NON HOMESTEAD TAX RATES AND CITY COMPETITIVENESS

Prepared for:

City of Rochester

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CGR Mission Statement

CGR is an independent, nonprofit research and management consulting organization that serves the public interest. By developing comprehensive perspectives on issues facing communities, CGR distinguishes itself as a unique professional resource empowering government, business and nonprofit leaders to make informed decisions. CGR takes the initiative to integrate facts and professional judgment into practical recommendations that lead to significant public policy action and organizational change.

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Summary

Background

State legislation has allowed municipalities in New York to tax residential and business property classes at different rates following property revaluation, effectively legalizing a well-established practice of shifting the burden of taxation from residential property owners to commercial property owners. By permitting dual rates (called "homestead" and "non homestead" for residential and business properties, respectively) for different classes of property, the state intended to improve compliance with state law requiring that all property be assessed at a uniform proportion of full market value. While a phase-out of differential rates was not required in the legislation, official sanction of dual rates would allow communities to equalize the burden across property classes gradually. As the over-assessment of business property was significant in many communities, an accurate revaluation would otherwise have forced a substantial and immediate increase in residential tax rates, making revaluation even less politically desirable than it is in normal circumstances.

Currently, the City of Rochester taxes business property at 2.5 times the rate it taxes residential property. Although city business property makes up less than forty per cent of the tax base, the owners and tenants pay over sixty per cent of the total tax levy. Members of Rochester City Council wisely observed that the ability of the city to attract and retain commercial and industrial enterprises might be seriously impaired by the city's high relative tax rate. The council therefore engaged the Center for Governmental Research (CGR) to study the city's non homestead tax rate and its impact on business.

Findings

- High taxes are only one of a large number of factors influencing business location and investment decisions in Rochester. Through our own econometric analysis of employment trends and relative tax rates of 155 cities in New York, Pennsylvania, New Jersey and Ohio, we found that higher property tax rates have a negative impact on job creation, albeit a very small one. Our findings were confirmed by a comprehensive review of other analyses of the impact of property tax rates on employment and business location.
- The NYS Homestead Tax Law is a poorly written law. Regardless of the virtues of differential taxation across property classes—for good or ill this is a common practice in other states—New York's law is difficult to interpret and inflexible. Arcane at best, irrational at worst, the legislature should substantially revise this law.
- *"Who pays the property tax?"* The similarity between the tax burden per square foot of space for McDonald's facilities across Monroe County's municipalities suggests that the burden of the tax differential for business property has been shifted to the building owner through a reduction in market value. Yet as consumers of affordable housing face a Rochester "monopoly," the homestead tax law likely enables landlords to shift the burden of city taxation onto city renters.
- The differential between Rochester's homestead and non homestead tax rates is greater than any major city in the state. State financial assistance to close the gap is much less likely than if Rochester were one of many cities imposing significantly higher tax rates on business property.
- Tax rates and property values are intertwined. Consistently high tax rates lead to a reduction in property value. Low property values necessitate higher tax rates as the community seeks to raise tax revenue that is roughly comparable on a per person or a per household basis.
- Tax *rate* is not what ultimately influences a firm's profitability. Actual tax paid (rate times property value) is what figures into the firm's balance sheet. Our limited sample suggests that the effective tax burden for business property in Rochester is similar to other communities in the county, despite the significant difference in tax rate. This is due to the much lower market value of real estate within the city.
- Given the lower market value of residential real estate, Rochester's effective tax burden for the median value home is the lowest in Monroe County. The "ability to pay" of city residents is, of course, also much lower than in most suburbs.

Recommendations

- CGR finds no compelling evidence to suggest that shifting the tax burden to residential property owners will have a significant impact on economic development. CGR recommends that City Council resolve to hold the line on the differential and not bring Rochester further out of line with other cities. Other factors requiring the attention of the council and tax revenue collected by the city—such as infrastructure development and investments in public safety—are very important determinants of economic stability.
- Rochester's tax rate should not be an impediment to the city's attempt to encourage new investment. Negotiated payment-in-lieu-of-tax (PILOT) deals with major new investors and exemptions under Section 485b of the NYS Real Property Tax Law should both continue.
- Although the City already takes advantage of the 485b property tax exemption, it does not avail itself of new provisions allowing a slower reduction in the value of the exemption. CGR recommends that the City administration work to establish an Industrial and Commercial Incentive Board in order to adopt the more generous exemption.
- Rochester should support changes that would rationalize the Homestead Tax Law and give the city more flexibility in adopting differential tax rates for different classes of real property. Failing statewide revision, Rochester should work with the local delegation to seek special legislation granting flexibility to the city. Specifically, Rochester should seek to reduce the rate of taxation on residential non homestead property.
- A large portion, perhaps 40 per cent, of Rochester's renters live in units taxed at the non homestead rate. Often these are individuals and families with the least ability to pay for housing. CGR recommends the City undertake further study of the effects of the non homestead tax rate on the market for City rental housing.

