NYU Furman Center

POLICY BRIEF | FEBRUARY 2017

The Latest Reform Proposal for the 421-a Program:

A Look at Impact of the Increase in Tax Exemption, the Affordability, and the Construction Wage Requirements

This report looks at the impact of the latest reform proposal for the 421-a program from both the taxpayers' and developers' perspectives for the construction and operation of 300-unit residential buildings in four different market types in New York City. We do not opine on the merits of securing higher construction wages through an expansion in the schedule of property tax exemptions, but rather, we look simply to shed light on two issues: (1) How expensive is the wage requirement from the taxpayers' point of view? And, (2) given the increased property tax savings for a developer, how large an increase in hard construction costs might developers be able to absorb without affecting their profitability?

WWW.FURMANCENTER.ORG | @FURMANCENTERNYU

In June of 2015, when the 421-a property tax exemption program was set to expire, New York State extended the now-expired program for six months through January 15, 2016 and adopted new rules to take effect in January of 2016 that enhanced the tax relief and increased the affordability requirements.[1] Our November 2015 analysis, *The Latest Legislative Reform of the 421-a Tax Exemption: A Look at Possible Outcomes*, compared the revised program, which is now in suspension, to the expired 421-a program. It found that those reforms made participation in the 421-a program more attractive in the four market types we analyzed using the unleveraged Internal Rate of Return (IRR) as a measure of long-term financial return and somewhat less attractive in certain markets according to a short-term measure, Net Operating Income (NOI) yield.[2]

The justifications for these changes rested on a number of policy objectives: expanding affordability requirements to all participating rental developments, increasing the share of affordable units in all 421-a rental buildings with affordable housing, increasing overall development of housing (both market rate and affordable), and tipping the scale toward rental development over condominium development (particularly in Manhattan where condominiums, even without any tax exemption, were becoming an increasing share of newly constructed housing). These new rules never went into effect, however, because they were made contingent on the Real Estate Board of New York (REBNY) and the Building and Construction Trades Council of Greater New York (Trades) reaching an agreement on wages for construction workers.

Recently, the parties united behind a new proposal (the "2017 proposed" revisions to the 421-a program) that met the desire of the governor to include a requirement on construction wages.[3] This 2017 proposal permits the suspended rules to go into effect, but makes the following modifications to the suspended rules for buildings of 300 or more residential units in Manhattan below 96th Street, and in the portions of Brooklyn and Queens Community Districts 1 and 2 that are within one mile of the water:

- Construction wages must average a minimum of $60/hour in the affected parts of Manhattan and $45/hour in the affected portions of Brooklyn and Queens. As an alternative, developers can sign a project labor agreement.[4]

- The affordability requirement expands to 40 years from 35 years. In addition, if a developer builds under Option A (option with lowest AMI levels), the affordability level for the five percent of units permitted at 130 percent of AMI under the suspended program is reduced to 120 percent of AMI.

- The exemption is expanded to a full 35 years rather than 25 full years with a 10-year phase out under the suspended program.[5]

[1] See tables in the appendix showing differences in the provisions of the prior program (the "expired" program), the June 2015 rules (the "suspended" program, and a newly proposed program (the "2017 proposed" program).

[2] See earlier report for definitions and assumptions used to build the model used for this analysis. In a moderate market such as Astoria, Option C under the suspended rules allowed for a higher NOI yield than what was achievable under the expired program.

[3] Statement from Governor Andrew M. Cuomo on Agreement Reached by REBNY and the Building Trades. (2016, November 10). Retrieved December 22, 2016, from https://www.governor.ny.gov/news/statement-governor-andrew-m-cuomo-agreement-reached-rebny-and-building-trades.

[4] These agreements are made on a project-by-project basis with the unions and cover wages and working rules.

