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Ronnie Lowenstein
DIRECTOR

July 27, 2016

Brooklyn Borough President Eric L. Adams
Brooklyn Borough Hall
209 Joralemon Street
Brooklyn, New York 11201

Dear Borough President Adams,

At your request, the Independent Budget Office has examined the cost of implementing a property tax abatement to help offset an anticipated rise in rents for small commercial tenants as the recently approved East New York rezoning is implemented. A new property tax abatement would be enacted to abate a portion of their property tax bill in order to compensate landlords for limiting rent increases for their tenants. The structure would be similar to the current Senior Citizen Rent Increase Exemption (SCRIE), which protects qualifying rent-regulated tenants by freezing their rent. The East New York commercial rent abatement would benefit tenants with 100 or fewer employees. Under this definition of a small business there are currently 218 small businesses in the East New York rezoning area, with 96 percent having 25 or few workers.

IBO estimates that it would it cost between $4.4 million and $10.6 million per year, depending on how fast commercial rents and property values grow in the area. Note that our cost estimate pertains only to an abatement targeted at the East New York rezoning area. If similar benefits were to be offered in other areas of the city undergoing rezoning by the de Blasio Administration, the estimated cost would increase. The attached memo provides additional detail on the assumptions and calculations used in arriving at these estimates.

As discussed in the memo, there are some aspects of the SCRIE program that differ from the hypothetical commercial rent increase abatement modeled by IBO. Most notably, SCRIE protects qualified tenants from increases in regulated rents. But in the case of commercial leases there are no regulations limiting rent increases. Thus, this abatement could have the unintended consequence of allowing landlords to raise commercial rents faster than they otherwise would have when leases for small businesses expire, with the city covering the cost.

If you have further questions, please feel free to contact me at 212-442-0225 or RonnieL@ibo.nyc.ny.us. Alternatively, please contact George Sweeting, IBO's deputy director at 212-341-6044, or GeorgeS@ibo.nyc.ny.us.

Sincerely,

Ronnie Lowenstein

MEMORANDUM

Date: **July 16, 2016**

To: **George Sweeting**

From: **Geoffrey Propheter**

Subject: **Cost of a Property Tax Abatement to Freeze Small Business Rents in East New York Rezoning Area**

Introduction

Brooklyn Borough President Adams requested that IBO provide a cost estimate for a proposed property tax abatement that would freeze rents for small businesses in the East New York rezoning area. The structure of the suggested abatement mirrors that of existing programs that freeze rents for senior citizen and disabled tenants.[1] The intention of the proposal is to ensure that commercial property tax increases resulting from rezoning do not harm the ability of existing small businesses to remain in the area.

Under the Borough President's proposal, landlords with small business tenants in the rezoning area would receive an abatement to offset increases in rents. Small business tenants would remain liable for the rent set at the level prior to the rezoning while the city provides an abatement to the landlord equal to the difference between the imposed and pre-rezoning rents. The abatement would last for 35 years, the same amount of time affordable housing would have received a property tax exemption under the recently suspended 421-a program.

IBO identified 218 small businesses—those with 100 or fewer employees—operating in the rezoning area at the end of 2013. Of these, 96 percent were micro businesses—those with 25 or fewer employees. Based on historical trends in commercial property taxes and various assumptions about future tax growth, IBO estimates a property tax abatement for these small businesses would cost between $4.4 million and $10.6 million a year over the proposed benefit period. Our estimates do not account for the possibility that the existence of the property tax abatement may lead landlords to charge higher rents, in which case we will have underestimated the annual cost of the abatement.

It is Mayor de Blasio's intention to replicate the East New York rezoning vision and process in other neighborhoods such as East Harlem. IBO's analysis does not consider the cost of applying the proposed abatement to other prospective rezonings being carried out in conjunction with the Mayor's mandatory inclusionary housing initiative. Though it is likely that if such an abatement were enacted it would cover all such rezoned areas citywide, the cost estimate provided in this analysis cannot be extrapolated to other areas of the city. Estimating the cost of an abatement available in all rezoned areas would require analysis of the characteristics of each neighborhood individually.

Methodology

To estimate the cost of an abatement for small businesses, IBO first needed to determine what constitutes a small business. The U.S. Small Business Administration defines a small business differently for different types of businesses but generally defines them as any firm employing less than 500 people.[2] New York State law is more restrictive and defines a small business as any firm employing less than 100 people.[3] New York State law further identifies a subclass of small businesses called micro businesses that employ 25 or fewer people.[4] IBO calculated cost estimates for micro businesses and all other small businesses based on New York State law.

