

WHY WE NEED TO END NEW YORK CITY'S MOST EXPENSIVE HOUSING PROGRAM.

POLICY BRIEF

NEW YORK'S UNAFFORDABLE HOUSING PROGRAM: TIME TO END 421-A

Tom Waters and Victor Bach, Community Service Society of New York

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By Victor Bach and Tom Waters



The Community Service Society of New York (CSS) is an informed, independent, and unwavering voice for positive action representing low-income New Yorkers. CSS addresses the root causes of economic disparity through research, advocacy, and innovative program models that strengthen and benefit all New Yorkers.

David R. Jones, Esq., President & CEO

Steven L. Krause, Executive Vice President & COO

About the Authors

Tom Waters has been a Housing Policy Analyst at the Community Service Society since 2005. Prior to joining CSS, Mr. Waters was at Tenants & Neighbors, an organization that works to preserve and improve the state's existing stock of affordable housing. He has a M.A. in political science and is working on a doctoral dissertation on housing and neighborhoods at the City University of New York Graduate Center.

Victor Bach has been Senior Housing Policy Analyst at the Community Service Society since 1983. He was a Research Associate at the Brookings Institution and on the faculty of the New School for Social Research and the LBJ School of Public Affairs at the University of Texas, Austin. He holds a Ph.D. in Urban Studies & Planning from M.I.T.

Introduction

New York City's 421-a tax exemption, which sunsets on June 15, 2015, is a relic of a past time, costing the city an enormous amount of lost revenue while contributing very little to affordable housing. Attempts to reform it have failed, and the potential for future reform is limited because the exemption does not provide a mechanism for matching the amount of the tax foregone to the value of the affordability created. Rather than renewing it, the state legislature should allow it to expire and replace it with a new program built around an explicit mechanism tying the cost of the tax subsidy to the public benefit in terms of affordability.

The original 421-a was enacted in 1971 primarily to promote new residential investment in New York City at a time when private construction had stalled. Today, the city's economy has been transformed, and 421-a has been legislatively modified several times, but its rich as-of-right tax benefits live on, costing the city over a billion dollars a year in lost revenue. Although it is now often described as an affordable housing program, affordable apartments make up only a small fraction of the 163,000 units that received the tax exemption in 2014, and many of those apartments receive significant other subsidies, as well. The 421-a program primarily subsidizes market-rate, even luxury, housing.

The \$1.07 billion in foregone revenue due to 421-a in 2014 was the city's largest single housing expense. It is more than the entire budget of the city's Department of Housing Preservation and Development. It is more than the combined rents of all tenants in the New York City Housing Authority (NYCHA) and also more than NYCHA's federal operating subsidy that supplements those rents. It is more than the total amount of federal Section 8 housing vouchers that NYCHA administers. Indeed, if the billion dollars a year expended on 421-a were used to fund housing vouchers similar to Section 8, it would provide

homes for 100,000 of the city's poorest families. There is no question that the affordability benefits of 421-a fall far short of that standard.

While affordable housing advocates and good-government groups criticize 421-a for its high cost, its inefficiency as an affordable housing program, and its tendency to steer benefits to the politically powerful, proponents defend it by pointing out that it does create some affordable housing, by claiming that a tax incentive is still needed to build in New York City or that the removal of the incentive would be disruptive, or by arguing that the program can be made efficient through reform. Much of this paper is devoted to showing that the amount of affordable housing produced is far too low to justify the cost. It also argues that most of the benefits of 421-a are going to developments that would have been built without the subsidy, and that 421-a's inefficiency is deeply rooted in its structure and cannot be reformed away.

Summary of Key Conclusions

- At \$1.07 billion a year, 421-a is the largest single housing expenditure that the city undertakes, larger than the city's annual contribution of funds for Mayor de Blasio's Housing New York plan.
- The annual cost of 421-a to the city exploded during the recent housing boom as a result of market changes, not because of any intentional policy decision to increase the amount of tax incentives for housing construction.
- Half of the total 421-a expenditure is devoted to Manhattan.
- The 421-a tax exemption is a general investment subsidy that has been only superficially modified to contribute to affordability goals.
- The 421-a tax exemption is extremely inefficient as an affordable housing program, costing the city well over a million dollars per affordable housing unit created.

- The reforms made to 421-a in 2006 and 2007 have not resulted in a significant improvement of 421-a's efficiency as an affordable housing program.
- A large share of buildings that receive 421-a and include affordable housing also receive other subsidies, such as tax-exempt bond financing. Affordable units in these buildings cannot be credited entirely to the 421-a program.
- The great majority of the tax revenue forgone through 421-a is subsidizing buildings that would have been developed without the tax exemption.

Policy Recommendations

- Allow 421-a to expire when it sunsets on June 15, 2015.
- Replace it with a targeted tax credit or other new incentive that is structured to provide benefits only in proportion with a building's contribution to the affordable housing supply.

History and Design of the 421-a Tax Exemption

The 421-a tax exemption was born in 1971,¹ a time when private housing investment in New York City was lagging. The city was sometimes seen as part of the Rust Belt, and planners were alarmed by the exodus of high earners for the suburbs. Private housing starts fell from over 45,000 houses or apartments per year in 1961 and 1962 to 10,000 or fewer from 1968 to 1970. The city and state of New York responded by enacting 421-a to incentivize residential investment in the city and make it more competitive with the suburbs and Sun Belt locations.

