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Money Rejected: How Rhode Island Has Turned Away $197.3 Million per Year in Federal Funds for Affordable Housing

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Executive Summary

As the housing crisis ravages Rhode Island, our state has turned away an average of $197.3 million per year in federal funding for affordable housing available under the 4% tax credit program of the federal Low Income Housing Tax Credit. From 2014, to 2020, Rhode Island was eligible for up to $1.553 billion in 4% tax credit funds, but we only spent $171.4 million, turning away a total of $1.381 billion. This averages to $197.3 million per year. Over the next 5 years, Rhode Island will see a sizable increase in the amount of dollars available for the development of affordable housing. Recent changes to federal law have made the subsidy offered by 4% credits 27% more generous. Additionally, if the current draft of the federal Build Back Better Act passes, the amount of eligible funding available over the next five years would more than double. However, this boost would expire at the end of 2026. In total, we estimate that these provisions would give Rhode Island an opportunity for $4.19 billion in federal affordable housing funding—an opportunity that might never arise again. To take advantage of this historic opportunity, we must correct our state's failure to maximize affordable housing funding and work quickly to ramp up the production of affordable housing.

We have identified three primary reasons for our state's failure to maximize the 4% credit funding stream to build affordable housing:

1. **Insufficient state funding for affordable housing.** Until the very end of 2020, 4% credits only subsidized 30% of construction cost. Thus, additional subsidies are needed to finance the construction of affordable housing. Today, even with the 27% boost to a 38% subsidy, some additional state subsidies are still needed.
2. **State affordable housing funds have not been used to help make 4% credit projects work.** State funds have typically gone to build affordable housing units with purely state subsidy and no matching 4% funds--mainly because the income limits for state subsidies are too high to qualify for 4% funding.
3. **Simply relying on the private market to take advantage of this program does not work because markets are not perfectly efficient.** The assumption that private corporations will appear to take advantage of every opportunity does not happen in reality. In general, developers avoid utilizing 4% credits because they can make more money devoting their time and energy to building higher income housing.

To fully maximize available 4% credit funding, we make the following recommendations:

1. **Rhode Island Housing should immediately issue the full annual allocation of 4% credit-qualifying PABs, and state agencies should cease issuing PABs subject to the cap that do not qualify for 4% credits.**
2. **State and local affordable housing funds should be devoted exclusively to providing gap subsidies to make 4% credit projects work.**
3. **Existing state and municipal programs that subsidize housing, such as Rebuild RI, the state TIF, historic tax credits, affordable housing trust funds, TSAs, underassessments, etc. should be prioritized for making 4% credit projects work.**
4. **The state should devote $500 million of ARPA funding towards capitalizing a state corporation that will build the 4% credit-funded affordable homes that the private market will not.**
5. **If the Build Back Better Act passes with these 4% credit provisions, the state**

should issue general obligation bond funding to cover the subsidies needed for the state corporation to ensure that no 4% credit funds will be wasted.

6. **Sites that mitigate segregation and environmental concerns but still fall within QCTs and DDAs should be prioritized.**
7. **To minimize the amount of state funds needed for gap subsidy, we suggest that the state provide the land for the state corporation to build on from existing underutilized state land, especially land within QCTs and DDAs.**
8. **In order to attract a sufficient increase in the construction workforce to handle the volume of construction needed, prevailing wage should be paid on all projects.**
9. **To reduce the gap subsidy, social housing projects should be included to allow market-rate profits to cross-subsidize 4% credit-funded affordable units.**
10. **The state should consider using inclusionary zoning to require all market-rate developments to build at least 20% of the units as affordable units that tap into 4% credit funds.**

Background

In order to understand exactly how Rhode Island is turning away this vast volume of federal funding designed to build affordable housing, it is necessary to understand some background on housing policy and federal affordable housing programs in particular. We must first understand what the 4% credit is. In this section, we are describing the affordable housing system as it is. We are not describing how we believe it should be. We believe a significant reason for Rhode Island's failure to take full advantage of these programs is their complexity. Indeed, we believe that the deep complexity of this convoluted system is wholly unnecessary. With that, we will attempt to lay out the relevant background as clearly as we can.

The Housing Crisis

The state of Rhode Island is facing a major affordable housing crisis. The state's unsheltered population has increased 68% over the past year and levels of those who are severely housing cost-burdened has skyrocketed since the start of the pandemic. The average price of a home in Rhode Island has increased dramatically, and today nearly 35% of Rhode Island households are housing cost burdened. This means that 30% of their household income goes to paying for housing. More specifically, 74% of renter households with incomes under $14,764 spend more than 50% of their income on housing. Further, minority households face housing cost burdens at a much higher rate than White households. The percentage of Black and Latino households who are cost burdened is 14% higher than that of White households. To fix this housing shortage, the state must work to build more affordable housing units where the price cannot exceed 30% of the households' income.

The federal government has worked to create multiple incentives for state governments and private investors to finance and develop affordable units. And, while the state has been using these programs for generations, in this report, we document how Rhode Island has failed to take advantage of these programs, turning down an average of $197 million per year from 2014 to 2020 under the federal government's largest affordable housing subsidy program--the

4% Low-Income Housing Tax Credits.

What Is Affordable Housing?

One of the main solutions American states have been advancing to address the housing crisis is the development of affordable housing. Affordable housing was designed to set prices based on what is affordable, not what maximizes profits. Under affordable housing, a restriction is placed on the deed to fix rent and utility payments at 30% of income. Each unit sets income at a certain percentage of the area median income (AMI)--the median income over a statistical area maintained by the federal Department of Housing and Urban Development (HUD). Only people who make under that income level are eligible for the unit.