[5] Bagli, C. V. (2016, November 10). Cuomo Strikes Deal to Revive Affordable Housing Program. *The New York Times.* Retrieved from http://www.nytimes.com/2016/11/11/nyregion/cuomo-strikes-deal-to-revive-affordable-housing-program.html; Tempey, N. (2016, November 11). Cuomo Reaches Deal For Proposed Renewal

This report looks at the impact of the proposed changes from two perspectives: that of city taxpayers and that of developers. To do this, we explore the following two questions:

1. How expensive is the wage requirement from the taxpayers' point of view? We isolate this figure for each hypothetical 300-unit building by considering the net effect on city taxpayers of the increase in property tax benefits coupled with the increased affordability benefits. The former is measured by the loss of potential tax revenue because of enhanced property tax exemptions. The latter is measured using the difference between the affordable rent levels and market rents to place a value on the increased affordability requirements.

2. How much can hard construction costs (of which wages are only a part) rise in different markets of New York City as a result of the increased tax benefits without decreasing the attractiveness of 421-a participation?

To be clear, this follow-up study focuses only on the impact of the changes from the suspended 421-a program to the 2017 proposed program, and does not analyze how well the suspended program balanced the increase in the property tax exemption with the numerous non-wage policy objectives outlined above.

To answer the first question, we determine the net cost imposed on city taxpayers to secure the construction wage requirement for a 300-unit building. The net cost takes into account both the increase in tax expenditure between the suspended 421-a program and the 2017 proposed program and the increase in benefit to the city from the additional affordable housing requirements. This requires us to estimate separately for both the suspended and proposed programs 1) the net present value (NPV) of the property tax savings that accrue over time to the property owners and 2) the NPV to the city of the increased affordable housing benefit as measured by the cost that the city would otherwise have to incur to subsidize the market rents in comparable properties to achieve the same level of income restrictions.[6] By comparing the change in the NPV of the expenditure with the change in the NPV of the affordable housing benefit, we can isolate the dollars government would be spending to secure the construction wage requirement for a 300-unit building.

Of Developer-Friendly 421-A Tax Scheme: *Gothamist*. Retrieved December 22, 2016, from http://gothamist.com/2016/11/11/421-a_cuomo_sells_us_out_again.php

[6] The net present values (NPV) discussed in the text are calculated using a 6.25% discount rate. More detail on NPV calculations can be seen in the Appendix.

NYU Furman Center

Table 1: Tax Expenditure Incurred to Pay for Construction Wage Requirements* based on a 300-Unit Building (Millions of Dollars)

		Option A	Option C
@6.25% Discount Rate	Manhattan Core	$5.1	N/A
	Downtown Brooklyn	$3.9	$5.7
	Astoria	$3.0	$5.4
	Bedford-Stuyvesant	$2.6**	$5.1**

*This is the net present value of the tax expenditure for a building minus the net present value of the affordable housing benefit amount of that building. Figures are rounded to the nearest hundred thousandth.
**These numbers reflect the change in net costs if a developer in Bedford-Stuyvesant opted to participate in the proposed framework.

Table 1 shows the net costs of securing the construction wage requirements in the different market types for a 300-unit building.[7] We find that in all cases the net cost (NPV of increase in tax exemption minus the NPV of the increase in the affordable housing benefit) to city taxpayers rises with the change from the suspended to the proposed program and this cost can be interpreted as the dollars paid to secure the wage requirement. In Table 1, we find that the cost for Option C is higher than for Option A in the parts of the city where both options are available.[8] In the Manhattan Core, we estimate that the wage requirement would cost the city $5.1 million per building. In Downtown Brooklyn, we estimate the wage requirement would cost $3.9 million per building under Option A and $5.7 million per building under Option C. In Astoria, we estimate the wage requirement would cost $3.0 million per building under Option A and $5.4 million per building under Option C. In Bedford-Stuyvesant, an area not subject to the wage mandate, if a developer opted in to the proposed rules to secure the more generous tax exemption, we estimate that the wage requirement would cost $2.6 million per building under Option A and $5.1 million per building under Option C.