As originally conceived, 421-a did not have a strong affordability mission. Because New York City appeared to be suffering in competition for investment with other cities and with the suburbs, and because residential construction was perceived as lagging relative to non-residential development, the reasoning went, property tax exemptions should be directed to any and all residential development,

increasing the expected cash flow from new apartment buildings in the city. Thus the design of the exemption was reasonably well matched to the perceived supply problem that it was supposed to correct.

By the middle 1980s, the city's development picture, especially in Manhattan, had improved considerably. There was concern that 421-a had become a giveaway to developers, as illustrated by Mayor Ed Koch's unsuccessful attempt to block benefits for the Trump Tower condominium on Fifth Avenue in 1984.² The influential housing expert George Sternlieb was quoted in the New York Times a few years later suggesting that 421-a was not effective in stimulating construction because land prices had risen to reflect the additional cash flow due to the tax exemption, steering benefits to landowners and removing the incentive to develop. "My guess is that the existence of 421-a basically raised the land costs," he said. "All these deals are penciled backwards, and 421-a made it possible for landowners to raise prices."³

Lawmakers responded to this situation in 1984 by making changes to 421-a. Exemptions in a large part of Manhattan were ended in 1985, but the city was given the power to allow exemptions in that area for buildings that provided affordable housing directly or indirectly. Instead of curtailing 421-a, then, lawmakers gave it a new justification by adding provisions related to affordable housing. Under rules that took effect in 1987, buildings in a "Geographic Exclusion Area" or GEA in Manhattan from 96th Street down to Houston Street on the West Side and 14th Street on the East Side could obtain the exemption only by either including affordable apartments in the new building or by steering money to off-site affordable developments through a certificate sale program.

In the off-site program, now being phased out, developers built affordable housing, generally in low-income areas, and applied to the city for four or five certificates per apartments built, depending on the degree of affordability. The developers then sell the certificates at market prices to other developers who are building market-rate developments and want to receive 421-a. The affordable

developers use the proceeds to repay their construction loans, and the market-rate developers can develop one tax-exempt apartment per certificate they buy. (Recently, 421-a certificates were selling for \$20,000 to \$40,000 each.)

The 1984 changes to the law turned 421-a into a hybrid affordable housing program and pure development subsidy. They did steer needed money to affordable housing development, but they did so in a way that would never have been designed if subsidizing affordability had been the prime concern.

As originally conceived, 421-a did not have a strong affordability mission.

One problem with the new design of 421-a was that its affordability component did not include any provision for matching the value of the tax exemption with the affordable housing benefit. Both of these values are clearly related to the value of the building's site, but there is no reason to expect them to line up. In cases where the value of the expected tax exemption is less than the income foregone by accepting lower rent on the affordable apartments, the developer can forego the exemption or not build the development. In cases where the exemption is worth only a little more than the foregone rent, the development will be built with 421-a, and the foregone taxes will be approximately reflected in the added affordability. And in cases where the tax exemption is worth much more than the foregone rent, then the developer (or more likely the original landowner) will receive a windfall.

Another problem with the program was that it assumed the market conditions of 1985 as the basis for a long-lived program. During the period from 1985 to 2008, the economics of building housing in Harlem, lower Manhattan, and the inner areas of Brooklyn and Queens

was utterly transformed, but the 421-a tax exemption for these areas did not change, leading to the devotion of many hundreds of millions of dollars in tax expenditures to 100 percent market-rate developments in areas that were just as profitable as the core Manhattan area subject to the 421-a affordability requirements—in some cases, more so.

In 2006 and 2007, legislators (first in the New York City Council and then in the state legislature) finally responded to these problems. They eliminated developers' option to locate the affordable housing off-site through the certificate program and expanded the area where affordability requirements apply. The Geographic Exclusion Area (GEA) now covers all of Manhattan and large areas of Brooklyn, as well as scattered areas of the other boroughs. The choice of areas to include in the GEA was essentially political and has been extensively criticized, including by city housing commissioner Vicki Been.⁴ But the expansion of the GEA represented an attempt to improve the alignment of the tax incentive with affordability goals. Unfortunately, it has so far had a minimal effect on the production of affordable housing, as we will show below.

In its current form, 421-a provides for several different types of exemption.

- **Within the GEA**, comprising Manhattan, brownstone Brooklyn, and a few other neighborhoods, a developer can obtain a 20-year 421-a exemption by including apartments on site that are affordable to households with incomes of \$46,600 per year for a household of three,⁵ implying a rent of \$1,165 per month for a two-bedroom apartment. Twenty percent of apartments in the building must meet this affordability standard. In return, there will be no property tax on the estimated market value of the building up to about \$188,000.⁶ There will still be property tax on the value of the land and on the building value above \$188,000. This exemption will be in full force for twelve years, then phase out over eight years.

- **Within the GEA**, a developer may still be able to obtain a 10-year 421-a exemption by purchasing 421-a certificates

(one for each apartment) that were created when another developer built affordable housing elsewhere in the city. No more of these certificates are being created, and there are probably very few still available. This exemption will be in full force for two years, then phase out over eight years.

- **Within the GEA**, a few developers may still obtain 10-year 421-a exemptions without providing any affordable housing at all if they are outside the pre-2008 GEA and received the necessary building permit before June 30, 2008.
- **Outside the GEA**, a developer can obtain a 15-year 421-a exemption with no affordability requirement. This exemption will be in full force for eleven years, then phase out over four years.
- **Outside the GEA**, a developer can obtain a 25-year 421-a exemption by including apartments that are affordable to households with a range of incomes, but averaging \$62,000 a year. This exemption will be in full force for 21 years, then phase out over four years.
- **Throughout the city**, developers are also able to obtain 421-a tax exemptions in combination with other forms of subsidy that are allocated competitively by government agencies.

