Private Activity Bond Volume Cap and Housing Production

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Introduction

The United States is experiencing a housing shortage and affordability crisis. From 2000-2015, the country fell 7.3 million homes short relative to need.[1] This shortage makes housing, particularly in high-opportunity areas, less available which in turn contributes to the affordability crisis. Millions of American households are cost burdened —spending more than 30% of income on rent — and are unable to find affordable homes proximate to jobs and amenities. More than 47% of renter households experience this cost burdening, which has short- and long-term consequences on individual financial security and on overall economic health, including increasing inequality.[2]

Cost burdening is felt by renters across the income spectrum, but the affordability crisis most severely impacts households with lower incomes. 71% of extremely low-income renters, those who earn 30% or less of Area Median Income (AMI), are severely cost burdened, which means more than half of their income goes to rent.[3] This group makes up a quarter of all renters but because of a major shortage in low-cost units, only 36 homes are affordable and available for every 100 extremely low-income renter households. Cost burdening compounds inequality, excludes families and individuals from high opportunity areas, and limits access to safe housing options. Housing is a critical resource, and affordable rental projects are important for relieving cost burdens on low-income renters.

Affordable housing developments that provide units to lower income residents are critical for meeting housing goals and for ensuring that low-income families and individuals have access to quality housing. However, it often costs at least as much to build affordable units as it does to build market-rate units, and construction costs can make it economically infeasible for property owners to charge rents at levels low-income households can afford. The number of low-cost rental units declined by 3.1 million between 2012-2017, a drop from 33% to 25% of total units.[4] For developers, financing below-market rate units is difficult and unsustainable without tax incentives and other financing programs. Private Activity Bonds (PAB) are one such mechanism and, in conjunction with the Low-Income Housing Tax Credit (LIHTC), are essential for financing hundreds of thousands of affordable housing units. PABs are tax-exempt, and therefore investors are willing to accept a lower rate of return than they would for taxable investments. This lowers the cost of borrowing, freeing up additional capital and allowing savings to be passed to projects, which in turn results in more affordable units.

While PABs go to a variety of qualifying private activities, the majority goes to affordable multifamily rental housing projects.[5] From 2016-2018, $44 billion of the total $73 billion issued in bonds funded affordable housing projects.[6] PABs play a critical role in ensuring the affordable multifamily housing gets built. Together with LIHTC, PABs help to finance more than 52,000 affordable homes each year.[7]

Despite a critical and growing need for affordable housing and the efficacy of PABs on housing production, the volume cap on tax-exempt PABs limits the number of affordable projects that can be built. The annually adjusted tax-exempt volume cap requires states and localities to make tradeoffs in allocating funds. As the housing affordability crisis grows, PABs become an even more critical resource in financing housing but continue to face funding competition with other qualifying activities. Affordable housing is critical for a healthy economy and functioning society, and innovative adjustments to the bond volume cap can help increase the supply of housing and reduce the burden on renters and homeowners.

As the country grapples with the consequences of COVID-19, the critical need for affordable, quality housing is even more apparent. The major public health crisis coupled with shocks to the economy and labor market that have left millions of Americans unemployed, has also put millions of people at risk of losing their homes. Many of these families were already cost burdened and unable to save for an emergency on the scale of COVID-19, and their future economic outlook is even more grim. Additionally, nationwide shelter-in-place ordinances have helped shed light on both the importance of and the inequitable access to quality housing. The recovery from COVID-19 will require workforce development, housing construction, and infrastructure development. Modifying the PAB rules around the volume cap will help recovery in all three of these areas, and will, most importantly, increase the supply of affordable, quality housing.

This paper explores how PABs are used in the creation and preservation of affordable units and how bond regulations can be improved to have an even larger impact on the affordable housing crisis. This work is conducted by Up for Growth and is not intended to serve as an endorsement of any specific legislation.

How Private Activity Bonds Work

State and local governments issue bonds to cover the costs of important infrastructure and public works projects. Typically, interest on bonds for projects are taxable, but PABs for qualifying projects and government bonds, which go toward public goods, are both tax-exempt. PABs are issued for 27 qualified private activities, and 14 of these activities are subject to a bond volume cap. Qualifying activities include things like affordable multifamily housing, airports, water, sewage, and waste facilities, and highspeed rail projects. Interest earned on these bonds is tax-exempt, which means that investors are willing to accept a lower interest rate on the bonds. This reduction in borrowing costs allows for increased investment in the creation and rehabilitation of affordable rental units. Under federal law, half of a state's bond allocation goes to the state, and the other half goes to localities, but states have the authority to alter this distribution percentage.[8]

Importantly, PABs work in conjunction with the 4% LIHTC to provide a large share of affordable units. LIHTC incentivizes the production and rehabilitation of low-income affordable units. The tax credits are issued by the federal government to state and territory governments and awarded to developers by state housing agencies. Developers then sell credits to investors and use the capital to build or rehabilitate affordable units. Affordable housing projects that finance at least 50% of costs with tax-exempt PABs and meet certain criteria receive a 4% LIHTC, which further increases the equity for the project, incentivizing developers and making affordable projects more feasible.[9] This coupling is increases the overall economic benefit of multifamily residential projects relative to other qualifying private activities, and is critical for ensuring affordable units get built.