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Staff Team

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Non Homestead Tax Rates and City Competitiveness

Introduction

Taxing jurisdictions across the state of New York had a long-standing (if little acknowledged) practice of over-assessing business property relative to residential property, effectively shifting a disproportionate share of the tax levy onto business. While section 305 of the Real Property Tax Law (RPTL) requires that assessments be at a uniform share of market value, actual assessment practice often disregarded the statute. Of course, community-wide reassessment would abruptly bring values into parity, eliminating this implicit subsidy of residential real property and increasing the tax rates of voters in favor of businesses whose owners may or may not live within the taxing jurisdiction. Reassessment is unpopular in any event, yet this assessment practice made revaluation virtually impossible politically. As a way of facilitating property tax assessment reform, the NYS Legislature established a procedure enabling separate property tax rates for business and residential property, provided that a revaluation was completed first. The law (RPTL §1903), passed in 1981, permitted establishment of a system of dual rates, called "homestead" for residential and "non homestead" for business properties (which includes residential properties of more than three units per structure). The legislation allowed taxing jurisdictions to set tax rates in a way that maintains the shares of tax levy imposed on homestead and non homestead property as they were prior to the reassessment.

The city of Rochester is one community that has taken advantage of the Homestead Tax Law. Declining nonresidential real property value and increasing competition from suburban communities for commercial and industrial development led the Rochester City Council to engage the Center for Governmental Research (CGR) to study the city's tax rates and the possible impact of these rates on competitiveness. Some City Council members have expressed concern that high business taxes are limiting the city's ability to attract and retain commercial and industrial properties. Consider the following:

- Rochester's tax rates on business property are 2.5 times those on residential property. Business property is less than forty percent of the tax base, but the owners and tenants of business property pay more than sixty percent of the total tax levy.

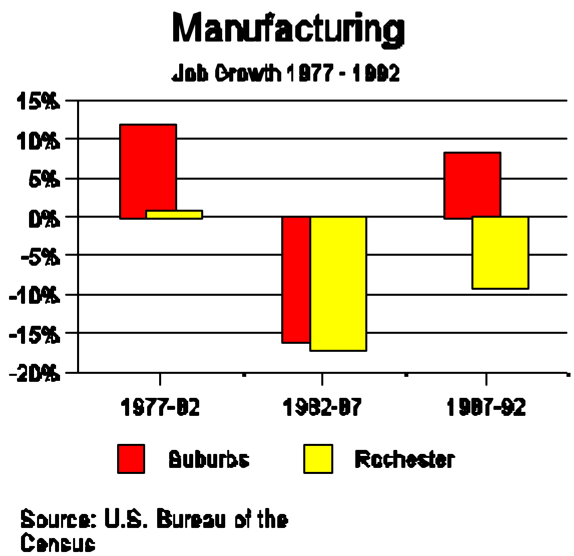
- In no other major city in New York State is the disparity between non homestead and homestead tax rates as great as it is in Rochester.

- The median full value tax rate on business properties in Monroe County towns and villages is $30.48. The city non homestead rate is $52.75, 173 per cent of the median for jurisdictions in Monroe County and double the tax rate in Henrietta. The effective burden of this rate is adjusted by differences in property value between the city and the suburban towns.

The city faces a difficult decision. The tax rate differential, while a stated problem for many business firms in Rochester and a factor contributing to the city's reputation in some circles as an inhospitable place for business, can only be reduced through 1) cost economies reflected in a lower tax levy, 2) a shift of burden from business to residential property or 3) an increase in state aid.

