Analyzing the Effectiveness of the Low Income Housing Tax Credit (LIHTC) Program

By Prateek Patel
Master of Public Administration

Introduction

The Low-Income Housing Tax Credit (LIHTC) program was created by The Tax Reform Act of 1986 to provide incentives for private developers to build low-income housing units. The LIHTC program is now the largest subsidy program for low-income rental housing in the country. The program has financed the creation of more than 1.4 million new units per year.[9] Under the LIHTC program, investors can reduce their federal income taxes by $1 for every dollar of tax credit received. They are able to receive this credit for up to 10 years, and the property must remain occupied by low-income households for at least 15 years. This paper will explore the effectiveness of the program and whether the program lives up to its anticipated goals and objectives.

In order to do this, the paper will analyze the LIHTC process and explore variables related to the program's impact, including: the specific private/public mechanisms through which housing units are produced, whether the cost per unit is reduced, if the number of units produced matches demand, what income levels these units serve, and where the units are located. First, the paper will discuss how the Low-Income Housing Tax Credit (LIHTC) works and then analyze the specific private/public mechanisms through which the units are produced.

How the LIHTC Program Works, and How Tax Credits are Produced

Within the LIHTC program, the IRS allocates the amount of LIHTC provided to state agencies based on their population and assigned 'need'.[10] The LIHTC program requires that each state agency that distributes tax credits have a document called a Quality Allocation Plan (QAP) in place, which must provide preferences to certain projects and serve low-income residents. [9] The QAPs also need to show that LIHTC plans are in qualified census tracts (QCTs), which have a poverty rate of around 25 percent, or where half of the households' income levels are 60 percent below the area median income (AMI). They also must be located in Difficult Development Areas (DDAs), locations where the costs of construction, land, and utility costs are high compared to the AMI. Along with this, QAPs require that a project include the use of existing housing as part of a community revitalization plan and project sponsorship characteristics. Many states adopt more rigorous criteria to target priority populations and locations as part of the QAP proposals, although they must be approved by the IRS.[9]

Then the State Housing Agency determines which developers will be awarded tax credits for their projects. Developers may only submit proposals for four percent or nine percent credits, to be granted by the State Housing Agency if they meet all QAP standards[9], after which developers may sell these tax credits to investors or utilize a syndicator to sell these tax credits. With the additional equity gained from selling credits, developers are able to build affordable housing. Developers may also receive additional subsidies to reduce their construction and management costs. Once the development is built, developers must charge a lower rent for LIHTC units.[9]

Finally, for the property to continue to receive LIHTC funding, units must remain affordable for low-income tenants. The tax-credit recipient will receive credits annually for 10 years, but the property must remain affordable for an additional five years.[9] If the IRS finds rents have risen above the maximum rent caps at any point of during the15 years in operation, investors are subject to a financial penalty where some credits will be recaptured. Housing has to remain viable for residency and in good condition throughout these 10 years to continue to receive tax credits. Even though LIHTC units are not a guaranteed permanent residency for low-income households, low-income residents pay a lower level of rent than market rate based upon their AMI level[9]. After the full 15 years, the landlord can charge the market rate unless additional affordability restrictions are placed on these apartment buildings.[9] Most of these housing units will continue to serve low-income households after 15 years, but assistance to pay for

essential renovations will be needed. After 15 years, units may also not convert to market-rate occupancy based on how many improvements need to be made.

The Tax Credit Process and How Developers Receive Credit

To apply for tax-credits, a developer must follow each step of the Qualified Allocation Process, which varies from state by state.[10] The credit applicant will need to determine the total development cost of the LIHTC project.[10] This can be computed by determining the overall cost of land and whether it needs to be purchased, along with construction material costs, environmental and regulatory costs, the furniture-fixture-equipment costs, and factoring any additional costs that will come from the construction requirements.[10] These additional costs can be from elevators, ac/heater installation, electrical wiring costs etc. Once an estimation of the overall cost is determined, the financer will determine the financially acceptable cost and the lowest rate that they can afford to charge the renter.

