



THE CITY OF NEW YORK
OFFICE OF THE PRESIDENT
OF THE
BOROUGH OF MANHATTAN

MUNICIPAL BUILDING
NEW YORK, N.Y. 10007
(212) 669-8300

RUTH W. MESSINGER
BOROUGH PRESIDENT

October 19, 1993

Mr. Eugene J. Keilin
Chairman
Municipal Assistance Corporation
for the City of New York
One World Trade Center
Suite 8901
New York, NY 10048

Dear Mr. Keilin:

Attached is a proposal for property tax reform that I intend to present to the Real Estate Tax Commission at this evening's hearing. I hope you will examine it carefully, and I would be very interested in discussing it with you at your convenience.

Thanks so much for your attention to this difficult and urgent matter.

Sincerely,

A handwritten signature in black ink, appearing to be "RW Messinger", written over a horizontal line.

Ruth W. Messinger

A NEW APPROACH TO PROPERTY TAX REFORM

There are probably few New Yorkers today who don't know that we have a property tax system that assesses and taxes apartments (whether rented or owner-occupied) much more heavily than detached houses, and even fewer who don't see anything wrong with this system. But when we move from diagnosing the problem to prescribing a cure, we always reach an impasse. All proposals to redress the system's inequities seem to be trapped between the Scylla of doubling the taxes on homeowners and the Charybdis of massive City revenue losses. Either alternative appears to involve prohibitively large economic and political dislocations.

But the prevailing wisdom is wrong, both as to the ultimate impact of tax reform and as to the choices we face during the reform. The proposal that follows is built around two principles:

- **First, an equitably designed property tax system will generally yield significant gains as well as strains for future homeowners, and on balance will only modestly increase their taxes.**
- **Second, we should and indeed can--without compromising our final goal--manage the critical transition to tax equity without adding to the tax burdens on *current* homeowners.**

I. The real impact of tax equalization: a new perspective

Today the typical (i.e., average) property tax bill for a single-family house in New York City is \$1,388. Imposing a single effective rate on all residential properties (without reducing the total residential levy) would raise that bill to around \$2,760.¹ Even though 40 percent of the bill is offset through income tax deductibility, what remains--the owner's annual net property tax burden--still doubles. Even if the equalization is phased in over ten years, the end result does not change--the annual bill and net burden in class 1 still ultimately double. This is the mountain that blocks our path, that we cannot seem to get over or go around.

And yet this mountain is, from a longer perspective, largely a mirage. That longer perspective is one that considers the *lifetime* net property tax payments of New York City homeowners, instead of just focusing on the net payments in a single year.

Despite the doubling of the class 1 typical bill, a revenue-neutral residential rate equalization will not come *anywhere close* to doubling the lifetime net property taxes of the typical class 1 homeowner. In fact, the real lifetime increase will be more on the order of just 25 percent. And at the same time, the real lifetime tax savings of both apartment owners and renters in what

¹ This takes into account the effect of changes in tax rates on the property tax base. More on this below.

is now called class 2 will be around 40-45 percent (that is, pretty much in line with the size of the reduction in the unit bill).

How is this possible? There are two reasons:

First, *the typical class 1 homeowner does not spend his whole life in class 1*--in fact, as Census Bureau data show, he doesn't buy his first house until he has reached his mid-30s, before which he has spent some fifteen or so adult years as a tenant in class 2. What this means for the current owner is that the low annual taxes he is now paying (or expects to pay) in class 1 were previously offset, to some degree, by the excessively high taxes that were tucked into his rents in class 2. What this will mean for the future homeowner under property tax equalization is that the higher taxes she will pay when she buys into what is now class 1 will be offset, to a significant degree, by the reduced taxes she will have first borne while renting in what is now class 2.

Second, *when taxes are raised or lowered matters*. If your taxes are lowered from \$2,000 to \$1,000 this year and raised from \$1,000 to \$2,000 next year, you will come out ahead if in the interval you can take this year's tax savings and invest them at a positive rate of interest. Next year's taxes, in other words, must be discounted by that rate of interest before they are added to this year's taxes to see what your real two-year tax total is.²

It is in discounted (or net present value) terms--the standard terms used to evaluate any stream of incomes or costs--that tax equalization will raise the future typical homeowner's lifetime property taxes by just 25 percent.

The future lifetime tax savings will be much higher for typical renters and co-op and condo owners because, spending their entire lives in what is now class 2, both their early and late taxes will be reduced by equalization.

