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LOW INCOME HOUSING
AND TAX REFORM:
A POTENTIAL CRISIS

BY

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LOW INCOME HOUSING AND TAX REFORM:
A POTENTIAL CRISIS

by

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LOW INCOME HOUSING AND TAX REFORM:

A POTENTIAL CRISIS

ABSTRACT

The President's tax proposal (PTP) includes a number of provisions which are likely to adversely impact the supply of low income housing. Recent studies have concluded that the implementation of these proposals will result in a decline in the supply of multi-family housing and significantly increase rents. Low income housing will be impacted more than more expensive housing.

The objective of this paper is to suggest that the real issue is whether to stimulate low income housing by tax preferences or by alternative means such as direct subsidies. The history of tax preferences for real estate indicates that Congress has opted for tax preferences as an incentive to the supply of low income housing. A review of the tax provisions in PTP indicates a major change in philosophy, as incentives for low income housing are removed from the Internal Revenue Code.

The potential results of the tax changes on multi-family housing are analyzed. The recent studies on the possible impact of the provisions on rents are examined. The issue of tax preferences versus alternative stimuli for low income housing is examined in the final section.

Until Congress debates this issue, tax incentives for low income housing should be retained.

LOW INCOME HOUSING AND TAX REFORM: A POTENTIAL CRISIS

INTRODUCTION

The President's tax proposal (PTP) has important consequences for the development of low income housing. Historically Congress has intentionally used tax preferences to stimulate low income housing. Some of these preferences relate to real estate in general. Others are targeted specifically to low income housing. PTP changes policy and removes these preferences.

The objective of this paper is to suggest that the real issue is whether to stimulate low income housing by tax preferences or by alternative means such as direct subsidies. This is the issue that should be carefully studied and debated. Potential market adjustments resulting from PTP need to be carefully examined before Congress reverses its use of tax preferences for low income housing.

Several studies reviewed herein suggest significant increases in rents for real estate in general and disincentives for the development of low income housing in particular.

The history of tax preferences for real estate is reviewed in Section II and indicates Congress has opted for tax preferences as a stimulation to low income housing. In Section III the changes in relevant provisions in tax preferences are reviewed. The potential impact of PTP on multifamily housing is examined in Section IV. The issue of tax preferences versus subsidy is considered in Section V.

II. EVOLUTION OF REAL ESTATE TAX SHELTERS

Tax advantages to real estate and in particular to low income housing result from the deliberate action by Congress to provide stimulus to real estate as well as an attempt to stimulate the economy in general. Advantages have been modified by I.R.S. regulations, subsequent tax acts and court decisions.

A number of important ideas are indicated by a review of the history of these provisions. Congress has considered real estate favorably in the tax code and particularly housing, with low income housing receiving the largest tax preferences.

The relative advantages of low income housing, residential housing, and commercial and industrial real estate have often changed. The advantage of real estate relative to other forms of investment has also changed as Congress has struggled with the dual objectives of stimulating the economy and avoiding abuses in the tax code.

Two major tax acts which stimulated real estate were mainly the result of the objective of stimulating purchase of machinery and equipment rather than a stated objective of stimulating real estate. Accelerated depreciation was allowed for buildings in the Internal Revenue Code of 1954. This went along with the allowance of accelerated depreciation for machinery and equipment. In 1981 the Economic Recovery Tax Act (ERTA) drastically shortened depreciation lives with the primary objective of stimulating the economy. Real estate also received these advantages.

The Tax Reform Act of 1969 was important in that it scaled back many benefits for real estate but added an important incentive to low income rehabilitation housing. Accelerated depreciation for commercial real property and used residential rental property was reduced. This gave a relative advantage to new residential over other forms of real estate investment such as shopping centers or office buildings. A new provision was added which allowed certain expenditures that rehabilitate low income rental housing to be amortized on a straight line basis over a period of only five years. Section 167(k) thus was added to the code, significantly changing the relative tax advantage between low income rehabilitation housing and other real estate investments.

The ability to use limited partnerships in real estate ventures has provided developers with the ability to pass through tax losses to investors. Construction of FHA-sponsored rental housing was encouraged by the Housing Acts of 1961 and 1964 where changes were made to permit partnerships to own and operate FHA-sponsored rental housing. Historically it has been a combination of preferences in the tax code and preferential financing resulting from HUD programs as well as the tax-exempt status of industrial development bonds which have stimulated the supply of low income housing.

The Tax Reform Act of 1976 reduced further preferential tax treatment for real estate: construction period interest and taxes had to be capitalized and written off over a period of

time. There were differences in the application of this rule with preference given to rental housing. The five-year amortization subsidy for low income housing rehabilitation was extended for two more years. This has been repeatedly continued and is currently still in effect. Recapture rules were also tightened. For all real property except low income rental housing, all depreciation deductions in excess of straight line will be recaptured when the property is sold.

Real estate received a relative advantage over non-real estate investments. Under new "at risk" rules, limited partners may not take losses in excess of the amount they are "at risk". Included in the "at risk" basis is the amount the investor has actually invested in the project plus whatever debt he is personally obligated for. Real estate is exempted from this rule.

