

The Excessive Costs of Creative Finance: Growing Inefficiencies in the Production of Low-Income Housing

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Abstract

The paper examines creative finance as a means of low-income housing production and preservation. The low-income tax credit has evolved as the main federal housing production program in recent years. But this evolution can only be understood as a last resort. The inefficiencies of this approach outweigh any advantages. High transaction costs, inappropriate targeting of benefits, and insufficient monitoring are among the problems. Recent changes in the tax credit may actually cost the government more. Furthermore, current policy in fact creates the same time bombs now exploding in the prepayment projects. Current proposals for housing reform and revitalization have positive features, but are either underfunded or still rely on creative finance. What is needed is a direct one- or two-step low-income production program.

Creative finance is a dirty word

Though it could have been used before that time, the term “creative finance” first gained notoriety in California during the 1970s, when housing prices soared, local markets went out of control, and the demand for mortgage money exceeded the willingness of conventional suppliers to extend enough credit at affordable terms to satisfy that demand.

According to Jack Lowry,¹ “As both purchase prices and the number of transactions increased, the amount of credit needed to complete each year’s transactions grew from about \$9.4 billion in 1975 to more than \$40 billion in 1979.” As a result, most Californians “became familiar with the devices of creative finance — sellers’ loans, assumed loans, all-inclusive trust deeds, land contracts, junior liens, unamortized short-term loans, graduated payments, graduated interest rates, and others.”

By the end of 1982, Lowry estimates that as many as a sixth of all California’s homes were subject to liens held by their former owners, who had provided at least \$36 billion in mortgage credit — financial time bombs that would have to be repaid or refinanced

during the next ten years. In short, in the California context in which it evolved, creative finance was an ad hoc, costly, and potentially dangerous set of financing alternatives negotiated by buyers and sellers designed in response to a pathological set of market conditions. Surely, no responsible student of housing would propose such a system as a national model for financing market-rate housing.

Yet, housing advocates, Congressional committees, the Department of Housing and Urban Development (HUD), policy analysts of various stripes, and others engaged in serious policy debate about the preservation and production of low-income housing are in the process of institutionalizing and, to the limited extent possible, perfecting the use of creative finance in the low-income housing arena. This highly inefficient, costly, and labor-intensive means of producing low-income housing evolved in the 1980s as an ad hoc, emergency response to another pathological set of conditions — the unprecedented withdrawal of the federal government from its historical role as a long-term lender and subsidizer of new and substantially rehabilitated housing for the poor.

Seller's loans that cannot be repaid from rental income, balloon payments that cannot be paid off unless a low-income property is converted to market-rate use, graduated-payment mortgages that anticipate that tenant incomes will rise faster than the national average based upon the hoped-for positive outcomes of employment training and entrepreneurial development programs that are not yet even in place, put in place options that enable limited partners to walk away from their investments in 15 years. Federal tax credits that are as complicated to use as they are costly to the government to provide have become the instruments of creative finance in the low-income housing sector. And they have an even greater potential for causing long-term mischief than do their market-rate counterparts.

Thus, the theme of this paper is that rather than being ennobled and enshrined, the use of creative financing to preserve and produce low-income housing should be viewed as a system whose time should never have come. In elaborating upon this theme, it is important to distinguish how low-income housing is financed in this country from who actually produces low-income housing.

The extraordinary accomplishments of the network of community-based housing developers that have come of age during the past ten years deserve praise. These permanent, sophisticated organizations, many of which were helped by national intermediaries like

the Local Initiative Support Corporation (LISC) and the Enterprise Foundation, have kept local low-income production pipelines from running completely dry. Make no mistake about it, these community-based organizations are a far cry from their underachieving and underdeveloped 1960s nonprofit counterparts.

Regardless of how partisan differences about housing legislation are ultimately resolved by Congress, it is a foregone conclusion that the community sector will play a major role in the next generation of low-income housing production programs. However, unless a more rational way of financing housing for the poor is created, the costs of doing business for the government and for these local production entities will remain extraordinarily high. More important, perhaps, it will continue to be necessary for these groups to focus their creative energies on financial packaging rather than on ensuring that the families who will occupy their housing receive the services they need to become more productive, self-sufficient members of the community.

