

# PROPERTY TAXES AND THEIR LIMITS: EVIDENCE FROM NEW YORK CITY

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## INTRODUCTION

The property tax is the largest source of tax revenue for local governments and an irresistible policy instrument for municipalities wanting to influence the urban landscape and the local distribution of income and wealth.<sup>1</sup> But the widespread use of the property tax for planning and redistribution means that virtually no jurisdiction straightforwardly calculates the tax liability for a property as a fixed percentage of its market value.<sup>2</sup> Instead, property tax rates tend to

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1. The U.S. Census reports that, for the twelve months ending March 2013, property tax revenue was greater than any other source of state or local tax revenue. During that period, \$477,773 million in property tax revenue was collected by states and localities. The second highest collection was the individual income tax at \$322,391 million. See U.S. CENSUS BUREAU, QUARTERLY SUMMARY OF STATE & LOCAL TAX REVENUE tbl. 1 (2013), available at <http://www.census.gov/govs/qtax>.

2. The Lincoln Institute for Land Policy's *Significant Features of the Property Tax* database includes comprehensive information on state property tax laws, by year. It is avail-

vary with the use to which a property is put or the identity of its owner. As a consequence, many of the potential benefits of the property tax, such as ease of administration, transparency, the clear reflection of the costs and benefits of local services, and the intuitive fairness of imposing taxes in proportion to property wealth, are lost.<sup>3</sup>

At the same time, each of these rate variations is designed to remedy a perceived defect with taxing only in proportion to property value. In this Article I report empirical evidence on the distributional effects of one such deviation: caps on annual assessment increases. Assessment caps limit the rate at which a property owner's taxes can increase from year to year, and are ubiquitous.<sup>4</sup> From a policy perspective, assessment caps are designed to create neighborhood stability and prevent cash-poor homeowners from being forced out of their homes because of escalating property values. I find that, in New York City, property tax caps on small residential properties represent a significant tax benefit that accrues to the most valuable properties and in the wealthiest neighborhoods. Moreover, rather than benefiting long-time homeowners on fixed incomes, who are their putative targets, the largest benefits go to the properties that are *most* likely to have been recently sold and to be located in neighborhoods where cash incomes have increased the most.

My study provides a more comprehensive and detailed description of who benefits from assessment caps than has previously been reported. This study is also the first to examine how the neighborhoods that benefit the most from assessment caps have changed over time. One justification for assessment caps is to foster neighborhood stability, particularly for cash-poor households, yet previous work has not explored how the dynamics of neighborhood change correlated with assessment caps.<sup>5</sup> Part I describes the context in which assessment caps were popularized: one of widespread dissatisfaction with particular features of the property tax. Part II describes how assessment caps proliferated in response to taxpayer frustration and the harms that they were meant to address. In Part III, I report the original results from my study of assessment caps in

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able at LINCOLN INST. OF LAND POL'Y, <http://www.lincolnst.edu/subcenters/significant-features-property-tax> (last visited Mar. 28, 2014).

3. See Joan M. Youngman, *The Variety of Property Tax Limits: Goals, Consequences and Alternatives*, 46 ST. TAX NOTES 541, 542 (2007). These benefits are in addition to the efficiency and equity advantages of a system of uniform market value taxation. See, e.g., Richard F. Dye, Daniel P. McMillen & David F. Merriman, *Illinois' Response to Rising Residential Property Values: An Assessment Growth Cap in Cook County*, 59 NAT'L TAX J. 707, 712-15 (2006) ("Economic principles of equity and efficiency (not to mention administrative simplicity) suggest that property should be assessed uniformly with respect to its market value . . . a system that allows significant deviations from uniformity is sure to breed hostility and disrespect.").

4. Twenty states impose property tax limits of various kinds. MARK HAVEMAN & TERRI A. SEXTON, LINCOLN INST. OF LAND POL'Y, PROPERTY TAX ASSESSMENT LIMITS 11 (2008), available at [http://www.lincolnst.edu/pubs/1412\\_Property-Tax-Assessment-Limits](http://www.lincolnst.edu/pubs/1412_Property-Tax-Assessment-Limits).

5. For a summary of this literature see *infra* Part II.B.

New York City, and in Part IV I evaluate how well the caps have achieved their purposes. I find that, in the case of New York City's property tax caps, the cure for what ails the property tax has been worse than the disease, and I propose either a means-tested circuit breaker or a property tax deferral regime to address the liquidity issues facing truly cash-poor homeowners without conferring an unnecessary and expensive tax benefit on other households.

### I. WHY ARE PROPERTY TAXES SO HATED?

The property tax is one of the most hated taxes in the United States.<sup>6</sup> A number of reasons have been offered for its unpopularity: (i) it is very salient to property owners,<sup>7</sup> (ii) valuation can seem arbitrary or, worse, discriminatory,<sup>8</sup> and (iii) it is often perceived as regressive, imposing relatively greater burdens on middle class and lower income households.<sup>9</sup> Perhaps the most common complaint is that property taxes can increase sharply from year to year with changes in property values.<sup>10</sup> This raises a puzzle. An individual's income taxes can also increase from one year to the next with increases in her income, yet those fluctuations do not create the same frustration. If tax variability were something that taxpayers disliked, one might expect at least as much resistance to it in the case of the income tax. However, there are no smoothing provisions under the income tax to mitigate the effects of wage income volatility and no

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6. See, e.g., TAX FOUND., SPECIAL REP. NO. 166: HOW DO AMERICANS FEEL ABOUT TAXES TODAY? (2009), available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr166.pdf> (reporting survey evidence that the property tax is viewed as less fair, on average, than all taxes other than gas taxes and the federal estate tax).