There are of course many caveats and extensions of this analysis to consider. Most New York City homeowners do their prior renting as City residents, but this is not true of all owners. Wealthier owners tend to make the jump from renting to homeownership earlier in their adult lives (a few--undoubtedly far better off than average--even own homes their entire adult lives). Others become owners later in life. And some return to renting in their old age. All this (and much else) influences the real lifetime tax profile associated with homeownership.

A detailed background analysis covering many of these variables will follow. But the main

² In this example, the two-period undiscounted tax total is \$3,000 both before and after the tax shift. But with an interest rate of 5 percent, your *net* tax total after the shift is \$3,000 less the \$50 you earn on the increased first period savings, or \$2,950 (in current dollars). Net present value analysis expresses the same result by applying a 5 percent discount to the second period tax. Thus in discounted (or net present value) terms, your tax total was $\$2,000 + \$952 = \$2,952$ before the tax shift and $\$1,000 + \$1,905 = \$2,905$ after the tax shift. The shift saves you \$47 (in first period dollars).

outlines remain as stated here: most future class 1 owners will have, on balance, much less to fear from property tax equalization than is commonly assumed.

However, this still leaves the question of *getting to* tax equity. The lifecycle perspective also sheds more light on the particular risks and costs of the transition--and provides a few clues as to how to manage and minimize these risks and costs.

II. Managing the transition to tax equity: safeguards for homeowners

During the transition from the existing rate system to an equalized system, new class 1 owners will fare worse than either their successors or predecessors. This is because this transitional cohort will have the worst of both worlds: having previously paid excessive class 2 taxes as renters under the old property tax regime, they will now face higher class 1 taxes under the new one.

As will be seen in a moment, slowing down the phase-in of higher billable values in class 1 will significantly mitigate this problem. But there is an additional step that I recommend we take to limit the transitional dislocation: *exempt most or all current homeowners from assessment and rate equalization--that is, raise assessment ratios and effective rates in class 1 only as properties pass from incumbents to new owners.*

Eventually, all class 1 properties will turn over, and assessment equalization will spread through the entire class (and also through class 2). But nobody who owns a home *now* will get hit with big tax increases.³ New owners will pay more than they would have without tax reform, but the later into the transition they switch from renting to owning, the more of this increase will have been offset by lower class 2 taxes. And new owners won't experience equalized class 1 tax rates as *rising* tax rates.

This solution is not perfect, for it creates a temporary but significant tax gap between those fortunate enough to have purchased a class 1 house immediately before the tax reform (locking in the current low effective rate) and those unfortunate enough to purchase immediately after (at the higher equalized effective rate). This is where tinkering with the phase-in of assessment changes comes in.

Extending the period for phasing-in [increases in assessed value (AV) resulting from equalization of residential assessment ratios will, in general, soften the transitional impact of equalization in class 1. But armed with our lifecycle perspective on tax burdens, we can more precisely position the needed transitional shock absorbers. We can focus assistance where it is most

³ However, the assessment cap should be replaced with circuit-breakers and a multiyear phase-in of annual assessed value changes both for properties that have changed hands after the reform and had their assessment ratios adjusted *and* for properties that haven't yet changed hands (except possibly those with older incumbent owners). More on the cap below.

needed by giving those who purchase a class 1 home immediately after the start of tax reform the longest phase-in period for equalization-related ΔV increases, gradually shortening the phase-in period for those who purchase later. This will roughly key the length of the class 1 AV equalization phase-in to the amount of offsetting class 2 tax reductions that new homeowners will get before they graduate to class 1.

For example, suppose tax reform is initiated in 1995. Those purchasing a class 1 home within two years of that date (through 1996) could get, say, a 15 year phase-in of the assessment equalization increase; those purchasing in the third and fourth years of the transition period (1997-8) would get a 14 year phase-in, and so on, until everyone purchasing on or after 2005 would get a ten-year phase-in of the assessment equalization. (Meanwhile, assessment changes due to movements in market value would always continue to get the usual five-year phase-in.⁴)

III. Getting to tax equity: further questions and answers

The grandfathering-in of current homeowners and the "sliding scale" for phasing in the equalized AVs in class 1 are the two main elements of what I believe may be a minimally disruptive transition to property tax equity. In this section I will flesh out some of the arguments for choosing this approach and address some additional concerns.