Expense of the 421-a Program

In fiscal year 2014, New York City spent \$1.07 billion in 421-a tax expenditures to support the construction of buildings with a total of 163,000 units, as reported in the city’s own Annual Report on Tax Expenditures. Most of these units are apartments, but some parking and storage spaces also qualify.

As Table 1 shows, the 421-a tax expenditure is the city’s largest housing cost, far larger than the entire annual expense budget for the city’s Department of Housing Preservation and Development. Although it is less than the total budget for the New York City Housing Authority, it is larger than any of NYCHA’s three largest funding streams: tenants’ rents, the federal public housing subsidy, and the federal subsidy for Section 8 vouchers.

The de Blasio administration estimates that its “Housing New York” plan to build 80,000 and preserve 120,000 units of affordable housing will cost \$41.1 billion over ten years, but most of that will come directly or indirectly from the federal government. The plan projects that the city and its arms will contribute \$8.2 billion over ten years—an annual contribution that is less than the revenues foregone through 421-a.

Table 1: Selected housing expenditures in New York City

City Funding		Federal Funding	
PROGRAM	COST	PROGRAM	COST
421-a construction tax benefit	\$1,073 million	NYCHA Section 8 vouchers	\$934 million
City share of HPD capital	\$320 million	NYCHA-operated housing	\$830 million
J-51 improvement tax benefit	\$259 million	HPD Section 8 vouchers	\$317 million
City share of NYCHA capital	\$69 million	Federal share of NYCHA capital	\$259 million
City share of HPD expense	\$59 million	CDBG share of HPD expense	\$197 million
		Federal share of HPD capital	\$44 million

Each figure is for Fiscal Year 2013 or 2014. Sources: New York City Department of Finance, Annual Report on Tax Expenditures, 2014. The City of New York, Adopted Budget Fiscal Year 2015: Expense, Revenue, Contract. The City of New York, Adopted Budget Fiscal Year 2015: Capital. New York City Housing Authority, Adopted Budget for FY 2015 and the Four Year Financial Plan FY 2016–2019.

These comparisons demonstrate the outsize prominence of 421-a among the city’s housing activities, and they imply a high standard for the amount of social benefit such a large expenditure should provide.

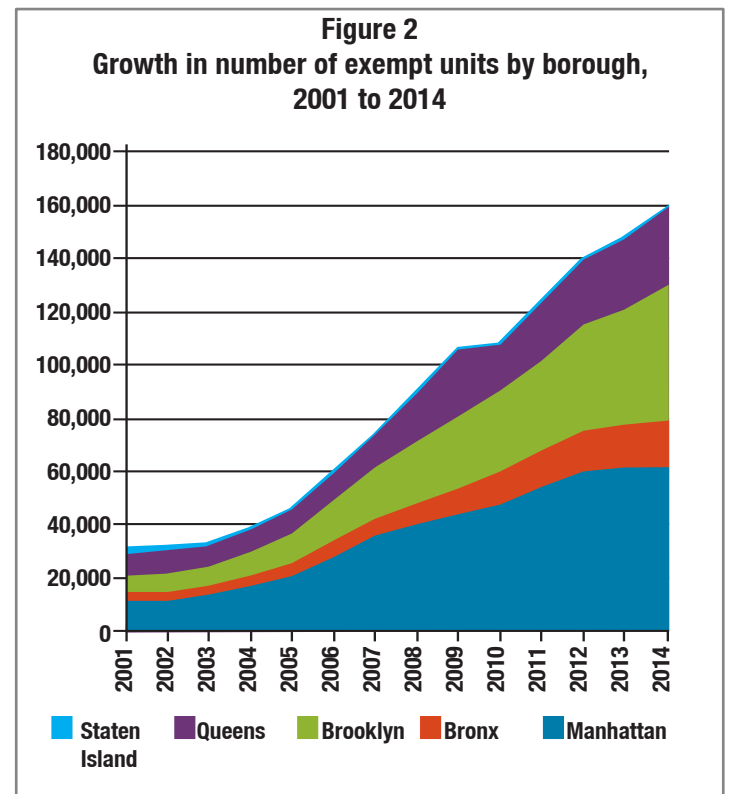
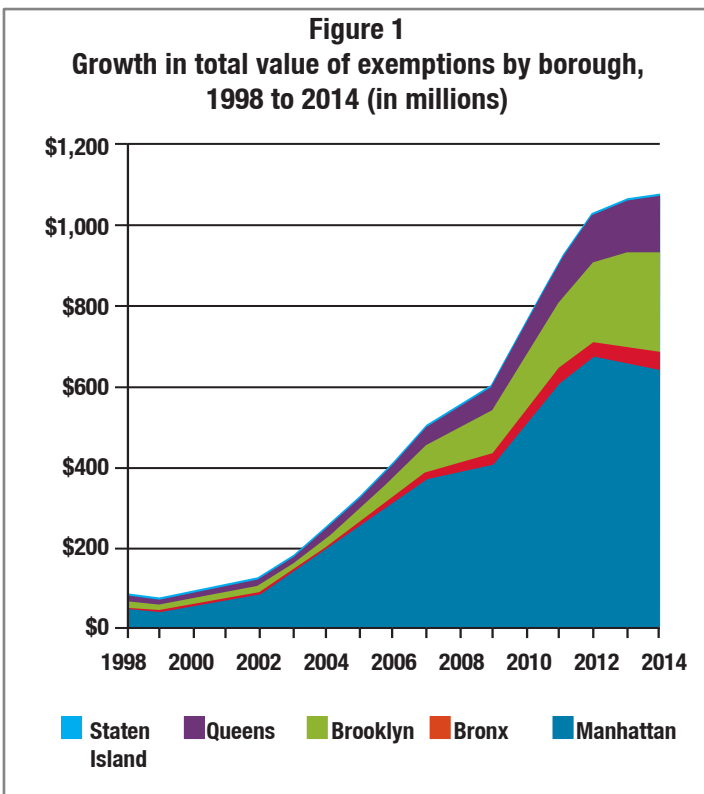
Growth and Distribution of 421-a Benefits

