Thoughts on Rental Housing and Rental Housing Assistance

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Abstract

The United States has long exhibited enthusiasm for homeownership. The converse of this is that it has tended to neglect rental housing. This article seeks to do the following: (1) explain why rental housing is desirable; (2) lay out the policies that favor owner-occupied housing; (3) discuss current subsidy programs for rental housing, with particular emphasis on programs that are not simply legacies of past policy; and (4) examine how these programs might be improved or reformed. It argues that in a second-best world of restrictive zoning and preferences for ownership, rental subsidies may be justified on both equity and efficiency grounds.

Introduction

If anything shows how research and policy have neglected rental housing, it is a search of the words “rental housing” on scholar.google.com. Of the 10 most cited studies on this issue, the youngest is 10 years old, 5 are from the 1980s, and 4 are from the 1970s. And it is not as if more recent papers will catch up soon—the 10th most cited paper has been cited only 34 times.

Yet rental housing is a big deal. The 2007 American Housing Survey (AHS) shows that 35 million households lived in rental housing in that year, housing 81 million people. The events of the past 2 years have made renter housing more important, because many households that were foreclosed upon have been forced to move into rental housing. For mobile people who do not want to bear the fixed costs of owning and busy people who do not want to bear the management cost of owning, rental housing is an important option.

The neglect of rental housing is the natural product of America’s obsession with owner-occupied housing. This obsession goes back at least as far as de Tocqueville (de Tocqueville, 1835: 231):

Nations are less disposed to make revolutions in proportion as personal property is augmented and distributed amongst them, and as the number of those possessing it increases.
The reverse of the American embrace of owner housing has been hostility toward rental housing in general and apartments in particular.

This article argues that in a second-best world, one in which the federal government provides substantial benefits to owners and local zoning is often hostile to renters, rental subsidies may be appropriate on both equity and efficiency grounds.

Not all rental subsidies are created equal, however. Rent control is inefficient and often inequitable. Tax credits may encourage low-rent housing in places it is least needed and may be very “leaky”; that is, a large share of the subsidy does not find its way to renters. The Section 8 Housing Choice Voucher Program (vouchers) provides the most promising form of rental assistance, but, because it is not an entitlement, its may produce perverse results.

This article seeks to do the following: (1) explain why rental housing is desirable; (2) lay out the policies that favor owner-occupied housing; (3) discuss current subsidy programs for rental housing, with a particular emphasis on programs that are not simply legacies of past policy; and (4) examine how these programs might be improved or reformed.

**Why Rental Housing Is Desirable**

Rental housing can be better for some households than owner-occupied housing for a few reasons. Rental housing—

- Is compatible with labor mobility.
- Allows for households that wish to invest in something other than housing to do so.
- Generally allows for the provision of safe, sanitary housing while reducing the risk and perhaps the cash-flow cost of such housing to dwellers.

This section discusses each of these points briefly. When making a decision between owning and renting, a household might perform a financial calculation regarding which form of tenure minimizes housing costs. Although housing costs are generally addressed in terms of cash-flow costs (discussed later in the article), they also need to be addressed in terms of fixed costs—the fixed costs involved in purchasing a home are inevitably higher than they are for renting.

The reason for this disparity is the nature of the transaction: owners need to know their tenure is secure in perpetuity (or something close to it), and lenders that finance owner-occupied housing need to perform due diligence to make sure their loans are well collateralized. This due diligence imposes fixed costs in the forms of downpayment, title insurance, and loan origination costs on owners that do not exist for renters. The buyer-seller transaction is also more likely to go through a broker than is a landlord-renter transaction. Moreover, homeowners bear these types of fixed costs both when purchasing and selling a house. These costs produce a friction that is much larger than in the rental market.

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1 Brokers are usually involved in commercial real estate leases, but are less involved in apartment/house leases.

2 A landlord must perform due diligence as well, but not to the same degree as a lender or a title insurance company. If a landlord makes a mistake, he or she loses a few months’ rent; if a lender or title insurance company makes a mistake, their potential losses are considerably larger.
Homeownership is often sold as a method that enables households—particularly low-income households—to accumulate wealth. This argument has some appeal, because an amortizing mortgage allows households to save and consume simultaneously.