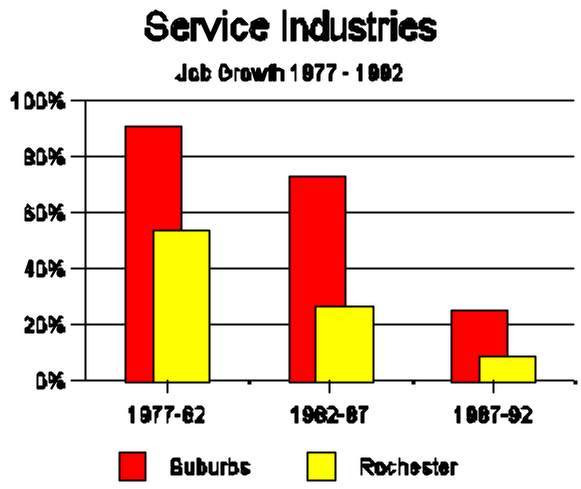
Taxes & Economic Vitality

Employment Trends

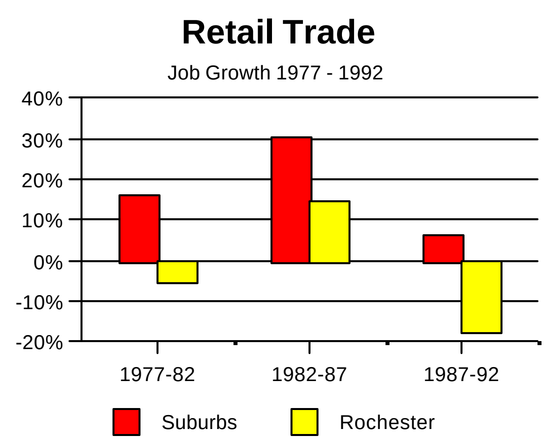


Between 1977 and 1982, almost all of Monroe County job growth in manufacturing took place outside Rochester, although the sector did grow slightly even in the city. By 1982, the city of Rochester was home to 4,222 establishments in the retail trade, services and manufacturing sectors. These establishments employed 122,000 people with a total payroll of $2.8 billion. The manufacturing sector was the backbone of the economy, providing the lion's share of city jobs, about 87,000. Between 1982 and 1987, both the city and the suburbs lost manufacturing jobs at double digit rates, the city losing 17 per cent and the suburbs 16 per cent of manufacturing jobs. Between 1987 and 1992, there was a three percent decline in Monroe County manufacturing jobs overall, but all of that came from within the city limits. Suburban manufacturing jobs actually grew by eight percent while City jobs declined by nine percent.

A similar story can be told in the service and retail sectors: Most of the growth has occurred in the suburbs. The city's retail sector has been particularly weak. The Monroe County suburbs were home to 5,210 establishments in the retail, services and manufacturing sectors in 1982, and they employed 90,000 people with a total payroll of $1.5 billion. Just over half of the suburban jobs were in the retail and services sectors. County wide, the retail and services sectors grew considerably in the following decade. Employment in retail trade swelled from 46,800 to 58,500 between 1982 and 1992, with the increase occurring before 1987 and stabilizing thereafter. In the services industries, employment grew from 34,100 to 57,300 over the same period.



