TO:	Mayor Bill de Blasio, City of New York
FROM:	Daniel Duffy, Analyst, Department of Housing Preservation and Development (HPD); Gonzalo Talavera Forlin, Analyst, HPD
DATE:	May 5, 2015
SUBJECT:	421-a reform proposal

The City of New York should reform the 421-a tax exemption in order to advance Mayor de Blasio's affordable housing agenda of constructing 200,000 units over the coming decade. New rules should require that developers:

1. Change 421-a to a voucher in the form of tax exemption that is equal to 100% of market rent, plus an additional incentive amount less the tenant's rent for each unit of new affordable housing (see Appendix 2).
2. Provide affordable units regardless of where a building is sited to receive benefits.
3. Do not use the same affordable housing units to satisfy requirements for different subsidies.

These reforms will accelerate Mayor de Blasio's objectives by providing an attractive incentive for developers to develop affordable housing that specifically focuses the subsidy on rent reduction, boosting the government's cost-efficiency of affordable housing construction, and ensuring that more subsidy benefits renters. 421-a reform will efficiently aid the de Blasio administration in alleviating the stress of high rents on New Yorkers. It will also preserve diverse neighborhoods, which are compromised by the rising cost of housing. Finally, since most households earning low/moderate incomes are renters, they lose out on the increased equity that results from increasing housing values. Reform will slow skyrocketing property values, which contribute to high rents.

421-a analysis

Effectively, the current program subsidizes the construction of market rate and luxury units more than affordable housing, subsidizing affordable units inefficiently. 421-a exempts a property owner's tax liability on added value resulting from new construction of multiple dwellings, and in some cases requires that they provide 20% of a development's units with rent control. Renters in those units earn below a percent of Area Median Income (AMI), and that rent is not supposed to take up more than 30% of their income. However, these rules apply for few units that receive the

421-a exemption: currently only 12,000 out of 150,000 satisfy affordability requirements.[1] Annually the city forgoes more than $1 billion in tax exemptions for these few units.

421-a and other programs have lagged in their ability to provision affordable housing in New York. A growing number of renters are rent burdened; rent takes up more than ⅓ of their income. Despite tacking on new requirements, previous reforms to 421-a have failed to adapt to changing conditions of the City. Originally, New York City passed 421-a in 1971 as a tax exemption to stem population flight from the city's neighborhoods to the suburbs. However, because of major reinvestment in the city, New York's housing markets improved. In 2007 the City expanded the Geographic Exclusion Area (GEA) and imposed the current affordability requirement within it in order to keep up with a high rent trend that expanded out of Manhattan. Still, developers have benefitted from building high-end properties outside of the GEA without the requirement of also building affordable housing.

The subsidies that individual developments receive in the form of exemptions are large, and frequently only a small portion is committed to reducing rents. Analysis of a sampling of properties estimates this amount—the tenant's portion—as the difference between market rents and the amount tenants pay. This portion is represented as a percent of each unit's annual total subsidy here:

- 11% of $550,000 at 535 West End Ave, NY
- 7% of $353,300 at 285 Bowery, NY
- 74% of $30,120 at 252 18th St Brooklyn, NY[2]

The City foregoes a considerable amount in taxes to generate a few units of affordable housing (see Appendices 4-6).

Another threat to cost efficiency are the current rules that allow developers to use the same affordable units to receive benefits from different programs. Developments in the GEA use the same affordable units required for 421-a to also receive a density bonus under the Voluntary Inclusionary Housing Program, or subsidies from the Low-Income Housing Tax Credit (LIHTC).[3]

Aside from the few affordable units that 421-a has created, overall the program threatens affordability since it likely contributes to rising property values. A landowner's asking price for property factors in the future taxes and income that developers receive, for instance 421-a benefits. Some estimates show the present value property taxes (and benefits) completely reflected into property values.[4] Thus extravagant annual subsidies like 421-a are proportionally capitalized into property values, and as a result, rents.

Conceivably, new housing would have positive effects on a neighborhood by increasing population density,[5] thus making the cost of municipal services per resident cheaper,[6] and providing more clients to local businesses[7]. This is not the case for many 421-a properties, which attract investors who oftentimes don't live in their properties,[8] leaving them to sit vacant, reducing housing supply without adding further residents are added to neighborhoods to patronize local businesses.

