Financial Incentives May Alleviate Affordable Housing Crisis

By **Eric DeBear and Madeline Williams** (September 5, 2024)

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The issue of affordability in the housing market has become a national policy issue, as recently highlighted in Vice President Kamala Harris' broad set of proposals aimed at making housing more affordable.[1]

Previously, we **reviewed** how zoning reform can be used to increase housing supply and, therefore, reduce rent and purchase prices. This article focuses on another powerful tool that governments use to address affordable housing: financial incentives for developers, homebuyers and renters.

Resources for Developers

Tax Incentives and Abatement

There are a variety of tax policies that have been created at the federal, state and local levels to incentivize affordable housing and investment in challenging markets.

The most popular federal program is the low-income housing tax credit. The LIHTC was created in 1986 as part of the federal Tax Reform Act and has since been revised several times.[2]

LIHTC offers two types of tax credits — a 9% credit and a 4% credit. For the 9% credit, the federal government issues the credits to state governments that are then responsible for awarding the credits to developers and builders through a competitive bidding process. For the 4% tax credit, developers may apply directly to the federal government without a bidding process.[3]

LIHTC is primarily used by developers to generate equity investments through the sale of credits to private investors who use the credits to reduce their tax liability.[4] Overall, the LIHTC program has been successful in creating a funding mechanism for affordable housing projects, with the average project able to finance 55% of development costs through the program.[5]

Some criticisms of LIHTC include that affordability requirements usually only apply for 15 years and apartment units are reserved for moderate-income households, as opposed to very low-income households. LIHTC is also complex and costly, thereby contributing to higher costs for developers.

As an alternative to tax incentives, many state and local governments use tax abatement programs to incentivize the creation of affordable housing. In general, a tax abatement program will reduce or eliminate real property tax liability for a qualifying development, thereby reducing the overall cost of owning, developing and maintaining the applicable development.

Tax abatement programs take many forms, each of which carries its own qualifying criteria and abatement levels. Some programs, such as New York City's 421-a incentive program, will freeze a property's tax assessment from value increases that would result from the improvements constructed by the developer.[6]

Other programs, such as Washington, D.C.'s High-Area Needs Tax Abatement program, provide an overall reduction in tax liability that is capped at a certain value.[7]

By reducing carrying and operating costs, tax abatement programs are undoubtedly helpful for developers and can promote the construction of affordable housing.

However, the downside of these programs is they can only offer a modest reduction in the overall cost of developing and owning property. Therefore, other incentives and funding sources are needed to make an affordable development make sense from an investment perspective.

Direct Funding Sources

As an alternative to tax incentives, governments provide direct funding sources for affordable housing through housing trust funds, multifamily housing bonds, block grants and the sale of publicly owned land at below-market rates.

Over the past decade, housing trust funds have risen to prominence across the country. There are now housing trust funds established at the national, state, county and municipal levels.[8]

In all, 47 states and the District of Columbia as well as over 100 cities across the country have dedicated housing trust funds.[9] Most housing trust funds are funded through direct appropriations from the federal, state or local budget or through increased taxation, including on real property taxes or recordation and transfer taxes, and development impact fees.

In general, housing trust funds offer low-interest loans to developers and builders through a competitive bidding process. Although varying by program, loans may be available for predevelopment costs, site acquisition or gap financing.

In exchange for the loans, a certain percentage of the housing must be preserved as affordable to specific income levels, such as 30% or 60% of the area median income, or AMI, each of which carry maximum amounts that can be collected as rent or sale prices.

For example, the city of Seattle offers 50-year loans at an interest rate as low as 1% through its housing trust fund.[10] Developers that are awarded these loans must set aside at least 60% of units at 30% of AMI.[11] Meanwhile, Washington, D.C., currently offers 42-year loans at an interest rate of 3% and requires units to be set aside at no greater than 50% of AMI.[12]

One of the benefits of housing trust funds is that governments have flexibility to establish priorities such as identifying projects in certain neighborhoods, mixed-income buildings, the amount of family-sized housing being provided or sustainable building techniques being employed.

While housing trust funds have become critical in creating and preserving affordable housing, there are a number of challenges and drawbacks.