The amount of revenue foregone through the 421-a exemption exploded from the late 1990s through 2014, increasing twelve-fold from \$88 million in 1998 to \$1.07 billion in 2014, as shown in Figure 1. Two factors drove this growth. One was the boom in construction, which meant that more buildings were receiving the exemption. The number of units exempted grew from 32,000 in 2001 to 163,000 in 2014, as shown in Figure 2.

The other factor in the growth of the total revenue foregone was an increase in property values, which increased the value of each exemption. The average annual per-unit value of an exemption grew citywide from \$3,430

in 2001 to \$6,595 in 2014. Not surprisingly, the values were highest in Manhattan, \$10,327 in 2014. Manhattan’s share of units exempted has fluctuated around 40 percent since 2001, but its share of the total value of exemptions has been much higher, rising from 61 percent in 1998 to 78 percent in 2005 before falling back to 60 percent in 2014. Because of the changing nature of the housing market, exemption values rose fastest in Brooklyn, going from \$1,646 in 2001 to \$4,845 in 2014. As a result, Brooklyn’s share of the total value of exemptions went from 11 percent in 1998 to 23 percent in 2014.

It is worth noting that the 12-fold increase in tax expenditures due to 421-a from 1998 to 2104 did not come about because of any intentional act by the city or state government. Instead it occurred because of changes in the housing market, while the law remained relatively constant. The city and state did revise the 421-a law in 2006 and 2007, with changes taking effect in 2008. These changes were intended to make the tax exemptions somewhat



Source for Figures 1–4: New York City Department of Finance, Annual Report on Tax Expenditures, 1998 - 2014.

harder to get—not to increase the expenditure. But the market-driven escalation of benefits that was already underway when these measures were passed continued after they took effect. The growth of the expenditure did slow somewhat beginning in 2012, but this shift was the result of market changes, not legislation.

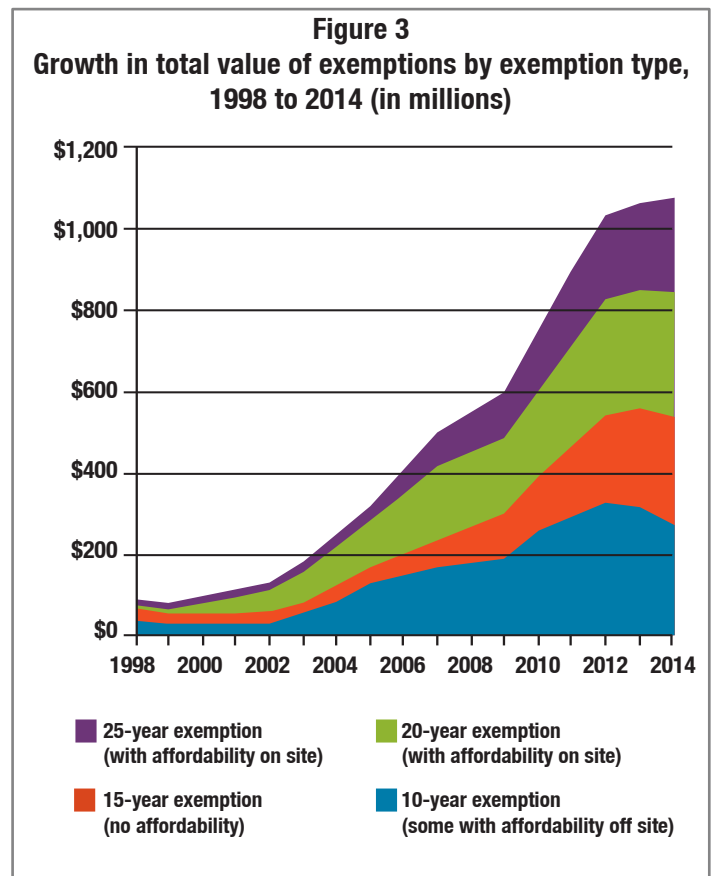
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Because each building receives the exemption for 10 to 25 years, the total amount of benefit each unit receives is much higher than the annual amount. Suppose that one building in that total is within Geographic Exclusion Area in Manhattan and received an exemption worth \$10,327 (the Manhattan average) in the fifth year of its 10-year period exemption. That would suggest it received \$17,212 in each of the first two years, declining to \$3,442 in the last two years for a total of \$103,270 over the full period—all in return for buying a certificate that probably cost \$40,000 or less. A building in Harlem that was permitted for construction before June 30, 2008, could receive the same \$103,270 worth of exemption without buying a certificate, because Harlem was outside the original exclusion area. Or consider a building built outside the exclusion area in Brooklyn that received a 15-year exemption that averaged \$4,845 per year over its period. This building would receive \$72,765 over the full period without any affordability benefit at all. These examples illustrate why the 421-a program is so inefficient. In one case only 40 percent of

the foregone revenue ends up helping to pay for affordable housing. In the other two cases, none does.