Most commonly, units are set at 60% of AMI because it is the maximum allowed for most rental units under the federal Low Income Housing Tax Credit (LIHTC), but the AMI percentage can vary depending on the circumstances. Because 60% AMI is so common, let's look at an example rent calculation for a 60% AMI unit. To begin with, we need to calculate the family size from the number of bedrooms. The family size equals the number of bedrooms times 1.5, unless it's a studio unit, in which case the family size is 1. For instance, a one-bedroom unit has a family size of 1.5, a two-bedroom unit has a family size of 3, a three-bedroom unit has a family size of 4.5, etc. For each family size, HUD publishes the AMI for different areas around the country. For our example, let's choose a one-bedroom unit. For most of Rhode Island in 2021, 60% AMI works out to $36,360 for a family of 1 and $41,520 for a family of 2. Averaging that, it works out to $38,940. Then, we multiply this by 30% to get a figure of $11,682 for the annual affordable level of housing cost. To get monthly costs for utilities plus rent, we divide by 12 and round down to the nearest dollar, getting a figure of $973/month. Finally, we subtract out a utility allowance. There are multiple allowable mechanisms for calculating this, often using figures from the previous year. For this example, we will use Rhode Island Housing's calculation for a low rise apartment heated with natural gas, $213. With this number, we get a final rent of $760/month for a one-bedroom affordable apartment at 60% AMI in most of Rhode Island. For a two-bedroom, it would be $900/month.

One-bedroom: ($41,520+$36,360)/2*0.30/12-$213 = $760.50, rounding down to $760

Two-bedroom: $46,740*0.30/12-$268 = $900.50, rounding down to $900

The idea of affordable housing is not that costs never rise. The idea is that costs are adjusted based on what is affordable. If utilities rise, then the utility allowance will go up, and rents will drop accordingly. If incomes rise, then rents will rise. As long as incomes rise faster than utilities, rents will continue to rise under affordable housing, but they will not rise faster than what families can afford.

Crucially, affordable housing does not lower rents if a family's income is much lower than the income limit set for the unit. Often, families whose incomes are quite a bit under 60% AMI will move into a 60% AMI unit. The rent does not lower with their income. Some federally funded housing programs, true low-income housing programs, do work that way, including: Section 9 public housing, Section 8 Housing Choice Vouchers, and Section 8 Project-Based Rental Assistance. Under these programs, a family might pay rents as low as $100, if that's all they can afford. Affordable housing does not work this way, but because the federal government has severely limited these sorts of true low-income housing programs, every state in America uses affordable housing to try to close the gaps that true low-income housing programs are too limited to fill.

Affordable housing can legally be built without any subsidies, but because keeping rents this low would make it hard for developers to make a profit, considerable subsidies are usually needed to build affordable housing in practice. Several options are available. Often, states provide their own subsidies with their own rules. Sometimes, the profits from market-rate housing are used to cross-subsidize affordable units, a mechanism known as “social housing.” In many municipalities, especially outside of Rhode Island, developers are forced to provide a certain percentage of affordable units whenever they build market-rate housing, a policy known as “inclusionary zoning.” Sometimes, various flexible federal subsidies, such as HOME funds, can be used. However, one form of subsidy dominates all around America--the federal Low-Income Housing Tax Credit (LIHTC).

How Do Low-Income Housing Tax Credits (LIHTCs) Work?

The Low-Income Housing Tax Credit (LIHTC) was created as part of the Tax Reform Act of 1986. It gives a dollar-for-dollar reduction in federal taxes for ten years. Typically, because affordable housing developers do not have enough federal taxes to use the tax credits themselves, they sell the tax credits to investors, usually banks, who then use the tax credits to reduce their federal taxes. The size of the tax credit is set equal to a certain percentage of “qualified basis” costs, including all construction costs and most “soft” costs like design costs and interest on construction loans but excluding land acquisition costs. There are two forms of LIHTCs, the 9% credit and the 4% credit.

Assuming a project has “qualified basis” costs of $10 million, a 9% credit would deliver $900,000 each year for ten years for a total of $9 million, and a 4% credit would deliver $400,000 each year for a total of $8 million. In practice, however, affordable housing developers instead sell the credit on financial markets for a lump sum up front payment that goes to fund the project.

Confusingly, the 4% tax credit rate was not actually equal to 4% up until the Consolidated Appropriations Act of 2021 was signed into law on December 27, 2020. Under the old system, the value of the 4% credit would be adjusted so that a developer selling their 4% credit allocation on the open market could net 30% of their qualified basis costs in up front cash. Usually, the credit would actually be closer to 3% than 4%. Now, because the credit is fixed at 4%, it will be worth more. Using the floating rate percentage in place for December 2021, 3.15%, we estimate that the 4% credit will now generate 38.1% of qualified basis costs, which we will round down to 38% in this study. (This is a fairly conservative assumption, as inflation is currently elevated, and falling inflation will raise the value of the credits.) Under the current floating rate for 9% credits, we estimate that these credits will currently generate 85.6% of qualified basis costs.

