Improving Arizona's Rental Unit Availability through New Construction

Arizona Department of Housing

Rental Housing: Encouraging New Construction

HFA Staff Contact
Janelle Johnsen
janelle.johnsen@azhousing.gov

Introduction

With Arizona's rapidly increasing population growth, housing is at an all-time demand and housing costs have been rapidly increasing at a concerning pace over the past few years. Hampered by the Great Recession, new construction in Arizona took a hiatus in the mid-2000's, and did not pick up until the late 2010's, when all of a sudden the Arizona multi-housing builders began focusing on luxury rental housing, as well as single-family construction for rental, leaving an overwhelming gap in attainable rental housing.

To address this, the Arizona Department of Housing (ADOH) determined that the highest and best use of its limited 9% Low-Income Housing Tax Credit (LIHTC) resources would be to construct new units, rather than simply to reinvest in existing housing at this point in time. While preservation can be an important investment in certain times and places, it does nothing to provide relief in the market in times of undersupply. Those units not receiving immediate "preservation" financing really weren't going anywhere so the only thing that made sense in the current circumstances has been to focus on adding new units.

With this strategy in mind, in 2018, the Department implemented scoring criteria to incentivize new construction and built an efficiency scoring category in its Qualified Allocation Plan (QAP) to encourage production of more units. By 2020, the Department realized an 89% increase in newly constructed units between the 9% and 4% programs, when compared to the previous 10 year average.

Innovative

We reviewed dozens of QAPs from around the country looking for ways to improve our tax credit unit production, but came away with no real solutions that would incentivize developers to develop more new units for less credits. So we decided to get creative, and push the envelope when it comes to more for less.

With three changes to its QAP, Arizona was able to: (1) realign its priority to add new units to its housing stock by adding one single point to its QAP, while reducing "amenity" points, (2) implemented a strategic design approach to encourage higher production of units, and (3) encouraged developers to take practical measures to reduce the amount of credits needed to achieve project feasibility.

Replicable

These three simple but basic changes could be made in any QAP. It can be as easy as 1-2-3.

1 – PRIORITIZING POINTS FOR WHAT MATTERS – MORE NEW UNITS

The first change the Program introduced was a prioritization of points and adding one point for new construction. This one point became increasingly important as the Program was put through a rigorous review of its entire point structure to enable the Program to layer on a strategic Tie Breaker (see #3 below).

The task of streamlining available points was important so developers weren't simply chasing "amenity" points which were frequently meaningless, as most residents were not benefiting from the amenities. All points that were retained, were considered meaningful and necessary. In determining what points were critical, the Program reduced its consideration of the point structure to considerations such as this: is it better to locate every affordable housing project to be near a library or urgent care facility (which could disappear at any time) or build more units? Was it important to provide a "service rich environment" on site to benefit a very limited number of interested tenants, or build more units? In the end, many "amenities"

just didn't make the cut. Points that remained were determined to be critical, such as availability of grocery stores and nearby public transportation.

By limiting the number of amenity points, developers were able to consider a much wider range of locations to locate their projects. This took care of additional concerns that had plagued the Program in recent years, such as too many projects being located within close proximity of other tax credit projects, and resulted in projects being planned for neighborhoods that had long been neglected by the Program.

2 – ENCOURAGING EFFICIENCY IN BUILDING – MORE NEW UNITS

The strategic approach to get more units was factored into a project through building efficiency measures. The QAP includes a scoring criteria based upon the ratio between the residential floor area and the total project square footage. To see whether the ratio was improving the efficiency of the limited amount of tax credits in the State's tax credit ceiling, the Department then analyzed the residential floor area produced compared to the number of tax credits required to produce that floor area. To make the data more meaningful, the Department compared a static imputed 800 square foot apartment to determine how many units could be produced for every $100,000 tax credits allocated. This measure provided a meaningful way to look at the measure's success without skewing the results due to the size of the tax credit ceiling, the size of the units produced, or the building type. The measure includes different ratios depending upon the type of unit (i.e., buildings that require corridors vs. garden style walk up.) Simply put, the more housing units that are proposed to be built when compared to common space, the better the score.