The Economic Recovery Tax Act of 1981 (ERTA) provided an important stimulus to all real estate investment. For most depreciable real property the lives were reduced from forty years to fifteen years. The thrust of the act was to stimulate the economy. The combination of short depreciable lives and accelerated rates of recovery often produces substantial tax losses in the early years of a tax shelter. These losses contribute significantly to the investment as the investor can use these losses to offset other income. ERTA also changed the relative advantages of alternative forms of real estate. Because of the rapid depreciation write-offs and favorable recapture rules, real estate tax shelters grew rapidly. Congress began to be concerned

that investment was diverted from more productive investment projects. In the Deficit Reduction Act of 1984 (DRA), Congress extended the 15 year depreciation period to 18 years for real property other than low income.

The proposed changes of PTP represent a drastic change in Congressional approach to tax preferences in real estate. Rather than targeting preferences for real estate and adjusting for abuses as in the past PTP removes the majority of tax preferences for real estate. It changes the relative advantages of different forms of real estate. It drastically changes the relative merits of real estate and other investments. These changes will likely have significant effects throughout the economy. We will examine these changes and hypothesize on how they may impact real estate investment in general and low income housing in particular.

III. TAX IMPACT ON MULTI-FAMILY HOUSING¹

Changes in tax provisions affecting multi-family housing resulting from the President's Tax Proposal are summarized in Exhibit I. Those changes which impact low income housing particularly are summarized in Exhibit II.

Each of the changes should be examined as to how it impacts decision making after all rules are in place. The question is whether multi-family housing will be at a relative advantage or disadvantage compared to alternative investments such as stocks or bonds for example.

¹Readers familiar with the prepared tax changes may wish to skip to Section IV.

EXHIBIT I

COMPARISON OF TAX PROVISIONS AFFECTING REAL ESTATE:

CURRENT LAW AND PRESIDENT'S TAX PROPOSAL

CODE SECTION PROPOSAL	CURRENT LAW	PRESIDENT'S TAX PROPOSAL
Depreciation (sec.168)	18 Years ACRS 175% Declining Balance	28 years CCRS 112% Declining Balance, Index Basis
Personal Tax Rates	14 brackets, 11%-50%	3 brackets, 15%-35%
Capital Gains on Land (sec.1202)	60% exclusion	50% exclusion Index option, 1991
Capital Gains on Buildings (sec.1202)	60% exclusion Partial recapture	No exclusion Indexed basis
"At Risk" provisions (sec 465)	Not applicable to real estate	Extended to real estate for individuals
Depreciation Recapture (sec.168)	Excess of accelerated over straight line on residential, all accelerated on com- mercial, no recapture if straight line used	All gains ordinary on depreciable property
Construction Period Interest and Taxes	10 year amortization	Depreciated
Denial of rate reduction due to "excess" depreciation	No current provision	Include in income over 3-year period, 40% of "excess" over \$300,000
Investment Interest Limitation	Does not apply to interest expense of limited partners	Applies to limited partners

EXHIBIT II

COMPARISON OF TAX PROVISIONS AFFECTING LOW INCOME HOUSING:

CURRENT LAW AND PRESIDENT'S TAX PROPOSAL (1)

PROPOSAL CODE SECTION	CURRENT LAW	PRESIDENT'S PROPOSAL
Depreciation Life and Method (section 168)	15 years, 200% declining balance	28 years, 112% declining balance indexed basis
Rehabilitation of Low Income Housing (section 167K)	60 month amortization	Repealed
Industrial Development Bonds (section 103)	Excludes from income interest on state and local industrial development bonds to finance low and moderate multi- family housing	Repealed

(1) See Exhibit I for provisions impacting real estate in general.

The proposal may also be examined from the standpoint of how relative preferences will change from current law. Many of the arguments for the President's Tax Proposal (PTP) are based on neutrality in incentives between investments. The question which does not appear to be addressed adequately is how the PTP changes relative incentives from the status quo. It must be realized that Congress in prior revenue acts has determined that real estate and particularly residential real estate should be stimulated through the tax law. PTP is a drastic change from this philosophy as it removes these relative advantages and in some cases provides for a relative disadvantage.

Marginal Tax Rates

The President's proposals would eliminate the present system of 14 brackets of tax rates ranging from 11 to 50 percent. This would be replaced by a three bracket system with tax rates of 15, 25, and 35 percent.

One goal of the system is to foster economic growth by encouraging work, saving and investment, and allowing resources to be allocated efficiently on the basis of economic rather than tax considerations. It is projected that individual's marginal tax rates on economic income would be approximately 19 percent lower than under current law (PTP, ch. 1.01). This allows investors to keep more of their ordinary income. This is more of an advantage to investments which have been taxed at full rates than it is for real estate income which has been sheltered to a large extent.

Inflation Adjustment for Basis

Because the preferential tax rate on capital gains does not account systematically for the effect of inflation, PTP (ch. 7.03) allows individual taxpayers an election to index the basis of their capital assets for inflation occurring after January 1, 1991. The inflation adjustment will reduce taxable gains on sales. Each year the inflation adjustment increases the remaining basis on which depreciation is calculated.