Finally, both the 4% and 9% credits receive a “basis boost” of 30%, increasing their overall subsidy amount by 30%, if they fall in one of two kinds of areas: a “Qualified Census Tract” (QCT) or a “Difficult Development Area” (DDA). A QCT consists of a low-income neighborhood, and a DDA consists of an area where housing development has historically been difficult. DDAs tend to be high-income, low-density suburbs. In RI, the DDAs currently are West Greenwich, Narragansett, Barrington, Jamestown, most of western Cranston, and an area stretching west from the fringes of URI into Richmond. In RI, the QCTs contain all of Central Falls, most of Providence, the section of Pawtucket around Downtown and I-95, the northern corner of Cranston south of Silver Lake, a section of West Warwick near Arctic Village, central Woonsocket by the Blackstone River, downtown Westerly, the North End of Newport, downtown Warren, and the eastern section of East Providence between I-195 and the Ten Mile River.

In theory, it would be ideal to only develop in QCTs and DDAs. However, several factors make that difficult. To begin with, developable land in DDAs and much of the available land for development in the wealthier sections of QCTs tends to be hard to develop. Strict zoning rules keep allowable unit density low and require a suburban sprawl development style that undermines the state's environmental goals. Much land in these areas is currently occupied and not available for development. Most importantly, however, there are issues of segregation and fairness. If affordable housing development just happens in low-income neighborhoods, it reinforces segregation, running counter to the state's ideal policy goals on racial and economic integration. Additionally, if development is limited to QCTs and DDAs, it leaves out areas that desperately need relief from the housing crisis through affordable housing development.

In order to estimate the realistic amount of funding Rhode Island could get from fully taking advantage of 4% credits, we need to estimate the portion of affordable units that could be built in QCTs and DDAs. Our estimate is ⅔. This estimate is fairly conservative, and likely a higher proportion could and should be achieved for several reasons. To begin with, QCT and DDA designations move around, allowing the state to effectively cover more area over time than can be covered at any one moment. Other factors relate to the details of the specific parcels. Although the QCTs are ostensibly low-income areas, many areas within QCTs can be effectively developed in a way that reduces segregation. For instance, the entirety of the I-95 land, Downtown Providence, and the Jewelry District currently fall within a QCT due to the presence of some low-income housing in Downtown, although most of the new housing projects scheduled are geared towards much higher income residents. Because Brown University students are often technically low income despite social class and future earnings potential that argue otherwise, significant areas of the East Side with a high concentration of Brown students fall within a QCT. The North End project in Newport falls within a QCT. This is public land slated for development, allowing the possibility of building a new, integrated neighborhood with significant affordable housing. Similarly, Downtown Pawtucket has been heavily depopulated, allowing the creation of a new neighborhood with integrated housing at multiple income levels.

Additionally, affordable housing can be built in very low-income areas in a way that desegregates because affordable housing brings in higher income people than are currently living there. The best opportunities for these sorts of developments fall within public housing complexes, which often are built to a low density with significant developable land, despite an ability to navigate around zoning and permitting obstacles. Finally, in order to mitigate segregation, affordable housing can be developed as social housing where market-rate and affordable units are mixed within the same building. This approach desegregates on the building level, not the neighborhood level. Social housing can also facilitate the financing of 4% credit developments by using the profits from market rate units to cross-subsidize the affordable units. Within DDAs, we believe development can be facilitated in a significant way if--and likely only if--the state creates a public corporation able to bypass municipal zoning in order to build at a viable and environmentally appropriate density. For all these reasons, we believe ⅔ of development in QCTs and DDAs is more than achievable. Thus, in our calculations on 4% credit funding, we will assume this ⅔ number.

How Are 9% Credits Allocated?

The 9% credits are allocated to states for state housing agencies--in Rhode Island, Rhode Island Housing--to allocate to projects in the state. Rhode Island receives the small state minimum allocation, which is $3,246 million for 2021, with these credits lasting for ten years. Under current market conditions, we estimate that Rhode Island affordable housing developers can net $30.9 million from the sale of our current 9% credit allocation. Because 9% credits subsidize so much of the costs that developers can build affordable housing at a profit, as long as land costs are low enough, the demand for 9% credits vastly outstrips the supply. As long as Rhode Island is purely reliant on 9% credits to subsidize affordable housing, our overall expenditures will be capped, and each project will simply displace funds from other projects.

How Are 4% Credits Allocated?

Like 9% credits, 4% credits are also allocated to states on a limited basis, but the limits are much higher. The limits happen indirectly through a financing vehicle known as a Private Activity Bond (PAB). To qualify for the 4% tax credit, an affordable housing project must finance at least 50% of its qualified basis costs with a PAB. The federal government allocates each state a “volume cap” of PABs, with Rhode Island receiving the small state minimum, which was $325 million in 2021. Under the old system where these credits generate 30% of qualified basis costs, that would leave Rhode Island with a maximum of $234 million in 4% credit funds. Under the new system in place as of 2021, where these credits generate 38% instead of 30%, our state is eligible for $296.4 million in 4% credit funding if we fully maximize our $325 million volume cap.

PABs are a special financing vehicle where a state agency can issue bonds to benefit private sector actors, with the federal government exempting the interest income the bondholders will earn from federal taxation. As a result, PABs can sometimes generate somewhat lower interest rates than other forms of state agency debt. PABs can technically be used to finance a range of uses that will not qualify for 4% credit funding, but it is strongly in states’ interest to use as much of the PAB cap as possible for 4% credit funds. Unused PAB cap space can be carried forward for up to three years, and any PABs left unused at the end of the carryforward period can be turned into mortgage credit certificates instead of expiring. Mortgage credit certificates can provide low-income homeowners with small tax benefits by allowing them to deduct mortgage expenses from their income on federal income taxes even if they take the standard deduction. Although vastly less efficient than 4% credits at addressing housing affordability, mortgage credit certificates can ensure that no PAB capacity is ever allowed to expire.

