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## Locating Affordable Housing: The Legal System's Misallocation of Subsidized Housing Incentives

Brandon M. Weiss

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# Locating Affordable Housing: The Legal System's Misallocation of Subsidized Housing Incentives

BRANDON M. WEISS<sup>†</sup>

*The primary goal of subsidized housing policy in the United States is to increase access to affordable housing for low-income households. Yet data show that states disproportionately award low-income housing tax credits to finance the development of projects in neighborhoods where there is already a relatively high number of housing units available at similar rent levels. Through a fifty-state study of state housing agency allocation rules, this Article evaluates the legal apparatus that facilitates this "misallocation problem." I find that approximately seventy-five percent of states fail to make the provision of below-market rents a threshold requirement of receiving an award of low-income housing tax credits. As a result, locational choices often are dictated by private developers who are incentivized to develop where land is cheapest. I argue that states should revise their allocation rules to ensure that, as a default, tax credits are awarded to projects that offer at least a ten percent rent advantage as compared to the local private market. The Article considers challenges to this proposal related to lack of state housing agency autonomy, federal framework limitations, land costs, and local political opposition and, in each case, offers a variety of responses.*

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## TABLE OF CONTENTS

INTRODUCTION .....	216
I. THE MISALLOCATION PROBLEM .....	222
II. STATE ALLOCATION RULES ANALYSIS.....	225
A. FEDERAL FRAMEWORK & THE STATE QAP .....	225
B. FOUR VARYING STATE APPROACHES .....	226
1. <i>Rent Differential as Threshold Requirement</i> .....	227
2. <i>Rent Differential as Incentive</i> .....	228
3. <i>Clear Reference with No Instrumental Relationship</i> .....	229
4. <i>No Clear Reference to Rent Differential</i> .....	230
C. MODEL STANDARDS AND THE SUPREMACY OF FINANCIAL VIABILITY .....	232
III. NEIGHBORHOOD SCENARIO ANALYSIS.....	234
A. SCENARIO 1: “CROWDING-OUT” MARKET RATE HOUSING.....	234
B. SCENARIO 2: UPGRADING HOUSING QUALITY .....	236
C. THE INADEQUACY OF FINANCIAL VIABILITY TO GUARANTEE PROGRAMMATIC SUCCESS .....	237
IV. OBSTACLES TO ADDRESSING THE MISALLOCATION PROBLEM .....	238
A. LACK OF AGENCY AUTONOMY .....	238
B. FEDERAL FRAMEWORK LIMITATIONS.....	240
C. LAND COSTS .....	242
D. LOCAL POLITICAL OPPOSITION.....	244
CONCLUSION.....	245

## INTRODUCTION

Housing affordability remains a persistent challenge for households across the United States. This reality is particularly true for those at the bottom of the income distribution. For every one hundred extremely low-income renter households, only thirty-five units of affordable housing are available.<sup>1</sup> The result of this affordability gap is severe and no less detrimental despite its familiarity: children grow up in substandard housing that has lifelong impacts on health outcomes,<sup>2</sup> families are forced to make painful tradeoffs between housing and

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1. See NAT’L LOW INCOME HOUS. COAL., *THE GAP: A SHORTAGE OF AFFORDABLE HOMES 2* (2017) (defining “extremely low-income households” as households whose income is at or below 30% of the applicable area median income (AMI) or whose income is at or below the poverty line; defining “affordability” as paying no more than 30% of household income on rent and utilities). The report makes similar findings for renter households that earn 50% of AMI—for every one hundred such households, only fifty-five units of housing are affordable and available. *Id.* at 5.

2. See Michael Weitzman et al., *Housing and Child Health*, 43 CURRENT PROBS. PEDIATRIC & ADOLESCENT HEALTH CARE 187 (2013) (noting the significant developmental impacts of substandard housing).

other necessities,<sup>3</sup> and, most extremely, more than half a million Americans go homeless on any given night.<sup>4</sup>

Given the costs of land and housing production, coupled with restrictive local land use regulatory regimes, the private market alone will not solve this problem. Since the 1930s, the federal government has experimented with programs aimed at filling this housing gap.<sup>5</sup> The U.S. Department of Housing and Urban Development (HUD), the federal agency presently charged with administering the bulk of such programs, has an annual budget of approximately fifty billion dollars.<sup>6</sup> Nonetheless, unlike typical “entitlement programs,” at current funding levels only one in four households that is income-eligible for assistance receives it.<sup>7</sup>

The Low-Income Housing Tax Credit (LIHTC) program has replaced public housing as the primary federal program aimed at producing new units of housing affordable to low-income households. While only approximately one million units of public housing remain,<sup>8</sup> the LIHTC program has produced roughly three million units of subsidized housing.<sup>9</sup> Despite being hailed as the most successful federal subsidized housing production program in history,<sup>10</sup> the program has faced a number of critiques, including that it: ignores federal civil rights laws;<sup>11</sup> is inefficient;<sup>12</sup> leaves tenants more rent-burdened than other

3. See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION’S HOUSING* 33–34 (Marcia Fernald ed., 2017) [hereinafter 2017 JCHS REPORT] (finding that low-income households significantly cut back on food, transportation, and healthcare consumption when housing costs take up most of their income).

4. U.S. DEP’T OF HOUS. & URBAN DEV., HUD 2016 CONTINUUM OF CARE HOMELESS ASSISTANCE PROGRAMS HOMELESS POPULATIONS AND SUBPOPULATIONS 1 (2017), [http://www.hudexchange.info/resource/reportmanagement/published/CoC\\_PopSub\\_NatTerrDC\\_2016.pdf](http://www.hudexchange.info/resource/reportmanagement/published/CoC_PopSub_NatTerrDC_2016.pdf).

5. See Charles L. Edson, *Affordable Housing—An Intimate History*, 20 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 193 (2011) (reviewing the history of major federal subsidized housing programs).

6. See U.S. DEP’T OF HOUS. & URBAN DEV., FISCAL YEAR 2018 BUDGET 1–9 (2017), [http://portal.hud.gov/hudportal/documents/huddoc?id=FY\\_18\\_CJS\\_COMBINED.PDF](http://portal.hud.gov/hudportal/documents/huddoc?id=FY_18_CJS_COMBINED.PDF).

7. See 2017 JCHS REPORT, *supra* note 3, at 37 (“For the 75 percent of eligible households that are eligible for assistance but do not receive it, affordable housing choices are in increasingly limited supply.”).

8. See CTR. ON BUDGET & POLICY PRIORITIES, UNITED STATES FACT SHEET: FEDERAL RENTAL ASSISTANCE 1 (2017) (reporting that 1,020,000 households are currently assisted by public housing).

9. See Office of Policy Dev. & Research, *Low Income Housing Tax Credits*, U.S. DEP’T OF HOUS. & URBAN DEV., <https://www.huduser.gov/portal/datasets/lihtc.html> [hereinafter HUDUSER] (last updated June 6, 2018) (noting the 3.05 million units produced by the LIHTC program through 2016).

10. See, e.g., JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: CAUSES, CONSEQUENCES, RESPONSES, AND PROPOSED CORRECTIVES* 13 (2009), [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/disruption\\_of\\_the\\_lihtc\\_program\\_2009\\_0.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/disruption_of_the_lihtc_program_2009_0.pdf) (“The Low-Income Housing Tax Credit (LIHTC) program is widely regarded as the most successful affordable housing production and preservation program in the nation’s history.”).

11. Florence Wagman Roisman, *Mandates Unsatisfied: The Low Income Housing Tax Credit Program and the Civil Rights Laws*, 52 U. MIAMI L. REV. 1011, 1012 (1998).

12. See Michael A. Stegman, *The Excessive Costs of Creative Finance: Growing Inefficiencies in the Production of Low-Income Housing*, 2 HOUSING POL’Y DEBATE 357, 370 (1991) (arguing that the high transaction costs make the program inefficient). *But see* Michael A. Stegman, *Comment on Jean L. Cummings and Denise DiPasquale’s “The Low Income Housing Tax Credit: An Analysis of the First Ten Years”: Lifting the Veil of Ignorance*, 10 HOUSING POL’Y DEBATE 321, 323 (1999) (stating that as the program matured over the

federal subsidized housing programs;<sup>13</sup> fails to reach the lowest-income households;<sup>14</sup> and will create a sizeable problem, beginning in 2020, when rent restrictions start to expire and low-income tenants may face the risk of eviction.<sup>15</sup>

Notwithstanding these critiques, the LIHTC program has garnered significant bipartisan support in Congress since its creation in 1986.<sup>16</sup> The recent tax reform effort preserved the program in its entirety despite numerous efforts to cut similar tax credits.<sup>17</sup> The program provides approximately eight billion dollars annually in federal support for subsidized housing production<sup>18</sup> and continues to produce more than one hundred thousand housing units every year.<sup>19</sup> As a permanent tax credit, the program is insulated from annual partisan battles over congressional funding appropriations. When state housing finance agencies (HFAs) allocate the credits strategically, they can avoid, or at least alleviate, some of the classic critiques of the program.<sup>20</sup> While some have

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first ten years, it has become “a sophisticated and increasingly efficient low-income rental housing production system”).

13. See Anne R. Williamson, *Can They Afford the Rent? Resident Cost Burden in Low Income Housing Tax Credit Developments*, 47 URB. AFF. REV. 775, 794 (2011) (“[T]he LIHTC appears to serve households without vouchers in a narrow income range (50% to 60% AMI) relatively well, but leaves lower income tenants cost burdened—some, severely cost burdened.”).

14. See Katherine M. O’Regan & Keren M. Horn, *What Can We Learn About the Low-Income Housing Tax Credit Program by Looking at the Tenants?* 23 HOUSING POL’Y DEBATE 597, 609 (2013) (“[R]elative to households assisted by the other largest federally assisted rental programs, LIHTC recipients have higher incomes.”).

15. See Brandon M. Weiss, *Residual Value Capture in Subsidized Housing*, 10 HARV. L. & POL’Y REV. 521, 546, 563 (2016) (finding that starting in 2020 and continuing until 2043, the thirty-year rent restrictions on more than two million LIHTC properties will expire, subjecting the low-income residents to potential displacement).

16. See *America’s Affordable Housing Crisis: Challenges and Solutions: Hearing Before the S. Comm. on Fin.*, 115th Cong. 1 (2017) (statement of Sen. Orrin G. Hatch, Chairman, S. Comm. on Fin.) (“As many of you are aware, the last time we underwent a national, comprehensive revision of the tax code was in 1986, with the passage of the Tax Reform Act. At that time, affordable housing tax incentives were baked into statute, with the Low-Income Housing Tax Credit being chief among them. Since then, this important section of the tax code has enjoyed bipartisan support.”).

17. See Michael Novogradac et al., *Tax Reform and Its Consequences for Affordable Rental Housing*, 27 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 107, 108 (2018) (“The 2017 tax reform legislation . . . was responsible for the most sweeping changes to the Internal Revenue Code . . . [but], nothing in the Act directly addressed affordable housing.”).

18. STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014–2018, at 26 (2014).

19. See HUDUSER, *supra* note 9 (“An average of over 1,435 projects and 108,810 units were placed in service annually between 1995 to 2016.”). For the twenty-year period spanning 1987–2006, LIHTC-financed units constituted approximately one-third of all multifamily rental housing constructed in the United States. OFFICE OF POLICY DEV. & RESEARCH, U.S. DEP’T OF HOUS. & URBAN DEV., WHAT HAPPENS TO LOW-INCOME HOUSING TAX CREDIT PROPERTIES AT YEAR 15 AND BEYOND? xi (2012).

20. For example, coupling LIHTC financing with Section 8 assistance can help the program reach households at the lowest income levels. See O’Regan & Horn, *supra* note 14, at 609 (“The extent to which states serve households with the lowest incomes is highly correlated with the extent to which LIHTC tenants receive other rental assistance.”).

recommended dramatic overhauls to current federal subsidized housing policy,<sup>21</sup> until such approaches become politically viable, the LIHTC program, as essentially the only federal subsidized housing production program in town, is worth improving.