Our second question considers the value of the proposed programs from the point of view of a developer. In other words, how much can the net increase in the value of the tax expenditure shown in Table 1 cover in terms of increased hard construction costs (of which wages are a subset)? To answer this question, we estimate the degree to which hard construction costs can rise due to the more generous tax exemption without reducing the return to developers as compared with the return such developers would have received under the suspended program. For this analysis we rely on the two measures of a developer's return used for our previous study: NOI yield which is a short-term measure of return and does not take into account any impact beyond year four, i.e., it excludes any consideration of either the increase in tax benefit or the increased duration of the affordability requirements; and an unleveraged Internal Rate of Return (IRR), which does take into account the impact of these changes on the future stream of net earnings.

[7] The 300-unit buildings in the Manhattan Core and Downtown Brooklyn are high-rise. The 300-unit buildings in Astoria and Bedford-Stuyvesant are mid-rise.

[8] Program details can be found in the tables in the appendix.

NYU Furman Center

Table 2: Tolerance for Increase in Hard Construction Costs Between Suspended and Proposed Rules and NOI Yield Change for Corresponding Cost Increase

		Maximum Percent Increase in Hard Costs Permissible with Proposed Framework to Maintain Unleveraged IRR Under Suspended Program	Corresponding % Change in NOI Yield from Suspended Program
Manhattan Core	**Suspended Option A to Proposed Option A**	18%	-7%
Downtown Brooklyn		16%	-8%
Astoria		11%	-17%
Bedford-Stuyvesant		10%	-7%
Manhattan Core	**Suspended Option C to Proposed Option C**	N/A	N/A
Downtown Brooklyn		15%	-7%
Astoria		11%	-13%
Bedford-Stuyvesant		10%	-7%

Given that NOI yield does not take into account any changes in the proposed revisions to the 421-a program that affect revenue and costs after the property is fully leased up (year four in our pro forma), any increase in hard construction costs causes NOI yields to fall. NOI yields for Option A are further depressed, although only slightly, by the proposed lowering of the income band for five percent of the building units.

For developers who primarily focus on the longer-term, unleveraged IRR gives a better indication of changes in the attractiveness of development (assuming no change in land prices induced by the program changes). Based on our model, such developers building with Option A under the proposed rules would be able to absorb an increase in hard construction costs of 18 percent in the Manhattan Core, 16 percent in Downtown Brooklyn, 11 percent in Astoria, and 10 percent in Bedford-Stuyvesant (see Table 2). Under Option C, the comparable figures are 15 percent in Downtown Brooklyn, 11 percent in Astoria, and 10 percent in Bedford-Stuyvesant. These percentage increases in hard costs would allow labor costs to rise at an even higher rate since labor costs comprise only a portion of hard costs (materials are another key component of hard costs). However, it is unclear how much, if at all, the wage requirements will cause hard construction costs to rise.

Any lesser increase in hard construction costs would indicate that a more modest increase in the property tax exemption from the suspended to the proposed program would be sufficient to keep the unleveraged IRRs unchanged between the suspended and the proposed program. Otherwise, if the proposed increase in property tax exemption goes into effect and costs do not rise (or rise to a lesser extent than we identified) the program changes could result in higher bids for land. Correspondingly, if hard costs in these markets rose by these percentages, NOI

yields could drop between seven and 17 percent from the levels achievable under the suspended program (see Table 2).

In summary, we find that the wage requirement could cost city taxpayers between $2.6 million per building and $5.7 million per building for our illustrative 300-unit buildings. Moreover, we find a higher net cost under Option C, where available, than under Option A. While we cannot say if there will be higher labor costs, and if so, how much higher the labor costs will be, we find that developers under the 2017 proposed program would be able to absorb an increase in hard construction costs from 10 to 18 percent without lowering the unleveraged IRR—a long-term measure of financial return.