IBO collected business, employment, and wage data for firms in the East New York rezoning area using the Quarterly Census of Earning and Wages (QCEW) maintained by the New York State Department of Labor. We used data from calendar year 2013, which is the most recent full year of data we have available, and further restrict the dataset to only those businesses still operating at the end of the year. A limitation of the QCEW is that it does not distinguish between part-time and full-time employment. Because the state's definition of a small business does not depend on employment status, however, failing to distinguish part-time from full-time employment would not affect our cost estimates. A second limitation of QCEW data is that it only contains data on businesses whose workers are covered by unemployment insurance laws. As a result, self-employed independent contractors are not included in the data. IBO has no information on how many of these businesses are headquartered in commercial real estate in East New York and would therefore be eligible for the rent freeze.

IBO collected property tax data from the city's tax roll maintained by the Department of Finance. Implied in the Borough President's proposal is the assumption that businesses, in their capacity as tenants, will bear some portion of an increase in property taxes due to development in the East New York rezoning area, a cost passed on most likely through increased rents. This suggests IBO would need to know how much of a tax increase is actually passed on to tenants through rent in the rezoning area, which would require a separate analysis well beyond the scope of the Borough President's request.

Instead, IBO assumes that the share of the tax passed on to commercial tenants is the same before and after the rezoning. This does not mean that rents do not increase, but rather that any increase is due entirely to a property tax increase rather than to other changes that affect the supply of and demand for commercial space—and therefore rents—in the rezoning area. The effect of this simplifying assumption is that we only need to estimate what taxes would be in the area with and without the rezoning. By assuming all increases in rent are due to increases in property taxes, the marginal increase in taxes reflects the marginal increase in rents—the difference being the abatement amount necessary to keep post-rezoning rents at pre-rezoning levels.[5]

In addition, businesses enter and exit the market over time as economic conditions change. It is impossible to know which existing businesses will remain in the rezoning area for the duration of the proposed 35-year abatement. For the purpose of estimating the abatement cost, IBO used the simplifying assumption that all businesses eligible for the abatement—those operating prior to the rezoning as of December 2013—continue to operate over the next 35 years. As eligible businesses exit the market over time, however, the cost of the abatement will fall, and thus this assumption produces an overestimate of the abatement's lifetime cost.

Unless otherwise noted, all dollar values are expressed in present terms using a 4 percent discount rate.

Overview of Small Businesses in East New York Rezoning Area

IBO identified 218 small businesses operating in the East New York rezoning area in 2013. Of these, 96 percent were micro businesses. Retail trade accounted for a little more than one-third of the micro businesses, with professional and personal service businesses composing another 24 percent and lodging and food services another 14 percent.

Nearly Every Business in the East New York Rezoning Area in 2013 Employed 25 or Fewer Workers

	Micro Businesses		Other Small Businesses	
Business Sector	**Number of Businesses**	**Average Annual Wage**	**Number of Businesses**	**Average Annual Wage**
Accommodation, Food Services, and Recreation	30	$14,000	0	-
Construction	10	34,700	0	-
Health Care and Social Assistance	7	30,000	3	47,800
Manufacturing	13	27,300	0	-
Professional and Personal Services	50	19,600	1	28,400
Real Estate, Finance, and Insurance	8	35,400	0	-
Retail Trade	73	25,600	1	15,200
Transportation and Warehousing	7	25,700	4	39,900
Wholesale Trade	11	42,800	0	-
Total	**209**	**$25,500**	**9**	**$39,300**

SOURCE: Bureau of Labor Statistics
NOTE: Includes both full- and part-time employees.

