State of the Market 52:

The problem of cost (or, "what scores points gets built")

By David A. Smith

With the Federal government now committed to shrinking one way or another and the economy still in the doldrums, Washington is going to cut costs. Unlike appropriated programs, which can be dialed back via sequester, tax expenditures that look fat risk getting not trimmed but killed.

Meanwhile, everyone in our industry professes to favor containing costs, yet up they rise … because what we say we want, and what we reward in QAPs, are fundamentally at odds. The rules we wrote and used have over the years and decades embedded within themselves a set of subtle but potent upward biases: things that add cost are rewarded in the scoring, things that cut costs are not.

Five years ago this was politically tolerable; no more. It's time to bring down affordable housing development costs, and be seen bringing them down.

Yes, we can do it – without compromising real quality.

Costs *are* high because ordinary people *think* they are high

Let us dispose briskly of the assertion that we're being unfairly targeted, and that perceived high costs are a political illusion. In politics, perception *is* reality, and if we tell a normal person the per-home costs of a new LIHTC apartment, that person thinks they are too high. And what the

"But it scored 100% on the QAP!"

people think too expensive, politicians feel free to cut. So for the time being, we have to put away our graphs and charts; hold in reserve our value-for-money calculations.

Two years ago they might have helped; today they're irrelevant, because the political and budgetary crisis is upon us, people have decided costs are high, and our saying they are not is a losing strategy.

The downside of high development costs

High costs have downside in both policy and politics; and of the two, policy is more important but politics is more dangerous.

In policy terms: efficiency in the face of demand outstripping supply. LIHTC is hotly competed for

because it's valuable, flexible, and scarce. No matter how worthy any particular property may be, any dollar of LIHTC going into *this* property means it will not go into *that* worthy property elsewhere in the state.

Nor are we coming close to keeping up with rising need. America's population is growing about 0.7% annually, resulting in at least 800,000 new households a year, representing at least 200,000 new income-eligible households. LIHTC produces no more than 60,000 new apartments annually. In other words, each state's growth in LIHTC-eligible demand is three to four times the growth of LIHTC supply.

So it's incumbent on every allocator, and behind that allocator every legislator, to make the precious resource go its furthest – and the Qualified Allocation Plan must be seen as less being a profile of who is rewarded and more the exclusionary profile of who is not.

In political terms: risk of program cuts. As I wrote in *State of the Market 48 (December, 2012): The undiscovered country,* we are in a period of never-ending budget crises to cut costs. Nor will tax increases, should any become feasible, help us. Tax increases will arise not from frontal assaults on higher brackets (good theater, bad politics), but through flanking actions euphemized as 'broadening the base' or 'eliminating preferences' – including ours.

This discussion has already circled LIHTC as a juicy target, because it's large and because its indictment is simple. Aren't tax credits sold to investors who expect financial returns? Aren't most of those investors banks? Aren't banks not exactly America's favorite corporations? Wouldn't it be cheaper just to do direct grants?

"But what about quality?"

Against the proposition of rewarding lower-cost developments, the objection is often raised, *Won't that compromise quality and lead to slipshod construction?* A quarter of a century ago, that might have been a material risk; today it is not. Properties with cash development fees have an inherent cushion. Further, developers are exposed for the full fifteen-year compliance period, with guarantees in the syndication agreements that put developers in first loss for the whole interval. And plenty of others scrutinize viability, which is underwritten by multiple external sources: private lenders, soft lenders, and LIHTC equity syndicators (and often, their investors behind them).

All right then, concedes the weary reader, *costs are high. How can we get them down?*

To decide what to reverse, we should examine why they have crept up.

The affordable-housing development obstacle course

As I wrote in *State of the Market 37 (April, 2011): More's the laws,* over the decades affordable housing development has become progressively more difficult, resulting in higher land prices and higher entitlement costs.

NIMBYism wrapped in public purpose. Many people are secretly NIMBYite, and for them procedural obstacles (wetlands, traffic, environmental, historic) are strategies with zero downside. Who can be against protecting the environment, our heritage, or *[insert beloved local*

icon here]? By slowing the project down, they discourage developers … and if they stop the development entirely, so much the better.

Zoning-induced land scarcity. Affordable housing is easy to build … in places that don't need it. But where job growth is strong, affordable housing development land is scarce, and made more expensive because it is artificially made more scarce. In addition to legitimate desires for planned communities and public space, some cities and towns use ostensibly objective criteria (e.g. lot sizes, setback requirements, sidewalk or driveway requirements) as economic exclusion, pushing up the per-home cost to where the only feasible developments are upmarket.