The evolution of 421-a can also be seen in the changing share of units receiving 10-year, 15-year, 20-year, and 25-year exemptions. This provides clues as to the amount of affordable housing being produced through the program. Fifteen-year exemptions provide no affordable housing. Ten-year exemptions sometimes, but not always, provide for off-site affordable housing. Twenty- and 25-year exemptions generally provide affordable housing, usually in conjunction with other subsidies.

It must be borne in mind that the varying lengths of the exemptions also skew their appearance in these statistics. The value of the 25-year exemptions observed in 2014 reflects exemptions granted over a 25-year period, while the value of 10-year exemptions in 2014 reflects exemptions granted in a period of only 10 years. Thus, Figure 3 shows



the actual values of the various types of exemptions, while Figure 4 shows values adjusted by dividing by the term of the exemption. This is an approximate average of the amount of annual expenditure added each year over the past 10 to 25 years, depending on the exemption type.

These graphs make clear the prevalence of 10-year exemptions in driving 421-a expenditures, but also that that prevalence began to fade after 2012. Somewhat harder to discern is the rapid growth of 15-year exemptions from 2006 to 2012, primarily due to development in Brooklyn. There were also increases in two categories with on-site affordable housing: 20-year exemptions (Manhattan below Harlem) starting in 2000 and 25-year exemptions (rest of the city) starting in 2002. The 10- and 15-year exemptions are the least efficient in producing affordable housing.

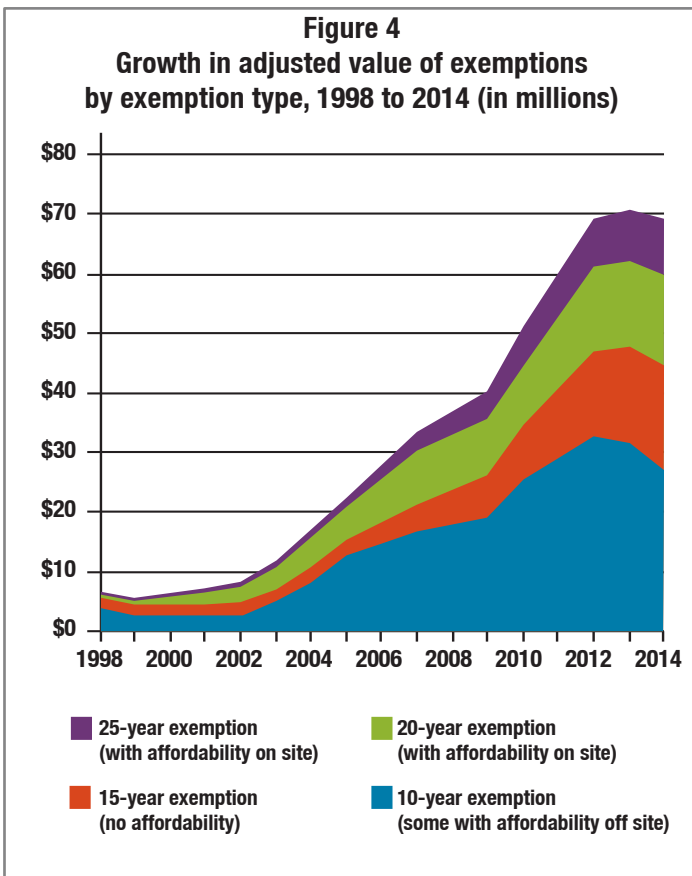
Number of Affordable Units

Each year, New York foregoes \$1.07 billion through the 421-a program. How much does this effort contribute to affordability? The answer to that question depends primarily on three considerations: the number of new affordable apartments built, the income group to which each apartment is targeted, and the amount of additional subsidy each affordable apartment received in addition to the 421-a benefit.

The number of apartments created is clearly low, but is not known with certainty. The city does not directly track the number of affordable apartments created. Instead, it is necessary to estimate the number based on the number of exemptions granted in different locations. Two organizations have recently analyzed the affordability created through 421-a by mapping the location of exempt buildings and assuming that a share of the units in each building is affordable if it falls within the Geographic Exclusion Area boundaries that applied at the time the building was constructed. The Municipal Art Society⁷ has produced an interactive map that estimates the number of affordable units in each building, but does not present any citywide total.

The Association for Neighborhood and Housing Development⁸ has taken a similar approach in its analysis, but it assumed that each development took three years to construct and was therefore subject to the GEA in place three years prior to completion—a conservative assumption. On this basis, ANHD estimates that 12,748 of the 153,000 residential units receiving 421-a exemptions in 2013 were subject to affordability requirements. That is 8 percent of the total. Given that all 421-a buildings receive the exemption for at least ten years, this suggests that the program is creating affordable apartments at a rate of no more than a tenth of 12,748 per year—up to 1,275 at the astonishing cost of at least \$833,000 each.

It is also important to consider whether the 2008 reforms to 421-a have made it a significantly better program. The buildings receiving exemptions in 2014 were constructed



up to 25 years earlier, so the performance of the program largely reflects the unreformed law rather than the version now in force. To evaluate the current 421-a program, we must examine buildings developed since the reforms went into effect.

Our analysis shows that the 2008 reforms have had little effect on the 421-a program’s ability to produce affordable housing, largely because most of the construction since 2008 within the expanded exclusion area was permitted by the city before June 30, 2008, and thus grandfathered in under the pre-reform rules.