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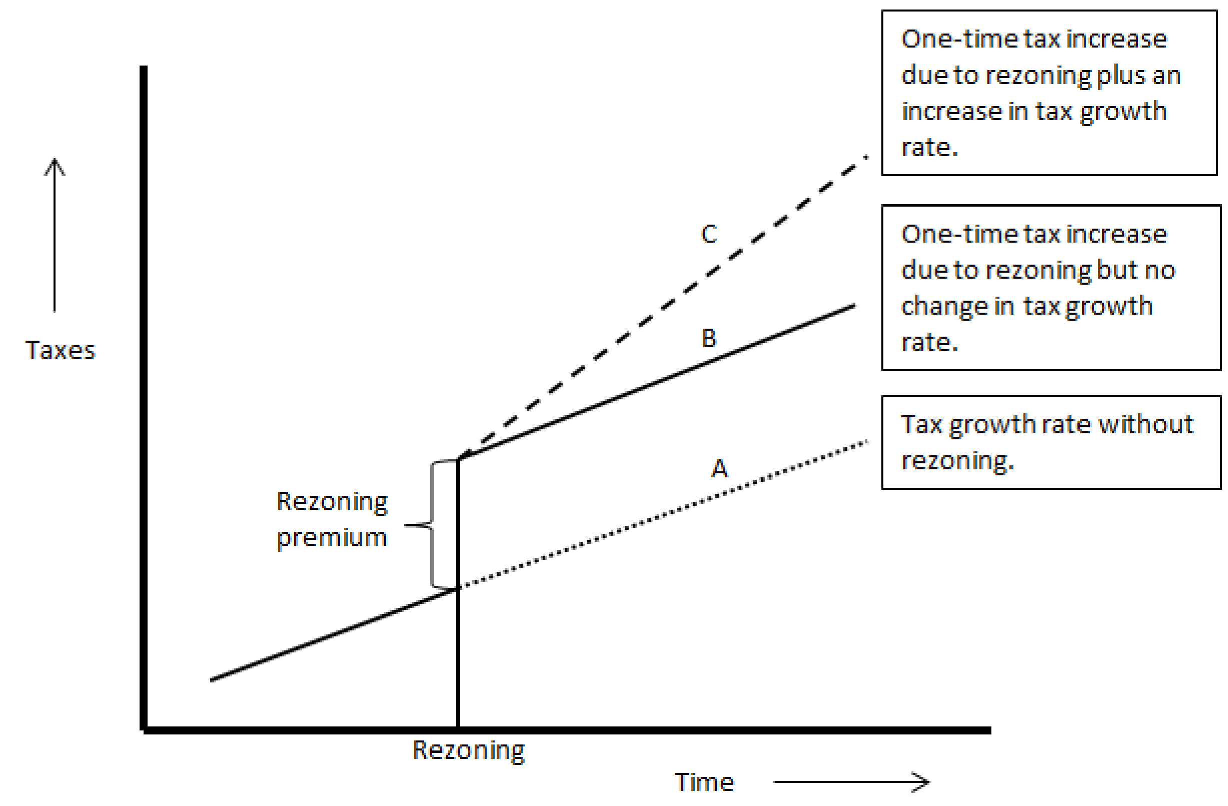
Cost to the City of a Commercial Property Tax Credit

As previously discussed, based on our simplifying assumption that all increases in rent are due to property taxes, it was necessary to determine what commercial property taxes would be in the rezoning area with and without rezoning. The difference is the cost of the abatement.

To estimate the property taxes that would be collected without the rezoning, we calculated the inflation-adjusted median property tax liability per square foot for all property in the rezoning area over a 22-year period, from 1994 through 2016.[6] IBO assumes that without rezoning, taxes would have continued increasing each year over the proposed 35-year abatement period at their 22-year average rate of 9.4 percent a year (line A in the graph). After applying this growth rate to the property taxes levied on landlords housing the 218 small businesses in the rezoning area over the next 35 years, we estimate that taxes would have been $150.5 million, or $4.3 million a year, without rezoning.[7]

The Cost of the Proposed Property Tax Abatement Equals The Difference Between What Taxes Would Have Been Without Rezoning and What They Will Be With Rezoning