Ownership, however, is surely not the only mechanism available for the poor to begin wealth accumulation. To the extent homebuyers must place equity into a house they will purchase (and loans with 100-percent loan-to-value ratios will be absent for awhile), they will have fewer savings to invest elsewhere. This absence of saving for other investment is not necessarily optimal for either households or the broader economy. Scholars such as Mills (1987), Hendershott (1997), and Taylor (1998) have argued that capital that has flowed out of plant and equipment and into housing has cost the United States productivity and, therefore, Gross Domestic Product.

Finally, regarding cash-flow affordability, consider that owners and renters both pay rent—the difference for renters is that the amount they pay is transparent, whereas, for owners, it is not; hence, for owners, it is called “imputed rent.” In equilibrium, however, the marginal renter must pay the same rent for a house of a particular quality as the marginal owner. This equilibrium condition helps explain why the cash-flow cost of renting is likely lower for renters than it is for owners.

Consider two dwelling units that are identical, except for the tenure of their residents. From the perspective of the landlord, she must earn a total return that is equal to the opportunity cost of her capital (OCC), or the amount she could earn on an investment with comparable risk to housing. Put aside taxes for a moment, and assume that rents increase each year. In equilibrium, the marginal owner’s cost should be indifferent between the cost of owning and renting.

Gross rent is the cash flow expense to the tenant; the sum of OCC and operating expenses is the cash flow expense to the landlord. If rents are expected to grow (as they should in a developing economy), the cash flow expense of owning at the beginning of an ownership period is greater than the cash flow expense of renting. As rents rise, the relationship can reverse, but, for those facing consumption constraints, the cost of owning in early years can be greater than the cost of renting. For owners with large mortgages, the cash flow expense takes the form of interest payments; for owners with large amounts of home equity, the cash flow expense is the foregone income from an investment other than housing.

For a poor person—and in particular for a poor young person who would need to take on a large mortgage to buy a house—who is consumption constrained, the ability to consume housing with less cash flow in a year could be very desirable. For an elderly, low-income person, converting home equity into an alternative investment can make the ability to consume rental housing quite desirable. There can be no doubt that such households are better off (or at least not worse off) when the option is available.
Policies Favor Owner Housing and Discourage the Development of Rental Housing

Despite the fact that rental housing can advance desirable policy goals, the United States has a pervasive policy bias toward owning. One possible consequence of such policy is that the market alone will not provide adequate levels of rental units at sufficiently low prices. Although rental subsidies might create distortions in an otherwise first-best world, they may improve welfare in a second-best world (it is also unlikely that the distortions that cause capital to flow to owner-occupied housing will be removed).

Policies that are beneficial to owner-occupied housing (or hostile to rental housing) may be divided into three types: (1) zoning policy (which is implemented by local governments), (2) tax policy (some of which is implemented at the local level, some of which is implemented at the state level, and some of which is implemented at the federal level), and (3) financial policy, which is implemented at the federal level.

Zoning Policy

Zoning came into existence for a very sensible policy purpose: to eliminate (or at least reduce) the negative effects—or externalities—that one type of land use might have on another. The iconic example is the oil refinery that wishes to locate next to a neighborhood of houses: the private benefit to the refinery might be large, but the cost to the adjoining neighborhood would also be high—likely higher. Such a use is sometimes referred to as a “nuisance use.”

The benefit of zoning is not only that it prevents a nuisance use, but also that it reassures people that they are avoiding the risk of a nuisance use. Hence, in principle, zoning is sensible policy.

Two metrics measure in theory whether zoning is optimal. First, if zoning exists, such that land values are maximized (that is, that no change in zoning would increase total property values), then zoning is optimal. Alas, knowing whether values are at their maximum possible value at a given level of zoning requires the knowledge of the full set of values that would be produced given a full set of zoning options, which is not possible.