Capital Gains

Capital gains and depreciation work together. Depreciation is a deduction for ordinary income. When a capital asset is sold it is taxed at preferential rates if long-term capital gains exceed short-term capital losses. A portion or all of a gain may be ordinary income because of the depreciation recapture rules. The ability to obtain capital gains in multi-family real estate has been an important incentive to investors. Because of the importance and complexity of the changes depreciation will be discussed later.

The President's tax proposal (PTP) provides that gains on sales of depreciable assets placed in service after January 1, 1986 would not receive the long-term capital gain deduction and therefore would all be taxed at ordinary tax rates. The advantage of accelerated depreciation is largely eliminated. The advantage of deducting depreciation at ordinary rates and paying tax on gains at a preferential rate is eliminated.

The argument is that incentives for investment in depreciable property would be provided through the CCRS depreciation allowances (PTP, ch. 7.03). It is suggested that the inflation adjustment in the PTP is a better method than the long term capital gain deduction to ensure that only real gains are taxed. Allowing depreciation deductions at ordinary rates and paying tax on gains at a preferential tax rate is considered to be unjustified.

Relative incentives for investment in multi-family real estate and investment in land, stocks and bonds is changed by this proposal. A 50%, long-term capital gain exclusion is provided for nondepreciable capital assets.

"At risk" provisions (IRC sec. 465) will be extended to real estate activities for individuals and certain closely held corporations. Current law exempts real estate from these rules which limit loss deductions to the amount an individual has at risk. Amount at risk is generally the capital investment plus the amount the individual is liable for on recourse debt.

The argument (PTP ch. 13.02) is that due to this exclusion individuals investing in real estate may offset current taxable income from other activities such as wages with tax losses that will never be matched by economic losses. Deferral of tax liability guarantees a return to the investor that may make an otherwise uneconomic investment plausible. Thus capital is diverted from more productive uses and causes overinvestment in

the tax preferred activities. The result is that prices and capital costs are distorted throughout the economy.

The result of this change would be to reduce the return to equity capital in multi-family real estate. It could also cause an incentive to sell off properties prematurely as the limit for loss deductibility was reached.

Construction Period Interest and Taxes.

Low income housing ventures can deduct these costs as expenses. Other real estate ventures can deduct these costs over 10 years. PTP causes these costs to be added to the depreciable basis and recovers them over the property life of 28 years. The result is to remove an advantage of low income housing. Furthermore, this proposal reduces the potential rate of return on all multi-family projects because it changes the timing of the deduction from the early years to spanning the life of the project.

Denial of Rate Reduction for "Excess" Depreciation

Generally this provision provides for inclusion in income over a three year period 40% of "excess" depreciation taken between 1/1/80 and 7/1/86. An exception is provided for the first \$300,000. "Excess" depreciation is defined as cumulative depreciation in excess of cumulative straight line earnings and profit depreciation on property placed in service after 1979 and before 1986 (PTP, ch. 7.07). This provision is designed to avoid a windfall benefit of tax rate reductions which should not have been contemplated by investors when past investments were made.

Investment Interest Limitation

PTP limits a noncorporate taxpayer's deduction for nonbusiness interest to the sum of interest on the taxpayer's principal residence, net investment income and \$5,000 (PTP, ch. 13.01). Tax losses from limited partnerships would reduce net investment income and thus reduce the size of the allowable interest deduction. Investors in multi-family limited partnerships would be negatively impacted if they did not have enough net investment income to use the interest deductions. The result is to reduce the attractiveness of these investments.

Low Income Housing

Current law provides several special benefits to low income housing as shown in Exhibit II. These include (1) immediate deductibility of construction-period interest and taxes, (2) the 15-year ACRS recovery period, (3) five-year amortization of rehabilitation expenditures, and (4) tax-exempt status for bonds issued to finance low income rental property. These are all eliminated by PTP.

Rehabilitation of Low Income Housing

Current law allows taxpayers to amortize over 60 months certain qualifying expenditures to rehabilitate low income rental housing (sec. 167K). PTP (ch. 7.06) repeals this provision. PTP argues that the incentive is unnecessarily costly to the government and suggests that if additional measures are needed to stimulate investment in low income housing, existing targeted spending programs should be expanded.

Industrial Development Bonds

Current law (section 103) excludes from income interest on certain state and local governmental obligations including industrial development bonds to finance low and moderate income multi-family housing. This is repealed by PTP (ch. 11.01). The argument is that industrial development bonds have caused erosion in the federal income tax base. Activities receiving tax exempt financing have a significant advantage over their competitors, which must raise capital with higher cost taxable obligations. Furthermore the federal subsidy provided through tax exempt bonds is inefficient because the subsidy is filtered through high income investors. Since part of the subsidy is captured by these investors, the revenue loss to the federal government is approximately 33-50 percent higher than the benefits received by the borrower. The National Association of Home Builders (NAHB p. 27-28) emphasizes the importance of industrial development bonds. They suggest that most new rental housing for low and moderate income households has been financed by tax-exempt state and local industrial development bonds, which provide debt financing at rates 200 basis points or more below conventional mortgage rates. Lower cost financing makes it possible for investors to achieve an adequate rate of return. They claim in many areas IDB financing is virtually the only mechanism by which nonluxury rental housing can be built.

