CITIZENS HOUSING AND PLANNING COUNCIL

THE URBAN PROSPECT

Housing, Planning and Economic Development in New York

July/August 1997 Volume 3, Number 4

The Missing Middle

This spring's protracted standoff over rent regulations produced some of the most heated housing rhetoric heard in many years. Tenant groups portrayed vacancy decontrol as a prelude to skyrocketing rent increases and a massive displacement of middle-class residents. Advocates of decontrol exaggerated the degree to which rent regulations suppress new housing construction in the city and promised a golden era of housing production if they were removed. Both sides largely ignored the allocational distortions that are probably the most pernicious effect of regulation.

The debate, however, temporarily focused the attention of the press and public on the dearth of middle-income housing production in the city. Now that the rent regulation issue has been tabled until 2003, many housing professionals are wondering how to sustain attention on the city's middle-income housing problems.

Easy Target

New housing construction in the city averaged 76,000 units per year during the 1920s, 35,000 per year in the 1960s, and only 10,500 annually in the 1980s. Although there has been a spate of residential building starts recently, only 35,000 new units were built during the first half of the 1990s, the lowest five-year total since the Second World War.

Strident opponents of rent regulations often attribute the city's declining rate of new housing production to the inhibiting effects of rent controls. While objective analysts can identify a number of market distortions, inequities and counter productive effects that result from rent regulation, few believe that Rent Stabilization plays more than a minor role in suppressing new supply.

A telling indication that others factors are overriding is the paucity of new housing built for the ownership market. If rent regulations were severely restricting the new supply of rental housing, the excess consumer demand should be partially satisfied through greater condominium, co-op, and conventional one- and two-family home production. In fact, just the opposite is happening. Offering plans filed with the Attorney General for newly-built condominium and co-operative buildings in New York City covered only 614 units in 1995, down from 11,684 in 1986. Indeed, during the past few years the vast majority of new multi-family buildings developed in the city were marketed as rentals.

It is possible that rent regulations discourage some would-be buyers from entering the ownership housing market if they are beneficiaries of below-market regulated rents. But regulation causes other families to pay more for their housing than they would in a free-market environment, and the net effect on new housing demand is probably small.

The Market Rules

Some housing economists argue that the city's long-term decline in housing production is due to a deterioration in household incomes relative to the cost of new construction. A smaller proportion of the city's families are able to afford the cost of new housing than in the past. Between 1970 and 1990, for example, the costs of housing construction nationally increased by 366 percent, while the median family income in New York rose by about 250 percent. The cost of building new housing in the city, moreover, has probably risen faster than in the nation as a whole, although there are no reliable price indexes that measure local costs. In New York, elaborate zoning, complex environmental considerations, restrictive building codes and union work rules raise the cost of building. Few housing professionals believe that any reforms that are politically possible could lower those costs in a meaningful way.

Builders say that it costs about $200 per square foot to construct new housing in the city, which translates into about $200,000 for a two-bedroom apartment. Providing for the developer's profit, debt service, and ongoing maintenance and operating expenses, such an apartment would need to rent for approximately $1,800 per month. At the conventional 30 percent rent-to-income ratio, a family would need an annual income of at least $72,000 to afford it. Less than one in eight city households have incomes that high.

There are relatively few neighborhoods in the city that can support market rents at those levels. For the most part, those areas are limited to Manhattan below 96th Street and to a handful of the most desirable neighborhoods in the other boroughs. As a result, new market-rate development is concentrated in Manhattan, where competition for sites bids

