

Stimulating Institutional Investment in Affordable Housing in Australia: Insights from the US

Abstract

America's Low Income Housing Tax Credit ('tax credit') program has been the cornerstone of efforts to expand the supply of affordable rental housing for 20 years.

Its perceived success, particularly in expanding the level of investment in the sector, has led to moves towards a broadly similar program in Australia.

This paper describes the US tax credits both from a policy perspective and with reference to practical outcomes that the program has achieved in the Bay Area of San Francisco. The case study of the Bay Area highlights the influence of local and regional context on how a national tax credit program works in practice.

The proposal for an Australian housing tax credit scheme (the National Rental Affordability Scheme) is compared with US experience in six areas:

- how might a new institutional investment market emerge;
- what costs are involved in delivering tax credits;
- which client groups and geographic areas are likely to be assisted;
- what are the implications of gap financing;
- will housing stock remain affordable in the longer term; and
- what will be the likely mix between for-profit and non-profit affordable housing developers?

Introduction

In the lead up to the 2007 federal election, the Australian Labor Party announced its intention to establish a new program, the National Rental Affordability Scheme (NRAS), to encourage large scale institutional investment in affordable rental housing in Australia, if elected to government (ALP, 2007; Rudd et al., 2007).

Following its success at the election, the Labor government has announced more details of the purpose and implementation of NRAS (Australian Government, 2008) and the Prime Minister has indicated that it will be expanded from its initial target of 50,000 dwellings to be achieved over five years to 100,000 if there is demand - presumably from investors and lenders (Rudd, 2008).

NRAS is a bold scheme, and a new direction for housing policy in Australia. A critical question is whether it will succeed in stimulating institutional investment in affordable housing and achieve its ambitious goal for building so many new homes. To start to address this question, this paper draws on over 20 years experience of using tax credits to stimulate private investment in affordable housing in the US to identify pointers from US practice and research that could contribute to framing and fine tuning incoming Australian policy.

Context

Encouraging institutional equity investment in Australian affordable housing is likely to be a challenge as there has been little tradition of using this type of finance, even for market-rate rental properties (Yates and Wulff, 2000).

The private rental sector has been sizeable (around 20-25 per cent or more of occupied dwellings) since the 1960s but it has operated in policy and market contexts that favoured individual, rather than institutional, investors (Berry, 2000; Seelig et al., 2006). Typical investors are 'petty landlords'—individuals or families owning their own home and renting out one or two further properties (Berry, 2000). Institutions have invested directly and indirectly in commercial real estate through property trusts but their exposure to residential property has been limited to *debt* acquired through the secondary mortgage market.

Australian securitised mortgage-backed investments stood at A\$155 billion as at December 2007 (Standard & Poor's, 2008: p.x). These assets are owned by domestic institutions and, since the launch of mortgage-backed Eurobonds in 1997, overseas investors. In contrast, actual schemes for institutional *equity* investment in property have been 'piecemeal and fragmented' (Berry, 2000: p.669).

Since 2000 there has been an intense period of development of policy proposals designed to attract private investment into affordable housing in Australia. Key contributions were made by individual academics and coalitions of industry, not for profit, consumer and financial stakeholders, such as the Affordable Housing National Research Consortium and the National Housing Summit (see, for example: AHNRC, 2001; Wood, 2001; McNelis et al., 2002; Allen Consulting Group, 2004; Housing Summit, 2007).

The preferred approach of the former group was a long-term government bond mechanism and that of the latter a fixed annual subsidy or tax credit incentive. As neither scheme is operational, comparison based on actual market responses cannot be made. Under the consortium bond model, an up-front subsidy in the form of a cash outlay was designed to enable debt financing of housing acquisitions over a 20 year period with asset growth accruing to the provider, which was intended to be either a state housing authority or a non-profit agency (Berry, 2002; 2003). Under the Housing Summit NARI approach, a tax credit or cash payment was proposed for investors or developers who were willing to make new housing available for rental at below market rents for a specified number of years (Housing Summit, 2007).

The recently announced NRAS scheme offers incentives for private financing and ownership of new lower cost rental housing through a Commonwealth contribution of a refundable tax offset valued at A\$6,000 per dwelling (in 2008/09) indexed in accord with the rental component of the Consumer Price Index for ten years, subject to annual compliance with the rules of the scheme. In the case of non-profit organisations participating in the scheme that are registered charities with the Australian Tax Office, the Commonwealth contribution will be provided as an annual cash grant.

Additionally, there will be a minimum financial contribution or equivalent from state and territory governments of A\$2,000 initially (in 2008/09) per dwelling for ten years (Australian Government, 2008). The required housing outcomes from the scheme are centred on allocation of dwellings to eligible low- and moderate-income households at no more than 80 per cent of market rents that are to be determined on a prescribed basis annually. No requirements apply to scheme participants after ten years. Under the NRAS model, subsidy will be provided annually over a ten-year period and asset growth will accrue to the investor. Thus, the proposed NRAS has more in common with the Housing Summit's proposal, the National Affordable Rental Initiative, than it does with the AHNRC proposal.

Information about the scheme so far indicates clearly the national government's intention to attract equity from institutional investors. By phasing tax incentives over a ten-year period, NRAS is likely to create a class of illiquid investments suited to institutions with a longer term liability profile. This is why superannuation (pension) funds are seen as key potential investors in Australian affordable housing. At the end of 2007 superannuation funds totalled A\$1.18 trillion, up from A\$200 billion in the mid-1990s (Berry, 2000; APRA, 2008). These funds are likely to continue to grow rapidly as the effects of higher compulsory employee contributions in 2002 work through. There is logic to encouraging superannuation funds to diversify away from their relative over-exposure to the stock market, and invest in residential property where around half the nation's net wealth is stored.