7. HAVEMAN & SEXTON, *supra* note 4, at 3 (asserting that property taxes face more scrutiny because they are more visible). There is also evidence that increasing the salience of the property tax increases opposition to it. Marika Cabral & Caroline Hoxby, *The Hated Property Tax: Salience, Tax Rates, and Tax Revolts* (Nat'l Bureau of Econ. Research, Working Paper No. 18514, 2012); Andrew T. Hayashi, *The Legal Salience of Taxation*, U. CHI. L. REV. (forthcoming). However, there does not appear to be any evidence to substantiate the comparative claim that property taxes are *more* salient than income taxes.

8. See Michael A. Pagano & Benoy Jacob, *Framing the Political Economy of Property Taxation and Land Taxation*, in CHALLENGING THE CONVENTIONAL WISDOM ON THE PROPERTY TAX 269, 274 (Roy Bahl, Jorge Martinez-Vazquez & Joan Youngman eds., 2010). For evidence of the correlation between homeowner race and property assessment, see Lee Harris, 'Assessing' Discrimination: The Influence of Race in Residential Property Tax Assessments, 20 J. LAND USE & ENVTL. L. 1 (2004).

9. This view is sometimes held at even the highest levels of state government. See, e.g., Press Release, Myron Frans, Revenue Comm'r, Minn. Dep't Revenue, Statement from Commissioner Frans on Preliminary Property Tax Levies for 2014 (Nov. 12, 2013), available at [http://www.revenue.state.mn.us/newsroom/Documents/20131112\\_PropTaxLevy\\_TNT\\_Statement.pdf](http://www.revenue.state.mn.us/newsroom/Documents/20131112_PropTaxLevy_TNT_Statement.pdf) ("Property taxes are regressive, disproportionately affecting middle-class Minnesotans, and are levied without taking into account a taxpayer's income or ability to pay the tax.").

10. James Alm, *A Convenient Truth: Property Taxes and Revenue Stability*, 15 CITYSCAPE 243 (2013).

apparent taxpayer agitation for them. It seems like tax variability is not, in itself, a sufficient explanation for why the property tax is so hated.

A likely explanation lies in the fact that income generated by an increase in property value is not accompanied by cash to pay the property owner's tax liability.<sup>11</sup> Income without cash is known as "phantom income" and is, for many taxpayers, as scary as it sounds because it may require the liquidation of the taxpayer's assets, or borrowing secured by those assets, to pay the tax bill. In general, federal income tax law is reluctant to require individual taxpayers to pay tax on non-cash income. As a consequence, income is not taxed until it is recognized, which, for cash-basis taxpayers, typically happens upon an event that also provides them with cash. For example, a taxpayer holding appreciated stock has income, but does not pay tax on that income until it is recognized, such as upon disposition of the stock. In the absence of a recognition requirement the taxpayer might be forced to sell some of her stock in order to get the cash to pay her tax bill. Property taxes do not have a recognition requirement. When a property increases in value, a homeowner's tax bill generally goes up even if their cash income has remained unchanged. This taxation of "paper gains" is very unpopular.<sup>12</sup>

The phantom income issue is more complex in the case of the property tax. It is often not feasible to sell a piece of the property to raise cash for a tax payment, and there is strong political resistance to the idea that homeowners should have to sell their homes if they cannot afford the property tax payments.<sup>13</sup> Moreover, in contrast to the case of marketable securities, homeowners often value their properties in more complex ways than they value stocks or bonds, which are generally held solely for their income-generating potential. Many owners have sentimental and emotional attachments to their properties that make selling them a more traumatic proposition than selling part of their investment portfolio. There are also significant financial costs involved in the selling of real property and emotional costs involved in relocation, particularly for families with school-age children. These concerns helped motivate a wave

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11. When a property increases in value its owner has income in the amount of the increase. Additionally, an owner who occupies her property derives imputed income from living in the property rent-free.

12. As one commentator has noted, "the most difficult issue" in implementing a system of mark-to-market taxation for federal income tax purposes is "the psychological concern of taxing paper gains." David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 109 TAX NOTES 1047, 1053 (2005).

13. See, e.g., Youngman, *supra* note 3, at 545 ("The political impetus for Save Our Homes, as its name implies, drew heavily on fears that unrestricted value-based taxes could increase to the point of threatening homeowners, particularly senior citizens, with the loss of their residences."). One option available to certain older homeowners is the Department of Housing and Urban Development's Home Equity Conversion Mortgage Program. The program allows older homeowners to extract their home equity to pay property tax and other bills. For a discussion of this option, see NAT'L CONSUMER LAW CTR., THE OTHER FORECLOSURE CRISIS 10 (2012), available at <http://www.nclc.org/issues/the-other-foreclosure-crisis.html>.

of limitations on property taxes that began thirty-five years ago and continues to this day.

## II. TAKING THE EDGES OFF WITH ASSESSMENT CAPS

### A. *The Proliferation of Assessment Caps*

Beginning in 1978 with the adoption of Proposition 13 in California, jurisdictions across the country have imposed limits of various kinds on property taxes.<sup>14</sup> Some of these are limits that apply on a jurisdiction-wide basis, such as limiting the total amount of revenues that can be collected, or restricting the property tax rate.<sup>15</sup> In other cases these limits apply at the level of individual properties to restrain year-to-year increases in their assessed (taxable) values. As of 2008, eighteen states had limits that applied to individual property assessments.<sup>16</sup>

One commentator notes that “[t]he popularity of [individualized] assessment limits is due, in part, to the perception that they will prevent sudden increases in property tax bills . . . . Voters fear that the elderly, especially those on fixed incomes, will be forced from their homes.”<sup>17</sup> Joan Youngman suggests that the imposition of property tax limits is not surprising in light of the fact that “increases in annual payments can be unpredictable, highly visible, and un-

