Why New Tax Housing Subsidies Would Likely Fail

By **Michelle Layser**

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Last week, House representatives Brian Higgins, D-N.Y., and Mike Kelly, R-Pa., introduced a bill to Congress that would create a new tax credit for neighborhood revitalization. The Neighborhood Homes Investment Act[1] would build onto the current low-income housing tax credit, which has long subsidized the development of affordable rental housing, by providing a new incentive to build affordable owner-occupied housing.

The bipartisan proposal comes in the wake of years of reports about skyrocketing housing costs and the scarcity of affordable housing in many parts of the country. For this reason, it will probably attract significant support from observers across the political spectrum. However, our history with tax-subsidized housing and community development provides reason to pause. My research on investment tax incentives and neighborhood change suggests that past policies may have contributed to housing segregation on the one hand, and harmful gentrification on the other.

Tax subsidies for housing are nothing new. The low-income housing tax credit has been the primary federal subsidy for affordable rental housing since the 1980s. Affordable housing developers compete for tax credit allocations, which they use to attract equity capital needed for new construction or rehabilitation of residential properties. To qualify for the tax credits, developers promise to comply with rent ceilings and agree to accept federally issued tenant rental vouchers. Depending on how the deal is structured, a developer may be required to set aside anywhere from 25% to 40% of units for low-income tenants. But as a practical matter, it is common for entire buildings to be occupied by low-income tenants.

Many people would not be surprised to learn that a disproportionate number of affordable housing projects financed through the tax credit program are located in high-poverty neighborhoods with a high percentage of minority residents. After all, our country’s history of Jim Crow laws, redlining policies and exclusionary zoning alone would seem to predict these patterns. What may surprise some, however, is that tax law continues to reward and reinforce these segregation patterns through additional incentives. Stated simply, the tax law provides larger subsidies to developers who site projects in high-poverty areas, and the state housing authorities who administer the tax credits often prioritize such projects for tax credit allocations.

The rationale behind these policies is innocent enough. It can be both expensive and risky to invest in high-poverty areas, and residents in those neighborhoods face some of cities’ most dire housing needs. The problem is that the tax law and its administration have ultimately served to undermine other affordable housing policies, such as tenant vouchers, that purport to increase residential mobility and housing choice. Since private landlords often refuse to accept tenant vouchers, low-income tenants’ options tend to be limited to tax-subsidized affordable housing projects, which are clustered in high-poverty, often-segregated areas.

The story of tax subsidies and neighborhood effects does not end with the low-income housing tax credit, however. The beloved home mortgage interest deduction, which was significantly scaled back by the 2017 tax reform law, has also helped to reinforce historic segregation patterns. To see how, consider a potential home buyer who works at a law firm and earns $100,000 a year. She is considering two properties. The homes are of similar size and quality, but one is more expensive than the other because it is located in a neighborhood that is mostly white, whereas the other is located in a more racially mixed neighborhood — it is well-documented that homes in racially mixed neighborhoods tend to have depressed values.

If the taxpayer would have to pay more mortgage interest to finance the house in the white neighborhood, then she would receive a larger mortgage interest deduction for choosing that property. This is true even though the taxpayers' base income, and her ability to pay taxes, will be the same $100,000 regardless of which house she lives in. Yet, by buying the house in the white neighborhood, she will pay less taxes than if she purchases the house in the racially mixed neighborhood.

In effect, the tax law helps cover some of the increased cost of buying the home in the white neighborhood. In this way, tax law puts a thumb on the scale in favor of segregation. The partial repeal of the mortgage interest deduction has undoubtedly helped to reduce this tax-based distortion, but it is yet to be eliminated entirely.

Meanwhile, tax-based subsidies have also been used to more directly promote neighborhood change. Here, too, such neighborhood change is often to the detriment of low-income communities. The most recent example is the new opportunity zone tax incentive, which was introduced in the Tax Cuts and Jobs Act.[2] The law provides tax relief to taxpayers who invest capital gain proceeds into so-called opportunity funds.

Broadly speaking, opportunity funds are corporations or partnerships that pool investors' capital for the purpose of investing in designated opportunity zones. The law requires that substantially all of the funds' assets be located in the zones. The property holding rules are highly technical, but the upshot is this: By providing tax benefits to third-party investors, the law ultimately provides a significant subsidy to lower-tier businesses by enabling them to attract equity capital that may otherwise be unavailable.

The opportunity zones law has been criticized for its lack of safeguards for low-income communities. Critics worry that the law will contribute to the challenges faced by low-income communities by spurring gentrification, ultimately displacing low-income residents when rental rates rise too rapidly.

These concerns are valid for a number of reasons. First, the opportunity zones law places few restrictions on the types of investments funds may pursue. Second, the program lacks meaningful oversight or formal reporting requirements, leaving the program objectives entirely to the private market.

Thus, opportunity zones are poised to become the most recent chapter in the history of place-based investment tax incentives, most of which have utterly failed to lift up poor communities. Since the 1980s, most states have had laws that create "enterprise zones," which are areas where businesses can locate in order to claim tax breaks and regulatory relief. Research on these laws, which were originally introduced in response to developer lobbies hoping to profit from gentrification, has been mixed. Most has concluded that they have not produced many new jobs — at least not for zone residents — despite delivering significant value to zone businesses. Critics of opportunity zones have pointed to failed enterprise zone programs as evidence that the law probably won't help poor communities.

But an even better analogy to opportunity zones is the new markets tax credit, which provides debt financing for community development projects. Like enterprise zones law, the new markets tax credit has pro-gentrification origins. Indeed, the law was introduced during a period when even anti-poverty advocates viewed gentrification as a solution to urban poverty. Also like enterprise zones, the program has been far from perfect. The law permits a broad range of projects. Empirical studies suggest that the new markets tax credit has not produced many new jobs, but it has sometimes been used to fund fancy condos, high-end grocery stores, museums, opera houses and other projects that fail to address the most pressing needs of poor communities.

Nevertheless, my research on the new markets tax credit suggests that the program has been relatively effective at subsidizing projects that stand to benefit poor communities, such as homeless shelters, social services, youth centers and community centers. These findings are promising and may be attributable to the competitive process for tax credit allocations, combined with a requirement that tax credit recipients have a primary mission of serving low-income communities. The opportunity zones law lacks either feature, and early indicators suggest that the program is likely to subsidize market rate apartments and condos, tech start-ups, fancy recreational facilities like climbing gyms and yoga studios, and other investments that fail to meet the primary needs of low-income communities.

In sum, the history of tax-based subsidies for housing and community development provides reason to hesitate before adopting new place-based investment tax incentives like those proposed in the Neighborhood Homes Investment Act. So far, tax laws have been used to subsidize affordable rental housing in ways that segregate poor communities. They have subsidized movement by wealthy — and often white — people into white neighborhoods. And they have been used by developers to profit on investments in low-income neighborhoods, regardless of their impact on those communities.

Before adding to the list of place-based investment tax incentives that ultimately fail to address the needs of low-income communities, policymakers should carefully consider whether the proposed law confers power to community stakeholders, links place to community by addressing residents’ needs and incorporates a system for monitoring outcomes. Most past and current tax incentives have failed to meet these criteria and we should learn from those mistakes.

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[1] H.R. 3316

[2] 115 P.L. 97