

THE CITY OF NEW YORK
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October 15, 2002

Mr. Benjamin Dulchin
Director of Organizing
Fifth Avenue Committee
141 Fifth Avenue
Brooklyn, NY 11217

Dear Mr. Dulchin:

At your request, we have reviewed Assembly Bill 11337, which proposes a partial real property tax abatement for building owners who extend leases for existing tenants at rents below fair market rental value. We reviewed the bill's fiscal impact on the city, as well as other aspects of it.

A firm estimate of the fiscal impact is virtually impossible because it would require knowledge or a reasonable way to estimate too many factors that cannot be known or reasonably estimated in advance. Nonetheless, to present a sense of the magnitude of the possible impact, we constructed several scenarios with varying levels of fiscal impact. Depending upon the number of landlords who decided to take advantage of the abatement, and the difference between local fair market rental value and the actual rent charged, the cost could range from \$4 million per year to over \$40 million per year or more. Capping the fair market rental value could reduce the cost to the city.

We also make some observations on other aspects of the bill. The law would allow landlords to legitimately claim the credit even if they would not have raised actual rents, which could drive up the cost to the city and create inequities in the property tax system. In addition, as currently designed, the law's differential abatement rates applied to class 1 and class 2 buildings is not only not sufficient to result in equal percentage reductions in tax burdens, but could actually further widen the existing difference in effective tax rates between the two classes of residential buildings.

Mr. Benjamin Dulchin
October 15, 2002

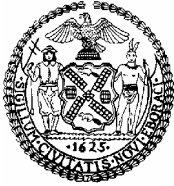
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The details of our analysis are contained in the attachment.

I hope these comments are helpful to you. Please feel free to contact me, at (212) 442-0220, if IBO can be of further assistance on this or any other topic.

Yours truly,

C. Preston Niblack
Deputy Director (Infrastructure, Environment, and
Uniformed Services)



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**Analysis of Assembly Bill 11337,
“The Community Stability Small Homeowner Tax Credit”**

Assembly Bill 11337 is intended to prevent displacement of existing low- and moderate-income tenants due to upward market pressure on local residential rents. Anecdotally, there have been instances where building owners raised rents of non-rent regulated apartments beyond what existing low-income tenants were able to pay, forcing them to move. The bill proposes to reduce the incentive for landlords to raise rents by providing a property tax abatement equal to 50 percent (for class 1 buildings) or 60 percent (for class 2 buildings) of the difference between the “fair market rental value” and the actual rent, not to exceed the building’s total tax liability. The abatement would be available to buildings with five or fewer units, which are not covered by rent stabilization laws.

We first discuss the fiscal impact of the proposed legislation, and then consider other aspects of the bill.

Fiscal Impact

Estimating the fiscal impact on the city of the proposed legislation is difficult.

- First, we must know or estimate the universe of eligible renters—the number of households living in one- to five-unit buildings with rents below “fair market rental value” and meeting the income and other qualifications—and their current rents. We can obtain an estimate of this based on Housing and Vacancy Survey data.
- Second, and more difficult, we must attempt to estimate how many landlords would take advantage of the abatement. This will depend on a number of factors that cannot be known or estimated in advance. How many units would be in areas where rents are rising? How many landlords will choose to take the abatement rather than simply raise rents? How much fraud might take place?

Absent answers to these questions, it is impossible to come up with a firm estimate of the cost. Nonetheless, to bound the problem and give some indication of the magnitude of the possible impact, we provide estimates below based on a range of assumptions.

We begin by estimating the number of eligible units. We used the 1999 Housing and Vacancy Survey, conducted by the U.S. Census Bureau for the city (results from the most recent HVS are not yet available). According to the HVS, there were about 444,000 rental units in buildings that would be covered by A.B. 11337—341,000 in class 1 buildings (one-, two-, and three-family homes), and 103,000 in class 2 buildings (four units and up). Of these, roughly 133,700 households met the qualifications for the abatement in 1999—approximately 101,000 in class 1 buildings, and 32,700 in class 2 buildings (see endnote 1 regarding qualifications).

Our next step was to attempt to gain an indication of the number of units in neighborhoods with significant upward market pressure on rents. To do this, we estimated from the HVS the number of qualifying units situated in community districts¹ that, between 1996 and 1999, experienced both an *increase* in the average rent greater than the growth in the federal housing department's fair market value, *and a decline* in the number of units renting at below the FMR, or fair market rent. Altogether over one-third of qualifying units—about 47,500—were in community districts that met both conditions.