The program's silver lining is that it is a discrete tool for the City to stimulate affordable housing construction; it is relatively stable and protected from political changes. Tax expenditure programs like 421-a are often less visible—their resources are less prone to appear in the normal budget process and be contested by the public or media—than other policies such as direct spending or grants. Thus 421-a construction is not subject to the vagaries of other programs under budget review.[9]

Align policy response with housing market shifts

Subsidies will more efficiently reach renters with reform. First, the City should end the GEA and require all development to provide affordable units in buildings that that receive 421-a. As gentrification trends rapidly expand outward from Manhattan, the GEA boundaries are only redrawn intermittently and lag behind. As a result, developers benefit from huge 421-a exemptions when building luxury condos in high market areas just outside the GEA, all while providing no affordable units. This may explain a 'halo effect' of 421-a buildings in recently gentrified neighborhoods in Central Brooklyn or Western Queens immediately outside GEA boundaries. Maps in Appendix 1 show high-end properties built near the borders of the current GEA.

However, even though 421-a is a lucrative proposition for many developers, reform should make them more confident that they will profit from future increases in rent, and thus more likely to build affordable units for a more reasonable subsidy. The current subsidy is structured to generate more building in general, which is why it subsidizes the added value of construction. This leads not only to vast cost-inefficiency per the discussion above, but also to developer uncertainty; a fixed subsidy based on current value is not clearly profitable in the long run. After considering that rents and inflation increase over time, a fixed subsidy may not be attractive when attached to the requirement of including 20% affordable units. On the other hand, with a guarantee that they can benefit from an increase in rent, developers may be more amenable to providing affordable units for less subsidy overall. 421-a should be structured as a voucher and directly subsidize rent reduction per the following calculation (also see Appendix 2):

Full Value of Tax Exemption =
(100% of Neighborhood Market Rent + Additional Incentive) – Tenant's Rent

The voucher would subsidize development in the form of a property tax exemption to property owners so that, for every unit of affordable housing they provide, they receive rent from tenants, the difference in the affordable rent and market rate rent, plus some additional incentive. The City's own assessment data and housing survey may be the most accurate and current for estimating neighborhood rent. The following should serve as additional guidelines:

- Like before, the exemption should apply to developments with 20% affordable units in order to promote mixed-income development. New rules should limit the exempted properties to a maximum of 20% rather than a minimum.
- Continue to apply the exemption to new construction only. Allowing current units to get the exemption would not encourage the supply of new housing, and may give a shock to the City's revenue stream.
- Limit the total annual number of exemptions issued per the Mayor's overall affordable housing construction goals.
- Cap the subsidy amount to avoid financing luxury units.
- Set the additional incentive in a way that balances fairness and scalability (while a fixed amount would subsidize housing equally, a percent amount may be needed to get the attention of larger developers of more affluent housing).

Assuming that changing 421-a does not dramatically decrease its appeal, these new exemption rules may lead to the efficient construction of more units of affordable housing overall. Inevitably, some developers will not opt-in to 421-a after reform. However, the enormous cost to the City of subsidizing high-end developers does not justify the modest number of affordable units built.

Also the City will promote the efficient construction of more housing by prohibiting “double” or “triple-dipping” benefits. Using multiple layers of subsidies to satisfy the objective of affordability is a wasteful practice; for every layer the City may lose out on taxes without adding more units of affordable housing. Also, even when subsidies are layered, renters still do not see a reduction in their rents.[10]

Secure future tax revenue

Currently, 421-a likely allows large future taxpayers to be removed from the tax base, and were it restructured to avoid doing so, the program might be more cost efficient and justifiable. The per-unit tax expenditure is higher in high-end housing developments than in less affluent developments and more future revenue is at stake for the City. A higher proportion receiving the exemption will be those that would not have been built otherwise, in which cases future taxes are foregone.

Housing supply subsidies can crowd-out private investment, which likely occurs in New York. Analysis of another supply subsidy, the LIHTC, shows that most housing subsidized by that program likely would have been constructed without it.[11] Appendix 3 shows how LIHTC subsidies increase the net quantity of housing starts only modestly while replacing private construction. When suppliers are willing to build housing even without a subsidy, the subsidy is simply absorbed without changing decisions about whether or not to build.