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14. Richard F. Dye & Therese J. McGuire, *The Effect of Property Tax Limitation Measures on Local Government Fiscal Behavior*, 66 J. PUB. ECON. 469, 469 (1997). (“Beginning with Proposition 13 in California in 1978, there has been a wave of tax and expenditure limitation measures across the United States.”). For empirical research attempting to explain the reasons for the wave of tax and expenditure limitations, see James Alm & Mark Skidmore, *Why Do Tax and Expenditure Limitations Pass in State Elections?*, 27 PUB. FIN. REV. 481 (1999) (finding that increasing state income and increases in property taxes and local revenues relative to state revenues are associated with increased likelihood of passing limits); David M. Cutler, Douglas W. Elmendorf & Richard Zeckhauser, *Restraining the Leviathan: Property Tax Limitation in Massachusetts*, 71 J. PUB. ECON. 313, 332 (1999) (examining voting data related to passing and subsequent overrides of Proposition 2.5 in Massachusetts); Judy A. Temple, *Community Composition and Voter Support for Tax Limitations: Evidence from Home-Rule Elections*, 62 S. ECON. J. 1002 (1996) (arguing that state limits on local fiscal decisions are preferred by voters in localities with greater variation in socioeconomic characteristics because of greater dissatisfaction with the collective decision-making process); Jacob L. Vigdor, *Other People’s Taxes: Nonresident Voters and Statewide Limitation of Local Government*, 47 J. L. & ECON. 453 (2004) (arguing that taxpayers support statewide tax limitations to lower rates in other communities).

15. For a general discussion of the types of tax caps, see Youngman, *supra* note 3. California is perhaps the most well-known example of a state with a cap on property tax rates. CAL. CONST. art. 13A, § 1(a) (limiting tax rate on real property to 1% of its full cash value). Massachusetts, for example, limits the total amount of property tax revenue collections as a function of property values. MASS. GEN. LAWS ch. 59, § 21C(b) (2007) (limiting municipal taxes assessed to 2.5% of the cash value of real estate and personal property).

16. HAVEMAN & SEXTON, *supra* note 4, at 14.

17. *Id.* at 22.

related to cash income.”<sup>18</sup> Nathan Anderson argues that the caps serve as insurance against unexpected increases in property value.<sup>19</sup> Anderson notes that, as of 2006, six states had voted to cap increases in assessments after already having revenue limits in place,<sup>20</sup> suggesting that factors beyond limiting the size of local government motivate adopting caps.

The introduction of property-level caps on assessment increases introduces another difficult decision: whether to reassess properties at their full market values when they are sold. Both California’s Proposition 13 and Florida’s Save Our Homes law, for example, permit annual adjustments to assessed values at the lower of a specified rate and the rate of inflation.<sup>21</sup> Assessments are then reset to market value upon the sale of the properties. This reset discourages long-time homeowners from moving out of houses that may no longer be suitable for them, on account of the large increase in taxes that they would likely owe upon purchasing another home.<sup>22</sup> This lock-in effect results in an inefficient allocation of housing. Arizona, Minnesota, New York City, and Oregon, on the other hand, do not reset assessed values upon a sale,<sup>23</sup> avoiding lock-in but generating persistent differences between property values and tax liabilities, thereby undermining the correspondence that is the foundation of the property tax.

#### B. Assessment Caps Are Tax Expenditures

Whereas jurisdiction-wide limits on aggregate assessments or tax rates only limit tax revenues, property-level caps on assessment increases also redistribute the property tax burden. The effect is easily illustrated with a simple example. Suppose that a jurisdiction generally taxes property at a rate of 5% of its assessed value, and that the assessed value of a property generally equals its

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18. Youngman, *supra* note 3, at 541.

19. Nathan B. Anderson, *Property Tax Limitations: An Interpretive Review*, 59 NAT’L TAX J. 685, 687 (2006).

20. *Id.* at 692.

21. Youngman, *supra* note 3, at 543. California’s law limits both the overall tax rate and the rate of assessment increases. The wide disparities in effective tax rates generated by the system were challenged but ultimately upheld. *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

22. See Fernando Ferreira, *You Can Take It with You: Proposition 13 Tax Benefits, Residential Mobility, and Willingness to Pay for Housing Amenities*, 94 J. PUB. ECON. 661 (2010) (finding that mobility for fifty-five-year-olds is 25% higher than for comparable fifty-four-year-olds, where fifty-five is the age at which homeowners can take their assessed value with them when they move); Nada Wasi & Michelle J. White, *Property Tax Limitations and Mobility: The Lock-In Effect of California’s Proposition 13* 20-21 (Nat’l Bureau of Econ. Research, Working Paper No. 11108, 2005), available at <http://www.nber.org/papers/w11108> (reporting that from 1970-2000 the average tenure length of owners and renters in California increased by 1.04 years and 0.79 years, respectively, relative to the homeowners and renters in control states, and attributing this to the lock-in effect).

23. HAVEMAN & SEXTON, *supra* note 4, at 14.

market value but cannot increase by more than 10% per year. Consider two properties, one worth \$200,000 and the other worth \$160,000. The property taxes amount to \$10,000 for the first property and \$8000 is due with respect to the second. The first property accounts for 56% of the aggregate property value and 56% of the tax revenue.

If in the following year the value of the first property remains unchanged but the second property has appreciated in value to \$200,000 then the tax on the first property will remain \$10,000 but the tax on the second property will only be \$8800 because its assessed value is capped at \$176,000. Now, the first property shoulders a disproportionate burden because it accounts for 50% of the total property value but 53% of the tax revenue. If the appropriate normative baseline for the property tax involves taxing all properties proportionally to their values, then the difference between the property tax that would be due from the second property if it were assessed at its full market value and the actual tax due should be viewed as a property tax expenditure, since it is economically equivalent to taxing that property at its full market value and then issuing a payment to the owner for the difference, which is \$1200 in this case.

Who benefits from assessment caps? The intended beneficiaries are long-term homeowners on fixed incomes who need protection from the vicissitudes of housing markets.<sup>24</sup> There is evidence that assessment caps and other tax benefits in Michigan tend to favor older homeowners with longer tenures, higher incomes and more valuable properties.<sup>25</sup> Scholars looking at the effect of assessment caps in Cook County, Illinois from 2003-2004 find that the benefits of the caps are larger, in dollar terms, in areas with more valuable properties.<sup>26</sup> Although they do not find a relationship between the size of the cap benefit and municipality median income, these researchers use data on 1999 incomes and data on tax benefits from 2003.<sup>27</sup> This lag between measured income and measured tax benefits makes it difficult to infer who is currently benefiting.