The central role of the low-income housing tax credit

At the heart of the creative finance system is the low-income housing tax credit created by Congress in the Tax Reform Act of 1986, which wiped out most other tax incentives to stimulate equity investment in real estate, including market-rate and low-income housing. To appreciate why the housing advocacy community continues to stand foursquare behind this highly inefficient and relatively inaccessible subsidy mechanism, one must recall the incredibly hostile housing policy environment that existed when the tax credit was enacted.

The tax reform debate raged at a time when the Reagan administration and Congress already had eliminated several of HUD's low-income production programs. President Reagan's fiscal year 1987 budget proposed deferrals and rescissions of billions of dollars of previously appropriated low-income housing funds, termination of the Section 202 housing program for the elderly and handicapped, and elimination of the Farmers Home Administration housing programs. With respect to the latter, HUD's significantly reduced housing budget then would be split evenly between urban and rural areas.

At this time, too, the House of Representatives was enthusiastically embracing Congressman Jack Kemp's right-to-buy bill that would

require public housing authorities to sell units to tenants on demand at steeply discounted prices. And, as if we needed another sign of how bad things had become for low-income housing by the mid-eighties, when the tax credit was created, E. F. Hutton issued an investment prospectus for \$200 million targeted to the acquisition of federally assisted low-income housing projects nearing expiration of their HUD use restrictions. The fund would seek to acquire projects that had high potential for conversion to market-rate rentals or condominiums, shopping centers, and other commercial development “of a type which would require prepayment of the government subsidized mortgage.”²

Almost as soon as it was passed, the tax credit law was generally acknowledged to be seriously flawed. The maximum tax credit cannot be used for projects being financed with tax-exempt bonds or for those receiving below-market-rate loans from a federal source. The tax credit law required projects to remain in permanent low-income use, and prohibited locking into a limited partnership agreement, a bargain sale of a tax credit project to tenants, or a nonprofit sponsor at the end of the 15-year compliance period. It failed to waive the tax liability of owners who do transfer their ownership interests to a tenant co-op. The passive loss limitations and income cap reduced the tax credit’s attractiveness to high-income individuals, and there was no increment in the tax credit for high-cost areas.

However, given the hostile housing policy environment that existed when the law was enacted, it is no wonder that the low-income advocacy community rallied behind a tax credit whose cost to the government may be double what it delivers to projects (see appendix for computation). This is a tax credit whose value to the developer has been estimated to exceed 50 percent of development cost but, when unaccompanied by other housing subsidies, cannot produce housing that is affordable to the poor.³ According to Joseph Guggenheim, for example, assuming average development costs, the tax credit alone can produce new, conventionally financed low-income housing at a rent of around \$491 a month for a two-bedroom apartment.⁴ In contrast, the average rent for public housing is \$109.

To put rental rates of tax credit projects in perspective, James Wallace points out elsewhere in this issue that nearly a third of all current residents of federally assisted housing have incomes of less than 20 percent of their respective area medians, while only 19 percent have incomes above 50 percent of median.⁵ Nevertheless, the tax credit law permits equity investors to access tax credit benefits by developing housing for families whose incomes are as high as 60 percent of median.

To afford a \$491 gross rent, assuming a 30 percent rent-income ratio, a household would need an income of \$19,640. A household with that income in a metropolitan area with a median income of \$32,800 would qualify as low income under the tax credit law because its income was less than 60 percent of the median for the area. That income, \$19,640, however, is around 30 percent higher than the 1986 median income of all renters in the United States. Surely this is not the income group that Congress intended to target in a limited-volume rental production program. After all, from 1974 to 1987, the number of renter households in the United States with incomes under \$5,000 (in 1986 dollars) grew from 2.7 million to 4.7 million.⁶ It is these households and others with poverty-level incomes that suffer from much higher rates of housing deprivation than do those who can be served by otherwise unsubsidized tax credit projects.

Consistent with the discussion above, one early assessment of tax credit projects found that when the sole source of government subsidy is the tax credit, “low-income” housing can be built in suburban fringe areas where costs are lower and incomes are higher, not necessarily where needs are greater.⁷ Indeed, according to the Mitchell-Danforth Task Force that studied the tax credit’s limitations, “In markets where costs are high and incomes low, development is difficult and the amount of additional subsidies needed are huge.”