Of course not all agree on the best credit allocation strategy. In a 2015 United States Supreme Court case, the Inclusive Communities Project sued the Texas Department of Housing and Community Affairs for its allocation of LIHTCs.<sup>22</sup> The nonprofit community advocacy group claimed that the department had violated the federal Fair Housing Act (FHA) by disproportionately awarding credits to developments located in majority nonwhite neighborhoods, having the effect of perpetuating residential racial segregation.<sup>23</sup> The Court did not decide the merits of the underlying claim, but for the first time it endorsed the disparate impact method of proving a violation of the FHA.<sup>24</sup>

The lawsuit served as a modern incarnation of a long-standing housing policy debate: whether the government should allocate scarce housing subsidy resources to build projects in relatively lower-income central city neighborhoods, occupied disproportionately by nonwhite households, or whether such resources should be directed to relatively higher-income, predominately white suburban communities. On the one hand, an increasing body of research shows that life outcomes are improved when young children move to so-called “communities of opportunity.”<sup>25</sup> In this vein, California recently revised its LIHTC allocation methodology to incorporate detailed

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21. See, e.g., Bruce Katz & Margery Austin Turner, *Rethinking U.S. Rental Housing Policy: A New Blueprint for Federal, State, and Local Action*, in REVISITING RENTAL HOUSING: POLICIES, PROGRAMS, AND PRIORITIES 319, 342–54 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008); Peter Marcuse & W. Dennis Keating, *The Permanent Housing Crisis: The Failures of Conservatism and the Limitations of Liberalism*, in A RIGHT TO HOUSING: FOUNDATION FOR A NEW SOCIAL AGENDA 139, 139–162 (Rachel G. Bratt et al. eds., 2006).

22. Tex. Dep’t of Hous. & Cmty. Affairs v. Inclusive Cmty. Project, Inc., 135 S. Ct. 2507 (2015).

23. *Id.* at 2514.

24. *Id.* at 2525–26. Under the disparate impact method, a plaintiff need not prove discriminatory intent, but instead must establish that the challenged policy or action has a discriminatory effect on a protected class. See Michael G. Allen et al., *Assessing HUD’s Disparate Impact Rule: A Practitioner’s Perspective*, 49 HARV. C.R.-C.L. L. REV. 155, 160 (2014).

25. See, e.g., Raj Chetty et al., *The Effects of Exposure to Better Neighborhoods on Children: New Evidence from the Moving to Opportunity Experiment*, 106 AM. ECON. REV. 855, 856 (2016) (finding that moving to a lower-poverty neighborhood before the age of thirteen leads to a reduction in single parenthood rates and an increase in earnings and college attendance); see also Brief of Leo T. McCarthy Center for Public Service and the Common Good and Forty-Five Housing Scholars as Amici Curiae in Support of Defendant and Respondent City of San Jose at 40, Cal. Bldg. Indus. Ass’n v. City of San Jose, 351 P.3d 974 (2015) (No. S212072) (presenting detailed data and analysis regarding the “Geography of Opportunity”: “Most Americans readily appreciate the importance of growing up in the right neighborhood. Decades of empirical research validate these intuitions, and vividly illustrate a powerful series of relationships between family residence and an individual’s projected life chances along a number of scales. The geographically varying set of institutions, systems and markets dramatically influence a person’s achieved socioeconomic status. Together, these institutions, systems and markets constitute the ‘opportunity structure.’” (citing George Galster, *Urban Opportunity Structure and Racial/Ethnic Polarization*, in RESEARCH ON SCHOOLS, NEIGHBORHOODS AND COMMUNITIES 47, 47–66 (William F. Tate, IV ed., 2012))).

“opportunity mapping” that gives preference to projects located in areas that score well across a variety of indicators and filters.<sup>26</sup> On the other hand, many are wary of repeating past mistakes of disinvesting in low-income communities of color.<sup>27</sup>

Worthy arguments are made on both sides of this debate. Housing policy should be concerned with *both* increasing access to housing opportunities in neighborhoods that are unaffordable to low-income households, as well as investing in neighborhoods where rents are already affordable but where targeted subsidies can help spur broader neighborhood revitalization. Our housing policy should be nimble and serve a multitude of purposes depending on what local circumstances warrant. What is most important is that scarce housing incentives be deployed in a manner that serves underlying public policy goals rather than, for example, allowing private market forces to dictate locational outcomes.

Unfortunately, research discussed herein shows that our primary low-income housing production tool is not being used particularly nimbly. More than ninety percent of LIHTCs are awarded to projects located in neighborhoods where there is already a relatively high number of housing units available at similar rent levels.<sup>28</sup> In other words, the restricted rent levels required by the program are at, or not significantly below, the rents already offered by the local

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26. CAL. FAIR HOUS. TASKFORCE, REVISED OPPORTUNITY MAPPING METHODOLOGY 1–2, <http://www.treasurer.ca.gov/ctcac/opportunity/methodology.pdf> (last updated Dec. 8, 2017) (“Opportunity mapping is a tool for understanding how public and private resources are spatially distributed. ‘Opportunity,’ loosely defined, can be thought of as all of the pathways to better lives, including through health, education, and employment. Mapping these pathways involves quantifying positive or negative attributes of neighborhoods using data from multiple sources, and conveying the information in a visual format. In essence, opportunity maps are intended to display which areas, according to research, offer low-income children and adults the best chance at economic advancement, high educational attainment, and good physical and mental health. . . . The tool is intended to inform regulations related to the siting of 9% new construction, large-family LIHTC developments in California, which have historically been concentrated in low-resource and segregated areas. It is the taskforce’s intent that the mapping tool be used in conjunction with new regulations to help incentivize more housing opportunities for families to live in high-resourced neighborhoods. The taskforce intends for the application of this tool to be part of a balanced statewide policy approach that increases access for low-income families to high-resource neighborhoods where there historically have been limited affordable housing opportunities, *and* provides investments to revitalize under-resourced neighborhoods.”).

27. For detailed accounts of how prior federal housing policies and practices, like redlining, historically led to disinvestment in low-income communities of color, see generally KEVIN FOX GOTHAM, *RACE, REAL ESTATE, AND UNEVEN DEVELOPMENT: THE KANSAS CITY EXPERIENCE, 1900–2010* (2d ed. 2014); RICHARD ROTHSTEIN, *THE COLOR OF LAW: A FORGOTTEN HISTORY OF HOW OUR GOVERNMENT SEGREGATED AMERICA* (2017). Justice Kennedy’s decision in *Inclusive Communities* expressed ambivalence about subjecting states to liability for opting to invest in the urban core rather than the suburbs:

It would be paradoxical to construe the FHA to impose onerous costs on actors who encourage revitalizing dilapidated housing in our Nation’s cities merely because some other priority might seem preferable. . . . From the standpoint of determining advantage or disadvantage to racial minorities, it seems difficult to say as a general matter that a decision to build low-income housing in a blighted inner-city neighborhood instead of a suburb is discriminatory, or vice versa.

*Inclusive Cmty. Project*, 135 S. Ct. at 2523.

28. See *infra* Part II.

housing market. Current policy thus appears to skew heavily away from furthering the goal of increasing housing opportunities in neighborhoods that are presently unaffordable to low-income households.<sup>29</sup>

Why would state housing finance agencies allocate scarce affordable housing incentives in a manner that does so little to produce below-market rents? That is the question this Article seeks to answer. Through a fifty-state analysis of LIHTC allocation rules, this Article aims to evaluate the legal apparatus that results in this “misallocation problem.”

Though a federal tax credit, the LIHTC program is primarily administered by the states. Each state receives an annual per capita allocation of tax credits that it in turn awards to private real estate developers.<sup>30</sup> States are required to enact a “qualified allocation plan” (QAP) that sets forth the scoring criteria used to evaluate proposed projects submitted by developers,<sup>31</sup> and those proposals that score the highest based on the QAP criteria receive an award of tax credits.<sup>32</sup> The QAPs thus play an instrumental role in setting state allocation priorities.

Although the federal government leaves much discretion to the states regarding the content of the QAPs, the federal rules do require that developers submit a market study of the “housing needs of low-income individuals in the area to be served by the project.”<sup>33</sup> Presumably, this is the mechanism Congress envisioned would facilitate the delivery of below-market rents.

In the first comprehensive analysis of QAP market study requirements, this Article explores why the market study mechanism has failed to achieve this goal. Analysis of all fifty QAPs and their respective market study requirements shows that states vary widely with respect to the effectiveness of ensuring that tax credits are allocated to projects where the LIHTC restricted rent levels are below local market rents. In particular, the analysis shows that approximately three quarters of states fail to make the provision of below-market rents a default threshold requirement of, or even an explicit advantage in the competition for, LIHTCs. An emphasis on project financial viability—a worthy goal and an improvement over prior housing programs—has come at the expense of achieving the original policy aim: namely, ensuring a net increase in affordability. As a result, as discussed herein, locational choices often are left to the discretion of private developers who are incentivized to develop where land is cheapest.

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29. Recent research also finds that “compared with other rental units, LIHTC units are located in neighborhoods with higher poverty rates, weaker labor markets, more polluted environments, and lower performing schools.” Ingrid Gould Ellen et al., *Gateway to Opportunity? Disparities in Neighborhood Conditions Among Low-Income Housing Tax Credit Residents*, 28 HOUSING POL’Y DEBATE 572, 572 (2018).

30. I.R.C. § 42(h)(3)(C) (2012).

31. *Id.* § 42(m)(1)(A)–(B).

32. *Id.* Note that there actually are two different tax credits under the federal program: 9% and 4% credits. CAL. CODE REGS. tit. 4, § 10327(c)(2)(A)–(B) (2018). Only the 9% credits are allocated competitively. *Id.* § 10327(A)(i)–(iii).

33. I.R.C. § 42(m)(1)(A)(iii).

This Article proceeds as follows: Part I further describes the nature and scope of the misallocation problem. Part II provides a detailed analysis of the fifty state QAPs and market study requirements and presents findings regarding the legal apparatus that gives rise to the misallocation problem. Part III considers various neighborhood scenarios to demonstrate that ensuring *financial viability* alone is insufficient to guarantee that a project will further the goals of the LIHTC program. Part IV addresses obstacles to fixing the misallocation problem related to housing finance agency autonomy, federal framework limitations, land costs, and local political opposition. Finally, this Article concludes with the recommendation that states should revise their allocation rules to ensure that, as a default rule, LIHTCs are awarded to projects that offer at least a ten percent rent advantage. Exceptions to this rule in the case of a gentrifying neighborhood or a neighborhood subject to a concerted community revitalization plan are also considered.

### I. THE MISALLOCATION PROBLEM

Congress intended the LIHTC program, enacted as part of the comprehensive Tax Reform Act of 1986,<sup>34</sup> to address a “national housing crisis” consisting of a “lack of decent, affordable housing.”<sup>35</sup> The program does this by providing tax credits to housing developers who typically transfer them to investors in exchange for equity used to construct housing.<sup>36</sup> To obtain the award of tax credits, developers must agree to certain rent and income limitations that are recorded on title of the underlying property.<sup>37</sup>

Contrary to the common misperception that the LIHTC program, like public housing, is aimed at housing the poorest members of society, the program actually does not provide shelter for the lowest-income households. Rather the standard federal rules of the program require that 20% of the units in a LIHTC development be affordable to households making at or below 50% of the area median income (AMI), or that 40% of the units be affordable to households making at or below 60% of AMI.<sup>38</sup> Housing affordability is defined as households paying no more than 30% of their gross income for housing.<sup>39</sup> Given

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34. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

35. 132 CONG. REC. 14,924 (1986) (statement of Sen. Kerry).

