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Testimony on New York City Property Tax Reform

Submitted to the New York City Advisory Commission on Property Tax Reform

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Thank you for the opportunity to submit testimony. The mission of the Citizens Budget Commission (CBC) is to achieve constructive change in the finances and services of the New York State and New York City government.

There is broad consensus that New York City's largest and most stable revenue source, its property tax, lacks transparency and equity. The Advisory Commission has the challenging task of proposing a redesign of the property tax that both addresses its shortcomings and preserves its crucial role in the City's fiscal health. In line with those dual objectives, CBC makes the following recommendations, each of which is explained in detail below:

- Move cooperatives and residential condominiums to Class 1 with one-, two-, and three-family homes.[1] The three remaining classes would remain residential rental buildings (Class 2); utility properties (Class 3); and commercial properties (Class 4).
- Class 1 should face the lowest tax burden, as measured by the effective tax rate (ETR, defined as taxes as a share of market value), with increasing ETR's for residential rental buildings, utilities, and commercial properties. The Commission should also consider whether underutilized buildings and land merit differential tax treatment.
- Valuation for tax purposes should reflect actual real estate market value, using more transparent methods that take advantage of the substantial data available to the Department of Finance (DOF).
- Full market value should be the starting point for assessing the tax base.[2] Differential ETRs to favor residential properties can be achieved through either differential assessment or different tax rates; the Commission should weigh the benefits and drawbacks of each.
- The existing class share system should be eliminated.
- Stability of the property tax should be achieved by phasing-in market value changes over three years for all parcels. Caps and phase-ins as currently structured should be eliminated.
- To ease burdensome tax bills, rebates should be provided of owner-occupied residential property taxes based on household income when tax bills exceed a set share of income. This "circuit breaker" should replace certain existing tax reduction programs.
- Transition to the new system should occur over a five-year period.

Classification

Property classification is intended to support City policy goals by mitigating the tax burden on certain types of properties. For example, one-, two-, and three- family homes are in Class 1 and receive preferential treatment in order to support homeownership. Cooperative and residential condominium units, despite being owned homes, are in Class 2. Some of these homeowners receive abatements to try to compensate for the discrepancy. This inconsistent treatment should be remedied by moving cooperative and residential condominium units into Class 1. The remaining classes should be maintained.

The property tax should not be structured to incentivize the development of commercial uses over residential uses. It is appropriate that income-generating properties, including Class 2 rental apartment buildings as well as Class 4 commercial property, are taxed more heavily than Class 1 residences. However, the tax burden on income-producing residential buildings should be less than on commercial income-producing property to maintain and boost the City's supply of rental housing. Homeowners should have the lowest tax burden.[3] Class 3 currently faces the highest ETR, even though high utility taxes are passed on to ratepayers; the Commission should consider whether it is appropriate to bring Class 3 closer in line with Class 4. Additionally, the Commission should look at mechanisms to address the underutilization of property and land in the city.

While differential tax burdens among property classes are justifiable in the service of policy goals, the divergence should not be too large. Currently ETRs of commercial and rental properties are four to five times those of owner-occupied homes, which is far higher than in most other cities. A report on the largest city in each of the 50 states indicates that ETRs on commercial properties are no greater than 2.25 times that of owner-occupied homes in 46 of 53 cities.[4]

Valuation

It is important to the credibility of the property tax system that methods of valuation are clear and transparent.

Class 1 homes, including cooperative and condominium units, should be valued in the same manner and valuations should reflect the real estate market. Data from sales of comparable properties can be used to provide an appropriate value because there are a sufficient number of arms-length transactions to develop robust models. One- to three-family homes are currently valued in this manner, but cooperatives and condominiums are valued based on the income stream of comparable rental buildings, which produces values substantially below sales prices.[5]

The City's well-established system of collecting real property income and expense data should allow for robust income-based valuation of rental and commercial property. Net-income capitalization, which captures the expected rate of return on a building's income stream through a capitalization rate, is currently used to value these properties.[6] However, the models often produce values that are less than half of sales-based values, indicating the methodology needs improvement.[7] Specifically, DOF should provide more information on the setting of capitalization rates used to translate net operating income into market value, as the calculation of the rate is not transparent.[8]

Utility property is generally valued by the State using replacement cost, and this method should be retained; limited sales data and regulation of the rates make valuation based on sales or income inadequate. Reductions (or increases) in the utility property tax levy are generally passed on to ratepayers through the utility rate setting process.

DOF should be required to conduct annual sales-ratio studies for all classes except Class 3 utility property to assess the validity of the valuations by comparing recent sales prices to DOF market value.[9] Transparent analysis and reporting of these statistics would provide greater accountability and foster respect and legitimacy for the valuation system.