In comparison with these prior studies, I provide a more complete and more detailed description of cap beneficiaries, reporting incomes drawn from administrative, rather than survey, sources that are contemporaneous with the measurement of cap benefits. My study is also the first to examine both the cur-

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24. According to Youngman, "many voters feel that a longtime resident who purchased property far in the past at a very modest sum should be protected from unpredictable future valuation increases, but that such protection need not extend to new purchasers with the wherewithal to pay inflated current market prices." Youngman, *supra* note 3, at 545.

25. Mark Skidmore, Charles L. Ballard & Timothy R. Hodge, *Property Value Assessment Growth Limits and Redistribution of Property Tax Payments: Evidence from Michigan*, 63 NAT'L TAX J. 509 (2010); Timothy R. Hodge, Mark Skidmore, Gary Sands & Daniel McMillen, *Tax Base Erosion and Inequity from Michigan's Assessment Growth Limit: The Case of Detroit* (Ctr. for Econ. Studies & Ifo Inst., Working Paper No. 4098, 2013).

26. Dye, McMillen & Merriman, *supra* note 3.

27. RICHARD F. DYE, DANIEL P. McMILLEN & DAVID F. MERRIMAN, UNIV. OF ILL., THE ECONOMIC EFFECTS OF THE 7% ASSESSMENT CAP IN COOK COUNTY (2006), available at <http://igpa.uillinois.edu/system/files/cookcountry7percentassessment.pdf>.

rent beneficiaries of property tax caps as well as the changing nature of the neighborhoods on which property tax caps confer the largest benefits, a necessary inquiry for determining if caps are helping their intended targets.

### III. THE BENEFICIARIES OF PROPERTY TAX CAPS IN NEW YORK CITY

#### A. *Overview of New York City's Property Tax Caps*

Every year, New York City's Department of Finance (DOF) estimates the market value of each one-to-three family home in the city by examining "comparable" properties sold in the prior calendar year. Determining the market value of a property is, however, just the first step in determining its tax liability. The property tax base is a property's "assessed value." DOF currently requires that the assessed value of a one-to-three family home cannot exceed 6% of its market value.<sup>28</sup> However, under state law, the assessed value of a property is also capped over one year and five-year periods. It cannot increase by more than 6% in any one year, or more than 20% over five years.<sup>29</sup> Thus its assessed value is the lesser of (i) 6% of its market value, (ii) 106% of the prior year's assessed value, and (iii) 120% of the assessed value from five years before. Once the assessed value of a property is determined, DOF then subtracts any exemptions to which the property is entitled. The result is the property's billable assessed value. The property tax due for any property is simply the nominal tax rate multiplied by the billable assessed value.

Figure 1 illustrates the effect of these property tax caps on tax liability for a hypothetical \$300,000 home located in Park Slope, Brooklyn from 2003-2008.<sup>30</sup> During this period housing prices in Park Slope increased by 67%. Had the property not been subject to the tax caps, its assessment would have followed the dashed blue line. The actual assessed value of the property, after taking the caps into account, is given by the solid red line. The difference between the two lines is the benefit to the property owner of the caps. In 2008 that benefit was \$1503 dollars in tax savings.<sup>31</sup> This tax savings is the cap benefit.

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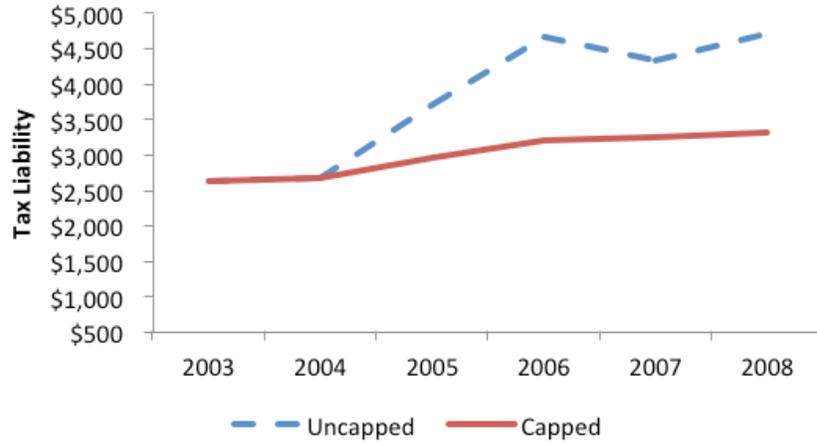
28. See DOF's instructions to the public, *Determining Your Assessed Value*, N.Y.C. DEP'T FIN., [http://www.nyc.gov/html/dof/html/property/property\\_val\\_assessment.shtml](http://www.nyc.gov/html/dof/html/property/property_val_assessment.shtml) (last visited Mar. 28, 2014).

29. N.Y. REAL PROP. TAX § 1805 (McKinney 2014).

30. Specifically, I assume that the property is located in ZIP code 11215.

31. This calculation applies the average nominal rate applicable for 2008/2009, which was 16.196%.

FIGURE 1: Cap Effects in Park Slope, Brooklyn



The cap benefit is necessarily greater for properties in more rapidly appreciating neighborhoods, but what other characteristics of neighborhoods change as the demand for homes in that neighborhood increases? Are higher home prices associated with rising incomes, or more turnover, or changing demographics? The main justification for assessment caps is that they benefit existing homeowners in appreciating neighborhoods, but it's unlikely that sharp increases in property values occur in an environment in which other economic variables are unchanged. But, if the neighborhood is changing, with rising incomes and new households moving in and old ones moving out, then the very heart of the case for assessment caps is undermined.

