

# The Relative Inefficiency of the Low-Income Housing Tax Credit in Minnesota

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## Executive Summary

The Low-Income Housing Tax Credit (LIHTC) is less efficient with public subsidies than other subsidized housing development programs in the State of Minnesota. Public subsidy is lost at the very beginning of tax credit deals when developers must sell the credits to investors. Historically, the market has resulted in credits being sold for 87 cents on the dollar, a loss of 13% in the value of the credit at the outset. We are unable to estimate the full cost in dollars of this leakage due to lack of data. Second, administrative costs are higher for tax credit projects than for non-LIHTC projects. We estimate a cost of up to \$1.9 billion in inflation-adjusted dollars since the inception of the program in 1986, or up to \$52.3 million per year through higher development costs relative to other programs of affordable housing development in Minnesota.

The Low-Income Housing Tax Credit (LIHTC) program is the nation's largest program of affordable housing development. The LIHTC program has been criticized for its complexity and for the inefficiency of the public subsidy involved. In this memo we report an analysis of development costs under the LIHTC program to determine whether it is less efficient than other affordable housing development approaches.

### The LIHTC Program

The Low-Income Housing Tax Credit (LIHTC) program was created by Congress in 1986. It has become the nation's largest program of subsidized housing development and has created nearly three million units since it began. The program is an indirect subsidy that works by providing investors with a tax benefit in exchange for their investment in affordable housing. Each state is allowed to distribute a limited amount of federal tax credits. In 2023, Congress

allocated to each state \$2.70 per capita or \$3.185 million, whichever was greater. Annual tax credit allocations from the federal government to states are adjusted for inflation. Investors experience tax benefits over a 10-year period. The current estimated cost of the LIHTC to the U.S. government in foregone tax revenues is \$11.4 billion.<sup>1</sup>

The program has been criticized on a number of accounts, and these critiques come from both the left and the right of the political spectrum. One of the most common critiques is that the program is overly complex and requires sophisticated tax and legal consultation for every project completed.<sup>2</sup> The complexity of the program is the basis for the second critique which claims that the program is an inefficient use of public dollars and that the administrative costs are greater than what is necessary to create affordable housing.<sup>3</sup> The program has also been criticized for utilizing unscrupulous contractors who violate labor protections,<sup>4</sup> for not delivering a deep enough subsidy to tenants,<sup>5</sup> and for projects being geographically concentrated within metropolitan areas.<sup>6</sup>

In this analysis we focus on the efficiency of the subsidy. As the Tax Policy Center writes, the program is criticized for having high administrative costs “because of the various intermediaries involved in its financing – organizers, syndicators, general partners managers, and investors – each of whom are compensated for their efforts.”<sup>7</sup> In 2002, The United States General Accounting Office (GAO) found that the LIHTC program cost anywhere from 5% to 16% more per unit than other forms of subsidized housing developments. That analysis, which is now more than 20 years old, compared LIHTC to other federal programs that are no longer major sources of new development.<sup>8</sup> In fact, the question of whether the LIHTC program is relatively inefficient compared to other means of financing affordable housing production is largely a settled matter. Very early on in the program’s history, policy analysts pointed out the program’s inefficiencies. In 1991, Michael Stegman, for example, a former White House economic policy advisor, Treasury Department policy advisor, and assistant secretary for policy development and research at HUD, estimated that the tax credit program costs the U.S. government about twice what a simple grant program of similar impact would cost.<sup>9</sup>

In this analysis, we attempt to update a portion of these analyses based on the information on subsidized housing development financed by the State of Minnesota.

## **Methods**

We assess the efficiency of the Tax Credit program by comparing development costs in the program with those of other affordable housing development programs. We focus on the experience of the State of Minnesota. The state’s population is close to the median and mean for all 50 states, and 73% of the state’s population is urbanized, very close to the median (74%) for the 50 states. There is little reason to suspect that the experience of Minnesota is significantly different than that of the U.S. as a whole. Nevertheless, our findings only reflect data from LIHTC projects in the State of Minnesota and caution should be used in extending these findings beyond the state.

We compared LIHTC to other programs of affordable housing development financed by the State of Minnesota’s Housing Finance Agency (Minnesota Housing). Minnesota Housing has programs of below market interest rate loans, deferred loans, and grants. These programs provide subsidies to developers that lower the cost of financing housing construction or rehabilitation. In exchange, the developer provides units at below-market rents for a specified period of time. We chose these programs as the comparison group for LIHTC because the way they provide the subsidy is closest to the Tax Credit program.