In New York City, for example, where both the Enterprise Foundation and LISC have facilitated the creation of many public-private partnerships that link the city and community-based developers with corporate equity investors, it takes up-front capital grants of at least \$25,000 a unit and 40-year, 1 percent financing to produce tax credit projects — even when they start with city-owned buildings. This then is why it is necessary to resort to creative finance to develop an increasing share of new low-income housing.

Creative finance as a necessity

Born of necessity, creative finance is the piggybacking of several different subsidies in a single project — until they are sufficient to reduce rents to affordable levels. Rather than bemoaning their inefficiencies and extraordinary packaging costs, in Alice in Wonderland fashion, the industry has coined a complimentary term to describe these developments. They are known in the trade as “boutique” projects. Although these projects are a credit to the dedication and sophistication of their nonprofit sponsors, because of

their extraordinarily high transaction costs and associated inefficiencies, they should not be held up as replicable models. Yet that is what seems to be happening.

Table 1. Sources of Funds for Two Low-Income Housing Projects

Project	Amount	Terms
An 89-unit SRO project for homeless, physically disabled, and elderly individuals		
Equity	\$ 350,000	
Loan 1	1,100,000	1%, 30 years
Loan 2	800,000	1%, 15 years
Leasehold mortgage	300,000	6%, 20 years
HUD Rental Rehabilitation Grant	450,000	
HUD Urban Development Action Grant	350,000	3%, 20 years
Loan		
State grant 1	750,000	
State grant 2	26,719	
Total development costs	\$4,126,719	
Cost per unit	46,368	
Annual income of group served	5,000	
A 15-unit SRO project for homeless single adults		
Equity	\$ 484,000	
City loan 1	90,000	2%, 15 year/30 year amortization
City loan 2	57,000	9.25%, 15 years
City loan 3	3,450	0%, 15 years, payable at maturity
State loan 1	240,000	5%, 40 years, payable only if no longer in low-income use
State loan 2	270,000	11.15%, 30 years
Total development cost	\$1,144,450	
Cost per unit	76,297	
Annual income of group served	7,737	

Not long ago I had the opportunity to review 24 tax credit projects that were widely regarded as “state-of-the-art” deals. Each project contained an average of five separate financing sources. Seven projects, nearly a third, had six or more separate sources of financing and, incredibly, one had fifteen. Table 1 outlines the extremely complex financial structure of two of those nonprofit-sponsored projects that used the tax credit to produce single-room occupancy

(SRO) units for homeless individuals with incomes in the range of \$5,000 to \$7,400. While their multilayered financing was due largely to the fact that they are intended for very poor, homeless people, the complex structure of these projects also emphasizes the most serious failure of a housing policy based on creative finance. *It simply doesn't make sense to have a national housing policy in which the deeper the targeting and the lower the income group served, the more complicated and costly it is to arrange the financing.*

HUD's disingenuous support of the tax credit

With HUD's proposed fiscal year 1991 budget containing virtually no new production funds, and with proposed cuts in the Community Development Block Grant and Farmers Home Administration programs promising to make it more difficult to package tax credit projects, Secretary Kemp's enthusiasm for the low-income housing tax credit rings just a little hollow. For example, in 1988, nearly a third (31.2 percent) of all tax credit projects were in rural areas and, of these, nearly half (45.8 percent) combined the credit with Farmers Home Administration Section 515 below-market-rate financing and rental assistance funds.

Despite the probable extension of the tax credit, it should be much more difficult to create new low-income housing in rural areas next year if Congress approves the president's housing budget as it was submitted. The Administration has proposed cutting back the Section 515 multifamily rental construction program by 31 percent and substituting a total of 8,000 rural housing vouchers to offset this and other rural housing program reductions.⁸

Similarly, nearly 40 percent of all 1988 tax credit projects planned to combine the credit with other HUD subsidies, including Section 8 Moderate Rehabilitation (mod rehab) funds, Housing Development Action Grants (HoDAG), Urban Development Action Grants (UDAG), and Community Development Block Grant funds (CDBG). The president's budget, for example, recommends the outright cancellation of HoDAG, the restriction of mod rehab funds for use in renovating a relatively few SRO units for homeless individuals, and a \$163 million cut in the CDBG program. If all of these cuts are approved, the role of creative finance in the production of low-income housing will become even more important.