This paper critically examines how the provision of affordable rental housing in Australia might develop under the stimulus of NRAS, in the light of national and local experience of using a national tax credit incentive scheme to build and rehabilitate housing for low and moderate income earners in the US. In the next section, a summary of the US tax credit program since its inception in 1986 is presented, with particular reference to evidence of how it has performed in relation to the scale and cost of investment achieved

and outcomes measured against public policy goals. The next part of the paper draws on primary research in the San Francisco region of California to provide a more detailed account of the practical application of tax credits. This highlights regional and local variations in the scheme's operation and identifies adjustments that have emerged over time. Both may be worth further consideration in Australia. The final section assesses implications of the US research for progressing institutional investment in Australian affordable housing. Particular issues covered are the prospects for a new institutional investment market in affordable housing; the likely cost effectiveness of the proposed approach; the requirements for gap financing; possible patterns of assistance by geographic area and target group, preservation of affordable housing beyond the ten-year horizon; and the potential roles of for-profit and non-profit affordable housing providers.

Housing Tax Credits in the United States

The Low Income Housing Tax Credit program dates from the Tax Reform Act of 1986 which simplified the US tax system, boosted home ownership by extending mortgage interest tax deductions and brought market forces to the allocation of supply-side affordable housing subsidies. The scheme replaced various Federal subsidy programs for private rental investors that were seen to be inefficient. Tax credits were made 'permanent' under the Clinton administration in 1993, enjoy bi-partisan support in Congress and are backed by a broad coalition of for-profit and non-profit developers, banks, business leaders, equity investors and consultants (Dreier, 2006).

Between 1986 and 2005 tax credits helped to fund 1.53 million units of affordable housing in 27,410 schemes across the US. The current annual cost to Treasury is some US\$5 billion, making it by far the largest subsidy for low income rental housing (HUD, 2008b). Tax credit housing has overtaken public housing which was started in 1937 and now caters for 1.2 million households (HUD, 2008c). In the decade to 2005, an average of 110,000 tax credit subsidised units were made available each year, 95 per cent for tenants earning below 60 per cent of area median income. A typical scheme is a multi-family building of 52 units in a lower income ethnically diverse central city location. Sixty per cent of schemes are new build, 40 per cent refurbishments (Schwartz, 2006).

Tax credits are funded nationally and Congress sets broad criteria for tenant eligibility and period of affordability. However, allocations to individual schemes are made by the states, which can set additional rules, as can local councils if they contribute funding. As a result the US tax credit scheme has resulted in a variety of outcomes in different parts of the country, even varying between neighbourhoods (Cummings and DiPasquale, 1999).

Tax credits, originally US\$1.25 per person rising to US\$1.75 in 2002 then indexed by inflation, are distributed each year to states based on headcount – not housing need or wealth. States develop an annual Qualified Allocation Plan outlining how they will distribute credits and which type of schemes will get priority. Organisations compete for credits in one or two 'allocation rounds' each year and the top rated bids meeting the application criteria receive funding. There is a minimum 10 per cent of credits set aside for non-profit developers, although they always receive more than this. For example 26 per cent of allocations in 2005 (ABT Associates, 2007: Table 2). Competition for tax credits introduces market forces and developers move up the allocation rankings if their scheme charges lower rents or serves poorer tenants than the minimum required. Over

time the transparent bidding procedures have raised the quality of proposals, although the complexity makes applications expensive.

Tax credits can be used for building or rehabilitating long-term (not transitional) rental housing. Developers normally target a range of different income groups as residents and include people with special needs: between 2003 and 2005, 27.4 per cent of schemes catered for the elderly, 12.1 per cent for disabled residents and 4.5 per cent the homeless (ABT Associates, 2007). Applicants for tax credits need to provide at least 20 per cent of units for tenants earning less than 50 per cent of the area median income or, alternatively a minimum 40 per cent of units for tenants earning less than 60 per cent of the area median income. Only units occupied initially by eligible tenants attract tax credits. Income criteria, published annually by the US Department of Housing and Urban Development, are based on gross income adjusted for family size.

Most developers will target more lower income tenants than required, motivated by philanthropic mission or to gain preference in tax credit allocations. Rents are set at 30 per cent of either 50 or 60 per cent the area median income (depending on the target income groups in the scheme), and are adjusted for the number of bedrooms. As rents are not related to individual tenant income, poorer families could spend considerably more than 30 per cent of their income on rent, even though in a five-city survey, 40 per cent of units were rented at substantially less than the maximum permitted (Burton et al., 2000: p.vii). Tenants can remain in occupation until their income reaches 140 per cent of area median, but there is flexibility for property managers who may allow the tenant to stay longer provided the entire scheme is compliant with targeting requirements.

When preparing proposals for a tax credit scheme the developer will calculate the 'qualified basis'. This is the cost of the entire project less land acquisition, finance fees, tax credit syndication fees and marketing or administration costs. A downward adjustment is applied to the figure if not all units are provided to tenants on low incomes. A 'basis boost' of 130 per cent is applied if the scheme is in a difficult area, for example where the poverty rate exceeds 25 per cent.

The developer then selects between two types of tax credit, used in equal measure in terms of numbers of units funded (Schwartz, 2006). The 'nine per cent tax credit' is calculated at 70 per cent of the present value of the 'qualified basis' for new construction and major rehabilitation schemes. Credits are awarded on a competitive basis although some jurisdictions operate a queuing system for viable projects. The 'four per cent tax credit' is calculated at 30 per cent of the present value of the 'qualified basis' and provided as of right to qualifying schemes for properties needing minor renovations. With both options, the actual figure claimable each year as tax credits is obtained from rates published monthly: 7.80 per cent and 3.34 per cent respectively for May 2008 (Enterprise Community Partners, 2008).

The significance of these percentages is they reduce the proportion of total project costs funded through tax credits. For example, the 'qualified basis' of a US\$10m affordable housing scheme might be US\$9m after deducting ineligible costs. This would generate US\$7.02m of nine per cent tax credits (US\$9m times 7.80 per cent times 10 years).