Second, the credit applicant needs to determine the number of units or at least the percentage of units that will be occupied by low-income households. The percentage of the total square footage occupied by these households must be multiplied by the eligible basis to determine the qualified basis.[10] Third, the developer must determine whether their project is located in either a difficult development area or a qualified census tract. If so, then the development can receive a basis boost of 30 percent, thus increasing the size of the qualified basis. The qualified basis is then multiplied by the credit rate to determine the size of the tax credit that can be taken annually for 10 years.[10] For new construction and substantial rehabilitation, the 10-year stream of tax credits is based on 70 percent of the present value of the qualified basis (around nine percent annually, while developments that cost less than $3,000 a unit to renovate can be considered for a smaller credit based on 30 percent of the present value of the qualified basis (around four percent annually).

After the housing developer receives their tax credit, they usually sell LIHTC credits. Developers can either directly sell their interest to private investors or more commonly, turn to syndicators for this purpose.[10] These syndicators will sell these credits to private investors and banks that will then finance construction costs.[10] Generally, developers will turn to syndicators to sell their interest on behalf of them to private investors. From this interest, private investors will receive some cash transfers to finance their construction operations along with this obtain tax credits to make building units with less rent, more feasible.[10] They sell an interest in the development to private investors, who receive the tax credits, other tax benefits, and perhaps some cash flow from operations and a portion of the capital gains if the property is sold.

The Power of Designated State Agencies and Syndicators

As stated earlier, tax credit amounts depend on the cost and location of the development and its portion of units dedicated to housing low-income residents. Tax credit funding assigned to individual properties also depends on total development costs including land and other expenses.[10] Properties located in difficult development areas or qualified census tracts tend to receive additional credits compared to LIHTC proposals that are in wealthier areas or in median income neighborhoods.[10] Tax credits are provided to individual housing developers by designated state housing agencies based on state population and the overall housing needs. As of 2007, states could allocate $1.95 per resident in tax credits and at least 10 percent of a state's tax credit allocation must go to housing developed by nonprofit organizations.[10] Generally, state housing agencies award federal tax credits to particular developers, who sell them to investors either directly or through syndication.[13] Once investors receive equity from the projects, they can use these tax credits to diversify the risks that investors will take. This provides individual housing developers with greater freedom regarding, which projects receive a boost.[13]

Generally, state housing agencies provide four and nine percent credits to offset approximately 30 and 70 percent of project costs.[13] However, the LIHTC can be boosted in value by 30 percent for building in low-income areas. State housing agencies have discretion to choose the projects that receive a 30 percent boost, which comes from the federal budget, causing many state housing agencies to abuse the

system in providing this boost many of its projects.[2] Developers make little effort to reduce their costs after the state's generous grants are given to them.[13] Many LIHTC projects operate at a loss, because investors can offset their taxes on other income if they receive additional funding.[13]

Major banks are the biggest financiers of LIHTC projects, because these projects allow them to fulfill certain requirements that make it easier for them to finance market-rate housing projects. Recently, it was found that close to 85 percent of total LIHTC equity investments were provided by banks and almost half of the equity investments have been provided by four banks.[2]

A 1997 study conducted by the Government Accountability Office discovered that the syndication process takes up anywhere from 10 to 27 percent of the equity on LIHTC projects. Due to state regulations regarding Qualified Allocation Plans, they have unique costs associated with financing, construction, and labor requirements compared to market rate housing. In many cases, these requirements have made the cost of affordable housing projects more expensive than market-rate housing projects.[12]

A lack of oversight over the LIHTC program has made it susceptible to tax fraud. An NPR investigation discovered that "little public accounting of the costs exists, even among government officials and regulators charged with monitoring the program."[11] The IRS hands out LIHTC benefits, but its oversight has been limited. Only 13 percent of the state housing agencies that hand out the tax credits have been audited by the IRS. The failure of the IRS to properly monitor how their allocations are used reduces the accountability of developers. This lack of oversight allows the state housing agencies to use their funds in any manner that they want.

