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Testimony on the Residential Conversion of Commercial Buildings

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Thank you for the opportunity to testify on the potential for commercial-to-residential conversions. I am Sean Campion, Director of Housing and Economic Development Studies at the Citizens Budget Commission (CBC), a nonpartisan, nonprofit think tank and watchdog devoted to constructive change in the finances and services of New York State and City governments.

Economic changes brought on by the COVID-19 pandemic have left the future of New York City's office market as uncertain as at any other point since the early 1990s, when, facing similar pressures, City and State policymakers created the now-expired 421-g tax incentive for office-to-residential conversion as part of a broader Lower Manhattan Revitalization plan.

421-g provided property tax exemptions and abatements to induce property owners in lower Manhattan to convert functionally obsolete office buildings to residential uses.

Ultimately, 13 million square feet of commercial space was converted into 12,865 residential units, mostly in buildings built prior to 1945. These conversions helped spark the transformation of lower Manhattan into a mixed-use neighborhood.

Even though New York City's economy and real estate market are both much stronger today than they were in the early 1990s, the history of 421-g remains relevant. Specifically, CBC's analysis of 421-g found that:

- Regulatory reforms, such as lifting the Floor Area Ratio (FAR) cap and making zoning and building code changes, were essential to make conversion possible for some buildings that otherwise would have been prohibited or financially infeasible to convert;

- Allowing conversions as-of-right, rather than through discretionary processes, maximized the potential number of conversions and allowed the market to determine where conversions were the best option;
- A tax incentive may not be necessary for conversions to market rate units, as such conversions have continued without 421-g; but
- Tax incentives would be needed to support mixed-income rental conversions.

The history of 421-g yields four questions that should guide the development of a potential incentive program:

1. **Is the vacancy crisis concentrated or widely dispersed?** If vacancies are concentrated in certain neighborhoods, the policy response—including any incentive—should be place-based, like the 1990s lower Manhattan plan. If vacancies are concentrated in specific types of buildings (such as age, size, or class), the policy response should specifically target those types of buildings. However, if vacancies are widely dispersed, the policy should be broad-based.
2. **What are the goals of the conversion program?** Is a plan needed to reduce the supply of office space? If so, redevelopment could be an alternative to conversions. Is the goal to transform central business districts into mixed-use neighborhoods? If so, the incentive might be more effective if it is a component of a broader neighborhood rezoning. Is the conversion program part of a fair housing strategy to build more affordable rentals in the Manhattan core? Incentives might be needed to make it worthwhile for developers to convert to mixed-income rentals instead of market-rate rentals or condominiums.
3. **What incentives are needed to advance these goals, in which circumstances, and at what levels?** Any conversion program should be based on a detailed financial feasibility analysis that looks at the types of conversions that would be feasible without subsidy, and which would require subsidies. For those that require subsidy, the analysis should also estimate the level and duration of tax breaks needed to incentivize the marginal project, and the amount of subsidy needed for different types of projects at different levels and shares of affordability.
4. **Is it cost-effective relative to other strategies?** Conversions may be a more cost-effective way to generate mixed-income units than new construction. Often, the total per-square foot cost of conversion projects, including land, is less than the cost of new construction. (See CBC's research on the 421-a program for more detail on how land values affect development feasibility.) If office values decline enough, it may become financially feasible to create rental housing in markets where ground-up development typically is not cost-effective. (It is important to note that for many well-located office buildings, valuations and occupancy rates have not yet fallen to the point at which conversions might make sense.) Some incentive would still be needed to induce developers to set aside a portion of those converted units at below-market rents, but

these units may be produced at substantially lower cost to the public than if the City were to subsidize the construction of new affordable units in those neighborhoods–either directly through capital subsidies or indirectly through tax expenditures. For projects that require subsidy or tax breaks, policymakers should take steps to ensure that those incentives are well-targeted and cost-effective.

While CBC has not modeled specific proposals or recommended an incentive structure, this framework can be used to evaluate potential proposals, such as the incentives and regulatory relief proposed in New York State's Fiscal Year 2024 Executive Budget.

Market-rate conversions need regulatory relief more than they need incentives. The Governor's proposal provides that through relief from the Multiple Dwelling Law's FAR cap for buildings built prior to 1991. By extending the building age to which the FAR cap applies from buildings built before 1969 to before 1991, an additional 120 million square feet of office space built at densities greater than 12 FAR could be converted in their entirety to residential use; otherwise, these buildings would be permitted to convert no more than 12 FAR to residential units, with the remaining building space reserved for commercial use, even if that is not the highest and best use for that space. Separately, the City's Office Adaptive Reuse Task Force identified several other zoning changes that the City should implement to allow more commercial buildings to convert to residential use as-of-right.

The Executive Budget also includes a property tax incentive only for mixed-income rental conversions. The proposed incentive would provide a partial tax exemption and would be less costly than 421-g, while also requiring developers to set aside affordable housing units, which 421-g did not. Again, we have not done a detailed feasibility analysis, but the proposal's approach seems reasonable.

In conclusion, the history of commercial-to-residential conversions in New York shows that if done well, conversions can enhance the long-term competitiveness of New York, protect its property tax base, and improve the lives of its residents. But this future is only possible if policymakers get the details right.

Further Reading:

- https://cbcny.org/research/potential-office-residential-conversions
- https://cbcny.org/research/amend-it-dont-end-it