Buoyed by a surge in usage of affordable housing construction, states are increasingly maxing out the PAB cap, with California seeing more demand for 4% credits than the PAB cap can provide after creating a state tax credit program to incentivize 4% credit usage. It isn’t just blue states that are running out of PAB capacity. States as diverse as Texas, Georgia, and Washington are seeing surging affordable housing production run into the PAB cap's ceiling. Rhode Island, however, as we document below, is not even coming close.

How Would the Build Back Better Act Affect 4% Credits?

Under current regulations, in order for an affordable housing development project to qualify for the usage of LIHTCs, 50% of the project must be financed by PABs. However, if the current draft of the Build Back Better Act passes, this 50% PAB-financed threshold would be cut in half to 25%. This 25% threshold would only remain in place for the 2022-2026 calendar years. The decrease in this threshold would allow the state of Rhode Island to stretch our PABs even further. During this five-year window, it would double the amount of 4% credit funding available to our state. If we take advantage of it, the Build Back Better Act would allow us to vastly increase our production of affordable housing units.

The current draft of the Build Back Better Act would also allow states to get an extra 50% in funding on up to 8% of the PAB cap, if the projects have an income limit of 30% AMI instead of 60% AMI. Cumulatively, if these provisions go into effect, Rhode Island's $325 million 2021 volume cap will translate to $612.6 million in available 4% credit funding. Assuming Rhode Island enters 2022 with PAB carryforward capacity of only $600 million and no increase in the volume cap--both conservative assumptions--during the five-year period of boosted 4% credits under the Build Back Better Act, Rhode Island will be eligible for $4.19 billion in 4% credit funding. Such a number puts significant affordable housing construction on the table. However, if Rhode Island fails to maximize 4% credits during this short five-year window, billions of dollars of funding for affordable housing will be lost. The stakes are very high.

The House of Representatives has voted to approve the Build Back Better Act and has passed the bill on to the Senate for final discussion and voting. As this opportunity will only be available for five years, the State of Rhode Island must work now in anticipation of the passage of the bill to ensure that the state can take advantage of this lower PAB percentage requirement right when it becomes available in 2022.

Rhode Island's 4% Credit Record, 2014-2020

With this background, we can now dig into the details of how Rhode Island has not taken advantage of the 4% credit. To assess our record, we have examined seven years of data from 2014 to 2020. We find that we have barely taken advantage of the 4% credit program, turning down an average of $197 million per year.

How Have We Used PABs?

During the 2014-2020 study period, Rhode Island overwhelmingly used our PAB cap for uses that do not qualify for 4% credits. During the seven-year period, we issued $1.65 billion of PABs for uses that do not qualify for 4% credits. We only issued $303 million of PABs for uses that do qualify for 4% credits. Surprisingly, we actually allowed $381 million of PABs to simply expire--more than we issued for 4% credit qualifying uses. We have consistently maintained a large carryforward balance, always above two full years of PAB cap.

Year	Federal Cap	Carry forward from previous two years	Amount issued to 4% qualifying	Amount issued to non 4% qualifying	Total Expired
2020	$321,755,000	$702,688,869	$98,085,000	$258,568,272	$60,000,000
2019	$316,750,000	$820,625,606	$61,900,000	$363,811,737	$975,000
2018	$311,375,000	$771,385,500	$14,000,000	$238,939,394	$9,195,500
2017	$305,315,000	$841,914,326	$69,215,000	$206,628,826	$47,890,773
2016	$302,875,000	$869,215,000	$30,100,000	$233,123,811	$66,951,863
2015	$301,520,000	$867,260,000	$17,800,000	$196,541,847	$85,215,153
2014	$296,825,000	$848,255,000	$12,000,000	$154,908,869	$110,911,131
Total	$2,156,415,000	N/A	$303,100,000	$1,652,522,760	$381,139,420

Rhode Island's usage of PABs from 2014 to 2020. Data obtained from volume cap presentations to the Public Finance Management Board, acquired with the assistance of the Senate Fiscal Office.

There were three main PAB uses that did not qualify for 4% credits: financing student loans at the Rhode Island Student Loan Authority (RISLA), financing mortgages issued by Rhode Island Housing, and converting PABs into mortgage credit certificates. Rhode Island also issued a $9 million PAB for a cardboard box manufacturer in a residential neighborhood of Pawtucket.

The fact that Rhode Island allowed such a large amount of PAB capacity to expire is striking, and we do not have a clear explanation for why this was allowed to happen. Intriguingly, in years where PAB capacity was allowed to expire, state agencies chose to issue taxable bonds instead of PABs. Perhaps part of the story can be explained by the fact that PABs did not actually generate significantly lower interest rates for the state agencies that use them compared to taxable bonds. According to RISLA's 2020 financial statement, in its May 27, 2020 bond issuance, RISLA's tax exempt PABs had "interest rates between 3.63% and 5.00% and maturities ranging from December 1, 2024 to December 1, 2037," while its taxable Series B bonds had "interest rates between 2.00% and 4.00% and maturities ranging from December 1, 2021 to December 1, 2038." The PABs seem to have actually had higher interest rates.

Even though most PABs are going to uses that do not qualify for 4% credits, there is little evidence that this is due to demand for these sorts of non-qualifying uses. It seems that demand for PABs at these agencies is not very high, and there are viable alternative financing vehicles. If Rhode Island maximizes our 4% credits, we do not need to worry about serious disruption to RISLA and Rhode Island Housing's lending programs.