36. For further explanation and data related to equity investment in LIHTC projects, see COHNREZNICK LLP, HOUSING TAX CREDIT INVESTMENTS: HIGH PERFORMANCE AND INCREASED NEED 28–29 (2017), [http://www.cohnreznick.com/-/media/resources/cr\\_lihte\\_sept2017.pdf](http://www.cohnreznick.com/-/media/resources/cr_lihte_sept2017.pdf).

37. For a more comprehensive description of the mechanics of the LIHTC program, see Weiss, *supra* note 15, at 534–40.

38. I.R.C. § 42(g)(1). Note that in 2018, Congress amended the LIHTC statute to allow for a third “Average Income Test.” Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, § 103, 132 Stat. 348, 131 (to be codified at I.R.C. § 42(g)). This new option allows developers to include units that are affordable to households making up to 80% of AMI in its calculation of restricted units, so long as 40% of the units are so restricted and the average of the income limitations does not exceed 60% of AMI. *Id.*

39. I.R.C. § 42(g)(2)(A). This is the standard definition used across federal housing programs. The LIHTC program is unique among federal housing subsidy programs in that program participants can continue to be rent-

that developers compete for credit allocations at the state level, often they will propose rents at levels lower than these baseline requirements to make their applications more attractive to the allocating agency. As a result, the program typically produces housing affordable to households that earn approximately 30% to 60% of AMI.<sup>40</sup> While these households earn significantly below the median income, they are not the lowest-income earners. Thus, without additional rental assistance, such as that provided by the Section 8 Housing Choice Voucher program, LIHTC housing is unaffordable to those at the very bottom of the income ladder.

Nonetheless, households in the 30% to 60% of AMI range face significant housing challenges. Kirk McClure, one of the nation's foremost experts on the LIHTC program, has found that 4,900 census tracts have a "demonstrable shortage" of units affordable to households in the 30% to 60% of AMI income range.<sup>41</sup> Given this shortage, if the LIHTC program effectively increased the housing stock available to households in the 30% to 60% of AMI range in these census tracts, the program would be achieving its goal of addressing the lack of decent, affordable housing for low-income households.

Unfortunately, this is not the case. McClure found that over a five-year period, of the 458,000 units produced by the LIHTC program, 428,000 of them were developed in census tracts that had a surplus of units affordable to households at the 30% to 60% of AMI level.<sup>42</sup> This pattern held across area type—central cities, suburbs, and non-metropolitan areas all saw more than 90% of their LIHTC units developed in tracts with a surplus of units.<sup>43</sup> McClure concluded that the data "suggest[] that the LIHTC program, despite the market analysis requirement, is largely indifferent to market need in the placement of

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burdened (spending more than 30% of gross income on housing), and even severely rent-burdened (spending 50% or more of gross income on housing). See 2017 JCHS REPORT, *supra* note 3, at 5 (providing similar definitions for cost-burdened and severely cost-burdened households). The program's rent and income limits do not prevent this. For example, a unit may qualify for the program by promising to charge residents no more than 30% of the applicable 60% AMI level as its rent limit, and by promising only to rent the apartment to households earning below 60% AMI as its income limit. Under the rules of the program, the owner could rent this apartment to a household that only earns 40% of AMI. Assuming the owner charged the maximum permissible rent (30% of 60% of AMI), the owner would be in compliance with the rules of the program, and yet the household would be paying significantly more than 30% of its actual household income on rent. As Anne Williamson and others have found, a significant number of households residing in LIHTC units, particularly those who do not receive additional rental assistance, experience rent burdens. See, e.g., Williamson, *supra* note 13, at 777. Williamson found that 91.2% of LIHTC households in Florida without additional rental assistance are rent-burdened, and that 15.0% of such households suffer from severe rent burdens. *Id.* at 791. Another study looking at eighteen states found that 70.5% of otherwise unassisted LIHTC households are rent-burdened, with 20.1% of such households suffering from severe rent burdens. See O'Regan & Horn, *supra* note 14, at 606 tbl. 5.

40. Kirk McClure, *Are Low-Income Housing Tax Credit Developments Locating Where There Is a Shortage of Affordable Units?*, 20 HOUSING POL'Y DEBATE 153, 156 (2010).

41. *Id.* at 162.

42. *Id.* at 164.

43. *Id.*

affordable units; if anything, it leans toward providing units where they are not needed.”<sup>44</sup>

McClure recently updated his data as part of testimony submitted to the United States Senate Committee on Finance in a hearing dedicated to evaluating the LIHTC program.<sup>45</sup> Based on 2015 data from the American Community Survey and 2017 data from HUD’s LIHTC database, McClure found that less than 9% of LIHTC units are located in census tracts where there is a shortage of units affordable to households with incomes in the range typically served by the program.<sup>46</sup> Even more strikingly, he found that “over one-half of all LIHTC units are in tracts with a surplus of more than 50 units. One-fourth of all LIHTC units are in tracts with a surplus of 200 or more units.”<sup>47</sup>

It must be noted that McClure’s figures may undercount the actual shortage of units *available* to households in this income range, since households with higher or lower incomes may occupy a portion of the units in this range.<sup>48</sup> This effect is likely offset to some degree by the fact that not every household in the 30% to 60% of AMI band occupies a unit of housing in this range. Further research is necessary to determine if certain census tracts deemed “surplus” tracts would be better categorized as “shortage” tracts when considering these factors.<sup>49</sup> Given the pervasiveness of McClure’s findings, however, it is unlikely that these dynamics would upset his basic conclusion that a large number of

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44. *Id.*

45. See *America’s Affordable Housing Crisis: Challenges and Solutions*, *supra* note 16, at 58–62 (prepared written statement of Kirk McClure).

46. *Id.* at 60.

47. *Id.*

48. McClure, *supra* note 40, at 162. (“[A] surplus of units does not mean that renter households in the 30 to 60% of AMFI category will find units readily available. Rather, these units are available to all renter households, and many renter households with higher levels of income choose to occupy units in this price range to lower their housing cost burden.”); see also Paul Emrath, *Comment on Kirk McClure’s “Are Low-Income Housing Tax Credit Developments Locating Where There Is a Shortage of Affordable Units?”*, 20 HOUSING POL’Y DEBATE 173, 174 (2010) (“Moreover, units being usurped by households who could afford more expensive accommodations constitute only one of the possibilities. Another is that severely cost-burdened households with incomes below 30% of AMFI occupy units that would seem more appropriate for typical LIHTC tenants . . .”). Presumably this dynamic also occurs in those tracts already deemed by McClure to have a shortage, thus further exacerbating the need in those areas.

49. Of course factors other than price also influence the ultimate “availability” of a unit, such as the likelihood of a landlord to comply with fair housing laws, to accept a Section 8 voucher, or to accept relatively low credit scores. For example, owners of LIHTC projects are barred from discriminating against tenants on the basis of their status as a recipient of Section 8 rental assistance. I.R.C. § 42(h)(6)(B)(iv) (2012). This is an additional positive way in which LIHTC projects increase access to affordable housing. However, a growing number of states and local jurisdictions have addressed this issue simply by passing laws directly banning this type of “source of income” discrimination in all rental housing. See generally POVERTY & RACE RESEARCH ACTION COUNCIL, EXPANDING CHOICE: PRACTICAL STRATEGIES FOR BUILDING A SUCCESSFUL HOUSING MOBILITY PROGRAM, <https://prrac.org/pdf/AppendixB.pdf> (last updated Sept. 14, 2018). Spending \$8 billion annually on the LIHTC program would seem an expensive way to obtain a similar policy outcome if the program is not also providing additional access to affordable housing in the form of lower rents. This Article thus is primarily focused on the issue of “availability” as it relates to price.

LIHTC projects are developed in census tracts with a surplus of similarly priced units.

Why are states channeling so many LIHTC developments into areas where there is already a surplus of housing units affordable at the same price point? In order to answer this question, it is necessary to understand the legal apparatus that facilitates the distribution of tax credits.

## II. STATE ALLOCATION RULES ANALYSIS

### A. FEDERAL FRAMEWORK & THE STATE QAP

Section 42 of the Internal Revenue Code sets forth the rules of the LIHTC program. Congress designed the program in a Reagan era dedicated to “devolution” and decentralizing traditional federal government functions to provide states and localities with greater flexibility to experiment. As a result, the federal law governing the LIHTC program provides a relatively bare bones structure, with the expectation that the states would flesh out the rules in the manner best suited to varying regional considerations.

The LIHTC authorizing statute requires that all fifty states enact a qualified allocation plan (QAP) “which sets forth selection criteria to be used to determine housing priorities of the housing credit agency which are appropriate to local conditions.”<sup>50</sup> The statute provides a basic list of ten factors that states must incorporate into the project selection criteria: (i) project location, (ii) housing needs characteristics, (iii) project characteristics,<sup>51</sup> (iv) sponsor characteristics, (v) tenant populations with special housing needs, (vi) public housing waiting lists, (vii) tenant populations of individuals with children, (viii) projects intended for eventual tenant ownership, (ix) the energy efficiency of the project, and (x) the historic nature of the project.<sup>52</sup> Scholars have noted that despite listing these factors, the statute provides no direction regarding how they should be incorporated into the selection criteria.<sup>53</sup>

In addition to these ten criteria, states must allocate at least 10% of the tax credits to projects involving nonprofit developers.<sup>54</sup> Essentially the only other guidance given to states regarding allocation priorities is that they are to give scoring preferences to projects that (a) serve the lowest-income tenants, (b) serve

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50. I.R.C. § 42(m)(1)(B)(i) (2012).

51. The only elaboration the law gives with respect to what is meant by “project characteristics” is to say, “including whether the project includes the use of existing housing as part of a community revitalization plan . . .” *Id.* § 42(m)(1)(C)(iii).

52. *Id.* § 42(m)(1)(C)(i)–(x).

53. *See, e.g.,* Roisman, *supra* note 11, at 1018 (“However, as GAO has noted, while ‘the Code specifically directs the agencies to include [originally] seven “selection criteria” in their allocation plans[,] the Code does not define these criteria or provide any guidance for their use.’ For example, the Code requires that each QAP’s selection criteria include ‘project location’ and ‘tenant populations with special housing needs,’ but does not tell an allocating agency what to do about these subjects. Moreover, the Treasury’s regulations provide no further guidance on these standards.” (second alteration in original) (footnotes omitted)).

54. I.R.C. § 42(h)(5).

qualified tenants for the longest periods of time, and (c) are located in certain high poverty “qualified census tracts . . . and the development of which contributes to a concerted community revitalization plan.”<sup>55</sup> Beyond those relatively minimal instructions, states are by and large permitted to award LIHTCs as they see fit. Furthermore, nothing in the law provides states with any guidance regarding how to prioritize these various factors and preferences.

Notably absent from the list of federal QAP requirements is anything that specifically references the degree to which the restricted rents of a proposed LIHTC project are below local area market rents. As noted above, the federal rules do require developers to submit a market study of the “housing needs of low-income individuals in the area to be served by the project.”<sup>56</sup> Presumably, Congress intended this market study mechanism to ensure that the program delivered additional affordability. However, the federal statute fails to provide any additional guidance regarding the contents of the required market study; nor does federal law require that the results of the market study be incorporated into the actual scoring criteria employed by the state.

As a result of this discretion afforded to states, QAPs exhibit significant variance in their allocation priorities, particularly with respect to their market study requirements. HUD has noted this fact and observed that it comes with certain costs.<sup>57</sup> However, to date, the nature of this variance has not been systematically studied.

#### B. FOUR VARYING STATE APPROACHES

In order to home in specifically on the legal apparatus that gives rise to the misallocation problem, between January and April 2017 I obtained the current QAP for each of the fifty states.<sup>58</sup> Some QAPs contain the market study requirements within the body of the QAP itself, while other states include them

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55. *Id.* § 42(m)(1)(B)(ii). The LIHTC statute defines a “qualified census tract” as “any census tract . . . in which 50 percent or more of the households have an income which is less than 60 percent of the area median gross income for such year or which has a poverty rate of at least 25 percent.” *Id.* § 42(d)(5)(B)(ii)(I). See *infra* Subpart IV.B for further discussion of this provision.