It is important to note that changes to the value of the City's taxable real estate will also have indirect fiscal impacts.[10] The Constitutional debt limit sets the maximum outstanding debt for New York City at 10 percent of the five-year average of market value. Similarly, the maximum property tax revenue that can be raised and used for operating expenses, excluding long-term debt, is set at 2.5 percent of the five-year average of market value. If improvements to the valuation increase the City's total market value, both limits would likely increase, granting greater flexibility to both take on additional long-term debt and to increase the overall property tax levy.

Assessment and Setting the Tax Rate

The starting point to determine tax liability should be 100 percent of market value.

The current caps on and phase-ins of assessed value growth distort ETRs and should be eliminated. These mechanisms were intended to reduce sudden, significant changes in tax bills, but the well-documented impact over time has been to impose inequitable tax burdens within property classes, with properties in rapidly appreciating neighborhoods facing lower ETRs than those in neighborhoods with more stable real estate markets.[11]

Similarly, the fixed class shares result in substantially higher ETRs for commercial and rental properties and should be eliminated. Class shares currently limit the portion of the levy that can be raised from each class to historical shares, allowing only incremental annual change. Instead, imposing lower tax burdens on certain types of properties should be done in a simple and straightforward way by taxing a lower percentage of full market value (known as fractional assessment) or by setting a lower tax rate for that class of property. For example, Class 1 homes could be taxed on 50 percent of their market value, not 100 percent. Alternatively, the tax rate on such properties could be lower than the rate set on others. A third option, used by some states and municipalities, is a homestead exemption that exempts a portion of the value of owner-occupied residential property from taxation.[12]

As noted above, the differential in tax burdens should not be as great as it is in the current system; the Commission should consider setting limits for how much variation there can be in ETRs across classes.

Stability of the Property Tax

While it is important for the property tax system to provide stability to both taxpayers and the City, the current combination of caps, phase-ins, and abatements is distortive and leads to inequities in burdens between properties in the same tax class and contributes to discontent and misunderstanding among taxpayers.

Lower-income residential property taxpayers can be protected appropriately from sudden increases in property values through rebates of their taxes based on income–generally referred to as a circuit breaker. A circuit breaker that refunds the portion of property taxes in excess of a set percentage of a household's income can provide targeted relief to those in need. It should replace programs such as the Co-op and Condo Abatement that benefit many wealthy owners and can be designed to incorporate the beneficiaries of the Senior Citizen Homeowner Exemption as well as other households that spend a disproportionate portion of their income on the property tax. The design of a circuit breaker needs careful consideration as to thresholds, income limits, and other eligibility criteria; as an example, the circuit breaker could apply to property taxes on residential properties that exceed 5 percent of household income for households with income below $100,000.[13]

For the City as well as property owners, there are benefits to gradually reflecting changes in the market through slower growth in assessments to provide insulation from sudden, significant changes in the market.

Therefore, a market value-based assessment system should be adopted and changes in market value across all properties and classes should be phased in over three years. The current five-year phase-in of assessment increases, and the 20 percent cap on assessed value growth over five years on Class 1 homes result in foregone revenue by delaying or foregoing the recognition of the growth. Reducing the phase-in from five years to three would halve the lost revenue from phase-in properties while still providing stability in valuation over time.[14]

Transition to the New System

The substantial changes recommended would result in redistribution of the property tax levy across properties in the City. Additionally, since property taxes are taken into account in sales prices and market values of property, the transition could result in price adjustments in the market. To temper these changes, the new system should be phased in over five years. Essentially, the City would calculate tax liability under the new system and an estimate of the liability under the existing system and reflect an additional one-fifth of the difference (negative or positive) in each of the five transitional years.

The Property Division of DOF should be able to implement these recommendations with the existing resources; property tax reform should not increase the City's cost to administer the tax.

Conclusion

Attempts to reform the property tax system since it was adopted in its current form in 1981 have been largely unsuccessful and many of the most prominent inequities are a result of the structural features. To address meaningfully the disparities and provide New Yorkers with an equitable and transparent property tax system, a comprehensive redesign is needed. While the transition is likely to be difficult and may be unpopular among some taxpayers, it is long overdue and necessary to assure the City has a property tax system that functions simply, fairly, and effectively well into the future.

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[1] While Class 1 also includes small condominium buildings, single-family homes on cooperatively owned land, and residential vacant land, for simplicity the memo refers simple to one- to three-family homes.

[2] In other words, the assessed value should be 100 percent of market value.

[3] In part this responds to the federal cap on the deductibility of state and local taxes, which effects homeowners but allows owners of income-producing property to continue to deduct the full amount of their local taxes.