Once a developer has identified an affordable housing scheme and been allocated tax credits by the state, development capital is raised by 'selling' credits to investors. The cash flows and tax benefits are shown in [amalgamations \(Schwartz, 2006\)](#)

Figure 1. Normally the sale will be to a syndicator who acts on behalf of a group of institutional investors. A new limited company is set up for each scheme with the syndicator as a limited partner owning 99.99 per cent of the shares but having limited voting rights, and the developer as general partner owning 0.01 per cent equity.

Syndicators normally establish funds of between US\$50m and US\$150m which they invest in a number of tax credit schemes (Ernst & Young, 2003). Investors make a pooled investment in the larger fund, reducing default risk on a particular scheme.

Tax benefits only flow to investors if the scheme remains compliant for 15 years with rules set when the tax credits were allocated, for example the proportion of tenants on or below particular income levels. Initially in 1986 properties only had to remain affordable for 15 years, although this requirement was extended by a further 15 years in 1989. The US Inland Revenue Service (tax office) monitors compliance based on annual reports from housing providers and periodic inspection visits. Therefore the regulation of federally funded affordable housing is through the tax system, monitored by syndicators on behalf of investors to preserve their tax and depreciation benefits. There is no direct regulation of developers, except in their general capacity as corporations or non-profit organisations.

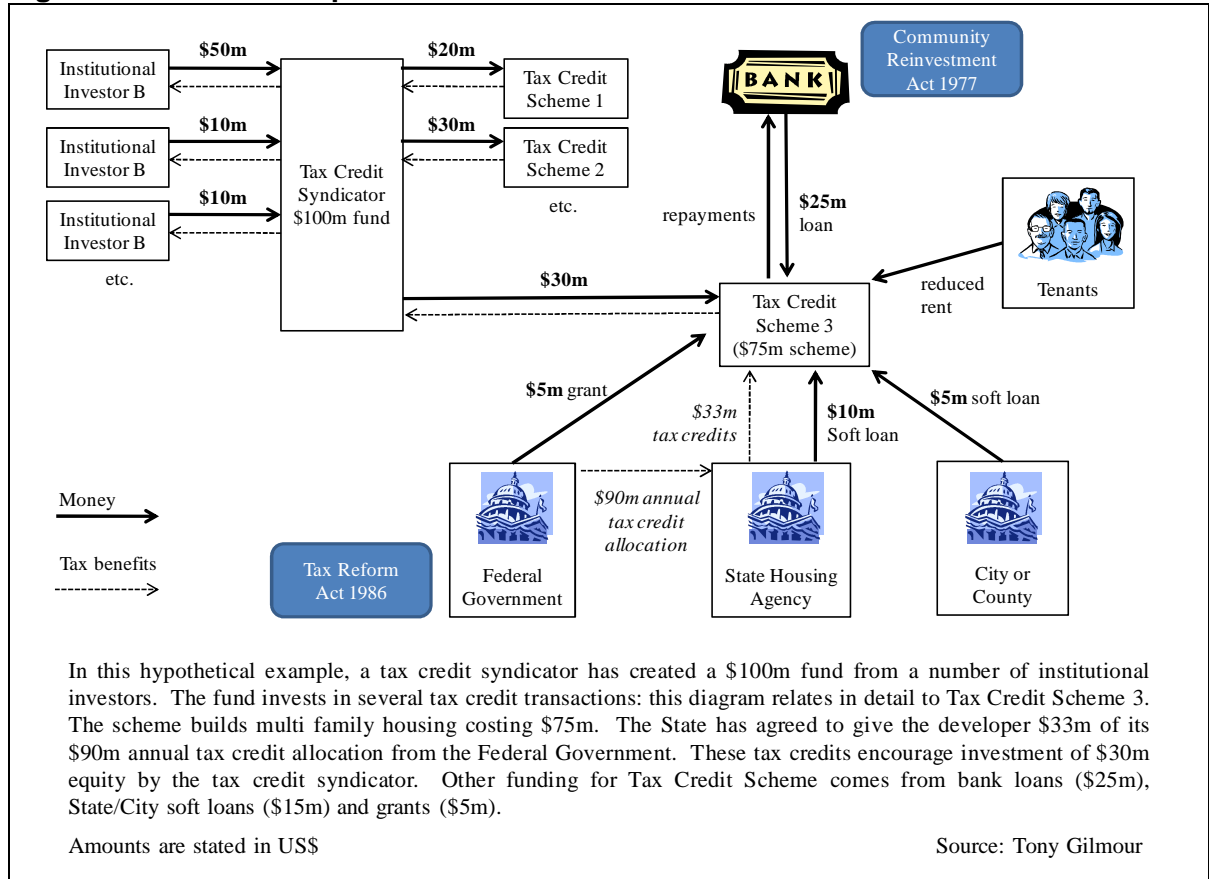
Investors in tax credits receive a dollar-for-dollar reduction in their tax bill over ten years and can claim accelerated depreciation allowances on the property. Investors decide how much they are prepared to pay the developer for the ten-year flow of tax benefits, and this amount varies depending on their assessment of risk and general market conditions. In the early years of tax credits investors would pay only 50 cents for each tax credit dollar, and if transaction costs were 10 cents in the dollar, this would leave only 40 cents for the developer. After the scheme was made permanent by Congress, and investors understood the risks, the rate of return they expected fell. Similarly, syndication fees declined as the market became more established and competitive.

By 2005, developers received around 90 cents for each tax dollar (Schwartz, 2006). Using this figure, in the example given earlier of a US\$10m project that produced US\$7.02m of nine per cent tax credits, the cash received from the syndicator would be US\$6.32m.