56. I.R.C. § 42(m)(1)(A)(iii).

57. See DAVID B. WILDERMAN, OFFICE OF MULTIFAMILY HOUS. PROGRAMS, U.S. DEP’T OF HOUS. & URBAN DEV., MARKET STUDY STANDARDS 1–2 (2011), [https://www.novoco.com/sites/default/files/atoms/files/market\\_study\\_standards\\_alignment\\_072711.pdf](https://www.novoco.com/sites/default/files/atoms/files/market_study_standards_alignment_072711.pdf) (“While some excellent model practice standards exist for market studies, there is no national standard of practice for market studies comparable to Uniform Standards of Professional Appraisal Practice (USPAP) for appraisals and no broadly acknowledged ‘keeper’ of such standards comparable to the Appraisal Foundation, which promulgates and periodically amends USPAP. . . . Among states, practice varies widely, with some States prescribing sound but unique methodologies, while others have only loosely defined standards . . . . The effects of disparate market study practice and quality can be both specific and cumulative. Specific effects include confusion, loss of time and extra expense for developers and owners who pay for market studies that may add little value to the quality of real estate decision making.”).

58. For purposes of comparison at the U.S. state level, the QAPs for the Northern Mariana Islands, Puerto Rico, the Virgin Islands, and Washington, D.C. were not included in this analysis. All studied QAPs are on file with the Author.

in separate documents. For states that fall into the latter category, I also obtained the separate market study documents during the same period.

As expected, the market study requirements vary widely. This is particularly true with respect to the way in which states integrate a comparison of local area market rents versus proposed LIHTC restricted rents into their requirements. Almost every state requires that developers seeking an award of tax credits conduct a market analysis that in some way considers the rents of housing already existing in the local area. The states vary dramatically, however, with respect to how they use the results of this analysis.

More specifically, each of the fifty states falls into one of four categories that I describe herein as follows: (1) rent differential as threshold requirement, (2) rent differential as incentive, (3) clear reference with no instrumental relationship, and (4) no clear reference to rent differential. These four categories are further described below.

### *1. Rent Differential as Threshold Requirement*

States in this category make it an explicit threshold requirement that in order to receive a LIHTC award, the proposed project must have rents that are lower than the rents of comparable unsubsidized properties in the local market area. Nine states fall into this category.<sup>59</sup>

Alabama is an example of a state in this category. The state's QAP requires a market study that "*must demonstrate that there is a rent advantage over non-subsidized housing in the defined market area.*"<sup>60</sup> Similarly, Idaho requires that the "maximum tax credit rents . . . *must be less than the market rents for comparable units in the area where the development is to be located.*"<sup>61</sup> The imperative nature of the language means that proposed projects receive an allocation of tax credits only if there is a demonstrated rent differential between market rents and the LIHTC restricted rents.

Some states in this category go further and, not only require a showing of *any* rent differential, but actually specify a certain magnitude of differential that

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59. The states are: Alabama, California, Georgia, Idaho, Iowa, Louisiana, New Jersey, South Carolina, and Wisconsin. For a general review of the QAPs of these states, see *Affordable Housing Resource Center: 2017 QAPs and Applications*, NOVOGRADAC & COMPANY LLP, <https://www.novoco.com/resource-centers/affordable-housing-tax-credits/application-allocation/qaps-and-applications/2017-qaps-and-applications> (last visited Nov. 21, 2018).

60. ALA. HOUS. FIN. AUTH., 2017 HOUSING CREDIT QUALIFIED ALLOCATION PLAN 8 (2016), [https://www.ahfa.com/Content/Uploads/ahfa.com/files/MF%20Allocation/2017%20docs/2017%20Housing%20Credit%20QAP%20Addendums\\_govapproved.pdf](https://www.ahfa.com/Content/Uploads/ahfa.com/files/MF%20Allocation/2017%20docs/2017%20Housing%20Credit%20QAP%20Addendums_govapproved.pdf) (emphasis added).

61. IDAHO HOUS. & FIN. ASS'N, LOW-INCOME HOUSING TAX CREDIT PROGRAM QUALIFIED ALLOCATION PLAN FOR THE STATE OF IDAHO 69 (2018), <https://www.idahohousing.com/documents/qap-approved-february-20-2018.pdf> (emphasis added).

must be demonstrated. For example, California,<sup>62</sup> Georgia,<sup>63</sup> Iowa,<sup>64</sup> New Jersey,<sup>65</sup> and South Carolina<sup>66</sup> all *require* a 10% differential between area market rents and proposed LIHTC rents. In other words, to receive an allocation of tax credits, a developer must show that the rents of a proposed project will be at least 10% below local area market rents.

## 2. *Rent Differential as Incentive*

States in this category do not go so far as making a showing of a rent differential a requirement of receiving an award of tax credits. However, these states directly link the showing of a rent differential to the final score assigned to a proposed project. They do this by awarding a discrete number of points to projects capable of demonstrating that such a differential exists. While not a strict prerequisite for LIHTC funding, these states nonetheless clearly incentivize the production of housing where LIHTC rents are below area market rents. Only three states—Michigan,<sup>67</sup> Montana,<sup>68</sup> and Wyoming<sup>69</sup>—fall into this category.

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62. CAL. CODE REGS. tit. 4, § 10325(f)(1)(B) (2018) (“The proposed tenant paid rents for each affordable unit type in the proposed development will be at least ten percent (10%) below the weighted average rent for the same unit types in comparable market rate rental properties . . .”).

63. GA. DEP’T. OF CMTY. AFFAIRS, 2017 STATE OF GEORGIA QUALIFIED ALLOCATION PLAN app. 1, at 15 (2017), [https://dca.ga.gov/sites/default/files/2017\\_qualified\\_allocation\\_plan.pdf](https://dca.ga.gov/sites/default/files/2017_qualified_allocation_plan.pdf) (“The minimum rent differential between the proposed rents and average market rents (as explained in the Market Study Manual) must be 10%.”).

64. IOWA FIN. AUTH., IOWA FINANCE AUTHORITY LOW-INCOME HOUSING TAX CREDIT PROGRAM 2017 9% QUALIFIED ALLOCATION PLAN 6 (2017), [https://www.novoco.com/sites/default/files/atoms/files/iowa\\_2017\\_final\\_qap\\_030117.pdf](https://www.novoco.com/sites/default/files/atoms/files/iowa_2017_final_qap_030117.pdf) (“The market study provider will be instructed to assume all LIHTC Units have a minimum ten percent (10%) market advantage for each bedroom size when evaluating comparable market rate (free market) Units in a primary market area. If the Applicant applies with proposed rents that exceed this level, the Applicant shall be required to adjust rents in the deficiency period.”).

65. N.J. HOUS. & MORTG. FIN. AGENCY, LOW INCOME HOUSING TAX CREDIT ALLOCATION PLAN 28 (2017), [http://www.nj.gov/dca/hmfa/media/download/tax/qap/tc\\_qap.pdf](http://www.nj.gov/dca/hmfa/media/download/tax/qap/tc_qap.pdf) (“The proposed rent shall have at least a 10 percent rent advantage in relation to the estimate of market rent.”).

66. S.C. STATE HOUS. FIN. & DEV. AUTH., LOW-INCOME HOUSING TAX CREDIT PROGRAM 2017 AND 2018 QUALIFIED ALLOCATION PLAN 8 (2016), <http://www.schousing.com/library/Tax%20Credit/2017/FinalQAP.pdf> (“Market Advantage: All developments must have an overall minimum market advantage of 10% to be considered for funding.”).

67. MICH. STATE HOUS. DEV. AUTH., 2017–2018 LIHTC SCORING CRITERIA (2017), [https://www.novoco.com/sites/default/files/atoms/files/michigan\\_2017-2018\\_scoring\\_summary\\_081616.pdf](https://www.novoco.com/sites/default/files/atoms/files/michigan_2017-2018_scoring_summary_081616.pdf) (“All projects in locations where the average rents of comparable market-rate rental units, based on the Primary Market Area and the comparables described in the project market study, exceed the affordable 60% AMI rent limit by 20% or more will be eligible for 5 points.”).

68. MONT. BD. OF HOUS., HOUSING CREDIT PROGRAM: 2017 QUALIFIED ALLOCATION PLAN (QAP) 37 (2017), <http://housing.mt.gov/Portals/93/shared/docs/MultifamilyDevelopment/QAP/2017QAP.pdf>.

69. WYO. CMTY. DEV. AUTH., 2016 AFFORDABLE HOUSING ALLOCATION PLAN (HOME, TAX CREDIT & TAX-EXEMPT PROGRAMS) 18 (2016), [http://www.wyomingcda.com/documents/2016\\_FINAL\\_QAP.pdf](http://www.wyomingcda.com/documents/2016_FINAL_QAP.pdf) (“Up to a negative 100 points may be assessed if the [sic] any of the proposed rents or the weighted average of the proposed rents are above market rate rents for the area.”). Note that similar language does not appear in the 2017 Wyoming QAP. WYO. CMTY. DEV. AUTH., 2017 AFFORDABLE HOUSING ALLOCATION PLAN (HOME, NHTF, TAX CREDIT & TAX-EXEMPT PROGRAMS) 26 (2017), [https://www.novoco.com/sites/default/files/atoms/files/wyoming\\_17.pdf](https://www.novoco.com/sites/default/files/atoms/files/wyoming_17.pdf).

Montana's 2017 QAP provides a clear example:

The application will be awarded points based upon the required Market Study's documentation that the Project meets the market needs of the community, as follows . . . Rents are at least 10% below adjusted market rents (20 points).<sup>70</sup>

First, the provision invites applicants to demonstrate that the rents of a proposed LIHTC project will be lower—in this case, by 10%—than area market rents. Second, the QAP directly links this showing to the final score assigned to the proposed project—in this case, by increasing the proposed project's final score by 20 points. Thus, while not as determinative as the QAP provisions in the threshold requirement category, these QAP standards do help ensure that LIHTC units only are developed in areas where there is not already a surplus of similarly priced units.

### 3. *Clear Reference with No Instrumental Relationship*

The third category—by far the largest—is like the first two in that state QAPs in this category contain a clear reference to analyzing the rents of comparable buildings in the market area. However, unlike the first two categories, QAPs in this category do not make showing a rent differential a threshold requirement of obtaining an award of tax credits, nor do they award a discrete number of points to projects that show such a rent differential exists. Rather, they leave unspecified the impact that this comparison has on whether or not a project ultimately receives an award of tax credits. Thirty-six states fall into this category.<sup>71</sup>

For example, in Rhode Island, “additional consideration will be given to projects that demonstrate that the proposed tax credit rents are below those of comparable, unassisted units in the market.”<sup>72</sup> While the state is clearly attuned to the rent differential issue, the language used in its QAP is entirely aspirational. Developers are not required to show that a rent advantage exists, nor are they awarded any discrete points for making such a showing. Rather, the QAP broadly gives “additional consideration” to projects where such a rent differential exists, without instrumentalizing this concept in any way.

Many other states require some comparison of market rents with proposed LIHTC unit rents, but do not even explicitly provide that any “additional

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70. MONT. BD. OF HOUS., *supra* note 68, at 37.

71. The states are: Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New York, North Carolina, North Dakota, Oklahoma, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, and West Virginia. For a general review of the QAPs of these states, see *Affordable Housing Resource Center: 2017 QAPs and Applications*, *supra* note 59.