We did not compare costs in the Tax Credit program to the Housing Choice Voucher (HCV) Program, which is the other main program of housing subsidy in the U.S. We made this decision because the method of delivering the subsidy for the HCV program is dramatically different than it is for the Tax Credit program. Others, however, have done such analyses. The 2002 GAO report found that a LIHTC unit costs the government 20% more for one- and two-bedroom units than equivalent HCV units.<sup>10</sup> A 2005 analysis by another researcher came to similar conclusions.<sup>11</sup>

We relied primarily on data from Minnesota Housing, the statewide allocator of tax credits.<sup>12</sup> In addition, we examined the financing workbooks from 67 projects from 2002 to 2022. Most of these 67 projects were developed between 2017 and 2020 and 64 of them (96%) are located in the Minneapolis-Saint Paul metropolitan area. We examined these projects to investigate the variation in different cost items across the projects. We also examined 40 financial workbooks from non-LIHTC projects financed by Minnesota Housing. We benefited from the “predictive cost model” that Minnesota Housing developed to track development costs across projects to which it contributes financing.

## Findings

As of 2021, there were 1,031 developments with LIHTC funding in the State of Minnesota. More than half of these projects are located in the Minneapolis-Saint Paul metropolitan area. Metro area projects are, on average, more than twice as large as other projects (80 units per project compared to 37 for non-Minneapolis/Saint Paul metro projects).

Our analysis revealed two sources of inefficiency in LIHTC projects compared to non-LIHTC developments. The first is in the way in which the tax credits are converted into financing for the housing, and the second has to do with additional development costs.

***The market for tax credits.*** Developers who are awarded tax credits sell them to investors. For most years, developers are unable to receive a dollar of investment for each dollar of tax credit. Since 2017, for example, the national price per credit has hovered around \$0.91 and \$0.92. In the last quarter of 2023, it fell below \$0.90.

To get an estimate of the market loss in tax credit subsidy in Minnesota we looked at the equity pricing for the 67 projects we examined. These projects sold their tax credits for an average of 87 cents on the dollar. Thus, before most of the development costs had even been

incurred, the average LIHTC development in our sample saw a 13% loss of subsidy simply through the mechanism by which tax credits generate housing investment. This is a cost that does not apply to non-LIHTC projects where the public subsidy goes directly into a loan or grant to the developer.

Long-range data suggests that 13% may underestimate the subsidy leakage due to pricing over the program's full history. In the earliest years of the LIHTC program the equity pricing was so low that developers sometimes received less than 50 cents of investment per dollar of tax credit.<sup>13</sup> Pricing trended higher as the program grew, however, and has in fact exceeded \$1.00 per tax credit dollar at times. However, even as recently as the recession years of 2009-2011, the price of tax credits was at or below \$0.70.<sup>14</sup> For the most part, the price has been well less than \$1.00 per credit and has been an almost uninterrupted source of subsidy leakage from the beginning.

**Higher development costs.** The second source of inefficiency in the program has to do with development costs that might be higher for tax credit programs than for other programs. There are, of course, administrative costs associated with all subsidized housing development programs. Architects and engineers must be engaged to assess the land and property, and to design the project. Development teams must work with underwriters to finance the project, and work with City officials to ensure zoning and building regulations are followed, etc. But, as noted earlier, the complexity of the tax credit program requires additional administrative tasks that are not present in other programs. The Minnesota Housing predictive cost model provides the best overall estimate of the added administrative costs associated with the tax credit program. The Agency's analysis models costs for all Agency-subsidized housing projects.

Higher development costs in LIHTC projects are driven by elevated administrative costs. The Minnesota Housing data indicate that additional administrative burden for LIHTC projects increase total development costs by an average of \$25,030 per unit higher compared to other projects, all else being equal.