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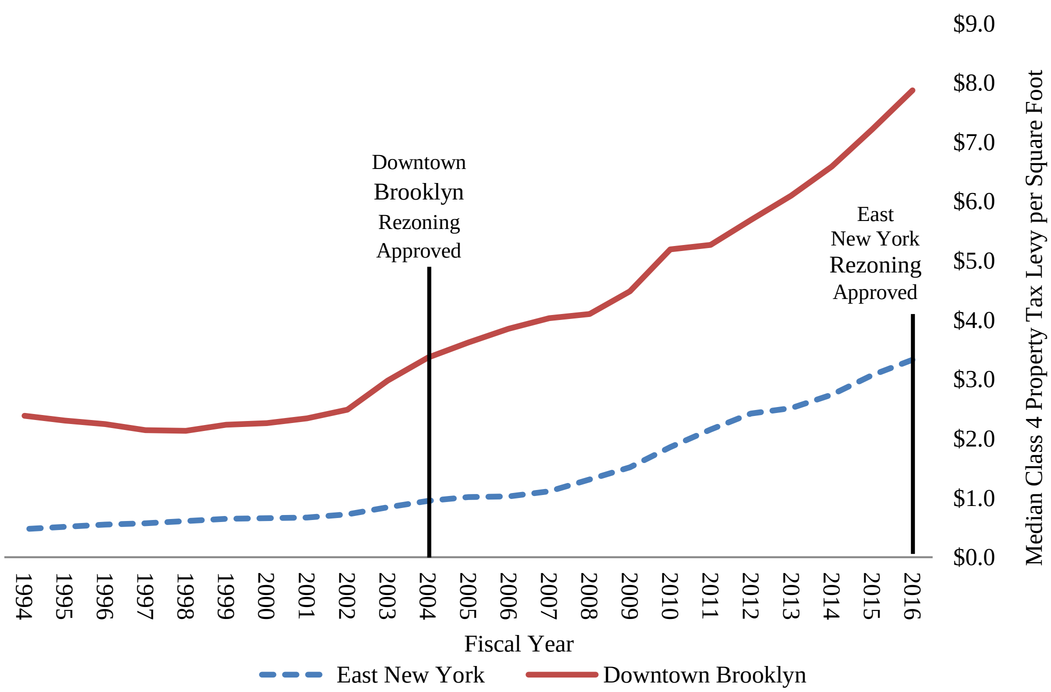
In IBO's simplified model, rezoning affects city tax revenues in one of two ways. First, it could result in only a one-time increase in tax collections—labeled the rezoning premium—that leaves the growth rate of taxes at its long-run average of 9.4 percent per year (line B). Alternatively, rezoning could result in a one-time increase in tax revenue coupled with an increase in the annual rate of growth of taxes in excess of the growth that would have occurred without rezoning (line C). The cost of the proposed property tax abatement depends on the assumptions made about both the size of the rezoning premium and any changes in the rate of revenue growth. In the event there is no tax premium and taxes grow at the same rate they would without rezoning, the proposed abatement would equal zero because rezoning would not have caused a change in taxes, thus negating the purpose for the abatement.

To determine if a rezoning could result in a tax premium, IBO considered the case of Downtown Brooklyn, where rezoning was approved by the City Council in June 2004. IBO estimates that the median property tax per square foot for commercial properties in current dollars is $1.33 greater because of the rezoning.[8] At the average annual median tax after the rezoning, the rezoning premium in Downtown Brooklyn was 36 percent. Given differences in demand and neighborhood amenities, such as access to Brooklyn Bridge Park and Manhattan, it is unreasonable to expect East New York to experience as large a zoning premium. Instead, we adjusted the premium downward by the ratio of the median commercial tax per square foot in the two rezoned areas in 2016, resulting in an estimated commercial tax premium in East New York of 16 percent.

As in Downtown Brooklyn, Median Commercial Taxes in the East New York Rezoning Area Had Been Increasing in Real Terms Before Rezoning Was Approved



SOURCES: Department of Finance, Department of City Planning

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IBO does not know how the rezoning will affect the rate at which taxes grow. In both Downtown Brooklyn and East New York, inflation-adjusted median commercial property taxes were on upward trajectories prior to rezoning. At a minimum, it is reasonable to expect taxes in the East New York rezoning area to continue increasing at their historical average rate of 9.4 percent a year after rezoning, implying that the only increase in taxes is the premium due to rezoning. If rezoning prompts additional commercial investment that drives more rapid growth in taxes than what they would have been without rezoning, we would expect to see growth in the long run exceed 9.4 percent.

IBO modeled the rate of growth in property tax revenues under two scenarios. Under our low-growth scenario we assume that over the proposed 35-year abatement period, median collections per square foot grow at the same rate as over the prior 22 years—9.4 percent a year on average. Under our high-growth scenario, we assume that collections grow at the same average annual rate commercial property taxes in East New York have grown since 2010, the first fiscal year after the Great Recession. The 22-year average masks wide variation in growth rates before and after the recession. From 1994 through 2009, median taxes per square foot in the East New York rezoning area grew an average of 8.2 percent a year. Since 2010, however, annual increases in median taxes in East New York have averaged 12.0 percent. Under our high-growth scenario, we assume tax collections continue to grow at an average rate of 12.0 percent.

Based on IBO's low-growth scenario, we estimate that taxes for small businesses in the rezoned area over the next 35 years will total $304.2 million, an estimate reflecting the projected zoning premium but no additional tax growth beyond the 9.4 percent average growth over the past 22 years. In the high-growth scenario, IBO estimates taxes would total $521.4 million. Over the proposed 35-year abatement period, the annual cost of the abatement would be between $4.4 million and $10.6 million.