72. R.I. HOUS., STATE OF RHODE ISLAND 2017–2018 QUALIFIED ALLOCATION PLAN FOR THE LOW-INCOME HOUSING TAX CREDIT PROGRAM 25 (2017), [https://www.novoco.com/sites/default/files/atoms/files/rhode\\_island\\_2017-2018\\_final\\_qap\\_2017.pdf](https://www.novoco.com/sites/default/files/atoms/files/rhode_island_2017-2018_final_qap_2017.pdf) (“Developers are *encouraged* to set rents so that the proposed rents are affordable to residents in a given location and not simply set at the program's maximum rents.” (emphasis added)).

consideration” will be given to below-market projects. Indiana requires developers seeking a LIHTC award to “[d]erive a market rent and compare it to the applicant’s proposed rent in the form of market advantage.”<sup>73</sup> Maryland requires developers to “[d]erive a market rent and an achievable rent and then compare them to the proposed rent.”<sup>74</sup> Illinois requires developers to “[p]rovide a comparison summary of the proposed development and the competing market-area rental developments.”<sup>75</sup> Kentucky requires developers to “[c]ompare the analyst-determined market rent and the proposed rent for each bedroom type. Discuss how proposed rents compare to market rents.”<sup>76</sup> None of these QAPs, however, links this comparison to a threshold requirement or to a discrete scoring incentive. It thus falls to the LIHTC allocating agency’s ad hoc discretion to determine how much, if at all, to consider the rent differential issue in making its LIHTC awards.

#### 4. *No Clear Reference to Rent Differential*

Unlike those of the prior three categories, the market study requirements of states that fall into this final category make no clear reference to showing a rent differential between market rents and proposed LIHTC rents. In accordance with the federal LIHTC statute, they do reference some analysis of market characteristics.<sup>77</sup> However, these requirements are often left broad and unspecified, in no way directly referencing the notion of whether there is an actual difference between area market rents and the proposed LIHTC-restricted rents. Only New Hampshire<sup>78</sup> and New Mexico<sup>79</sup> fall into this category.

New Hampshire’s QAP states:

Potential market demand must be proven, and the proposed project must not negatively affect an existing publicly-assisted affordable rental property. All applicants applying for LIHTC are required to submit a market study at the time of application prepared by a disinterested party (i.e. someone who does not have

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73. IND. HOUS. & CMTY. DEV. AUTH., STATE OF INDIANA 2016–2017 QUALIFIED ALLOCATION PLAN, SCHEDULE C MARKET STUDY REQUIREMENTS 10 (2016) (on file with author).

74. MD. DEP’T OF HOUS. & CMTY. DEV., MULTIFAMILY RENTAL FINANCING PROGRAM GUIDE, ATTACHMENT TO MARYLAND QUALIFIED ALLOCATION PLAN FOR THE ALLOCATION OF FEDERAL LOW INCOME HOUSING TAX CREDITS 34 (2016), [https://www.novoco.com/sites/default/files/atoms/files/maryland\\_2016\\_final\\_multifamily\\_rental\\_financing\\_guide\\_submitted\\_to\\_gov\\_080116.pdf](https://www.novoco.com/sites/default/files/atoms/files/maryland_2016_final_multifamily_rental_financing_guide_submitted_to_gov_080116.pdf).

75. ILL. HOUS. DEV. AUTH., STANDARDS FOR SITE AND MARKET STUDIES 2016–2017 QAP 10, <https://www.ihda.org/wp-content/uploads/2016/03/SPARLink9-2016-2017SiteandMarketStandards-2.pdf> (last visited Nov. 21, 2018).

76. KY. HOUS. CORP., MARKET STUDY REQUIREMENTS 10, <http://www.kyhousing.org/Development/Multifamily/Documents/MarketStudyRequirements.pdf> (last revised June 2017).

77. See I.R.C. § 42(m)(1)(A)(iii) (2012).

78. N.H. HOUS., NEW HAMPSHIRE 2017 QUALIFIED ALLOCATION PLAN FOR THE LOW INCOME HOUSING TAX CREDIT PROGRAM 4–9 (2016), [https://www.nhhfa.org/assets/pdf/2017QAP\\_052516\\_Final.pdf](https://www.nhhfa.org/assets/pdf/2017QAP_052516_Final.pdf).

79. N.M. MORTG. FIN. AUTH., STATE OF NEW MEXICO HOUSING TAX CREDIT PROGRAM QUALIFIED ALLOCATION PLAN 39 (2017), [https://www.novoco.com/sites/default/files/atoms/files/new\\_mexico\\_2017\\_final\\_qap\\_121216.pdf](https://www.novoco.com/sites/default/files/atoms/files/new_mexico_2017_final_qap_121216.pdf).

any interest in the development or have a relationship with the owner of the development) approved by the Authority.<sup>80</sup>

Developers in New Hampshire thus must prove “demand” for the proposed LIHTC housing; demand, however, is not further specified. Does it incorporate an analysis of the available subsidized and unsubsidized housing stock already available in the area? Some measure of how the combination of current supply and demand yield current market rents and how those market rents compare with the proposed LIHTC rents? Or could a developer demonstrate demand simply by showing that a certain number of low-income households reside in the area without looking at all to the existing supply side of the equation? The New Hampshire QAP does not answer these questions.

Going one step further, New Mexico’s QAP states that if a proposed tax credit project passes a certain threshold review and is a top scoring project, or if the housing finance agency otherwise deems it warranted, then the housing finance agency “*may* commission a standardized market study by outside professionals chosen pursuant to the requirements of [the housing agency’s] procurement policy and having no financial interest in any of the Projects.”<sup>81</sup> New Mexico’s QAP thus does not even make the provision of a market study an absolute prerequisite of receiving an award of tax credits.

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80. N.H. HOUS., *supra* note 78, at 4.

81. N.M. MORTG. FIN. AUTH., *supra* note 79, at 39 (emphasis added).

Categorization of States By Rent Differential Rules			
1. Threshold Requirement	2. Incentive	3. Reference / No Instrumental Relationship	4. No Reference
Alabama, California, Georgia, Idaho, Iowa, Louisiana, New Jersey, South Carolina, Wisconsin	Michigan, Montana, Wyoming	Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New York, North Carolina, North Dakota, Oklahoma, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia	New Hampshire, New Mexico

### C. MODEL STANDARDS AND THE SUPREMACY OF FINANCIAL VIABILITY

Clearly the largest cluster of states is in the third category. These are the states that require some consideration of comparable market rents to LIHTC proposed rents, but fail to directly link a showing of an explicit rent differential to a threshold requirement or to a specific scoring regime.

Given that so many states fall into this third category, it is worth closely exploring the standards used by these housing finance agencies. In 2013, the National Council of Housing Market Analysts (NCHMA) issued the Model Content Standards for Rental Housing Market Studies (“Model Standards”).<sup>82</sup> While the majority of state housing finance agencies have not explicitly adopted these standards, a number of states in the third category have integrated them into their market study requirements and many more have standards that employ

82. NAT’L COUNCIL OF HOUS. MKT. ANALYSTS, MODEL CONTENT STANDARDS FOR RENTAL HOUSING MARKET STUDIES (2013), <https://www.housingonline.com/wp-content/uploads/2014/09/Final-Model-Content-V3.0.pdf> [hereinafter MODEL STANDARDS].

similar methodologies.<sup>83</sup> The Model Standards thus serve as a helpful example of the sort of analysis employed by many of the states that fall in the third category.

Rather than focusing on establishing a rent advantage as the primary goal, the Model Standards instead take an underwriting approach to the market study. In other words, the primary goal is to determine whether a certain proposed LIHTC project will be *financially feasible*.<sup>84</sup> Market analysts are instructed to analyze a wide variety of factors in the “primary market area” in order to make this determination, including: basic characteristics of the proposed project (number of units, bedroom mix, proposed rents, income restrictions, project amenities, construction costs), location, employment and local economy, area demographics (population and household counts and characteristics, income distribution, analysis of trends, information on household rent burdens and substandard housing conditions), competitive environment (existing housing stock overview, recent construction activity, planned units in the pipeline, vacancy rates, absorption rates, identification of comparable unsubsidized and subsidized properties and comparison of rents, amenities, and features).<sup>85</sup> Analysts are further instructed to employ a number of metrics based on these factors to determine whether sufficient demand exists in the area for the proposed LIHTC development.<sup>86</sup>

As one component of the process, market analysts are instructed to “[d]erive a market rent and an achievable restricted rent and then compare them to the developer’s proposed rent” and to “[q]uantify and discuss [the] market advantage of the subject [property] and [its] impact on marketability.”<sup>87</sup> Thus, the Model Standards clearly require analysis of the rent differential issue. However, nowhere do the Model Standards indicate that market analysts must establish the existence of a rent advantage of the proposed LIHTC project over unsubsidized units in the area. Rather, NCHMA explicitly has endorsed the contrary view. The group acknowledges that a number of state allocating agencies do require that “income-restricted projects,” such as LIHTC projects,

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83. Among states in the third category, Connecticut, Kansas, Maine, Maryland, Massachusetts, North Dakota, Ohio, and Virginia all either rely exclusively on the Model Standards for their market study requirements, or use the Model Standards in conjunction with other state-specific supplementary requirements.

84. In December 2017, the National Council of State Housing Agencies (NCSHA) released a set of recommended practices in LIHTC administration. NAT’L COUNCIL OF STATE HOUS. AGENCIES, NCSHA RECOMMENDED PRACTICES IN HOUSING CREDIT ADMINISTRATION (2017), <https://www.ncsha.org/wp-content/uploads/2018/02/NCSHA-Recommended-Practices-in-Housing-Credit-Administration-Updated-Dec-2017.pdf>. Under its recommendations related to market studies, NCHSA similarly focused on financial feasibility without referencing anything related to establishing a below-market rent advantage. *See id.* at 11. (“Allocating Agencies (or contracted third-parties) should review each study to determine its implications for the *financial viability* of the property and whether it justifies the need for the number, size, and type (such as family, elderly, or other special needs housing) of rental housing proposed.” (emphasis added)).

85. MODEL STANDARDS, *supra* note 82.

86. *Id.*

87. *Id.*

should have below-market rents, often set to 10% below market.<sup>88</sup> However, the group states that in some cases such market rent advantage “may not be necessary,” and gives a list of examples where this may be true.<sup>89</sup>

When NCHMA uses the term “necessary,” it means necessary to ensure the *financial viability* of the proposed LIHTC project. This is not the same thing as being necessary to ensure the *goals of the LIHTC program*. Being financially viable means, among other things, that once completed, the proposed LIHTC project will be attractive to a critical mass of income-eligible households such that the new development will be leased up and will generate sufficient operating income to cover expenses. One might ask, isn’t the fact that a new LIHTC building leases up with income-eligible residents paying restricted rents evidence enough that the program is working, even if the LIHTC rents are no different than the rents offered by comparable unsubsidized properties? Why might such a LIHTC project that attracts enough income-eligible households not be sufficiently furthering the goals of the program?

### III. NEIGHBORHOOD SCENARIO ANALYSIS

One can imagine at least the following two scenarios in which LIHTC developments, offered at or near market rents, might attract sufficient income-eligible households so as to be financially feasible, while not necessarily furthering the purposes of the program. In each scenario, it is possible that program goals are well served, but current QAP allocation rules do not guarantee it.

#### A. SCENARIO 1: “CROWDING-OUT” MARKET RATE HOUSING

A first scenario is one in which LIHTC units simply displace units that the private market would otherwise produce. There is in fact empirical evidence supporting the notion that this occurs to some degree. Using a regression analysis, Nathaniel Baum-Snow and Justin Marion found that for every newly-constructed LIHTC unit, the number of recently constructed rental units within

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88. See Susan Burnett, *Calculating Market Rent*, NAT’L HOUSING & REHABILITATION ASS’N (Jan. 2006), <https://www.housingonline.com/councils/national-council-housing-market-analysts/resources/white-papers/calculating-market-rent/> (“A growing number of users of market studies for income-restricted projects require market analysts to determine whether a planned project’s proposed income restricted rents are sufficiently below market rents for a comparable unit. In the consideration of an income restricted project, many investors, lenders, and state allocating agencies think that the units should have below-market rents to compensate for their limited pool of potential tenants. The below market rents are expected to assure that the units can compete effectively for tenants with market rate units. Typically, lenders and investors indicate that a proposed project should have rents that are at least 10% below the rents the project could attain on the free market.”).