In order to assess 421-a’s current performance, CSS randomly selected a sample of 200 developments built from 2010 to 2013 and determined their actual affordability status, using city, media, and real estate industry sources. Our findings, summarized in Table 2, suggest that the

reforms have had only a small effect on affordable housing production. In 2010, 91 percent of buildings (weighted by number of apartments) that completed construction and received 421-a exemptions for the first time were not subject to any affordability requirement. In 2011 and 2012, that figure dropped, but only to 72 and 76 percent respectively. (Only three buildings with 21 apartments in our sample were built in 2013.) This shift probably reflects the delayed impact of the 2008 reforms, but even in the later years, two thirds of the apartments receiving 421-a exemptions for the first time in the expanded exclusion area were exempt from the new requirements because they were permitted prior to June 30, 2008.

In terms of apartments added to the affordable stock, the impact of this shift was minimal. In 2010, 41 affordable apartments were created on or off site—2 percent of the total. In 2011, that rose to 51 apartments or 6 percent of

Table 2: Affordability requirements in a sample of recent 421-a developments (approximate number of affordable units in parentheses)

	2010		2011		2012 and 2013	
	Buildings	Units	Buildings	Units	Buildings	Units
OUTSIDE ANY GEOGRAPHIC EXCLUSION AREA						
No affordability	60	1,116	33	223	36	413
WITHIN OLD GEOGRAPHIC EXCLUSION AREA						
Off-site affordability	0	0	2	30 (8)	0	0
WITHIN NEW GEOGRAPHIC EXCLUSION AREA						
No affordability	23	680	16	418	11	867
On-site affordability with additional subsidy	3	84 (17)	1	123 (25)	1	327 (66)
On-site affordability without additional subsidy	1	8 (2)	3	16 (4)	1	8 (2)
Off-site affordability	4	87 (22)	2	86 (22)	3	65 (17)

Source: CSS analysis of data on 421-a exemptions and the extent new and old Geographic Exclusion Area from the New York City Department of Finance, data on permits from the Department of Buildings, and news reports.

the total, and in 2012, 85 apartments or 5 percent. These numbers are based on a sample of 200 421-a exemptions out of 378 total from 2010 to 2013. Simple extrapolation suggests the true number of affordable units per year now stands at about 120. Even after the expansion of the exclusion area began to take effect, the affordable share of apartments receiving 421-a benefits for the first time is still lower than the 8.3 percent average for the 421-a stock overall as estimated by the Association for Neighborhood and Housing Development.⁹

Mixing and Matching Subsidies

In evaluating the efficiency of 421-a, we must also consider other subsidies that may have been given to the developments receiving the tax exemption.

The 421-a tax exemption is commonly combined with other subsidies in order to create affordable housing. In many cases, this combination is justified, because a government agency has reviewed the overall finances of a new development and determined that the total subsidy package is justified. In other cases, however, the developer has been allowed to double-dip, for example, receiving both tax-exempt bond financing and 421-a with the same affordable units justifying both subsidies and without a review to determine whether a lower amount of subsidy would have been sufficient to create the affordable units. In either the justified or the unjustified case, however, it would be an analytic error to attribute the affordable apartments entirely to the 421-a program. If 421-a only did half the work to create an affordable apartment, it should receive only half the credit.

Our analysis of the recently added 421-a stock illustrates this point. From 2010 to 2012, 21 buildings with 834 apartments received the tax exemption with affordability requirements. Eleven of those buildings with 268 apartments involved the creation of apartments off site through the certificate program. It is not possible to trace whether the 53 affordable off-site apartments involved any further subsidies, although it is quite possible that they did.

The other 10 buildings, with 566 apartments, included on-site affordable apartments. Of these, five buildings with 32 apartments were built with the 421-a subsidy only. Thus the 421-a program deserves full credit for the 8 units of affordable housing created in those buildings. The other five buildings, with 534 apartments, were developed with extensive other subsidies. These buildings are subject to regulatory agreements related to their other subsidies and it is likely that these buildings have been reviewed to ensure that the total subsidy package is reasonably related to the affordability benefit. However, it is also likely that 421-a was not essential to getting these buildings built, as government agencies do have other tools for extending tax exemptions to affordable developments.

If 421-a only did half the work to create an affordable apartment, it should receive only half the credit.

Because our sample contains only 10 recently developed 421-a buildings with on-site affordability requirements, we cannot confidently infer that this very high rate (94 percent) of additional subsidy use applies to 421-a developments as a whole. Nevertheless, the rate observed here is not inconsistent with the conventional wisdom that additional subsidy is used in most 421-a developments with on-site affordable housing.¹⁰

Our findings suggest that 421-a deserves perhaps only half the credit for 108 out of 173 affordable apartments developed with the exemption—which in turn indicates that the \$833,000 per unit estimate of the cost of creating affordable housing through 421-a was quite low. The true cost per unit is probably well over \$1 million.

Affordable To Whom?

The income targeting of the affordable units created through 421-a is another important consideration in evaluating the efficiency of the program. In most cases, incomes for 421-a units are set in proportion to a statistic calculated by the federal Department of Housing and Urban Development known as “Area Median Income.” This figure is not actually a median but rather a construct based on a combination of city incomes, suburban incomes, and housing construction costs. In 2015, AMI for New York City is \$86,300. The target for 421-a is to households at 60 percent of AMI, or \$51,780, for a family of four. Adjusted to a more typically sized family of three, that is an income of \$46,600, implying a rent of \$1,165 for a two-bedroom apartment.

