LAND COSTS AS NON-ELIGIBLE BASIS: ARBITRARY RESTRICTIONS ON STATE POLICYMAKING AUTHORITY IN THE LOW-INCOME HOUSING TAX CREDIT PROGRAM

Michael David Williams*

INTRODUCTION .............................................. 336
I. THE LOCATION DECISION ............................ 339
   A. Quantity Versus Quality ......................... 339
   B. The Importance of Neighborhood ............... 343
      1. Education ................................... 347
      2. Health ...................................... 348
      3. Economic Self-Sufficiency ................... 349
      4. Public Safety ................................ 350
II. INCENTIVES IN THE LOW-INCOME HOUSING TAX CREDIT PROGRAM ........................................... 351
   A. The Low-Income Housing Tax Credit Program . . 352
      1. Applicable Fraction and Applicable Percentage ............................................ 355
      2. Eligible Basis ............................... 356
   B. The Developer’s Location Choice ............... 358
      1. Depth of Subsidy ........................... 360
      2. Profit Structure ............................ 361
         a. Market-Rate Developers ................. 361
         b. LIHTC Developers ...................... 362
      3. Capital Structure ............................ 365
III. PROPOSALS .......................................... 369
   A. Congressional Action ............................ 370
   B. Executive Action ............................... 372
   C. State Action ................................. 374
CONCLUSION................................................ 375

LOCATION MATTERS

The value of a property is intrinsically related to where it sits. An apartment in one place is not worth the same amount as the exact same apartment somewhere else. It is better to be in a good neighborhood than a bad neighborhood. This is true in the real estate market, but it is also true for a policymaker deciding where affordable housing could be best built. Depending on the policy goals, a policymaker may prefer that housing be built in one neighborhood as opposed to another. These different goals might also affect the type of properties that are built. For example, in a poor neighborhood, one that contains barely habitable housing, a subsidy might provide new or renovated units and thereby serve the important policy goal of providing an improved supply of housing, even if there is little effect on rents because the market rents are already quite low. On the other hand, a more affluent neighborhood might provide high value to residents in the form of high-quality schools, access to employment opportunities through better transit, or any number of neighborhood amenities. A policymaker might reasonably decide that some portion of the overall housing subsidy should be allocated towards building units in these neighborhoods even if the end result is that the overall quantity of subsidized units decreases.1

The Low-Income Housing Tax Credit (LIHTC) is a large, highly decentralized federal program that provides a subsidy, in the form of a tax credit, to developers who construct or renovate affordable housing.2 Historically, LIHTC units generally have been built in low-income neighborhoods.3 Many people have recognized this as a problem and have argued that affordable housing should focus on “high-opportunity neighborhoods.”4 Jill Khadduri, specifically, has focused on the

---

1. Without reference to specific local economic and geographic conditions, I cannot answer the question of what the specific tradeoff should be. It is beyond the scope of this Note. I do, however, argue in Part I.B that there are measurable benefits to living in certain neighborhoods. In determining the tradeoff, the policymaker would weigh these benefits against the opportunity cost of development elsewhere.
2. See infra Part II.A.
3. For properties built in 2000, neighborhoods with LIHTC properties were twice as likely to be high-poverty neighborhoods than metropolitan neighborhoods generally. See Lance Freeman, Brookings Inst., Siting Affordable Housing: Location and Neighborhood Trends of Low Income Housing Tax Credit Developments in the 1990s 3 (2004).
role that a state’s Qualified Allocation Plan (QAP) plays in the location outcome. A state’s QAP sets out the policies for how the LIHTC credits are to be allocated. This is thought to have an effect on the spatial distribution of affordable housing. Khadduri has called for policymakers to amend QAPs through an “iterative process” that takes into account “the complexity of the QAPs, the varying political and economic geographies of states, and the dynamic nature of housing markets and finance.” I agree wholeheartedly with Khadduri. QAPs have an important role to play in the location decision made by developers. That said, no commentator has recognized that the statutory structure of the LIHTC program has effectively taken certain policy decisions off the table, thus limiting the influence of the QAPs. For a LIHTC project to be built, it must satisfy not one but two criteria. First, it must satisfy the state’s QAP or it will not receive an allocation of credits. Second, it must be profitable or the developer will not want to build it. As I will show in this Note, the LIHTC program places certain issues of profitability outside the scope of the state’s control.

This Note argues that the LIHTC program limits states’ abilities to make important policy decisions through their QAPs. It does this through the statutory formula it uses to determine the overall size of the subsidy to which the project is entitled. This formula treats land-acquisition costs differently from all other costs, excluding them from the subsidy calculation. This potentially inadvertent decision thereby increases the marginal cost of land to the developer once the subsidy is taken into account.

Housing Voucher Holders by Race and Ethnicity, 16 HOUSING POL’Y DEBATE 297, 320 (2005) (discussing the housing vouchers program).

5. KHADDURI, supra note 4, at 1.
6. Id. at 6–7.
7. In a recent empirical paper, my coauthors and I looked to see if changes to a state’s QAP are associated with changes in the poverty rates where units are built. Among other things, we found that when states prioritized high-opportunity neighborhoods in their QAPs, developers built in neighborhoods with lower poverty rates. See Ingrid Gould Ellen et al., Effect of QAP Incentives on the Location of LIHTC Properties (Mar. 6, 2015) (unpublished manuscript) (on file with author).
8. KHADDURI, supra note 4, at 9.
9. Developers look at both the QAPs and the recent projects that have been allocated credits under the QAP to try and tailor a successful application. See e-mail from Nathaniel S. Cushman, Assoc., Nixon Peabody, to author (Apr. 7, 2013) (on file with author).
10. I.R.C. § 42(m)(A) (2013) (“Notwithstanding any other provision of this section, the housing credit dollar amount with respect to any building shall be zero unless . . . such amount was allocated pursuant to a qualified allocation plan . . . .”).
11. See id. § 42(a)–(d).
Part I of this Note is focused on determining the role of the location decision in affordable housing and its impact on those who inhabit such housing. I consider the methodological difficulties of establishing the effect of neighborhood on outcomes and then present some empirical evidence that neighborhoods matter. Part II considers the effect the LIHTC program’s structure has on a developer’s incentives vis-à-vis location, and how that structure might affect the ability of states to set effective policy through their QAPs. This entails a technical analysis of the LIHTC program as well as an examination of the affordable housing developer as a profit-seeking agent, which requires an economic analysis and discussion of a developer’s business plans. Part II.A discusses the structure of the LIHTC program and its history. Part II.B is devoted to how that structure affects the developer’s location decision. Finally, Part III describes a range of proposals that could be pursued by policymakers to either reform aspects of the LIHTC program described in Part II or, if that is politically impossible, to at least counteract the incentives the program creates.

Central to this Note are the various impacts and values of the location decision. Of course, the residents themselves will have one view on this decision and the owners of affordable housing properties might have another. Policy planners might have a third view reflecting a broader array of social factors. It is this last perspective that should drive policy.12 In this Note, I generally defer to the judgment of state policymakers who, I assume, are trying to maximize some measure of social welfare.13 Social welfare surely takes into account the well-being of both the developers and the tenants, but does not solely look to either one.

12. There is one other important viewpoint that I will ignore throughout this Note: that of people living in neighborhoods where LIHTC units are built. There is a large body of literature on the effect of LIHTC units on neighborhoods, which mostly indicates that the fear of negative effects is overblown. See, e.g., Wenhua Di & James C. Murdoch, The Impact of the Low Income Housing Tax Credit Program on Local Schools, 22 J. HOUSING ECON. 308, 309 (2013) (finding no overall negative impact on local elementary schools when new LIHTC units are introduced); Ingrid Gould Ellen et al., Does Federally Subsidized Rental Housing Depress Neighborhood Property Values?, 26 J. POL’Y ANALYSIS & MGMT. 257, 273 (2007) (finding that “[t]he completion of LIHTC projects . . . is associated with an immediate positive and significant fixed impact, indicating that prices surrounding the tax credit housing rise more than prices in the larger neighborhood”); Matthew Freedman & Emily G. Owens, Low-Income Housing Development and Crime, 70 J. URB. ECON. 115, 115 (2011) (finding that introducing LIHTC units to a neighborhood has no measurable effect on property crime and is associated with a reduction in violent crime). 13. See generally Paul A. Samuelson, The Pure Theory of Public Expenditure, 36 REV. ECON. & STAT. 387, 387 (1954).
Throughout the Note, when I talk about the LIHTC program, I am mostly talking about the program as used in the urban as opposed to the rural setting.14 The two locations are very different from the standpoint of housing policy and so it does not make sense to talk about them together.

I. THE LOCATION DECISION

“Most people are keenly aware in their daily lives of the many tangible and intangible benefits of living in a ‘good’ as opposed to a ‘bad’ neighborhood.”15 Nonetheless, it is less clear that these benefits are important to affordable housing policy, at least when coupled with the fact that housing policy has limited resources at its disposal. While Part II will discuss how the location decision is affected by the LIHTC program’s design, this Part asks the broader question of how location matters to households and why a policymaker might want to subsidize affordable housing in high-opportunity neighborhoods.

One could very well argue that it is a waste of scarce resources to put low-income households in “good” neighborhoods when one could alternatively provide more housing in “bad” neighborhoods. This argument assumes, however, that quantity should be prioritized over quality in affordable housing policy. Part I.A will therefore address the fundamental question: how should a policymaker think about the trade-off between quantity and quality? Part I.B will then provide the theoretical and empirical framework a policymaker should employ when considering whether or not to subsidize units in high-opportunity neighborhoods despite the higher costs.

A. Quantity Versus Quality

“[T]he goal of federal housing policy . . . has been to improve family well-being, broadly defined.”16 Expanding on this vague goal, the U.S. Department of Housing and Urban Development’s (HUD) 2010–2015 Strategic Plan identifies five goals that the Department

---

14. In actuality, approximately 42% of all LIHTC units are located in the suburbs. FREEMAN, supra note 3, at 1. However, at least one state has “set-asides” whereby there is a separate amount of subsidy allocated between the two types of properties “so that suburban properties would not have to compete head-to-head with urban properties.” KHADDURI, supra note 4, at 17.


deems necessary to its role in federal housing policy, two of which are directly related to the question at hand: “Meet[ing] the Need for Quality Affordable Rental Homes” and “Utiliz[ing] Housing as a Platform for Improving Quality of Life.” \[17\] These two goals are in tension to some extent. The first is about “need” and thus concerns itself with the quantity of units and the size of the population served by them. \[18\] The second is focused on the quality of the housing, specifically its role as a “platform” from which a tenant may access local benefits and amenities. \[19\] Housing as a platform seeks to use policy in order to improve outcomes in education, health, “economic security and self-sufficiency,” and public safety. \[20\]

Given scarce resources, we can imagine a policymaker struggling to resolve the inherent tension between quantity and quality. We can imagine two extremes: on the one hand, the policymaker might choose to focus entirely on quantity. This policymaker would therefore seek to determine the cheapest way to build enough housing for everyone who needs it. \[21\] Only after fully satisfying the quantity criterion would that policymaker think about quality. On the other hand, another policymaker might focus entirely on quality, providing a subsidy to a smaller number of households, but at a depth-of-subsidy sufficient to put those people at some determined level of welfare. \[22\] In theory, there exists some “social welfare function” that we can maximize by choosing a point on the spectrum between extremes. \[23\] In actuality, policymakers, who necessarily take into account criteria that have been delegated to them under the law, must choose a point on this particular spectrum.