89. *Id.* (“Examples may include (1) a rehabilitation project that, in comparison to competing projects, will be similar in age, design, amenities, and tenant profile; (2) a new project with better amenities than any other in the primary market area, and (3) a market when there is limited supply and the restricted rates, although close to market, are affordable to the target tenant.”).

one kilometer of the project location increased by only 0.8 units.<sup>90</sup> In other words, the development of each new LIHTC unit yields only 0.8 of a unit of net gain. Other research into the displacement effects of LIHTC properties have found some evidence of even stronger crowd-out effects,<sup>91</sup> although in some cases they found that the primary impact of this effect was to push market rate development to other areas rather than displace it altogether.<sup>92</sup>

Simply displacing housing that otherwise would have been built by the private market certainly is not one of the legislative purposes of the LIHTC program. Yet the underwriting approach employed by the majority of state QAPs would facilitate this outcome. By focusing on financial feasibility, while neglecting also to require below-market rents, state housing finance agencies may be ensuring that LIHTC projects are financially viable—of course an important component of what federal subsidized housing policies should do—but without *also* ensuring that a net increase in affordability is also obtained.

However, in a gentrifying neighborhood,<sup>93</sup> substituting market-rate housing with rent-restricted LIHTC housing may in fact be serving the goals of the program, even if the rent-restricted units would be no less expensive than the market-rate units. In a gentrifying neighborhood, rents are expected to rise in the near future. Developing rent-restricted housing, even if not below market today, may deliver below-market rents *in the future* once area rents have increased. Thus, development of non-below-market LIHTC housing in gentrifying

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90. Nathaniel Baum-Snow & Justin Marion, *The Effects of Low Income Housing Tax Credit Developments on Neighborhoods*, 93 J. PUB. ECON. 654, 655 (2009).

91. Stephen Malpezzi & Kerry Vandell, *Does the Low-Income Housing Tax Credit Increase the Supply of Housing?*, 11 J. HOUSING ECON. 360, 360 (2002) (“[W]e find no significant relationship between the number of LIHTC units (and other subsidized units) built in a given state and the size of the current housing stock, suggesting a high rate of substitution,” though the authors noted certain limits to the regression model used).

92. Michael D. Eriksen & Stuart S. Rosenthal, *Crowd Out Effects of Place-Based Subsidized Rental Housing: New Evidence from the LIHTC Program*, 94 J. PUB. ECON. 953, 953 (2010) (“[N]early 100% of LIHTC development is offset by a reduction in the number of newly built unsubsidized rental units, although the confidence band around this point estimate allows for less dramatic assessments. Additional estimates suggest that LIHTC development has a much more moderate impact on construction of owner-occupied housing, but these estimates are imprecise. Overall, while LIHTC development may well affect the location of low-moderate income rental housing opportunities, our estimates suggest that the impact of the program on the number of newly developed rental housing units appears to be small.”).

93. For one of the earlier definitions of gentrification, see Peter Marcuse, *Gentrification, Abandonment, and Displacement: Connections, Causes, and Policy Responses in New York City*, 28 WASH. U. J. URB. & CONTEMP. L. 195, 198–99 (1985) (“Gentrification occurs when new residents—who disproportionately are young, white, professional, technical, and managerial workers with higher education and income levels—replace older residents—who disproportionately are low-income, working-class and poor, minority and ethnic group members, and elderly—from older and previously deteriorated inner-city housing in a spatially concentrated manner, that is, to a degree differing substantially from the general level of change in the community or region as a whole. The definition hinges on economic, social, and population changes that cause physical changes to the neighborhoods. The physical changes, however, are not the essence of the process. Furthermore, the definition distinguishes changes that may occur nationally, or on a city-wide or regional basis, from those situations where changes in certain neighborhoods are different from changes in other neighborhoods.” (footnote omitted)).

neighborhoods could serve the long-term purposes of the LIHTC program by preserving affordability in the event of future market escalation.

Baum-Snow and Marion found the crowd-out effect to be particularly pronounced in gentrifying neighborhoods, where each new LIHTC unit yielded only a 0.37 gain in total recently constructed rental units.<sup>94</sup> They conclude that there “appears to be significant crowd-out of private construction” in gentrifying areas, as “the private market would have created more than 60% of the LIHTC new construction in gentrifying areas if the program did not exist.”<sup>95</sup> If housing finance agencies engaged in this affordability preservation strategy deliberately, one could imagine a justification for allocating some LIHTCs to projects in gentrifying neighborhoods even where presently they would not be below market.

#### B. SCENARIO 2: UPGRADING HOUSING QUALITY

Another reason why a LIHTC project, offered at or near market rates, might attract enough income-eligible households so as to be financially feasible, without necessarily maximizing the goals of the program, relates to housing quality. One can imagine a scenario in which income-eligible residents of a neighborhood move from their current housing to a new LIHTC project, not because the new housing offers any additional affordability, but rather because it offers superior amenities. This is in fact one of the scenarios envisioned by NCHMA when arguing that a rent advantage is not always necessary to warrant LIHTC development—i.e., where a newly constructed LIHTC project offers “better amenities than any other in the primary market area.”<sup>96</sup>

Improving housing quality is an extremely important feature of subsidized housing programs. While it is not commonly thought of as the primary purpose of the LIHTC program,<sup>97</sup> upgrading the quality of the housing stock nonetheless is a laudable goal. Housing is a consumable good, and as it ages it must be replaced. The issue of affordability thus is inherently linked to the issue of housing quality—as supply deteriorates over time, upward pressure is exerted on the rents of the remaining stock.

However, given the housing quality standards of the LIHTC program, any new unit that is developed, wherever located, will be of good quality.<sup>98</sup> A random geographic allocation of LIHTCs would improve housing quality options for low-income households. The question is not whether or not the program will improve housing quality options for low-income residents. The

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94. Baum-Snow & Marion, *supra* note 90, at 655.

95. *Id.* at 655, 665.

96. Burnett, *supra* note 88.

97. See Williamson, *supra* note 13, at 777 (“While the provision of better-quality housing and housing located in low-poverty areas are also important U.S. housing policy goals, the issue of housing affordability is arguably the strongest reason for public intervention in private housing markets in recent decades.”).

98. See 26 C.F.R. § 1.42-5 (2018) (describing the regular physical inspections of LIHTC projects required to be conducted by housing finance agencies).

question is where to locate the high quality housing generated by the program. Presumably, the answer is that it should be located where it does the most to further the other goals of the allocating agency—be they, for example, increasing access to “communities of opportunity”<sup>99</sup> or revitalizing declining neighborhoods. Yet, the fact that the housing is occupied and financially viable tells us nothing with respect to how well the program is meeting other agency goals.

The development of a LIHTC project that is of high quality certainly can help spur broader neighborhood revitalization efforts. Indeed, as discussed at greater length in Subpart IV.B, the federal LIHTC statute actually contains a preference for certain projects that “contribute[] to a concerted community revitalization plan.”<sup>100</sup> Subsidized housing developments deliver far more than just quality shelter to individual households; they also can have a number of positive spillover effects in a community. For example, LIHTC projects have been found to increase property values in declining neighborhoods.<sup>101</sup> Thus, if an agency deploys credits as part of a broader revitalization plan, there may be an argument that the allocation is warranted even if not offering below-market rents.

#### C. THE INADEQUACY OF FINANCIAL VIABILITY TO GUARANTEE PROGRAMMATIC SUCCESS

The above scenarios demonstrate that the mere conclusion that a project is financially feasible does not guarantee that the project is well serving the goals of the LIHTC program. In Scenario 1 (Market Crowd Out), feasibility stems from the fact that there is sufficient demand for housing at a price that the private market would deliver on its own without the deployment of scarce housing subsidy resources. In such cases, the LIHTC program is not increasing affordability beyond what would be offered by the private market. In Scenario 2 (Housing Quality Upgrade), project feasibility results from the fact that the LIHTC program has improved the quality of housing options available to low-income households—clearly a desired outcome—but one that would be attained regardless of *where* the housing is located. Feasibility does not ensure that the locational decisions of the allocating agency maximize the other goals of the program.

At the same time, these scenarios also demonstrate that in some cases, there may be a strong rationale for building LIHTC projects even when they do not offer below-market rents. In a gentrifying neighborhood, LIHTC financing can serve as a mechanism to preserve affordability in the face of anticipated future market rent hikes. In declining neighborhoods, LIHTC projects can serve as an important stimulus tool when contributing to a concerted revitalization effort.

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99. See Chetty et al., *supra* note 25 and accompanying text.

100. I.R.C. § 42(m)(1)(B)(ii)(III) (2012).

101. See Baum-Snow & Marion, *supra* note 90, at 663.

Yet unfortunately current LIHTC allocating practices permit the allocation of credits to projects that neither deliver below-market rents, nor serve these other policy goals. Market study requirements that focus primarily on whether a building will be financially viable do not disaggregate these scenarios, or any other scenarios in which tenants may choose to occupy a new LIHTC project. This point is a critical step in understanding what I have described above as the “misallocation problem.” A central reason why housing finance agencies award scarce tax credits disproportionately to projects located in census tracts where there is already a surplus of units at similar rent levels is because the QAPs and market study requirements do not make provision of below-market rents a priority. Nor do they effectively prioritize other programmatic goals. Rather, they place primary importance on ensuring that a project will be financially viable. *These concepts are not equivalent.* As a result, as discussed below in Part IV, locational outcomes are by default left to the discretion of private developers often motivated to develop where land is cheapest.

#### IV. OBSTACLES TO ADDRESSING THE MISALLOCATION PROBLEM

This Article began with a simple question: why would states overwhelmingly direct scarce housing production incentives to areas where there is already a surplus of housing available at similar rent levels? Below, I consider four obstacles a state might encounter in trying to address this misallocation problem related to: 1) lack of agency autonomy, 2) federal framework limitations, 3) land costs, and 4) local political opposition.

##### A. LACK OF AGENCY AUTONOMY

The LIHTC program is a federally allocated tax credit administered by the fifty states. Yet, as described above, in many ways the program actually is implemented in a diffuse manner by the decisions of thousands of private real estate developers. Private developers, after all, are the parties who conceive of a project, draw up the plans, organize the necessary layers of financing and, most critically, select the site on which a project will be built. The state housing finance agency (HFA), it could be argued, plays somewhat of a passive role. The agency receives an application for tax credits, evaluates the proposal, and awards the incentives to the top scoring projects. Thus, a state HFA lacks the autonomy to directly dictate where projects are located.

This sort of argument proved persuasive to the district court in the *Inclusive Communities* case referenced in the Introduction.<sup>102</sup> As noted above, the plaintiffs in that case argued that the Texas Department of Housing and Community Affairs had violated the federal Fair Housing Act by disproportionately awarding LIHTCs to developments located in majority nonwhite neighborhoods, thus furthering residential racial segregation in the area. The United States Supreme Court upheld the disparate impact theory of

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102. See *Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmty. Project, Inc.*, 135 S. Ct. 2507 (2015).

liability under the FHA in general, but remanded the case to the district court to determine whether the plaintiffs had proven their disparate impact claim in this particular instance. Justice Kennedy’s opinion emphasized the importance of establishing “robust” causality between the challenged policy or practice and the alleged disparate impact.<sup>103</sup> On remand, the district court dismissed the case for, among other reasons, failure by the plaintiffs to establish the requisite causality. The court stated that the plaintiffs had failed to show that “local zoning rules, community preferences, or *developers’ choices* did not contribute to the statistical disparity.”<sup>104</sup> In other words, you cannot blame the housing department for locational outcomes that, at least in part, were caused by the decisions of private developers.