Change in Government Policy

Significant change in governmental attitude towards tax preferences for low income housing is evident by the discussion in PTP (ch. 7.06) concerning rehabilitation of low income housing. The proposal points out historically that low income housing has benefited from a variety of direct and indirect government subsidies, including rental subsidies, grants, loans, and credit supports and guarantees. It then discusses the current tax preferences which encourage investment in real estate in general, including housing and the particular preferences which benefit low income housing.

PTP points out that tax benefits associated with real estate investment attract capital from high-income taxpayers who are willing to trade negative cash flows or below market returns for substantial tax savings, and therefore appear to cause increased investment in real estate, including low income housing. Reference is made to a Congressional Budget Office study entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," which estimates that, because of the cost of packaging tax shelters and the high after-tax returns enjoyed by tax shelter investors, less than one half of government revenue losses attributable to real estate tax shelters ever reach builders and developers.

The conclusion is that to the extent that the current tax laws encourage investment in low income housing, the incentive is unnecessarily costly to the government. Further if additional

measures are needed to stimulate investment in low income housing, existing targeted spending programs should be expanded.

Historically this is an important change in policy. Previous law has maintained relative advantages for real estate. It has provided for relative advantage for residential real estate over other forms of real estate. Finally it has provided for special tax preferences for low income housing. These provisions have not been accidental. Rather they are the result of definite Congressional policy. The question then is whether the implications of this change in policy have been debated.

In a later section we discuss whether the savings in tax preferences are likely to be offset by the costs of additional direct subsidies. Is it likely that low income housing will be rescued by direct subsidies? Will direct subsidies be more efficient in accomplishing their objective than tax preferences?

Depreciation

PTP would establish the Capital Cost Recovery System (CCRS) of six classes, with property placed in a class generally based on its current ACRS classification. Real estate which is currently classified as 18-year ACRS property and 15-year low income housing would be merged and classified as CCRS class 6.

Under CCRS a declining balance rate of depreciation is applied to the adjusted asset basis, indexed for inflation. The rate for real estate is 112% declining balance for 28 years which is equivalent to 4 percent per year applied to the declining balance.

Exhibit III compares depreciation tax rules for different forms of real estate before ERTA, current law, and PTP. Exhibit IV compares the depreciation allowances for \$1,000 depreciable basis of real estate assuming a five percent inflation rate and a four percent real discount rate.

PTP (ch 7.01) claims that ACRS has created investment distortions and that the recovery provisions have hampered economic efficiency. PTP states the tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. PTP argues that taxpayers have made otherwise uneconomic investments in order to obtain tax benefits and this is done partially because of the large deductions that can be taken in the early years of an investment which is used to offset unrelated income. A further argument of the proposal is that the prospect of substantial upfront deductions encourages excessive leveraging and churning of assets.

The stated purpose of CCRS is to preserve investment incentives while explicitly accounting for inflation and different rates of economic depreciation. PTP's objective is to prescribe depreciation schedules and recovery periods which produce systematic investment incentives that are neutral across recovery classes.

Examination of Exhibit III (which compares depreciation lives and methods prior to ERTA, under current law, and PTP) illustrates

EXHIBIT III

COMPARISON OF DEPRECIATION TAX RULES

BEFORE ERTA, IN CURRENT LAW, AND UNDER PRESIDENT'S PROPOSAL

	BEFORE ERTA	CURRENT LAW	PRESIDENT'S PROPOSAL
Rehabilitation of Low Income Housing	Five years straight line	Five years straight line	Repealed
Low Income Housing, New	Forty years 200% Declining bal.	Fifteen years 200% Declining bal.	Twenty-eight years 112%, declining bal. Index basis
Residential, New	Forty years 200% Declining bal.	Eighteen years 175% Declining bal.	Twenty-eight years 112%, declining bal. Index basis
Residential, Used	Forty years 125% Declining bal.	Eighteen years 175% Declining bal.	Twenty-eight years 112%, declining bal. Index basis
Commercial Rehabilitation	Forty years straight line Credit	Eighteen years straight line Credit	Repealed
Historic Structures Rehabilitation	Forty years straight line Credit	Eighteen years straight line Credit	Twenty-eight years 112%, declining bal. Index basis
Commercial, New (1)	Forty years 150% Declining bal.	Eighteen years 175% Declining bal.	Twenty-eight years 112%, declining bal. Index basis
Commercial, Used (1)	Forty years straight line	Eighteen years 175% Declining bal.	Twenty-eight years 112%, declining bal. Index basis

(1) Many commercial properties use optional straight line to avoid depreciation recapture on sale.