Tax law makes tax credits unattractive for private individuals, who were not permitted to claim depreciation allowances after the Tax Reform Act of 1986, and for non-profit organisations because they do not have taxable profits. Therefore tax credit investors are predominantly corporations. Ernst & Young (2003) estimated the investor mix in 2002 was banks (43 per cent), 'Government Sponsored Enterprises' such as Fannie Mae and Freddie Mac (30 per cent), insurance and other financial service companies (19 per cent), and non-financial corporations (eight per cent). Many banks invest to satisfy their obligations under the Community Reinvestment Act of 1977. This Act requires lenders to serve the credit needs of households, including low income and minority households, in all areas in which they obtain deposits and provides for community challenges to the risk

of fulfilment of these obligations in circumstances such as institutional closures and amalgamations (Schwartz, 2006)

Figure 1: Worked example of US tax credits



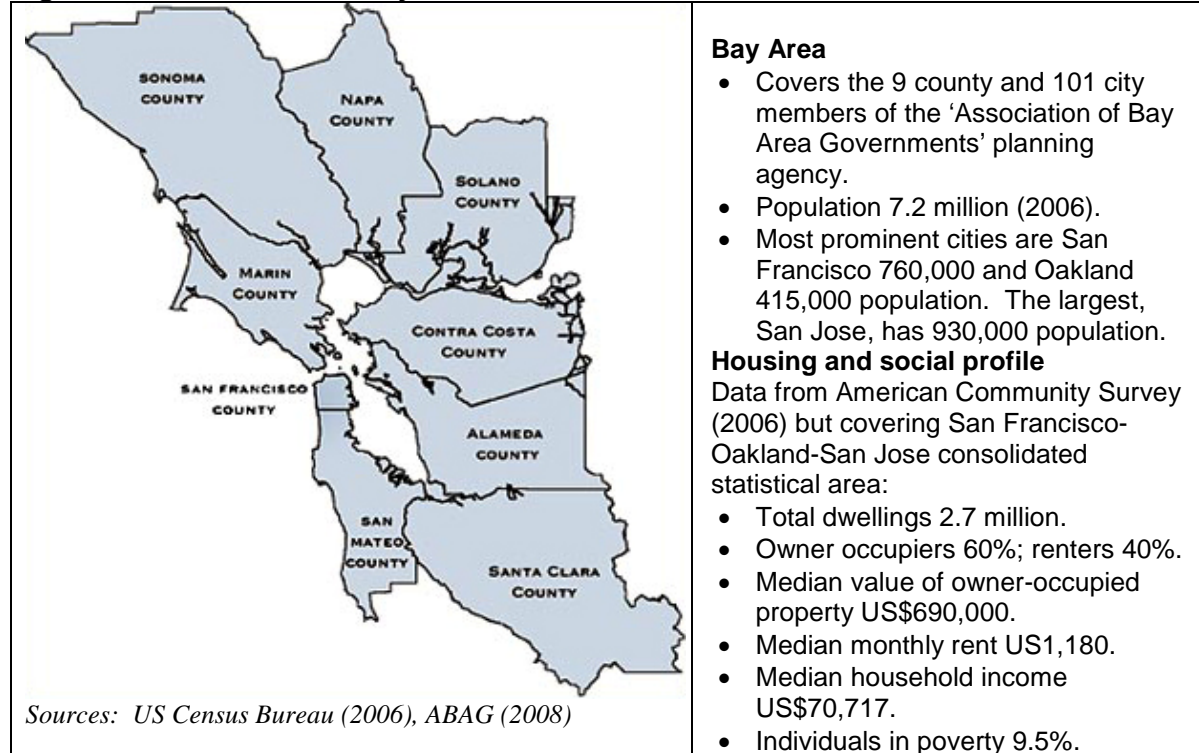
Housing Tax Credits in the San Francisco Bay Area

The US tax credit system is a nationally legislated and funded program. However its impact varies between states because they can apply additional rules for applicants and coordinate tax credits with other state-controlled sources of affordable housing finance. In order to give a concrete example of how US tax credits work in practice, this section uses information obtained from field research carried out by the authors in the San Francisco Bay Area in the latter part of 2007. Semi-structured interviews took place with 55 staff and directors at three US non-profit organisations, and with representatives of capacity building organisations, finance providers, government officials, lobbyists and academics.

The Bay Area has a population of over seven million people and extreme housing affordability problems. In 2006 the top three least affordable counties in the US measured by the hourly wage required to rent a two bedroom unit were in the Bay Area: Marin, San Mateo and San Francisco counties respectively (NLIHC, 2007). In 2003 only 12 per cent of San Franciscan households could afford to purchase the median priced property (Rosenthal et al., 2003). Prices have been driven high by the limited availability of land suitable for development and strong neighbourhood opposition to urban-infill building (Hird et al., 1991). Median salaries are high in the Bay Area compared to

California or the nation, although there are wide disparities in income. The poverty rate is above the state average, at 9.5 per cent, and homelessness is a major problem (Rosenthal et al., 2003). Owner occupation is relatively low in the Bay Area, at 60 per cent of the housing stock and extremely low in San Francisco county at 35 per cent, making the supply of affordable rental housing a major political issue in the region. Figure 2 highlights salient information.

Figure 2: San Francisco Bay Area



Tax credits in the Bay Area are determined by the Californian Tax Credit Allocation Committee that distributes Federal tax credits in two rounds, in March and July (CTCAC, 2008b). The Committee also monitors compliance with Federal legislation by inspecting records every three years: in 2007, 680 schemes were investigated with 99.2 per cent of residents found compliant with income requirements. Federal nine per cent tax credits are allocated by the national government based on the state's population, a total value in 2007 of US\$759m for California measured over the ten year term of the credits, calculated at a rate of US\$1.95 per resident per year. From the introduction of tax credits, 1,730 schemes have been supported in California at a total cost of US\$9.6bn (CTCAC, 2008a). While this level of funding is impressive, demand for tax credits in California consistently exceeds supply – in 2007 by a factor of three to one.