While it is no doubt true that states may not directly dictate the location of LIHTC developments, they can play a heavily influential role. States have significant leverage in the ability to determine the priorities set forth in the qualified allocation plans (QAPs) used to score proposed LIHTC developments. Some research has shown that developer choices are sensitive to QAP incentives.<sup>105</sup> Given the QAP analysis contained herein, however, it appears that states are not effectively using this leverage to influence the locational choices of developers. Nothing would prevent all fifty states from following the lead of the nine states in the “Rent Differential as Threshold Requirement” category described above,<sup>106</sup> and requiring that projects be located in neighborhoods where there is an established rent advantage—commonly ten percent—of the LIHTC project as compared to area market rents.<sup>107</sup> Alternatively, nothing would prevent a state from following the lead of the three states in the “Rent Differential as Incentive” category described above,<sup>108</sup> and providing an explicit scoring boost to any project that demonstrates a substantial rent advantage. Despite the fact that state housing agencies do not on a project-by-project basis determine where a development is located, they could steer these outcomes

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103. *Id.* at 2523–24.

104. *Inclusive Cmty. Project, Inc. v. Tex. Dep’t of Hous. & Cmty. Affairs*, No. 3:08-CV-0546-D, 2016 WL 4494322, at \*9 (N.D. Tex. Aug. 26, 2016) (emphasis added).

105. *See infra* notes 113–114, 121 and accompanying text; *see also* Ingrid Gould Ellen & Keren Mertens Horn, *Points for Place: Can State Governments Shape Siting Patterns of Low-Income Housing Tax Credit Developments*, 28 HOUSING POL’Y DEBATE 727, 740 (2018) (“[W]e think our results suggest that allocation plans matter. We find statistically significant relationships between changes in state allocation plans and the locations of privately owned housing developments allocated tax credits, despite our small sample size. In general, states that increased the priority given to developments in higher opportunity areas in their allocation plans saw increases in the share of tax credits allocated for projects in low-poverty areas and decreases in the share of tax credits allocated for projects in largely minority areas.”).

106. *See supra* Subpart II.B.1.

107. Additional research has shown that QAPs fail to use their leverage in other ways that might be beneficial with respect to locational outcomes. For example, one study of thirty-six QAPs found that only twelve of them contained any preference for locating in “high-opportunity” neighborhoods. JILL KHADDURI, POVERTY & RACE RESEARCH ACTION COUNCIL, *CREATING BALANCE IN THE LOCATIONS OF LIHTC DEVELOPMENTS: THE ROLE OF QUALIFIED ALLOCATION PLANS* 15 (2013).

108. *See supra* Subpart II.B.2.

much more effectively by increasing strategic location-related incentives to influence the decisions of private developers.

#### B. FEDERAL FRAMEWORK LIMITATIONS

Another potential challenge to addressing the misallocation problem relates to the federal LIHTC statute.<sup>109</sup> As mentioned above, among the few directions the statute provides related to state QAPs is the requirement that states give preference to projects that are located in “qualified census tracts . . . and the development of which contributes to a concerted community revitalization plan.”<sup>110</sup> A qualified census tract (QCT) is defined as “any census tract . . . in which 50 percent or more of the households have an income which is less than 60 percent of the area median gross income for such year or which has a poverty rate of at least 25 percent.”<sup>111</sup> There is no legislative history with respect to the original QCT feature of the LIHTC statute, nor has recent HUD guidance on the mechanics of the QCT requirement expressed any policy objectives.<sup>112</sup> The LIHTC statute provides a significant positive multiplier in the calculation used to determine how many tax credits projects located in QCTs are awarded.<sup>113</sup> Thus, the federal rules inherently incentivize the development of LIHTC projects in neighborhoods where incomes are below the area median. Assuming typical market dynamics, these neighborhoods are likely to be those where rents are similarly below area median rents. As a result, it might be argued that the federal framework contains structural features that promote LIHTC development in those neighborhoods where they are least needed: namely, those where LIHTC restricted rent levels are likely to be comparable to market rents.

Research shows, however, that the effect of the federal QCT rules may be modest with regards to agency decisions concerning the allocation of tax credits. McClure finds that only about a third of LIHTC projects are developed in QCTs.<sup>114</sup> Baum-Snow and Marion find that census tracts just above the minimum requirements to qualify as a QCT do receive significantly more LIHTC units than those census tracts which fall just short of the minimum requirements.<sup>115</sup> However, the “response of LIHTC units to QCT status seems driven by developers’ location choices rather than government preferences, as . . . the discontinuity in units at the threshold is driven by the number of applications by developers rather than state housing authorities’ acceptance rate

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109. See I.R.C. § 42 (2012).

110. *Id.* § 42(m)(1)(B)(ii)(III).

111. *Id.* § 42(d)(5)(B)(ii)(I).

112. See KHADDURI, *supra* note 107, at 10 nn.15–16.

113. I.R.C. § 42(d)(5)(B)(i) (“In the case of any building located in a qualified census tract . . . in the case of a new building, the eligible basis of such building shall be 130 percent of such basis determined without regard to this subparagraph, and . . . in the case of an existing building, the rehabilitation expenditures . . . shall be 130 percent of such expenditures determined without regard to this subparagraph.”).

114. McClure, *supra* note 40, at 165 (finding that over the studied time period, of the 458,516 LIHTC units developed, only 151,083 were in QCTs).

115. Baum-Snow & Marion, *supra* note 90, at 655.

of proposed projects.”<sup>116</sup> In other words, the QCT rules do seem to influence *developer* decisions, but not *state housing agency* decisions.

Why do the QCT rules seemingly not influence state housing agency decisions? This is likely because the federal statute provides no guidance regarding how to implement the QCT preference.<sup>117</sup> Thus, states are free to implement the preference as they see fit. As such, wide variance exists. Recall that the statute requires a preference for projects in QCTs that “contribute[] to a concerted community revitalization plan.”<sup>118</sup> Yet one study of QAPs found that most states “simply ignore” the community revitalization plan language and that not a single state limits eligibility for the QCT multiplier to projects that contribute to such a revitalization plan.<sup>119</sup> At least one federal district court has dismissed the QCT language in the LIHTC statute as being too “vague and amorphous to create judicially enforceable rights under § 1983.”<sup>120</sup> Many states do “provide some competitive points” to projects in QCTs.<sup>121</sup> However, the relative magnitude of the preference is completely within the discretion of the state agency to determine.

While some have criticized the lack of specificity in the LIHTC statute,<sup>122</sup> the discretion afforded to states with respect to the QCT preference may in fact be a virtue. In implementing their QAPs, states are not bound by a particularly restrictive federal framework. They are not required to give any preference to QCT projects that do not contribute to a concerted revitalization plan. States also can use their discretion as they see fit, for example, awarding a relatively small preference to projects located in QCTs, and a relatively large preference to projects that establish a significant rent advantage as compared to area market rents. The fact that private developers disproportionately propose LIHTC projects in QCTs may be evidence that developers indeed are sensitive to program incentives.<sup>123</sup> The federal framework does not bind the hands of states

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116. *Id.*

117. See OFFICE OF POLICY DEV. & RESEARCH, U.S. DEP’T OF HOUS. & URBAN DEV., EFFECT OF QAP INCENTIVES ON THE LOCATION OF LIHTC PROPERTIES 3 (2015) (“[W]hile the federal statute requires that states give ‘preference’ to projects that are located in QCTs subject to a community revitalization plan, it provides no specific guidance on what constitutes such a plan. Some states provide a point bonus while others use set-asides to prioritize development in QCTs.” (footnote omitted)).

118. I.R.C. § 42(m)(1)(B)(ii)(III).

119. See KHADDURI, *supra* note 107, at 10–11; see also SARAH OPPENHEIMER, POVERTY & RACE RESEARCH ACTION COUNCIL, BUILDING OPPORTUNITY II: CIVIL RIGHTS BEST PRACTICES IN THE LOW INCOME HOUSING TAX CREDIT PROGRAM 7 (2015) (“Although nearly half of the QAPs include point systems that favor developments in Qualified Census Tracts (QCTs) if they contribute to a ‘concerted community revitalization plan,’ fewer (15) provide more explicit details on what this term in the LIHTC statute means, or what should be included in such a plan.”).

120. Myron Orfield, *Racial Integration and Community Revitalization: Applying the Fair Housing Act to the Low Income Housing Tax Credit*, 58 VAND. L. REV. 1747, 1793 (2005) (quoting *DeHarder Inv. Corp. v. Ind. Hous. Fin. Auth.*, 909 F. Supp. 606, 615 (S.D. Ind. 1995)).

121. See KHADDURI, *supra* note 107, at 11.

122. See Roisman, *supra* note 11, at 1018.

123. See Baum-Snow & Marion, *supra* note 90, at 655 (“We find that developers’ location choices respond strongly to the tax credit incentives.”); see also McClure, *supra* note 40, at 166 (“However, it does suggest that

from shifting the priorities in their QAPs to incentivize developers to make different locational decisions.

### C. LAND COSTS

Another obstacle to addressing the misallocation problem concerns the cost of land. States might argue that no matter how they set priorities in their QAP, private developers will not build projects in locations where high land acquisition costs make development financially unattractive. The federal LIHTC program does not subsidize the cost of acquiring land.<sup>124</sup> Developers thus must find other sources to cover these costs. The primary financial benefit to developers in most LIHTC projects is a large developer fee that program rules authorize them to take as compensation for developing the project.<sup>125</sup> The size of the developer fee is not directly tied to the amount of money expended on land acquisition. The economics of a typical LIHTC deal, therefore, are such that developers are incentivized to keep land acquisition costs low.

Where are land costs likely to be low? The answer of course is in neighborhoods that already have low rents. The basic economics of a LIHTC deal thus contribute to the misallocation problem. Developers propose projects where LIHTC rents are not much different from area market rents because this maximizes the value of the deal. States can change their QAPs to prioritize development elsewhere, but if this makes LIHTC deals financially unattractive, developers will not be incentivized to build.

To say that a project developed in a high land cost neighborhood may be less attractive to developers however is not to say that it will be so unattractive as to prevent development. Demand for low-income housing tax credits among developers is extremely strong. In one study by a leading tax credit accounting firm, the firm found that demand for low-income housing tax credits outstripped supply in every state.<sup>126</sup> In some cases, the oversubscription rate is as high as 5-to-1—meaning that the state received applications for five times the amount of tax credits that are available.<sup>127</sup> Note that this likely *undercounts* the true level of demand since it only registers the demand of developers who actually submit

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the boost in subsidy provided through the QCT process can have a positive influence on the location of investments. Possibly this positive influence could be better directed if it was tied to the presence of market need (demand in excess of supply) rather than the presence of poverty independent of the scale of the supply of affordable housing.”).

124. See I.R.C. § 42, Low-Income Housing Credit, at 306 (2015), [https://www.irs.gov/pub/irs-utl/IRC\\_42.pdf](https://www.irs.gov/pub/irs-utl/IRC_42.pdf) (“Expenses related to acquiring the land are excluded from eligible basis.”) (last revised Aug. 11, 2015).

125. As an example, developer fees in California for LIHTC projects are capped at \$2 million for 9% projects. CAL. CODE REGS. tit. 4, § 10327(c)(2)(A) (2018). 4% projects are capped at \$2.5 million. *Id.* § 10327(c)(2)(B).

126. Michael Novogradac, *In Demand: Allocation Ratios Show Strong Interest in LIHTCs*, NOVogradac & COMPANY LLP (Mar. 3, 2014, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/demand-allocation-ratios-show-strong-interest-lihtcs>.