What we cannot explain is why Rhode Island has consistently chosen to allow PAB capacity to expire rather than get converted into mortgage credit certificates. Mortgage credit certificates may be significantly less beneficial than 4% credit qualifying PABs, but it seems clear to us that they are preferable to allowing PAB capacity to expire.

How Much 4% Credit Funding Have We Actually Used?

Rhode Island Housing has generously provided us with the data on the actual amounts of 4% credit funds issued in the 2014-2020 study period. Because the fixing of the 4% credit floor had not yet raised the credit from 30% to 38%, during this period the maximum amount of 4% credit fund equaled 72% of the available PAB cap (30% / 50% * 120% = 72%). (Here, we are assuming that only ⅔ of projects will be built in QCTs or DDAs, a somewhat conservative assumption.) With these assumptions, $1.55 billion of 4% credit funding could have been obtained by maxing out the PAB cap. Instead, Rhode Island raised only $171 million to finance affordable housing projects through the sale of 4% credits, an average of just $24.5 million per year. The total amount of federal funds rejected over the seven year period was $1.38 billion. That works out to an average of $197.3 million of 4% credit funds turned away each year instead of being used to finance our state's desperate affordable housing needs.

Year	PAB Cap	Carryforward Available	4% Credit Funds Available (72% of PAB Cap)	4% Credit Funds Used	4% Credit Funds Wasted
2020	$321,755,000	$702,688,869	$231,663,600	$30,625,747	$201,037,853
2019	$316,750,000	$820,625,606	$228,060,000	$23,597,063	$204,462,937
2018	$311,375,000	$771,385,500	$224,190,000	$16,836,981	$207,353,019
2017	$305,315,000	$841,914,326	$219,826,800	$44,000,907	$175,825,893
2016	$302,875,000	$869,215,000	$218,070,000	$21,586,083	$196,483,917
2015	$301,520,000	$867,260,000	$217,094,400	$24,637,223	$192,457,177
2014	$296,825,000	$848,255,000	$213,714,000	$10,117,662	$203,596,338
Total	$2,156,415,000	N/A	$1,552,618,800	$171,401,666	$1,381,217,134

Rhode Island's usage of 4% credit funds, compared to the amount available. Data on actual 4% credit funds spent obtained from Rhode Island Housing.

During this period, there were only four new production projects financed with 4% credits. Twenty-four projects used 4% credits to help preserve existing affordable housing developments. Usually, affordable housing deed restrictions expire after 30 years, and without additional subsidies, developers typically do not agree to extend the deed restrictions voluntarily. Often, renovations are needed, and 4% credit funds can help pay for both the renovations and extending the deed restrictions. Crucially, however, these deals do not increase the overall housing supply.

Year	Number of New Production Developments	Number of Preservation Developments	Total Number of Units
2020	1	2	344
2019	0	4	534
2018	0	3	302
2017	2	6	901
2016	0	3	354
2015	0	5	563
2014	1	1	131

Breakdown of affordable housing projects financed with 4% credits in Rhode Island. Most of these projects were not new construction. Instead, they were to finance the preservation of existing deed-restricted affordable units. Data obtained from Rhode Island Housing.

The low number of only $24.5 million/year in 4% credit funding comes into stark relief when compared against the $3.79 billion Rhode Island will be eligible to spend over the next five years if the Build Back Better Act passes. If we only spend $24.5 million a year on 4% credit projects over the next five years, and the Build Back Better Act passes, we will be spending $3.67 billion less in 4% credit funding than we could be. The amount of money that could be lost is staggering. More staggering still is the volume of affordable housing that we will be missing out on.

Factors Driving the Failure to Maximize 4% Credits

How has our state gotten to this point? Why are we failing to maximize the largest federal funding stream for affordable housing? Why are we failing while other states are succeeding? We have identified three primary factors driving our state's failure to maximize 4% credits.

1. Lack of State Subsidies for Gap Financing

In our conversations with developers, housing officials, and policy experts, we heard a consistent theme: Making a 4% credit project work requires additional state subsidies, and Rhode Island does not provide enough state subsidies for affordable housing. While developers certainly have an incentive to exaggerate the need for subsidies in order to pad profits, we do believe that these subsidies are needed in most cases.

In order to make a project work, developers have to maintain a continuously positive cash flow. As the project ages, even if the developer continually accumulates capital wealth in the form of building equity, if the cash flow is negative, the project math cannot work. As a result, a minimally viable project still involves the private developer accumulating a significant amount of wealth. However, in order to attract a significant increase in affordable housing development, balancing cash flow is not enough. Some profit is also needed.

In our cost analysis, we calculated the need subsidies under different scenarios and assumptions. From comparisons to projects like Amherst Gardens, a family development in Olneyville completed in 2017 at a cost per unit of $271,000 per unit, we assume total costs per unit of $300,000 for a two-bedroom unit, split between $250,000 of qualified basis costs (mostly construction) and $50,000 of non-qualified costs (mostly land). We believe these numbers are achievable.

We assumed a two-bedroom rent of $900, taxes of 8% of rent, and ongoing maintenance and management costs of $225 per unit per month. We assumed that rent will rise fast enough to cancel out increases in maintenance costs. We examined two scenarios of profit and interest rate, a "worst case" scenario with an interest rate of 5%, no basis boost, and a profit margin of $100 per month and a more realistic case with an interest rate of 3.5%, a basis boost, and a profit margin of $50 per month.