This simple enumeration is unlikely to represent the actual number of units the owners of which would be motivated to seek the abatement. There are numerous factors that would influence a landlord's decision to take advantage of the proposed abatement. On the one hand, we would not expect all eligible landlords to take the exemption. Some will simply not be aware that it is available. Others may choose to raise rents rather than take the abatement.

Another consideration is the possible differences between owners of class 1 versus class 2 buildings. In about half of the 101,000 class 1 buildings, the owner also lives in the building, whereas in the class 2 buildings less than one-third of buildings have an owner-resident. Owners and renters may have a different relationship in these circumstances, in which the value of a stable and responsible tenant may outweigh the potential advantages of a higher rent. Renters may even be family members. Since the preponderance of units appear to be in class 1 buildings, this could be a significant consideration that might tend to pull the estimated impact down—but by how much we cannot say. In addition, the law would exclude members of the owner's immediate family who would otherwise qualify, and we cannot estimate how many units that might represent.²

In counterbalance to these considerations is the possibility that the very existence of the abatement may lead landlords who would not otherwise have raised rents to claim that they intend to do so in order to reap the abatement's benefits. This incentive adds to the importance of adjusting "fair market rental value" for particular neighborhoods in order to limit the potential benefit to a level reflecting local conditions (see the discussion below).

Because the magnitudes of these various factors are immeasurable, we provide a range of estimates below, based on the number of units receiving the abatement. The estimate below is equivalent to an average annual abatement of \$1,700 per class 1 unit, or \$142 per month—which is equivalent to an average monthly rent \$284 below the average fair market rental value—and \$2,200 per class 2 unit, equivalent to a monthly rent about \$300 below market. (See endnote 2 for details of the calculations.)

The cost to the city is limited by the fact that in some, perhaps many, instances, the value of the abatement may exceed the building's total tax liability, in which case the abatement would equal

¹ The HVS actually uses sub-borough areas based on census tracts, which correspond closely, but not precisely, to city community planning boards (CPB). Due to sample size issues, in four instances the HVS combines two city CPBs, resulting in 55 sub-borough areas (compared to 59 CPBs).

² The bill defines immediate family as spouse, child or stepchild, parent, grandparent, or spouse's parent. Whether by design or not, siblings and spouse's grandparents are not included.

the property tax liability, which would be reduced to zero (the abatement is non-refundable). This is particularly likely to be true for class 1 buildings, for which the average tax bill citywide is approximately \$1,700—nearly identical to our estimate of the average abatement for a class 1 unit.

Estimated Cost of Tax Abatement under Alternative Assumptions, Fiscal Year 2003		
Number of units*	Percent of eligible units*	Estimated total abatement cost
2,380	1.8%	\$4.3 million
9,500	7.1%	\$17.3 million
15,700	11.7%	\$28.5 million
23,800	17.8%	\$43.1 million

SOURCE: IBO.
 NOTE: The number of units is based on the estimate of eligible units located in sub-borough areas that, between 1996 and 1999, experienced both average rents that rose faster than HUD FMR and a decline in the number of units renting for below FMR. The percent of eligible units is based on the total number of eligible units in all sub-borough areas—133,700. See text for further explanation.

Other Considerations

Setting fair market rental value. As we noted in our previous discussions on an earlier draft of the legislation, the reference point for fair market rental value is the Fair Market Rent established by the U.S. Department of Housing and Urban Development for the New York region. This is a single figure for the entire city, which clearly is an inaccurate measure of true market rent levels in all but a few neighborhoods. The current legislation recognizes this by allowing the rent figure to be adjusted by HPD, at its discretion, and suggests an examination of the property tax assessment roll in order to determine fair market rental value “in particular neighborhoods.”

The term “neighborhood” is not defined in the legislation. There are existing geographically defined areas that could be used, although each has its limitations: The Community District is likely to be too large and diverse to share common rent profiles. The Department of City Planning has identified roughly 300 neighborhoods citywide, but their geographic boundaries are not defined.

In our model, we simulated the neighborhood adjustment of fair market rental value. Based on HVS data, fair market rental value for each sub-borough area was set by multiplying the 1999 HUD FMR of \$891 by the ratio of mean rent in that area to citywide mean rent. This yielded local fair market rental values ranging from a low \$569 per month in the South Bronx, to \$1,982 on the Upper East Side.