[4] The study includes the largest city in each state, plus the second largest in New York and Illinois, plus the District of Columbia. See: Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, *50-State Property Tax Comparison Study for Taxes Paid in 2017* (April 2018), pp. 37-38, https://www.lincolninst.edu/publications/other/50-state-property-tax-comparison-study-2.

[5] Citizens Budget Commission, *Options for Property Tax Reform: Equitable Revenue Raising Reforms for New York City's Property Tax* (prepared by Andrew Hayashi, December 5, 2013), https://cbcny.org/sites/default/files/media/files/Options%20for%20Property%20Tax%20Reform.pdf; and George Sweeting, *Twenty-Five Years After S7000A: How Property Tax Burdens Have Shifted in New York City*, "Cause and Effect: An Analysis of Changes in Property Tax Burdens Since 1981" (City of New York, Independent Budget Office, December 5, 2006), http://www.ibo.nyc.ny.us/iboreports/propertytax120506.pdf.

[6] While some observers have suggested valuing these properties based on sales data, often there are not enough sales transactions to allow for robust statistical modeling.

[7] The Independent Budget Office study of commercial property sales prices compared to DOF market values found that in 2006, the ratios exceeded two (meaning sales prices were twice the DOF value) for office buildings and retail in the Bronx, Brooklyn, and Queens and exceeded three for factories, warehouses, garages, and Manhattan retail stores. See George Sweeting, *Twenty-Five Years After S7000A: How Property Tax Burdens Have Shifted in New York City*, "Cause and Effect: An Analysis of Changes in Property Tax Burdens Since 1981" (City of New York, Independent Budget Office, December 5, 2006), p. 38, http://www.ibo.nyc.ny.us/iboreports/propertytax120506.pdf.

[8] For example, DOF's Annual Assessment Guidelines, which report on the incomes and capitalization rates used in determining market value, should be required to have a section describing the method and data used to set the capitalization rates.

[9] Sales-ratio studies compare the DOF value for properties that were sold in arms-length transactions in recent years to assess the validity and consistency of the valuation. The ratio measures the sales to DOF value for properties, while a coefficient of dispersion measures the variation between properties of the same type that sold and their sales ratios.

[10] The valuations used for the debt limit and operating margin are based on valuations as adjusted by New York State but have been within 2.5 percent of the City's market valuation for the past five years.

[11] Jenna Davis and Ana Champeny, "New York City Homeowners: Who's Got the Unfairest Tax Burden of Them All?" *Citizens Budget Commission Blog* (September 12, 2018), https://cbcny.org/research/new-york-city-homeowners; Ana Champeny, *New York City Property Taxes: 3 Things Owners and Renters Should Know* (Citizens Budget Commission, December 22, 2016), https://cbcny.org/research/new-york-city-property-taxes; Citizens Budget Commission, *Options for Property Tax Reform: Equitable Revenue Raising Reforms for New York City's Property* Tax (prepared by Andrew Hayashi, December 5, 2013), https://cbcny.org/sites/default/files/media/files/Options%20for%20Property%20Tax%20Reform.pdf; and George Sweeting, *Twenty-Five Years After S7000A: How Property Tax Burdens Have Shifted in New York City*, "Cause and Effect: An Analysis of Changes in Property Tax Burdens Since 1981" (City of New York, Independent Budget Office, December 5, 2006), http://www.ibo.nyc.ny.us/iboreports/propertytax120506.pdf.

[12] A single class for all residential property, combined with a homestead exemption, would provide a lower ETR for owner-occupied primary residences, relative to residential property in the class which is being rented or being occupied part-year. Florida and California, for example, offer homestead exemptions for owner-occupied primary residences. See: Lincoln Institute for Land Policy, *Significant Features of the Property Tax: State-by-State Property Tax in Detail* (accessed November 20, 2018), http://datatoolkits.lincolninst.edu/subcenters/significant-features-property-tax/state-by-state-property-tax-in-detail.

[13] For more information on designing circuit breakers, see: Aidan Davis, *Property Tax Circuit Breakers in 2017* (Institute for Taxation and Economic Policy, September 2017), https://itep.org/property-tax-circuit-breakers-in-2017/; and John H. Bowman and others, *Property Tax Circuit Breakers: Fair and Cost-Effective Relief for Taxpayers* (Lincoln Institute for Land Policy, May 2009), https://www.lincolninst.edu/publications/policy-focus-reports/property-tax-circuit-breakers.

[14] Foregone revenue from caps is not necessarily recouped as the growth in assessed values is capped at 6 percent per year or 20 percent over five years in Class 1 (and 8 percent per year or 30 percent over five years for Classes 2A, 2B, and 2C). In effect, some of this potential revenue is lost to the City in perpetuity.