Under the worst case scenario, in order to achieve the $100 per month profit margin, the project required 117% of the federal subsidies to be matched on the state side. The cost of the state subsidy would be $111,300 per unit. Such a subsidy, while significant, is still affordable for the state under many conditions. At this level, however, maximizing Rhode Island's 4% credit capacity might require an unrealistic level of state expenditures.

Under the more realistic case, in order to achieve a $50 per month profit margin, the project required 43% of the federal subsidies to be matched on the state side. Under this case, the state subsidy would fall to $53,300 per unit. A subsidy of this level is much more favorable to the state. It puts maximizing the 4% credits within reach.

State subsidies, then, are in fact needed in most cases to develop affordable housing using 4% credits, and Rhode Island's overall level of affordable housing expenditures is low. To maximize 4% credits without the passage of the Build Back Better Act, assuming the realistic case estimate of 43% of federal subsidies, the state would need to invest $89 million per year in order to maximize the 4% credits. In comparison, Rhode Island's affordable housing budget line item is only $4 million per year, plus an initial $25 million capitalization, and it was only implemented this year. The main state program to support affordable housing has been four state bonds, $50 in 2006, $25 million in 2012, $40 million in 2016, and up to $50 million in 2021. (The $65 million 2021 bond could be used entirely for affordable housing, but current plans are for $15 million to go to community revitalization funding.) This is not enough funding to maximize 4% credits.

2. State Subsidies Go Towards Projects With Excessive Income Levels

Rhode Island could have used our existing state affordable housing funding streams to help close the gap on 4% credit projects. However, virtually none of Rhode Island's state affordable housing funds have gone towards helping take advantage of 4% credits. Instead, state affordable housing funds have been targeted at workforce housing, affordable housing with income limits too high to qualify for any federal LIHTC funding.

Under the state bond financing program, projects can have income limits as high as 120% AMI for ownership units and 80% AMI for rental units. To qualify for LIHTC funding, however, the income levels cannot exceed 80% for ownership units or 60% AMI for rental units. Under the affordable housing line item program, the maximum is 80% AMI for both ownership and rental, allowing 80% AMI rentals that are not compliant with the 60% AMI LIHTC limit. Typically, these funds have gone towards these higher AMI units, either as an addition to LIHTC-funded projects or on their own. Very few, if any, state funds have gone towards 4% credit bridge subsidies. Many state programs, such as California's, are tailored towards gap financing to leverage 4% credit funds. Rhode Island's are not.

Rhode Island also has substantial programs that subsidize housing without being restricted to affordable housing. These programs include RebuildRI, municipal and state TIFs, municipal TSAs, historic tax credits, municipal underassessments, sales tax breaks, etc. None of these programs are directed towards providing 4% credit gap financing either, although many of them could be. In some cases, programs historically used to subsidize market-rate housing could be also used to subsidize social housing projects with both market-rate and affordable units integrated together.

3. The Private Market Does Not Perfectly Adjust

We believe there is an additional factor underlying the failure to maximize 4% credits. The private market does not fully adjust. And when it does adjust, it can take many, many years. It cannot be taken for granted that simply providing the public funds will induce enough developers to immediately create proposals to take advantage of these opportunities. It is especially implausible to expect the private sector to create proposals fast enough to scale up housing production at the speed needed to address the immediate housing crisis facing the state right now. Speed is also needed to take advantage of the limited time five-year doubling of 4% credit capacity the Build Back Better Act would create, a unique opportunity our state may never see again.

Private sector housing construction requires that new businesses form, existing businesses expand, and significant changes and realignments happen within the developer community and workforce. It also requires a slow process of financing and seeking an array of public sector approvals. It requires a ramp-up and expansion of the affordable housing development community on a scale that just does not seem realistic. Part of what has stopped Rhode Island from doing 4% credit projects is simply that the developer community has not chosen to make it happen.

Moreover, 4% credit projects face significant competition for developer attention. Developers are much less likely to do a 4% credit project even if it is profitable if there is a more profitable opportunity in market rate housing. Additionally, because a developer would always prefer that their project be financed through 9% credits, a developer might have an incentive to compete for 9% credit funding rather than go for 4% credits.

In many cases where safety net services are provided by private-sector entities through public funding, not enough businesses are formed to take advantage of public funding to deliver the services, even if there is enough money to make the numbers just barely work. Similar obstacles have been observed within the healthcare and human services sector. What drives the private sector to meet these needs is profit, usually significant profit. And services for low-income people are very rarely funded at such a lavish level that substantial profit will be part of the equation.

Recommendations for Maximizing 4% Credits

Taking advantage of the massive volume of 4% credit funds our state is currently turning away will require a major shift in our state's economy and public policy. Significant changes will be needed because the scale is significant. Challenges exist, but we believe maximizing the credits is possible. And we believe it is possible in a very short turnaround time. To get there, we propose ten recommendations.

1. Rhode Island Housing should immediately issue the full annual allocation of 4% credit-qualifying PABs, and state agencies should cease issuing PABs subject to the cap that do not qualify for 4% credits.

Every dollar of PAB capacity issued to a non-4% qualifying use reduces the amount of 4% funds available to the state. Rhode Island must begin issuing all available PAB capacity to multifamily development bonds designed to finance 4% credit projects. Once these bonds are issued, the state will have a limited amount of time to actually develop the projects, but issuing the bonds will buy some time. For instance, under the Build Back Better Act's proposed limite-time five-year doubling, the time limit applies to the year the PAB was issued, not the year the project broke ground. Especially if Build Back Better passes, we must immediately issue the PABs for 4% projects. However, this will not be enough. If the bonds are issued, but no projects are available for the money to be spent on, the funds will be wasted, and no 4% credit funds will be drawn down. The state must also make changes to ensure the projects will be constructed.