In this study I examine the five-year housing boom from 2004-2008 in New York City to determine whether property tax caps tend to benefit existing homeowners who held the properties in 2004, or new owners who purchased properties already subject to a cap.<sup>32</sup> I also describe the extent to which the cap benefits were claimed in neighborhoods that experienced significant demographic and economic changes, such as increases in household income. The answers to these questions will help answer the larger question of how well New York City's assessment caps accomplish its objectives, which I explore in Section IV.

32. I focus on a period of price appreciation because this is when the caps create a benefit for property owners.

## B. Data

Data for this study were collected from four different sources. New York City's Real Property Assessment Database (RPAD) contains data on every tax lot in the city, including DOF's estimate of the properties' market values, assessed values, and exemptions.<sup>33</sup> These are the data that the city uses to calculate property taxes and they allow for the calculation of the cap benefit for each individual property. The cap benefit is the difference between its assessed value in the absence of the caps (i.e., 6% of its market value) and the actual assessed value of the property, multiplied by the tax rate. RPAD also contains detailed geographic identifiers that allowed me to associate properties with ZIP codes and sub-borough areas. Sub-borough areas are census geographical units that correspond to large neighborhoods of New York City such as the Upper East Side and Greenwich Village in Manhattan, or Greenpoint/Williamsburg in Brooklyn. Unfortunately, RPAD contains no information about the property owner, other than their name and mailing address. Consequently, I could not identify the relationship between demographics and cap benefits at the individual property level. There are roughly 677,000 one-to-three family homes in the dataset.

I was able to match individual properties with the ZIP codes to which they belong. In order to collect information on neighborhood income characteristics, I matched the RPAD data with data provided by the Internal Revenue Service's Statistics of Income division.<sup>34</sup> These data report, by tax year, ZIP code, and income group, the number of tax returns filed, aggregate adjusted gross income, and the amount of wages, interest, dividends, net capital gains, and information about the itemized deductions taken. These data are available for the entire five-year period of the study.

In order to explore the relationship between changing neighborhood demographics and cap benefits, the RPAD data were also matched with data from New York City's Housing and Vacancy Survey (HVS).<sup>35</sup> The HVS is conducted by the census every three years, including in 2005 and 2008, and includes responses to a series of questions about homeownership, race, and gender characteristics, as well as income. Individual households in the HVS are identified at the sub-borough area level. These data provide a rich picture of neighborhood characteristics, albeit a picture at a relatively high level of geographical aggregation, every three years. There are fifty-five sub-borough areas in New York City.

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33. The RPAD data are available from the Department of Finance, upon request.

34. *Individual Income Tax Statistics—Zip Code Data*, INTERNAL REVENUE SERV., <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Statistics-ZIP-Code-Data-%28SOI%29> (last updated Feb. 7, 2014).

35. *New York City Housing and Vacancy Survey*, U.S. CENSUS BUREAU, <https://www.census.gov/housing/nychvs> (last visited Mar. 29, 2014).

Finally, the data were merged with information from New York City's Automated City Registration Service (ACRIS).<sup>36</sup> ACRIS is the document-filing system for property records in New York City where mortgages and deed transfers are recorded. ACRIS provides information on which properties were sold during the period of my study. This information allowed me to identify whether the homeowners who benefited from property tax caps in 2008 were the same ones who owned the properties in 2004.

### C. Analysis

My analysis of the beneficiaries of the property tax caps is structured around three questions: (1) how are cap benefits associated with contemporaneous neighborhood income and demographic characteristics, (2) how are cap benefits associated with *changes* in neighborhood income and demographic characteristics, and (3) are the caps serving their intended purpose of reducing the property taxes of existing homeowners or are they benefiting new purchasers? These questions are directed at the primary policy justifications for the caps.

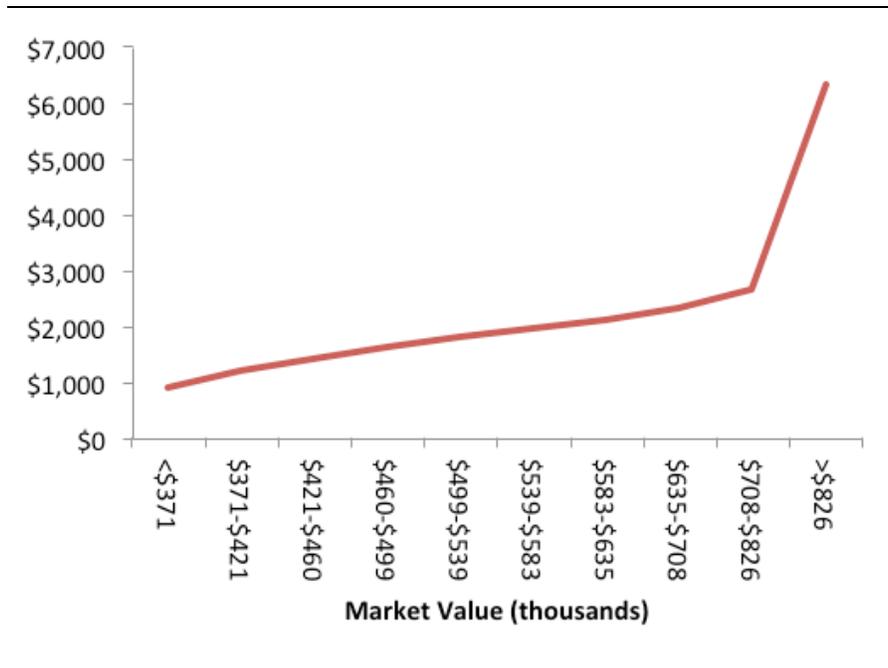
#### 1. Who Currently Benefits from the Caps?

The value of cap benefits for one-to-three family homes in New York City is enormous, accounting for more than \$1.5 billion in foregone property tax revenue in 2008, or about 12% of the city's total property tax revenue from that year. The benefits accrue primarily to the most valuable properties in the city. Figure 2 divides all one-to-three family homes into ten deciles according to the value of the property and reports the average annual tax benefit that goes to properties in each decile.

