Comment to the President's Advisory Panel on Tax Reform
Submitted by The Enterprise Foundation/Enterprise Social Investment Corporation
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Introduction and Overview

The Enterprise Foundation and the Enterprise Social Investment Corporation ("Enterprise) appreciate this opportunity to comment to the President's Advisory Panel on Tax Reform. Our comment focuses on two tax provisions currently in law and a tax proposal that has been advanced by the president. The two existing tax provisions are the Low Income Housing Tax Credit (LIHTC) and the New Markets Tax Credit (NMTC). The tax proposal is the Homeownership Tax Credit (HOTC). We encourage the Panel to support these tax provisions in its recommendations. Our comment focuses primarily on the LIHTC because it has been in existence the longest; it has been subject to extensive evaluation that has shown its efficiency and effectiveness; and because it is in many respects the basis for the NMTC and the HOTC.

Enterprise is a family of social venture organizations that provides capital and other assistance to support affordable housing and economic development in low-income urban and rural communities nationwide. Enterprise has deployed nearly $6 billion to support the creation of 175,000 affordable homes, among other activities. This investment has provided decent, affordable homes for more than half-a-million people and strengthened hundreds of neighborhoods and local organizations. Most of this activity has been generated by the LIHTC.

The LIHTC is itself a result and an example of tax reform. Congress enacted it as Section 42 of the Internal Revenue Code in the Tax Reform Act of 1986. Prior to the Act, the Code contained various provisions to encourage investment in rental housing properties. These included accelerated depreciation schedules, five-year amortization of rehabilitation expenses and expensing of construction period interest and taxes. These tax provisions were widely regarded as inefficient and poorly targeted. Taxpayers could claim their full value even if only some apartments in tax-subsidized properties served low-income renters, while the rest rented at market rates.

The LIHTC effectively replaced and improved upon these tax incentives for rental housing by tying tax subsidy to public benefit: credits can only be claimed with respect to apartments serving low-income tenants. In enacting the LIHTC in the context of comprehensive tax reform Congress affirmed the importance of encouraging the private market to help provide affordable rental housing through the tax code, while demanding greater public benefit for the federal expenditure. Through the past 18 years the LIHTC has demonstrably met and arguably exceeded Congress' objectives.

The balance of our comment summarizes some of what we believe are the most relevant aspects of the LIHTC's structure and performance for the Panel's work. We frame our comments in response to questions that we understand the Panel has applied to other aspects of the tax code:

- Does the LIHTC achieve a genuine public purpose?
- Is the LIHTC effective at achieving its purpose?
- Is the LIHTC efficient at doing so?

Public Purpose

The purpose of the LIHTC is to enable the private market to provide newly constructed and rehabilitated rental homes that low-income families and individuals can afford. According to the General Accounting (now Government Accountability) Office: "In establishing the tax credit incentive, Congress recognized that a private sector developer may not receive enough rental income from a low-income housing project to (1) cover the cost of developing and operating the project, and (2) provide a return to investors sufficient to attract the equity investment needed for development."[i]

The LIHTC provides taxpayers a dollar-for-dollar reduction in federal income taxes for investments in rental housing developments serving very low-income people for extended periods. The amount of tax credit is based on a percentage of eligible development costs and claimed over a ten-year period. Tax credits can only be claimed with respect to costs incurred to provide housing for low-income families that remains affordable to them and in good condition for 30 years. Specifically, LIHTC-assisted homes must remain rented affordably to tenants whose income does not exceed 60 percent of area median income. By way of illustration, this amount for 2005 is roughly $35,000 for a family of four on a national basis; the amount varies significantly by area.

In practice the LIHTC serves much lower income tenants on average than the law requires. The GAO found that LIHTC renters earn on average 37 percent of their area's median income (AMI).[ii] GAO found, and other evaluations have confirmed, that nearly 40 percent of LIHTC renters have incomes of 30 percent or less of AMI and three quarters earn 50 percent or less of AMI. Thirty percent of AMI and below is considered "extremely low-income" with respect to federal housing programs. Fifty percent of AMI and below is considered "very low-income."