EXHIBIT IV

DEPRECIATION ALLOWANCES UNDER ALTERNATIVE DEPRECIATION METHODS
FOR A CLASS 6 ASSET (1)

YEAR	PROPOSED CCRS 5% INFLATION	CURRENT LAW	
		ACRS	STRAIGHT LINE
1	20	50	28
2	41	90	56
3	41	80	56
4	42	80	56
5	43	70	56
6	45	60	56
7	47	60	56
8	50	50	56
9	52	50	56
10	55	50	56
11	58	50	56
12	61	50	56
13	64	40	56
14	67	40	56
15	70	40	56
16	74	40	56
17	77	40	56
18	81	40	56
19	85	20	28
20	89	0	
21	94	0	
22	99	0	
23	104	0	
24	109	0	
25	114	0	
26	120	0	
27	126	0	
28	132	0	
29	69	0	
Nominal total (2)	2128	1000	1000
Inflation adjusted total (3)	1000	715	666
Present value (4)	610	570	502

Source: Office of the Secretary of the Treasury Table 7.01-6
accompanying President's tax proposal.

(1) Depreciation is computed on an asset placed in service by a calendar
year taxpayer on July 1 of Year 1 without regard to mid-month convention

(2) current dollars (3) Assumes a 5 percent inflation rate.

(4) Assumes a 4 percent real rate of return.

a significant change in policy. Prior to ERTA distinctions were made between residential and commercial and between new and used structures. There were special provisions for rehabilitation of low income housing, commercial rehabilitation, and rehabilitation of historic structures. Current law, which was established under ERTA in 1981, sharply shortened the lives of the assets but maintained preferences for low income housing and for the various rehabilitation incentive programs. PTP removes these distinctions and cancels the rehabilitation incentives. It lengthens the lives from 18 to 28 years and provides for a 118% declining balance rate compared to 175% under prior law. For low income housing the change is from 200% declining balance at 15 years. Current law applies rates to a cost basis. PTP would adjust the basis for inflation. Note that PTP is a significant improvement over allowances prior to ERTA.

Whether PTP is an improvement over ERTA depends on the relationship of holding period, the inflation rate and the real discount rate used to measure the present value of depreciation benefits. Exhibit IV compares depreciation allowances under CCRS with current law for real estate (PTP, ch 7.01, Table 7.01-6). Assuming a five percent inflation rate and a four percent real discount rate and further assuming the real estate is held for the full 28 years the present value of the CCRS deductions is \$610 compared to \$570 under ACRS per 1000 of original basis. Assuming no inflation, CCRS gives a present value of \$610

compared to \$760 for ACRS. At a 10% inflation rate CCRS gives a present value of \$610 compared to \$454 for ACRS.

NAHB also makes a similar comparison (page 23). The assumption is a six percent inflation rate and an eight percent real discount rate. For a 28 year holding period ACRS is \$427 compared to \$392 for CCRS. However, each used different inflation and discount rates. NAHB also finds ACRS superior at a 5-year, 10-year and 18-year holding period. The advantage of ACRS is greater the shorter the holding period. The lower the rate of inflation the greater the advantage of current law. NAHB concludes that despite the adjustment for inflation CCRS is generally less attractive for rental housing than ACRS except under high inflation rates. NAHB also points out that 8 to 10 years is a more typical holding period for real estate and that the advantage of ACRS over CCRS is greater the shorter the holding period.

The discussion accompanying PTP states that "ACRS operates as an undeclared government industrial policy which largely escapes public scrutiny and systematic review" (ch. 7.01). This does not seem to be true in the case of the historical record for real estate. Congress intended the special tax incentive rehabilitation programs and the special treatment given to low income housing. Congress must decide whether this policy should be changed to provide for tax neutrality.

IV. IMPACT OF PROPOSED CHANGES

The PTP justifies changes in terms of fairness and economic neutrality. Congress must consider whether the likely

consequences of the proposed changes meet the criteria of fairness and economic neutrality as well as other desired goals. It is obviously difficult to project the likely consequences of PTP when so much is being changed. However if the result of the PTP on housing and particularly low and medium income housing is similar to the expectations of several recent studies then Congress will be in a dilemma. It must go beyond the immediate direct consequences and ask: (1) Are these the desired results? and (2) What kinds of programs must be substituted for tax preferences? (3) Is the cost of these substitute programs greater or less than the cost of tax preferences? (4) Will the substitute programs be a better way to stimulate low and moderate income housing than tax preferences?

Projected Consequences

Recent studies attempt to project the impact of the PTP on housing. One is the study of the National Association of Home Builders (NAHB) referred to earlier. Another is a product of the Joint Center For Housing Studies of M.I.T. and Harvard University and of Wharton Econometric Forecasting Associates, Inc., (hereafter referred to as MIT). Both of these use sophisticated computer simulations to hypothesize the impact of PTP on housing. A study (L&R) by A. Lepcio and K. Rosen of U.C. Berkeley projects the impact on the investment results of two actual buildings. The Maisel and Quigley (M & Q) study results in dissimilar conclusions.

Increased Rents

Three studies predict substantial rent increases. MIT predicts an average increase of 20-24%; NAHB estimates an increase of 21-28%; L&R show substantial rent increases on both its 10 unit apartment building and the larger building of 180 units. Low income housing is impacted even more because of the elimination of the tax-exempt status of income from industrial development bonds. NAHB projects a necessary rent increase of 38-45% for low income housing. M & Q suggest rents will be little changed because of adjustment of a number of variables including interest rates in particular.