Number of New Dwelling Units Built in New York City

YEAR	Total	NYCHA	Mitch-Lama	Section 8	Section 202	421-a	10-Yr Plan	1 Family	2 Family
1951	49,012	16,610	0	0	0	0	0	5,128	3,648
1952	37,674	8,154	0	0	0	0	0	4,439	6,250
1953	25,527	5,839	0	0	0	0	0	4,748	4,510
1954	22,265	6,677	0	0	0	0	0	3,894	3,038
1955	27,395	7,303	0	0	0	0	0	4,799	3,294
1956	29,202	2,959	0	0	0	0	0	4,689	4,556
1957	27,508	5,471	25	0	0	0	0	4,466	5,354
1958	32,296	9,882	1,130	0	0	0	0	3,875	5,858
1959	37,204	8,037	541	0	0	0	0	3,734	7,044
1960	35,247	3,454	1,222	0	0	0	0	3,089	8,440
1961	35,127	5,541	2,823	0	0	0	0	2,779	7,158
1962	47,304	4,434	4,811	0	0	0	0	3,528	7,830
1963	60,031	1,265	12,235	0	0	0	0	2,938	7,314
1964	51,919	7,941	12,048	0	306	0	0	2,794	6,082
1965	49,452	10,703	7,128	0	0	0	0	2,907	5,882
1966	32,131	3,136	1,251	0	256	0	0	2,301	5,172
1967	23,036	1,150	2,154	0	0	0	0	1,650	4,234
1968	17,242	3,111	17,914	0	0	0	0	1,874	5,140
1969	17,469	2,773	683	0	0	0	0	1,677	4,944
1970	14,334	1,667	4,112	0	0	0	0	1,631	4,316
1971	19,463	2,414	7,470	0	0	0	0	1,261	3,464
1972	22,667	1,218	16,734	0	0	7,060	0	1,208	3,467
1973	20,936	4,864	3,547	0	0	12,046	0	1,453	4,256
1974	20,339	3,043	22,798	0	0	2,993	0	1,019	3,234
1975	21394	1994	6921	0	0	2531	0	879	1774
1976	23,917	451	8,169	0	0	1,592	0	737	1,684
1977	10,223	1,742	3,244	2,514	0	2,661	0	1,129	1,212
1978	7,068	683	252	208	0	5,373	0	1,151	984
1979	9,715	269	0	1,398	0	2,139	0	1,276	1,220
1980	8,886	1,093	0	3,149	992	2,716	0	1,303	900
1981	8,734	772	0	2,189	714	3,277	0	1,021	884
1982	7,249	378	0	2,548	689	3,036	0	1,001	828
1983	9,021	974	0	1,800	1,160	2,029	0	976	754
1984	10,285	1,017	0	1,390	834	5,602	0	820	694
1985	5,567	0	0	1,983	927	6,307	0	811	1,012
1986	12,123	2,826	0	0	0	4,270	0	1,049	1,166
1987	12,617	495	0	0	0	11,367	0	1,398	1,496
1988	13,220	1,169	0	0	350	11,864	0	1,812	1,936
1989	14,685	506	0	0	198	6,214	1,683	1,807	1,760
1990	11,901	139	0	0	272	6,211	4,012	2,203	846
1991	7,639	336	0	0	770	3,848	3,892	1,323	758
1992	7,900	0	0	0	577	2,470	7,843	1,178	826
1993	5,510	814	0	0	303	1,527	5,906	1,114	1,474
1994	6,964	187	0	0	748	859	4,577	1,624	2,004
1995	7,428	0	0	0	503	2,127	2,788	1,321	1,726

Note: "Total" reflects some housing types not shown individually. "10 Year Plan" represents city subsidized production for low and moderate income households. Nehemiah and Partnership programs included in "1 Family" and "2 Family". Table compiled by CHPC from City Planning, NYCHA, and HPD data.

up land costs and market rents even further. In the vast majority of the city's neighborhoods that could accommodate new housing development, market rents do not remotely approach the levels that would be necessary to stimulate construction. Families that can afford the rents required to support new housing often prefer to purchase cheaper existing housing in the city's most attractive, low-rise neighborhoods or to seek better housing values in the suburbs.

New multi-family housing must compete with city's huge stock of one- and two-family homes; there are nearly 600,000 one- and two-family homes in the outer boroughs. Of the city's 320,000 households who earned $70,000 or more in 1992, 58 percent were owner-occupants and more than half of those were conventional homeowners. In Brooklyn, Queens and the Bronx the few high-rise developments that command rents equivalent to those that would be required to support new development cater mostly to affluent, empty-nester retirees.