18. See id. at 21–22.

19. See id. at 25 (“We know that housing can be a platform for driving other outcomes—that housing is not just a typical market good, but a place to anchor services and where different policies central to opportunity can be overlaid.”).

20. Id. Another sub-goal is “housing stability” for vulnerable populations, which is not especially important for purposes of this Note. Id.

21. In this form, the policymaker is essentially minimizing the rate of homelessness.

22. This is conceptually equivalent to minimizing a poverty gap measure. See generally Amartya Sen, Poverty: An Ordinal Approach to Measurement, 44 ECONOMETRICA 219, 220 (1976).

23. However, even if we could calculate all the inputs of the function, “[i]t is not a ‘scientific’ task of the economist to ‘deduce’ [the function, which] can have as many forms as there are possible ethical views.” Samuelson, supra note 13, at 387.
Some housing programs are better situated to address quantity than quality. A voucher program, for example, provides policymakers with a great deal of control over quantity but very little over locational quality. Housing vouchers, one of the largest subsidy programs, provide tenants with vouchers that the tenants may use to pay rent.\(^\text{24}\) Since the program works by merely providing households with resources that tenants use to find homes in existing housing stock, the quantity can be increased almost instantaneously by issuing vouchers to households on the voluminous waiting lists.\(^\text{25}\) By contrast, housing vouchers do little to address quality. In fact, tenants participating in the voucher program often stay in the types of low-opportunity neighborhoods in which they already lived.\(^\text{26}\) Some of this may be due to tenants’ choice: they wish to live in neighborhoods where they feel comfortable, close to the social networks they rely on. A more troubling explanation, however, is that tenants have a hard time finding housing in high-opportunity neighborhoods because even with the subsidy, rents are too high.\(^\text{27}\) And worse still, many tenants find that they face discrimination from landlords when they try to use their vouchers in high-opportunity neighborhoods.\(^\text{28}\)

All things considered, the housing voucher program seems to be an especially poor tool for prioritizing quality over quantity. Prioritizing quality would require cutting the number of vouchers while increasing their value, and then hoping that tenants use their additional income to move to high-opportunity neighborhoods. Insofar as households stay in the same neighborhoods, such a decision would essen-


\(^{25}\) In some places, including New York City, waiting lists are so long that the agencies are no longer accepting new names on the list. See Section 8 Assistance: Frequently Asked Questions, N.Y.C. HOUSING AUTH., http://www.nyc.gov/html/nycha/html/section8/lh_app_faqs.shtml (last visited Apr. 3, 2015).

\(^{26}\) See Kirk McClure, The Prospects for Guiding Housing Choice Voucher Households to High-Opportunity Neighborhoods, 12 CITYSCAPE 101, 101–02 (2010) (“In general, although the recipients of vouchers use them to reduce the burden of housing costs, they have not used the vouchers to move to demonstrably better neighborhoods in proportion to the availability of affordable units and are, in fact, confronting increasing difficulties in gaining access to good neighborhoods.”); Kirk McClure, Deconcentrating Poverty with Housing Programs, 74 J. AM. PLAN. ASS’N 90, 91 (2008).

\(^{27}\) See David P. Varady & Carole C. Walker, Housing Vouchers and Residential Mobility, 18 J. PLAN. LITERATURE 17, 21 (2003).

tially just be a shift of resources from one set of low-income households to another, with no other policy benefit. 29

Similarly, the LIHTC program, which is more expensive than the housing vouchers program, seems like a poor policy tool for prioritizing quantity over quality. 30 Where quantity is most important, a policymaker presumably would prefer to expand the voucher program and contract the LIHTC program, since this would result in a greater number of subsidized units. The LIHTC program, then, “is most valuable when it does things that choice-based housing vouchers cannot do or do as well.” 31 In addition, while the voucher program gives policymakers no control over quality and location, states can exert control over where LIHTC affordable housing is built through the use of their QAPs. 32

States’ ability to control the location of affordable housing through QAPs makes the LIHTC a good policy tool for encouraging development in low-opportunity neighborhoods to provide much-needed investment, despite the apparent suitability of the LIHTC program to prioritize high-opportunity neighborhoods. 33 However, this argument focuses on the external effects of affordable housing on neighborhoods, rather than on neighborhoods’ effects on tenants, and so it looks outside the scope of this Note. However, it is worth observing that there is little evidence that affordable housing has been able to put neighborhoods on such an upward trajectory. 34 Beyond this investment effect, another potential benefit of LIHTC developments in low-opportunity neighborhoods relates to market rents. Economic theory tells us that an increase in the aggregate supply of affordable housing

29. Keep in mind that while a voucher can only be used to pay rent, the income it represents is still fungible. If a household was paying $600 for rent and receives a $400 voucher then, if they stay in the same unit, they have an additional $400 to spend on other goods. Even if we were to think this is a good outcome, it seems a roundabout way to provide a cash subsidy.

30. See Khadduri, supra note 4, at 2; Lan Deng, The Cost-Effectiveness of the Low-Income Housing Tax Credit Relative to Vouchers: Evidence from Six Metropolitan Areas, 16 HOUSING POL’Y DEBATE 469, 496–503 (2005).

31. Khadduri, supra note 4, at 2 (emphasis omitted).

32. See id. at 2–3, 6.

33. This is the logic behind the qualified census tract bonus. See infra notes 130–31 and accompanying text.

will lower rents, and may do so even in market-rate units. This cannot be counted on, however, as the subsidized rent might actually be higher than the market rent in low-income neighborhoods.

In the end, the quantity-versus-quality question is defined by the fact that the government has scarce resources to spend on the LIHTC program, and they must be allocated between two, sometimes conflicting, goals. On the one hand, the LIHTC program could put a premium on quantity, providing an in-kind housing subsidy to as many low-income households as possible. On the other hand, the program could focus on quality, providing a larger subsidy to fewer households. This decision will be based on the costs and benefits of the two options. The policymaker, then, must rely on a mix of empirical evidence and quantitative and anecdotal knowledge of local conditions to decide how to make the quality-versus-quantity decision. Where the costs associated with high-opportunity neighborhoods are relatively high, the policymaker may decide that prioritizing quality is not worth the expense. On the other hand, if low-opportunity neighborhoods have especially poor schools, high crime, or other such negative characteristics, there may be a better argument for diverting at least some of the state’s resources, including resources like the LIHTC that the federal government has put in the states’ hands, toward building affordable units in high-opportunity neighborhoods.

B. The Importance of Neighborhood

In making decisions about subsidizing affordable housing, policymakers must pay attention to many things, from political questions about how government resources should be distributed, to legal questions about how laws might restrict certain choices, to economic and administrative questions related to operating a government pro-

35. This effect is highly dependent on the degree to which affordable housing does not “crowd out” private investment in housing, thereby increasing the aggregate supply. See Nathaniel Baum-Snow & Justin Marion, The Effects of Low Income Housing Tax Credit Developments on Neighborhoods, 93 J. PUB. ECON. 654, 664–65 (2009).

36. Gregory S. Burge, Do Tenants Capture the Benefits from the Low-Income Housing Tax Credit Program?, 39 REAL EST. ECON. 71, 87–89 (2011) (finding that predicted market rent barely exceeds statutory limits). This effect comes from the fact that the LIHTC program sets rents at the metropolitan level and not at a level associated with a smaller geography. See generally infra note 211 and accompanying text.


38. See supra notes 17–18 and accompanying text.
gram. That is to say, a policymaker must consider the social welfare function. There is evidence that the location of affordable housing has an effect on social welfare. Such evidence might lead a policymaker to design a QAP to prioritize quality over quantity.

The extent of this evidence is important since, as described in detail below, the LIHTC program places distortions on developers’ decisions, making it difficult for QAPs to incentivize development in high-opportunity neighborhoods. If there is no evidence that location matters, then this distortion is a completely reasonable cost-saving device, and any prioritization of quality over quantity should rely on something other than location. If, however, the location decision has an effect on policy outcomes, then there is little reason to take the location decision out of the hands of the states.

In starting this analysis, it is important to note that the effect of neighborhood on outcomes is complicated and very hard to prove precisely. In their survey of the empirical data on neighborhood effects, Ingrid Gould Ellen and Margery Austin Turner ask whether neighborhood “matters.” What they discover is that the research “generally confirms that neighborhood environment has an influence on important outcomes for children and adults. But efforts to identify which neighborhood characteristics matter most, and to quantify their impor-

39. This social welfare function, in theory, takes into account the effect of public expenditure on the aggregate utility functions of society. See Samuelson, supra note 13, at 388–89. Samuelson argues that this function exists and cannot be optimized merely through market activity. Id. Further, as discussed supra note 13, he is careful to note that “it is not a ‘scientific’ task of the economist to ‘deduce’ the form of this function; this can have as many forms as there are possible ethical views.” Id. at 387.

40. See infra Part II.

41. One might argue that Congress, in authorizing the LIHTC program, intended to take certain policy decisions away from the states based on a belief that state governments may not be good at making policy. The federal government might therefore want to put limits on the size of the credit so that the subsidy is not wasted on neighborhoods with uncertain (and potentially incalculable) benefits. I reject this argument, however, on the grounds that the LIHTC is meant to be a flexible instrument to further state housing policy decisions. See Mark H. Shelburne, An Analysis of Qualified Allocation Plan Selection Criteria, 1 J. TAX CREDIT HOUSING 1, 1 (2008) ("Congress recognized that it was creating a very adaptable instrument for use in thousands of different housing markets. What is common sense for a production and rehabilitation subsidy in central South Dakota will be quite different in South Central Los Angeles. Congress and the IRS acknowledged that states are far better equipped to apply the flexibility of LIHTCs to the many different regional conditions."); see also I.R.C. § 42(m)(1)(B)(i) (requiring that states select “housing priorities . . . which are appropriate to local conditions”); id. § 42(m)(1)(C)(i) (listing “project location” as the first in a list of mandatory criteria a state must consider).