Who's in charge?

It does not take a rocket scientist to understand that when no one is in charge of orchestrating so many separate loans and subsidies, an unethical or highly inefficient developer might receive far more subsidy than is needed to get the project built. That is, indeed, what has already happened with many tax credit projects, especially when the credits were combined with HUD Section 8 mod rehab subsidies. A recent General Accounting Office (GAO) audit of eight tax credit/mod rehab projects determined that —

When the developers sold their ownership interests in these projects along with the related tax credits, and when these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds far greater than the costs associated with acquiring and rehabilitating the properties. We estimated cash flows to developers on the eight projects ranged from about \$254,000 for a 36-unit project to about \$2.1 million on a 352-unit project. On a per-unit basis, the range was from about \$3,500 to \$11,400.⁹

According to GAO, “neither the mod rehab program nor tax credits provide developers incentives to minimize costs. In fact, there is an incentive to increase costs . . . because the amount of tax credits is based on a percent of rehab and acquisition costs, developers have an incentive to increase expenses, either by inflating costs or incurring unnecessary costs.” Moreover, with no centralized oversight of the “total benefit packages provided to individual projects, there is a real opportunity for excessive benefits.”¹⁰

That is why Congress banned the use of mod rehab subsidies in tax credit projects and recently imposed new underwriting requirements on the state agencies charged with allocating tax credits. Under the new rules, those agencies must develop written allocation plans before awarding credits, give priority to projects that produce the greatest number of low-income units and are more deeply targeted, and evaluate projects to provide only the minimum amount of tax credit necessary for economic feasibility. Clearly, the preferences for maximizing both production and targeting are in conflict unless the tax credits leverage large amounts of nonfederal funds, which seems to be what federal housing policy is all about these days.

For largely the same reason, in January 1990, under Congressional directive, HUD issued a similar regulation that would apply to all applicants for HUD program assistance, including financing insured by the Federal Housing Administration. Under the new regulation,

developers must state whether they expect to use tax credits. If they do, just as Congress has directed state credit allocation agencies to be the last ones to come to the table with project benefits, HUD also wants to be the last with the least.

To help HUD determine reasonable project needs, all applicants for HUD aid must specify the terms of the tax credits the aid will secure; identify the income limits that will be in effect; list all federal, state, and local government insurance, loans, grants, and subsidy programs in which the applicant plans to participate; and identify all grants and below-market interest rate loans expected from nongovernment sources. For each loan, the applicant must also specify the loan amount, interest rate, term, and monthly debt service.

The problem here is twofold. First, even if all the requested project data could be accurately provided at this early stage in the development process, HUD would likely choke on information overload. With the elimination of most multifamily production programs and a move to coinsurance during the era of President Reagan and Secretary Pierce, HUD lost a great deal of its inhouse multifamily underwriting capability. More important, not every agency and financing source that participates in a project can be, in Reggie Jackson's words, "the straw that stirs the drink." Like an equation that has too many unknowns to have a unique solution, a creatively financed tax credit project that requires virtually all financing components to be locked in before any will be committed cannot be underwritten.

Although these new laws and regulations might make more efficient use of the tax credit and, thereby, possibly save the federal government some tax expenditures, they also will substantially increase the transaction costs of producing low-income housing that must be borne by states and localities. That is because project proposals will now bounce back and forth between the state credit allocation agencies, HUD, and local agency participants that provide separate pieces of the financing. And, every time one of the participants changes a number, all other parties to the deal will have to reassess the extent of their respective participation, and the project underwriting and review process will go on and on.

As rational as they seem, a serious problem with these new tax credit requirements is that they all focus on saving the federal government money, and not on creating financing programs that minimize total resource costs. As the GAO correctly observed, public-private partnerships have become important development

entities in recent years, not because they are inherently efficient or sensitive to client needs, but because they are “vehicles for both limiting federal expenditures and leveraging federal funds.”¹¹ This proposition is especially applicable to the case of the new extended use requirement that Congress imposed last year on tax credit projects.

