is, developers are reporting the planning challenges associated with mixed-income development. I propose another explanation: that the rules and policy incentives related to affordable housing and New Urbanist development strategies do not mix well.

This comment explores reasons for this alternative explanation. The first section examines how the rules governing federal tax incentives for affordable housing hinder New Urbanist objectives. The second notes the ways in which the rules for these tax incentives prevent mixing affordable housing and commercial development, an aspect that Johnson and Talen do not address. Finally, I discuss some possible reasons why New Urbanism may not work well in the context of affordable housing regardless of government incentives. I conclude that mandating New Urbanism in the context of affordable housing is likely to be counterproductive because of the increased cost of housing.

### **Federal tax incentives for affordable housing**

Because of a complicated set of requirements, the rules for the nation’s largest and most important affordable housing production program hinder mixed-income development and, by extension, New Urbanism. The Internal Revenue Code § 42 Low-Income Housing Tax Credit (LIHTC)<sup>2</sup> program provides a stream of tax credits for developers constructing and operating affordable housing units. The total value of credits generated by an LIHTC project depends on its “eligible basis,” which for a new building is approximately equal to the cost of construction.

In return for tax credits, LIHTC projects are required to provide affordable housing. For LIHTC-qualified properties, 20 percent or more of the units must be leased to tenants whose income is 50 percent or less of the

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<sup>1</sup> In particular, the authors describe practitioners reporting that higher development costs for New Urbanist projects result from the fact that economies of scale from multiple uses/types of structures cannot be realized. Further, engineering techniques used for suburban master-planned communities cannot be used, thereby generating additional expense. Transportation costs for greenfield developments can also be higher for New Urbanist projects due to the need for additional infrastructure, such as rear lanes or sidewalks

<sup>2</sup> All section references refer to the Internal Revenue Code.

area median income (AMI), or, alternatively, 40 percent of the units must be leased to tenants whose income is 60 percent or less of the AMI. Further, the rents that can be charged are limited according to AMI and family size.

Johnson and Talen's survey results find that the most commonly used federal incentive for developing affordable housing among the sampled New Urbanist developers is the LIHTC program. Given its size, this is not surprising. According to the 2007 report of the congressional Joint Committee on Taxation (JCT), the tax expenditure for LIHTC projects for 2008 is estimated to be \$5.3 billion, with another \$700 million for tax-exempt bond financing of affordable housing. By contrast, for example, the HOME program, among other purposes, allocates less than \$2 billion a year to state and local governments to supplement financing for the construction of affordable housing, including LIHTC projects.

However, mixed-income development is complicated by the interplay of rules for the LIHTC program. Given its mix of housing and tax rules, § 42 is one of the most complicated stand-alone sections of the tax code. These complicated rules, not to mention the market structures that have evolved to link developers with real estate financing, can easily generate negative consequences for developers and communities desiring to incorporate other objectives, such as New Urbanism, in connection with the development of affordable housing.<sup>3</sup>

For example, an LIHTC building that contains both affordable and market-rate units must demonstrate that the cost of the market-rate units is no more than 15 percent higher than the cost of the affordable units or else the basis of all the market-rate units must be excluded from eligible basis, thereby reducing the value of the LIHTCs. This maximum cost differential is often not large enough to compete with other market-rate units. For this and other program-related administrative and compliance reasons, many LIHTC developers dedicate their properties entirely to low-income use, thereby working against the New Urbanist principle of mixing income classes within dense neighborhoods.

Another unfortunate effect of these rules is to discourage the mixing of various tax incentives for development with the LIHTC program; these include energy-efficiency tax incentives (such as the § 45L new energy efficient home

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<sup>3</sup>As a general example, in 2003, the Bush administration's dividend exclusion proposal would have had a negative impact on the production of affordable housing because of the way the LIHTC system operates (Ernst & Young 2003).

credit and the § 179D energy efficient commercial buildings deduction) and the § 47 historic rehabilitation tax credit. This is due to the fact that claiming any other tax incentive in conjunction with the LIHTC is unlikely to produce net positive effects because the benefit lost from the LIHTC will be larger than the benefit gained from claiming the other credit or deduction.<sup>4</sup> The reason for this effect is that most tax credits and deductions for businesses require reducing the basis of the property or building by the full amount of the incentive—or in limited cases a portion of the amount.<sup>5</sup>

To the extent that these incentives promote New Urbanist development, the inability to claim other incentives in addition to the LIHTC hurts the prospects of promoting affordable housing with New Urbanist concepts. With respect to the tax incentives I have noted, energy tax incentives promote green or sustainable communities and the historic rehabilitation credit is useful for preserving the characteristics of an existing community—both New Urbanist objectives—and neither works well with the LIHTC program.

### **Federal tax incentives for commercial development**

Johnson and Talen's examination of developer survey data focuses exclusively on affordable housing issues in New Urbanist projects. Given that the proponents of New Urbanism strive to mix commercial and residential structures that are within walking distance of each other, this focus provides an incomplete picture. Hence, examining how federal tax incentives for both affordable housing and commercial development interact, as well as how they can be used for mixed-use purposes, is important for understanding how affordable housing can be included in New Urbanist projects.

For example, in general, LIHTC properties may not contain space for nonresidential use. This effectively prohibits mixing retail and housing in the same property and blocks one strategy for achieving New Urbanist objectives in most affordable housing construction.

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<sup>4</sup>Most LIHTCs are claimed as 70 percent present value tax credits, with an additional 30 percent basis boost for targeted areas.

