ChangeLab Solutions

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Policy Primer: Tax Incentives to Encourage Affordable Housing Development

Introduction

Communities across the United State face a variety of pressing challenges related to the safety, stability, and affordability of housing. For the past year, ChangeLab Solutions has been working with local governments and housing advocates in eight communities across the country as part of the Housing Solutions Collaborative, a peer-learning cohort focused on building capacity and partnerships to advance housing equity. Although no two communities are the same, the technical assistance provided to our partners has revealed common needs and areas of interest. This memo is one of five in a series that provides a high-level overview of strategies and policies that the cohort explored together: using tax incentives to spur affordable housing, best practices for establishing and expanding local emergency rental assistance, adopting antidisplacement policies to protect tenants, supporting affordable housing production, and adopting strategies to address housing-specific racial inequities. The memos highlight equitable solutions to housing challenges that local jurisdictions and communities face throughout the United States.

Housing Challenge: Lack of Housing Production & Affordable Housing

As the nation remains mired in a housing affordability crisis with an estimated deficit of 3.8 to 5.5 million housing units,[1] jurisdictions are looking to spur the development of housing units. Despite record-high rents and home prices, housing production continues to lag behind population growth.[2] Housing production in the United States is driven almost entirely by private developers in response to market conditions. When market conditions do not align and there is a mismatch between housing development expenses (such as construction, land, and entitlement costs) and the revenue that can be generated from that development, the result is limited development that, when coupled with rising demand for housing, greatly exacerbates affordability. Because most housing is produced through private market mechanisms, many policy responses seek to use market-based solutions in an effort to minimize this mismatch.

Policy Solutions: Property Tax Incentives

Property tax incentives for affordable housing are one set of policies intended to increase the amount of affordable housing developed by reducing development costs. These policies aim to help close the gap between costs and revenue by reducing or relieving the property owner's tax-related expenses. Theoretically, redirecting property tax revenue (or money that would otherwise be tax revenue) back to developers and property owners helps induce the development of housing where it would otherwise not be financially feasible. However, the weight of the evidence suggests that tax incentives may not be the most cost-effective way to produce new and affordable housing. Nevertheless, given the continued interest in this policy option, this memo identifies what tax incentives are and how they work, provides a review of the academic evaluations of tax incentives, and discusses their equity implications.

Property tax incentives can be structured in several ways, such as through abatements, exemptions, and tax increment financing (TIF). *Tax abatements* reduce or provide a credit toward the amount of taxes owed on a parcel of real estate for a specified period.[3] Examples are reducing the property tax liability for newly developed parcels meeting certain conditions by a percentage or a flat amount. An abatement can be tailored to promote land uses that increase the supply of affordable housing such as tax abatement programs for development containing a certain percentage of affordable units or for the rehabilitation of distressed housing stock.[4]

Tax exemptions reduce the assessed value or rate of taxation for a parcel of real estate, resulting in a lower tax bill.[5] This is different from an abatement because it changes how the property tax is calculated rather than how much is paid after calculation. Though they operate differently, both tax exemptions and abatements reduce the amount of tax a property owner otherwise would pay. Exemptions can also be structured to incentive affordable housing such as developing affordable units or the rehabilitation of old housing.

Tax increment financing (TIF) is a mechanism for collecting real estate taxes in a designated tax district above a base value and are earmarked for spending within that TIF district. Typically TIFs are time-bound, with many lasting between fifteen and twenty-five years.

To illustrate, consider a parcel slated to be developed within a newly designated TIF district with a life span of twenty years. The value of the property at the time of designation (and prior to any development) is the base value. Assume that the value of the building before the TIF is implemented is $100,000, and the tax owed on that property at that moment is $25,000. This is the tax liability of the base value of the property. After the property is developed, assume its value has increased to $200,000, bringing its tax liability to $50,000. Because the property is in a TIF district, the property owner will pay only $25,000 in taxes, rather than $50,000, effectively freezing the assessed value of the property for the duration of the TIF. The difference between the new tax assessment and the base value, the tax increment, is $25,000, which may be diverted to a secondary tax revenue stream and earmarked to be used according to the provisions of the TIF legislation.