2015]  LOW-INCOME HOUSING TAX CREDIT PROGRAM  345
tance for families and children, have been inconclusive overall.”43
This basic difficulty is repeated throughout the literature in some form
or another.44

Many dynamics are at play. A neighborhood might have one ef-
fect on existing residents and a different effect on new residents. For
example, neighborhoods with dense social networks are likely benefi-
cial for existing residents but not so for new residents who, for the
same reason, might become isolated in that neighborhood.45 On the
other hand, looking at the effect of public schools, we would expect to
see similar effects (positive or negative) both on households already
within the neighborhood and on households that move to the neigh-
borhood from somewhere else.46

In addition, the characteristics of specific households may inter-
act with neighborhood characteristics in different ways. This feature
of the problem, called “endogeneity,” refers to the fact that a house-
hold’s decision about where to live is itself subject to certain “personal
or family influences” that might either amplify or conceal neighbor-
hood differences.47 Ellen and Turner present three possible hypotheses
about the structure of the endogeneity. First, they hypothesize that
“neighborhood environment may be more influential for families who
lack social and economic resources than for those who can replace

43.  Id. at 833.

44.  See, e.g., Rowland Atkinson & Keith Kintrea, Disentangling Area Effects: Eva-
dence from Deprived and Non-Deprived Neighbourhoods, 38 URB. STUD. 2277, 2278
(2001) (“Area effects are difficult to identify as they are located among a number of
social processes which are themselves circuitous and interrelated.”); Robert D. Dietz,
The Estimation of Neighborhood Effects in the Social Sciences: An Interdisciplinary
Approach, 31 SOC. SCI. RES. 539, 549 (2002) (“There are a number of serious empiri-
cal complications that researchers of neighborhood effects must confront.”); Jeffrey R.
Kling et al., Experimental Analysis of Neighborhood Effects, 75 ECONOMETRICA 83,
has also proven difficult . . . .”); Xavier de Souza Briggs, Moving Up Versus Moving
Out: Neighborhood Effects in Housing Mobility Programs, 8 HOUSING POL’Y DEBATE
195, 218 (1997) (citing “four persistent challenges” to studies of neighborhood ef-
fects: choosing the relevant definition of “neighborhood,” selection effects, family-
based endogeneity, and a lack of data on social interaction).

45.  However, “[a]lthough relocation may lead to an initial disruption of social net-
works, . . . [this isolation] may diminish as networks are established in new neighbor-
hoods.” MTO, supra note 16, at 140.

46.  See Ellen & Turner, supra note 42, at 837. The move from a very-high-poverty
neighborhood to a very-low-poverty neighborhood has been associated with a dou-
bling of the proportion of students who pass the state reading test and an increase in
math and reading scores by approximately a quarter of a standard deviation. Jens
Ludwig et al., Urban Poverty and Educational Outcomes, in BROOKINGS-WHARTON
PAPERS ON URBAN AFFAIRS: 2001, at 147, 183–84 (William G. Gale & Janet Rothen-

47.  See Ellen & Turner, supra note 42, at 856–58.
what is missing in their immediate surroundings.”

Second, they expect that certain characteristics such as race and gender might interact with neighborhood characteristics. Finally, they believe that “neighborhood conditions may influence children not only directly, but also indirectly through effects on their parents.”

In an attempt to address the endogeneity issues, HUD conducted the Moving to Opportunity (MTO) study, a long-term examination of the effect of neighborhood on household outcomes that was “the most ambitious randomized social experiment ever conducted by HUD.” The study, authorized by Congress in 1992, aimed to address many of the econometric issues in this field by using a randomized control trial, “akin to drug trials in medicine,” to explore the effects of neighborhood. It took 4604 low-income families in five cities and randomly assigned them to three groups: (1) the control group, (2) the Section 8–only group, and (3) the experimental group. The control group received no special subsidy through the program, but continued to be eligible for the same project-based assistance as before. The Section 8–only group received regular housing vouchers that could be used anywhere. The experimental group received housing vouchers that could only be used in census tracts with poverty rates below ten percent. The study ran from 1994 to 2009 and created a large and detailed dataset on “physical health, mental health, economic self-sufficiency, risky and criminal behavior, and educational outcomes.”

The results of the MTO study are subject to some caveats, however. For one, 97.8% of the households in the sample were headed by women, and only 37.5% of the heads of household had a high school
diploma or better. 59 Almost 72% were unemployed. 60 The average household income was less than $13,000 and the average household size was 3.7. 61 In short, these were very poor and very disadvantaged households. Given that neighborhood effects are likely to be different for different households, this might skew the results. 62 Thus, while the study aimed to address endogeneity within the population that it studied, the sample itself created an endogeneity problem, making it hard to apply the findings of the MTO study to other populations.

Despite this problem, the MTO does provide some of the best data available for investigating the types of outcomes that a policymaker might be interested in: education, health, “economic security and self-sufficiency,” and public safety. 63 Location was found to have effects on all of these outcomes but, as predicted above and discussed in detail below, the findings were mixed and seemingly impacted by the problems with the study’s design.

1. Education

Probably the most obvious and intuitive benefit of a good neighborhood is its effect on educational outcomes through access to improved public schools for children. 64 HUD notes that the “nation’s economic competitiveness depends on providing children and youth—particularly those growing up in poverty—with an education that will enable them to succeed in the global economy.” 65 If the location decision was important for HUD policy goals then we would want to see a neighborhood effect on education.

Studies have consistently found that living in a better neighborhood has an effect on school readiness, in the form of standardized scores for adolescents and achievement. 66 The MTO study, however,

59. Id. at 8.
60. Id. at 9.
61. Id.
63. HUD refers to these outcomes in its Strategic Plan. See supra note 17 and accompanying text.
64. See, e.g., Ludwig et al., supra note 46, at 183–84.
65. STRATEGIC PLAN, supra note 17, at 26.
66. See Tama Leventhal & Jeanne Brooks-Gunn, The Neighborhoods They Live in: The Effects of Neighborhood Residence on Child and Adolescent Outcomes, 126 PSYCHOL. BULL. 309, 315–18 (2000) (summarizing previous research); see also Thomas P. Vartanian & Philip M. Gleason, Do Neighborhood Conditions Affect High School Dropout and College Graduation Rates?, 28 J. SOCIO-ECON. 21, 29–31 (1999) (finding that dropout rates for low-income African Americans are lower in neighborhoods where “mean income is high, the poverty rate is low, a high proportion of households are headed by two parents, and there are a relatively large number of adults working in professional or managerial occupations”).
found that “[t]he experiences of MTO children are not unlike the experiences of low-income children in urban communities nationwide.”67 While troubling, there are reasons to believe that the specifics of the MTO’s program design resulted in the study underestimating the effect of education. For one, the study’s official report argues that the small effect may be due to the fact that, contemoraraneously with the study, all five of the MTO cities “initiated high-profile efforts aimed at improving the educational outcomes for students in city schools.”68 Alternatively, the report notes that residential mobility itself may have a negative effect on educational outcomes because it can be disruptive to the student.69 Finally, one report notes that most of the MTO families only lived in high-opportunity neighborhoods for one or two years, a period which is likely too short to see significant educational effects.70

2. Health

HUD recognizes that “healthy housing is inextricably tied to individual health.”71 In pursuing its goal of increasing health outcomes, HUD considers access to health services and resources.72 Households in high-opportunity neighborhoods generally have increased access to health care facilities and medical services compared to households in low-opportunity neighborhoods.73 A variety of studies have shown that neighborhoods affect mental and physical health outcomes,74 and this is confirmed by the MTO study.

The data from the MTO experiment finds significant mental-health benefits for both parents and children, including fewer depres-

67. MTO, supra note 16, at 214.
68. Id.
70. See MARGERY AUSTIN TURNER ET AL., URBAN INST., BENEFITS OF LIVING IN HIGH-OPPORTUNITY NEIGHBORHOODS: INSIGHTS FROM THE MOVING TO OPPORTUNITY DEMONSTRATION 2–3 (2012).
71. STRATEGIC PLAN, supra note 17, at 26.
72. See id.
74. See, e.g., Dolores Acevedo-Garcia et al., Does Housing Mobility Policy Improve Health?, 15 HOUSING POL’Y DEBATE 49 (2004) (discussing studies regarding the effect of housing on health outcomes).
sion and anxiety symptoms.\textsuperscript{75} One study within the MTO program found that among boys ages 8–18, dependency problems fell by 53% and anxiety/depression problems fell by 42%.\textsuperscript{76} Another study found that the share of MTO households that moved and that reported being “calm and peaceful” at least most of the time rose from 47% to 60%.\textsuperscript{77} The MTO experiment found less of an effect on physical health, however.\textsuperscript{78} This is not wholly surprising since while access to health care is a strong determinant of health outcomes and neighborhoods differ in their access to health care,\textsuperscript{79} in the MTO study, there was no significant effect on health care access for the households that moved.\textsuperscript{80}

3. Economic Self-Sufficiency

Another important outcome for the purpose of affordable-housing policy is income and economic self-sufficiency.\textsuperscript{81} While the HUD Strategic Goals are narrowly focused on providing job opportunities and training,\textsuperscript{82} we can look more broadly at a larger class of labor outcomes, such as employment and income. When evaluating the prioritization of quality over quantity, the “people who are in a position to markedly increase their self-sufficiency” are especially important to consider.\textsuperscript{83} We want to make a policy decision that provides these people with access to job opportunities and training.

Research exploring neighborhood effects on adult employment outcomes is mixed. While some studies have found higher employment rates for households that move to higher-opportunity neighborhoods, others, including the MTO, have found no significant result.\textsuperscript{84}

\begin{itemize}
  \item \textsuperscript{75} Tama Leventhal & Jeanne Brooks-Gunn, \textit{Moving to Opportunity: An Experimental Study of Neighborhood Effects on Mental Health}, 93 \textit{Am. J. Pub. Health} 1576, 1580 (2003); see also Ellen et al., supra note 73, at 397–400.
  \item \textsuperscript{76} See Leventhal & Brooks-Gunn, supra note 75, at 1579–80, 1581 tbl.4.
  \item \textsuperscript{78} See MTO, supra note 16, at 102–03. This is subject to many of the same arguments noted above. See supra text accompanying notes 59–62.
  \item \textsuperscript{79} See Ellen et al., supra note 73, at 393.
  \item \textsuperscript{80} See MTO, supra note 16, at 101.
  \item \textsuperscript{81} See \textit{Strategic Plan}, supra note 17, at 27.
  \item \textsuperscript{82} See \textit{id.} (“For those individuals who are able, increasing self-sufficiency requires access to life-skills training, wealth-creation and asset-building opportunities, job training, and career services.”).
  \item \textsuperscript{83} \textit{Id.} This population is contrasted with “people who will need long-term support (for example, the frail elderly and people with severe disabilities).” \textit{Id.}
  \item \textsuperscript{84} MTO, supra note 16, at 142 (reviewing several other studies).
\end{itemize}
This result can be largely attributed to the fact that the MTO families had such low levels of economic and social resources that they were not able to take advantage of employment opportunities.\textsuperscript{85} Other studies provide convincing evidence that long-term labor market effects are stronger when one looks at adult outcomes of low-income children who move to high-opportunity neighborhoods.\textsuperscript{86} Furthermore, there is evidence of such effects on a multi-generational scale; location affects outcomes not for the people moving but for their children and their children’s children.\textsuperscript{87} In short, it seems unlikely that even a long-term study like the MTO would capture the economic outcomes of households that move.