Who's Eligible to Live in the LIHTC Homes

The cost of renting LIHTC units are usually factored into their overall cost of production by developers to ensure that low-income renters can afford them.[9] The reduced cost of rent allows LIHTC developments to be occupied by low-income households. Depending on where the LIHTC unit is located, the developer will receive more tax credits and the cost of building the unit declines. The Area Median Income is the midpoint of a region's income distribution – half of families in a region earn more than the median and half earn less.[9] These policies help identify which households are eligible to live in income-restricted housing units, and determine the cost of housing at three levels of affordability: at or below 30 percent AMI, between 31 and 50 percent AMI, and between 51 and 80 percent AMI.[9]

Within properties that dedicate more than 40 percent of their units to low-income renters, low income is defined as being up to 60 percent of the median family income, while in properties where only 20 to 39 percent are dedicated to low-income renters, low income is defined as being up to 50 percent of the median family income.[9] In most cases, the cost per unit is uniform across LIHTC units within a particular location, and market rate plays a role in influencing average rental costs for low income households based around the AMI rules. With market rate being higher on average within metropolitan areas, many lower-income residents cannot afford the high cost of rent.[9]

The Locational Patterns of LIHTC Development

Sociologist Deidre Oakley's 2005 research study examined neighborhood characteristics and spatial patterns of LIHTC developments in four metropolitan areas. Utilizing HUD's LIHTC database and collected census data, Oakley used socio-spatial analysis to determine how clustered or dispersed LIHTC units are. She determined that the program attained high levels of success in locating units in less advantaged neighborhoods. However, the research showed the LIHTC program failed to build units in more affluent locations on aggregate.[8] Originally, one of the stated goals of the program was integrated by income level. However, socio-spatial analysis showed that LIHTC developments were not being placed in upper-income neighborhoods where there are affordable housing shortages, despite there being a major demand for the affordable rent range in these neighborhoods (Oakley, 2005). Therefore, the program has a higher likelihood of rewarding developers that place LIHTC units in qualified census tracts where a heavy flow of other LIHTC projects already exist. From this assessment, it can be determined that the

program is only building units where a majority of the low-income housing units already exist (Oakley, 2005).

Does the LIHTC Increase the Overall Supply of Housing?

The LIHTC program aims to place units in neighborhoods with a home shortage, and state agencies allocate federal funds to resolve a specific area of need through their Qualified Allocation Plans. Economists John Malpezzi and Deborah Vandell found no significant relationship between the number of LIHTC units built and the overall supply of housing.[5] This suggests a high rate of substitution and that LIHTC units only added to the existing affordable housing stock. From this assessment, we can determine that the program is building units where a majority of the low-income housing units already exist.[5]

This creates a high level of housing demand in cities without sufficient housing stock. With an inflow of new residents entering large cities for job opportunities, education, or business ventures, housing supply is limited. No one wants to be unsheltered, and cities have a priority to house all permanent residents and visitors, whenever they enter their city.[1] LIHTC credits are generally unaccounted for in large cities, because they tend to have the most regulations associated with home-building. Generally, the lack of available land and higher labor standards in metropolitan areas result in high costs for developers to build additional LIHTC units.

This leads many economists to argue against federal tax subsidies, and instead advocate for state and local policy changes.[1] Both building and zoning regulations decrease the supply of housing, potentially causing homelessness, as is evident in larger cities. With the LIHTC, the rising costs and regulations of buildings in large cities deters many developers from building in wealthier communities[3]. And generally, these larger metropolitan cities have an extremely high demand for multifamily housing for low-income tenants and renters that are unable to afford expensive rent and home-mortgage costs.

Has the LIHTC Improved Poverty De-Concentration?

Over the past decade, poverty de-concentration has become a major federal housing policy goal to help reduce the income gap.[15] One major aim of the LIHTC program has been to deconcentrate poverty and promote mixed income living. By increasing the supply of housing in metropolitan areas is an example, but the policy needs to also create units across the median income neighborhoods to improve standards.