A short note by Colwell and Dehring (1999) implies a somewhat better metric. Although the model contains many strong assumptions, it offers some insight. The model has a market with two types of land use, one of which produces negative externalities (commercial) and one of which does not (residential). In the absence of zoning, when the two types of land uses abut each other, their values will be equal—the value of the residential property will be encumbered by the commercial property, and equilibrium requires them to be equal at their boundary. As residential uses become more distant from commercial uses, the negative effect of the commercial uses on residential uses becomes smaller. On the other hand, because commercial property is not affected by residential property, its value remains the same everywhere (this conclusion assumes that views, topography, and the distance from the central business district, etc., were considered). Consequently, residential land that is not next to commercial land is more valuable than commercial land. Because commercial land is relatively inexpensive, commercial uses tend to get too much investment, and residential uses too little. Optimal zoning would restrict commercial development until the value of
commercial land is just equal to the value of residential property that is sufficiently far from commercial activity that its value is not affected by it. A test of optimal zoning, then, is whether property values away from boundaries between uses are the same or different. If commercial uses are restricted to the point that commercial values become higher than residential values, zoning has gone too far; it prevents the optimal development of commercial uses.

Communities seem to have a presumption that apartments have a negative effect on single-family houses—this presumption would explain why apartments are almost always subject to more restrictive zoning than single-family houses. Yet no compelling evidence indicates that apartments produce negative externalities. Certainly, apartments create a smaller fiscal burden for cities, because only about 15 percent of apartment dwellers in buildings with more than 50 units have children, whereas about 37 percent of dwellers in detached single-family homes have children.

The question of whether communities restrict apartments too much is not a settled question, although a previous HUD report essentially argues that it is (Ashey and Kean, 1991). It is a question worth revisiting, and HUD could survey whether apartment land values are more or less equal to single-family property values across a number of U.S. cities.

If communities are restricting apartment construction beyond what is socially justified, the effect of zoning policy is to levy a tax on apartment dwellers. According to the 2007 AHS, the median income of those living in detached houses is more than twice the median income of those living in large apartment buildings. Equity suggests that low-income apartment dwellers should receive some sort of subsidy. Too much zoning also leads to a shortage of rental units, which is economically inefficient.

The alternative is to induce municipalities to loosen up zoning codes; the politics of such actions are problematic. Although economists are suspicious of subsidies in general, in a second-best world, undoing the effects of one distortion by introducing another may improve social welfare.

### Tax Policy

Nearly every country in the world uses tax policy to encourage homeownership. The method is passive: equity owners of housing earn imputed rent, and such rent is rarely taxed. The Congressional Budget Office (CBO) includes nontaxation of net imputed rent as a tax expenditure.

One could argue that such treatment (nontaxation) makes sense from the standpoints of transparency and simplicity. Taxing imputed rent would be difficult to explain to taxpayers, and so it is not transparent. As for simplicity, taxes are best levied on things that are easily measured. The difficulty that the Bureau of Labor Statistics has with measuring the owner-housing component of Consumer Price Index suggests that imputed rent is NOT easily measured. Indeed, the fact that before 2007

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1. Although apartments are not synonymous with rental housing, multifamily properties have a higher share of the rental market than do single-family homes. According to the 2008 AHS, 80 percent of units in buildings with more than 50 units had renters and 86 percent of detached single-family units had owners.

2. Children are not negative externalities, but the short-term cost of educating them is.

3. Communities also use ordinances such as occupancy codes to prevent nonrelated people from renting together, which is effectively a restriction on rental housing.
the CBO estimate of the tax expenditure on imputed rent was smaller than the tax expenditure on the home mortgage interest tax deduction (additional information follows) shows how difficult such a measurement is. Until 2007, the value of home equity in the United States was higher than the value of mortgage debt outstanding (Federal Reserve, 2011), and returns to equity should be higher than returns to debt. The implication is that imputed rent should have been larger than mortgage interest.  

It is easy to understand why imputed rent is not taxed, but the fact that it is not taxed makes the mortgage interest deduction something of a puzzle. Many English-speaking countries (Canada, Australia, and the United Kingdom) do not have policies that allow homeowners to deduct mortgage interest. Moreover, the idea that mortgage interest deduction was designed to spur homeownership is something of a myth: it is actually a residual of the 1913 Income Tax Code, which allowed all consumer interest to be deductible. The predecessor proposals to the Tax Reform Act of 1986 would have eliminated the deductibility of all consumer interest. Brilliant lobbying on the parts of the National Association of REALTORS®, the National Association of Home Builders, and the Mortgage Bankers Association convinced Congress that the mortgage interest deduction was crucial to maintaining and increasing the homeownership rate in the United States (Birnbaum and Murray, 1987).