Doesn't the lifecycle approach show that incumbent class 1 owners, having already gotten their tax break, should not be shielded from equalization?

Not entirely. As we saw, recent owners have paid their high class 2 tax dues but *not* yet received much of a class 1 low tax payoff. In this they are similar to new owners, those coming into class 1 right after the tax equity transition starts. Why subject the latter to (phased-in) tax equalization but exempt the former? There is one important difference between the situations of these two groups: prospective new home buyers will know beforehand that higher class 1 taxes are coming, and they will be able to adjust their decisions accordingly. They can decide that purchasing a house now is still worth it, or they can decide to put off buying for a while or to buy a co-op or condo, which will be a more attractive alternative with the prospect of

⁴ Here a comment is in order. It is justly argued that one of the problems with our existing tax system is its mind-numbing complexity. Clearly, once residential assessment ratios are equalized, there can be no remaining justification (if there was ever any) for assessing properties at less than full market value and causing effective property tax rates to deviate from nominal rates. But as long as there is any multi-year phase-in of annual assessment changes, *billable* values will generally not equal market values, even if assessed values do. Thus the nominal tax rate won't exactly equal the effective rate on most properties most of the time, although it will usually be reasonably close. However, this departure from the simplicity ideal is worth the protection it provides taxpayers against rapid appreciation of property values. It may be worth noting that a proposed alternative protection scheme--capping the annual growth of the entire tax levy so that it cannot exceed the rate of inflation, regardless of how fast market values are growing--also introduces complexities into the system, since it would mandate temporary tax rate reductions and would (like the existing class 1 cap) tend to discriminate against properties and owners in depressed neighborhoods.

lower taxes.

For someone who has just bought a house, however, adapting to the new world will not be so easy. He may, like some prospective new buyers, decide that other options are more appealing than owning a private home right now under the new tax regime. But it will cost him to change the changes in housing arrangements he has already made.

An argument can be made that recent home-buyers should get at most a delayed introduction to tax equalization, not a complete bye. This could be done, for example, by requiring full or partial assessment equalization to begin after (say) 2004 for properties still held by owners who got in before 1994. This will shorten the duration of the temporary tax gap between new and recent buyers. But this would only moderately pick up the overall pace of equalization, and it may be possible and preferable to do this by providing one-time incentives for incumbent owners to return to the real estate market.

At first blush, there seems less justification for grandfathering-in longer-established class 1 incumbents, since these owners *have* already enjoyed enough years of low class 1 rates to more than offset whatever high class 2 taxes they bore in their youths. But for this group, there is something else to consider: the fact that most of them are relatively advanced in age, are approaching or have reached retirement (with all its implications for income), and will not sustain their ownership and its accompanying tax advantages very many years into the post-tax reform era.⁵

Indeed, whatever doubts may arise as regards perpetuating the newly-acquired tax advantages of recent additions to the roster of class 1 ownership, it is clear that the cause (and pace) of tax justice will not be appreciably advanced by cutting off the advantages of older owners. The case for grandfathering-in is strongest for this group.

When would tax equalization be complete?

If future housing turnover rates are similar to those of the past, about a third of all homes will change hands and start to have their assessment ratios and effective rates adjusted within 7-8 years of the beginning of tax reform;⁶ half of all homes will begin passing through the adjustment within 12-15 years; at least two-thirds within 20 years; four-fifths within 25 years; close to 90 percent within 30 years; and about 95 percent of all homes within 40 years. These projections are only approximate, since many demographic and social factors (including the tax

⁵ Besides, incumbent owners won't entirely escape the fallout from tax reform even if their current class 1 effective rates are grandfathered in, since the not previously anticipated increase in taxes for the *next* owner of the property will slightly lower the incumbent's expected capital gains from its sale. Future homeowners, who will both purchase and subsequently sell their properties under equalized rates, won't face this problem.

⁶ With the variable phase-in of equalization assessment changes, this means full adjustment of effective rates for these properties within 15 years.

changes themselves) can affect turnover. A slower market--the mid-'80s was exceptionally frenetic--will make for a somewhat longer transition to tax equity. Overall, however, holding incumbent homeowners harmless still allows for a brisk pace of retirement of the tax breaks in class 1.⁷

How much would the proposals for allaying the transitional impact of tax reform really help?