California switched to distributing tax credits on a regional basis in 1997, in part as a reaction to a large proportion of early funding going to the larger and more professionally run Bay Area non-profit housing organisations. Targets for California's ten regions are based on a formula incorporating population, housing costs, wealth and urbanisation - arguably a fairer system than the allocation to states that is by population alone. California's regional distribution system adds fine grain detail as to how US tax credits work in particular localities. Politicians in San Francisco, which is a single administrative city, county and tax credit region, have a 'queuing system' for city funded 'gap finance'

through a managed list of mainly non-profit housing organisations (Community Economics, 2007).

Without city and county funding, few tax credit schemes would proceed. Across the Bay in Oakland, organisations have to bid for tax credits against competition in six counties and over one hundred incorporated cities. Hence the introduction of market forces into affordable housing through bidding for tax credits works more efficiently in some areas than others.

California is considered a politically progressive state and this is reflected in how it has moulded the Federal tax credit scheme. Extra points are awarded to tax credit bids incorporating smart growth housing close to transit stops, and for energy efficient building design. A condition of state-sourced gap funding of nine per cent tax credit schemes is that properties should remain affordable for 55 years, considerably longer than the 30 year Federal requirement. Low income housing schemes in California must now have on-site social service provision, a change in state law which prompted a community based organisation in Oakland to appoint a new Director responsible for non-housing service delivery (East Bay Asian, 2007a). Given that these additional requirements are legislated at state level, there is considerable variability between the working of tax credits in different parts of the US.

Non-profit housing organisations dominate Northern California. Between 2000 and 2005 over 70 per cent of the very low and low income units in the Bay Area were developed by non-profit organisations (Bay Area LISC, 2005). Seven of the eleven federal 9 per cent tax credit allocations in the Bay Area in 2007 were to non-profits, as were both allocations in San Francisco. Due to traditions of grassroots activism, a pro-affordable housing city administration, a robust and larger non-profit sector and steady supply of graduates from Berkeley and Stanford universities, San Francisco is the heartland of California's non-profit housing organisations (Gammal et al., 2005; NPH, 2007). The city is home to a wide range of non-profit capacity building and training organisations, lobby groups, broader housing coalitions, regional peak bodies, tenancy managers, consultants, financiers and tax credit syndicators. The dominance of Bay Area non-profits competing with for-profit affordable housing developers for tax credits is not typical of the rest of California.

In the south of the state, particularly in populous Los Angeles County, for-profit developers win most tax credit allocations. These developers do not keep properties affordable indefinitely, and tend to target fewer tenants on very low incomes (CHPC, 2007; NPH, 2007; UC Berkeley, 2007). Therefore, even in regions within a state that has consistent tax credit allocation criteria, the workings of US tax credits are not uniform. In areas where the non-profit housing sector has greater capacity, more tax credits will be awarded, paving the way for future capacity building. Regional variations matter, even in a national scheme.

Institutional investment and affordable housing: issues for Australia

This section draws on available evidence from the US to comment on how institutional investment in affordable housing under the NRAS incentive may develop in Australia, and uses that country's experience to suggest issues that may arise and how they might be addressed. The approach assesses the design and structure of NRAS as developed so far against recognised normative evaluative criteria of appropriateness, efficiency and effectiveness, and against the stated objectives of the scheme. NRAS aims to:

‘increase the supply of affordable rental dwellings; reduce rental costs for low and moderate income households; and encourage large-scale investment in and innovative delivery of affordable housing’ (Australian Government, 2008: p.2).

The issues that emerge from these considerations are discussed around six broad headings: how NRAS might generate a new institutional investment market; its potential cost effectiveness; which client groups and geographic areas it is likely to assist; the implications of gap financing; will housing stock be affordable in the longer term and what will be the likely mix between for-profit and non-profit affordable housing developers.

Raising institutional investment

The US has a longer track record than Australia in encouraging both direct and institutional investment in affordable housing. Schemes such as *section 236* of the US National Housing Act 1968 provided investor subsidies to reduce debt servicing costs and led to the provision of over one million homes for low and moderate income families (Schwartz, 2006). These schemes were run by both non-profit organisations and for-profit developers but most investors were private individuals able to claim accelerated depreciation allowances on the property to off-set against income tax (Orlebeke, 2000).

This situation ended with the Tax Reform Act of 1986, which heralded a decisive shift from private to institutional investors and from smaller to larger transactions. US tax credits succeeded in creating an entirely new asset class that was able to tap funds from institutional investors, particularly banks looking to meet their Community Reinvestment Act obligations. Without this legislation, one Bay Area banker's opinion is that ‘if bank's didn't have to do it, I'm not sure if they would' lend to affordable housing developers (Washington Mutual, 2007). Guthrie and McQuarrie (2007) disagree, seeing tax credit lending as a lucrative business activity for banks. However, they agree with the point made by a senior Wells Fargo executive (2007) that until tax credits were launched by the Tax Reform Act of 1986 there had been little socially responsible bank lending under the Community Reinvestment Act.

| [Figure 3](#) compares features of US tax credits against the categories used by Berry (2000) to explain barriers to equity investment in Australian market-rate and social housing.

Figure 3: Equity investment barriers to rental housing, Australia and the US

Barrier	Australian context	US tax credit comparison
Low returns	There is presently no institutional investment market, therefore investor appetite for returns are hard to gauge. Berry (2000) suggested low yields may be a barrier to institutional investment, though this was without NRAS style subsidies.	When investors became familiar with the scheme and it was made permanent, their required return - as built into the bid price for credits - fell from 20.5% in 1987 to 11.8% in 1994 (Cummings and DiPasquale, 1999: p.294).
High risks	Uncertainty for investors over scope for capital appreciation, poor/variable tenancy management and potential changes in government subsidy and tax policies.	Tax credit scheme has been consistent since introduced in 1986 and enjoys bi-partisan support. Investors look for tax and depreciation benefits, not capital appreciation.
High management costs	The small-scale and fragmented nature of the sector in 2008 offers few economies of scale. Non-profit providers exist with tenancy management skills, but only a few have development capability.	In 1986 when tax credits were launched the sector had only limited development or tenant management experience and few scale economies. Funding from developer fees on tax credits led to a rapid growth in sector capacity.
Illiquidity	Liquidity a potential problem compared to investing in shares and bonds. No development of a market in syndicated products as yet.	Institutional investors have a wide range of portfolios to choose between with different maturities. There is also a secondary market in tax credits (McQuarrie and Guthrie, 2005)
Poor market information	Markets are segmented by type, quality and location and there is limited monitoring. Lack of longer-term time series of performance measures.	The sector is supported by a large number of experienced consultants. Specialised national tax credit syndicators such as LISC and Enterprise established over 20 years ago.
No track record	Few structured equity investment deals written in Australia. Lack of capacity for larger deals where an institution could invest over A\$10m.	Housing managers, regulators, investors and syndicators have had experience with a largely unchanged regulatory and financing system over the last two decades.