Using a single citywide FMR increases the amount spent in neighborhoods with lower rents, compared to using locally-adjusted fair market rental values, and reduces the amount spent in higher-rent neighborhoods. (We assume no change in behavior of landlords in response to a different fair market rental value.) Using the 1999 HUD FMR of \$891 in all areas reduces the cost to the city by 19 percent. Adjusting rents locally as in our base case but capping the local fair market rental value at the HUD FMR further reduces costs—by another 3 percent.

Differential abatement for class 1 and class 2 buildings. Effective tax rates—tax levy as a percentage of fair market value—for class 1 properties are substantially lower than they are for class 2 properties. This difference arises because the assessment ratio—the ratio applied to full market value to determine the assessed value of the property—is lower for class 1 buildings than it is for class 2. The current assessment ratio for class 1 properties is 8 percent of full market value, while that for smaller class 2 properties is 25 percent—or 3 times the ratio for class 1 buildings. The slightly lower tax rate on class 2 properties (10.792 percent versus 11.609 percent for 2003) only slightly mitigates the disparity.

In recognition of the difference in effective tax burdens, A.B. 11337 provides for an abatement of 50 percent for class 1 buildings and 60 percent for class 2 buildings. This difference will only partially offset the gap in effective tax burdens, and in fact could actually result in wider gaps in effective tax rates. To see why, consider the following example:

We compare a class 1 building with 3 units and a class 2 building with four units. The *per unit* full market value is the same—\$50,000 per unit. However, the tax on the class 1 building is only \$1,393, compared to \$5,396 for the class 2 building. The effective tax rate (tax as percent of market value) is 0.93 percent for the class 1 building and 2.7 percent for the class 2 building—nearly 3 times greater, despite the fact that the class 2 building’s market value is only one-third more than the class 1 building.

	Class 1	Class 2	Ratio, Cl. 2 to Cl. 1
Number of units	3	4	
Units receiving abatement	1	2	
Full market value, per unit	\$50,000	\$50,000	
Full market value, building	\$150,000	\$200,000	1.33
Assessment ratio	8%	25%	
Assessed value	\$12,000	\$50,000	4.17
Tax rate	11.609%	10.792%	
Tax before abatement	\$1,393	\$5,396	3.87
Effective tax rate	0.93%	2.7%	2.91
Annual abatement	\$1,200	\$2,880	
Tax after abatement	\$193	\$2,516	13.03
Effective tax rate	0.13%	1.26%	9.77
Percent reduction	- 86.1%	- 53.4%	

Consider now the effect of the abatement. We assume that both landlords agree to rent a unit (two units in the class 2 building) for \$800 per month, but that the fair market rental value is \$1,000. Fifty percent of the difference is credited as an abatement for the class 1 building, reducing its tax to \$193—0.13 percent of full market value. The abatement for the class 2 building is equal to sixty percent of the difference, or \$2,880 for two units for a full year, which reduces the tax on the class 2 property to \$2,516, or 1.26 percent of full market value. The ratio of the class 2 tax to the class 1 tax, however, is greater after the abatement than it was before the abatement, and the effective tax rate is nearly ten times greater for the class 2 building.

Note also that the lower the actual rent is relative to the fair market rental value, the wider the disparity in after-abatement taxes per unit.

Only a credit that captured the full difference in effective tax rates would preserve the current ratio and result in equivalent percentage reductions in per unit taxes. For example, to achieve comparable reductions in tax burden in the example above would require roughly a 30 percent abatement for the class 1 unit—a rate that may be too low to attract much participation among class 1 property owners, thereby reducing the protection for tenants that the legislation seeks. Alternatively, the class 2 abatement could be made greater

Administration: Fraud. The legislation's intention is to reduce the incentive to raise rents. The existence of the abatement, however, creates some incentives and opportunities for fraud.

Section 5 of the law gives the administering agency the right to revoke or terminate fraudulent abatements or claims based on a misrepresentation of the actual rent paid (it does not, however, provide for any criminal penalty). This provision is intended to protect against outright fraud—cases where the landlord claims to be charging a lower rent than he actually is.

A subtler form of “fraud” is also possible: The existence of the abatement may propel landlords who did not intend to raise rents to neighborhood fair market levels (however determined) to claim the abatement anyway. There is little protection against such claims because there is no way to prove the landlord's intentions. In fact, such a claim would not constitute fraud under the law. The result could be, therefore, that some landlords would be “rewarded” for behavior that they would have continued even in the absence of the abatement, at a cost to the city in foregone property tax revenue—in some cases, perhaps even entirely eliminating property tax liability.