A typical prospective homeowner just renting her first apartment when tax reform begins to kick in will not do quite as well a typical owner starting out later (after tax reform is complete), because apartment unit taxes will not have fully dropped at the point that she makes the change over to homeownership. Still, with a ten-year phase-in of the reassessment that begins when she buys her house, her lifetime discounted property taxes will be no more than about 33 percent higher than under the current tax regime--still a far lower impact than is usually projected.

Those who start out in what is now class 2 just as the transition begins and remain apartment renter or owners, will see about a 20 percent reduction in their real net lifetime burdens as compared to under the existing tax regime, about half the reduction that their successors (who come along after residential equalization is complete) will enjoy.

It is the homeowner making the transition from renting in the first year of tax reform (i.e., without any offsetting reductions in class 2 taxes) who is most vulnerable to the tax changes. With a normal five year phase-in of the assessment equalization increase, he would pay 82 percent more in subsequent discounted lifetime taxes than he would pay under the existing tax regime. My proposed 15 year phase-in would cut this to 69 percent. (Even longer equalization phase-ins or equivalent measures would reduce the transitional impact still further.)

Couldn't we avoid all these difficulties by just cutting effective rates in class 2 down to the level of the existing rates in class 1?

Equalizing residential rates by levelling class 2 down to class 1 would reduce property tax revenues by almost \$2 billion (current fiscal year dollars), creating a very large budget gap that realistically could be closed in only two ways: reducing municipal services, or raising City income taxes. Neither alternative (nor any combination of the two) would leave homeowners--or their properties--unscathed.

It is well-known that housing values (market prices) are influenced by changes in property tax rates. With the long phase-in of rate changes proposed here, those market effects should be relatively mild--for several years the growth in nominal values will fall a bit under the long-term trend (roughly, the rate of inflation) in what is now class 1 and a rise a bit above the long-term

⁷ It will be important, however, for the tax reform legislation to ensure that grandfathering-in of current tax rates does not extend beyond the residency of current homeowners or their spouses--i.e., that the low rates are not legacies to be passed on to sons or daughters by making them co-owners.

trend in what is now class 2.⁸

What is less commonly recognized is that changes in the level of municipal services also influence property values. If we were to close the gap created by levelling down class 2 tax rates by slashing the City budget, this would cut the flow of housing services per dollar of homeownership costs; and just like a rise in costs per unit of housing services, this would be capitalized into lower (or more slowly growing) property values.

If we were to close the budget gap by raising City income taxes, this would not only result in a net tax increase for homeowners--which was what the levelling-down of property tax rates was trying to avoid. It could also itself eventually yield lower or slower growing class 1 home values.⁹

If class 2 rental properties are included in residential rate equalization, how do we insure that tax reductions are passed on to tenants?

Estimates of the proportion of rental unit property taxes passed on (in rents) by landlords to tenants range from 50 to 100 percent. Generally, the tighter the rental market, the less mobile are renters and the more taxes are shifted. New York City's traditionally low vacancy rates, the relatively low incomes and high rent-income ratios of many renters, and the fact that property taxes imbedded in rents are not deductible by renters, all indicate that property taxes fall more heavily on renters than on private homeowners (and probably more heavily than on most co-op and condo owners as well). Thus it is vital to include rental properties in residential tax equalization.

With rent regulated properties, pass-through of the class 2 rate reduction is relatively easily assured; lower taxes should be reflected directly in the cost formulas used to determine annual rent increases, leading to a slower pace of increases than would have occurred with continuation of the existing tax regime. For unregulated properties, however, the same tight markets that make it easy for landlords to shift property tax increases will make it easy for landlords to hold on to tax reductions--at least for a time; eventually, the lower taxes should be reflected in slower growing market rents. We now have no ready way to force the issue. This is a critical problem regardless of how tax reform is phased in.

Why wouldn't this scheme entrench tax inequalities the way Proposition 13 has in California?

⁸ These value movements will themselves soften the impact of equalization on house and apartment tax bills; this effect is already incorporated in the tax change estimates given here. It should be pointed out that these unavoidable market value adjustments make "revenue neutrality" a somewhat less straightforward baseline than it would otherwise be.

⁹ See Helen Ladd and Katharine Bradbury, "City Taxes and Property Tax Bases," *The National Tax Journal*, Vol. XLI, No. 4 (December 1988), pp. 503-523.

The transition proposed here will indeed open up tax disparities between older and younger homeowners, but in complete contrast to California, these will be temporary and self-liquidating.