4. Public Safety

A predicate of all of the aforementioned outcomes is always going to be physical safety.\textsuperscript{88} And it is here that the effect of location is the most clear. Health, education, and economic outcomes function through complex mechanisms and are likely affected by family-level variation more than neighborhood-level variation. Intuitively, if you take a low-income household and put it in a high-income neighborhood, the household’s income has not changed, and it is only through improved access to employment and educational opportunities that the household’s income might increase in the long term. In contrast, if you move a household from a high-crime neighborhood to a low-crime neighborhood, its exposure to crime decreases instantaneously.\textsuperscript{89}

\textsuperscript{85.} Id.; see also supra text accompanying notes 59–62.


\textsuperscript{88.} See STRATEGIC PLAN, supra note 17, at 28 (“Enhancing physical safety and reducing crime are essential to improving health, education, and economic outcomes.”).

\textsuperscript{89.} This reasoning and the mental-health effects of crime exposure, specifically those associated with violent crime, may explain why mental-health outcomes are among the strongest neighborhood effects we see in the research. See supra text accompanying notes 74–77. See generally Bradley D. Stein et al., A Mental Health Intervention for Schoolchildren Exposed to Violence: A Randomized Controlled Trial, 290 J. AM. MED. ASS’N 603, 603–04 (2003) (examining the relationship between violence and mental health). There is also evidence that violence has effects on educational outcomes. See Patrick Sharkey et al., High Stakes in the Classroom, High Stakes on the Street: The Effects of Community Violence on Students’ Standardized Test Performance, 1 SOC. SCI. 199, 214–15 (2014) (examining the relationship between violence and educational outcomes).
The relationship between crime and low-income neighborhoods is strong. While it is not necessarily proven or true that there exists a causal relationship between poverty and crime,\textsuperscript{90} the two are certainly highly correlated: low-income neighborhoods are very often high-crime neighborhoods.\textsuperscript{91}

For the reasons discussed above, the empirical evidence is never completely clear when it comes to the effects of neighborhood on household outcomes. However, there is broad evidence—from the MTO study and other studies conducted over the years—indicating that the location decision is critical to all of the outcomes that HUD has associated with quality under its goal of “Utiliz[ing] Housing as a Platform for Improving Quality of Life.”\textsuperscript{92} Insofar as this implies that the location decision is important for the LIHTC program, the next step is to look at how the program structures incentives with respect to the location decision.

II. INCENTIVES IN THE LOW-INCOME HOUSING TAX CREDIT PROGRAM

Historically, LIHTC properties have been built in low-income neighborhoods.\textsuperscript{93} Considering that the program is decentralized and the specific location decisions are made by developers working under


\textsuperscript{91} See John R. Hipp & Daniel K. Yates, \textit{Ghettos, Thresholds, and Crime: Does Concentrated Poverty Really Have an Accelerating Increasing Effect on Crime?}, 49 CRIMINOLOGY 955, 955–56 (2011) (“[O]ne bedrock conclusion is that the presence of more poverty is associated with more crime.”).

\textsuperscript{92} See STRATEGIC PLAN, supra note 17, at 24–28.

the policy decisions of state QAPs, it is unfortunate how little research there has been on developers’ incentive structure. Specifically, no author has looked at the role of the LIHTC statute in affecting that incentive structure.

This Part is devoted to understanding that incentive structure and the effect that this structure has on the location decision made by developers. To complete this analysis, I start by analyzing the statute itself and discussing the background on how the program works. I then discuss the business model used by affordable housing developers and how it differs from that of a market-rate developer. I then analyze a number of characteristics of the LIHTC program that, given this business model, make it difficult for affordable housing developers to build in high-opportunity neighborhoods. I conclude that the LIHTC statutory formula for calculating the subsidy amount makes building affordable housing in high-opportunity neighborhoods an exceedingly difficult task, stymieing the states’ ability to use their QAPs to incentivize such development.

A. The Low-Income Housing Tax Credit Program

Since it was created by Congress in 1986, the LIHTC program has been the vehicle for the creation of more than 2.6 million affordable units. The program provides a subsidy to developers of affordable units in the form of tax credits that can be applied dollar-for-dollar against income tax liability. The developer generally sells these credits, which have a certain market value, to a tax credit investor—usually a bank or other financial institution with tax liability—and uses the cash it receives in exchange as equity to fund the development project. In economic terms, the transaction is equivalent to the government buying equity in the project in exchange for a rental subsidy for low-income tenants. The remainder of the project will be funded through a mixture of equity and debt from other sources.

94. Professor Lang views the developer’s incentives on the rent side and suggests that a spread between market rents and affordable rents drives developers to build in low-rent neighborhoods. See Bree J. Lang, Location Incentives in the Low-Income Housing Tax Credit: Are Qualified Census Tracts Necessary?, 21 J. HOUSING ECON. 142, 144 (2012). As will be discussed later, this theory misses important aspects of an affordable housing developer’s business plan, which relies less on rents than on the development fees that come out on the front end. See infra Part II.B.


96. See I.R.C. § 38(b) (2013) (authorizing thirty-six business credits, including the low-income housing credit, under section 38(b)(5)).

97. For reasons discussed below, this simplified form differs from reality in important ways, specifically insofar as it affects the location decision. However, it is a
The developer agrees to maintain rents at a certain level for thirty years and, in return, receives an annual credit for the first ten years after the property is placed in service. While the credit offsets income tax liability on a dollar-for-dollar basis, investors buy the credit for the discounted present value of the ten-year stream of credits; the discount includes the risk that the developer will not compliantly operate the property. Over time, as investors have become more comfortable with the program and syndicators have moved in to market diversified portfolios, the discount has been reduced.

Since the tax credit may only be used by the owners of the property, the developer and investors must form a business entity that permits tax write-offs to pass through to the tax credit investors. Investors and developers usually form a limited partnership for this useful way to concretize what is otherwise a complicated and technical subsidy program.

98. The agreement is made up of a fifteen-year “compliance period,” see I.R.C. § 42(i)(1), and a further fifteen-year “extended use period,” see id. § 42(h)(6)(D). The extended use period is mandatory. See id. § 42(h)(6)(A).

99. See id. § 42(f)(1).

100. If the developer fails to comply with the affordable restrictions or is otherwise out of compliance, the investor will no longer get the credit and credits already received may be recaptured. See id. § 42(j).


102. Frank Narron, The Evolution of the Low-Income Housing Tax Credit and the Boom in Affordable Housing, 21 REAL EST. FIN. 18, 19 (2004) (“[T]he market has matured to a point that developers are able to secure 80 to 90 cents of capital for every $1 of tax credit that they sell to investors. . . . By contrast, the tax credits were selling for only 35 to 40 cents on the dollar when the program was launched.”). In addition to the investor comfort with the program, the discount has fallen as investors, who are subject to the Community Reinvestment Act of 1977, Pub. L. No. 95-128, 91 Stat. 1111, 1147–48, are able to earn “CRA Credits,” which are used to determine whether they are in compliance with the Act. See Fred Copeman et al., The CRA Effect, AFFORDABLE HOUSING FIN. (July 2, 2013), http://www.housingfinance.com/lihtc/the-cra-effect.aspx (“Between 2005 and 2007, when LIHTC equity volume peaked, housing credits were valued more or less at par ($1 per $1 of tax credit) in many locations.”).

purpose. In such a partnership, the developer is the general partner and makes all the day-to-day decisions regarding the project while the investors enjoy limited liability. These partnerships are usually structured so that the investors get 99.9% of the operating profits. The developer’s profit, as discussed in more detail below, is mostly derived from up-front development fees included in the project’s budget.

It is through their QAPs that states retain significant discretion in how they run their LIHTC programs. Because they receive more applications for credits than they have allocations available, states are in a position to require developers to compete for credits by building projects with certain characteristics. States generally assign points to projects that meet certain standards, including construction costs, layering of subsidies, and the decision to serve households earning below the LIHTC program’s subsidy level. These state policies are reflected in each state’s QAP.

The competitive process thus provides states with an important tool to incentivize certain behavior, including, importantly for this Note, the location decision. This decision, however, remains subject to

104. *Id. But see id.* at 54 & n.14 (arguing that a limited liability corporation would now be more efficient than a limited partnership).
105. *Id.* at 54.
106. *Id.* Even though investors receive 99.9% of the operating profit, this is generally 99.9% of nothing. *See* MARK P. KEIGHTLEY, *CONG. RESEARCH SERV., RS22389, AN INTRODUCTION TO THE LOW-INCOME HOUSING TAX CREDIT* 4 (2013) (“Typically, investors do not expect the project to produce income. Instead, investors look to the credits, which will be used to offset their income tax liabilities, as their return on investment.”).
108. Other potential sources of developer profit that we ignore for the purposes of this Note are profits that a developer might derive by providing additional services as a general contractor or property manager.
111. For example, Delaware provides points to developers that use historic tax credits, contributions from local governments, and other additional sources of subsidy. *See* DEL. STATE HOUS. AUTH., *QUALIFIED ALLOCATION PLAN* 43–44 (2014).
112. *See, e.g.*, *id.* at 39 (awarding points for the targeting of tax credit units at different income levels).
the economic realities of the project.\textsuperscript{114} If the economics of building a LIHTC development in a low-income neighborhood are significantly better than building in a high-income neighborhood, the policy decisions made through the QAP are going to have limited effectiveness. One can imagine a situation in which building in a high-opportunity neighborhood would not be economically viable in spite of the LIHTC subsidy; in such a situation, a QAP providing incentives to build in such neighborhoods would have no effect since there would be no market to take advantage of those incentives.\textsuperscript{115} For that reason, it is not enough to examine a state’s QAP. We must look also at the economic incentives flowing from the LIHTC: the amount of the LIHTC credit and the contours of how that amount is calculated.

The amount of the credit is determined through a formula whereby a portion of the developer’s tax basis in the development is used to derive an annual credit allocation.\textsuperscript{116} The LIHTC program is codified under I.R.C. section 42, which provides, among other things, the formula for calculating the tax credit.\textsuperscript{117} The formula derived from section 42 is relatively simple: the annual credit is equal to the eligible basis times the applicable fraction\textsuperscript{118} times the applicable percentage.\textsuperscript{119}

1. Applicable Fraction and Applicable Percentage

The applicable fraction is used to provide a partial subsidy in the case of mixed-income buildings, but in practice, the applicable fraction is usually close to 100%.\textsuperscript{120} The applicable percentage is either

\textsuperscript{114} See generally infra Part II.B.
\textsuperscript{115} In the extreme case, a mandatory requirement to build in such high-opportunity neighborhoods would just collapse the market since there would be no economically viable projects.
\textsuperscript{116} See infra Part II.A.1 (providing an overview of the formula used to calculate developers’ annual credit allocations).
\textsuperscript{117} See I.R.C. § 42(a) (2013); see also id. § 38(a) (authorizing a credit against tax imposed).
\textsuperscript{118} The applicable fraction is a share of the building made up of low-income units measured by the lesser of the floor area and the number of units. Id. § 42(c)(1)(B).
\textsuperscript{119} The statute directs the Secretary to establish “percentages which will yield over a 10-year period amounts of credit . . . equal to . . . 70 percent of the qualified basis of a new building . . . [and] 30 percent of the qualified basis” for a renovated building. Id. § 42(b)(1)(B).
\textsuperscript{120} Using the LIHTC Database, which has data on projects developed between 1986 and 2011, I calculated that 86% of new construction had an applicable fraction of 100% or had only one market rate unit. LIHTC Database, U.S. Dept. of Housing & Urban Dev., http://lihtc.huduser.org/ (select “Replace Missing Total Units with Low-Income Units,” “Replace Missing Total Units with Low-Income Units,” “All States,” and Construction Type=“New Construction”; click “Retrieve Project Data”) (last vis-
4% or 9%, depending on the type of tax credit to which the project is entitled. Only new buildings are eligible for the 9% credit. Other than that, the key difference between the two types of credit is that the 9% credit is competitive while the 4% credit is an as-of-right credit, which the developer is entitled to by virtue of applying for and receiving tax-exempt bonds.