The risk of crowd-out in high-end housing markets is strong because of suppliers’ willingness to build more housing as price increases, also known as supply elasticity. Developers have claimed that regulations like permitting, zoning and rent stabilization set barriers to housing development.[12] Certainly, some challenges in adhering to these rules come at a cost.[13] However, in New York’s high-end housing market, most developers probably do not need a tax exemption to handle the costs of developing in the given regulatory environment. First, New York’s high-end housing market has some supply-elastic conditions that likely outweigh barriers to development, for example a relative advantage to investment alternatives, and currently the availability of low interest rates.[14] One57, a luxury condominium building in Manhattan, had long-since undergone construction when it received the 421-a exemption. Moreover, from 1992-2003, more housing was built without 421-a than with it, even in Manhattan where labor costs were highest.[15] Over the past 20 years, 64% of new construction in New York has taken place without the help of 421-a[16].

In high-end markets, demand is also unlikely to be affected dramatically by the presence of tax exemptions. People demand this type of housing in part because of the unlikelihood that it will lose its value. In extreme cases, foreign investors under investigation for abuse or fraud have purchased high-end housing in New York City via shell companies. Housing represents a safe haven for their wealth.[17]

The City should set the additional incentive amount described above so that 421-a housing subsidizes housing that would not have otherwise been constructed. It should set the amount at a level that makes 421-a affordable housing construction a better proposition than market rate housing; builders should garner slightly higher returns on their equity. A danger in setting the exemption high is losing a large amount of future tax dollars through crowd out.

Build public housing in high market areas

Building affordable housing in high-end markets is inherently expensive, even when financed by means other than tax expenditures. Given Mayor de Blasio's commitment to promoting diverse, mixed-income communities, providing affordable housing in those neighborhoods will be necessary despite the costs. Insofar as high-end developers decline to develop 421-a housing with the subsidy cap, the City will need to take special steps to provision public affordable housing in those neighborhoods. When it builds public housing in these markets it can control how the incidence of public spending is shifted and efficiently maximize the benefits for low/moderate income renters. Those developers that are discouraged rather encouraged to build affordable units and do not apply for the exemption will pay all the taxes of high price properties, increasing tax revenues.

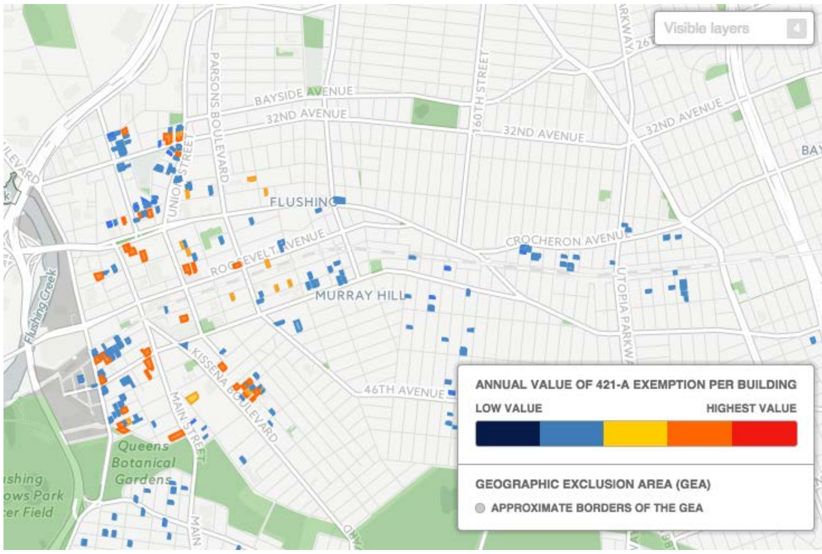
421-a and LIHTC

Mayor de Blasio should use 421-a rather than ending it and relying on other large programs like LIHTC and public housing. First, since there is more income balance in their buildings than LIHTC buildings, 421-a is more ideal for renters, providing them with access to more affluent social networks. Where 20% of units in 421-a buildings are rent-controlled, half of LIHTC projects have more than 83% affordable units. Many renters are still rent burdened in these LIHTC units (see Appendix 8).[18]

Also, redundancy strengthens New York's affordable housing policy. 421-a is able to generate affordable housing construction at times when other programs cannot. While 421-a depends primarily on the strength of New York's housing market, LIHTC construction tends to depend on corporate earnings. In years when one program subsidizes less housing, the other program may subsidize more (see Appendix 3). Such was the case in the mid-2000s, when LIHTC allocations slowed, but 421-a credits remained relatively stable. In order to meet the Mayor's goals for affordable housing development, construction must be steady and reliable.