2. State and local affordable housing funds should be devoted exclusively to providing gap subsidies to make 4% credit projects work.

Currently, several sources of affordable housing funding at the state and local level in Rhode Island exist, including municipal affordable housing trust funds, the bond-financed Building Homes Rhode Island state program, and the state affordable housing line item. These funds are rarely being utilized for gap financing to facilitate 4% credit projects. The first and easiest step to maximizing 4% credit funds is to more strategically invest existing state funding streams for affordable housing to exclusively devote them towards bringing in matching 4% credit funds. Instead of using state funds to develop workforce ownership housing units at 120% of AMI or 80% AMI rental units, state funds should be limited to projects that qualify for 4% credits. The higher income units do much less to achieve affordability goals. In many cases, they actually produce fewer units for a given amount of state funds because no additional federal funds are brought to the table. To increase the amount of available funding, better targeting of state funds is an easy first step.

3. Existing state and municipal programs that subsidize housing, such as Rebuild RI, the state TIF, historic tax credits, affordable housing trust funds, TSAs, underassessments, etc. should be prioritized for making 4% credit projects work.

Rhode Island currently has significant state programs available that subsidize market-rate housing, and these funds can be leveraged to catalyze affordable housing investments by providing gap financing for 4% credit projects. The array of programs is considerable, and each one has special conditions, but each one can be leveraged for affordable development. On paper, underassessments and TSAs might seem off the table for 4% credit funding. However, we believe that they can be utilized indirectly by subsidizing market-rate units that then cross-subsidize affordable housing units in the same development through the social housing model.

4. The state should devote $500 million of ARPA funding towards capitalizing a state corporation that will build the 4% credit-funded affordable homes that the private market will not.

Scaling up the production of 4% credit-funded affordable housing is a significant endeavor. We believe it is difficult to actualize fast enough without the state taking an active role in the provisioning and logistics necessary to make it actually happen. A state corporation can also significantly reduce the cost of gap subsidies needed to finance these projects. The state corporation does not have to run a profit. It simply needs to meet cashflow. Because of the implicit state guarantee, a state corporation will be able to access lower construction financing costs than a private developer, which will significantly reduce costs. In fact, our analysis shows that by reducing the monthly profit margin to just $10 and the interest rate to 2.5%, if the development takes place in a QCT or DDA, the necessary amount of state subsidy would drop to just 20.9% of the federal funds unlocked. Such a savings makes projects much more achievable. This interest rate, though low, may well be more than achievable for a state corporation in the near-term environment depending on Fed policy decisions. And this excludes economies of scale in maintenance and construction costs, which may also help reduce the amount of subsidy needed.

Land costs provide another critical opportunity for the state corporation to cut down the need for state gap subsidy. Because land costs are not eligible for 4% credits, they contribute to a project's viability much more than construction costs. Especially in DDAs, restrictive municipal zoning rules serve as one of the main drivers of land costs. In parts of the Western Cranston DDA, for instance, Cranston's A-80 zoning requires a minimum lot size of 80,000 square feet and limits housing to only single family homes. As state entities are typically exempt from municipal zoning, the state corporation will have the ability to bypass these sorts of restrictions that typically hold back private development of these areas. Additionally, the state corporation can be empowered with limited eminent domain powers to facilitate site acquisition. Due to the expansive nature of these powers, strict process controls should be put in place to prevent abuses. The state corporation can also be empowered to provide public infrastructure support, such as sewer connections, to enable dense development.

With these tools, we believe a state corporation will be able to significantly reduce land costs. Combined with a lack of need for profit and the much lower interest rates a state corporation can access, this land cost reduction can even allow the project to move forwards without gap subsidy. For instance, take our model where the monthly profit margin is $10 and the interest rate is 2.5%. With non-qualified costs (mostly land costs) reduced to $24,000 per unit, we calculate that the development will be able to meet and balance cashflow without any additional state subsidies. With the DDA/QCT boost, land cost reduction, lower profit margins, and the state's unique access to very favorable interest rates, we believe it is possible to do some projects without any state subsidy. However, we understand that in the real world, not all of these conditions may be achieved in every case, so the state corporation does need access to a significant pool of gap financing. Moreover, the state corporation will face significant start-up costs to build out logistical capacity. We therefore suggest a $500 million allocation of ARPA funds to capitalize the state corporation.

If the state does not act, in many cases municipalities can access some of these benefits of public housing production corporations by creating one at the municipal level. With public housing authorities and redevelopment authorities already in place in many municipalities, some of the infrastructure already exists. While we believe a state corporation is preferable, municipal options also exist. For development within public housing lands, we believe the public housing authority should be the lead partner.

5. If the Build Back Better Act passes with these 4% credit provisions, the state should issue general obligation bond funding to cover the subsidies needed for the state corporation to ensure that no 4% credit funds will be wasted.

In the event that the Build Back Better Act passes, additional state gap subsidies will probably be needed to maximize the 4% credits. We suggest that the state issue a large general obligation bond to fund these subsidies. The exact size of the necessary bond will depend on the degree to which the state is able to effectively reduce gap subsidy through the means we have outlined here.

