Message from the Chairman:

A Lesson on the Need for 421-a

April, 2011

In all of my economics classes at the Wharton School, regardless of the level of the class, illustrative examples were used to demonstrate economic principles and frequently included a mythical product called a widget. Widget manufacturers had various fixed and variable costs, various operating and profit margins, overhead, cost of goods sold and so on. I would like to revert back to my college days and revive the widget to illustrate a point about our housing market in New York City.

Let's assume we are board members at New York Widget Company; we are producing widgets; and sales volume is very slow. We decide that in order to increase demand, we are going to offer buyers financing to purchase widgets, and the financing periods can range from 10 to 20 and even 25 years. In the Wharton classroom, we would have calculated the net present value of the payment stream and compare that to the cost of goods sold in order to determine how worthwhile it was to offer these various forms of financing.

But what if our cost of producing a widget was zero, nada, not one penny? Wouldn't it make sense to offer this financing benefit if it would allow us to sell many more widgets? After all, even if the net present value of the payments was relatively low, each dollar represents 100 percent profit.

At the next NYWC board meeting, our chief financial officer informs us that the widgets we have managed to sell have sold for $100 apiece. On a net-present-value basis, those sold with a financing benefit resulted in an average sale of $70. Since NYWC has been offering the financing benefit, sales are up by 500 percent, and now, rather than selling 100,000 widgets per year, we are selling 600,000. Our income has now gone from $10 million per year from selling 100,000 widgets at $100 apiece, to $45 million from selling 100,000 at $100 apiece, plus an additional 500,000 widgets at, effectively, $70 apiece. The additional 500,000 widgets sold produced an additional $35 million in revenue, and because our cost to produce widgets is zero, all of this revenue flows to the bottom line.

Everyone in the boardroom is ecstatic, as widgets are now selling well and profits are way up. Everyone, that is, except Mr. Assemblyman. You see, Mr.

Assemblyman stands up and criticizes the board for operating imprudently. According to his calculations, NYWC has "lost" $15 million based upon the $30 discount on the marginal 500,000 widgets sold.

Other board members explain to Mr. Assemblyman that his thinking is backward because it is likely that none of the marginal 500,000 units would have been sold if the financing benefit was not offered. He maintains his position, saying that "these widgets are expensive and are purchased by wealthy people. Why should we be giving them a benefit?"

The board explains to Mr. Assemblyman that a significant portion of the profits NYWC makes get funneled back into the community. Notwithstanding this fact, Mr. Assemblyman continues to object to the financing benefit. He would rather see no marginal widgets sold than see people who could afford to purchase our widgets receiving a break. How long would any rational board member keep Mr. Assemblyman on the board?

While the widget example was somewhat lengthy, it illustrates what is going on presently with New York's 421-a tax incentive program.

The widgets, in this case, are new market-rate and affordable-housing units. The additional $35 million in revenue is the marginal tax revenue that is generated from new construction. This marginal new construction would not occur without the 421-a benefit being available. The financing benefit in our widget example is the 421-a benefit itself. The buyers of the widgets are the buyers of condo units subject to the 421-a benefits as well as the tenants in buildings receiving the benefits. The community benefits mentioned are the thousands of affordable-housing units the program has led to. And lastly, Mr. Assemblyman is, well, you know who he represents.

In 1971, the 421-a tax incentive program was created to encourage housing development. Back then, New Yorkers were fleeing and property values were falling in the city. Under the original program, developers were given a defined period of time during which their tax assessments would not go up based upon the additional value they created by constructing a new building.

The underlying property continued to be taxed just as it had been prior to the point at which the additional value was created. As an example, a builder could construct a $25 million building on a parking lot worth $4 million and continue to pay tax only on the original $4 million value for a defined period of time. In rental buildings, rents were determined formulaically and then regulated for the duration of the abatement period. In condo buildings, prices were not controlled, as the tax benefits were passed along to the buyers of the units.

From 1971 through 1987, more than 60,000 units were constructed using the 421-a benefits. It is estimated that the "lost" taxes on these units was approximately $550 million. Critics opposed this "cost" of creating these units.

This position is worth exploring. First, it is likely that a good portion of the 60,000 units would not have been created in the absence of the benefit. Second, if the new buildings were not constructed, tax collections would have remained at levels obtained prior to the new construction. Therefore, the $550 million is not even remotely a "cost" to the city. Public officials do not write checks to pay for this benefit. It is an increase in tax revenue that is simply delayed until the 421-a benefit burns off. And, third, even if the $550 million was a true cost, it created 60,000 units for $9,200 apiece. Even in the 1970s and 1980s, how could anyone, particularly the public sector, possibly deliver housing units to the market at a cost that low?

In 1985, the 421-a program was modified to encourage the construction of affordable housing. A geographic exclusion area (GEA) resulted that eliminated Manhattan neighborhoods between 14th Street and 96th Street from eligibility for 421-a benefits.