Little, if any, evidence suggests that this claim is correct. The countries listed previously that lack a mortgage interest deduction policy have homeownership rates similar to that of the United States, which is 66.4 percent: in Australia it is 71 percent, in Canada it is 65 percent, and in the United Kingdom it is 69 percent (Proxenos, 2002). Some simulations (Green and Reschovsky, 1999) imply that the ownership rate would fall by a minuscule amount if the mortgage interest deduction were eliminated. Another simulation (Green and Vandell, 1999) shows that a targeted tax credit would be a far more effective method for encouraging homeownership than the current mortgage interest deduction.

The largest problem with the mortgage interest deduction is that it provides virtually no benefits to below-median-income households. Such households, even when they own, may not take the mortgage interest deduction at all because, for them, the standard deduction will be more valuable than itemized deductions, including one for mortgage interest. And even if they do itemize, the marginal benefit of the deduction, relative to the standard deduction, will be quite small, meaning that it will provide little incentive for ownership. At the same time, the deduction provides disproportionately large tax relief to those at the upper end of the income distribution (Follain and Ling, 1991). Finally, the mortgage interest deduction encourages households to take on debt. Canadians

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6 One could calculate imputed rent by calculating the total value of home equity and multiplying that total by some interest rate. But it is difficult to know the “correct” rate; as such, a rate would be a function of both expected duration and risk. Both of these factors could vary substantially across homeowners.

7 Landlords can deduct mortgage interest, but they also pay tax on the rental income they receive.

8 Classic papers on the effect of the mortgage interest deduction include Poterba (1992), Rosen (1979), and Rosen and Rosen (1980). More recent papers include Glaeser and Shapiro (2003), Green and Reschovsky (1999), and Green and Vandell (1999).

9 Rosen and Rosen (1980) wrote their paper at a time when the standard deduction was much smaller, so that the mortgage interest deduction was more valuable to lower income households.
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and Australians are just as likely to be homeowners as Americans, and they use mortgages, but they pay their mortgage balances more quickly, meaning their households are less leveraged and, therefore, less vulnerable. Only a limited number of economists (Woodward and Weicher, 1989) have kind things to say about the mortgage interest deduction. They argue that an elimination of the deduction gives an advantage to those who can buy houses with cash (presumably higher income people) relative to those who need mortgage financing.

The mortgage interest deduction may also make rents more expensive than they otherwise would be. Bid rent theory implies that the bidder who most values the land will set the land prices. Consider two bidders: one has the benefit of the mortgage interest deduction, and another does not (that is, a renter). Because the bidder who uses the deduction faces a lower after-tax cost of capital, she will outbid the renter, thus leaving the renter with the options of paying the high price set by the subsidized bidder, or settling for an inferior location (which might have higher commuting costs). Consequently, the total cost of renting per unit of housing quality is driven upward by the mortgage interest deduction.

Despite the fact that many policy analysts have issues with the mortgage interest deduction, the last time it was threatened was during the debate about the Tax Reform Act of 1986. Gyourko and Sinai (2003) estimated the net benefits of the mortgage interest deduction by congressional district. On the one hand, they found that if the proceeds from the mortgage interest deduction were returned as lump sum payments to taxpayers, most districts would benefit from the elimination of the mortgage interest deduction, but by a small amount. On the other hand, the districts that benefit from the mortgage interest deduction would lose large amounts if it were eliminated. When a policy's benefits are concentrated and costs are diffused, it will usually have substantial lobbying support.

As with zoning, the mortgage interest deduction leads to a suboptimal allocation of rental housing, and makes rental housing more expensive. It may be reasonable for the federal government to offset these negative effects with subsidies.

Financial Policy

For many years, owner-occupied housing received preferential treatment in finance markets through two mechanisms: Government Sponsored Enterprises (GSEs) and bank capital requirements.