During the city's housing inflation of the 1980s, some market-rate multi-family residential construction activity occurred in Park Slope, Brooklyn and its surrounding areas. Some housing experts believe that the recent surge in Manhattan residential construction will eventually spill over to upscale neighborhoods in other boroughs, such as Forest Hills and Flushing in Queens.

Like Manhattan, however, those neighborhoods have a scarcity of developable sites. Housing construction is inherently cyclical, and each successive peak of the city's cycle has been somewhat lower than the last. In the 1960s, for example, in the peak year new housing production reached 60,000 units and in the 1970s, about 24,000 units. Even at the height of the 1980s real estate boom, however, production failed to top 15,000 dwelling units annually. Housing development professionals attribute that pattern of declining cyclical peaks to the shortage of sites in Manhattan and the few other marketable areas of the city.

In adding to the difficulty of assembling sites for new development rent regulation may actually play its most constraining role. Because the city's rent regulations give tenants the absolute right to a lease renewal, and thus to continued tenancy, owners can have great difficulty clearing sites for redevelopment. Often property owners and tenants can reach a negotiated relocation settlement, but that can add significant cost to the project and examples of "hold out" tenants obstructing redevelopment are legion. The amendments to the Rent Stabilization law enacted in July contain a provision aimed at facilitating site clearance.

The decline in construction of conventional, one- and two-family homes has been one of the under-appreciated aspects of the city's production falloff, and is another indication of the difficulty of renewing the housing stock in a fully-developed city. During the 1950s, new dwelling units in one- and two-family houses totaled over 92,000, or about 28 percent of total new housing production. In the 1980s, only 23,000 such units were built (although they still accounted for 25 percent of the city's new supply).

The "build-out" of the outer boroughs is one of the primary reasons for that decline. Between 1950 and 1970 the population of Queens grew by 400,000 and as late as the 1960s, there were still large tracts of undeveloped land available for efficient homebuilding. In most marketable neighborhoods of the city today, builders must purchase and demolish older structures in order to acquire land for the construction of new, more modern homes. Indeed, during the 1980s that practice stirred significant community opposition that resulted in zoning changes intended to inhibit it.

Small home construction is also affected by the same market realities that affect multi-family housing. A smaller proportion of the city's households are able to afford the cost of newly-built private homes, and they are usually not interested in moving to inner-city neighborhoods where cheap land is available. Consequently, subsidized home-building like the Nehemiah Plan and The New York City Housing Partnership's New Homes program have accounted for a large proportion of the city's new production, bridging the gap between the costs of new development and what the market in marginal neighborhoods will bear.

Capital Offenses

The extremely low rate of new construction during the first half of the 1990s represents a cyclical trough, attributable to some extent to the lingering regional recession and to an overbuilt condo market. However, some housing professionals say that changes in financial markets and federal policy have made financing multi-family housing more difficult.

The 1986 tax reform act extended the depreciation period for residential structures, terminated the favorable treatment of capital gains on real estate, and restricted "passive loss" deductions, reducing the attractiveness of real estate investments. While the act also created the Low Income Housing Tax Credit, the changes contributed to an 80 percent drop in multi-family housing construction nationwide.

Particularly damaging to New York were the new restrictions placed on tax exempt bond financing. Through the New York State Housing Finance Agency (HFA) and the New York City Housing Development Corporation (HDC), tax exempt bond financing had been used extensively to encourage new housing construction, especially for middle-income

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residents. The 1986 act strictly capped the amount of "private activity" bonds that could be issued annually and restricted the type of housing developments that are eligible for tax exempt financing. Since the volume caps are not indexed, inflation continues to erode the real value of that financing tool.

Changes in banking regulations dating back to 1978 further contributed to a more difficult housing finance environment. One of the most important regulatory changes was made through the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), one provision of which requires saving and loans and commercial banks to hold more equity capital for certain classes of assets, including multi-family mortgages.