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36. The ACRIS data are also available, upon request, from the Department of Finance.

FIGURE 2: Average Cap Benefit by Property Value



Average cap benefits increase with property values. The most valuable 10% of properties enjoy a \$6331 reduction in their property taxes, on average, from the caps. The total cap benefit allocated to this group is over \$428 million. Thus, it is not only the fastest appreciating properties that benefit from the caps, but also the most valuable ones. Of course, property taxes are paid by people, not by properties. The crucial question, from a policy perspective, is not which properties but which people receive the largest cap benefits.

Figure 3 shows how incomes vary with the average cap benefit by ZIP code. The ZIP codes are arranged on the horizontal axis in ten bins, arranged from left to right in increasing order of average cap benefit. For example, the bin labeled \$1296-\$1532 includes those 10% of the ZIP codes in New York City that have an average cap benefit within that range. The solid green line shows that ZIP codes receiving the largest cap benefits have a mean adjusted gross income (AGI) of \$217,000. This is more than twice the mean income for the next highest decile of ZIP codes. The blue and red dashed lines show that the largest cap benefits also go to ZIP codes with the smallest share of tax returns reporting under \$25,000 of AGI and the largest share of returns reporting more than \$100,000 of AGI. The dashed purple line shows that these are also the ZIP codes where wages make up the smallest share of AGI, and interest and dividends make up the largest share. In sum, the largest cap benefits go to the

ZIP codes with the highest incomes and with the largest shares of non-labor income.

FIGURE 3: Income Characteristics of ZIP Codes by Cap Benefit

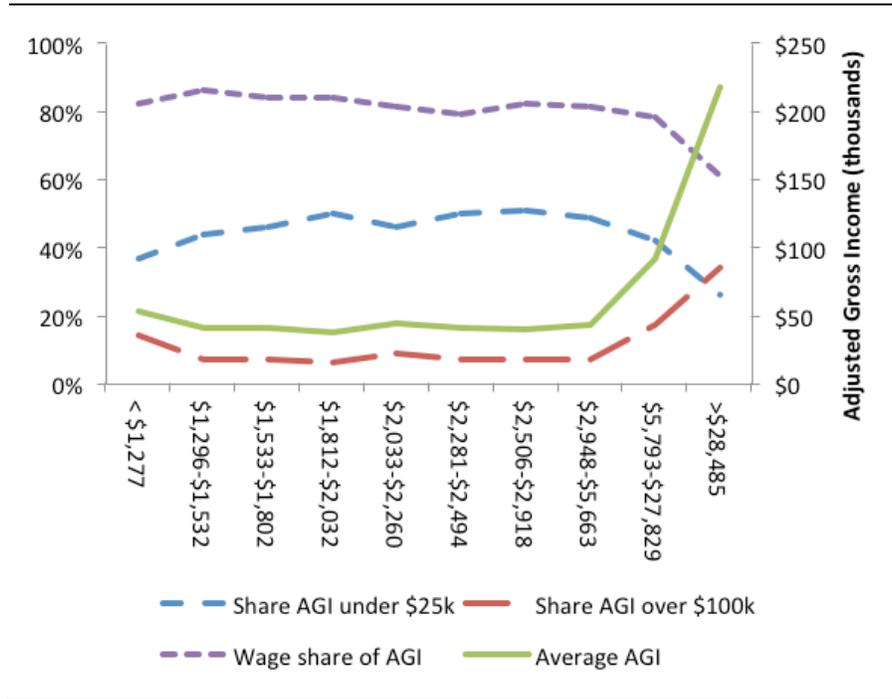


Table 1 shows how SBA demographic characteristics vary with the average cap benefit in those SBAs. The SBAs receiving the greatest benefit from the caps are all in Manhattan: Greenwich Village, Chelsea, Stuyvesant Town, and the Upper West and Upper East Sides. SBAs with the greatest average benefit have the lowest percentage of Hispanics (3%), highest percentage of whites (91%), and lowest percentage of blacks (2%). These are also the SBAs with the smallest share of homeowners with a mortgage and the shortest average tenure in their home.

TABLE 1: SBA Demographic Characteristics by Cap Benefit

Avg. Cap Benefit	Hispanic	White	Black	Asian	Owners w/mort.	Tenure
<\$1343	14%	76%	16%	6%	72%	15.92
\$1,443-\$1,581	17%	44%	49%	5%	67%	17.75
\$1,609-\$1,928	12%	38%	47%	12%	69%	16.84
\$1,999-\$2,177	13%	65%	14%	20%	66%	16.63
\$2,186-\$2,275	7%	65%	7%	28%	59%	17.18
\$2,359-\$2,636	14%	67%	9%	23%	64%	16.26
\$2,648-\$2,995	18%	71%	14%	13%	57%	19.11
\$3,404-\$4,921	20%	73%	19%	7%	64%	14.55
\$5,232-\$27,497	10%	62%	29%	7%	63%	15.70
>\$28,180	3%	91%	2%	7%	58%	12.54

Although the relationship between cap benefits and neighborhood characteristics is not always constant over the entire range of benefits, it is clear that the neighborhoods currently getting the largest benefits from the caps are those with the most valuable properties, the most affluent households, and the smallest share of minorities. Residents in these neighborhoods also have the highest incomes and the shortest tenure, on average, suggesting that these neighborhoods have changed the most during the period from 2004-2008, and raising the question of how they have changed.