Government either directly or implicitly backed four housing finance entities: Ginnie Mae, a government agency that securitized Federal Housing Administration (FHA) and Veterans Administration mortgages; Fannie Mae and Freddie Mac, private enterprises whose investors believed had the backing of government, and the Federal Home Loan Bank System, which could make low-cost advances to member banks for the purpose of funding mortgages. This article does not extensively discuss GSEs, except to note that for many years these programs drove down the cost of capital required for owner-occupied housing.

Fannie Mae, Freddie Mac, and FHA also would purchase multifamily loans, but, until recently, these businesses were quite small, especially for Freddie Mac and FHA. Freddie Mac nearly got out of the multifamily business altogether when its book of multifamily loans performed very badly in the early part of the 2000s. It is likely that the Affordable Housing Goals that arose from the Federal
Housing Enterprises Financial Safety and Soundness Act of 1992 did encourage Freddie Mac to start doing more multifamily lending recently, but Fannie Mae and Freddie Mac have long had a far larger footprint in the single-family mortgage business than in the multifamily mortgage business.\textsuperscript{10}

The capital requirements of banks were subtler. When a bank bought and held a mortgage-backed security (MBS) from Fannie Mae or Freddie Mac, the security carried a risk weight of .2, which meant that well-capitalized banks needed to put only 1.6-percent capital behind a GSE MBS. Whole apartment loans, on the other hand, generally carried risk weights of between 50 and 100 percent, meaning that well-capitalized banks needed to put 4- to 8-percent capital against such loans. Although Fannie Mae and Freddie Mac could securitize apartment loans that would also receive favorable treatment, their propensity to do so was quite small. According to the Federal Housing Finance Agency's \textit{Annual Report to Congress}, in 2009 Fannie Mae had almost $2.4 trillion in single-family MBS outstanding but only $47 billion in multifamily MBS. Freddie Mac had $1.47 trillion in single-family MBS and $15 billion in multifamily MBS (FHFA, 2010).

The capital standards, which arose from Basel I\textsuperscript{11} seemed reasonable at the time, because, over the long haul, single-family mortgages, in general, and GSE mortgages, in particular, performed quite well. Historically, however, single-family mortgages have performed quite poorly in some regions of the country (the Midwest in the late 1970s, Texas in the mid-to-late 1980s, New England in the late 1980s and early 1990s, and California in the early to middle 1990s). To some extent, Fannie Mae and Freddie Mac could manage regional downturns through geographical diversification, but these regional problems undermined the idea that home mortgages were inherently safe instruments.

Bank capital is expensive, so the fact that banks needed to put less subsidy behind GSE MBS (which overwhelmingly favored the single-family sector) once again placed apartments at a disadvantage relative to detached single-family homes.

\textbf{How Renters Are Currently Subsidized}

Assuming there are compelling reasons on equity and efficiency grounds to subsidize rental housing, it is important to do so in the most efficient and equitable manner possible. Void of the consideration of the proper level of rental subsidy, it is almost indisputably the case that many of the U.S. rental subsidy programs are neither efficient nor equitable.

Currently, renters are mainly subsidized via federal programs in four ways\textsuperscript{12}: (1) the Section 42 Low-Income Housing Tax Credit Program (Tax Credits; LIHTC), (2) the tenant-based Section 8 Housing Choice Voucher Program (vouchers), (3) Public Housing, and (4) other project-based housing assistance, including project-based Section 8. Exhibit 1 depicts the relative size of such programs from 1941 to the present. This article will also not discuss Public Housing and project-based Section 8

\textsuperscript{10} Except in the aftermath of the financial crisis, at which point Fannie Mae, Freddie Mac, and FHA dominated both single-family and multifamily lending.

\textsuperscript{11} Basel I established international standards for defining well and adequately capitalized banks.

\textsuperscript{12} A small number of large cities, most notably New York, Los Angeles, and San Francisco, subsidize renters with rent control. Although rent control is not ubiquitous in the United States, it does have a profound effect on rental markets in the places where it exists. For a discussion, see Green and Malpezzi (2003).
housing, because it has been some time since new units have been produced using those programs, and it does not seem likely that any political appetite exists to resume construction through such programs. The LIHTC program, although likely more efficient than past supply subsidy programs, arguably still retains some of the issues endemic to such programs. Vouchers have their own problems (discussed later in the article) but are also statistically the most effective method for providing rental subsidy.