3 – ENCOURAGING EFFICIENCY IN CREDIT USE – MORE NEW UNITS

The Tie Breaker has been critical to reducing requests for tax credits. To utilize a tie breaker you need to ensure as a basic threshold that everyone who meets the program's most basic priorities ties. With the reduction of superfluous points, they do. While the reduced scoring criteria, and use of the tie breaker points has been an issue of consternation from many in the development community, it is without a doubt one of the most meaningful "tools" the Program has ever had to insuring efficiency of credit use. In essence, the lower your total tax credit ratio to total development costs, the better situated you are to win.

Responded to an important state housing need

For years, the National Low Income Housing Coalition (NLIHC), and other national housing reports, has gauged Arizona to be among the states with the lowest availability of affordable housing per low-income renter. This is thought to be due to the relative "youth" of the state, its huge growth in a relatively short span of years, and its late start in seeking eligibility or being eligible for a plethora of federal housing resources that other states took advantage of decades before Arizona established a housing agency in 2002.

Many states, have housing resources well beyond that of Arizona. Given the state went from being one of the lowest populations nationally to the seventh largest, with the fifth largest city in the nation as its capitol, in a matter of a few decades, Arizona has missed out on years of resources other states enjoyed, and is now playing a desperate game of catch up with less than ample resources. Arizona needs more units.

Demonstrated measurable benefits to HFA targeted customers

Arizona's competitive 9% LIHTC program has seen a steady increase in production since its QAP was revised to promote efficiencies in 2018. Arizona's 2020 program showed a 22% increase when compared to the previous five year average, at a time when land and construction costs are increasing **(see Figure 1)**. Further, all 9% projects financed since changes made in 2018 have been newly constructed units.

With "customers" being those in need of an affordable unit and the owners of those units, we believe Arizona's strategy to increase the number of newly constructed units is a win-win for both. Adding new housing stock makes more units available and newly constructed units generally are more energy efficient and less likely to need maintenance than older units that have been renovated.

Proven track record of success in the marketplace

Not influenced by the QAP's competitive scoring per se, the push for newly constructed units in Arizona has spilled over from its 9% round, to the 4% projects, as more developers are putting together new construction projects in order to have some consideration under both the 9% and 4% resources. The 10 year average shows the number of newly constructed units under the 9% program averaged 740, while the 2020 round created 1,110 new units. New construction under the 4% program over the previous 10 years averaged just 88 units a year, while in 2020, 452 new units were created. Altogether, 2020 delivered 1,562 newly constructed units, an 89% increase when compared to the previous 10 year average **(see Figure 2)**.

Benefits that outweighed the costs

This policy did not add costs, but made winning projects more efficient, stretched the state's federal tax credits, and added more affordable units to the state at a time when construction costs are increasing.

Demonstrated effective use of resources/Achieved Strategic Objectives

Changes made to Arizona's QAP have demonstrated that you can stretch tax credits and increase your unit production despite increasing land and construction costs, while allowing for a wider selection of potential sites in previously underserved markets. Three years into utilizing this QAP model, however, the model now has a proven track record that the restructuring has achieved the results as the Program intended, and believes that states interested in stretching their tax credit resources might wish to implement a similar initiative.

Effectively employed partnerships

The LIHTC program is only possible through partnerships with the development community, and feedback from that community was helpful in understanding that buildings being built through the state's program could be more efficient. We also received feedback from some developers that some of the service type amenities for which projects were scoring to win were rarely utilized by their residents. This feedback was important to understanding where changes might be made to reprioritize the program's incentives.

Summary

In 2016, credits covered 90% of all project costs. By 2020, credits were covering only 72% of the total development costs, resulting in more units **(see Figure 3).** While some portion of the declining value may be attributed to slightly lower credit rates, rates have not dropped significantly over this period, so overall, the largest factor in lowering the ratio of tax credits to total development costs has been the Program's tie breaker, which incentivizes developers to request fewer credits per project.

With the LIHTC under fire in recent years nationally as being inefficient, we believe that other state QAPs would benefit from tightening up the use of credits to ensure they are getting the most units from this resource. By increasing new construction numbers through program efficiencies, housing agencies can credibly demonstrate that they are actively implementing measures that counter those criticisms.