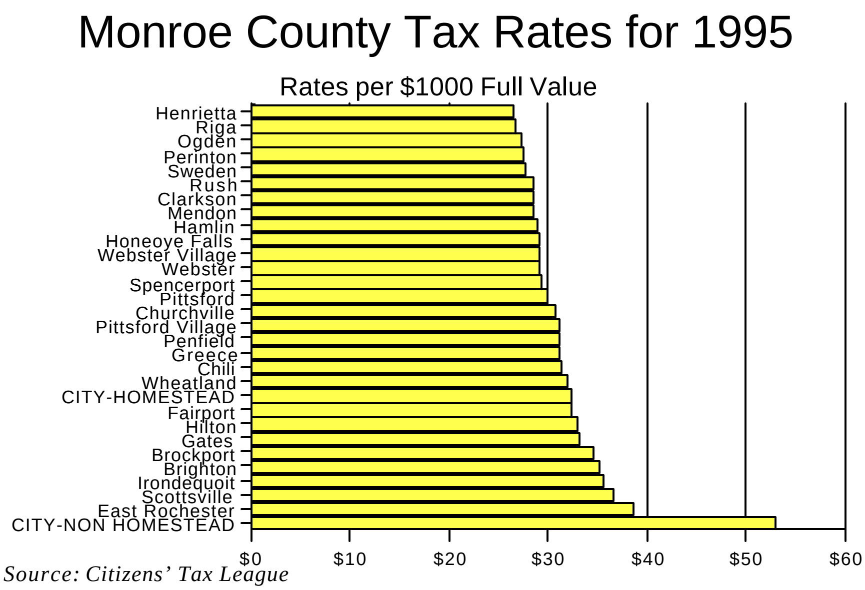
Source: U.S. Bureau of the Census



Source: U.S. Bureau of the Census

While city retail jobs climbed from 14,600 to 16,800 between 1982 and 1987, by 1992 they had plummeted to 13,900. Suburban retail employment soared from 32,200 jobs in 1982 to 42,000 jobs in 1987 and continued upwards to 44,600 jobs in 1992, while city retail employment fell by 17 per cent between 1987 and 1992. Employment in the services industries, on the other hand, continued to grow in both the city and the suburbs. Between 1982 and 1992, city employment increased from 20,500 to 28,000 jobs in this sector. But here too the bulk of the job growth occurred outside of the city, as the number of suburban jobs grew by nearly 16,000 and employment more than doubled from 13,600 jobs to 29,300 over the ten year period.

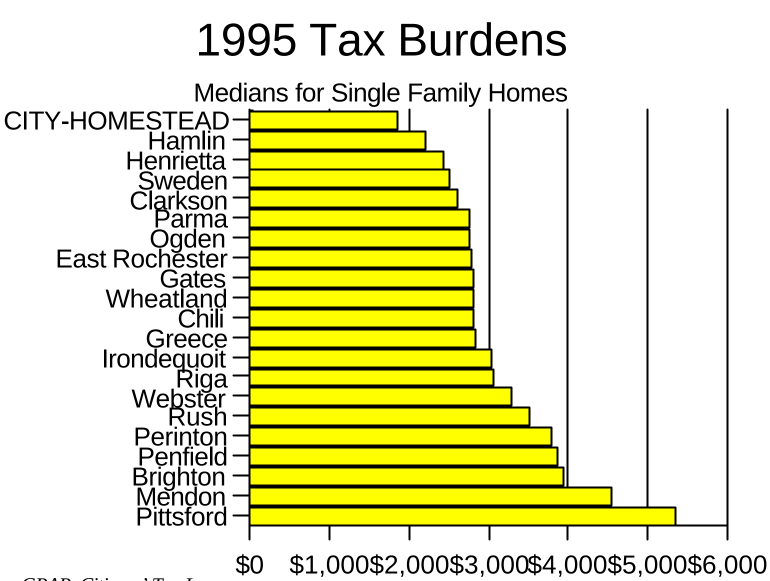
Service industries are the only one of the three sectors where the city has seen recent job growth. But in every five year period, this growth has lagged the suburbs. Between 1987 and 1992, employment in this sector grew by 8 per cent in the city but by 24 per cent in the suburbs.



Source: Citizens' Tax League

Comparative Tax Rates: Rochester & Monroe County Suburbs

The city of Rochester is the only jurisdiction in the county to have a higher property tax rate on businesses than on residential property. On a comparable full value basis, Rochester's non homestead tax rate is the highest tax rate in the region. The non homestead rate in Rochester is 173 per cent of the median tax rate of all jurisdictions in Monroe County and double the rate of the contiguous suburb of Henrietta. The central issue this report investigates is the role non homestead taxes play in business decisions.



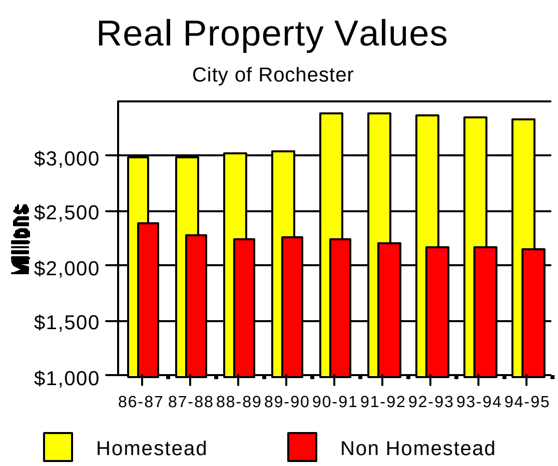
Source: GRAR, Citizens' Tax League

CGR also distinguished between the nominal tax rate (tax paid per dollar of market value) and the effective tax burden (tax paid per median value single family residence). The nominal tax rate for Rochester homeowners is in the middle of the range for Monroe County, yet the effective tax burden is the lowest in the county, 17% below Hamlin, the lowest of the towns, and 35% below Chili, the town with the median residential tax burden. As the cost of services is driven by population rather than by the value of housing, a community with homes of lower value must impose a higher rate of taxation to achieve the same tax per household as a community with homes of higher value.