Williamson, Smith, and Strambi-Kramer's article analyzes whether the Housing Choice Voucher and the LIHTC have worked together to reduce poverty concentration. The authors found that LIHTC units are important sources of housing opportunity for voucher holders in some areas, but also found evidence that LIHTC location patterns in economically distressed areas known as Qualified Census Tracts may reinforce existing poverty concentrations.[15]

With income separation, area property values increase at a higher rate. Lower property value neighborhoods tend to have low levels of development and a large amount of poor residences.[15] By bringing low income residents to wealthy neighborhoods and high income residents to poor neighborhoods through gentrification, the property values of both areas increase. Higher property values mean higher property taxes for cities, allowing them to increase their revenues, which can be used to improve the amount of support and opportunities provided to citizens from improved education, infrastructure, and recreation.[15]

The Market Price of Low-Income Housing Tax Credit Housing

Imagine a housing project that costs $10 million to build and receives the seven percent credit. Investors would get tax credits of $700,000 a year for 10 years, totaling $7 million. Those two credits would be worth about $5 million on a present-value basis, or about 50 percent of all construction costs. This would allow the government to cover around 50 percent of the project, while allowing the investors to reduce income taxes they are paying by around $5 million dollars. The amount of tax revenues that are lost in funding one development in the example above shows how much money can be spent on aggregate

if supervision is absent. Many economists argue that the LIHTC will become more expensive in financing a high level of housing support in comparison to tenant-based policies such as vouchers.

Additionally, there are many liquidity constraints faced by LIHTC developers in allocating subsidies and developers selling tax credits at low discounts below the actual value of the construction.[2] Currently the price has been estimated to be around $0.73 per dollar of tax credit and has averaged to be around $1.8 billion annually compared to allocating a cash transfer to developers.[2] Such policies overstate the overall cost of LIHTC units and allow developers to benefit.

Market price influences what unit rents are set at, however this whole assessment is subjective.[9] Land assessors determine property values and from this assessment, the apartments will decide based upon the demand, how much market-rate rent prices should be set at. However, the actual cost of rent can be based not on what is affordable, but by how much others are willing to pay.[9]

A recent study by the Washington State Department of Commerce found that once a federal LIHTC allocation has been secured and the investor has made their money, they have few incentives to reduce development costs of affordable projects[14]. The over-regulation and the high costs of metropolitan areas reduce the incentives for developers to build in these regions. However, with the full appropriated federal LIHTC credits, they will not worry about saving money on material costs and labor costs, and this will make the overall project cost to be more expensive than projected.

By the government allocating money to developers to build these cheaper LIHTC properties, the goal of providing affordable housing should be the primary incentive. But instead, homes are being built and will continue to be built, regardless of the LIHTC credit. So, if private demand prices are determining the rates, then LIHTC units have not assisted with poverty de-concentration. All it has done is provided nicer apartments by tearing down old ones, in poor and low-income areas. And generally, only the supply of homes has increased in low-income areas, where there are already enough low-income units. In order for income integration to happen, the state housing agencies need to further incentivize low-income home creation in upper-income neighborhoods. The problem comes from the lack of willingness to accept less wealthy people in the more affluent communities. With the higher standard of living in these areas, the cost of goods and services are too high for a low-income individual to afford residency. Cities need to reduce their property tax rates and de-regulate certain market barriers, to allow low-income residents to have the ability to live in wealthier communities.

Are LIHTC Units Affordable?

LIHTC developments tend to set rents between 30 to 60 percent of the area median income, as discussed earlier.[3] But rents are still too high, especially for poor families whose incomes are below 30 percent of the median. A majority of the people that live in poverty are far below the current AMI standards, and these families typically do not have the income to afford even the lowest-rent cost.[3] In some states, some extremely poor residents receive vouchers for financial assistance to help them pay rent, but even then the cost is still high.