Widely supported by housing advocates, this requirement mandates that all housing units supported by low-income tax credits remain in low-income use for up to 30 years. Specifically, owners wishing to sell or convert a tax credit project at the end of 15 years first must give the state credit agency one year to find a buyer willing to maintain the project as low-income housing for the balance of the 30-year period. If the agency cannot find a buyer and the project is sold or converted by the original owners after 15 years, the law provides protection for existing low-income tenants for 3 years under a vacancy decontrol requirement.

In practical terms, without a public financing program that would enable nonprofits to buy out for-profit sponsors at the end of 15 years, the 30-year use restrictions will become just a 3-year extension followed by another expiring-use crisis. This time, however, rather than being primarily a federal problem, it will have to be resolved by states and localities because Congress failed to provide any means for the tenants in occupancy or a local nonprofit to buy tax credit projects in their sixteenth year, before vacancy decontrol is slated to begin.

Who uses the tax credit?

According to the trade journals, the concern expressed here about these new regulations is misplaced. According to many “inside sources,” the impacts of the 1989 revisions to the tax credit law, including the extended use provision, will, if anything, be positive and will lead “to increased selectivity by agencies in choosing projects to receive credits, increased participation by nonprofit sponsors as a result of the greater emphasis on deeper targeting in projects, or joint ventures by for-profit firms with nonprofits, and downward pressures on developer fees and profits.”¹²

With specific reference to the effect that the extended use restriction might have on the value of the tax credit to private investors, Bart Harvey of the Enterprise Foundation anticipated little change in price. This is because Enterprise’s national and local syndications

are private placements targeted exclusively to corporate investors that raise capital for projects developed by nonprofit sponsors. These partnerships “have always been structured without any expectation of residual benefits for investors.”¹³ While Harvey may be correct, the fact is that in 1987, 94 percent of all investors in tax credit projects were individuals, and just 6 percent were corporations.¹⁴ While more recent tax credit acquisition data probably will show a greater rate of corporate participation, the largest players in the tax credit game continue to be individual investors who acquire partnership interests in both public and private placement tax credit limited partnerships.

This fact has significant long-term implications because it implies that despite the terrific press received by the community housing sector, for-profit developers are the principal beneficiaries of tax credits. According to the National Council of State Housing Agencies, states utilized about two-thirds of their tax credit authority in 1988, allocating credits to 3,027 projects containing 77,825 low-income units. And, while not all projects for which credits were allocated will actually get built, 90 percent of all projects and 97 percent of all housing units supported by 1988 tax credits were sponsored by for-profit developers.

The fact that for-profit developers outnumber nonprofit developers by so many, and that individual investor-oriented limited partnerships are more likely to price their partnership shares with an expectation of realizing residual benefits to the extent that local market conditions will allow, these partnerships will be more reluctant to maintain a low-income use at the end of their mandatory 15-year compliance period. Thus, a substantial number of expiring use tax credit projects can be expected to come on the scene shortly after the turn of the century. These projects, it will be recalled, were placed in service prior to the recent extension of low-income use restrictions to 30 years.

We must monitor projects to ensure compliance

Even if the 1989 statistics are more favorable to nonprofit developers and the 1990 numbers become better still, they will not tip the production of tax credit projects in favor of nonprofit, community-based organizations. The fact that a relatively large number of tax credit deals are small-scale projects developed by for-profit investors — the average tax credit project has just 30 units — suggests that monitoring creatively financed housing for long-term compliance

with the applicable low-income use restrictions will be both more necessary and more difficult than would be the case if nonprofit developers dominated the production scene.