Abatement Increase. Section 2 of the bill provides that the tax abatement would increase at 3 percent of the annual rent for the eligible unit for each year a lease was extended to the same household at below fair market rental value. This provision is intended to reward landlords for renewing leases for the same tenant over a period of years by protecting the landlord against a declining abatement.

In cases where actual rent were to grow at a *slower* rate than the growth in FMR, the *difference* between FMR and actual rent would grow at a *faster* rate than FMR, and this provision of the law would limit the rate of growth of the abatement to *below* the rate of growth of the difference.

In cases, however, where rent were to grow at a *faster* rate than FMR growth (while remaining below FMR), the difference between FMR and actual rate would grow at a negative rate (i.e., decline), because it would be steadily shrinking. In such cases, this rule would result in growth in the abatement that would not occur if the abatement were simply calculated on the basis of the difference between FMR and actual rent in each year.

In other words, the 3 percent growth provision would serve as a *floor* for the increase when actual rents grow by more than FMR, and as a *ceiling* for the increase when rents grow more slowly. The effect of this is to reward landlords with higher abatements when they increase actual rents by *more* than the growth in FMR, and reduces their abatement when they increase

actual rents by *less* than the growth in FMR, compared to what the abatement would have been if it were simply calculated on the basis of the difference between FMR and actual rent in each year. (See endnote 3 for an illustration). One possible way to strengthen the incentive to hold down the growth in annual rent would be to set the abatement at the lesser of either the simple abatement (50 or 60 percent of the difference between actual rent and FMR) or as the previous year's abatement plus 3 percent of current annual rent.

End Notes

1. A qualifying unit is one in a building with five or fewer total units, occupied by a household making no more than 80 percent of area median income and paying more than 30 percent of income in rent, for which the landlord was charging less than the HUD-established fair market rent (\$891 per month in 1999). The rent figure we used was the HVS "contract rent." The HUD proposed FMR for the New York metropolitan region for 2003 is \$1,031.
2. The estimates are calculated based on the number of qualifying class 1 and class 2 units in HVS sub-borough areas meeting the conditions defined in the text. The abatement value is calculated based on the adjusted fair market rental value less the mean contract rent for that sub-borough. Fair market rental value was adjusted by multiplying the HUD FMR for 1999 of \$891 by the ratio of the sub-borough mean contract rent to citywide mean contract rent. As an example: mean monthly contract rent citywide for rental units in 1 to 5-unit buildings was \$632. The 1999 mean contract rent in the Park Slope/Carroll Gardens area of Brooklyn (corresponding to Brooklyn Community Board 6) was \$762, or 121 percent of the citywide mean. We therefore used 121 percent of FMR—1.21 times \$891, or \$1,075—as the fair market rental value for that sub-borough area. The average annual abatement for a class 2 unit is therefore calculated as 60 percent of \$1,075 less \$762—\$187—multiplied by 12, or \$2,249. (Although mean average rents of eligible households may not be the same as mean rent for all units in buildings with five or fewer units, the HVS sample size does not allow for a reliable estimate of the eligible sub-population.) We updated these calculations to reflect the growth in FMR between 1999 and 2003 (proposed) of 15.7 percent; the 2003 value would therefore be \$2,603.
3. The following example illustrates how setting the growth of the abatement to the previous year's abatement plus 3 percent of the annual rent results in a lower abatement to landlords who hold the rate of growth of actual rent to below the rate of growth of FMR, compared to simply calculating the abatement as 50 or 60 percent of the difference between FMR and actual rent.

	FMR	Scenario 1: Actual Rent Grows Slower than FMR			Scenario 1: Actual Rent Grows Faster than FMR		
		Rent ^a	Abatement ^b	3 pct rule	Rent ^a	Abatement ^b	3 pct rule
1999	\$891	\$800	\$655	\$655	\$800	\$655	\$655
2003	\$1,031	\$900	\$943	\$759	\$972	\$422	\$764
Annual rate of growth	3.72%	3.00%	9.54%	3.74%	5.00%	-10.42%	3.91%
SOURCE: IBO.							
NOTES: ^a Monthly actual rent. ^b Annual abatement calculated as 60 percent of the difference between FMR and actual rent.							