Reduced Housing Stock

Both MIT and NAHB project a decline in the housing stock. This would happen because the market would not absorb immediately the increase in rents required to maintain investment returns. The result would be a drop in construction activity and in the value of existing rental properties. NAHB suggests the decline in value would depend on investors' expectation of future rent increases. If investors do not anticipate a positive rent response, resale values of existing properties could decline by as much as 25%. MIT estimates increases in the cost of homeownership would reduce construction of single units, producing a reduction in investment in total new housing units of all types (including multiple units) averaging over 200,000 units per year, reducing the housing stock by approximately 1,880,000 units by 1994.

Cost of Homeownership

After-tax cost of homeownership would increase by approximately 10-12 percent according to the MIT study. This would make it more difficult for a young renter household to purchase a home, thereby increasing demand for rental housing.

NAHB suggests the after-tax cost of homeownership would increase relative to the cost of other goods and services. This would make it less attractive for people to become homeowners.

NAHB suggests a scenario such as the following. PTP results in less depreciation, ordinary income on gain on sale, loss of tax benefits of development bonds and other tax preferences that have been explained earlier. This in turn results in a lower expected rate of return based on current rent levels. Developers then do not undertake projects which would have previously been undertaken. Low and moderate rental housing is impacted more than high income housing because of the loss of tax exemption on the development bonds. Non-real estate investment forms are treated better, so funds are attracted away from real estate.

Current values incorporate tax benefits. Loss of these tax benefits reduces resale value of existing properties. Rents increase as the supply of existing housing decreases. The adjustment is a slow process. In the short run the increase in rents is not sufficient to make the relative returns sufficient for builders/developers and investors to take risks inherent in building housing. Construction activity drops. This causes loss of jobs in construction and related industries.

Low and Moderate Income Households

Low and moderate income households would be damaged the most by the proposals according to both the NAHB and MIT studies. MIT points out that a typical renter household devotes approximately 30 percent of annual income for housing, while low and moderate income renter households commonly spend 35 percent or more of their income for housing. Further, the vast majority of renter households spend more on rent than they pay for federal income tax. MIT notes that even modest rent increases would be sufficient to completely offset any advantage low and moderate income households might gain as a result of the proposed tax cuts. If rent increases caused by PTP are 20%, virtually no renters would be ahead. Only those with annual incomes exceeding \$45,000 would have tax savings exceeding rent increases.

The advantage to low income households of PTP will be offset by rent increases, by decline in wealth for homeowners resulting from decline in value of their homes, and reduction of construction of rental units that are being built as a result of below market rate financing offered by state and local housing finance agencies. NAHB has similar conclusions. Elimination of special provisions such as favorable treatment of depreciation, gains on sale, construction period interest deductions and the elimination of tax exempt bonds all hurt the supply of low and moderate income rental housing.

As rents increase, moderate income households would attempt to find units that are less expensive. They would compete with

low income housing, causing pressure on the lowest priced units. On the supply side, the elimination of tax-exempt IDB financing and special tax preferences for low income housing would cause required rents for the lower priced units to increase more than required rents for higher priced units. This in turn would cause the greatest production cutbacks to occur among low rental units.

Interest Rates

An important and difficult question is the impact of PTP on interest rates. Lower marginal tax rates and the limitation on deductions of consumer and investment interest expense together with reduced incentives for investment could result in declines in interest rates.

Conceivably the decline in interest rates could offset the disadvantages to real estate of PTP. However, there is significant disagreement on this point. THE NAHB study estimates only a 20 basis point decline in market interest rates (p. 37) and states that given the potential for increased budget deficits and increased inflation as a result of the tax changes, it is quite possible that nominal interest rates actually would increase over time.

The MIT study does not agree with the proponents of PTP that rates will fall because marginal personal tax rates would be cut. This study suggests that other factors would offset this pressure and that interest rates would actually be slightly higher (pp. 67-68). The MIT projection shows a likely increase in interest rates by under 50 basis points (p. 3).

MIT argues that PTP would result in a revenue loss that would cause an increase in inflation and in the federal government deficit. This in turn would cause an increase in government borrowing which puts upward pressure on rates. The assumption is that the Federal Reserve Board would accommodate some but not all of the increase in nominal GNP that would result from implementing the Administration proposals (p. 67).

U.S. interest rates are determined to an extent in international markets. Since foreigners do not pay U.S. taxes on income earned abroad and funds move freely across the U.S. border, international fund flows might offset the downward effects of reduced U.S. tax rates. International funds are volatile. If funds left the country or less came in, interest rates might rise.

Other uncertainties include: (a) a higher required rate of return for wealthy taxpayers who control most assets and who now are the prime beneficiaries of tax preferences; (b) changes in relative amounts of equity and debt financing because of change in relative cost of equity due to PTP. This is because PTP might raise the relative cost of equity financing and increase the use of debt financing; (c) an unknown change in the marginal propensity to save which would be impacted in one direction by lower marginal tax rates and in the other direction lower marginal tax rates would reduce the amount that must be saved to attain a given future level of income.