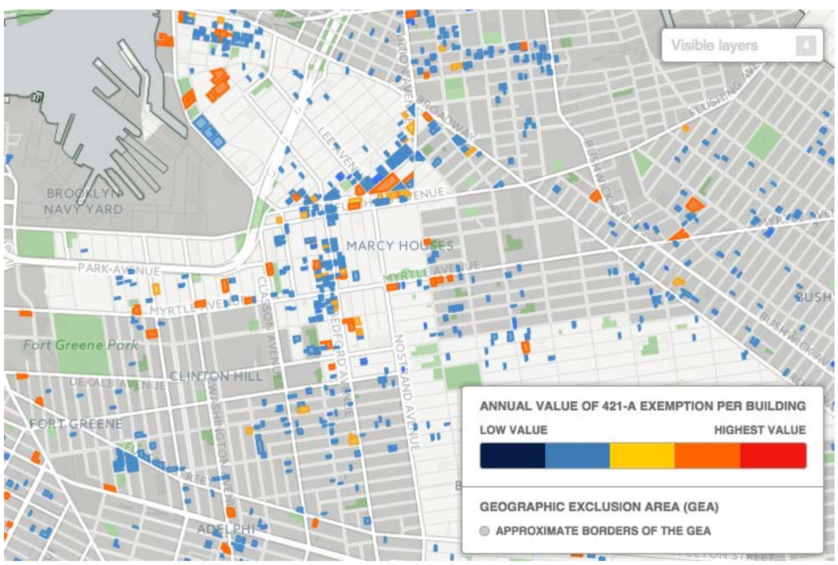
Appendix 1: High-end developments benefiting from 421-a out of GEA.

Developments near the GEA in Queens



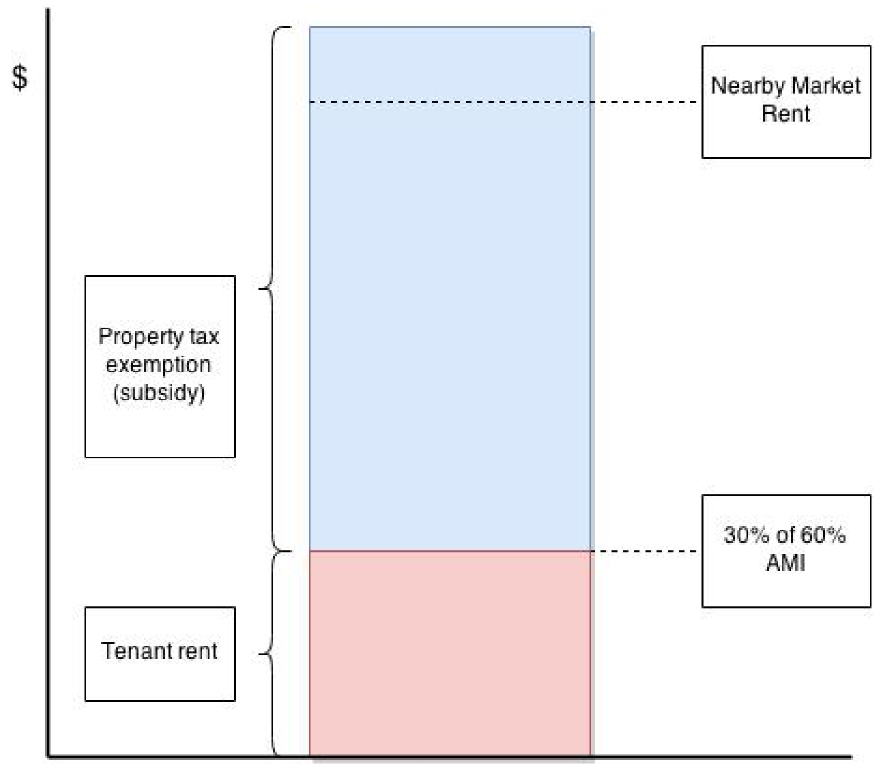
Source: http://www.mas.org/urbanplanning/421a/