We have no evidence as to whether the wage requirement would increase the hard costs of construction in any or all of the market areas studied. If costs do not rise, or rise by a smaller degree than what we identified, developers focused principally on a long-term measure of financial return may find building more financially attractive than building under the expired or suspended versions and may bid more for land—thus potentially leading to an inflation of land prices. However, to the extent developers make their decisions based on NOI yield—a short-term measure of financial return—development activity could be dampened as those developers will find the proposed program less attractive than the expired or suspended versions if labor costs rise even slightly. Such developers may elect to construct buildings with fewer than 300 units so as to avoid the wage requirement.

Authors

Eric Stern
Mark Willis

The NYU Furman Center advances research and debate on housing, neighborhoods, and urban policy. Established in 1995, it is a joint center of the New York University School of Law and the Wagner Graduate School of Public Service. More information about the Furman Center can be found at www.furmancenter.org.

Appendix Table 1: A High-Rise 300-Unit Residential Building in Manhattan Core

Manhattan Core ($80/sf) High-Rise

	Scenario	**Expired**	**Suspended Option A**	**2017 Proposed Option A**
	Percent of Units at Market	80%	75%	75%
Affordable Housing Benefits	Affordable Units	60	75	75
	Affordability	20% at 60% of AMI (60 units)	10% at 40% of AMI (30 units)	10% at 40% of AMI (30 units)
			10% at 60% of AMI (30 units)	10% at 60% of AMI (30 units)
			5% at 130% of AMI (15 units)	5% at 120% of AMI (15 units)
	Affordability Duration	35 years	35 years	40 years
	Wage Requirement	No	No	Yes
Developer Benefits	4% Low Income Housing Tax Credits	Yes	Yes	Yes
	Full Exemption	12 years	25 years	35 years
	Exemption phase out	8-year phase out	25% tax exempt for years 26-35	N/A
Return	NOI Yield	5.2%	4.9%	4.9%
	IRR	5.7%	6.6%	7.4%
@ 6.25%	NPV of Tax Exemption	$43,787,031	$61,871,752	$72,225,613
	NPV of Affordable Housing Benefit	$51,847,940	$63,095,601	$68,323,605
	NPV of Tax Exemption - NPV of Affordable Housing Benefit	-$8,060,909	-$1,223,849	$3,902,007

Appendix Table 2: A High-Rise 300-Unit Residential Building in Downtown Brooklyn

Downtown Brooklyn ($60/sf) High-Rise

	Scenario	Expired	Suspended Option A	2017 Proposed Option A	Suspended Option C	2017 Proposed Option C
	Percent of Units at Market	80%	75%	75%	70%	70%
Affordable Housing Benefits	Affordable Units	60	75	75	90	90
	Affordability Depth	20% at 60% of AMI (60 units)	10% at 40% of AMI (30 units)	10% at 40% of AMI (30 units)	30% at 130% of AMI (90 units)	30% at 130% of AMI (90 units)
			10% at 60% of AMI (30 units)	10% at 60% of AMI (30 units)		
			5% at 130% of AMI (15 units)	5% at 120% of AMI (15 units)		
	Affordability Duration	35 years	35 years	40 years	35 years	40 years
	Wage Requirement	No	No	Yes	No	Yes
Developer Benefits	4% Low Income Housing Tax Credits	Yes	Yes	Yes	No	No
	Full Exemption	21 years	25 years	35 years	25 years	35 years
	Exemption phase out	4-year phase out	25% tax exempt for years 26-35	N/A	30% tax exempt from 26-35	N/A
Return	NOI Yield	5.2%	5.0%	5.0%	5.2%	5.2%
	IRR	6.7%	6.8%	7.6%	7.3%	8.1%
@ 6.25%	NPV of Tax Exemption	$43,092,359	$46,154,179	$53,782,904	$50,683,028	$58,621,272
	NPV of Affordable Housing Benefit	$35,831,932	$43,097,349	$46,855,948	$30,619,244	$32,872,993
	NPV of Tax Exemption - NPV of Aff. Hsg. Benefit	$7,260,426	$3,056,829	$6,926,956	$20,063,784	$25,748,280