Since most new construction ends up being funded through the 9% credit, this Note, unless otherwise indicated, assumes that a developer has a 9% applicable percentage and a 100% applicable fraction. Given that the applicable percentage and applicable fraction are constant by assumption, the most salient determinant of the LIHTC allocation turns out to be the eligible basis.

2. Eligible Basis

Section 42(d)(1) defines the eligible basis for the LIHTC credit as the developer’s adjusted basis in the new building. The eligible basis represents the cost of developing the property, including capitalized expenses associated with the construction.

121. The 4% and 9% numbers are set so that the net present value of the credit is equal to 30 and 70% of the qualified basis. See supra note 119. Despite being called 9% and 4% credits, the actual applicable percentage will change depending on market interest rates. In September 2014, the rates for the 4% and 9% credits were set at 3.24% and 7.56%, respectively. See Rev. Rul. 2014-22, 2014-37 I.R.B. 534.

122. See I.R.C. § 42(b)(1)(B).

123. See Novogradac Affordable Hous. Res. Ctr., Tax-Exempt Housing Bond Basics 1, 3, http://www.ipedinc.net/powerpoints/tax-exempt_housing_bond_basics.pdf (last visited July 31, 2015). By applying and receiving an allocation for “private activity ‘volume cap’ tax-exempt bonds,” developers get access to low-cost debt and the 4% tax credit. See id. at 3. The discussion throughout this Note is focused primarily on the 9% credit and its incentives. Since they are not allocated according to the QAP, further research would be necessary to fully analyze the 4% credit along the lines pursued in this Note.

124. According to my calculations, using the LIHTC Database, I find that between 1986 and 2011, 75.4% of all new construction received the 9% credit. LIHTC Database Access, U.S. DEP’T HOUSING & URB. DEV., http://lihtc.huduser.org/ (select “All States,” Construction Type=“New Construction,” Financial Characteristics Codes=“70%/30% Credit”; click “Retrieve Project Data”) (last visited Sept. 12, 2014). The “70%/30%” variable reflects whether the tax credit was 9% or 4%, respectively. See supra note 121.

125. See supra notes 120, 124.

126. I.R.C. § 42(d)(1).

127. The eligible basis for the project does not include land costs. See id. § 42(d)(4)(A) (“[T]he adjusted basis of any building shall be determined without regard to the adjusted basis of any property which is not residential rental property.”) (emphasis added); id. § 168(e)(2)(A)(i) (defining “residential rental property” as “any building or structure if 80 percent or more of the gross rental income from such
sis includes all hard costs and most depreciable soft costs but not the costs of acquiring the underlying land. The LIHTC statute’s failure to include land as an eligible cost for purposes of calculating the tax credit is one of the most important concepts in this Note.

The definition of “eligible basis” is paramount since it describes which sorts of developers’ costs will be subsidized and which will not. Despite its importance, however, the line between eligible and non-eligible costs is often a purely formal distinction bearing little relation to the policy objectives. This formalism quickly leads to irrational outcomes. For example, if a developer decides to spend $100,000 to build solar panels on the roof, the entire amount it pays for the panels is included in the eligible basis. On the other hand, if the developer spends an additional $50,000 to purchase land with better light and is able to produce the same amount of power with a $25,000 solar panel, we would all agree that the latter is a better policy outcome. However, the LIHTC program would provide the former with a larger eligible basis.

The statute does provide two limited ways for developers to obtain additional credits in their allocations through their land choices. These options do not, however, allow the developer to include land costs within the eligible basis but, in a somewhat ham-fisted fashion, just increase the eligible basis by a fixed amount to roughly make up for the increased land costs. For example, Congress provided for a 30% bonus on eligible basis for “high cost areas,” including “qualified census tracts” and “difficult development areas.” Qualified census tracts are census tracts where income is low or poverty is high. A difficult development area is “any area designated by the Secretary of building or structure for the taxable year is rental income from dwelling units” (emphasis added)).

128. The construction industry divides the capital costs of developing a property into hard costs (the cost of materials and labor required to build the physical structure), soft costs (development costs such as design fees, legal fees, and insurance), and site costs (the cost of the land itself and associated costs). See Am. Inst. of Architects, Emerging Professional’s Companion 162–63 (2013), http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aiaa097759.pdf.

129. See infra Part II.B.


131. A qualified census tract is one in which the Secretary determines that either 50% or more of households have income which is less than 60% of the area’s median income or the poverty rate of at least 25%. See id. § 42(d)(5)(ii)(I). Some have criticized the qualified census tract as violating the “compelling goals of poverty deconcentration and racial integration mandated by the Fair Housing Act.” Poverty & Race Research Action Council, Civil Rights Mandates in the Low Income Housing Tax Credit (LIHTC) Program 1 (2004), http://www.prrac.org/pdf/crm Mandates.pdf.
Housing and Urban Development as an area which has high construction, land, and utility costs relative to area median gross income." 132 This definition seems to provide considerable discretion to HUD but is limited in scope. 133 In practice, the Secretary has used a formula to designate areas where the fair market rent greatly exceeds the maximum rent that a LIHTC-eligible tenant would pay. 134 I discuss later some ways which these basis boosts can be used to implement some of the policies discussed in this Note. 135

B. The Developer’s Location Choice

The amount of eligible basis has a huge role to play in determining the amount of the subsidy. It should therefore be unsurprising that the formal distinction between eligible basis and non-eligible basis has powerful effects in the developer’s decision-making. When thinking about how these effects might influence the location decision made by affordable housing developers, it is crucial to understand the business plan under which these developers generally operate. By looking at this plan, especially in comparison to the model employed by a market-rate developer, we see how the two types of developers face different incentives when deciding where to build housing, resulting in a distortion that encourages affordable housing developers to site their projects in low-income neighborhoods.

In many ways, affordable housing developers are just like market-rate developers. Each developer starts with some idea for a project that will provide it with a sufficient rate of return to justify invest-

133. The discretion is limited by I.R.C. § 42(d)(5)(B)(iii)(II), however, which states that no more than 20% of the population living in metropolitan statistical areas can live in a difficult development area. A similar rule applies to nonmetropolitan areas. Id. A metropolitan statistical area is defined as having “at least one urbanized area of 50,000 or more population, plus adjacent territory that has a high degree of social and economic integration with the core as measured by commuting ties.” OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, OMB BULL. NO. 13-01, REVISED DELINEATIONS OF METROPOLITAN STATISTICAL AREAS, MICROPOLITAN STATISTICAL AREAS, AND COMBINED STATISTICAL AREAS, AND GUIDANCE ON USES OF THE DELINEATIONS OF THESE AREAS 2 (2013).
135. See infra Part III.B
ment. Over time, the developer will “pencil out” the project: that is, it will estimate the costs (including both construction and financing costs) and the projected revenues. If the return is comparable to or higher than alternative investment opportunities, in risk-adjusted net-present-value terms, then the developer will move forward. Throughout the process, the developer will seek ways to lower its costs and raise its revenues, maximizing its profits on the margin while also keeping an eye on the QAP requirements to ensure that the project is competitive for the tax credits under the QAP.

My basic model of the developer’s production function considers a developer as combining land \((L)\) with mobile capital \((M)\) in order to build housing, which it then rents to tenants in order to generate income. Under the assumptions of the model, mobile capital has the same costs everywhere, while land has different costs across space. Since the model assumes constant returns to scale, we can normalize it so that all the numbers are on a per-unit basis. As such, we should think about a change in \(L\) as being a change in cost per square foot rather than, say, indicating an increase in the number of square feet purchased. \(L\) is the outcome of the developer’s location decision.

136. Of course, many affordable housing developers are not-for-profits, and the federal government even requires that states set aside at least 10% of their credits for projects involving a not-for-profit organization. See I.R.C. § 42(h)(5). In the model of developer behavior presented in this Note, the key difference between the for-profit and not-for-profit developer is that the not-for-profit developer will not take as high a developer fee. See Megan J. Ballard, Profiting from Poverty: The Competition Between For-Profit and Nonprofit Developers for Low-Income Housing Tax Credits, 55 HASTINGS L.J. 211, 233 (2003). Because of possible grants and other subsidies, not-for-profit developers likely have alternative sources of financing. Additionally, there may be some added productive inefficiency that is ignored for the purposes of this Note. See Henry Hansmann, Economic Theories of Nonprofit Organizations, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 27, 38 (Walter W. Powell ed., 1st ed. 1987) (arguing that entrepreneurial nonprofits are “inherently subject to productive inefficiency (that is, failure to minimize costs) owing to the absence of ownership claims to residual earnings”).

137. See E-mail from Nathaniel S. Cushman, Assoc., Nixon Peabody, to author (Apr. 7, 2013) (on file with author).

138. Under the Epple-Gordon-Sieg model, the housing production function is given by \(Q(L,M)\) where \(L\) is land, \(M\) is “a composite of all mobile nonland factors,” and \(Q\) refers to “housing service units,” which are a “homogenous and divisible” measure of utility. Dennis Epple, Brett Gordon & Holger Sieg, A New Approach to Estimating the Production Function for Housing, 100 AM. ECON. REV. 905, 907 (2010).

139. See id. at 911.

140. Id. at 912.

141. The source of variation in land prices is largely based on proximity to amenities. Id. at 908 n.11. There is an extensive urban economics literature related to the spatial dimensions of housing prices. The Rosen-Roback model predicts that “high housing prices must reflect either high income or high amenities or both.” Edward L.
It is useful to compare this model to the quantity-versus-quality framework I have discussed throughout. Since the model is normalized on a per-unit basis, it holds quantity fixed. The choice between $L$ and $M$ can therefore be seen as a tradeoff between location-based quality and other quality characteristics. If I can show that the incentive structure makes developers choose to use relatively more $M$ and relatively less $L$, then I have shown that the incentive structure makes it difficult for states to incentivize the development of affordable housing in high-opportunity neighborhoods.

The salient feature of the LIHTC program—for purposes of this Note—is its treatment of land as a non-eligible cost. Because of the different ways land and non-land costs are treated by the LIHTC statutory formula, the optimal decision by an affordable housing developer will not be the same as the market-rate development. As I will argue, this optimal decision will be tilted in favor of constructing units in places where land is relatively cheaper. We must therefore examine exactly how the program distorts an affordable housing developer’s decisions. The distortion occurs as a result of several factors: (1) the depth of the subsidy, (2) the profit structure, and (3) the capital structure and the project’s riskiness.