Developments near the GEA in Brooklyn



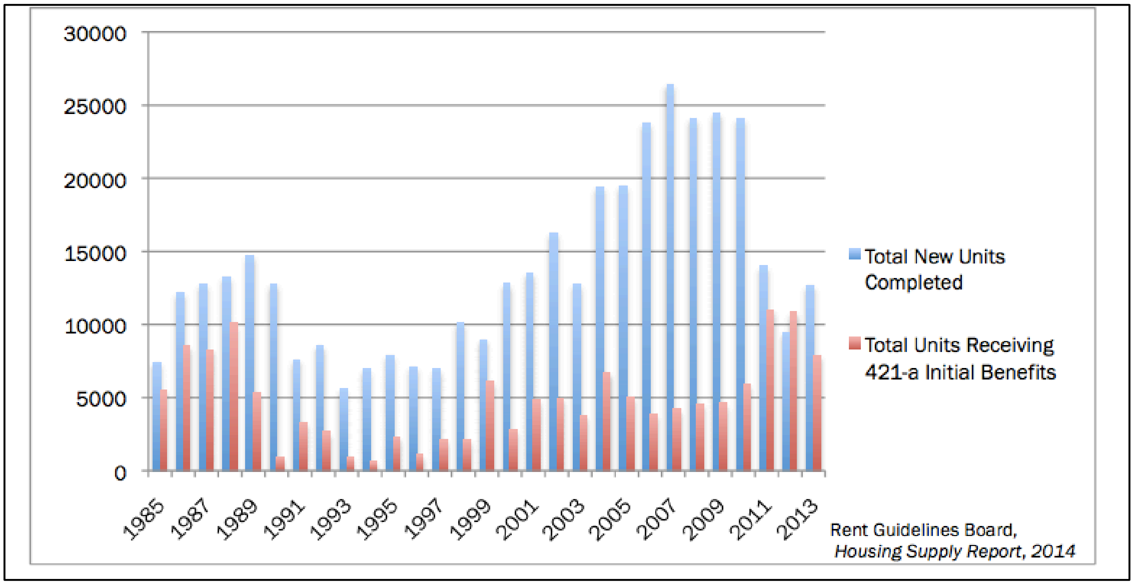
*GEA is colored dark grey.
Source: http://www.mas.org/urbanplanning/421a/