LIHTC also generates higher development costs through the need for more sources of funding. Virtually all subsidized housing developments require multiple sources of financing, and this has been true for decades since the large federal programs of the 1960s and 1970s were eliminated or significantly reduced. In this respect, the tax credit program is no different than other contemporary programs of affordable housing development; it simply does not generate enough investment to fully finance a project, making multiple sources of financing necessary. According to Minnesota Housing data, however, LIHTC projects require *more* sources of financing than non-LIHTC developments. In fact, Minnesota Housing figures indicate that the average LIHTC project in their database has 8.3 different funding sources, compared to 5.7 funding sources for non-LIHTC deals. Moreover, each additional source of funding is associated with \$2,275 in added costs per unit. Thus, the average LIHTC project generates an additional \$5,915 in development costs due solely to the fact that more sources of funding are required than in other projects. These incremental costs are independent of the additional soft costs previously reported.

Taken together, these two sources of increased administrative costs combine to raise per unit costs in the LIHTC program to \$30,945 more than comparable non-LIHTC projects. For an average LIHTC project with a total development cost of \$286,303 per unit,<sup>15</sup> these additional costs account for 10.8% of the cost of developing a LIHTC project.

Applying the estimated added administrative costs per unit (\$30,945) to all of the more than 60,000 LIHTC units that have been completed in the State of Minnesota since the program's inception,<sup>16</sup> the added development costs of the LIHTC program have amounted to an estimated \$1.9 billion over what would have been incurred if the same number of non-LIHTC units had been built. This averages to about \$52 million per year since 1986.

These numbers are estimates and thus should be considered cautiously. However, even if they overstate the costs by 10%, they still indicate total surplus costs of \$1.7 billion over the life of the program or \$47 million per year. If these estimates overstate the actual increment by a full 20%, there would remain a total cost increment of \$1.5 billion or \$42 million per year.<sup>17</sup>

It is equally possible, however, that the true difference between LIHTC and non-LIHTC loan programs is greater than we estimate above. Non-LIHTC housing production subsidies in the form of loans result in repayments to the government. For these programs, the overall public costs decrease over time as the government receives payments. In certain instances, this could lead to "negative subsidies" if the governmental entity earns back more than the original loan amount. Our analysis does not take this into account – we focus only on the total development costs that must be financed at the outset of a project. Long-term differences in subsidy costs between LIHTC and other forms of housing production subsidy are likely to be greater than what we report for initial costs.

## Summary

The LIHTC is a relatively inefficient way of subsidizing the development of affordable housing. This has been an accepted conclusion almost from the beginning of the program and has been corroborated by careful research over the years. The analysis reported in this memo attempts to update a portion of earlier studies and to do so within the context of Minnesota. The figures presented in this memo are estimates and, as such, are imprecise. However, our findings and our conclusions are not novel, nor are they out of line with previous and more extensive studies of the question. While estimating the full extent of the inefficiencies in LIHTC is beyond the scope of this study, we are able to identify two sources of subsidy leakage in the program compared to non-LIHTC production subsidies. The first is through the process by which credits are converted to housing investments. Developers sell credits to investors and the market has consistently valued those credits at less than dollar for dollar. The second source of leakage is through the additional administrative costs associated with the LIHTC program that must be paid for through the financing of each project.

## Notes

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<sup>1</sup> Ed Gramlich, 2023. *Low-Income Housing Tax Credits – 2023 Advocates Guide*. Washington, D.C.: National Low Income Housing Coalition. The \$11.4 billion in foregone tax revenues estimated for 2023 is based on the Joint Committee on Taxation forecast issued November 5, 2020.

<sup>2</sup> See, e.g., Miriam Axel-Lute, 2023. “LIHTC: How it Started, How it’s Going.” *Shelterforce*, November. <https://shelterforce.org/2023/11/15/lihtc-how-it-started-how-its-going/>. See, also, Chris Edwards and Vanessa Brown Calder, 2017. “Low-Income Housing Tax Credit: Costly, Complex, and Corruption-Prone.” Cato Institute, Tax and Budget Bulletin No. 79. <https://www.cato.org/tax-budget-bulletin/low-income-housing-tax-credit-costly-complex-corruption-prone>.

<sup>3</sup> Corianne Payton Scally, Amanda Gold, and Nicole DuBois, 2018. “[The Low-Income Housing Tax Credit: How It Works and Who It Serves](https://www.urban.org/research/publication/low-income-housing-tax-credit-how-it-works-and-who-it-serves).” Washington, DC: Urban Institute. <https://www.urban.org/research/publication/low-income-housing-tax-credit-how-it-works-and-who-it-serves>; Edwards and Calder, “Low-Income Housing.”