This is another reason why LIHTC units are not being developed in high-opportunity neighborhoods, because poor families cannot afford the rents even at 30 percent AMI in wealthy areas. In low-income neighborhoods, market rents are typically much lower than the 30 percent to 60 percent area median, so LIHTC owners have to set lower rents. In these cases, these owners would not be able to fill these newly built units if they are above market rate.[3] That's not the case in high-opportunity areas, where most apartments will be filled due to the large housing demand. state Qualified Action Plans (QAPs) have the ability to set restrictions to make LIHTC units more affordable. In order to compensate the owners, certain programs like the HOME Investment Partnership, Community Development Block Grant, or National Housing Trust Fund are in place to cover anticipated revenue losses from the rent cost so that the owner is able to cover operating costs and payments on debt from development costs.[3] Even then, by placing low-income families in more affluent areas, they still face a high risk of displacement.[3]

Certain city barriers need to be lifted to allow lower-income people to be incentivized to move to wealthier neighborhoods. Wealthier neighborhoods may have better schools and more job opportunities, but the high cost of living in these areas deters low-income households from moving to these areas.

Marketing and Tenant Selection Discrimination

Whenever poor families and minorities can afford LIHTC rent costs, they still may have lower credit scores than more affluent families.[3] In many cases, there is a rigid credit screening process to ensure that the most qualified individuals obtain residency in LIHTC units located in upper-income areas. The lack of high credit scores is one of the major reasons that people tend to be poor in the first place, and this criterion further inflate the overall goals of building the LIHTC development. This prevents many impoverished people from having access to LIHTC housing in high-opportunity areas. Along with this, they have their own personal networks within lower-income neighborhoods, so they may not know people that can potentially vouch for them to enter the upper-income residence.

The goal of the LIHTC program is to help the poor and disenfranchised, but these barriers to entry directly discriminate against people the program intends to help.[3] It is necessary for states to address these barriers through more targeted outreach to attract underrepresented groups to LIHTC developments. States usually have detailed marketing criteria in place, and people of color and underserved populations need to have greater access.[3]

Voucher Assistance Program

A majority of the poor households that reside in LIHTC developments need some federal rental assistance in order to afford housing.[3] This assistance generally gives families have the capability to pay 30 percent of their income towards rent. Housing Choice Vouchers, which are tenant-based and can be used in the private market, are the most common form of federal rent assistance.[3] Housing vouchers allow low-income families to relocate to better apartments where units go unfilled and they are charged a lower rent than the market rate.

Both the programs working together will allow poor families to rent housing in high-opportunity areas where the rent is very high. However, with vouchers, states or sometimes cities decide whether apartments have to mandatorily accept vouchers. "Good credit is needed to apply for apartments, and voucher holders must compete with each other where vouchers are accepted..[9] Generally, the people with the least credit, usually the poorest individuals in society, will receive these vouchers. However, there are issues with state implementation of the program when states do not force apartments to accept vouchers from low-income residents. When allowed to choose apartments tend to deny voucher recipients residency or implement an even more rigid voucher selection process.

These voucher subsidies can and usually do work in tandem with LIHTC units, because these low-income homes are made to house the poorest residents. However even with LIHTC developments (depending on the state or locality), apartments can discriminate with voucher-holders by choosing the applicant with the highest levels of credit.[9] Allowing these programs to work together will improve the overall success of LIHTC developments in housing the disadvantaged residents it aims to serve, but certain changes need to be made to the voucher program at the federal level to ensure that apartments are willing to accept voucher recipients.

LIHTC Tenant Protections, A Good-Cause to Evict?

All LIHTC unit residents must be allowed to pay lower rent costs for up to 15 years. Owners of LIHTC properties can evict tenants only if a good cause is provided.[7] The good cause requirement has helped prevent many low-income residents from being evicted. In many cases, tenants may be delayed in making necessary rents and payments, putting their tenancy at risk. This has led certain tenants to be forcefully removed from their apartment without notice. A lack of tenant protections would allow apartments to remove tenants at will. Such problems have led to the creation of LIHTC tenant protections. Some states like California have required the good-cause requirement and require a letter to be delivered to low-income residents informing them of their rights[7], while other states like Wisconsin and Massachusetts have made references to a good-cause requirement in their LIHTC regulatory agreements.