1. **Depth of Subsidy**

   While a developer may use a tax credit directly to offset its tax liability, it usually sells the credit to an investor for an amount of cash that functions as the real subsidy from the point of view of the developer. The size of this subsidy is based on the factor of two amounts: the tax credit, which, based on our assumptions, is equal to 70% of the eligible basis, and the discounted value of the tax credit, which we will assume is 90%. Simple math tells us that the depth of subsidy is therefore equal to 63% of the eligible basis.

   We can now compare two projects with the same overall cost—one in a high-opportunity neighborhood, the other in a low-opportunity neighborhood—to see how changing the mix between eligible and non-eligible costs impacts the size of the subsidy. If, on the one hand, the developer opts for the high-opportunity neighborhood, the

---


142. See supra text accompanying note 140.  
143. See supra text accompanying notes 129–30.  
144. See supra Part II.A.  
145. See About the LIHTC, supra note 101.  
146. See supra note 119.  
147. See supra note 102.
cost of land acquisition will be a higher share of total costs. For example, if we suppose that the total project cost is $2,000,000, and land—which is non-eligible basis—makes up 50% of the total costs, then the eligible basis is $1,000,000 and the depth of the subsidy is $630,000. If, on the other hand, the developer chooses to build in a low-opportunity neighborhood where land is only 25% of the total costs, the depth of the subsidy is $945,000.

While the federal government makes a distinction between eligible and non-eligible costs in the LIHTC program, there is no a priori reason for a developer to prefer one over the other. From the developer’s point of view, all that matters is the total subsidy amount, since this will determine how much debt the project will have to take on. In the example given above, due to the program’s distortions, development in a low-opportunity neighborhood is clearly the more attractive investment for the developer.

2. Profit Structure

Market-rate and affordable housing developers have different profit structures. While both desire to maximize their profits, their profit functions are otherwise quite different: a market-rate developer will expect to get its profits either through rents or through the sale of an income-producing property; an LIHTC developer’s profit comes in the form of an up-front development fee paid out of the project’s costs. These different profit functions yield different optimization strategies.

a. Market-Rate Developers

Like all profit-seekers, market-rate developers seek to profit on the difference between their costs and their revenues. Developer reve-

---

148. But see infra Part II.B.2.
149. A fundamental metric used by investors in real estate is the capitalization rate, which is usually defined as the ratio of the property’s net operating income over an estimate of property value. See Petros S. Sivitanides et al., Real Estate Market Fundamentals and Asset Pricing, 29 J. PORTFOLIO MGMT. (SPECIAL ISSUE) 45, 47 (2003). Since a capitalization rate represents a measure of the return on investment, we would expect observed rates to represent some risk-adjusted real interest rate and to have a significant correlation with Treasury bond rates. See id. at 50–51.
150. See supra notes 107–08 and accompanying text.
151. If you ask a developer why they do the deals they do, they will invariably say that “every project is different.” See Vince O’Donnell, Address at Roundtable Discussion at the Affordable Housing Policy Institute (Sept. 8, 2011). This is certainly true; when deciding whether to build a project, a developer will rely on a combination of data, experience, and intuition. However, for the sake of precision, this Note will express things abstractly wherever possible.
nues are rental incomes; the costs include the costs of purchasing the land and constructing the building, as well as operating and financing costs that occur after the initial development phase. Developers may also seek to profit through market appreciation, selling their property sometime in the future after its value has risen.

In economics terms, all market-rate developers have a production function that combines land (L) and mobile capital used in construction (M). At the margin, a market-rate developer will choose some combination of L and M to maximize its profit and will choose the combination such that the marginal profit from the last unit of L is the same as the profit from the last unit of M. Since the price and productivity of mobile capital do not vary between neighborhoods, “broadly speaking, housing developers will use different development strategies depending on the price of land.” All else equal, higher-value land attracts more mobile capital than lower-value land. Therefore, it should not be surprising that market-rate developers will build fancier high-rent properties in neighborhoods with high land costs.

b. LIHTC Developers

As noted above, LIHTC developers have a different profit function from market-rate developers. Most LIHTC developers get their profit from developers’ fees. Developers’ fees are usually paid up front out of the investor’s equity contribution, and do not represent a claim on residual income in the same way that a market-rate developer’s equity position might. The difference between LIHTC developers and market-rate developers is simple to state: market-rate developers maximize profits by maximizing the present value of the difference between revenues and costs; LIHTC developers maximize profits by maximizing their developers’ fees.

A developer’s fee is made up of two separate amounts: an improvement fee, which is a percentage of eligible costs and is itself included in the eligible basis (and therefore subsidized with additional

152. See supra notes 138–41 and accompanying text.
153. See Mingche M. Li & H. James Brown, Micro-Neighborhood Externalities and Hedonic Housing Prices, 56 Land Econ. 125, 134 (1980) (“A comparison of the estimates from the two specifications indicates that the structural attributes are least affected by the introduction of the micro-neighborhood variables; this is not surprising since their construction costs are basically independent of location.”) (emphasis added)).
155. See supra notes 106–08 and accompanying text.
156. See Diamond, supra note 103, at 54.
tax credit equity), and a land acquisition fee, which is a percentage of the amount spent on land (which, as discussed, is not included in the eligible basis and so must be paid for out of debt or equity).157 These two fees are determined according to the QAP used by the allocating agency in each state; the allowable fee for land acquisition is generally lower than the allowable improvement fee.158

It is useful to consider an example to better understand how the different fees interact with the eligible basis.159 Assume a 15% fee on improvement costs and a 10% fee on land acquisition. Suppose, too, that a developer has a project that costs $2,000,000, half of such costs being allocated to the eligible basis and the other half to land-acquisition costs. On the $1,000,000 of eligible costs, the developer will receive $150,000 as the developer’s fee, which is added to the other eligible costs to get to the eligible basis of $1,150,000.160 Based on this eligible basis, the project will receive tax credits with a present value of $805,000,161 providing the developer with $724,500162 of equity, which it receives from selling the tax credits to the tax investor. On the $1,000,000 of land acquisition costs, the developer will receive a $100,000 developer’s fee for a total of $1,100,000 in non-eligible costs. The total—both eligible and non-eligible—costs are $2,250,000. Of this amount, the tax credit equity pays for $724,500 and the remaining $1,525,500 is paid for with debt, which must be serviced using rental income from the property. The developer will

157. State and local agencies have some discretion in how they set the developer’s fee. Some have clear rules, while others reserve the power to review fees on a more ad hoc basis. Compare 13 V.A. ADMIN. CODE § 10-180-60 (2015) (providing that upon receiving an application, the agency shall “examine the development’s costs, including developer’s fees and other amounts in the application, for reasonableness, and if [the agency] determines that such costs or other amounts are unreasonably high, [it] shall reduce them to amounts that [it] determines to be reasonable”), with MASSHOUSING, DEVELOPER’S FEE AND OVERHEAD POLICY 1 (2006), https://www.masshousing.com/portal/server.pt/document/415/developer%27s_fee_overhead_policy (allowing 5% of land acquisition costs, 15% of the first $3 million in “Fee-Based Development Costs,” 12.5% of the next $2 million of such costs, and 10% of the excess of such costs).

158. See, e.g., MASSHOUSING, supra note 157.

159. Throughout this section, I will talk about development fees in absolute terms. The developer will actually be concerned more with its rate of return, which would be the development fee divided by investment costs. In the case of affordable housing developers, since there is no equity investment by the developer, the investment costs would be reflected in the opportunity cost that the developer incurs by working on that project as opposed to some other project.

160. Note that the improvement fee is itself capitalized as part of the eligible basis. See I.R.C. § 263A (2013).

161. The credit is equal to 70% of the eligible basis. See supra note 119.

162. This is assuming that the developer can sell the credits for ninety cents on the dollar. See supra note 102.
receive total fees in the amount of $250,000. The developer’s average fee is therefore 12.5% of the project’s cost.

On the other hand, if a LIHTC developer has a project that costs $2,000,000, only a quarter of which is used for land acquisition, then the total developer’s fee will be $275,000\(^{163}\) and the debt will be only $1,067,500, since the rest will be paid for out of tax credit equity generated by the eligible costs.\(^{164}\) The developer’s average fee under this scenario is 13.75%. Thus, by substituting eligible basis for non-eligible basis, the developer increases both the equity in the project and the fee it receives. On the other hand, if a quarter of the costs are eligible costs, then the developer’s fee is only $225,000 and there is $1,862,750 in debt on the property.\(^{165}\) The developer’s average fee is reduced to 11.25%.\(^{166}\)

According to basic economic intuition, a profit-maximizing developer would choose a mix of inputs such that the marginal benefit it received from the last unit of each input is the same. Since the affordable housing developer maximizes profit by maximizing its developer’s fee, and the return on \(M\) is the fee for improvement costs, which is greater than the fee for land acquisition, the LIHTC developer would prefer to use only mobile capital. This obviously is not an option be-

\(^{163}\) That is, $225,000 for improvement costs and $50,000 for land acquisition costs.

\(^{164}\) Eligible basis of $1,725,000 yields $1,207,500 in tax credit equity. Total costs of $2,275,000 require $1,067,500 in debt.

\(^{165}\) Total costs are $2,225,000. Eligible basis is $575,000.

\(^{166}\) These differences may seem insignificant, but keep in mind that they mean that a developer with 75% eligible costs earns 20% more than a developer with 25% eligible costs.
cause, houseboats excepted, a building clearly cannot be built without any land. However, this result indicates that an LIHTC developer maximizes profits by choosing the minimum possible value for $L$, given practical considerations of the construction technologies available, and then maximizing $M$.

Based on profit structure, then, there are differing incentives for market-rate developers and LIHTC developers. The main source of this difference is the fact that LIHTC developers get their profits through a fee rather than as a residual. Furthermore, the fee is structured in a way that can be influenced by the developer’s production choices, specifically the choice between land and mobile capital. Given the structure of the LIHTC program and its distinction between eligible and non-eligible costs, we would expect LIHTC developers to try to maximize their fees by penciling out a project on which they spend as little as possible on land while still earning the necessary QAP points to be awarded the competitive 9% credits. Assuming a 15% improvement fee and a 10% land acquisition fee, we can think of the distortion in these terms: for every dollar a developer spends on eligible basis, it gets fifteen cents added to its profit, but for every dollar it spends on land, it gets only ten cents in fees. Considering that the developer’s profit is derived from the developer’s fee, this has the effect of reducing the developer’s rate of return when building in high-opportunity neighborhoods.

3. **Capital Structure**

In addition to having implications for the developer’s profit function, the LIHTC program further affects a developer’s incentives by changing the optimal capital structure. The location decision, by impacting the eligible basis as a share of total costs, alters the mix of debt and equity required to fund the project. This was alluded to before in connection with the discussion about depth of subsidy, but this mix has practical effects on the operation of the property and provides an additional constraint on the LIHTC developer.