Source: Categories based on Berry (2000).

In Australia, NRAS will be launched to a market where investors have not had an opportunity to fully understand the risks and rewards of affordable housing through prior experience. This is unlike the US where investors become familiar with section 236 projects prior to the introduction of tax credits in 1986. Australia's institutional investment market is therefore likely to take longer to develop than in the US, offer less liquidity and investors will seek high rates of return - especially in the early years of the scheme.

Uncertainty about whether NRAS will be ongoing at scale will inhibit market growth and may deter more cautious investors from entering the market, and secondary markets may be slow to develop until investment volumes reach critical mass. Australian markets may develop differently than the US where 92 per cent of investors in affordable housing tax credits are financial institutions, many encouraged by their obligations under the Community Reinvestment Act. Banks may be more modest backers of Australian tax credits than in the US, with the shortfall needing to be filled by superannuation funds and corporate investors.

There may also be greater difficulty in establishing the institutional investor market at the current stage in the economic cycle because of the international downturn in property markets and credit shortages. However, as mentioned earlier in the paper, Australia has

the potential for well-funded superannuation funds to invest in affordable housing to help diversify their portfolios.

Cost Effectiveness

Tax credit optimists in the US point to syndicating efficiencies over time with reduced fees, investors earning more realistic returns and the net amount received by developers rising. Funds available for developers per tax credit dollar, before deduction of syndication fees, remained within the 50 to 60 cent band until 1995: since there has been a steady increase, to over 80 cents in 2001. The change followed tax credits being declared 'permanent' in 1993 (Ernst & Young, 2003: Exhibit II-4).

Improved transaction efficiency has helped overcome Stegman's (1990) criticisms that tax credits delivered excessive investor profits. Yet, despite the improvements, US tax credits remain less efficient dollar-for-dollar than direct grants because public funds for affordable housing are still lost on professional fees and investor returns (Freeman, 2006). The complexities have necessitated employing expensive consultants when structuring transactions, and there is an on-going compliance burden for developers. Transaction and compliance costs are multiplied for each finance source, and there are often eight different sources per project. The highest number of finance sources encountered in the Bay Area research was eleven (Bridge Housing, 2007a). However, while the cost inefficiencies of tax credits are quantifiable, it is not possible to calculate the benefits brought by market forces improving bid quality through the competitive tax credit allocation process. Additionally, compliance costs would not necessarily be less if the US had a centralised regulatory and inspection system for affordable housing providers.

There is insufficient detail released so far about NRAS to calculate the costs of the scheme. However, some pointers follow from US experience. For example, a portion of taxpayers subsidies delivered through tax credits will be lost to non-housing outcomes such as professional fees, administration costs and corporate/investor profits. To balance these costs, the US has a competitive and transparent tax credit bidding system that encourages efficiency. If Australia is to achieve similar efficiencies it will need to be similarly transparent. So far it appears that the establishment phase of NRAS to mid-2010 will be more 'managed' than 'market' driven. With tax credit funding, costs will be higher if the system is complicated and there is uncertainty over its 'permanence'. The US program is largely a market regulating system with tax credit syndicators monitoring project compliance on behalf of institutional investors to protect their entitlement to tax credits. In Australia it appears likely regulators in national and state government will each have a role with the risk that compliance costs could be higher than in the US, potentially deterring private sector investment. It will be important to streamline and harmonise administrative functions and regulatory requirements of different levels of Australian government to minimise these costs.

Individuals and areas assisted by tax credits

The US tax credit program has succeeded in targeting households with incomes noticeably below the 60 per cent of area median income upper threshold introduced by Congress. Ernst & Young (2003) reported that for tax credits allocated in 2001, 44 per cent were for families on incomes below 50 per cent of the area median income, 49 per

cent for incomes 51 to 60 per cent of the area median income and only 7 per cent for more than 60 per cent of the area median income. There is little evidence that developers are using tax credits to serve only households at the upper income levels of 50 or 60 per cent of area median income permitted under Federal legislation, even though it would help their cash flows. Most residents of US tax credit schemes are working families with incomes in the range 30 to 60 per cent of area income (Buron et al., 2000; East Bay Asian, 2007b) - somewhat higher than households in public housing where 65 per cent have incomes below 30 per cent of the area median income (HUD, 2008a). Therefore it appears that tax credits that are issued are serving the needs of a deserving, modest income segment of the population but are not addressing, and were not intended to address, what some commentators see as 'sharpening income and housing inequality' in the US (Tilly, 2006: p.35). The problem is in part one of quantum: for every five applications for tax credits, four are rejected for lack of funding (Bridge Housing, 2007b). Successive Presidential Administrations and Congresses have chosen not to make housing assistance an entitlement and have rationed both supply and demand solutions to the growing problems with housing affordability (Grigsby and Bourassa, 2003).

