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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. In this June 2023 Letter, Fannie Mae Research Economist Yiwen (Xavier) Kuai, Ph.D., studies the 4% Low-Income Housing Tax Credit program and how it may be used to achieve more fair housing goals and uplift neighborhoods.

Yiwen Kuai's contributions to this article occurred prior to his appointment at Fannie Mae. Yiwen Kuai received his Ph.D. in Urban Planning from UCLA. The views expressed are those of the author and not those of Fannie Mae or the Federal Housing Finance Agency. This work was supported by the UCLA Ziman Center's Howard and Irene Levine Program in Housing and Social Responsibility and UCLA Graduate Division. This Economic Letter is based on Yiwen Kuai's research paper, "A Missed Opportunity? The 4% Low-Income Housing Tax Credit Program." The complete study, including all citations and graphs, may be found here.

A New Opportunity

The 4% Housing Tax Credit Offers Fresh Ways of Lifting Neighborhoods from Poverty

By Yiwen (Xavier) Kuai, Ph.D.

INTRODUCTION

The Low-Income Housing Tax Credit program (LIHTC) is the primary financing source for affordable housing in the U.S. Two different credit types, the 9% credit and the 4% credit, are subject to different allocation criteria. The 4% program has been flying under the radar of policymakers, housing advocates and researchers since its inception. Whereas newly constructed 9% units are increasingly sited in lower poverty neighborhoods, 4% investment is made in high-poverty and low-opportunity neighborhoods.

Our research reveals that states that allocate the 4% credits have not actively influenced the "locational outcomes" of tax credit allocation– that is, the particular types and locations of neighborhoods that could benefit low-income tenants or where investment could catalyze neighborhood revitalization. States only recently began to leverage Qualified Allocation Plans (QAPs) to influence the siting outcomes of 4% projects. Although states increasingly

emphasize neighborhood opportunities for the 9% credits in their QAPs, more clarity is needed for the 4% credit program. (QAPs outline a state's siting priorities and criteria for tax credit projects. Most states issue QAPs annually.)

The design of the LIHTC program leads to two competing objectives: 1. siting affordable housing in neighborhoods that provide tenants with neighborhood opportunities, and 2. furthering investment in blighted neighborhoods and catalyzing revitalization by creating new affordable units or preserving existing housing stock. State LIHTC allocators have not been using the 4% program in the same way that they regulate the 9% program. The 9% program increasingly focuses on siting newly constructed LIHTC units in lower-poverty neighborhoods to improve socio-economic mobility of low-income households across states.

> *"Many 4% tax credits have been invested in high-poverty areas. But new ways of implementing them could further fair housing goals and improve the economic mobility of low-income households, which have been the recent focus of the 9% program in many states."*

There are concerning signs that new developments enabled by the 4% credit are built in higher-poverty and lower-opportunity neighborhoods in recent years. If meeting the goal of much-needed neighborhood revitalization is prioritized for the 4% program, the state allocator may need to lay out plans to avoid the concentration of poverty. States can do this by designing set-asides of funds for targeted investment in neighborhood revitalization, placing stringent selection criteria, evaluating and monitoring siting outcomes, and engaging with the community before drafting their QAPs. With increased competition for affordable housing funding, states may also leverage locational incentives in QAPs to start influencing the locations of 4% projects as seen in the 9% program.

OVERVIEW OF LIHTC: 4% VS 9% CREDIT

The Low-Income Housing Tax Credit (LIHTC) program has financed over 2.5 million low-income units with at least 30 years of affordability since 1986. The program provides a dollar-for-dollar reduction in federal income tax liability for developers or investors in rental housing that serves low-income households. As the largest federal subsidy for affordable housing production and rehabilitation, there is growing policy interest in this program. Some scholars and analysts have paid particular attention to this program, motivated by evidence that relocating low-income households to lower-poverty neighborhoods with better opportunities could yield improved life outcomes. It is believed that the LIHTC program has the potential to be an important tool to combat poverty and racial concentration and revitalize neighborhoods.

States have significant authority in the allocation of tax credits. The 9% credit is awarded competitively primarily to subsidize new construction. State housing finance agencies score proposals in terms of financial pro forma, development and management experience, community support, tenant composition, and locational criteria included in their QAPs. In recent years, several states added more locational incentives in their QAPs for the allocation of 9% credits to steer developments into neighborhoods with better amenities and economic opportunities. The 4% credit is claimed for rehabilitation and new construction on a noncompetitive basis. Applications for the 4% credits often are not subject to extensive reviews. Whereas the 9% credit covers up to 70% of the eligible costs, the 4% credit only covers 30% and thus requires other significant financing. The tax-exempt bond is the most frequently used source to couple with the 4% credit.