**Section 42 Low-Income Housing Tax Credit Program**

A classic debate in housing policy is whether demand subsidies are better than supply subsidies for housing. The crux of the debate is between what some call the economist view—that the best way to help the poor is to provide direct income subsidies—and the planner/lawyer view—that the government and nonprofits can deliver housing at a lower cost because they do not retain profits. Some analysts, including Ellen et al. (2007), have also argued that place-based investment programs can have positive spillover benefits, at least in New York City. The planner/lawyer expresses concern that demand subsidies will ultimately flow through to landlords and, therefore, do little to actually help the poor.

Advocates of supply programs argue that, in the absence of supply subsidies, it is never in the interest of developers to build low-rent housing, in part because rents do not rise as rapidly in low-rent buildings. They also note that, because construction costs in many cities are high, affordable rents (generally defined as 30 percent of income) are insufficient for new affordable construction to be feasible in the absence of subsidy. There can be no doubt that, in many cities, unsubsidized rents are not affordable for large numbers of households. Exhibit 2 uses American Community Survey (ACS) data to compare rents at the 25th percentile with household incomes at the 25th percentile.
Exhibit 2

Ratio of 25th Percentile Gross Rent to 25th Percentile Household Income for Renters, 2008

Source: American Community Survey
Among the 50 largest U.S. metropolitan areas, rents at the 25th percentile are always more than 30 percent of income at the 25th percentile. The market alone does not do an adequate job of providing affordable housing.

On the other hand, many analysts (including Malpezzi, 2002) argue that new construction programs for subsidized housing crowd out existing affordable housing. The evidence on whether this is true is actually murky—although empirical tests cannot find evidence that supply programs increase the stock of affordable housing, the lack of a finding may be the result of the design of such tests.¹³

Supply subsidies have essentially disappeared from American housing policy, with the exception of the Section 42 LIHTC Program (revisit exhibit 1, which shows how the number of public housing units and project-based Section 8 units are declining). Simple simulations may reveal whether the incidence of the program benefits renters or landlords.

The structure of the LIHTC Program essentially offers developers a trade: in exchange for agreeing to limit rents to 30 percent of the 60 percent of Area Median Income (AMI), developers receive a tax credit. If the developers build “ground up” new housing, the credit is equal to 9 percent of qualified construction costs; if the developer rehabilitates an existing property, the credit is equal to 4 percent of qualified construction costs.

A comparison of the value of the tax credit with the value of foregone rents will help explain the nature of the subsidy. An example will clarify. Assume the typical two-bedroom unit is 850 square feet, investors discount the value of tax credits with a 7-percent discount rate, construction costs are $150 per square foot,¹⁴ qualified costs are 80 percent of construction costs, market rent is $900 per month and AMI is $50,000. If developers of LIHTC properties agree to charge no more than 30 percent of 60 percent of AMI, their renters will be charged no more than $9,000 per year in rent. Thus, the federal government helps renters get a subsidy of $1,800 per year in rent for 30 years in exchange for giving up $9,180 (850*120*.09) in tax revenue per year for 10 years.

Assume the real discount rate to the government and renters both is 3 percent. The present value of the rent savings is $35,280. The present value of revenue cost to the government is $78,307. Hence, in this example, less than one-half of the subsidy from the government is going to help the renter.

The fraction of the government subsidy that goes to renters depends on the size of the discount a renter receives. This discount varies considerably from one market to the next. As a crude measure of the size of the rent discount for markets, ACS data are used to compare median rent to 30 percent of 60 percent of AMI by county. (Note: These data are a rough cut at the issue—rents are actually set based on AMIs.)