Appendix 2: Proposed subsidy structure

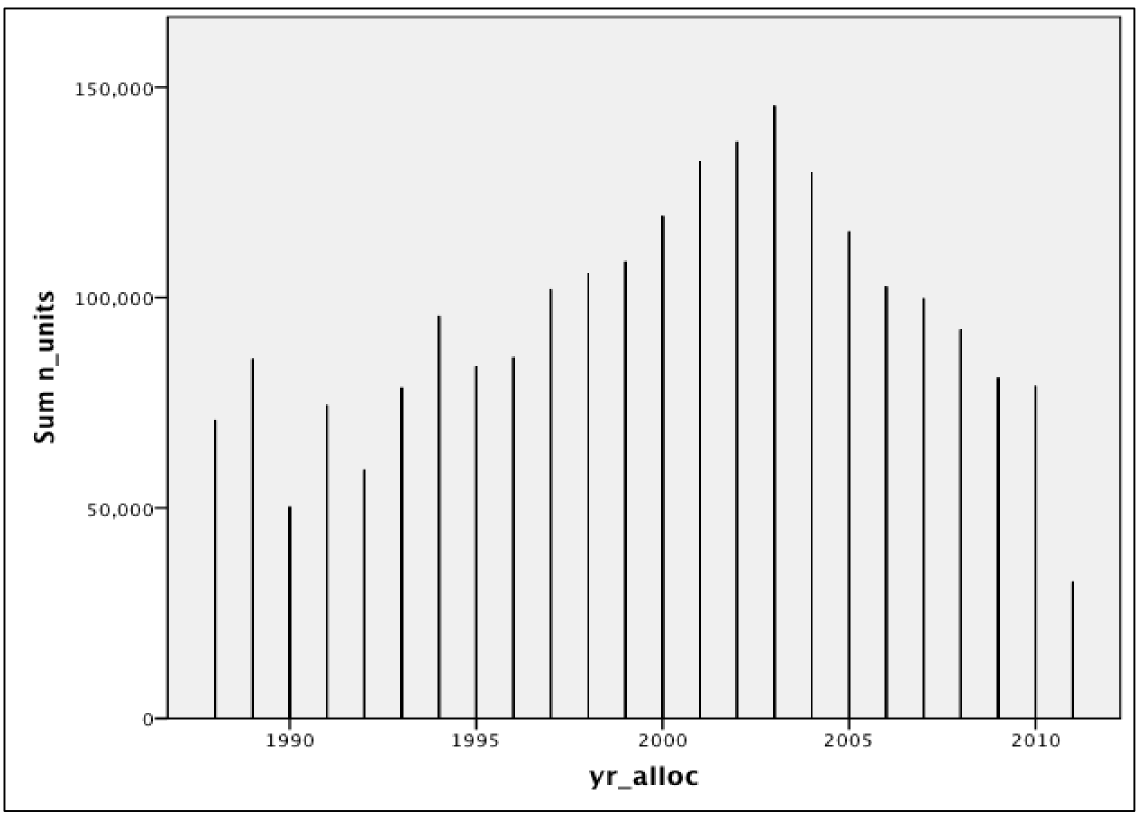


Appendix 3.

Annual allocations of 421-a benefits, compared with total construction



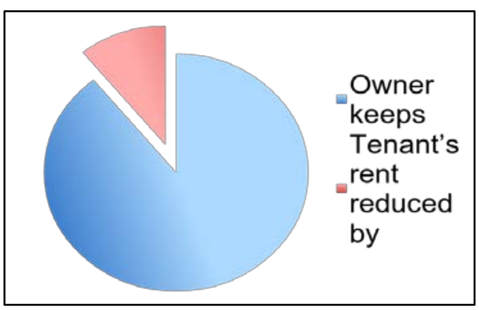
LIHTC units receiving 421-a benefits by year



Based on analysis of data from hud.gov

Appendix 4: 535 West End Ave, New York

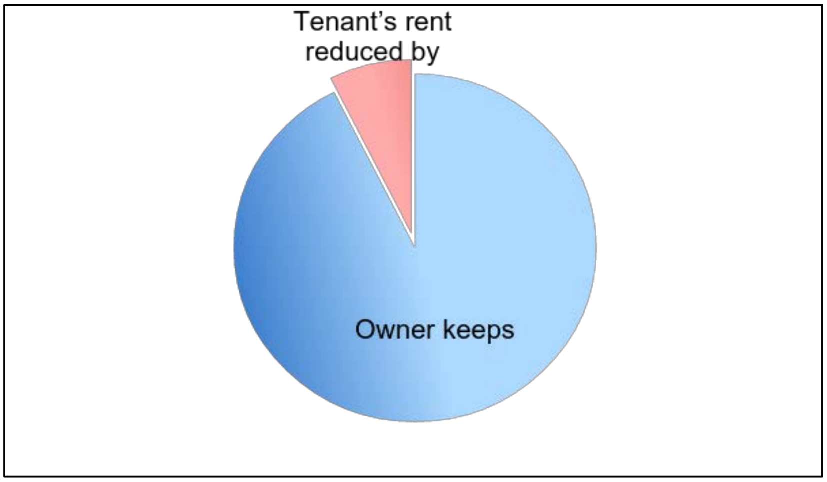
535 West End Ave	
New York, NY	
Government foregoes (tax expenditure)	**$550,000**
Owner keeps	**$490,790**
Tenant's rent reduced by	**$59,210**
Tenant's portion	**11%**



Based on analysis of data provided by the Municipal Art Society (MAS) at mas.org

Appendix 5: 285 Bowery, New York

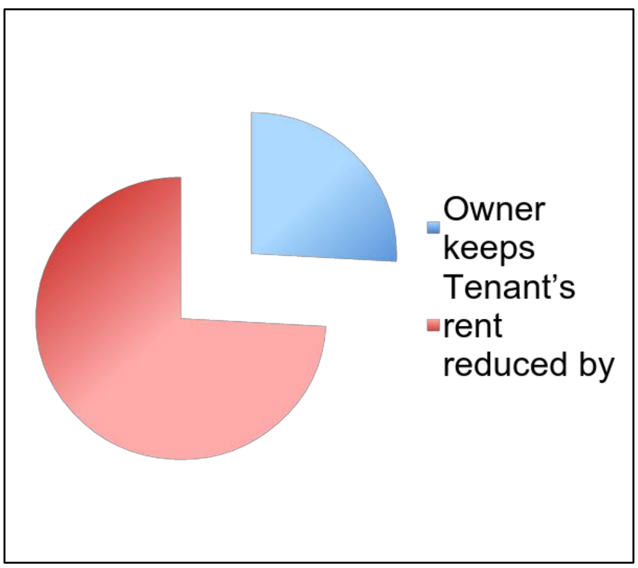
285 Bowery	
New York, NY	
Government foregoes (tax expenditure)	$353,800
Owner keeps	$327,740
Tenant's rent reduced by	$26,060
Tenant's portion	7%