IBO Estimates a Property Tax Abatement to Freeze Rents at Pre-Rezoning Levels Would Cost $4.4 million to $10.6 Million a Year
2016 dollars in millions

Business Sector	Number of Small Businesses	Low-Growth Abatement	High-Growth Abatement
Accommodation, Food Services, and Recreation	30	$4.3	$22.7
Construction	10	5.7	14.8
Health Care and Social Assistance	10	26.8	67.6
Manufacturing	13	25.5	49.1
Professional and Personal Services	51	18.3	48.2
Real Estate, Finance, and Insurance	8	8.7	15.0
Retail Trade	74	46.3	106.9
Transportation and Warehousing	11	7.7	18.5
Wholesale Trade	11	10.6	28.1
Total Over 35 years	**218**	**$153.8**	**$370.9**
Abatement Per Year		$4.4	$10.6

NOTE: Values may not add due to rounding.

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Potential Unintended Consequence

Our estimates do not account for possible behavioral responses to a property tax abatement to freeze rents. Knowing they will collect the full rent charged small businesses, landlords have an incentive to increase rents when leases expire in excess of the amount their property taxes increase each year. In the analogous rent freeze programs for senior citizen and disabled tenants, landlords do not have the opportunity to act similarly because program eligibility requires that tenants occupy rent-stabilized apartments. Because rent increases are restricted by law in such cases, residential landlords are prevented from increasing rents beyond the regulated level. Commercial tenants do not enjoy a similar form of rent regulation, and thus commercial landlords can increase rents by whatever the market is able to bear. By guaranteeing landlords the difference between actual rent and rent prior to the rezoning, the proposal is providing an incentive to increase actual rents when leases expire in excess of property tax increases. The city would therefore not only be subsidizing small businesses' rents but also landlords' operations by oversupplying tax relief. Adopting commercial rent limits, which have been debated by city policymakers from time to time since at least the 1980s, would lower the cost of the abatement but would also reduce citywide property tax revenue because commercial businesses are valued for tax purposes on the income they generate.[9]

IBO has no way to determine how landlords would respond to the incentives arising jointly from the abatement and the absence of restrictions on increases in commercial rents. However, we expect profit-maximizing landlords to increase rents in excess of what they would have been without the abatement to one degree or another. It is thus appropriate to consider our abatement cost estimates as understating the actual costs to the city—or more precisely, to all other commercial taxpayers—if the abatement were adopted as proposed.

Endnotes

[1]The Senior Citizen Rent Increase Exemption (SCRIE) and Disability Rent Increase Exemption (DRIE) have eligibility criteria restricting the benefit to tenants earning less than $50,000 a year and having a monthly rent-income ratio exceeding 30 percent. There are currently no business income or rent-burden eligibility criteria included in the small business abatement proposal IBO analyzed for Borough President Adams.
[2]For detailed employment standards promulgated by the Small Business Administration for businesses by sector, see https://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf
[3]See New York Economic Development Law, Article 4-B, §131.
[4]See New York Economic Development Law, Article 4-B, §134(12).
[5]It is unlikely that commercial tenants bear the full cost of a property tax increase. By implication, our methodology will overestimate the amount needed to actually freeze rents at pre-rezoning levels, because a portion of the property tax increase will fall on landlords, who are not intended beneficiaries under the Borough President's proposal. For empirical evidence, see McDonald, J. F. (1993). Incidence of the property tax on commercial real estate: the case of

downtown Chicago. *National Tax Journal*, 46(2): 109-120; Man, J. Y. (1995). The incidence of differential commercial property taxes: Empirical evidence. *National Tax Journal*, 48(4): 479-496.

[6]While the 1994 starting point is somewhat arbitrary, it marks the fiscal year where we see a bit more meaningful growth in annual taxes in the rezoned area in real terms. From 1985—the first year we have reliable property data for—to 1993, property tax growth was minimal.

[7]A number of small businesses occupy commercial space in mixed-used housing. For example, a four-unit building may house two residences and two commercial businesses. To estimate the commercial tenants' share of the building's total tax bill, we first apportioned the levy between the commercial and residential tenants according to square feet, and then we apportioned the commercial levy between the two businesses according to the number of employees. The second apportionment was only used if we did not know how much square footage a particular commercial tenant occupied.

[8]The estimate was obtained through the use of difference-in-difference methodology. The comparison group was the portion of Brooklyn Community District 2 that was not rezoned.

[9]Commercial rent limits would also lead to economic inefficiency by encouraging relatively less productive businesses to use land that could be employed for more productive purposes.