The ACS contains information on median income and median rents in 1,889 counties and municipalities in the 50 United States, the District of Columbia, and Puerto Rico.¹⁵ The first thing worth noting is that, in 1,691 counties and municipalities, median rent is less than 30 percent of 60 percent

¹³ To use statistical language, just because one cannot reject a null hypothesis does not mean that the null hypothesis is true.
¹⁴ This is roughly the cost of construction in Madison, Wisconsin, for a one- to three-story apartment building according to RS Means.
¹⁵ The ACS does not have these data for counties with small populations.
of median income. Unless the median rental unit in these counties is in unacceptably poor condition (and, according to the AHS, only 3 percent of rental housing in the United States suffers from “severe” physical problems and 7 percent suffers from “moderate” physical problems)—these data reveal that, for all but around 200 counties with these data, the LIHTC Program is superfluous—because sufficient numbers of “affordable” units are available, based on the program’s own definition of affordability.

But, of course, counties are not the same as people. Many of the 20 largest counties in the United States have median rents higher than 30 percent of 60 percent of AMI, as shown in exhibit 3.

### Exhibit 3

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<th>Tax Credit Gap for the 20 Largest U.S. Counties</th>
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<td>Population</td>
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<td>Santa Clara County, CA</td>
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<td>Broward County, FL</td>
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<td>Bexar County, TX</td>
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<td>New York County, NY</td>
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Exhibit 3 shows that, in 60 percent of the largest counties, a household at 60 percent of county median income cannot afford the median rental unit (although, in Dallas County, it is very close). This is not to say that Dallas County does not have affordability problems. Exhibit 1 makes clear that the top 50 metropolitan statistical areas fail to deliver affordable market rent housing to the bottom income quartile of renters. It does suggest, however, that the method the program uses to define housing need has serious problems.

The affordability issues are most concentrated in New York City, California, and Florida; affordability issues plague these states in smaller cities, too. The fact that all areas are allocated credits based on population suggests that the Section 42 subsidy is not well targeted. The fact that affordable rents are defined as 60 percent of median income also leads to inappropriate targets.

The worst case county among the 20 counties is Kings County, New York (that is, Brooklyn). A household at 60 percent of county income would need a subsidy of $2,825 per year to “afford” the
median rent. Hard costs for apartment construction in New York City outside of Manhattan are about $200 per square foot (Scanlon, 2008). This assumption qualifies a cost of $170,000 for an 850-square-foot apartment. At a real discount rate of 3 percent, the cost of the subsidy from the government is around $130,000 and the benefit to renters is around $55,000.16

Median rents and median incomes are just not sufficient methods for determining housing needs—one needs to investigate how the distributions of rents and incomes vary from one metropolitan area to the next. It may be the case that 30 percent of 60 percent of AMI produces a rent that is not affordable for many, many households. It also may be the case that 30 percent of 60 percent of median rent may be higher than market rent (consider exhibit 3). If the federal government wishes the Section 42 program to help more people more effectively, it needs to reconsider how it allocates tax credits across states and also to think more carefully about entire distributions of rents and incomes, instead of applying arbitrary ratios to medians.

Section 8 Vouchers

The Section 8 Housing Choice Voucher Program provides for two types of vouchers: Section 8 project-based and Section 8 tenant-based vouchers. The larger program is the Section 8 tenant-based program, which has portable vouchers. Section 8 tenant-based vouchers currently serve about 1.2 million households nationally; the project-based Section 8 program serves around 30,000 households. The public housing authorities (PHAs) that administer Section 8 determine recipient qualification. Recipients can earn no more than 50 percent of AMI, so the program is targeted to “very” low-income renters. Renters receive a voucher equal to the difference between 30 percent of their income (which is what they are expected to pay for housing) and Fair Market Rent, which is defined as the 40th percentile of rent for an area. PHAs are also required to allocate three-fourths of their vouchers to households at the 30th percentile of the rental distribution.

Section 8 is not an entitlement. According to U.S. census data, roughly one-fourth of U.S. households (or 27 million households), earn less than $25,000 per year, which is about one-half of the U.S. median household income (DeNavas-Walt, Proctor, and Smith, 2009). Yet, the best evidence suggests that Section 8 is an effective method for delivering housing subsidy—it is more efficient and equitable than any construction program (Green and Malpezzi, 2003).