Has the disparity in tax rates been responsible, at least in part, for the loss of jobs in Rochester? Clearly, the loss of employment in the city is due to many factors other than just the tax rate.[1] It is, however, intuitively obvious that taxes would play a part in a business person's decision to relocate, go out of business, or expand. Taxes are, after all, a cost of doing business. It would make sense that the tax rate has been a consideration in business decisions for many years and that some of those decisions have led to job loss in the city. It may, for example, play a part in the decision to upgrade or expand one location over another.

Homestead and Non Homestead Taxes

In the 1984-85 budget year, the city divided the tax levy between the homestead, or residential, and the non homestead, or business, classes of property. The division of the tax burden between the two classes of property was based on the apportionment which existed in 1983-84, the year prior to the implementation of full value assessments. Thus, 66 per cent of the tax burden was placed on the city's businesses and 34 per cent on residential property owners.



Source: City Budgets

The system of dual tax rates maintained the historic share of tax burden on businesses, which had traditionally been over assessed. While the non homestead class of property constituted two thirds of the city's total assessed value in 1983-84 (based on inflated business property assessments), the non

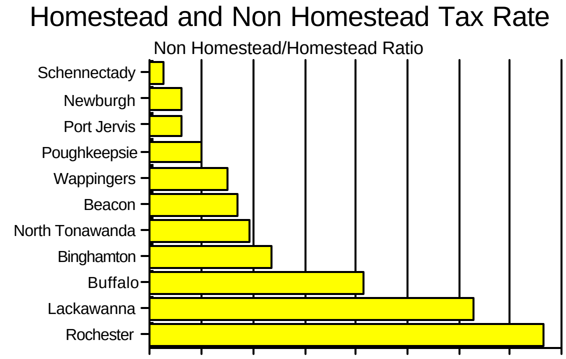
[1]Remember that the effective tax rate on business property *before* the Homestead Tax Law was roughly the same as after. Adopting dual tax rates certainly made the difference explicit, however, confirming the belief that many business owners had that they were being treated differently than residential property owners.

homestead share of total assessed value in 1986-87 (after the revaluation was complete) was about 44 per cent, declining to 39 per cent of the total by 1994-95.

The portion of the tax burden paid by the two classes of property has been incrementally adjusted over time. In the 1995-96 budget year, 38.2 per cent of the tax levy fell on the homestead class and 61.8 per cent on the non homestead class. The adjustment mechanism dampens the effect of changes in the relative values of homestead and non homestead property classes. Any shift in the value between property classes is adjusted by the original split in tax burden responsibility between classes. Year to year shifts are limited to five per cent for both classes of property. Thus, if the homestead portion of the tax levy is 30 per cent in one year, it can be no more than 35 per cent the next year, regardless of how much its value has increased relative to the non homestead class.

As an example of how the adjustment works, consider a hypothetical community where the full value of the homestead and non homestead classes is $2.5 billion each. The community has divided the tax levy so that the homestead class bears 35 per cent and the non homestead class bears 65 per cent. Suppose that the value of homestead properties increases by 10 per cent in a particular year yet the value of non homestead properties does not change. The complex formula embedded in the Real Property Tax Law adjusts the burden on the homestead class upward to 37 per cent of the total tax burden and the non homestead class downward to 63 per cent.

In terms of the disparity between business and residential tax rates, Rochester has set itself apart from other cities with a dual rate system. Rochester's non homestead tax rate is 2.5 times its homestead rate. No other major city comes close to matching this disparity. Rates on business property in Schenectady are barely higher than rates on residential property. Buffalo and Lackawanna are closer to Rochester, but with non homestead tax rates of 1.8 and 2.2 times homestead tax rates, they are still considerably below Rochester's differential.



Source: Local Assessors

Do Taxes Matter? Experience in Other Cities

How do property taxes affect local business growth and retention? This has been and continues to be a controversial issue among economists and policy academics. Some hold that state and local taxes do not have a significant effect on business growth for one or more of the following reasons:[2]

- Business location and expansion decisions are driven by innumerable factors of great complexity, against which the singular effect of taxation is insignificant.
- Local property taxes are one of many costs of doing business and the magnitude of other costs may overwhelm the cost of the taxes.
- Differences in state and local taxes may reflect varying levels of services, which also drive business location and expansion decisions.
- Relocating businesses plan to stay at their sites for a longer time period than the elected officials who make tax policy.
- Fewbusinesses are perfectly mobile and able to uproot solely because of a change in local taxation.