## 2. What Has Changed in Neighborhoods with the Largest Cap Benefits?

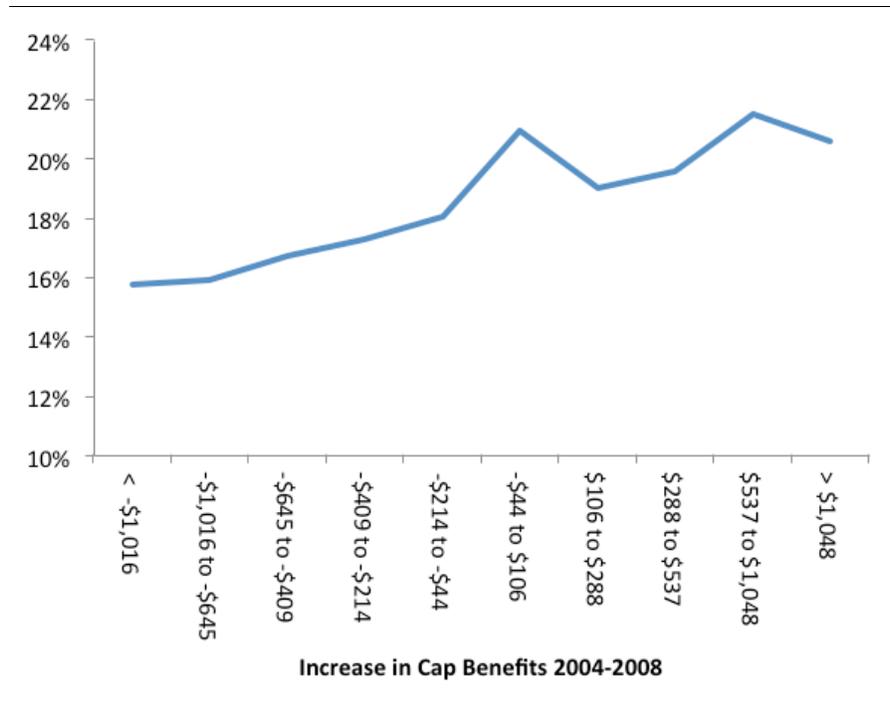
Table 2 shows how changes from 2004-2008 in ZIP code income measures vary with changes in the average cap benefits. This comparison is helpful in directing attention to how well caps protect homeowners from increases in property taxes that are not accompanied by increases in cash incomes. The ZIP codes that were helped the most by the caps during 2004-2008 were ZIP codes with the largest increases in adjusted gross incomes. The ZIP codes receiving the very largest cap benefits reported an average increase in AGI of more than \$23,000 per tax return. These were also the ZIP codes with the largest increase in the share of returns reporting more than \$100,000 in AGI. Furthermore, this increase in AGI is not attributable to the selective recognition of capital gains for tax purposes; wages as a share of AGI also grew for this group by 2.5 percentage points.

TABLE 2: Changes in Neighborhood Incomes and Changes in Cap Benefits 2004-2008

Avg. Cap Benefit	% AGI under \$25,000	% AGI over \$100,000	Wage % of AGI	Avg. AGI
< -\$581	-1.0%	3.6%	-0.1%	\$6,999
-\$581 to -\$330	-0.8%	3.0%	0.4%	\$5,247
-\$330 to -\$75	-1.3%	2.1%	0.8%	\$3,396
-\$75 to \$115	-2.2%	1.8%	0.7%	\$3,218
\$115 to \$222	-1.9%	1.5%	-0.1%	\$2,756
\$222 to \$414	-2.3%	1.1%	-0.2%	\$2,751
\$414 to \$690	-3.1%	0.8%	-0.1%	\$2,549
\$690 to \$3,789	-4.4%	2.9%	1.0%	\$8,310
\$3,789 to \$17,757	-2.7%	2.5%	0.4%	\$17,335
> \$18,122	-2.0%	4.3%	2.5%	\$23,234

A comparison of changes in neighborhood demographics during this period with changes in cap benefits does not reveal a significant relationship. However, there is a positive correlation at the individual property level between increases in cap benefits and the likelihood of being sold. Properties that appreciate more rapidly are more likely to sell. Figure 4 shows the share of all properties that were sold in 2004-2008 by the change in cap benefits over that period. Properties with the largest decline in cap benefits were sold at a rate of 15.8%, while properties that appreciated the most rapidly sold at a rate of 20.6%.

FIGURE 4: Properties Sold by Change in Cap Benefit from 2004-2008



#### IV. EVALUATING NEW YORK CITY'S CAPS

In light of the evidence reported in Section III, it does not appear that New York City's property tax caps accomplish their intended purpose. In fact, the effects seem to be perverse. The caps confer their largest benefit on owners with the most valuable properties, in neighborhoods with the highest average incomes. These are also the neighborhoods in which passive income in the form of interest and dividends make up the largest share of adjusted gross income. Relative to taxpayers' income, the property tax caps have a regressive effect. A full examination of how cap benefits are correlated with household wealth is not possible because data on property owners' assets and liabilities are not available. However, as Figure 2 illustrates, cap benefits are greater for owners of more valuable properties. Moreover, Table 1 shows that sub-borough areas receiving the largest cap benefits are also those with the lowest mortgage rates, suggesting that those homeowners have the greatest amount of equity in their homes relative to their property values. Taken together, cap benefits appear to be allocated to the neighborhoods where owners have the highest incomes and greatest property wealth. Even if progressivity is not an important

feature of the property tax,<sup>37</sup> the *regressive* effects of the caps appear to be unintended and need justification.

The most common justification for property tax caps is that they address the liquidity problem that arises for existing homeowners who would otherwise face rising property values and tax bills without an increase in cash income with which to pay those bills. On this view, regardless of their *level* of income and wealth, homeowners should be protected against increases in property taxes because they do not have the increase in cash income to pay the increase in taxes, and we do not think it is appropriate to require them to sell or mortgage their properties to pay tax bills.

This justification rests on the presumption that property values increase without accompanying increases in cash income. In some cases, that may well be true. The weakness of this justification, however, is that property values are endogenous to the economic market and, in general, one would expect that increases in property owners' incomes will accompany increases in property values.<sup>38</sup> For example, as household incomes increase there are likely to be more investments in home improvements and in demand for local amenities, such as high-end retail and food services, which will make the neighborhood more attractive to high-end homebuyers and drive up home prices. And, in fact, I find that the neighborhoods that benefitted the most from property tax caps from 2004-2008 were also those that had the largest increases in AGI. To be sure, AGI is not the same thing as cash. However, over the same period the average wage income in these neighborhoods rose by more than \$18,000 on average. Thus, it appears that the caps tend to benefit households that, on average, also have plenty of additional cash income.