Based on analysis of data provided by the Municipal Art Society (MAS) at mas.org

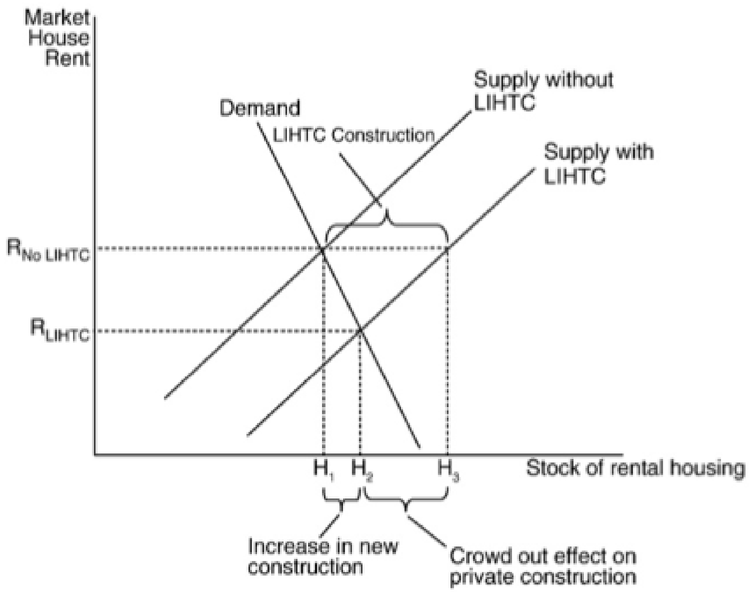
Appendix 6: 252 18th St Brooklyn, NY

252 18 Street	
Brooklyn, NY	
Government foregoes (tax expenditure)	**$30,120**
Owner keeps	**$7,800**
Tenant's rent reduced by	**$22,330**
Tenant's portion	**74%**



Based on analysis of data provided by the Municipal Art Society (MAS) at mas.org

Appendix 7: LIHTC subsidies' effect on private construction.



Source: Eriksen, M. D., & Rosenthal, S. S. (2010). Crowd out effects of place-based subsidized rental housing: New evidence from the LIHTC program. *Journal of Public Economics*.

Notes:

[1] Association for Neighborhood and Housing Development, Inc. (2015). *421a Developer's Tax Break: Fix it or End it*. http://www.anhd.org/wp-content/uploads/2011/07/ANHD-421a-Fix-it-or-end-it.pdf

[2] Data from MAS NY. http://www.mas.org/urbanplanning/421a/

[3] Association for Neighborhood and Housing Development, Inc. (2015) *421a: Developer's Tax Break*. http://www.anhd.org/wp-content/uploads/2011/07/ANHD-421a-Analysis-Maps_-012815.pdf?utm_source=421a-1-29-2015&utm_campaign=421a-1-29-15&utm_medium=email

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[10] Association for Neighborhood and Housing Development, Inc. (2015) *421a: Developer's Tax Break*. http://www.anhd.org/wp-content/uploads/2011/07/ANHD-421a-Analysis-Maps_-012815.pdf?utm_source=421a-1-29-2015&utm_campaign=421a-1-29-15&utm_medium=email

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[15] New York City Independent Budget Office (2003). *Worth the Cost? Evaluating the 421-a Property Tax Exemption.* http://www.ibo.nyc.ny.us/iboreports/421aTaxFiscalBrief.pdf

[16] Pratt Center for Community Development (n.d.). *Understanding the NYC "421-a" Property Tax Exemption Program How Can it Be Reformed to Create Affordable Housing?* http://www.habitatnyc.org/pdf/advocate/Pratt421-a.pdf

[17] New York Times (2015). *Stream of Foreign Wealth Flows to Elite New York Real Estate.* http://www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html?_r=0

[18] Based on analysis of HUD and MAS data. Data retrieved from hud.gov and mas.org, respectively.