In terms of affordable housing, PABs can go toward three purposes — Mortgage Revenue Bonds (MRB) for low-income homebuyers, Mortgage Credit Certificates, and multifamily bonds for affordable multifamily residential projects. Residential rental projects qualify using criteria like those for LIHTC projects. Namely, either 20% of units must be set aside for residents who earn less than 50% AMI or 40% of units set aside for households earning less than 60% AMI. Housing projects make up the vast majority of PAB use — 91.5% of PABs go to affordable housing, including 61.1% to multifamily affordable rental housing and 30% to single-family housing.[2] The share of PABs used in housing has been increasing — in 2016 only 60% of PABs went to housing.[2] The rapid growth in housing-related PAB use indicates a critical and growing need across states and localities and proves that PABs are a valuable tool for affordable housing developers. The growth in use also leads to decision points around the tradeoffs between bond-backed housing activities and the other qualified private activities, and sheds light on the limitations that the bond volume cap places on the efficacy of the subsidy.

The Private Activity Bond Cap Problem

The federal government places an annual state volume cap on 14 of the 27 qualified private activities. The volume cap is determined on a per capita basis; for 2020, each state received $105 multiplied by the state population, with a minimum cap of $321,775,000. The volume cap applies to all eligible private activities, and states and localities have discretion with how the funds are distributed. If the state intends to use bond authority that it did not use during the first year it was received by the state, the

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Our mission is to forge policies and partnerships to achieve housing equity, eliminate systemic barriers, and create more homes.

Launching Policy Briefs

Up for Growth is excited to launch its series of policy briefs where we offer evidence-based and data-driven analysis of a variety of pro-housing policies. Each brief will focus on a specific local, regional, state, or federal policy and will inform policymakers, advocates, and practitioners as they advance meaningful solutions to housing underproduction. Up for Growth's member network will be surveyed to obtain critical insights and considerations to inform policies that further our organization's mission.

Members can email policy@upforgrowth.org to submit their ideas for policies to be evaluated in future briefs.

state must file a form with the Internal Revenue Service indicating that it will carryforward that bond authority and designating the amount of bond authority it will use towards each of the eligible private activities. Once the state has designated how it will use its carryforward bond authority, that designation is irrevocable. That means the state is unable to redesignate the bond authority for any of the other eligible uses, even if its priorities change or changes in the economy make a project infeasible. Carryforward authority is available for an additional three years, after which it expires. In 2018, the carry forward was $89.7 billion.[10]

The use of bond authority differs significantly across states, with different states prioritizing different activities and some using all of their available bond authority, while others are unable to do so. However, in recent years, the vast majority of PAB authority nationwide has gone to housing-related activities, but 75% of the multifamily housing bond authority has been used in just 11 states.[9]

Congress places controls on tax-exempt bonds through the volume cap and through determination of what private activities qualify for the bonds. The private activity bond cap originated in the Deficit Reduction Act of 1984 and was modified in the Tax Reform Act of 1986.[11] Congress put in place the volume cap because of concerns about the amount of tax-exempt bond issuance for private activities at the time, which lowers federal revenues, and because of concerns that bond financing for private activities was competing for investors with bond financing for traditional public projects, thus requiring state and local governments to raise interest rates for the bonds issued for public projects in order to entice investors, leading to inefficiency in the allocation of capital.9 While there is a revenue loss associated with tax-exempt bonds, the activities can themselves be revenue-generating, and the benefits can offset the costs.

Furthermore, as the nation struggles with an affordable housing crisis that stems from a lack of supply, innovative financing schemes are critical in the path to a solution. PABs help spur the creation of 40,000-50,000 housing units each year and have created nearly 1.2 million affordable units since their establishment.[12] They are incredibly important tools for developers to leverage in creating more affordable projects. The economic benefits of affordable housing extend beyond the units themselves. Access to jobs, education, transportation, healthcare, and other amenities is critically important to low- and moderate-income residents of affordable units, yet this access is limited by the already constrained market. The public and economic good of providing more affordable units provides states and localities with significant benefits. PABs offer a path to creating these units, but the volume cap means that many of these projects do not get funded.