The most recent work on the housing voucher program has focused more on its effect on labor markets than its effectiveness as a housing program per se. On the one hand, vouchers should outperform other types of housing subsidy regarding labor markets, because they allow for mobility, at least within metropolitan areas. On the other hand, as household income rises, the value of vouchers gets clawed back, until, ultimately, households lose their eligibility altogether. Because households are required to pay 30 percent of their gross income in rents, those who receive vouchers effectively pay a 30-percent marginal tax rate on income.17

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16 The reality is that the share of the subsidy going to renters in Kings County is smaller, because AMI for metropolitan New York is $77,000, whereas, for Kings County, it is a shade under $50,000. Therefore, 30 percent of 60 percent of AMI—the point at which rents are affordable—is higher, and so the subsidy to renters is lower.

17 Clawbacks are a problem with all rental subsidy programs.
Studies of the labor market effect of vouchers have shown mixed outcomes, which is informative: they suggest in total that the portability feature of vouchers does not, on its own, solve labor market problems for the poor, but also that the marginal tax rate does not seem to strongly discourage labor participation either. Ludwig, Duncan, and Pinkston (2005: 131) found that—

…providing low-income families living in public housing units with private-market rental subsidies that can only be redeemed in very low-poverty neighborhoods reduces rates of welfare use by around 15 percent. Most of this reduction appears to be explained by differences in welfare-to-work transitions. [But they also found] that providing families with unrestricted housing vouchers has little effect on economic outcomes beyond the first year.

All housing assistance programs produce implicitly high marginal tax rates, through clawbacks, that can discourage work. But because vouchers are not site specific, they do not impede labor mobility as much as project-based assistance and so appear to have a smaller effect on work incentives.

Olsen et al. (2005) similarly found that all housing assistance discourages labor participation, but also that tenant-based subsidies discourage labor participation less than other kinds of subsidy.

Having said all that, a comprehensive study of vouchers as housing policy per se, such as the Experimental Housing Allowance Program, is long overdue. The most important recent study on vouchers comes from Susin (2002), who maintained that vouchers push up rent enough that the costs to nonvoucher recipients is greater than the benefit to voucher recipients. This argument is not necessarily against vouchers but suggests that, when vouchers are not distributed comprehensively, they can harm those individuals who do not receive them.

The question of the effect of vouchers on rents is what economists would call an elasticity question. Susin (2002) noted that locations with more vouchers had higher rent increases than those with fewer vouchers. But disentangling this observation from other market characteristics—such as differences in supply elasticities across metropolitan areas—is very difficult. Susin’s results are also inconsistent with previous literature (Barnett and Lowry, 1979).

When thinking about rental subsidies, it is therefore important to consider elasticities: how sensitive housing markets are to changing quantities in response to changing rents, and how sensitive housing costs are to changing incomes. If housing quantities are quite responsive, then subsidies will have a small effect on rents; if they are not responsive at all, rents will rise. If rents rise and not everyone gets a subsidy, those who do not get the subsidy can be made worse off by the subsidy program. To understand how the benefits of vouchers are distributed among tenants and landlords, studies of housing elasticity—especially elasticity around the bottom one-half of the rent distribution, is crucial.

**Conclusion**

This article argues that in a second-best world, one in which the federal government provides substantial benefits to owners and local zoning is often hostile to renters, rental subsidies may be appropriate on both equity and efficiency grounds.
Not all rental subsidies are created equal, however. Rent control is inefficient and often inequitable. Tax credits may encourage low-rent housing in places it is least needed and may be very “leaky”; a large share of the subsidy does not find its way to renters. Vouchers are the most promising form of rental assistance, but when they are not entitlements, they may produce perverse results.

HUD could develop better measures of housing market characteristics—especially supply elasticities for low-cost housing—and tailor housing policy based on that research. Reducing funding for tax credits and redirecting it to vouchers may also produce better outcomes. It would be worth at least testing the effect of rental subsidy entitlements for vouchers in small markets. A comprehensive study of the effectiveness of current large housing programs, including Housing Choice Vouchers, Section 8 project-based assistance, and Low-Income Housing Tax Credits, akin to the Experimental Housing Allowance Program, is long overdue.

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18 For a summary, see http://www.huduser.org/search/Bibliography.asp?id=179.