First, the amount of funding appropriated to housing trust funds will vary between jurisdictions and from year-to-year within a given jurisdiction.

Second, the competitive bidding process creates a longer time frame for developers to access funds, thereby creating uncertainty over the financial viability of a project. Third, there is oftentimes a lack of transparency over which projects are selected by state and local agencies for funding.

Resources for Renters

Approximately one-third of households in the U.S. are cost-burdened, meaning that those households spend more than 30% of their income on housing.[13]

The number of cost-burdened renters in the U.S. has increased from 20.4 million in 2019 to a record high of 22.4 million in 2022.[14] As the percentage of American renters increased from 22.5% in 1999 to 36% in 2021, and with younger adults becoming a greater proportion of renters, funding and financial assistance for renters has become a critical need.[15]

Financial assistance programs for renters seeking affordable housing are generally classified as project-based or tenant-based. Project-based programs are tied to a specific residential unit and, therefore, do not transfer with the renter. Conversely, tenant-based programs provide financial assistance directly to the individual renter who may apply the benefit to different units.

The largest rental assistance program in the U.S. is a federal tenant-based program called the Section 8 Housing Choice Voucher Program, which was created in the 1970s.[16] This program is administered by the U.S. Department of Housing and Urban Development, and geared toward extremely low-income households with 75% of participants having incomes below the poverty line or 30% of the local median income.[17]

HUD also provides a project-based program called the Section 8 Project-Based Rental Assistance program, which subsidizes units that are privately owned by participating property owners to be set aside for low-income households, or those with income less than 80% of the local median income.[18]

Through this program, the subsidy pays for the difference between the tenant's housing contribution, which is generally 30% of their income, and the cost of maintaining and operating the unit.[19]

Rental support is provided at the state level as well. Maryland administers the Statewide Rental Assistance Voucher Program, which provides vouchers and financial rental assistance for low-income households who are currently on the waitlist for the federal Section 8 Housing Choice Voucher program.[20]

This illustrates how the federal government and the states can implement collaborative programs to improve efficiency and maximize the benefits provided through these programs.

Inclusionary zoning programs and ordinances offer another approach to providing affordable housing by requiring developers to set aside a certain number of units for low-income households in exchange for zoning flexibility such as increased density. These programs give lower income renters access to neighborhoods in which they might otherwise be priced out.

The District of Columbia has one of the most comprehensive inclusionary zoning programs by providing guidance through numerous legislative acts and inclusion in the comprehensive plan and zoning regulations to provide policy guidance.[21]

Some states and localities have implemented inclusionary zoning programs, whereas others have limited or prohibited inclusionary zoning altogether.[22] These policies may vary between localities within a single state, like Virginia, which has varying degrees of inclusionary zoning restrictions depending on the locality.[23]

Resources for Homeowners

Like renters, the number of cost-burdened homeowners has also increased from 16.7 million households in 2019 to 19.7 million in 2022.[24] The increased demand for housing and limited supply has contributed to the worsening housing crisis by causing median home sale prices to surge.[25] As such, financial assistance programs for homebuyers and homeowners are also an important component to the housing crisis equation.

There are a number of federal programs geared toward homeowners. HUD administers the Housing Choice Voucher program, which provides low-income, first-time homeowners with financial assistance in the form of a voucher to buy a home and other homeownership expenses.[26]

More recent programs were created as a result of new challenges. In the wake of the COVID-19 pandemic, the U.S. Department of Treasury, through the American Rescue Plan Act, continues to provide financial support for homeowners impacted by the pandemic for housing-related expenses.[27]

Other programs have a more preventative approach to preserving affordable housing. The California Department of Housing and Community Development implements a Foreclosure Intervention Housing Preservation Program, which provides financial assistance in the form of grants or loans to eligible sponsors to acquire and rehabilitate properties at risk of foreclosure or those within the foreclosure process for affordable housing.[28]

Conclusion

In closing, there is a wide array of financial incentives and assistance that can be provided to both developers and individuals, and governments at the national, state and local levels must prioritize these programs in order to chip away at the housing affordability problem.

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