POVERTY DECONCENTRATION AND ACCESS TO OPPORTUNITY

A growing body of evidence suggests that geographic disparities in neighborhood opportunities may have serious consequences for residents. Low-income families that live in distressed and often high-poverty neighborhoods face daunting challenges as they attempt to obtain a sound education, secure a steady job, raise children, and advance their status. There is strong empirical evidence that neighborhoods affect the earning trajectory of children from low-income households. Also, papers on the Moving to Opportunity experiment, a major randomized housing mobility experiment in the U.S., show that relocating to lower poverty neighborhoods improves the long-term well-being of low-income individuals.

Poverty deconcentration and racial desegregation have never been consistently pursued as housing policy goals in the U.S. Housing advocates have long pushed the LIHTC program to further fair housing goals. Fair housing

advocates argue that affordable housing should generally be placed in high-opportunity areas to improve the socioeconomic mobility of low-income households. A project-based subsidy, such as the LIHTC, can expand the opportunities for low-income households to live in relatively high-cost neighborhoods, counteracting the tendency of housing market dynamics and historical patterns of racial segregation and discrimination. Supporters of community-oriented development believe tax credit investment should be made in struggling neighborhoods to create additional low-cost housing and revitalize disadvantaged communities. Multiple studies documented small-positive or non-adverse effects of LIHTC properties on surrounding property values. Studies also show that new LIHTC properties are unlikely to exacerbate poverty concentration and minority segregation, nor do they appear to reduce them. However, the program has shown somewhat limited effect in stimulating neighborhood revitalizations.

WHY THE 4% CREDIT DESERVES A CLOSER LOOK

The 4% program is a rather unexamined aspect of the program. Prior studies generally show that LIHTC developments, regardless of credit type, are located in less desirable neighborhoods than other rental units but more desirable ones than public housing. Prior research also shows that LIHTC tenants live in neighborhoods comparable to those of poor renters across the U.S. The LIHTC program on the whole does not seem to exacerbate the concentration of poverty, although it does little to reduce it. In some cases, tax credit investments may have sparked small-scale neighborhood revitalizations in distressed neighborhoods.

Our study explores the relationship between state locational priorities and siting outcomes in the 4% program, with particular attention to the role in poverty deconcentration, racial integration, access to higher-opportunity neighborhoods, and neighborhood revitalization. It is expected that allocation mechanisms and outcomes of the 4% program differ significantly from those of the 9% program due to their different benefits and competitiveness. As 4% applications do not uniformly require competitive reviews, prioritizations toward poverty deconcentration, racial integration, siting in high-opportunity neighborhoods, or revitalization may not apply. Our paper extends previous studies of policy incentives in the 9% program, by introducing more recent allocation cycles, examining siting patterns, and using the 9% process as a benchmark.

VALUE OF THE 4% PROGRAM

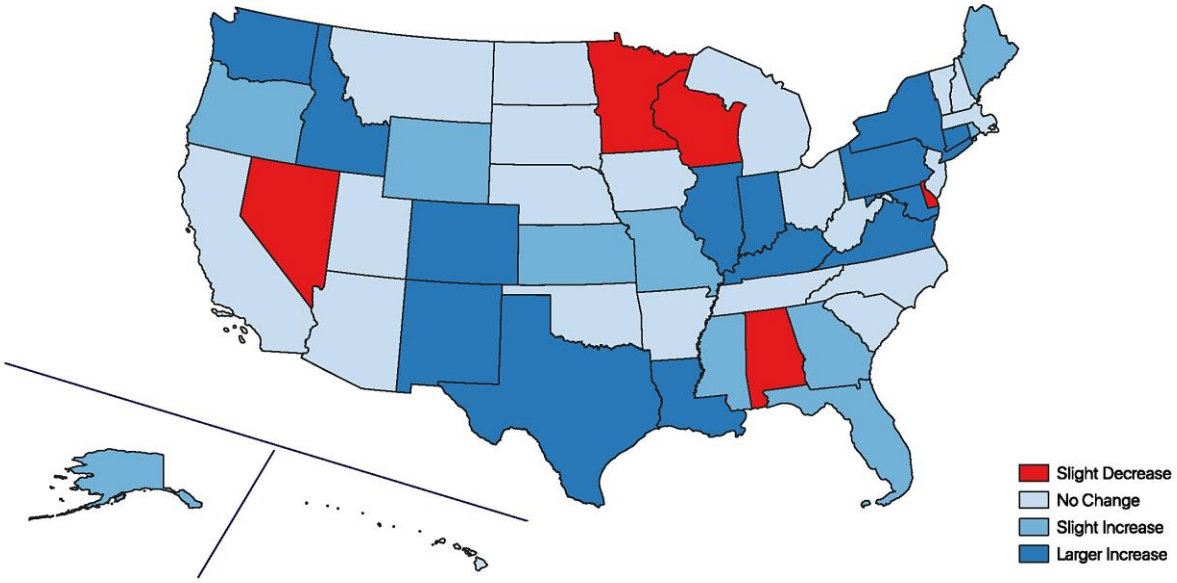
- As competition for housing funds increases, the 4% credit becomes an even more important state policy lever.
- The 4% credit is claimed for rehabilitation and new construction on a noncompetitive basis. This adds flexibility to revitalization in high-poverty areas because applications for the 4% credits often are not subject to extensive reviews.
- Drawing on lessons from previous practice with subsidized housing, states should be explicit about fair housing goals and design a Qualified Allocation Plan for the 4% credit that avoids poverty concentration and racial segregation.
- Given the sometimes-competing fair housing and community development goals, deliberate consideration is needed to balance them.