A Dissimilar View

Maisel and Quigley (M & Q) disagree with the conclusions of the NAHB study and the MIT study on the resultant impact on rents of PTP. Their analysis indicates that the effect of PTP on rents and property values is likely to be minor (p. 2). M & Q disagree with the previously cited studies because: (1) rents are forced to equilibrate the entire market for real capital to an environment changed by tax and depreciation rules; (2) the role of taxes in affecting pre-tax interest rates is neglected; and (3) the differential effect of tax reform on various property owning entities is ignored (p. 3).

M & Q argue that interest and capitalization rates will decline and some costs of development and management will decrease. The competition of real estate investment trusts (REITs) and tax-exempt entities for real property ownership will become more intense. As a result of these adjustments, any movement in rents will be quite small (p. 6).

Interest rates will decline as a result of the decrease in income tax rates (p. 17). M & Q further argue that investment and savings decisions are based upon real after-tax costs and earnings. A numerical example is provided which shows that the same real rate of return is provided if interest rates drop to 10 percent from 13 percent as tax rates drop from a 50% marginal rate to the proposed 35% marginal rate. Tax reforms are not expected to change the after tax real interest rate substantially. This rate equates the quantity of savings with the

marginal efficiency of capital (MEC). The MEC is derived from the production function in the economy and the stock of capital. Tax rate changes only influence the after-tax real interest rate as they affect the total stock of capital.

Reference is made to a paper by Peek and Wilcox which analyzes empirical evidence on the relationship between marginal tax rates and market interest rates. Peek and Wilcox conclude that historically, when tax rates change, after-tax interest rates are unchanged.

Significance of the Studies

The studies point out potential dire consequences of PTP for housing in general and low income and moderate housing in particular. It is not clear whether a decline in market factors such as interest rates would offset these dire effects. What is clear is the high probability that there will be significant detrimental effects on low income housing; otherwise what will happen as a result of the combined PTP is far from certain.

Congress has a number of possible alternatives. One is to attempt to have more research done on the potential effect on housing. Such a proposition is subject to the usual problems of economic forecasting and is still likely to be uncertain. Another alternative is to put low income housing in the sacred category such as home mortgage interest. A third alternative is to pass the law and establish non-tax subsidies for low income housing.

V. TAX PREFERENCE OR DIRECT SUBSIDY

The real issue is whether aid to low income housing should be accomplished through the tax code or through direct subsidies. Assuming government aid must be forthcoming for low income housing it must be accomplished in one of the above two ways or through a combination of both.

Direct subsidy programs and their continued funding have not been the choice of previous Congresses. Congress has chosen to exercise an important role in housing policy through the tax mechanism. The tax writing committees have had the problem of balancing the goal of stimulating housing with the disadvantages of providing tax shelter to those taxpayers who benefitted by the stimulus.

The debate will be influenced by the current balance of political forces. A tax incentive is an expenditure of government funds. It is as much a government subsidy as a direct expenditure. In addition, a variety of other costs are associated with the two alternatives. Alternative costs can be the starting point for comparing alternatives (CBO p. 15).

Cost and Administration

Supporters of tax incentives argue they are simpler and require less government supervision than subsidies. Red tape, detailed supervision and costs of a government bureaucracy to administer the program are eliminated. For example it is relatively easy for taxpayers to take deductions for interest and property taxes and those expenses associated with limited

partnership investments. Alternatively, according to the CBO, HUD direct grant and loan subsidies have been difficult to administer (CBO p. 52-53). Extensive paperwork is required, along with extensive and multiple reviews which, in turn, result in time delays. Eligibility for HUD subsidies is limited by law, regulations and the availability of subsidy funds. Subsidies in the tax code are available to anyone who qualifies for the deduction.

Surrey claims direct expenditure programs can also be structured to pay out government money with few administrative controls. He claims the origins of the argument for tax incentives probably lie in overstructured, badly designed direct expenditure programs and that the solution is better designed programs (Surrey, p.132).

Administration problems arise when two or more agencies are administering the same program. Different requirements may exist in the two agencies. This in turn results because the goals for the different agencies may not be congruent. For example HUD and the IRS may have different objectives (CBO p.53).

Implementing social programs through tax legislation complicates the consideration and administration of social programs as well as the subsequent budgetary process (Surrey p.141). Tax incentives result in other tax incentives. Addition of new tax incentives changes the balance of investment incentives in the system. Those that have lost this relative advantage then put forth their claim for tax incentives. This can be seen readily

in the activities of the various lobbying groups who are reacting to the President's tax proposals.

Efficiency

According to the CBO a subsidy is efficient if it does what it is supposed to do at the lowest possible costs (CBO p. 51). One problem is to direct the benefit to the areas of most urgent need. If the goal is to reduce rents for low and middle income taxpayers this might best be accomplished by direct rental subsidies. Under a tax incentive arrangement, benefits for construction of low income housing are enjoyed by investors, builders and developers as well as the renters. The issue then is whether it is more efficient to provide a direct subsidy rather than share the subsidy with high bracket taxpayers. The CBO reports that only about half of what the tax shelter subsidy costs the government in lost revenue ever reaches builders and developers (CBO p. xiv). The rest goes in the form of payments to the outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the tax shelter package.

Tax Equity and Neutrality

One of the stated purposes of the PTP is to provide for tax neutrality. Economic decisions should not be biased by tax considerations. Tax equity requires that individuals in the same economic circumstances should be treated equally. It also provides for a general concept of fairness which underlies the progressive tax structure.