The problem in California is that assessments are frozen at 1975-76 levels for properties that haven't turned over since Prop. 13 was passed, while newly purchased homes are assessed at their acquisition price (and then not again until resale), leading to bills sometimes as much as five times as high as bills for properties that have remained with their original (pre-'78) owners. The difference in our tax reform would be that all properties (both newly sold and unresold) would continue to be reassessed annually, so that the gap between the assessments of unresold homes and newly sold homes would not grow the way it does in California.

A second difference is that our tax reform would be revenue-neutral, so that as higher assessment ratios and effective rates spread through class 1, the additional revenues these rates bring will be used to gradually lower assessment ratios and effective rates across class 2, meaning that overall there would be (in sharp contrast to California) a convergence of effective residential rates. Over the transitional period when homes are being sold and assessment ratios adjusted, the effective rates borne by the growing number of new (purchasing post-reform) class 1 owners would be higher than the rates on the dwindling number of incumbent (purchased pre-reform) owners, but still lower than the effective rates in class 2; finally all residential rates will be equal when the post-reform class 1 turnover is complete.

It cannot be stressed strongly enough that the *passing* nature of the grandfathering in this plan is key to its success in leading us to full residential equity. A Proposition 13-type "reform" introducing permanent differences in tax rates for younger and older homeowners would make New York City's property tax system even worse than it is now.

Won't inflation have a devastating impact on homeowners if the class 1 cap is removed?

All else being equal, property values tend to grow over the long run at something like the rate of inflation (i.e. in tandem with nominal output or income). Of course, all else rarely is equal, and it is quite common not only to see property values swing widely over the course of a business cycle, but also to see values persistently grow faster than personal income in expanding regions and *fall* faster than income in declining regions.

The class 1 assessment cap was designed to shield homeowners in an inflationary environment from rates of property appreciation in excess of income growth. Insofar as such episodes are intermittent rather than entrenched, removing the cap will not have a large impact on the real lifetime taxes of homeowners. If high inflation is entrenched, tax reform that includes dumping the cap will eventually yield increases in class 1 tax bills (compared to current tax regime bills) many times larger than estimated above.

But to see this as crushing homeowners is to look at the thing through the wrong end of the telescope. For what will really happen is that a very long period of high inflation will make the existing assessment caps work too well--class 1 assessed values will fall further and further

below market values, effective rates will shrink to the vanishing point, and tax bills will become an insignificant share of owner income (and more and more of the total tax levy will be shifted to the other classes). It is only compared to *this* scenario that equalization and removal of the cap will greatly enlarge class 1 tax bills; in fact these equalized bills will be no larger vis à vis market values (and owner incomes) than under the moderate-inflation scenario assumed above.

It is in the short run that property values can run ahead of personal income growth and pose real hardships on homeowners (and renters, by the way). But assessment caps have proven to be a highly imperfect and inequitable way of coping with this problem. As many have argued, the only way to ensure that protection against excessive property tax/income ratios is channelled to where it is truly needed is to directly target those tax/income ratios, and provide meaningful income tax circuit breakers when these ratios surpass reasonable bounds.

What about class 4?

In testimony before the Property Tax Commission, the Real Estate Board of New York has endorsed the idea of a two-class property tax system with a fixed ratio between the effective rates of the commercial and residential classes. Given the sad history of how the City Council used its discretionary powers to change class shares during the 1980s, the REBNY proposal makes better sense than Council Member Eristoff's plan to set the rate ratio by local law every year.

A critical question is whether the class rate ratio is fixed at a point that (initially) preserves the current residential and commercial/utility shares of the total tax levy, or at a point that rolls back some of the past decade's discretionary increases in class 4's share of the levy.

An effort should be made to roll at least some of those increases back, if not all at once than over time. Doing this would require a somewhat higher equalized residential effective rate than used in deriving the tax reform impacts reported above. But the basic shape of the changes in real lifetime household owner and renter taxes would not be drastically affected.

One thing that should be kept in mind is that a roll-back of class 4's share would also reduce the burden of the commercial rent tax (CRT): taking class 4's non-utility property share back to the 1987 level would cut the CRT by about \$50 million; going back to the 1983 level would yield a \$100 million CRT drop. From the business point of view this is all to the good, and this would be a viable way to start chipping away at this deservedly infamous tax. But from the City's point of view, there are obvious budgetary consequences that must be addressed. The Property Tax Commission should consider how far it wants to make reducing the CRT part of its reform mandate--and whether a reform should be revenue-neutral *net* of a CRT reduction.