Against this, states have counterattacked with inclusionary zoning (legislated as in Massachusetts' Chapter 40B, judicially imposed as in New Jersey's *Mount Laurel*), which helps but doesn't neutralize the price rises. And when local land suitable for affordable housing does become available, these few parcels are bid up.

The non-optimized LIHTC value chain

High LIHTC development costs are also a natural outgrowth of 'upward drift': forces we accepted when the economy was growing.

Excessive complication adds uncertainty and soft costs. Conventional financing is two-source – hard debt plus hard equity. Affordable housing finance is usually multi-source – hard debt, soft equity (via LIHTC sale), and a crazy-quilt of soft debt sources. The resulting complicated capital stack has much larger soft costs of application, underwriting, and compliance; frequency of processing delays; and high likelihood of re-underwriting as shifting rates and terms require redoing the sums.

The LIHTC development value chain is not sequenced for efficiency. A conventional developer secures its scarcest or least controllable resource *first*. That yields a reliable linear process which shortens lead times and reduces costs.

In LIHTC, the most important resource is also the least controllable and comes *last* – only after the developer has secured site control, permanent debt commitments, soft debt commitments, and equity commitments subject to award. The result is high sunk costs (optioning the land, pre-development design specifications, LIHTC application QAP optimization) spent just to perfect an option that often fails.

Developers have a 'brass-ring' mentality. Because the demand for LIHTCs far exceeds supply, many developers know they will lose two applications for every one they win. The winners have to pay for the losers, and that's costly too.

Lack of residuals means overemphasis on development fee. Conventional developers and owners make their money downstream, through cash flow, refinancing, and sale. LIHTC developers know that free cash flow will be small (pledged to soft debt), residuals distant and abstract. So they beef the up-front fees.

"Just one more feature"

Little things multiply.

Necessary luxuries, especially progressive ones. When times are good, what had been a luxury becomes a new necessity. Because affordable housing resides at the nexus of private

development and public resources, it makes a lovely laboratory for innovative additionality: 'prevailing wage' and Davis-Bacon construction requirements; deep income targeting (below 30% of Area Median Income); special-needs populations; additional resident services; urban design and aesthetics; and green amenities for which there is not yet a business case.

However worthy these ideas may be, few of them pay for themselves (incremental NOI greater than increased debt service), which means they are financial-feasibility deadweight. And they multiply up. If each adds 4% to the TDC, six of them combined boost costs 27%.

The dark matter of non-housing costs. Affordable housing is more than just shoeboxes poor people sleep in; it includes site amenities such as clubhouse, community room, activities areas. Infill properties get tagged for infrastructure (interior roads, new site or even trunk piping and wiring). Then there's the sinking fund for non-economic resident services need to win QAP points. They all have to be carried in the development budget.

The perception of 'free funding upward'. Because affordable housing always requires subsidy (either LIHTC or soft debt or income subsidy or otherwise), there is a tendency to presume that any additional cost will just be 'funded upward' for 'free.' Either the developer will take a lower fee, or the allocator will add more subsidy, and either way, that's free, isn't it?

To change the result, change the rules

Change DNA and the species changes; change the QAP and the new inventory changes. But to reverse or rescind decisions or policies made in the before time means confronting particular constituencies that like their individual corners of the status quo.

De-mandate. Desirable features that begin as experiments evolve into points-earners and mature as administrative mandates. In crunch time, yesterday's sensible mandate is today's millstone.

So let's downgrade 75% of recent administrative minima into point-scoring options.

Authorize micro-apartment pilots. With the explosion of broadband and information-based work and leisure, what we think of as 'minimum apartment size' is being dramatically redefined. In New York, San Francisco, Boston, and Seattle, pressure on costs is giving rise to micro-apartments: carefully engineered small space (250 to 375 square feet) suitable for working singles and very friendly couples.

They're not for everyone. There's a big difference between tiny apartments as a lifestyle choice and tiny apartments as sleeping closets for the poor.

So let's authorize these as a demonstration and learn what types of households will choose them.

Set up countervailing competitive pressure to lower costs*.* Among the several 'genius principles' of LIHTC is that innovation is driven not by regulation but by developer competition. Instead of specifying costs limits, a QAP could reward cheaper delivery: for instance, 10% of the QAP to the bottom quintile of TDC's per apartment, 5% to those in the second-bottom quintile.

So let's implement bonus points for lower TDC's, run 1½ years' worth of allocation cycles, and see what happens.

Conclusion

At fifty, wrote George Orwell, everyone has the face he deserves. Today's affordable housing delivery is the system we deserve. As stakeholders, we shaped and reshaped the rules that deliver highly innovative and responsive properties – with costs that ordinary citizens think are too high.

We can congratulate ourselves for our innovation and take our chances with the potential political backlash. Or we can redirect some of our creativity away from cost-inflating principles and toward cost-cutting ones.