The problem is not that the tax credit law lacks severe penalties for noncompliance. Failure to adhere to the law's low-income use restrictions subjects the taxpayer to potentially serious financial consequences:

If a building fails to meet certain tax credit program requirements during the 15 year compliance period a "recapture event" is triggered. The penalty for a recapture event is denial of tax credit for the current taxable year and recapture of the accelerated portion of tax credit previously claimed by the building owner One-third of the annual credit amount, plus prescribed interest, is recaptured for non-compliance during the first 11 years. For non-compliance in later years, the applicable recapture percentages [are lower].¹⁵

Unfortunately, the federal government does not have a very good record when it comes to monitoring the performance of public-private partnerships oriented toward community development. As often as not, it tends to rely on the word of local officials about the accomplishment of the partnerships' goals. However, according to the U.S. General Accounting Office:

While local partnership projects tend to claim success in reaching their target populations, the success of some federal programs in addressing the needs of their target populations has been questioned. For example, HUD reported that, since 1982, 97 percent of the benefits from CDBG state and small cities grants have gone to low- and moderate-income people. However, a 1988 report by HUD's Inspector General questioned whether the grants were effective in reaching low- and moderate-income people. This discrepancy highlights the importance of evaluating whether a program improves the condition of its target population.¹⁶

Although the law requires recipients of tax credits to provide HUD with project information requested by the secretary, and to file annually at least three tax credit-related Internal Revenue Service (IRS) forms, no single government agency is responsible for ensuring that tax credit-supported projects meet their occupancy restrictions. This fact was acknowledged by the IRS at an April 27, 1990, hearing held by the Senate Banking Committee's special HUD investigations subcommittee. According to David Blattner, the IRS's assistant commissioner for examination, although "the IRS so far has disallowed first year tax credits claimed by 225 taxpayers and has various investigations underway, [we do not] have sufficient

information now to determine if there is widespread noncompliance by taxpayers with tax credit program requirements.”¹⁷ Even though the IRS now is working to put in place a system that would match taxpayer forms with those filed on the same project by housing credit agencies, this still would not get at the heart of the potential noncompliance problem. The problem could best be dealt with through a HUD-conducted biennial audit of a nationally representative sample of tax credit projects to determine the extent to which compliance varies with project size and type, sponsorship, over time, and the real estate cycle. After all, as long as HUD supports the tax credit as the primary vehicle for producing and preserving low-income housing, it should take the lead in monitoring sponsor performance.

Conclusion

We need to return to a more efficient and, yes, a more generous means of financing the preservation and production of low-income housing in the United States. For, when all is said and done concerning the increasing importance of creative financing, the fact remains that only a relatively small number of states and localities are investing heavily in the production of low-income housing.

According to the National Council of State Housing Agencies, just 4 percent of all 1988 tax credit projects contained one or more local subsidies, and just 10 percent contained a state subsidy. Fully 60 percent contained at least one federal subsidy in addition to tax credits, including Farmers Home Administration loans and interest subsidies (14.3 percent), mod rehab aid (4.1 percent), and Section 8 rental assistance (21.2 percent).¹⁸

If the Administration and Congress stay on their present budgetary course, these supplemental production resources will continue to dry up, and competition for Section 8 certificates and vouchers will intensify as this vital source of rental assistance becomes available to support public housing tenant buy outs and other Administration-sponsored resident conversion ventures.

Unless Congress fully funds housing programs other than the President's Home Ownership for People Everywhere (HOPE) initiative, which contains virtually no funds for new construction — such as the HOME program contained in the National Affordable Housing Act, containing flexible funds that can be directed by states and localities to preservation, rehabilitation, or new construction,

the future of low-income housing will revolve increasingly around the tax credit and creative finance. Among other things, this means that the location of future additions to the nation's permanent supply of low-income housing will be determined more by variations in construction cost and local income distributions, and by the degree of local packaging expertise and grantsmanship, than by demonstrated need. It also means that without the federal government as partner in local public-private partnerships, many states and localities will choose to remain on the sidelines, investing little of their own resources in housing production.

At the same time, budget exigencies will force some of the larger states that have been national leaders in the public-private production process to the sidelines as the required subsidy costs per unit rise to politically unacceptable levels. In this regard, it should be pointed out that "California, Connecticut, Massachusetts, and New York contended with revenue shortfalls ranging from \$250 million to over \$1 billion," and state and local budget woes have spread more broadly during the last 18 months.¹⁹ In short, creative finance cannot be a viable long-term national strategy for the production or preservation of low-income housing.