COMPETING OBJECTIVES AND LOCATIONAL INCENTIVES

The design of the LIHTC program leads to two competing objectives: (a) siting affordable housing projects in neighborhoods that provide tenants with neighborhood opportunities; (b) furthering investment in blighted neighborhoods and catalyzing revitalizations by creating new affordable units or preserving existing housing stock. Based on our results, this conflicting paradigm is particularly evident in many state regulations for the 4% LIHTC program. Many states have explicitly or inexplicitly included both objectives for the 4% program although increasingly emphasized the community-oriented development objective in recent years.

Nine states explicitly stated their preference for 4% credits in preserving and rehabilitating existing affordable housing in 2016. In contrast, however, some states have added incentives more in line with 9% programs. These include encouraging the siting of LIHTC housing developments in “areas of opportunity,” which have been defined either broadly or using specific metrics like low poverty rate, high school quality, and convenient access to jobs.

Chart: 4% Program Locational Priority Change Between 2005 and 2016



Source: State QAPs and tax-exempt bond regulations, 2005 and 2016. Note: Each locational incentive change is coded between -3 to -3, reflecting the direction and the strength of a change. Changes across categories are summed together to create an aggregate index in this chart. A slight change means the aggregated index is between 1 and 2 or -2 and -1. A larger increase means the change is greater than 2. See detailed coding in the full text.

SUMMARIZING STATE ALLOCATION PRIORITIES

There is significant variation in how states prioritize investment toward poverty deconcentration, racial integration, and access to opportunity for low-income households. To highlight two priorities: firstly, many states increased direct prioritization toward neighborhood opportunities in the 4% program from 2005 to 2016. In 2016, 23 states had explicit incentives to encourage siting of projects financed with the 4% credit in high-opportunity neighborhoods, up from 9 in 2005. States often use "low poverty rate," "access to quality schools," and "easy-to-reach job centers" to define an opportunity area. However, these definitions vary by state. For example, Minnesota awards various extra points for a project located in an "area of opportunity" which promotes economic integration, has access to higher performing schools, or in a workforce housing community. In comparison, 35 states prioritized opportunity in 2016 for 9% developments. Secondly, 31 states encouraged siting 4% projects near neighborhood amenities in 2016. For example, Washington gives incentives for "location-efficient projects," which are in transit-rich and walkable neighborhoods, for both 9% and 4% projects.

POLICY IMPLICATIONS

The 4% program is a vital financing resource for creating new affordable housing and persevering existing housing stock. The 4% program is still largely flying under the radar of policymakers, housing authorities, and researchers. Each state, which has significant power over the tax credit and bond allocation processes, has a great opportunity to balance sometimes-competing housing goals.

If a state wants to prioritize goals of furthering poverty deconcentration, racial integration, and helping tenants reach opportunity, 4% tax credits could be a unique opportunity. However, if a state wishes to use the 4% tax credit to preserve the existing stock of affordable housing and revitalize distressed neighborhoods, it should be explicit about these goals and design a QAP and allocation mechanism that avoids poverty concentration and racial segregation. If the sometimes-competing goals of fair housing and community development are both necessary, they should be balanced with deliberate consideration.