There are two ways that the average income for taxpayers in these neighborhoods could have increased. The first way is if income of the 2004 residents increased. The second way is if new homebuyers in these neighborhoods had higher incomes than the residents that they replaced. As Figure 4 illustrates, cap benefits are associated with *greater* ownership turnover. Approximately 20% of the property owners receiving the largest benefit from the caps from 2004-2008 did not live in the properties in 2004. The value of the cap benefit in 2008 to property owners who acquired the property in the previous five years was \$270,063,162 thereby conferring a very large benefit on new homeowners, rather than current homeowners at risk of being taxed out of their homes.

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37. It is difficult to implement redistributive tax and spending programs at the local level, on account of the relative ease with which high-income taxpayers can leave local jurisdictions. See, e.g., Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1408 (2004).

38. Nick Timiraos, *Linkage in Income, Home Prices Shifts*, WALL ST. J. (Aug. 17, 2011), <http://online.wsj.com/news/articles/SB10001424053111904253204576512532609819142>.

It is hard to know without more information exactly who benefits from a property tax cap on a recently sold property, because the benefit of the cap may be incorporated into the purchase price of the property. Homebuyers should take property taxes into account when figuring how much they are willing to pay so that, all else equal, a property with cap benefits will be sold for more than a property that does not have cap benefits. Indeed, there is some evidence that the value of tax benefits is *overcapitalized* into the price of a home by inattentive purchasers who overestimate the value of the tax benefits.<sup>39</sup> In that case, the benefits of the caps remain with the seller of the property. As a policy matter, however, this does not appear to be a desirable outcome either. The objective of the caps is to permit property owners to stay in their homes in the face of rising housing values, not to simply grant them a tax benefit that can be monetized with the sale of the property. Viewed from this perspective, the caps may have the perverse effect of being an inducement to sell.

New York's property tax caps are regressive. The benefits of the caps are greatest in neighborhoods with the largest increases in cash incomes, undermining the liquidity case for the caps. Moreover, the caps have their greatest value in neighborhoods that have the greatest turnover, so that in many cases the benefits do not go to protect existing homeowners from being priced out of their homes, but instead go either to new homebuyers or to current residents who sell their homes. Along almost any policy dimension, the caps are inadequate.

There are alternative ways to allow property owners on fixed incomes to stay in their homes while avoiding the effects of caps, which tend to benefit higher-income and wealthier property owners and provide the greatest benefits in precisely those neighborhoods that are likely to have the most turnover. One way to assist residents earning low, fixed incomes would be to provide for a means-tested "circuit breaker" that limits property taxes only for owner-occupants who satisfy income criteria. This proposal would make property taxes a direct function of the homeowner's cash income, reducing her property tax liability if her income fell below a certain threshold. In comparison with the current system of assessment caps, which does not distinguish among property owners with appreciating properties, a circuit breaker would eliminate the tax benefit for households that don't need it. It would also be more effective in allowing homeowners with low, fixed incomes to remain in their homes. Assessment caps only restrict the rate of property tax increases, from year to year, but provide no absolute limit. A circuit breaker could be devised to provide an absolute cap on property taxes for low-income homeowners.<sup>40</sup>

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39. Sebastien Bradley, *Inattention to Deferred Increases in Tax Bases: How Michigan Homebuyers Are Paying for Assessment Limits 4-5* (Jan. 2014) (unpublished manuscript) (available at [http://faculty.lebow.drexel.edu/BradleyS/Prop\\_tax\\_cap\\_draft.pdf](http://faculty.lebow.drexel.edu/BradleyS/Prop_tax_cap_draft.pdf)) (finding that people overpay for temporary tax benefits, treating them as if they persisted indefinitely).

40. For a summary of how circuit breakers have been used in other states, see HAVEMAN & SEXTON, *supra* note 4, at 34.

Another possibility for dealing with the liquidity issue arising from having to pay tax on paper gains is to allow homeowners to defer their tax payments until they either dispose of the property or they die and their estate is settled, with the unpaid taxes secured by a lien on the property. Twenty-five states plus Washington, DC had some deferral program in place as of 2005.<sup>41</sup> These programs generally target the elderly and disabled and have income and residency requirements.<sup>42</sup> For example, Washington State's program permits deferring one half of the property taxes due, up to 40% of home equity, with more generous rules for seniors.<sup>43</sup> This alternative represents a very different response to the illiquidity problem than either assessment caps or circuit breakers. The issue of homeowner liquidity, the difference between cash tax liability and the availability of cash income, is primarily a matter of timing rather than ability to pay. The homeowner may have enough value in her estate, including in the home itself, to discharge the tax liability but simply cannot access that value without selling her property or obtaining financing that may not be available in any event. A deferral regime allows the homeowner to overcome the liquidity issue without also conferring a real reduction in tax liability that might be unnecessary given the homeowner's overall economic position.<sup>44</sup>

#### CONCLUSION

The property tax is a hated tax, but attempts to curtail its most offensive feature, the rapid increase in taxes that can accompany paper gains in property value, have had unintended distributional consequences that are hard to justify on policy grounds. In New York City, the caps are regressive and tend to benefit new homebuyers and sellers rather than current homeowners on fixed incomes. The caps should be replaced with a property tax circuit breaker or deferral system.

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41. DAVID BAER, AARP, STATE PROGRAMS AND PRACTICES FOR REDUCING RESIDENTIAL PROPERTY TAXES (2003).

42. HAVEMAN & SEXTON, *supra* note 4, at 35.

43. *Id.*

44. For a summary of how deferral regimes have been used in other states, see *id.*