In some cases, all or a portion of the earmarked revenue can be paid to project developers or property owners within the TIF district as an incentive. In this case, the program functions like an abatement. In other cases, revenue is earmarked—for example, for servicing bond debt related to TIF projects or direct spending on infrastructure or improvements that can indirectly incentivize developers to build in a particular area.[6]

Unlike the other two tax incentive types, TIF is predicated on the assumption that property values in the TIF district will increase, thus increasing the tax liability and generating a secondary tax revenue distinct from revenue created by taxing the base value. The value of the TIF to the developer generally increases over the life span of the TIF as long as the property values also increase in that span.

These tax incentives can be structured in various ways to further local goals. For example, to stimulate the development of affordable housing, a locality could implement a temporary tax abatement for new developments that meet affordability criteria. Or to stimulate rehabilitation of existing affordable housing, a locality could exempt the value of improvements and repairs from the property tax bill. As for TIF districts, the excess captured revenue from these districts can be used for numerous purposes, including financing public infrastructure, as a tax abatement, or a mixture of different uses to best incentivize affordable housing.

For more on tax abatements, exemptions, and tax increment financing, refer to the following resources:

- Local Housing Solutions, Tax Abatements or Exemptions
- Metropolitan Council, Tax Abatement
- Metropolitan Council, Tax Increment Financing
- Family Housing Fund, Stimulate Construction or Rehab Through Tax Abatements

Tax Incentives for Affordable Housing

Tax incentives can be designed in several ways to further affordable housing goals, such as stimulating new affordable housing development, maintaining or rehabilitating "naturally occurring" affordable housing, and providing support for low-income or other vulnerable homeowners.

Affordable Housing Production

Localities can stimulate affordable housing production by targeting tax incentives to development projects that contain a predetermined proportion of affordable units. For example, in 1971, New York City enacted its 421a tax abatement program that generally gives property owners a tax abatement if they construct new multifamily housing on lots that were previously vacant and dedicate 20 percent of the units created as affordable.[7] The tax incentive program has produced an average of over 2,100 affordable units per year, or more than ten times the annual output of New York City's inclusionary zoning programs.[8] However, it is estimated that the current 421a tax abatements cost the city about $1.77 billion a year in lost tax revenue.[9]

Preservation & Rehabilitation of Existing NOAH

Tax incentives can also be used to encourage the preservation and rehabilitation of existing naturally occurring affordable housing (NOAH), defined as housing that is affordable to lower and middle-income tenants without a public subsidy. These housing units are typically older and often include fewer amenities than newly constructed buildings.[10] In many cases, the maintenance of these properties may be greater than the income generated by rent, the building owner may be unable to finance rehabilitation projects, or a rising rental market may encourage landlords to increase rents beyond affordability. To keep NOAH in the rental market, tax incentives can be targeted to property owners who improve or maintain affordable units. The incentive can be selectively offered in neighborhoods with "a larger number of vacant, abandoned, distressed" properties.[11]

In Minneapolis, the city's 4d Affordable Housing Incentive offers a 40 percent property tax reduction to owners if at least 20 percent of the units are kept affordable to households making less than 60 percent of the area median income and subsidizes the cost of green retrofits such as weatherization and solar panels for select criteria meeting projects.[12]

Housing Stabilization for Low-Income & Fixed-Income Homeowners

Localities can also offer tax incentives or other forms of property tax relief to income-qualified homeowners or other economically vulnerable groups such as senior residents, persons with disabilities, and veterans. This policy may be a fit for jurisdictions with rapidly rising property values to ensure that homeowners with limited incomes or financial means can stay in their homes despite burgeoning property taxes. Although these policies can be structured in a variety of ways, they generally work by capping property taxes so that they do not exceed a predetermined proportion of the qualified homeowner's income.[13] These tax benefits are sometimes referred to as "property tax circuit breakers." The policies can also be extended to renters by treating some portion of the rent paid as attributable to property taxes and providing income tax credits, effectively acting as a rent subsidy.