Recent research into business location and expansion decisions, however, indicates that local taxes play a role in such decisions. Some research demonstrates that firms are sensitive to production cost differentials across regions. Even the relatively small costs of taxation may affect a firm's location decision in competing areas. Also, studies which attempt to hold the level of public services constant across regions show a statistically significant, but small, tax effect on business location. Furthermore, while few firms are perfectly mobile, local taxes do affect their decisions to expand in one region as opposed to another.

In Timothy Bartik's book on economic development policy, *Who Benefits From State and Local Economic Development Policies?*, the author attempts to summarize all empirical studies in the area of business location decisions between 1979 and 1991. His conclusion is that state and local taxes have a statistically significant effect on regional business growth. He also finds that these tax effects are larger for intrametropolitan business location decisions. That is, the difference in taxes between Rochester and Greece, for example, plays a bigger part in a firm's location decision than the difference between

[2]Bartik, Timothy J., *Who Benefits from State and Local Economic Development Policies?*, 1991, p.36.

Rochester and Syracuse. This is an effect we would expect, because a potential location is more likely to have closer substitutes with similar potential profits within the same metropolitan area than in another state or region.[3]

Bartik identifies 14 studies of property taxes on business activity within a metropolitan area. Of those 14 studies, ten showed that property taxes did matter to business activity and that they had a negative effect.[4] None showed that property taxes positively influenced business activity. The range of effects on business activity across the studies is fairly wide. The study with the smallest effect showed that a one percent increase in property taxes led to a 0.1-0.2% decline in per capita manufacturing employment. The study with the largest effect showed that a one percent increase in property taxes on industry led to a decline in the demand for industrial land of over four per cent.

From this body of research, CGR is led to conclude that businesses are increasingly sensitive to the property tax. Even though it is a relatively small cost of doing business, the property tax is still a cost, and the empirical research generally supports the notion that businesses regard it as such and seek to reduce it. It is more difficult to conclude how much property taxes matter to businesses. Also, property taxes are one of many factors influencing business activity decisions, many of which cannot be measured.

Summary of Academic Research

CGR has compiled a small library of relevant books and articles which attempt to explain the effect of taxation on business location decisions with empirical research. A number of studies reviewed to date indicate that taxation is a significant factor in business location, especially in different communities within the same metropolitan region. Certain empirical studies also quantify the relationship between taxation and employment and support the intuitive concept that lowering taxes causes job growth. Highlights of studies reviewed include:

[3]Bartik, p. 37.

[4]The studies showing significant and negative effects from property taxes took place in different metropolitan areas and used different measures of business activity. These measures included employment, manufacturing start ups, manufacturing employment per capita, changes in building permit values, and the amount of industrial land available in the community.

- Timothy Bartik's 1985 study of corporate location decisions for new manufacturing plants found that interstate variations in business property taxes were important. Bartik estimated that a 10% increase in a state's average business property tax rate causes a 1-2% decline in the number of new plants. To put this in context, however, he found that the strength of unions in a given state was far more important to the corporate decision to locate a new plant in a particular location.
- A 1993 study of the location determinants of manufacturing firms in ten school districts within Harris County, TX (Houston), looked at the effect taxes have on the probability of firm location. Calculations revealed that, on average, a one percentage point increase in a jurisdiction's tax rate will cause the probability of firms locating in the district to fall by 0.14%.
- Property taxes and other fiscal variables were found to be significant determinants of business location in a 1981 study focusing on land area in industrial use. The author concluded that state policies which encourage or seek to moderate local tax differentials may be significant in influencing the location of the industrial tax base.
- An empirical analysis of the Minneapolis-St. Paul metropolitan area studied the importance of local property taxes in intra metropolitan location decisions. The author found that tax rates probably do matter, but to what extent is unclear, and may vary from metro area to metro area depending on institutional details of the local government structure and assessment policies.
- In a study of the greater Philadelphia area between 1980 and 1983, relatively high effective property tax rates were found to depress the density of new manufacturing firms in communities within some of the suburban counties. Across a wider five-county region, relatively high property tax rates again appeared to depress the density of new manufacturers, but the effect was not strong. Other factors, primarily density of population and the area's percentage of business land acreage, were more important in establishing the general boundaries of where a potential firm will conduct a search for a site. Tax differentials appeared to become relevant only after the search area had been narrowed. Additionally, the general environment of the central city part of the region was a deterrent to potential manufacturing starts.
- In a 1993 study of the Chicago metropolitan area, the basic empirical finding was that an increase in the property tax rate applied to commercial and industrial property has a large negative effect on the growth of the commercial and industrial tax base.
- Results of a 1980 study indicate that local property tax differentials are a statistically significant determinant of relocation for manufacturing and wholesale trade firms when municipalities which have restrictive industry zoning are excluded from the sample. For construction, retail trade,