127. *Id.*

applications.<sup>128</sup> Many others may refrain from expending the cost of preparing a LIHTC proposal given the high level of competitiveness.<sup>129</sup>

There is thus room to test developer sensitivity to shifting program rules. Perhaps requiring that developers build in areas where land costs are higher may in fact reduce some of the profitability of the program for developers. And perhaps in certain cases this is a virtue rather than a vice—redirecting some private profit into public value captured in the form of affordable rental housing where it is actually needed to increase affordability. Until the LIHTC program is no longer significantly oversubscribed, states should experiment with program rules to obtain better locational outcomes.

However, in certain states with relatively lower oversubscription rates, and/or in census tracts with particularly high land costs, it may be the case that LIHTC development simply is not financially attractive to developers. Under such conditions, the costs of land pose a formidable challenge to development. In such cases, if development is desirable as a public policy, government may need to help bear the increased costs. State and local governments already heavily subsidize land acquisition costs. It is not uncommon for a local government to provide the entire amount of upfront capital needed for land acquisition in the form of a significantly below-market long-term loan, often with the implicit assumption that the loan will be forgiven at the end of the loan term.<sup>130</sup> In some cases, a governmental entity already owns land, perhaps having acquired it through the use of eminent domain, and dedicates the land to the development of affordable housing. There is thus significant precedent for state and local government involvement in overcoming land acquisition barriers for LIHTC projects.

In order to reduce the burden this would add to state and local government budgets, some states have already begun experimenting with innovative initiatives. For example, Massachusetts recently passed a program, modeled on similar programs in Illinois and Missouri, called the Donation Tax Credit (DTC).<sup>131</sup> The DTC provides tax credits to owners who donate properties to qualified nonprofits for use as long-term affordable housing.<sup>132</sup> The tax credit is worth 50% of the value of the donated property.<sup>133</sup> The program is intended to leverage the value of the federal charitable tax deduction, which, on its own, is often insufficient to incentivize land donation. Coupling the federal charitable deduction with the state DTC, however, provides property owners with a strong incentive to donate land, while allowing the state to share the burden of foregone tax revenue with the federal government. Since 2001, the Illinois version of the

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128. *Id.*

129. *Id.*

130. See Weiss, *supra* note 15, at 538.

131. Andrew Spofford, *The Donation Tax Credit—a New Affordable Housing Tool for Massachusetts*, NOVOGRADAC & COMPANY LLP (Sept. 7, 2016), <https://www.novoco.com/periodicals/articles/donation-tax-credit-new-affordable-housing-tool-massachusetts>.

132. *Id.*

133. *Id.*

program has enabled the creation or preservation of approximately 18,000 affordable housing units.<sup>134</sup>

The DTC and federal charitable exemption can thus work as complementary programs to the LIHTC program—with the DTC and federal charitable exemption helping to subsidize land acquisition costs and the LIHTC program helping to subsidize development costs. Other states could adopt similar programs, while experimenting with the specific provisions. For example, perhaps the size of a donation tax credit could be reduced—maybe a 30% state tax credit, coupled with the federal charitable deduction, would be sufficient to induce land donation from parties already somewhat motivated to dedicate their land to a public purpose. While of course the introduction of a new state tax credit is not revenue neutral, higher costs or less total units produced may be the price necessary to allow the LIHTC program to meet the goal of providing access to otherwise unaffordable neighborhoods.

#### D. LOCAL POLITICAL OPPOSITION

Assuming state HFA autonomy concerns, federal framework limitations, and land cost barriers could all be overcome, states might encounter a final barrier to addressing the misallocation problem: namely, local political opposition. Not In My Back Yard (NIMBY) is now a well-known phenomenon.<sup>135</sup> The political opposition of neighborhoods with relatively higher market rents no doubt contributes to the misallocation problem, as developers select projects that are less likely to encounter extended and costly entitlement battles.

Part of this opposition stems from a lack of information. Modern LIHTC development is not the subsidized housing of decades past. Rather, a modern LIHTC project typically bears little resemblance to the popularly ingrained images of a Cabrini Green or Pruitt-Igoe-style public housing project.<sup>136</sup> LIHTC developments are regularly low-density, well-designed projects that blend in with modern market rate development. Nor have LIHTC projects been found to lead to an increase in crime, even when located in higher-income neighborhoods.<sup>137</sup>

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134. *Id.*

135. See, e.g., Michael B. Gerrard, *The Victims of NIMBY*, 21 *FORDHAM URB. L.J.* 495, 499–500 (1994) (“Local opposition to low-income housing often focuses on efforts to pressure local governments to use their zoning and land use powers to exclude such units. In accommodation of such pressure, many municipalities have adopted a variety of techniques: requirements for large building lots; restrictions on the ability to subdivide property into smaller lots; restrictions on new hookups to sewers, drinking water lines, and other utilities; exactions (such as fees to reimburse the municipality for the development’s impacts on parks, schools, or other public facilities); expensive construction and design standards; construction moratoria; and zoning that prohibits multi-family dwellings.”).

136. For a description of the stereotypical perception of public housing, see Alexander Hoffman, *High-Rise Hellholes*, *AM. PROSPECT* (Dec. 19, 2001), <http://prospect.org/article/high-rise-hellholes>.

137. Rebecca Diamond & Timothy McQuade, *Who Wants Affordable Housing in Their Backyard? An Equilibrium Analysis of Low Income Property Development* 20 (Stanford Graduate School of Business, Working Paper No. 3329, 2017), [https://web.stanford.edu/~diamondr/LIHTC\\_spillovers.pdf](https://web.stanford.edu/~diamondr/LIHTC_spillovers.pdf).

These facts notwithstanding, research shows that higher-income white households have a negative preference for proximity to LIHTC developments.<sup>138</sup> According to a study by Rebecca Diamond and Tim McQuade, in neighborhoods with median incomes above \$54,000 and where the nonwhite population is below 50%, LIHTC construction leads to housing price declines of roughly 2.5% within 0.1 miles of the LIHTC project.<sup>139</sup> The authors state, “Such results suggest that white households may have a preference for neighborhood homogeneity, which interacts with how they view the amenities/disamenities provided by LIHTC construction.”<sup>140</sup>

Federal fair housing laws exist to counteract this “preference for neighborhood homogeneity.” Not all purported individual preferences are viewed the same in the eyes of the law. State and local governments that receive federal financial assistance have a duty to affirmatively further fair housing.<sup>141</sup> As such, state governments should ensure that NIMBYism does not prevent otherwise worthy LIHTC projects from being developed in locations where they would serve the purpose of increasing affordability.

State governments have already experimented with measures aimed at curbing local political opposition to affordable housing. For decades in Massachusetts, state law known as Chapter 40B has allowed a developer of an affordable housing project that is denied approval by the local zoning board to appeal directly to a state appeals committee.<sup>142</sup> In September 2017, California enacted SB 35, a state law that establishes a “streamlined, ministerial approval process” for proposed multifamily housing developments in localities that are failing to meet state-mandated housing production targets. The law explicitly prohibits local regulatory discrimination against projects on the basis of their receipt of “public investment in housing affordability.”<sup>143</sup> Other states would be wise to follow suit.

#### CONCLUSION

Despite record levels of wealth and relatively steady growth in per capita real gross domestic product for decades,<sup>144</sup> the United States continues to

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138. *Id.* at 31, 35.

139. *Id.* at 2.

140. *Id.* at 35.

141. See 42 U.S.C. § 3608(d) (2012); 24 C.F.R. §§ 5.150–58, 91, 92, 570, 574, 576, 903 (2018).

142. MASS. GEN. LAWS ch. 40B, § 22 (2018) (“Whenever an application filed under the provisions of section twenty-one is denied, or is granted with such conditions and requirements as to make the building or operation of such housing uneconomic, the applicant shall have the right to appeal to the housing appeals committee in the department of community affairs for a review of the same.”).

143. See S.B. 35, 2017 Leg., Reg. Sess. (Cal. 2017).

144. See Kerry Close, *Americans’ Total Wealth Reaches Record High*, TIME (June 9, 2016), <http://time.com/money/4363471/americans-total-wealth-record-high/> (reporting that in the first quarter of 2016, total U.S. wealth reached a record high of \$88.1 trillion); FED. RESERVE BANK OF ST. LOUIS, FRED ECONOMIC DATA: REAL GROSS DOMESTIC PRODUCT PER CAPITA (2018), <https://fred.stlouisfed.org/series/A939RX0Q048SBEA> (last updated Oct. 26, 2018) (charting the steadily increasing U.S. per capita real GDP from 1950 to 2018).

struggle with the persistent problem that a significant portion of its population is unable to afford decent housing. The LIHTC program is the primary, and essentially only, federal program aimed at subsidizing the development of new housing for low-income households. Yet states appear to be allocating much of this \$8-billion-dollar annual incentive with a lack of precision regarding locational outcomes.

Approximately three quarters of states do not make it a threshold requirement or even an explicit scoring advantage in the competition for LIHTCs that a proposed project offer rents that are below local market rents. Rather, the majority of these states focus in large measure on ensuring that a proposed project will be financially feasible—a necessary but insufficient factor in determining whether a proposed project will successfully serve the goals of the program. Financial feasibility may indicate that the project is increasing affordable housing opportunities; or it may indicate that a LIHTC project is merely crowding out housing that the private market otherwise would have provided or increasing housing quality without optimizing any other programmatic goals.

As such, states should do a better job of ensuring that their QAP rules for allocating tax credits are calibrated to achieving the purposes of the program. Specifically, as a default, all states should follow the lead of the handful of states that already make it a threshold requirement of receiving a LIHTC award to prove that a proposed project will offer rents that are at least ten percent below area market rents.

There may be certain scenarios in which this default requirement can be overridden—I can foresee two. First, the default could be overridden where a developer can make a convincing case that a proposed project is located in a gentrifying neighborhood with rents likely to escalate rapidly in the near future. In such a neighborhood, while not offering a rent advantage immediately, the rent-restricted LIHTC housing will serve to preserve housing affordability that otherwise would be lost as market rents rise. Second, the default could be overridden where a project is located in a neighborhood with a robust neighborhood revitalization plan in place. In such a neighborhood, the positive spillover effects of a LIHTC project as a vehicle to further revitalization efforts could warrant development even where no significant rent advantage exists. Setting a ten percent advantage as the default rule however would orient state HFAs in a manner that ensures below-market rents are obtained barring a compelling reason to the contrary. This would be a far different regime than the current prevailing one in which tax credits can be awarded to projects that do not offer a rent advantage, are not located in a gentrifying neighborhood, and do not contribute to a concerted neighborhood revitalization plan.

States no doubt will encounter obstacles to addressing the misallocation problem. States lack the autonomy to propose the location of new LIHTC projects and must simply select among the best private developer proposals. The federal QCT rules require a state preference for projects located in relatively

low-income areas. Land costs likely are to be higher and NIMBY sentiments stronger in many areas where LIHTC projects would offer a rent advantage.

Yet, states have a number of options at their disposal that they should use to overcome such obstacles. They hold significant leverage over private developers in their ability to set strategic QAP priorities and developer decisions appear to be sensitive to those priorities. Federal rules are vague and allow significant discretion in setting the relative priority of preferences. The competition for LIHTCs is high, affording room to test developer sensitivity to rule changes that may increase land costs; and where such experiments fail, the government should step in with innovative programs to subsidize the cost of land, even if the price to pay for an effective program is higher costs or less total output. Additionally, the misperceptions of neighbors about what a modern subsidized housing project looks like based on dated stereotypes, or the preferences of local neighbors for racial homogeneity, are exactly what our federal and state fair housing laws are aimed to address. State governments, in living up to their duty to affirmatively further fair housing, should consider state-level appeals and streamlined approval processes for affordable housing projects that face unwarranted neighborhood opposition.

All of these measures—a ten percent default rent advantage with limited exceptions, strategic prioritizing of QAP preferences, innovative land acquisition assistance programs, state-level appeals and streamlined approval processes—together can help to ensure that our federal subsidized housing policy meets its goal of increasing affordable housing for low-income households by incentivizing development where it is actually most needed.

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