Boston provides one example of a property tax circuit breaker policy.[14] It allows senior homeowners and renters (those age 65 and older) making less than $62,000 to claim up to a $1,170 tax credit based on income level and the amount of property taxes or rent paid.

How Effective Are Tax Incentives for the Creation of Affordable Housing?

Tax incentive programs for housing production and economic development have been implemented throughout the nation with generally mixed or unclear results. These incentives may also have adverse equity impacts.

Although the effectiveness of property tax incentives on affordable housing has not been closely studied, some studies have found that tax incentives may be more costly than other forms of subsidizing affordable housing development and may not be tailored to produce housing affordable for those who need it most. For example, a study of the performance of New York City's 421a tax abatement program from 2017 to 2020 found that the average affordable unit produced through the abatement is estimated to cost $1.4 million in present value (or $4.2 million over the thirty-five-year span of the abatement).[15] Though 421a has significantly outperformed the city's inclusionary zoning program in terms of the number of affordable housing units created,[16] the majority of those units have been developed through the city's capital resources and not through the 421a program.[17] Furthermore, despite the high cost per unit, most of the units created through the abatement are set at 130 percent Area Median Income, the maximum affordability levels allowed under the program, making those units unaffordable to nearly 75 percent of New Yorkers. Many of the new units are located in neighborhoods where the rent of the so-called affordable units is nearly indistinguishable from market-rate units.[18] Others have observed that 421a results in overproduction of units and gentrification in certain areas.[19]

In contrast to the lack of information on the effectiveness of local tax incentives in creating affordable housing, more studies have focused on the effect of tax incentives on encouraging economic development. While tax incentives for economic development purposes typically do not target the development of affordable housing, many do include among their purposes the development of market rate housing.

For additional case studies and examples of tax incentive programs and their successes and failures in creating both affordable and market rate housing, refer to the following resources:

- U.S. Green Building Council, Transforming a City One Home at a Time: Cincinnati's Successful Residential Tax Abatement Program
- Community Service Society of New York, Upgrading Private Property at Public Expense: The Rising Cost of J-51
- Matthew Pickering, Measuring the Efficiency, Equity, and Success of Philadelphia's Residential Property Tax Abatement
- State of New Jersey, Office of the State Comptroller, A Programmatic Examination of Municipal Tax Abatements

Much evidence on economic development tax incentives suggests that they do not effectively stimulate economic growth beyond what would have occurred naturally without the incentive.[20] Research also shows that these types of incentives are not only often ineffective but also economically inefficient because they are more frequently used in wealthier neighborhoods with little need of public investment and are either not used or fail to stimulate growth in areas with less economic opportunity.[21] This problem may be exacerbated by a lack of transparency and accountability in the administration of tax incentive programs, which may result in tax incentives being used on projects with unclear public benefits.[22] Other sources note that tax incentives are particularly ineffective in weak housing markets where the incentives alone may be insufficient to fill the financing gap needed for new construction or rehabilitation.[23]

Legal Considerations

Dillon's Rule Analysis

Because there are two types of states when it comes to how authority is allocated to local governments, home rule and Dillon's Rule, localities interested in property tax incentives should be aware of the limits on their authority to pass and implement such legislation. This is particularly true in Dillon's Rule states, where localities can exercise only powers that are explicitly granted to them by the state.[24] Although the power to excise property taxes is often granted to localities in Dillon's Rule states,[25] the ability to create special tax districts such as TIF districts may not be. Specific authorizing legislation from the state, such as in Connecticut and Maine,[26] may be required to implement tax incentive districts.