It is difficult to make a direct comparison of targeting of US tax credits and the likely situation under NRAS because of fundamental differences in the income distribution and underlying welfare support systems in the two countries and, more immediately, because the eligibility and allocation rules for NRAS have not been finalised. The US systems works in an environment where access to housing assistance for renters is severely rationed. While Commonwealth Rent Assistance is an entitlement for eligible social security clients who are renting privately in Australia, the low maximum rate of payment compared to market rents in many parts of the country suggests low-income households will continue to face high rents (though less than prevailing market levels) in NRAS housing in higher rent regions. Therefore, NRAS combined with Commonwealth Rent Assistance may not be sufficient to achieve reasonable affordability standards for many lower incomes households. One option to address this could be to offer additional rental subsidies to providers willing to allocate NRAS dwellings to high needs, low income households. This approach would be similar to project-based housing vouchers that were provided to tax credit projects in the US until recently. It would have an added attraction in the Australian context of providing an alternative housing option for the most disadvantaged households who rely presently on what the highly constrained homelessness service delivery system and social housing can offer.

There are important differences in the geographical distribution of tax credits between the US and Australian models. US tax credits are distributed annually on a per capita basis across states, and some states such as California further divide credits to different regions based on both headcount and housing need. In Australia it is not proposed to pre-determine the allocation of tax credits between states. It has been suggested that, as in the US, state governments may set additional needs criteria against which priority for projects to be recommended to the Commonwealth will be determined. However, without having a guaranteed share of the available credits, individual states may be reluctant to introduce local requirements that could discourage investors in their jurisdiction. Overall, the proposed approach suggests that the distribution of NRAS subsidies across Australia is more likely to reflect the location of high capacity affordable housing providers, access to gap finance (see below) and developable land, rather than be targeted to areas of poorest housing affordability. This was the problem faced in California during the first decade of

tax credits that led to the adoption of more specific geographical and needs-based targeting in 1997.

Tax credit schemes in the US do not have a good track record of producing mixed income neighbourhoods. In affordable housing projects it is common for 100 per cent of the units to be for eligible tenants to maximise the subsidy for developers and to gain additional points in the states' tax credit allocation procedures. This is despite the fact that US tax credit legislation allows for mixed income projects. Australia's NRAS guidelines so far are silent on this issue, although US experience suggests that, unless a firm position is taken on having mixed income projects, the tendency may be for tax credit linked developments to be segregated from market rate housing. This would be a change to current practice in the Australian market, which develops mixed-tenure, multi unit schemes as a norm.

Implications of gap financing

US tax credits do not, and were never intended, to fund the entire cost of affordable housing schemes. Certain costs cannot be claimed by developers, credits are calculated at only 70 per cent of the present value of cashflows and investors will pay less than the face value for tax benefits due to compliance risks. Ernst & Young (2003) estimated tax credits in 2002 contributed on average 42 per cent of project cost, followed by conventional bank debt secured by a mortgage at 36 per cent. In schemes catering to low income tenants, lower levels of bank debt than this are possible as rental income to cover debt servicing costs will be weaker (TNDC, 2007).

Beyond tax credits and bank debt, the additional amount required to make the project viable is known as 'gap finance' of which some two-thirds is likely to be 'soft loans' from state and local government. Normally these loans are accompanied by extra conditions on the housing developer, but are eventually written-off if all the terms have been met (Cummings and DiPasquale, 1999). The final slice of funding will come from donations (if the developer is a non-profit organisation), use of retained earnings, tax exempt bonds issued by the city or state and various grants. These grants include the HOME Investment Partnership Program, the Community Development Block Grant, and, importantly in rural areas, programs of the Rural Housing Services federal agency.

NRAS, following the US model, will only offer a partial contribution to the funding of affordable housing for lower income households. There is not enough detail yet to say how large the funding gap will be in Australia, although initial indications are that tax credits might raise a similar or slightly lower proportion than in the US – around A\$100,000 towards a property cost of A\$250,000 to A\$350,000 depending on market context. There are many sources of gap finance in the US but it is not clear what types will be provided in Australia. Revenue raising by local government, federal block grants to states, planning gain and philanthropic investment are used in the US but many of these sources appear to be less achievable in Australia.

Here there is a need to look to land commissions (such as Landcom and VicUrban), state grants, more widespread application of planning gain and other planning concessions for affordable housing, such as on parking requirements and fees. Australia has some community-sourced equity, for example from churches, but this is likely to be

opportunistic rather than available consistently or at scale. The level of debt finance that NRAS projects can support is not yet clear, though reliance on this source may create tensions as taking higher income tenants will strengthen cashflows but at the expense of lower income and high needs groups. Rental income for developers is likely to be higher than in the US, where rents for tax credit properties are pegged to area incomes (because rent vouchers are rationed), but lower than the UK where housing benefit covers the full gap between the individual tenant's assessed capacity to pay and market rent.

Finally, the problem of the supply of NRAS housing not being well-aligned with where housing affordability problems are greatest, discussed above, may be compounded by the requirement for higher proportions of gap financing in high cost, high need areas. This is unless this gap finance can be raised in these areas through the use of planning mechanisms, such as inclusionary zoning, which can work most effectively in high value areas, and where density is being up-scaled. (Gurran et al., 2008) evidence about the impact of planning contributions for affordable housing across several countries and advances reasons for how they can be used effectively.)

Retention of affordable housing stock

Although the US tax credit originally provided only 15 years affordability protection (for a 10 year credit), schemes funded more recently operate for a minimum of 30 years and much longer where soft loans from cities and states add additional restrictions. The Californian affordability restriction discussed earlier in this paper is 55 years, and in Boston it is the entire 'useful life' of the property (Davis, 2006). When earlier US schemes reach the end of their 15 year period there are a series of protracted negotiations between property managers and investors (Community Economics, 2007).

The three main factors identified as reducing the risk of losing affordable housing in US schemes after the expiry of the protection period are management by non-profits, the application of additional affordability restrictions (usually by the state) and the cost of rehabilitation necessary to return housing to the open market (Meléndez et al., 2008). Legislative changes in 1989 gave preference to transferring ownership at the end of the protection period to non-profits to keep properties affordable 'permanently' (Wallace, 1995). However, after 15 years major refurbishment is normally required and few of the earlier tax credit schemes have sufficient reserves in place. Some states use current but scarce tax credit dollars to refurbish older schemes but this limits resources for adding to the supply of affordable homes (Schwartz, 2006).