These are not the city's poorest people, but a group just below the middle of the income distribution. This group does face significant housing stresses in New York City today, but the needs of poorer people are even greater. It also normally costs much less to make housing affordable to this group than to lower-income people.

The value of the 421-a affordable housing to the people who actually live in it can be measured by the difference between that rent and what they would have paid for an unsubsidized apartment of similar size, quality, and location. A rent of \$1,165 per month is below market for a good-quality two-bedroom anywhere in the city, but it is further below market in some places than others.

The on-site affordable units in our sample that were created with 421-a benefits only are located in Bushwick and Bedford-Stuyvesant, Brooklyn, and Bathgate and Crotona Park, the Bronx. The on-site units created with a combination of 421-a and other subsidies are located in Harlem and East Harlem, Manhattan, and Fort Greene, Brooklyn. The off-site units are probably located mostly in low-income areas of the Bronx and Brooklyn. This suggests that the apartments created are renting for \$500 to \$1,000 below market. The present values of these benefit streams to the tenants are thus \$70,000 to

\$140,000 per apartment—far less than the amount of taxes foregone to create them.

Is a Tax Incentive Still Needed for Market-Rate Development?

The 421-a tax exemption is extremely inefficient if considered as an affordable housing program. Could it still be justified as a simple incentive for economic activity? Advocates for the real estate industry still occasionally argue that it is. Sometimes the argument is made directly, with the claim that tax incentives are needed to overcome the high cost of development in New York City. Other times it is made indirectly, with the claim that 421-a exemptions don't actually cost the city money because the buildings receiving the exemption would not have been developed without the tax benefit, and the city would thus not have received taxes.

Ultimately, these arguments should only be truly persuasive to those who think that the revenues that can be generated from New York City real estate are too low to overcome the costs. Most apartments receiving 421-a are in Manhattan or in areas of Brooklyn and Queens that can command very high rents.

In these areas, land that is suitable for developing apartment buildings sells at prices that are high multiples of the number of indoor square feet permitted under zoning rules. Recently reported land sales in Manhattan below Harlem were mostly above \$400 per buildable square foot, sometimes rising above \$1,000. Sales in Harlem, East Harlem, brownstone Brooklyn, and Western Queens were mostly between \$100 and \$500 per buildable square foot. Sales for less than \$100 per buildable square foot were generally in the Bronx and more remote areas of Brooklyn such as East New York and Sheepshead Bay. All of these prices have risen dramatically in recent years.

When developers agree to pay these prices, they estimate that the net income from the buildings they develop will be enough to repay a loan covering both the price of the

land and the cost of constructing the buildings. The greater the expected net income, the greater the land price that developers will agree to pay. The rising prices paid for land reflect rising expected net incomes, which in turn reflect rising rents. The expected value of the 421-a tax exemption contributes to these prices, because developers will pay more for land that “comes with” the tax benefit. But when land trades for \$100 a foot or more, the 421-a contribution is a relatively small part of the picture. Without 421-a, it is reasonable to expect that these developments would go forward, although the land would have to sell for a somewhat lower price.

Some 421-a supporters have argued that the tax exemption is necessary to compensate for New York's high land prices. This argument can be rejected where land prices are \$100 a foot or more, both because 421-a is part of the reason for the high price and because the high prices that developers pay for land prove that they expect high net incomes from their buildings. If 421-a were removed, land prices would adjust downward, but development would continue. In fact, a more sophisticated and plausible version of this argument says that ending 421-a would impose a disruptive, though temporary, transition while this adjustment takes place. But a perpetual subsidy of more than \$1 billion a year is hardly an appropriate response to this possibility.

At some point below \$100 per buildable square foot, however, the 421-a component of expected net income could become decisive in determining whether a development goes forward. Relatively few buildings receiving 421-a benefits are located in areas where such prices are the norm, and many of those that are developed in those areas also receive other subsidies. This makes sense, because it is difficult to turn a profit developing housing in some areas, even with 421-a. As a development subsidy, 421-a is only effective in a narrow band where expected rents are high enough that new development makes sense with the subsidy, but low enough that new development wouldn't make sense without it.

In a Daily News opinion column in March, 2015,¹¹ developer David Kramer argued that one of his projects falls into that band. The building in question appears to be 1295 Nostrand Avenue, a market-rate development at the corner of Nostrand and Clarkson Avenue. Kramer says that without 421-a, his firm would have to pay \$1.3 million a year in property taxes. Since the firm will still have to

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pay taxes on the land, that is a tax benefit of roughly \$1.2 million for 11 years, followed by lesser benefits for four years. This suggests a present value of the benefit roughly equal to the \$10 million that the firm paid for the land (about \$70 per buildable square foot), indicating that the deal might well not have gone forward without the tax subsidy.

But this building is exceptional. If the expected rents would have allowed a land price \$30 higher per buildable square foot, the subsidy would probably not have been necessary. If they had been lower by the same amount, the subsidy would be insufficient to incentivize the project. Only a very small share of developments receiving 421-a fit into this narrow band of financeability, indicating that the program is just as inefficient as a development subsidy as it is as an affordability tool.

It is also debatable whether it makes sense to subsidize a development like 1295 Nostrand Avenue even in an efficient manner. The building is receiving subsidies worth \$10 million without providing any affordable housing. Its rents will be above \$2,000 a month, unaffordable to 75 percent of the current residents in its area. The neighborhood is far more likely to see it as a gentrification agent than a benefit worthy of subsidy.