Preemption

Furthermore, even if a locality has the authority to pass tax incentives, its proposed legislation must also be consistent with state law so as to not be preempted. Preemption is a legal doctrine in which a higher level of government limits or even eliminates the power of a lower level of government to regulate a specific issue.[27] In the state preemption context, this typically occurs whenever a local law conflicts or is inconsistent with a state law. For example, a state law that sets the percentage by which property tax rates can change year to year has preemption implications for a local property tax incentive. State laws can also preempt local laws if the state's laws are so extensive within an area as to imply that the state intends to regulate all aspects of that area.[28]

While most localities retain some power in excising property taxes, many states have laws that limit local power in adjusting the collection, assessment, and expenditure of property taxes.[29] These tax and expenditure limitation state laws may have implications for all types of local tax incentives. An attorney familiar with state laws should be consulted before implementing tax incentives.

Equity Considerations

Although the efficacy of tax incentives differs depending on local conditions, research and commentary find that these programs are often ineffective at stimulating development and can have unintended equity consequences, including these:

- Forgone tax revenue for local governments, schools, and other overlying service or improvement districts
- Increased costs and burdens on taxpayers and residents
- Intraregional competition for jobs or housing, leading to a race-to-the-bottom effect.[30]

These effects particularly affect low-income and communities of color because they are more likely to use publicly funded services such as public schools and transit and are disproportionately affected by higher costs generally.

Forgone Tax Revenue for Local Governments, Schools & Other Taxing Districts

A major critique of property tax incentives is that their costs outweigh their uncertain benefits, to the detriment of the public.[31] If a local government grants an incentive to a development that would have occurred nevertheless, the government will be deprived of tax revenue it would have otherwise received. Depending on how a jurisdiction's property tax system and the incentive are structured, this can have a negative impact not just on the government that grants the benefit but also schools, which are funded in large part by property taxes.[32] For example, one study "found that three common tax abatements cost Ohio schools at least $125 million in revenue in Fiscal Year 2017."[33] This has equity implications because children of low-income households are more likely to be enrolled in publicly funded than independent schools.[34] For TIFs, the incentives can divert money from other taxing districts as well.[35] The problem of forgone tax revenue can also diminish funding for services and amenities, from police and fire to parks and open space, which undercuts tax incentives' very purpose:to stimulate economic revitalization.[36]

Increased Costs & Burdens on Taxpayers & Residents

Even if a tax incentive program successfully spurs development, the development's benefits may be outweighed by associated "negative externalities like traffic, crime, or noise pollution that lowers the value of nearby houses or businesses."[37] Low-income communities and communities of color already experience these externalities at higher rates.[38] New development may also increase demand for city services like schools, police, and fire, but as noted, incentive programs limit the amount of property tax revenue available to cover these new costs.[39] This issue is especially problematic for TIF programs where taxpayers from outside a TIF district are saddled with contributing to the increased demand for services within the district, even though they don't benefit from the TIF revenues retained by the district.[40] In some cases, jurisdictions may have to raise taxes or find other revenue to meet the demand for new services. In theory, a time-limited tax incentive that stimulates investments that would not otherwise happen will add to the size of the tax base at some future time; in practice, however, it is unclear whether incentives have a net positive effect on a jurisdiction's long-term finances.[41]

Intraregional Competition

Tax incentives can also encourage intraregional competition, which results in redistributing economic activity rather than producing new activity within the metropolitan region.[42] Such competition often leaves the region as a whole worse off as jurisdictions undercut each other to offer larger tax incentives for the same project, creating a race-to-the-bottom effect.[43] As for stimulating housing development, empirical data are unclear on how often these programs increase overall housing supply rather than move housing development from one area within the region to another, "blunting the desired effects on housing affordability."[44]

Although research has identified some potential best practices to improve efficacy or mitigate secondary impacts of tax abatement programs, the practices are often resource intensive or challenging to implement, making them feasible only for well-off communities that can dedicate the budgetary resources necessary for effective implementation.[45]

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