Now, as the nation grapples with the effects of the COVID-19 crisis, the need for affordable housing and the inequity of access to housing is more apparent than ever before. Housing production is critical for economic recovery, as housing stability directly influences financial stability, housing production is an economic stimulator and a job creator, and more housing production will bring critical revenue to states and localities. The effectiveness of housing production during recovery depends on a variety of factors, but financing is one of the most critical. Modifications to the bond volume cap, specifically as it relates to housing production, will help make PABs more efficient and effective at delivering much-needed housing supply while simultaneously spurring economic recovery.

Potential Solutions

The rise in the share of PABs that go toward affordable housing purposes indicates a dire need in many areas for increased affordable housing production, and modifications to the bond volume cap would help spur even more of this much-needed creation. The bond volume cap limits the effectiveness of PABs have on improving the housing supply. Improvements to the bond cap can have large benefits — not only on affordable housing markets but on the economy and labor force writ large.

A. REDUCED FINANCING PERCENTAGE

Current statutes require that 50% of construction and land cost for affordable housing projects be financed with PABs to be eligible for a 4% LIHTC allocation. Reducing this requirement to 25% will spread limited PAB volume cap across more projects, which means that more projects will receive LIHTC without Congress having to increase the overall bond cap. Recent estimates indicate that reducing the financing requirement to 25% will free up an additional $93.7 billion in PABs and will result in between 732,000 and 1.4 million additional units over the next 10 years.[13] The projects will provide the same public and private benefits and help mitigate the housing affordability crisis without challenging fears around inefficiency of tax-exempt bonds as a funding mechanism — the overall bond allocation would remain the same, but the number of possible projects would increase. Passing the 50% test will also be more difficult as states respond to the COVID-19 crisis, which makes lowering the threshold even more important.

B. EXEMPT AFFORDABLE HOUSING BONDS FROM THE VOLUME CAP

PABs are critical for financing affordable housing, and their effectiveness and efficiency can be improved with unlimited volume cap for multifamily residential projects and for qualified mortgages, even temporarily. When PABs are coupled with 4% LIHTC, the project's equity increases, and the public and private benefits of the project also increase. Removing qualified affordable housing activity from the bond cap, even over a period of 5 or 10 years, would help the states that face the most significant housing burdens increase affordable housing stock.

C. RECYCLING OF VOLUME CAP

75% of PAB dollars — both for affordable multifamily residential projects and qualifying mortgages — comes from just 11 states. These states have the highest housing need and are therefore either prioritizing housing-related tax-exempt bond projects or pushing up against their bond cap. A national pool that aggregates and redistributes unused bonds to states that can use them for qualifying projects would better allocate the funds and reduce the amount of carried over fund expiration. The Afford Housing Credit Incentive Act includes a proposal that would expand bond recycling for multifamily projects and MRBs. It would also expand the time states have to issue the recycled bond from 6 to 12 months.[14]

D. ALLOW FOR REDESIGNATED CARRY FORWARD

States can carry forward unused volume cap for up to three years after the bond issuance. To do this, states must file a form with the IRS declaring the amount and designated purpose of the carry forward. After this form is filed, no changes can be made to the designation or the dollar amount. This limits the ability of carry forward bonds to cover the most pressing housing needs. It also does not allow for adjustments based on market changes and updated project feasibility. Allowing for future redesignation of carry forward bonds would give states more flexibility in meeting affordable housing needs.

Conclusion

The United States is grappling with a housing shortage and affordability crisis, and solutions must come from all levels of government. The housing crisis is the result of a variety of interrelated factors — burdensome regulations that limit new housing production, labor shortages and cost, restrictive zoning that limits zoned capacity, and the increasing cost of raw materials. The difficulty of financing projects is one of the biggest obstacles that limits the supply of housing relative to need — particularly for low-income affordable units. PABs, coupled with 4% LIHTC, provide the financing to spur the creation of affordable units in high opportunity areas. The last few years have seen an increased use in PABs to finance housing projects, which indicates the growing need for housing and the efficacy of this financing structure.

The bond volume cap, however, limits the number of affordable housing projects that can be created, and forces states and localities to make cuts and tradeoffs as they attempt to meet housing needs. Modifications to the bond volume cap can spur the creation of more affordable housing. Affordable housing provides critical economic and social benefits, but innovative financing structures are necessary to incentivize development of these below-market units. Improving financing by improving the bond volume cap would enhance these public and economic benefits.

Endnotes

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