A recent review of Census data found a huge shortfall in the supply of homes for extremely low-income people. The analysis found that there were only 84 units of affordable housing for every 100 extremely low-income people in the country, representing a national shortage of 1.27 million units.[iii] The report concluded:

> Despite the improvements, 56 percent of renter households with extremely low-incomes—well over four million struggling households—paid more than half of their income for rent in 2000. The shortage of units affordable and available to extremely low-income renter households not only remained high in every state, but in many states and across the country, the shortage grew worse over a decade in which income growth and many other economic indicators were positive.[iv]

By no means does the LIHTC fully address all of the nation's most acute housing needs; the number of apartments it creates every year may not even equal the number lost due to abandonment, deterioration and conversion to market rate uses. The LIHTC is a finite resource (see below) and, as a capital subsidy, cannot on its own ensure apartments are affordable to the very lowest income renters; tenant income support is typically required and often provided to LIHTC renters through the Housing Choice Voucher program, but Vouchers are severely underfunded. In our view these are limitations of our national housing policy, not the LIHTC itself.

Effectiveness

The LIHTC has proven to be remarkably effective by a number of metrics. First and foremost, it does what Congress intended it to do: generate private capital investment to support development and rehabilitation of new and rehabilitated affordable rental homes for low-income people. The LIHTC has supported more than 1.6 million affordable homes and currently drives creation of approximately 125,000 homes annually.

A recent report from the Department of Housing and Urban Development (HUD) noted: "Since 1987—the first year of the credit program—the LIHTC has been the principal mechanism for supporting the production of new and rehabilitated rental housing for low-income households, with approximately $5 billion in annual budget authority."[v] Affordable housing experts estimate that the Credit annually accounts for the majority, if not nearly all, affordable rental housing produced in this country.

The LIHTC supports a wide range of housing types: large developments and small; in urban, suburban and rural communities; for families, senior citizens and individuals with special needs. In almost every case, the LIHTC provides financing on which affordable housing developments depend to be built. In LIHTC developments, the tax credits account for an average of 42 percent of total development costs. As a result, LIHTC developments have much smaller mortgages than conventional apartment properties.[vi] By reducing the amount of debt an affordable apartment development needs to support, the LIHTC ensures that property owners can serve lower income renters than otherwise possible *and* operate buildings viably with the limited rental income their low-income tenants can pay.

LIHTC developments have performed remarkably well. An analysis of nearly 8,000 developments built between 1987 and 1999 found that only 10—roughly one-one hundredth of one percent—had been foreclosed upon or tendered a deed in lieu of foreclosure to their lender. On this basis, the foreclosure rate for LIHTC developments is approximately 100 times lower than for commercial real estate.[vii]

A great deal of the LIHTC's effectiveness comes from its administrative structure. States administer the LIHTC (reducing federal administrative costs substantially). Each state receives an annual allocation of tax credits based on its population. The amount is $1.85 per capita in each state for 2005, amounting to $550 million available in 2005 credit authority. The cap is indexed to inflation. As a result of the huge need noted above for the kind of affordable rental housing the LIHTC makes possible, demand for LIHTC far exceeds supply, i.e., many developers seeking LIHTC financing do not receive any. Nationally, demand approaches three times available supply and is significantly higher in some states.[viii]

States award tax credits to developers under a public, competitive process in accordance with annual plans states develop that reflect their affordable housing needs. These plans are required by statute to give preference to developments serving the lowest income tenants, developments that serve income-qualified tenants for the longest periods and to developments in distressed areas that are part of a community revitalization plan. States subject applications for LIHTCs to multiple rigorous reviews and are required to allocate only as much LIHTC as a proposed development needs to be financially viable. Investors with money at stake also intensively review and monitor LIHTC properties. Strong oversight and accountability enforced by the private sector is a distinguishing feature of the LIHTC and a function of its structure as a tax provision.

States are also required by law to ensure that LIHTC apartments are in good condition and in compliance with tenant income and rent rules. States report instances of noncompliance to the IRS, which has the ability to recapture tax credits. The GAO found that LIHTC apartment rents were well below market rents (on average 25 percent less than the HUD's national "fair market rent") and that LIHTC properties were well maintained.

Some critics have asserted that LIHTC properties are disproportionately located in high-poverty areas. Rather than a defect of the LIHTC or divergence from congressional intent, this fact is largely a result of some states' determining that those communities had the most acute affordable housing needs. Not only has the LIHTC provided homes which otherwise would not have existed in those areas, but also helped revitalize them. An extensive analysis of LIHTC developments nationwide found the following:

> Overall roughly half of the properties in the sample were developed primarily to serve neighborhood improvement goals. The vast majority of these were developed by nonprofit sponsors and undertaken to address a specific problem site in the neighborhood...Regardless of motivation, roughly two-thirds of the properties could be said to have had a substantial, positive impact on their neighborhoods.[ix]

The remaining properties were found to have a moderate impact and some were in neighborhoods that did not need significant revitalization.