Here, developers of market-rate housing were required to purchase negotiable certificates from developers of affordable housing elsewhere in the city in order to obtain a 10-year tax benefit. A unit of affordable housing in which the tenants earned 60 percent, or less, of area median income (AMI) could generate certificates for five market-rate units. Developers were able to sell these certificates to anyone, and the values of the certificates were substantial—enough so to create incentive to create affordable housing all over the city. In some neighborhoods, the 421-a benefits could increase to 15 or 20 years and in some particularly distressed areas could reach 25 years.

Opponents of the program have written articles expressing outrage that condo buyers like Alex Rodriguez and Derek Jeter are getting huge tax breaks on multimillion-dollar condos. Let’s look at the realities of this position.

If the 421-a program did not exist, the land upon which A-Rod’s and Derek Jeter’s buildings sit may not have been constructed. If they were not constructed, the taxes the city collected would be based upon the previous value of the property—in most cases substantially less than the after-construction value. If those buildings were not constructed, the thousands of construction jobs required to build today’s towers would not have existed and all of the jobs created for people to service those buildings would not exist. Moreover, Alex and Derek are not exempt from paying taxes forever. Every two years, their taxes will rise, and at the expiration of the abatement period, they will each be paying tens of thousands of dollars per year in taxes.

Unfortunately, financially challenged people do not purchase luxury condos, because if they did, legislators would be remiss to point to them as having received a lucrative tax break. The tax benefit is being temporarily given to those who will eventually be paying enormous sums to the city through taxes.
However, the critics of this program proved especially loud.

In 2007, legislators amended the 421-a program again, this time increasing the GEA to include all of Manhattan and selected neighborhoods in the outer boroughs. The revisions also included the tragic elimination of the negotiable certificate program and called for a $65,000 cap on the portion of a market-rate apartment’s value eligible for the exemption. These new guidelines went into effect in June of 2008, with some extensions for the utilization of some certificates if a construction job had progressed far enough along with its foundation.

Unfortunately, at the end of 2010, the 421-a program expired, leaving the fate of thousands of planned units uncertain. Also uncertain is the fate of thousands of construction jobs—not a good thing when construction unemployment in the city remains elevated, at more than 20 percent. And these potential job losses are on top of hundreds of building-service jobs, which will also evaporate if construction does not proceed.
The elimination of the 421-a program will likely be devastating to our housing stock. It not only provides incentives for building much-needed market-rate and affordable-housing units, but also stimulates jobs and economic activity across a broad cross section of the city’s economy. Moreover, it provides a much-needed—albeit temporary and not nearly to the required degree—answer to what is a perplexing real estate tax system. This is particularly true for residential rental properties.

Today, without tax benefits, market-rate rental buildings can pay about 33 percent of their gross revenue in real estate taxes. This can equate to more than 50 percent of net income and that does not take into consideration any debt service on any financing that may be required. These numbers are outlandish and create a tangible disincentive for developers to construct new buildings.

Yes, we are used to paying taxes through the nose here in the Big Apple, but this is crazy. In most major cities across the country, real estate taxes hover between 7 and 15 percent of gross revenue. The inequities in the tax system are significant. Not wanting to alienate thousands of potential voters, legislators are reluctant to have single-family homeowners pay their fair share. For example, apartments in new condo and rental buildings are assessed for tax purposes at 45 percent of market value; comparably valued single-family townhouses are assessed at a mere 6 percent. Additionally, the rate of potential assessment increases is capped on single-families. This cap does not exist on apartment properties.

This issue all comes down to incentives. No matter how you look at it, our housing system is largely an incentives-based market.

In the 1970s, when Howard Cosell, the most prominent sports announcer of his time, famously proclaimed, "The Bronx is burning," during a World Series game at Yankee Stadium, property owners were abandoning buildings left and right. Insurance proceeds often exceeded what a property could be sold for, so arson became widespread. It was then that Major Capital Improvements were allowed to be passed on to the legal regulated rents and Individual Apartment Improvement renovations could be added to monthly rents. These incentives motivated the private sector to pour billions of dollars into the housing stock and are the main reasons why the quality of the housing stock is as good as it is today.

It is imperative that our housing system include a 421-a type of incentive program. No one can argue that our market doesn't need new market-rate and affordable-housing units. They can be created utilizing a program that doesn't cost a dime (just like our no-cost widgets).

Deferring some tax payments in the short term in exchange for the long-term health of our market seems like a no-brainer. As things stand now, it is unclear how much new stock will be constructed, as project feasibility is called into question in the absence of the 421-a program. The program needs to be reinstated.

This temporary tax adjustment is particularly needed as legislators demonstrate a lack of political will to eliminate the inequities within our real estate tax system. Our housing market, job market and broader economy will be hurt without it.

Sincerely,
Bob

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You can read Mr. Knakal's weekly article in The Commercial Observer entitled "Concrete Thoughts" at www.observer.com/commercial.