---

167. This is equivalent to recognizing that the housing production function is a fixed proportion production function. See Walter Nicholson & Christopher Snyder, *Microeconomic Theory: Basic Principles and Extensions* 308 (10th ed. 2008).

168. In reality, the developer is not just choosing a specific mix of $M$ and $L$ but has some choice between different production functions. In economic terms, the LIHTC developer would choose production technology that had a production function with a relatively high marginal rate of substitution between $M$ and $L$.

169. See supra Part II.A.
Developers finance their projects through a mix of debt and equity. Under the stringent assumptions of the influential Modigliani-Miller Theorem, “the market value of any firm is independent of its capital structure.” This means that a developer would be indifferent between financing using all equity, all debt, or any place in between. The Modigliani-Miller Theorem, however, is more of a framework than an actual representation of reality. By enunciating a baseline of indifference, it invites our attention to those distortions that favor debt over equity or vice versa. However, even if markets are perfect, the existence of taxes means that Modigliani-Miller will never hold precisely. In fact, Miller and Modigliani themselves proposed a new form of their model to properly reflect that not only should returns be viewed on an after-tax basis but also that, because of the interest payment tax deduction, debt and equity have different after-tax returns. Other writers have termed this distortion a “tax shield,” and have generalized the term to take into account the distortions arising out of things other than the interest payment tax deduction.

In the context of the LIHTC program, we might think of a different kind of shield resulting from the LIHTC’s statutory formula, which I will call a “subsidy shield.” That is, even if Modigliani-Miller otherwise held, we would expect there to be a distortion because of the differences between the costs of equity and the costs of debt from the point of view of the developer. This subsidy shield acts to make affordable housing developers prefer equity over debt to the extent possible. The subsidy shield comes into existence because of practical limits on the amount of debt that a property can support.

171. Id. at 268–69.
173. See Myers, supra note 172, at 85–86 (“[T]he Modigliani and Miller propositions are benchmarks, not end results. The propositions say that financing does not affect value except for specifically identified costs or imperfections.”).
174. See I.R.C. § 163 (2013) (“There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”).
176. For an estimate of the size of the distortion, see generally Deen Kemsley & Doron Nissim, Valuation of the Debt Tax Shield, 57 J. FIN. 2045 (2002).
Affordable housing deals are usually underwritten so that the rents\textsuperscript{177} cover operating costs\textsuperscript{178} plus service on (often subsidized)\textsuperscript{179} debt, with no additional rental revenue available for operating profits.\textsuperscript{180} Given that rents are fixed,\textsuperscript{181} this means that operating costs and debt service must come from the same fixed stream of income such that an increase of one must decrease the other. Furthermore, developers have only “limited control” over operational costs.\textsuperscript{182} They can, however, make certain investment decisions during construction to minimize operational costs once the property is placed in service. For example, they might choose between paying for better insulation or higher utility costs, or between an automatic security system and an on-site security guard.\textsuperscript{183} In both of these examples, the former option would increase construction costs but lower operation costs and the latter option would do the opposite.\textsuperscript{184}

Rather than adjusting operational costs, a LIHTC developer might bring its costs in line with its rental revenues by lowering the costs of its debt service. One way a developer can do this is by in-

\textsuperscript{177} Rents are set by HUD. See I.R.C. § 42(g). The Fair Market Rent (FMR) is determined at the metropolitan-area level. Final Fair Market Rents for the Housing Choice Voucher Program and Moderate Rehabilitation Single Room Occupancy Program Fiscal Year 2014, 78 Fed. Reg. 61,668, 61,669–71, 61,677 (Oct. 3, 2013). Since they are set at the metropolitan-area level, FMR is the same throughout such an area. This means that a developer, once it has decided to build in a given metropolitan area, must take the rental revenue as given.


\textsuperscript{179} For an empirical look at the layered structure of affordable housing in New York City, see Vincent Reina & Michael Williams, The Importance of Using Layered Data to Analyze Housing, 14 Cityscape 215 (2012).

\textsuperscript{180} See Part II.B.2.a (discussing the role of operating profits). There is usually also a requirement that developers keep a dedicated reserve fund. This was implemented to address some mistakes made in the early years of the program where projects lacked proper maintenance and reinvestment. See Edwin Meléndez et al., Year 15 and Preservation of the Tax-Credit Housing for Low-Income Households: An Assessment of Risk, 23 Housing Stud. 67, 70–71, 85 (2008).

\textsuperscript{181} See supra note 177.


\textsuperscript{183} Id. at 7.

\textsuperscript{184} A state may reasonably decide that this is the sort of quality that it wishes to subsidize through its QAP and might choose to allocate its competitive credits to smart development. The difference is that under the tax credit statute, the federal government will provide a subsidy for such decisions, while it would not do so for the decision to subsidize land acquisition costs.
creasing the amount of equity that it receives through the LIHTC credit, which naturally decreases the amount of required debt. A larger credit means a larger equity contribution and a smaller debt burden; this equity is “free,” as it is received from the government, while debt comes at the cost of making the property harder to operate.

In sum, because of the structure of the subsidy, a LIHTC developer exercises control over the mix between debt and equity through its location decision. For the affordable housing developer, the financial benefits of the LIHTC program are created through an equity investment by the tax credit investor in the affordable housing project; indeed, the program is designed to attract this sort of investment. The tax credit investor takes the place of equity in the capital structure that would otherwise be paid by the developer or some other equity investor. However, unlike the normal equity investor, the tax credit investor receives a benefit through the tax credits rather than a claim on profits.

This effect of the LIHTC program on the capital structure is somewhat different from the other effects I have reviewed. The effect on depth of subsidy prevents properties from “penciling out” and being built in the first place. The LIHTC’s development fee structure affects the profit incentives of developers and results in a preference to build in low-opportunity neighborhoods. The effect on capital structure is more complex and harder to predict; however, a number of potential effects are foreseeable. For one, higher levels of debt create increased financial risk on a project, which might lead investors to require a larger discount when buying the tax credits. Such investors

186. A private developer will generally receive an equity contribution from a limited partner who usually invests between 80% and 95% of the equity capital, with the rest of the equity provided by the developer. Financial Structures of Private Equity Real Estate Investments, Realty Mogul, https://www.realtymogul.com/blog/financial-structures-of-private-equity-real-estate-investments (last visited Apr. 3, 2015).
187. See Cummings & DiPasquale, supra note 185, at 3 (“[The LIHTC program’s] ‘equity’ contribution by the investors subsidizes development of the housing. . . . The return to the investors largely comes in the form of tax credits, paid in roughly equal annual allotments over 10 years.”). Investors in market-rate developments will get a return on their investment based on a “preferred return,” a share of the net cash flows, and almost all the tax benefits of the property, such as deductions from depreciation and interest payments. Financial Structures of Private Equity Real Estate Investments, supra note 186. The “preferred return” is an amount paid to the investor before remaining net cash flows are split between the developer (the “promoter”) and the investor. Id. Keep in mind that “[t]he preferred return is not a guaranteed dividend, however; sometimes the preferred return is not paid out because the property cash flows don’t allow it.” Id.
might reasonably fear that any financial distress will result in the project falling out of compliance with the LIHTC program, thus resulting in a recapture of the credits.\textsuperscript{188} Moreover, it is very likely that syndicators will have minimum equity ratios in their underwriting standards, which will prevent certain location decisions from being made.\textsuperscript{189} Similarly, increased financial risk will likely lead to increased borrowing costs. Lenders’ underwriting standards may even make certain projects impossible.\textsuperscript{190}

As I have argued in this Part, a salient feature of the LIHTC program is that it incentivizes developers to build in neighborhoods where land is relatively cheap. While not necessarily making it impossible for state QAPs to prioritize development in high-opportunity neighborhoods, it does make such policy decisions considerably harder. Where a state does manage to get developments built in high-opportunity neighborhoods, the developers will likely have more debt, resulting in riskier projects.\textsuperscript{191}

III. PROPOSALS

The LIHTC program contains a formalistic distinction between land costs and other costs, which has important potential effects for the economics of affordable housing development.\textsuperscript{192} Specifically, it has the effect of making building in high-opportunity neighborhoods less attractive for developers and, in some cases, it may make certain location choices impossible—that is, given the price of land at that location, there would simply be no way for a developer to make the project pencil out given the statutorily limited rents. These effects exist regardless of how a state structures the allocation of credits through its QAP. In this Part, I propose a number of ways in which this problem may be addressed. It is important to keep in mind, however, that other than amending the statute, the solutions proposed herein entail

\textsuperscript{188} See supra note 100.

\textsuperscript{189} I think that an examination of the underwriting standards used by syndicators may be an interesting direction for future research since the standards can be seen as an attempt by the syndicators to maximize the economic value of the credit to investors. This can be compared to the QAP, which can be seen as an attempt by the state to maximize the social value of the credit.

\textsuperscript{190} While one might expect loans from affordable housing lenders to have lax underwriting standards, this is not necessarily the case. New York City’s Housing Development Corporation usually packages its loans in highly rated bonds. See Official Statements, N.Y.C. HOUSING DEV. CORP., http://www.nychdc.com/pages/Official-Statements.html (last visited Apr. 3, 2015).

\textsuperscript{191} See supra Part II.B.3.

\textsuperscript{192} See supra Part II.
working around the statute rather than working with it. Such workarounds would likely be more expensive and less efficient than changes brought about through congressional action.

Broadly speaking, there are three ways in which the LIHTC program might be changed. First, Congress could act to rewrite section 42 of the tax code. This solution clearly has the most flexibility, but might also be politically difficult. The next best option is for HUD to take action through rulemaking. This option is limited, however, in that any promulgated rules must fit within the confines of existing law. Finally, a state might use some combination of the QAP and other affordable housing tools to counteract the LIHTC program’s negative effects on the location decision.

A. Congressional Action

If Congress wished to change the LIHTC program, it certainly could do so by amending the relevant statutory provisions. This would be the most straightforward option from both a legal and policy standpoint. However, it is also probably the least likely given the realities of the political process and the negotiations required to amend any statute, let alone the federal tax code. While congressional action is unlikely, it nonetheless is important to consider how the statute might be amended if only to provide a baseline by which to judge other proposals.

The statute determines the eligible basis “without regard to the adjusted basis of any property which is not residential rental property.” This language includes in the eligible basis the costs of the structures on the land, but not the land itself. This definition drives the economic effects detailed above. There are a few ways Congress could amend the statute to alleviate the restrictions on the location decision created by this definition. It could make the credit completely location-neutral by changing the definition of eligible basis to include land acquisition costs. Alternatively, it could choose a middle ground by allowing the inclusion of some portion of land costs or by providing a credit bonus for properties built in areas with high land costs. In fact, as discussed below, Congress has included similar exceptions to

193. One fear that is always present when tinkering with programs that provide assistance to low-income households is that once change by Congress is on the table, one never knows exactly how things will end up.
196. See supra Part II.
the general rule of calculating eligible basis in service of other policy goals. Those exceptions provide useful models.