Efficiency

The LIHTC is efficient by a number of metrics as well. First, as noted above, the annual amount of LIHTCs is capped and tied to population growth and inflation. Only developments that most effectively meet state-determined affordable housing needs and undergo rigorous underwriting and review are even eligible to receive credit allocations. Then, taxpayers may only claim the credits, at the risk of recapture by the IRS for 10 years, if LIHTC-financed developments remain affordable to qualified low-income renters and in good condition for the longterm.

Second, taxpayers cannot simply claim LIHTCs as they can many other tax benefits. They must pay for them in a highly competitive marketplace. Developers that receive LIHTC allocations sell them to corporate and financial institutions (individuals taxpayers account for perhaps two percent of the market). Since Congress removed the "sunset" on the LIHTC in 1993, prices for LIHTCs have climbed steadily, continuing to rise and achieve historic highs even after Congress increased the annual volume of LIHTCs by 40 percent in 2000. Today as a result, 90 - 95 cents of every LIHTC dollar "spent" by the federal government on a present value basis goes directly into affordable homes, a remarkably efficient rate for any government program.[x]

The more investors pay for LIHTCs, the more public benefit the government realizes for the tax expenditure. Strong "purchasing power" for the LIHTC (efficiency for the federal government) also makes the credit more effective at achieving its public purpose. One recent analysis noted: "The increased value in the credits over the last several years has allowed states to do two things: build even more housing units, and more deeply target lower-income and special need households."[xi]

Conclusion

As a federal tax expenditure, the LIHTC in and of itself cannot be said to enhance tax code simplicity. As a practical matter, however, the LIHTC is relevant only to entities with a stake in its purposes and interest in achieving them and, as noted above, has evolved into a highly effective, efficient program for its users and beneficiaries. Congress consciously chose to create the LIHTC as part of comprehensive tax reform and voted as recently as 2000 on an overwhelming and bipartisan basis to substantially expand it. That year, 375 members of the House and 81 Senators voted for bills to increase the LIHTC by 40 percent that became law in the "Community Renewal Tax Relief Act of 2000."

The Panel is charged with "recognizing the importance of homeownership" in its recommendations. Rental housing is important too, especially for people not yet able to buy. The deduction for home mortgage interest, which mostly benefits upper income people, will cost the government $76 billion in FY 2006 and $446 billion between FY 2006 and FY 2010. The LIHTC, which serves very low-income people, will cost $5 billion in FY 2006 and $22 billion between FY 2006 and FY 2010—5 percent of the cost of the mortgage interest deduction over that period.

Some of the signature strengths of the LIHTC summarized above are functions of the LIHTC's existence in the tax code. These include private sector underwriting, oversight and monitoring; competitive market-based pricing; high efficiency for the federal expenditure with low administrative costs; and powerful penalties for non-compliance. These attributes are not commonly associated with government spending programs.

The major elements that have made the LIHTC successful are present in the New Markets Tax Credit, enacted in 2000, and the Homeownership Tax Credit, which the president has proposed. The former stimulates commercial, manufacturing and small business activities in distressed areas. The latter would generate affordable for-sale housing in underserved communities the way the LIHTC does for rental apartments. Neither of these tax provisions yet can point to the track record of performance that the LIHTC can, but both are based on the same fundamentals that have made the LIHTC so successful. We urge the Panel to account for the importance of using tax policy on a carefully targeted, low-cost basis to help ensure that the broader economic system works for low-income people and communities.

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[i] General Accounting Office, *Tax Credits: Opportunities to Improve Oversight of the Low Income Housing Program*, March 1997, p. 22.
[ii] Ibid., p. 41.
[iii]Nelson, Treskon and Pelletiere, *Losing Ground in the Best of Times: Low Income Renters in the 1990s*, National Low Income Housing Coalition, March 2004, p. 8.
[iv] Ibid., p. 15.
[v]Climaco, Finkel, Nolden and Rich, *Updating the Low Income Housing Tax Credit (LIHTC) Database: Projects Placed in Service Through 2002*, Abt Associates, Inc., December 2004, p. 2.
[vi] Ernst & Young LLP, "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," National Council of State Housing Agencies, February 2003, p. 13.
[vii] Ernst & Young, "Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties," Ernst & Young, May 2002, p. 2.
[viii] National Council of State Housing Agencies.
[ix]Buron, Nolden, Heintz, Stewart, *Assessment of the Economic and Social Characteristics of LIHTC Residents and Neighborhoods*, Abt Associates, February 2000, pp. 6-11 - 6-12.
[x] Enterprise estimate based on tax analysis and market pricing.
[xi] Ernst & Young LLP, Ibid., p. 14.