NYU
Furman
Center

Appendix Table 3: A Mid-Rise 300-Unit Residential Building in Astoria

Astoria ($44/sf) Mid-Rise

	Scenario	Expired	Suspended Option A	2017 Proposed Option A	Suspended Option C	2017 Proposed Option C
	Percent of Units at Market	80%	75%	75%	70%	70%
Affordable Housing Benefits	Affordable Units	60	75	75	90	90
	Affordability Depth	20% at 60% of AMI (60 units)	10% at 40% of AMI (30 units)	10% at 40% of AMI (30 units)	30% at 130% of AMI (90 units)	30% at 130% of AMI (90 units)
			10% at 60% of AMI (30 units)	10% at 60% of AMI (30 units)		
			5% at 130% of AMI (15 units)	5% at 120% of AMI (15 units)		
	Affordability Duration	35 years	35 years	40 years	35 years	40 years
	Wage Requirement	No	No	Yes	No	Yes
Developer Benefits	4% Low Income Housing Tax Credits	Yes	Yes	Yes	No	No
	Full Exemption	21 years	25 years	35 years	25 years	35 years
	Exemption phase out	4-year phase out	25% tax exempt for years 26-35	N/A	30% tax exempt from 26-35	N/A
Return	NOI Yield	5.8%	5.6%	5.5%	5.9%	5.9%
	IRR	7.9%	8.1%	8.9%	9.0%	9.9%
@ 6.25%	NPV of Tax Exemption	$31,406,324	$34,038,371	$39,647,979	$39,313,201	$45,499,862
	NPV of Affordable Housing Benefit	$22,956,334	$27,043,824	$29,617,111	$11,312,193	$12,141,413
	NPV of Tax Exemption - NPV of Affordable Housing Benefit	$8,449,989	$6,994,547	$10,030,868	$28,001,008	$33,358,448

Appendix Table 4: Mid-Rise 300-Unit Residential Building in Bedford-Stuyvesant, assuming a Developer Opts in Based on Meeting the Wage Restrictions

Bedford ($44/sf) Mid-Rise

	Scenario	**Expired**	**Suspended Option A**	**2017 Proposed Option A**	**Suspended Option C**	**2017 Proposed Option C**
	Percent of Units at Market	80%	75%	75%	70%	70%
Affordable Housing Benefits	Affordable Units	N/A	75	75	90	90
	Affordability Depth	20% at 60% of AMI (60 units)	10% at 40% of AMI (30 units)	10% at 40% of AMI (30 units)	30% at 130% of AMI (90 units)	30% at 130% of AMI (90 units)
			10% at 60% of AMI (30 units)	10% at 60% of AMI (30 units)		
			5% at 130% of AMI (15 units)	5% at 120% of AMI (15 units)		
	Affordability Duration	35 years	35 years	40 years	35 years	40 years
	Wage Requirement	No	No	Yes	No	Yes
Developer Benefits	4% Low Income Housing Tax Credits	Yes	Yes	Yes	No	No
	Full Exemption	21 years	25 years	35 years	25 years	35 years
	Exemption phase out	4-year phase out	25% tax exempt for years 26-35	N/A	30% tax exempt for years 26-35	N/A
Return	NOI Yield	5.7%	5.0%	5.0%	5.5%	5.5%
	IRR	6.0%	6.8%	7.7%	8.1%	9.0%
@ 6.25%	NPV of Tax Exemption	$19,736,444	$28,577,098	$33,236,799	$34,210,584	$39,576,526
	NPV of Affordable Housing Benefit	$0	$20,596,027	$22,696,669	$3,574,836	$3,836,883
	NPV of Tax Exemption - NPV of Affordable Housing Benefit	$19,736,444	$7,981,071	$10,540,130	$30,635,747	$35,739,642