However, many state tax credit agencies have entirely failed to implement the good-cause requirement. This has become a major issue for LIHTC tenants and has led critics to advocate for change to the IRS.

For LIHTC residents in particular, the IRS created the "extended low-income housing commitment" (ELIHCs) in 2005, which has been enforced to a greater extent in some states than others. The good cause eviction requirement applies to all terminations of tenancy in the LIHTC program, whether during the term of the lease or at the end of the term. However, the ruling requires state agency tax credit allocators to review their LIHTC inventory to determine the extent of noncompliance and to simultaneously take action to protect tenants' rights during this process (26 U.S.C. § 42 (h)(6)(J)). Many of these states have their own bilateral ELIHC agreements between the state housing agency and the owner, requiring the owner to comply with existing agreements.[4]

Maintenance and Upgrades

Another major problem LIHTC housing has historically faced is the issue of maintenance and upkeep.[6] LIHTC credits are used primarily for construction, but every housing unit needs maintenance and capital upgrades.[1] With market-rate housing, owners generally raise rents to finance these upgrades. LIHTC properties have rent caps and income limits, constraining the ability and incentive of owners to make additional investments.[6] The age of properties is another point of concern, as they require increased upkeep due to higher wear and tear. If the LIHTC properties operated in the regular market, these improvements would be made at a faster rate.[1]

In many cases, the lack of upgrades can put the lives of tenants at risk. With units starting to face problems of asbestos and paint wearing out, the apartment owners should make immediate improvements.[6] But as the LIHTC apartment unit is under contract for cheap rent up to 10 years, the development owner does not have the same incentive for improving their homes. In addition, low-income tenants will need to be temporarily displaced or shifted until proper renovations or repairs are made, which increases the marginal cost for both parties.[6] However, the short-term impacts of not improving the property are heavily outweighed by the potential long-term problems of putting the health and safety of the tenant at risk.[6] This can be solved by state housing agencies threatening to take away tax-credits unless renovations are made periodically.[6]

Conclusion

Overall, the Low-Income Housing Tax Credit has many drawbacks that reduce the overall effectiveness and efficiency of the program. Providing cheap units to low-income residents through a free-market approach has many challenges, which has not shown to adequately benefit many of the low-income residents it intends to help. The goal of the program is to provide more low-income homes in difficult development areas and upper-income neighborhoods. Doing so will reduce the income gap and improve the standard of living for impoverished Americans.

The program has failed to be effective for several reasons. The first is money mismanagement. The LIHTC policy has few mechanisms in place to prevent the misuse of funds or adequately monitor how funds are allocated by state housing agencies. Lack of oversight has allowed developers and investors to make financial gains from the program at an unprecedented rate.

The second problem comes from the cost of "affordable" rent. Under the current LIHTC provisions, units are intended to serve households that have incomes between 30 and 60 percent of the area median income, yet a majority of impoverished households make less than the 30 percent AMI. This means that regardless of all the tax-credits, incentives, and affordability provisions, these LIHTC units are still too expensive for low-income residents.

The third problem is location. The LIHTC program aims to create cheaper developments in two types of areas: difficult development areas and upper-income neighborhoods. However, when it comes to upper-income neighborhood LIHTC developments, there has been little supply of homes and rental costs for lower-income residents have exceeded their affordability range. The LIHTC program does not account for the high cost of building and regulations within metropolitan areas, which de-incentivizes developers

from building cheap units in wealthy neighborhoods as they will lose money for 15 years. With LIHTC units being built only where low-income families are clustered, the program fails to accomplish one of its goals of income integration.

The fourth problem with the LIHTC program comes from credit discrimination. The LIHTC program does not do enough to reduce credit discrimination and help the low-income population that it was implemented to serve.

The final problem is maintenance, as the program leads to a lack of incentive for the property owners to renovate and upgrade their properties.

In summation, the Low-Income Housing Tax Credit has not effectively lived up to the goals and standards set during its implementation. Unless these policies are reconsidered and until changes are made, the program cannot be called efficient or effective.

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