Tax preferences such as incentives for investment in low income housing are in direct contradiction to the concept of vertical equity as they distort the progressive tax structure. High bracket investors, builders, and developers shelter their taxes through tax deductions. Tax preferences cause other taxpayers to lose confidence in the system because they feel they do not have the same opportunities.

The principal of tax neutrality is violated because more investment goes into real estate than would have if there were no tax incentives. Congress considered that the social goals were sufficiently worthwhile to allow distortion of the tax structure and violation of the neutrality concept.

Tax incentives are often supported on the basis that they encourage the private sector to participate in social programs. Surrey argues that government can cooperate with business in solving social needs by either direct expenditure or tax incentives (p. 1131). Tax incentives are assumed to promote private decision making rather than government-centered decision-making. This argument emphasizes individual decision making and private initiative in solving social problems. This in turn is more appealing to certain groups.

Both tax incentives and direct subsidy programs are criticized on the basis that they wastefully reward people for doing what they would have done otherwise. This is probably not true in the case of low income housing. CBO states that tax shelter

subsidies must normally be combined with other direct grant and loan subsidies before any significant amount of new construction will be undertaken at all. Removal or reduction of any one of the subsidies could make new construction of this form of rental housing uneconomical (CBO p. xiii).

Incentives for Management and Maintenance

Good management and maintenance are important concerns of low income housing and the incentives inherent in alternative policies must be considered in evaluating alternatives. Real estate tax shelter subsidies are associated with good management and maintenance in indirect ways. Most of the subsidy comes automatically through the tax system, whether management and maintenance is good, bad, or indifferent (CBO p. 54). Participants are encouraged to keep the project in sufficient shape that it does not go into foreclosure. Upon foreclosure, provisions of the tax law operate which substantially reduce the tax shelter benefits. Various direct subsidy programs may have built in incentives for good maintenance and management which differ in a variety of ways.

Choice

Congress may determine that tax incentives for low income housing are generally inefficient and wasteful as well as inconsistent with the goal of tax neutrality and tax equity. Congress might conclude that it would be better to substitute direct, efficiently drawn subsidy programs to replace these incentives. Cohen argues this position and believes direct subsidies would

allow greater control and greater efficiency at a lower cost (Cohen, p. 973).

Alternatively, Congress might conclude it prefers to support low income housing through the tax system because this approach would be less costly and the overall benefit would outweigh the disadvantages.

Before this decision can be made, alternative subsidies for rental housing must be carefully examined. For example the CBO has considered the following alternatives:

- (a) continuation of existing tax shelter subsidies;
- (b) direct HUD construction grants to builder/developers;
- (c) refundable investment tax credits for builder/developers;
- (d) nonrefundable investment tax credits for builder/developers;
- (e) interest subsidies for builder/developers;
- (f) Section 8 new construction programs (CBO pp. 60-93).

The General Accounting Office (GAO) recently developed a computer simulation for the purpose of developing information on the relationship between lower income families' rents and investors' after-tax rates of return for several incentives. Included are tax incentives, mortgage insurance, and direct financing subsidies.

The GAO reports at the market rent level required to earn investors about a 12.5 percent after tax rate of return under pre-ERTA conditions, investor rates of return are increased to 15 percent under the ERTA conventional tax treatment and about 16 percent under the ERTA low income tax treatment.

Financial leverage benefits from mortgage insurance increased the investor's rate of return to about 25 percent. The model assumed a loan amount equal to 90 percent of development cost with federal mortgage insurance compared to 75 percent of development cost with conventional financing (p. 13).

Below market interest rate benefits from a direct financing subsidy increases the rate of return to 29 percent. The model assumes a federally insured mortgage loan with an interest rate reduction of two points, from 13.5 percent to 11.5 percent (p. 15).

The incentives tend to increase investors' rates of return. To the extent the supply of rental housing expands as a result of these incentives rentals should adjust downward to balance supply and demand. The extent that rates of return increase or rents decrease depend on several factors. These include the rate of return required to induce supply, the ability of investors to take advantage of the incentives, the competitive nature of individual rental housing markets, and the degree of rent control.

To decide the best mix of incentives is a large task which cannot be done quickly. Congress in the interim could maintain the current tax preferences for low income housing.

Conclusion

The result of this analysis is that Congress should not remove the tax preferences for low income housing. A limited number of special deductions and exclusions would be retained

under PTP on the basis that they are "widely used, and generally judged to be central to American values" (PTP, p. 4). Low income housing should be added to this list which includes the home mortgage interest deduction, preferential treatment of Social Security and veterans' disability payments and the itemized deduction for charitable contributions.

Evidence from completed studies suggests that there is a high probability that there will be dire results for low income housing from the passage of PTP.

A debate on the merits of tax preferences versus alternative stimuli such as direct subsidies should precede the abandonment of tax preferences.

Congress cannot abandon low income housing. Revenue saved though removal of tax preferences for low income housing will most likely be completely offset by the cost of direct subsidies. Subsidies will cost more or less than tax preferences and have widely different social, political and economic implications.

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