Those regulatory changes reinforced the caution with which many financial institutions approached real estate investments in the wake of the savings and loan debacle of the 1980s. That caution extended to federal agencies, particularly the Federal Housing Administration (FHA), whose multi-family mortgage insurance activity dropped from nearly $5 billion in 1986 to less than $60 million in 1992.

FHA mortgage insurance, when available, enables commercial banks and other lenders to offer long-term, fixed rate loans for multi-family housing development. Such loans allow housing developers to lock in favorable interest rates and eliminate interest rate risk from their financial projections. Without the insurance, lenders are usually willing to provide only variable-rate mortgages or short-term balloon loans that must be refinanced periodically. FHA credit enhancement also allows developers to build with less cash equity invested and thereby expands the pool of projects that are feasible.

While a new class of domestic and foreign banks have since entered New York's multi-family lending market and FHA has stepped up its insurance operations, many housing professionals believe that financing residential development has become more complex and difficult than it was in the past. Developers must now have more equity at their disposal and be willing to assume more of the interest rate risk, factors which make marginal projects less likely to be undertaken.

Some developers also cite the city's tightening of eligibility for 421-a tax benefits as a significant damper on new housing development in Manhattan. The 1986 change severely restricted access to tax benefits for projects built in Manhattan below 96th Street. Several recent Manhattan projects have consequently been financed with a 20 percent low-income component, which allows the developer to recieve 421-a tax benefits, qualify for tax exempt bond financing, and access low-income housing tax credits. That technique, however, is severely limited by the federal cap on tax exempt bond volume and produces housing only for the very affluent and the very poor.

Scarcity by Default

In the past 50 years the "build-out" of the city has essentially been completed and its population stabilized; it no longer needs to produce the volume of new housing achieved in the 1920s. Nevertheless, for the city to remain an attractive and affordable place to live it needs to continually renew and modernize its housing stock; if the rancorous debate over rent regulation revealed any unanimity of opinion, it was that the city's recent rate of residential construction—the city's housing replacement cycle is now about 400 years—is insufficient to do so.

To replenish the city's housing stock exclusively by building housing for the homeless and others of very low-income is extraordinarily expensive; the amount of public subsidy available is not sufficient to acheive satisfactory production volume, and is in fact contracting. Middle-income housing production is critical because public resources can be leveraged to a greater extent, allowing more housing to be created per dollar of public subsidy. It also facilitates the traditional filtering process, opening up apartments for households with lower incomes, and helps to moderate rental price inflation. In recent years new middle-income housing has been produced primarily through the Nehemiah and Partnership programs, but those programs are land-intensive and cannot substitute fully for higher-density multi-family housing.

With limited federal housing resources increasingly targeted toward low- and very low-income housing development, there is also a pressing need for middle-income housing to further community revitalization objectives. If economically depressed areas of the city—many of which received a substantial injection of public investment during the late 1980s—are to continue to regain their social cohesion, it is critical that they retain their middle-income residents. To do that, there must be attractive local housing options available to households who have sufficient resources to leave but not necessarily enough to afford new, unsubsidized housing.

Since the end of the Second World War the majority of new housing produced in the city has been built with public subsidies, tax incentives or credit enhancement. During the 1950s and 1960s the New York City Housing Authority produced 27 percent of all multi-family housing built in the city, and between 1958 and 1977 the Mitchell-Lama program accounted for more than one-third. During its brief life, the Section 8 New Construction program accounted for nearly 30 percent of the multi-family housing built. In the 1990s, virtually all housing that is constructed takes advantage of some government program or tax incentive that facilitates its financing.

Most housing professionals recognize that very little new housing can be built in the city, with or without rent regulation, unless the public sector encourages and supports residential investment. The rent regulation controversy helped to focus public attention on the city's inability to produce new middle-income housing; many in the industry are hoping that a consensus can be forged for a new public initiative to address that housing need. In the meantime, they are pondering what type of program could most effectively stimulate middle-income housing development without a prohibitive commitment of public resources.