Unlike the current operation of tax credits in the US, there are no provisions for retention of affordability beyond 10 years in NRAS. Australia's scheme allows institutional investors tax benefits together with capital growth released through property sales at the end of the subsidy period, compared to the US where tax benefits are the main consideration as projects are structured not have surpluses when the protection period ends. This has policy and practical implications. What happens to the supply of affordable housing and to the housing outcomes for tenants as tax credits expire are critical issues best addressed at the outset of the scheme rather than retro-fitted. Similar models in the US and elsewhere driven by market considerations have had to be 'refloated' through the injection of additional subsidies at a higher real cost to government over time or valuable stock (and wealth accumulation) has been lost to the

affordable housing sector (Lawson and Milligan, 2007). While these problems may be mitigated somewhat with careful planning and/or refinancing strategies, they will add political and operational risks and hence add to costs. Moreover, because there is no requirement for the housing to remain rented at a below market price after ten years, this scheme is unlikely to overcome Australia's underlying structural drivers of affordability (Yates and Milligan, 2007). Therefore, a dual philosophy of assisting individuals and ensuring longer-term community benefits should guide policy development.

For-profit and non-profit housing providers

Tax credits in the US have led to the growth in capacity of both for-profit and non-profit affordable developers. Overall, the dominant providers are for-profit organisations, which account for three quarters of tax credit allocations. This has several policy implications: commercial developers normally have greater scale economies and access to equity markets and can therefore build more cheaply. On the downside, private companies earn profits on the back of public investment, may have shorter-term planning horizons leading to a neglect of maintenance and could show less interest in tenant welfare and community building (Wright, 2003). Non-profit affordable housing providers most likely have missions better aligned with public policy goals than private companies, and have played an important role in ensuring that a range of public policy objectives are met in the US. Factors that have contributed include the presence of a long established network of non-profits, particularly Community Development Corporations; the commitment and influence of individual community leaders, and professional development through organisations, such as universities and the nationally networked Local Initiatives Support Corporation.

In US tax credit transactions, the finances are put in place at the start of the project and, in general, there are no other forms of subsidy during the initial 15-year term. Therefore, if cash flows are not in line with forecast, schemes can run out of money. A 1995 survey found 78 per cent of tax credit schemes were cash-positive: those developed by for-profit organisations 83 per cent but only 60 per cent for non-profits (Cummings and DiPasquale, 1999: p.276). Because finance is provided for each scheme individually, and ring-fenced, developers cannot adopt a portfolio approach and use surpluses from performing schemes to subsidise non-performing. This is a particular problem for non-profits who cannot raise new equity without a major financial re-structuring and do not receive recurrent public subsidies to pay central overheads. Large and well managed non-profits, such as Bridge Housing in San Francisco, are robust, sustainable organisations. The future for many smaller non-profits that have not reached critical mass is less certain. According to Diane Spaulding of the Non profit Housing Association of Northern California: 'I think a shake-out's inevitable ... small organisations cannot sustain themselves' (NPH, 2007).

Striking the right balance between for-profit and non-profit providers under Australia's NRAS scheme will be difficult. The community sector has the potential to play an important role, especially to optimise the social policy benefits of NRAS, but will need to build capacity quickly. Providing the alternative of direct grants to charitable non-profits will help them to initiate projects where gap funding is available. This could be particularly important early on, if institutional investment doesn't flow initially. However, compared to the US, Australia's housing non-profits are small, and localised, do not receive substantial philanthropic donations and less than 20 presently have

experience in property development and long term asset ownership. Arguably, they have lower capacity than America's non-profits when tax credits were launched in 1986 as at that time Community Development Corporations had built their skill base, although their demonstrated experience in tenancy management is a strength that will be attractive to developers and equity investors. Australian policy makers need to consider funding non-profit capacity building programs, and encouraging partnerships as a positive way to combine private sector development skills with non-profit tenancy management expertise. Funding allocated for capacity building and facilitating partnerships in the 2008 federal budget is a good start.

Conclusions

Tax credit schemes for affordable housing in the US and proposed for Australia look similar on the surface, but there are deeper design differences that will affect how they work in practice. As NRAS moves from start up to consolidation over the next two years, two areas where there may be important and timely lessons for Australia stand out. The first concerns the distribution of tax credits and their take up across the country. The US scheme allocated tax credits between states based on population from the start so that there is a reasonable spread of benefits around the country - if not always to where housing need is greatest. Devolution of tax credit allocation to the US states has allowed them to overlay their own policy objectives, but it has led to a patchwork of different outcomes. In Australia, tax credits allocation will be at national level. This may lead to more uniform outcomes in terms of project structure, but seems less well placed than even the US to match public funding to housing stress. It remains to be seen how much the national incentive will be a catalyst to state and local jurisdictions contributing additional funding and to how the market responds under different policy and market conditions across the country. However, it is clear that a considerable up scaling of current levels of spending will be required in each state and territory for the scheme to achieve its targets and be matched to need.

The second issue concerns the long term housing benefits that the scheme will bring. The most problematic area with US tax credits has been preservation of housing affordability, though this has now been solved to a reasonable extent by having a minimum 30 years affordability built-in. The design of NRAS has not addressed this issue. Not only are tax credit supply and rent discounting only for ten years, but institutional investors will have built-in expectations of capital gain. It will be expensive for the government to claw-back or replace the NRAS stock from 2018, when affordability problems are projected to still be significant (Yates et al., 2008). Paradoxically to the scheme's objective of encouraging large scale investment, any thoughts of modifying NRAS mid-term may scare investors. Certainty of policy frameworks and bipartisan support proved crucial to deepening institutional investment in US affordable housing. Both are absent presently in Australia. Experience from the US confirms that with market-based policies such as tax credits, it is hard to strike the right balance between the needs of investors and those seeking affordable housing.

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