6. Sites that mitigate segregation and environmental concerns but still fall within QCTs and DDAs should be prioritized.

Although we understand that it may not be possible to make this happen in every case, we do recommend that QCT and DDA sites should be prioritized. However, we do urge that site selection attempt to mitigate the downsides of QCTs and DDAs as much as possible. With QCTs, the concern is segregation. With DDAs, the concerns include development of undeveloped woodlands that should be preserved as conservation land and aiding suburban sprawl development models that contribute to higher carbon pollution. There are several ways to achieve this. We recommend utilizing areas of QCTs with relatively few housing units currently and building new, integrated mixed-income developments. We recommend choosing areas of QCTs that actually are integrated into wealthier neighborhoods, such as on the East Side of Providence. Within DDAs, we recommend using state zoning override authority to build dense housing instead of following suburban sprawl development models. There are good examples around the country of how to build dense housing in a suburban context, such as Maple Lawn in Maryland. Working with local planners and municipal governments, these dense developments should integrate some neighborhood commercial development to mitigate the number of trips residents will need to take. Blue Back Square in West Hartford, CT is a good example of how to do this in a suburban context. DDA developments should also try to minimize clear-cutting of forests as much as possible. Not all of these goals may always be achievable, but we recommend a good faith effort to meet them.

7. To minimize the amount of state funds needed for gap subsidy, we suggest that the state provide the land for the state corporation to build on from existing underutilized state land, especially land within QCTs and DDAs.

Because land costs cannot receive 4% credit funding, land costs present a more serious cost driver than construction costs. To mitigate land costs, we recommend utilizing development parcels already owned by the public, especially those parcels within QCTs and DDAs. This can include integration of existing public housing complexes with affordable units. Examples of such opportunities within QCTs and DDAs include:

- The I-195 land, where several parcels remain undeveloped.
- The Federal Hill Expansion project, where the removal of the large ramp behind Caserta's Pizza will free up several acres of developable land. This land will have to be developed at high density to shield the neighborhood from the highway.
- The Newport North End project.
- Parking Lot L at Rhode Island College.
- Public housing developments with open space, such as Hartford Park, Manton Heights, Chad Brown, and Galego Court.

- The extended undeveloped land from the unfinished Henderson Expressway in East Providence.
- The Ryan Center lot and surrounding undeveloped open lawns at URI.

Within these sites, where costs ineligible for 4% credits should be very low, our cost analyses show that the land cost savings should make these parcels more than developable with no gap subsidy for the state affordable housing production corporation we proposed. For private development, we estimate that a small gap subsidy of roughly 6% of federal funds unlocked will be needed. Under our worst case scenario cost estimates for private development, we estimate that a subsidy of 30% of federal funds unlocked will be needed in these sorts of parcels.

8. In order to attract a sufficient increase in the construction workforce to handle the volume of construction needed, prevailing wage should be paid on all projects.

A logistical issue that may complicate scaling up such a large volume of construction is the workforce. In order to reduce the risk of workforce shortages, we recommend paying prevailing wage on all projects. These prevailing wage costs should allow affordable housing projects to out-compete projects that don't pay prevailing wage for a limited construction workforce.

9. To reduce the gap subsidy, social housing projects should be included to allow market-rate profits to cross-subsidize 4% credit-funded affordable units.

One way to help finance affordable housing gap subsidy is social housing. Under the social housing model, profits from market-rate housing cross-subsidize affordable units. Typically, affordable and market-rate units are integrated into the same building. In Rhode Island, where subsidies are often applied to market-rate units to increase developer profits, we believe the high profitability of market-rate housing can help a social housing model provide enough gap subsidy to help make 4% credit projects work. In some cases, these should be sufficient to eliminate the need for gap subsidy. In the case of state corporation development in QCTs or DDAs, especially when the land is already state-owned, social housing may actually allow 4% credit projects to generate profits that can go towards providing gap subsidy in other cases.

10. The state should consider using inclusionary zoning to require all market-rate developments to build at least 20% of the units as affordable units that tap into 4% credit funds.

A final option that exists to tap into 4% credit funds at no cost to the state is inclusionary zoning. Under inclusionary zoning, developers are required to build a certain percentage of affordable units for all large market-rate developments, using the profits from the market-rate units to cross-subsidize the affordable units. In general, inclusionary zoning should work without any additional subsidies, state or federal. However, if a state is failing to maximize the 4% credits, bringing in 4% credits to these projects is preferable to turning down those funds. Under the LIHTC rules, to become eligible for subsidies in a development where just 20% of units are affordable, the income limit must be set at 50% AMI or below. This does make the math harder than for a 60% AMI unit but in the case of inclusionary zoning at just 20% of units, the cross-subsidies from the profits on the market rate units should be more than sufficient.

Conclusion

With the housing crisis roiling Rhode Island, now is not the time to turn down federal funds allocated to our state to build affordable housing. Rhode Island must act fast to put in place the policies necessary to maximize the 4% credit federal funding stream. While a significant logistical effort will be required, we believe it is achievable. Indeed, we may have no choice. Without maximizing these funds, the damage done by the housing crisis may be too much to bear.

If Rhode Island were to fully max out 4% credit funds, tens of thousands of new affordable homes could be built. This would give tens of thousands of people a place to live. Building these homes would also create thousands of jobs and boost the economy. As Rhode Islanders, we have the opportunity to make big changes in increasing the affordability of housing in Rhode Island. We must max out the 4% credits each year.

Acknowledgements

Without the help of several key state agencies and offices, this report would not have been possible. We would like to thank the Senate Fiscal Office for answering our questions and working with us to help track down the volume cap reports and the critical data they contain. We would like to thank the Public Finance Management Board for producing and releasing the volume cap reports. Finally, we would like to thank Rhode Island Housing for answering our questions, sharing their expertise, and providing us with the data on the actual 4% credit projects and funds.