Appendix

The inefficiencies of the low-income housing tax credit

The two greatest sources of inefficiency of the low-income housing tax credit are the differences between the cost of the tax credit to the federal government in terms of foregone revenues and the amount of equity that is raised from sale of the tax credit; and the large amount of gross equity that is raised from sale of the tax credit that pays for syndication costs and, therefore, is not invested in housing. A third source of inefficiency that is even more difficult to measure is the high transaction costs that are borne by the public-private partnerships that develop low-income housing. The costs of packaging a housing project that consists of five or more separate financing sources are very high and frequently are not accounted for in a statement of "sources and uses of funds."

According to the National Council of State Housing Agencies (NCSHA), the average tax credit allocated by state agencies to low-income housing units supported by tax credits in 1988 was just \$2,598. Since the tax credit runs for ten years, the loss to the federal government in terms of forgone taxes is equal to the present value of \$2,598 per year for ten years, discounted back to the present at the government's long-term borrowing cost. Assuming the latter is 7.5 percent, the present value of the total tax expenditure associated with the average low-income tax credit housing unit in 1988 is \$17,833.

Because the typical private investor's required rate of return, or discount rate, is higher than the government's opportunity cost, the syndication of tax credits will almost always raise less equity capital than the federal government loses in tax revenues. Thus, for example, at a 15 percent rate of return, which is lower than the 16.3 percent median return to tax credit investors cited in Karl Case's paper, the sale of tax credits worth \$2,598 per year for ten years would raise a total of \$13,039.²⁰ That is, the present value of a ten-year tax credit annuity of \$2,598, discounted at 15 percent, equals \$13,039. Thus, sale of the tax credit results in a tax expenditure that is 37 percent greater than the equity capital it raises — a source of major inefficiency.

As indicated above, another inefficiency of most tax shelter subsidies is that not all of the capital raised through the syndication process ends up paying for bricks and mortar. As the Congressional Budget Office, GAO, and others have shown, preparing and marketing tax shelters is a costly business. In fact, a recent GAO study "reviewed prospectuses and/or summary data for all of the 19 public real estate partnership offerings on the market that use the low income housing tax credit. For comparison purposes . . . [the GAO] obtained information on the expenses and fees for the 48 residential or residential/commercial public partnership offerings being marketed that do not use the credit."²¹ According to GAO:

The 19 publicly offered partnerships being marketed for low-income housing tax credit projects on average use a higher proportion of equity to pay fees and expenses than partnerships for residential and residential/commercial investments. The low income housing partnerships devote an average of 27 percent of equity for fees and expenses, while the other types of investments use about 21 percent for this purpose.²²

Applying the 27 percent industry average for the amount of fees and expenses associated with the sale of tax credits by publicly offered partnerships to the \$13,039 in gross syndication proceeds computed above reduces the amount of capital available for housing investment by \$3,521 (27 percent of \$13,039). Thus, the sale of \$2,598 in 1988 tax credits will generate approximately \$9,518 in investable capital (\$13,039-\$3,521), which is just slightly more than half (53 percent) as much as the credits cost the federal government in forgone revenue. That is why we can say that a direct capital grant to the project sponsor equal to about half the government's tax expenditure would contribute roughly the same amount to development costs as does syndication of the tax credit. Assuming the average development cost of a low-income tax credit unit is \$50,000, this would amount to a 20 percent capital grant.

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16. GAO, 17.
17. Warren Gorham & Lamont, Inc., *Housing and Development Reporter* (April 1990).
18. Parenthetically, it should be noted that since enactment of the low-income housing tax credit, the number of new low-income housing units created has probably been grossly exaggerated. For one thing, not all proposed projects for which tax credits are allocated in any given year are actually constructed. For another, since so many tax credit projects also receive other federal subsidies, there is probably a great deal of double counting. In the government's reporting of low-income housing production, housing units receiving Farmers Home, HoDAG, and other direct federal subsidies should be accounted for under their respective program titles or counted as tax credit units, but should not be subsumed under both categories.
19. Tax Foundation, *Tax Features* 33, no. 1 (January-February 1989):1.
20. Karl Case, 341.
21. GAO, 1.
22. *Ibid.*, 2.