<sup>5</sup>In tax law, the basis of depreciable property (including buildings used for business purposes) is generally equal to the cost of construction. Basis is used to determine the flow of depreciation deductions available to the owner, as well as the amount of gain reported and the tax upon sale or disposition of the property. Reducing the basis, as may be required when claiming a tax credit or deduction, consequently reduces the net present value of the depreciation deductions and increases any future capital gains tax.

The federal tax incentives for commercial development in disadvantaged areas also hinder the mixing of affordable housing and retail properties.<sup>6</sup> The § 45D New Markets Tax Credit program, estimated by JCT (2007) to have a 2008 tax expenditure of approximately \$900 million, and the set of empowerment zone incentives (including renewal communities), estimated to total \$1.6 billion in 2008, prohibit qualified businesses from receiving tax benefits if those businesses involve a significant amount of residential rental activity (at least 20 percent of gross receipts, as defined—circuitously—through § 45D linking to § 1397C, which in turn links to § 168 depreciation rules). It may be glib, but it is not unfair to note that in this regard the tax code itself ironically employs more mixed-use concepts in its complicated layers of definitions than it allows for in actual community development.

Given the complicated rules outlined in this section and the previous one for affordable housing and commercial development incentive programs, reforming federal tax incentives to provide increased flexibility for builders and developers to respond to market demand for New Urbanism and promote affordable housing would be beneficial for all stakeholders. Indeed, Johnson and Talen report that almost half of the developers in their survey would include affordable housing in their future New Urbanist projects if the right incentives were included. Simple examples perhaps include waiving the required basis adjustment for using various development incentives together for the same project or allowing tax incentives to apply to projects containing residential and retail space within the same structure.

### **Limited market demand for New Urbanism**

Even increased flexibility in the major incentives for affordable housing and commercial development may not increase demand for New Urbanism among prospective residents and developers, however. Consistent with this claim, Johnson and Talen report that 52.6 percent of the sampled New Urbanist developers indicated that no incentive would be sufficient for them

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<sup>6</sup>Disadvantaged or targeted areas are defined differently in § 45D and empowerment zone programs. For § 45D, targeted areas are defined as any census tract with a poverty rate of at least 20 percent, census tracts not located in metropolitan areas for which the median family income of the tract is less than 80 percent of the statewide median family income, or census tracts in metropolitan areas for which the median family income is less than 80 percent of the greater of the statewide median family income or the metropolitan area median family income. Empowerment zones and renewal communities are designated by need according to the U.S. Department of Housing and Urban Development (in consultation with other federal agencies) on the basis of nominations by state and local governments.

to include affordable housing in their plans. Knowing why this is the case is clearly a useful subject for future research. I propose several hypotheses to explain why so many developers believe that no incentive would be effective.

First, demand for New Urbanism among developers and residents of affordable housing may be limited because major federal programs are targeted to renters. For New Urbanist projects to develop net social benefits and remain viable as socially and economically diverse neighborhoods, residents are expected to be stakeholders in the community. For economists, the most obvious method of making an individual or household a stakeholder is to provide an ownership interest (homeownership or business ownership).

However, with the exception of the § 143 mortgage revenue bond program, the major federal affordable housing programs in the tax code are targeted to rental housing.<sup>7</sup> To the extent that public programs promoting affordable housing primarily target renters, these programs may not efficiently complement New Urbanist planning.<sup>8</sup> Moreover, given a high elasticity of housing supply (competition among home builders), this challenge must be adequately addressed on both the demand and supply sides of the market. Johnson and Talen recommend educating developers on the merits of New Urbanism, but this is unlikely to be successful if the demand side of the market remains unsupportive. Developers ultimately supply what the market demands.

Second—and this is more fundamental—it may be that New Urbanism is generally ill-suited to produce affordable housing, and this is reflected in limited market demand for its concepts. There is a basic trade-off in urban economics between the price of a location in terms of land and housing and the transportation costs required to live there and commute to work. Transportation costs are paid as a combination of money and time, while location costs are paid primarily in money (with the exception of trading leisure for work and additional money). Among other factors, this trade-off can, for example, give rise to spatial mismatch phenomena (Jencks and Mayer 1990; Kain 1992), which can lead lower-income workers to live farther away from their jobs, thereby lowering their employment rate. This suggests that the

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<sup>7</sup>The mortgage revenue bond program provides below-market interest rate mortgages to first-time home buyers meeting certain income-targeted criteria.

<sup>8</sup>For a review of the literature on the impact of neighborhood homeownership rates on social and economic outcomes and implications for public policy, see Haurin, Dietz, and Weinberg (2002).

residents of affordable housing are more likely to substitute travel time for consumption of nonhousing goods and other amenities promised by New Urbanism, making the two policy objectives uneasy partners at best.

Given the estimates of New Urbanism's limited appeal to the market (Audirac 1999; Bookout 1997), it is likely that the demand for New Urbanist development is, at least for now, concentrated among certain classes of households based on income, tenure choice, and household size. For many households seeking affordable housing, New Urbanist amenities may not be worth the opportunity cost, and developers are therefore unlikely to incorporate New Urbanist planning in affordable housing projects, regardless of policy incentives.

## Conclusion

The research literature and a review of the federal programs available to developers suggest that New Urbanism and the policies that promote the production of affordable housing may not be complements. More important, this conclusion suggests that any mandates requiring New Urbanist development for affordable housing projects may be poorly conceived. Mandates that increase development costs to achieve certain New Urbanist objectives would have the perverse effect of increasing housing prices for future residents and hindering the goal of making housing affordable. Policy makers would be better advised to increase the flexibility of the current federal incentives for affordable housing and community development (including energy and historic rehabilitation incentives), and let New Urbanism evolve where the market demands it.

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