<sup>4</sup> “Preventing Exploitation on Low-Income Housing Tax Credit Financed Projects.” Laborers’ International Union of North America, Minnesota and North Dakota. See Edwards and Calder, “Low-Income Housing,” for other allegations of fraud and abuse in the program.

<sup>5</sup> Miriam Axel-Lute, 2023. “The Only Tool in the Box: What it Means That LIHTC Dominates Affordable Housing.” *Shelterforce*, December. <https://shelterforce.org/2023/12/08/the-only-tool-in-the-box-what-it-means-that-lihtc-dominates-affordable-housing/>.

<sup>6</sup> See, e.g., Will Fischer, 2018. “Low-Income Housing Tax Credit Could Do More to Expand Opportunity for Poor Families.” Center on Budget and Policy Priorities, <https://www.cbpp.org/research/low-income-housing-tax-credit-could-do-more-to-expand-opportunity-for-poor-families>.

<sup>7</sup> “What is the Low Income Housing Tax Credit and how does it work?” Tax Policy Center: Urban Institute and Brookings Institution, Washington, D.C. <https://www.taxpolicycenter.org/briefing-book/what-low-income-housing-tax-credit-and-how-does-it-work#:~:text=Calculating%20Costs%20and%20Benefits,housing%20for%20low%20income%20households>.

<sup>8</sup> U.A. General Accounting Office, 2002. *Federal Housing Assistance: Comparing the Characteristics and Costs of Housing Programs*. Washington, D.C. GAO-02-76.

<sup>9</sup> Michael A. Stegman, 1991. “The Excessive Costs of Creative Finance: Growing Inefficiencies in the Production of Low-Income Housing.” *Housing Policy Debate* 2:2, 357-73. James E Wallace of Abt Associates in 1995 came to a similar conclusion, that for a typical project, LIHTC delivers “to the project only 48 percent of the cost to the government of the tax credit mechanism.” See, James E Wallace, 1995. “Financing Affordable Housing in the United States.” *Housing Policy Debate*, 6:4, 785-814, page 798. See also Karl E. Case, 1991. “Investors, Developers, and Supply-Side Subsidies: How Much is Enough?” *Housing Policy Debate*, 2:2, 341-356.

<sup>10</sup> U.S. General Accounting Office, *Federal Housing Assistance*.

<sup>11</sup> See, Lan Deng, 2005. “The Cost-Effectiveness of the Low-Income Housing Tax Credit Relative to Vouchers: Evidence from Six Metropolitan Areas.” *Housing Policy Debate*, 16:3-4, 469-511; U.S. General Accounting Office, *Federal Housing Assistance*.

<sup>12</sup> We thank Minnesota Housing for sharing their information about the program. The Agency was helpful in providing us with pertinent information for our analysis. The Agency is not, however, responsible for any of the findings or conclusions we reach. This memo does not represent the Agency’s position in any way.

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<sup>13</sup> H. Blair Kincer and Mark O’Meara, 2020. “A Look at the LIHTC: Past Pricing Trends, the Current Market and Future Concerns.” Novogradac, <https://www.novoco.com/periodicals/articles/look-lihtc-past-pricing-trends-current-market-and-future-concerns>.

<sup>14</sup> See the data in [https://www.novoco.com/public-media/original\\_images/facts\\_lihtc\\_price\\_trends\\_lrg-01-min.png](https://www.novoco.com/public-media/original_images/facts_lihtc_price_trends_lrg-01-min.png).

<sup>15</sup> This figure is calculated from data in table 1 of Minnesota Housing’s 2023, *Cost Containment Report*, page 7. The figures in table 1 are from projects completed between 2003 and 2021 and adjusted for inflation and reported as 2023 dollars. There is no information in the report about how development costs in this period compared to those that prevailed in the first 17 years of the program (1986-2002).

<sup>16</sup> The exact number is 60,866. Our source for this is Novogradac’s Affordable Housing Tax Credit Resource Center.

<sup>17</sup> We provide a range of estimates that are more conservative than our initial estimate in order to avoid exaggerating the inefficiencies of the LIHTC program. Our total cost impact is based on development costs calculated on projects completed between 2003 and 2021. It is possible that development costs per unit (and adjusted for inflation) were lower in the earlier years of the program. Thus, we deflate our estimates by 10% and by 20%. However, it is also possible that development costs per unit were higher than those of the period we used for our calculations which would render our estimate a conservative one.