Fix It or End It?

The 421-a tax exemption is unacceptably inefficient regardless of whether it is considered as an affordability or a pro-growth policy. A wide variety of voices have declared that it cannot be allowed to continue in its current form. The question, then, is not so much whether 421-a is good policy as whether it can be made into good policy through legislative changes.

Key proposals to reform 421-a focus on eliminating the exemption for buildings without an affordable component and on increasing the affordability requirement where it does apply—by mandating either more affordable apartments or apartments targeted to lower-income people. These proposals would improve the efficiency of the program, both by increasing the affordable share of apartments receiving 421-a, and by decreasing the total number of 421-a apartments when more developers opt not to accept the exemptions.

What these proposals would not do is to provide any clear mechanism to relate the value of the exemption to the value of the affordable housing produced in order to get the exemption. Thus they would not cut off the flow of unnecessary subsidy to unaffordable housing.

When a building receives a property tax exemption, the value of that exemption is based on the amount of property tax that would otherwise be owed, which in turn depends on the assessed value of the property. Because real estate values vary very widely in New York City, the values of tax exemptions vary widely too. When government offers an exemption in return for providing affordable units, developers will accept the tax benefit whenever it is worth more than the cost of providing the units. In a few cases, the tax benefit will be only a little more than was necessary to incentivize the affordable housing production, but because the underlying values of the exemptions range so widely, there will inevitably be many more cases where the tax benefit is too high, resulting in an inefficient program overall.

Government could seek to overcome this problem by making 421-a more complicated. Instead of one Geographic Exclusion Area, there could be many concentric ones, with steadily increasing affordability requirements as you approach the city's core where the most valuable real estate lies. But this approach undermines the simplicity of the tax exemption program, which is often claimed to be its strength relative to more targeted subsidies. What's more, the system of concentric zones would have to be adjusted continuously, and accurately, in order to be effective.

The failure of the 2006 and 2007 amendments to significantly improve the 421-a program illustrates the difficulty of any geographic approach. The expanded Geographic Exclusion Area established in 2007 was never very well connected to real estate reality, and it immediately became out of date as the potential for high-end development expanded further into Brooklyn and Queens. Worse, the excessive grandfathering of developments allowed within the expanded exclusion area undermined its effectiveness almost completely.

Negotiating amendments to a fundamentally flawed program like 421-a is not the right way to create a truly effective and efficient affordable housing program. Instead, a new program should be developed that is built on the principle of exchanging subsidy for affordability benefits of similar value.

The huge amount of revenue foregone through 421-a could be better used for affordable housing in many ways. It could fund 100,000 rent vouchers similar to federal Section 8 to enable truly poor households to find housing in the private market. It could be used to provide capital subsidies to create place-based affordable housing similar to Mitchell-Lama. It could even be used for a better targeted tax subsidy, similar to the federal Low Income Housing Tax Credit, which does have an explicit mechanism to link cost to public benefit. Instead of tinkering with reforms to the structurally inefficient 421-a tax exemption, we should be debating which of these approaches is the best way to meet the city's vitally important affordable housing goals.

NOTES

1. Edward C. Burks, "Tax-Abatement Plan Seeks to Stimulate City Housing," *The New York Times*, October 31, 1971.
2. Citizens Housing and Planning Council, "Reassessing Tax Incentives," *The Urban Prospect*, March/April 1997. See also Donald J. Trump and Tony Schwartz, *Trump: The Art of the Deal*, page 189 ff. Random House 1987.
3. Michael deCourcy Hinds, "421a: A Subsidy That Cost \$551 Million," *The New York Times*, March 19, 1987.
4. Vicki Been, New York City Commissioner of Housing Preservation and Development, testimony before the New York City Council Committee on Housing and Buildings, January 19, 2015.
5. These figures are calculated from a "Area Median Income" standard established each year by the federal Department of Housing and Urban Development
6. Market value estimates by the city Department of Finance are generally much lower than actual sale prices.
7. Municipal Art Society of New York, "421-a Tax Exemption," available at <http://www.mas.org/urbanplanning/421a/>
8. Association for Neighborhood and Housing Development, "421a Developer's Tax Break Expiring June 15, 2015: Fix It or End It," available at <http://www.anhd.org/wp-content/uploads/2011/07/ANHD-421a-Fix-it-or-end-it.pdf>
9. This analysis also allows us to assess ANHD's estimate of the affordability share. They estimated a three-year construction period for each building, so that within the new part of the Geographic Exclusion Area, an affordability requirement was assumed for 0 percent of units first occupied in 2010 or earlier but 100 percent of those first occupied in 2011 or later. Our analysis suggests that a more accurate estimation of those figures would be 9 percent in 2010 and 24 to 29 percent in 2011 and 2012. Because 9 is much closer to 0 than 29 is to 100, we conclude that over the whole period after 2008, ANHD's estimate of the affordable share is probably a bit high.
10. This is also in line with what the Real Affordability for All Campaign found in its analysis of recent 421-a exemptions in an area of downtown Brooklyn. Because most of the developments in this study received their exemptions under the pre-2008 rules, most did not include an affordable component. Of those that did, RAFA found that all but one received other subsidies in addition to 421-a. And that one remaining development, with six affordable apartments, received an inclusionary zoning incentive. Real Affordability for All Campaign, "Luxurious Loophole: How Developers Use Taxpayers to Subsidize Housing for the Rich," April 2014.
11. David Kramer, "Why Builders Need 421-a Badly," *New York Daily News*, March 16, 2015.

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