Visuals

Figure 1

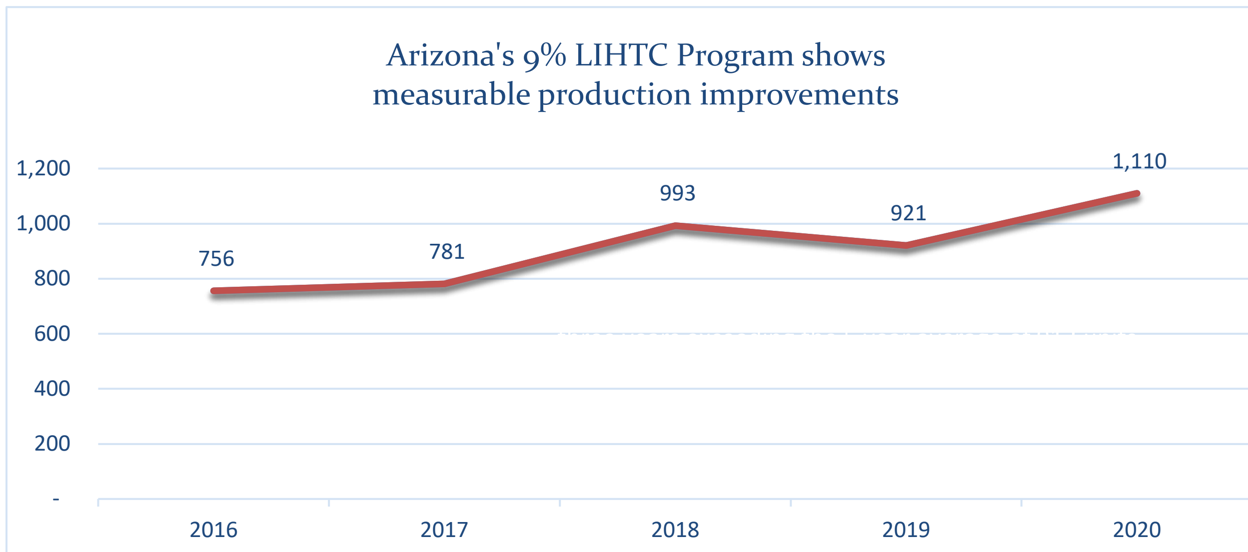

Figure 2

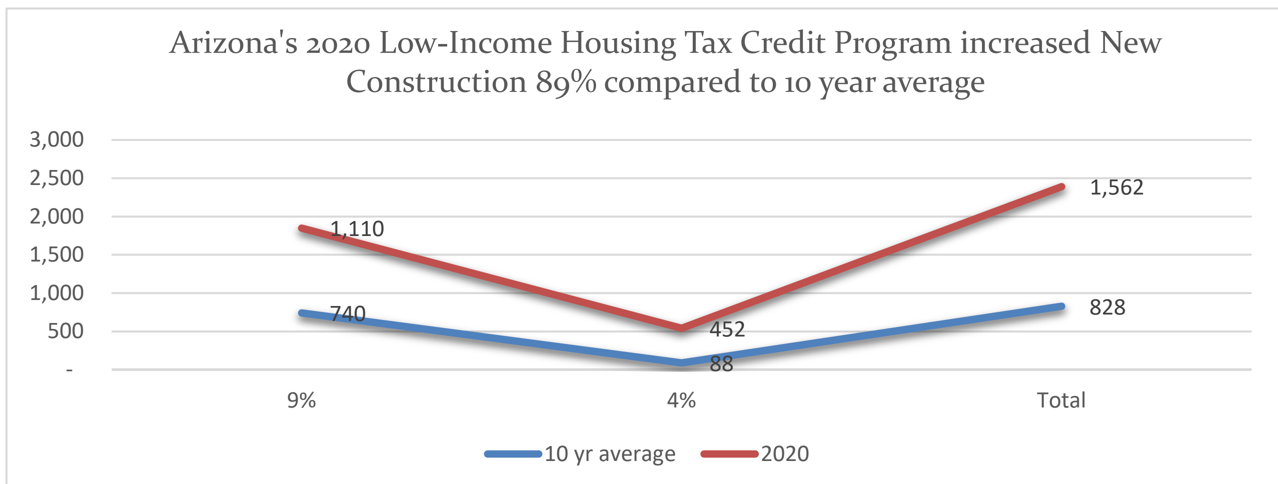

Figure 3

Besides the graphs above that demonstrate the increases in new construction, as well as the overall number of units produced, the chart below demonstrates the success that the program has had in making credits stretch further.