First, then, Congress could amend section 42(d)(4) of the tax code to include land acquisition prices in the eligible basis. This would make the LIHTC statute location-neutral. The choice between spending money on land or on other costs would not be distorted. Such a decision would shift a great deal of power to the states with respect to the location decision. By increasing the size of the subsidy to projects with higher land costs, Congress would enable states to use their QAPs to incentivize construction in high-opportunity neighborhoods. However, since states would still be able to provide less than the maximum credit allocation under this scenario, they could choose to use their QAPs to get the exact same outcome as under the current LIHTC statute.197

This option may go too far for Congress’s tastes, however. Congress may not want to put all control into the hands of the states for reasons beyond affordable housing policy.198 Or, recognizing the importance of location to household outcomes, Congress might want to allow land costs to enter into the formula for calculating the amount of the credit while maintaining the ability to limit the amount of credit that the developer may receive through purchasing land.

Assuming the latter, Congress could create an exception that would allow the LIHTC tax credit to take into account a specified portion of the cost of land. The statute currently allows for such a limited exception in the context of a “community service facility.”199 With regard to property used for that purpose, the statute allows an increase in the adjusted basis of the property, but only a percentage of the basis in the community service facility can be included in the eligible basis for the project.200 Without the exception, there would be no

197. See, e.g., KY. HOUS. CORP., 2014 QUALIFIED ALLOCATION PLAN 21 (2014) (setting a maximum credit of $1,250,000 for any project).
198. For example, one might imagine an anti-corruption rationale for minimizing the role of land costs in the calculation of the subsidy: a developer and a property owner might agree on a higher-than-market price in order to extract additional subsidy from the federal fisc to be split between the two parties. Land may pose a significantly higher risk of this strategy since other development costs are more likely to have a well-known local market price while the cost of land, because of its spatial element, is subject to much more variability. It is relatively easy for an agency to know the general market prices for cement, labor, and architectural design. It is much harder for it to value a specific lot.
199. See I.R.C. § 42(d)(4)(C)(i). Since a community service facility is not “residential rental property,” it is not otherwise included in eligible basis. See id. § 42(d)(4)(A).
200. See id. § 42(d)(4)(C)(ii) (25% of first $15,000,000 in eligible basis and 10% for any remaining eligible basis).
incentive for developers to pair their housing units with other community services that might be beneficial to low-income tenants. On the other hand, by limiting the exception, Congress ensures that most of the credit goes toward building housing and not toward the other services. This community service facility exception thereby allows Congress to recognize the value created by community-service facilities in housing outcomes while controlling for potential risks that would come from an unlimited inclusion. Congress could create a similar exception for land costs.

Finally, Congress could provide a bonus to the subsidy amount along the same lines as it does for "difficult development areas." Under that provision of the statute, properties built in "any area designated by the Secretary of Housing and Urban Development as an area which has high construction, land, and utility costs relative to area median gross income" are eligible for a 30% bonus to their eligible basis. Given that high construction costs are already reflected in the eligible basis, it seems reasonable for developers to receive bonuses based on building in neighborhoods with high land costs. Rather than creating a new classification to take into account high land costs, Congress could choose to amend the "difficult development area" language to focus on land rather than other costs.

Congressional action is unlikely, however. All sides recognize the need for substantial tax reform, but few see it coming in the near future. In the event that there are large-scale tax reforms, affordable housing advocates should lobby for the proposed statutory changes. Depending on the prevailing politics and the political horse-trading that would accompany a large-scale tax reform project, an amendment might increase or decrease the depth of the LIHTC subsidy.

B. Executive Action

Without congressional action, the President or HUD could act directly to resolve some of the issues discussed in this Note. While such action might be more likely given Congress’s current deadlock, the statute’s centrality to the analysis of this Note means that any executive fix would necessarily be second best.

202. I.R.C. § 42(d)(5)(B)(ii); see also supra text accompanying notes 130–34.
203. I.R.C. § 42(d)(5)(B). In practice, the difficult development areas are chosen based primarily on rents. See supra text accompanying note 134. Note that land costs are explicitly referenced in the statutory definition of “difficult development areas,” a fact that will be taken up below.
As discussed, the statute provides HUD with discretionary authority under section 42(d)(4)(B) to give a 30% bonus to eligible basis in difficult development areas. If Congress fails to take the action described above, HUD could change the formula it uses to determine what qualifies as a difficult development area. Currently, the Secretary determines such areas by looking for places where rents are high compared to the fair market rent that LIHTC tenants would have to pay. Instead, HUD could alter its formula to encompass areas with high land costs.

For a number of reasons, this option is not as good as amending the calculation of eligible basis. On its face, the bonus merely replaces one distortion with another. In addition, designating areas based on land costs is complicated compared to designating areas based on rents. Rents can be measured using household survey data that, thanks to the Census, is relatively rich due to the very large sample size. An index of land prices is much harder to calculate because vacant land rarely transacts, and when it does, it is unlikely to be representative of land in the area generally. Further, any definition of “difficult development area” would be necessarily crude in that if HUD were to designate entire metropolitan areas as it currently does, the bonus would have little effect on the location decision within each metropolitan area. Surveying and designating smaller geographies is possible, but it is also costly and hard to administer. That said, these difficulties are merely technical issues concerning the government’s ability to identify areas that are suitable for a subsidy bonus. Insofar as

204. See supra text accompanying notes 202–03.
206. See supra text accompanying notes 202–03.
207. See supra text accompanying notes 132–34.
210. See Michael Gedal & Ingrid Gould Ellen, Valuing Urban Land: Comparing the Use of Teardown and Vacant Land Sales 2 (July 26, 2012) (unpublished manuscript) (on file with author). Urban economists have created something called “teardown analysis,” which tries to estimate land prices by looking at property transactions where the buyer subsequently tears the building down. See id. Under such analysis, the price that the buyer pays, plus the demolition costs incurred, must be at least as much as the buyer values the underlying land. Id.
211. HUD is currently conducting a demonstration project for producing small-area FMRs, which could be used to designate difficult development areas at the zip-code level. See Section 8 Housing Choice Voucher Program—Demonstration Project of Small Area Fair Market Rents in Certain Metropolitan Areas for Fiscal Year 2011, 75 Fed. Reg. 27,808 (May 18, 2010).
the federal government is capable of identifying such high-opportunity neighborhoods, the existing “difficult development area” bonus could solve many of the issues highlighted in this Note.

C. State Action

Broadly speaking, states have two options for dealing with the distortion created by the LIHTC’s eligible-basis rules. They could use the QAP allocation process to try to incentivize certain decisions in spite of the economic realities, or they could use other subsidies to offset the distortional effect of the credit formula.

The main vehicle for LIHTC policy at the state level is the state’s QAP.212 QAPs might be adjusted to take into account the location decision more than they currently do.213 In some circumstances—namely, where the depth of subsidy is sufficient in high-opportunity neighborhoods for development to be economically viable—states might still be able to influence developers’ location decisions through their QAPs. Indeed, many states already attempt to incentivize this kind of development, with varying degrees of success.214 Massachusetts’s QAP represents an example of how states might adapt their plans to incentivize development in high-opportunity neighborhoods. Massachusetts gives points to a project sited in an “area of opportunity,” which it defines as “a neighborhood or community that offers access to opportunities such as jobs, health care, high-performing school systems, higher education, retail and commercial enterprise, and public amenities.”215

Alternatively, a state could simply use the QAP to change the developer’s fee structure and make it location-neutral by eliminating a separate land acquisition fee. This would reduce the developer’s incentive to build in low-cost neighborhoods since spending less on land would decrease the fee the developer received. However, it would also have the effect of increasing project costs since the developer would take out the additional fee without a corresponding increase in the subsidy. This would therefore be a relatively costly way to incentivize quality over quantity. Furthermore, this response will address the dis-

---

213. See generally Khadduri, supra note 4, at 10–17 (arguing that policymakers should look to the QAPs as tools for building more properties in high-opportunity neighborhoods).
214. See generally Ingrid Gould Ellen et al., supra note 7 (finding small but significant effects of QAP priorities on poverty exposure).
tortion through the developer’s profit structure, but will actually exacerbate the capital structure distortion by decreasing the amount of equity as a share of total costs.

Unfortunately, without additional sources of funding, there is a limit to what a QAP can do. A state’s QAP could conceivably be structured so that building in high-opportunity neighborhoods is de facto required to receive the allocation, but if the credit amount is too low for developers to build in those neighborhoods, then such a policy would merely eliminate the market for LIHTC development altogether.

The QAP is not a state’s only tool to affect the location decision. Given the limitations imposed by the LIHTC, a state might choose to provide an additional subsidy to offset the fact that the federal government does not subsidize land acquisition. This could take a number of forms, from the use of tax-exempt bonds and state tax credit programs, to other subsidy programs such as community development block grants. These programs are likely subject to restrictions outside the scope of this Note.

CONCLUSION

The LIHTC program is an important source of housing for low-income households in the United States. Like most housing inhabited by low-income people, these units are often found in low-income neighborhoods. How did this happen? Is it really the optimal policy? This Note argues that it probably is not. Additionally, this Note argues that the optimal policy is likely impossible under the current statutory

216. See supra Part II.B.1
217. See supra Part II.B.2.
220. The Community Development Block Grant Entitlement Program provides grants to cities to be used in a “wide range of community development activities directed toward revitalizing neighborhoods, economic development, and providing improved community facilities and services.” CDBG Entitlement Program Eligibility Requirements, HUD EXCHANGE, https://www.hudexchange.info/cdbg-entitlement/cdbg-entitlement-program-eligibility-requirements (last visited Apr. 3, 2015).
framework of the LIHTC program, but that there exist second-best policy outcomes that should be considered by policymakers at various levels of state and federal government.\textsuperscript{221}

There are policy reasons for siting households in high-opportunity neighborhoods. Households living in such neighborhoods have better educational, health, economic, and public-safety outcomes. These outcomes are associated with the broad affordable housing goal of utilizing housing as a platform to provide households with access to opportunities that they may not have through the market. This goes beyond merely four walls and a bed. Access to good neighborhoods is key.

While the LIHTC statute provides states with broad discretion when it comes to most policy decisions, it makes an arbitrary distinction between land costs and construction costs that has important negative effects. First, it lessens the amount of subsidy, as a share of total costs, for projects that require relatively higher land costs. Second, the distinction, along with the different treatment by state QAPs, results in developers receiving a different marginal developer’s fee for land costs and non-land costs. Finally, the distinction ensures that projects in high-opportunity neighborhoods will have to carry relatively higher levels of debt.

This Note is meant to serve two purposes. Primarily, I hope to highlight the implicit incentives in the LIHTC program. As long as the statute remains in force, policymakers at the state and federal levels will have to take these incentives into account. The second purpose is to argue that not only does the incentive exist, but also that it is also the wrong policy decision. In the end, I believe that there is a spectrum between quality and quantity, and that the point a policymaker picks on the spectrum must be determined by both empirical studies on neighborhood effects and local social and market conditions. I hope that this Note serves to provide policymakers with a review of the economic literature and offer some guidance about how one might frame such a policy prescription.

\textsuperscript{221} See supra Part III.