finance and service firms, tax variables do not appear to be statistically significant determinants of firm relocation.

~ In his 1981 research on suburbanization in 106 large metropolitan areas, W. Norton Grubb found that population and employment are inter-related, that "jobs follow people" and "people follow jobs." He was concerned with the movement of population and employment from cities to suburbs between 1960 and 1970 and found that taxes and public expenditures were not strong factors in the suburbanization of people or jobs. He found that employment location was generally insensitive to property tax rates. Relatively high public spending for different kinds of services in central cities tended to retard the movement of retail and manufacturing jobs to the suburbs, but not very much.

Some of these findings have more direct application to the city of Rochester. These studies all focus on single metropolitan areas with multiple taxing jurisdictions. We provide an expanded summary below:

Finney (1994), Harris County, Texas

Harris County is the most populous County in the Houston, Texas metropolitan area and it has ten school districts, with differing property tax rates. In 1994, Miles Finney from California State University used Harris County to examine what factors influence firm location in an urban area, concentrating on the impact property taxes have on manufacturing firm location. Finney assessed the probability of a given manufacturing firm locating in one of the ten school districts and discovered that firms are deterred by the property tax.

Finney's results, statistically significant at the 5% level, showed that, on average, a one percentage point increase in a jurisdiction's tax rate will cause the probability of new manufacturing firms to fall by 0.14%.

Fox (1980), Cuyahoga County, Ohio

In 1980, William Fox studied the role of fiscal variables, including the property tax, in industrial location. His hypothesis was that firms are concerned with differences in fiscal variables, such as taxes and services, between communities in a metropolitan area. His research excluded communities that used zoning to discourage industrial location. The area chosen to test the hypothesis was Cuyahoga County, Ohio which has 43 municipalities with populations over 2,500.

Fox's model measured the demand for industrial sites by firms entering these communities. He found that the demand for industrial land was lower in communities with a high property tax rate.

Although firms prefer lower taxes, they also prefer more services. Fox found that the demand for land was greater in communities with a higher level of business services because, without local government provision, individual firms would have to provide some services for themselves. Similarly, firms were found to be sensitive to the level of services provided. Fox used per capita police and fire department expenditures as a proxy for the level of services provided to firms and found that a one per cent reduction in the level of services resulted in a three per cent drop in land demanded.

Firms were found to be very sensitive to the property tax when it comes to buying industrial land. A one per cent increase in the effective tax rate would lead firms to demand four per cent less land than they would otherwise. In the average Cuyahoga County municipality, Fox estimated that a one per cent increase in property taxes would result in a net loss of revenue due to the loss of tax base from the drop in demand for industrial land.

Charney (1982), Detroit, MI

This study by Alberta Charney examined the role of fiscal factors, including local property and income taxes, played in the intra metropolitan location decisions of manufacturing firms. The metropolitan area she studied was Detroit, for firms relocating between 1970 and 1975. At that time, there were over 150 separate taxing jurisdictions in the metropolitan area with property taxes varying by over 100%. Three cities in the metropolitan area had a local income tax at the time (two had a 1% local income tax and Detroit itself had a 2% tax).

Charney found that relatively high levels of property taxes discourage firms from selecting sites in an urban area. She also found the negative effect of high property taxes to be larger for bigger firms. Her research also showed that the income tax had a weaker influence on firm location decisions. Charney also found that property tax rates matter most to durable goods manufacturing firms. Other findings:

- Firm location densities are lowest near large low income populations and in areas with a high proportion of high income households,
- Firms are attracted by sanitation facilities,
- Firms prefer to locate in areas with high employment density, and
- Transportation facilities do not influence firms' location decisions.

Charney's work considers the business location decision once the determination to move has already been made, not with the initial decision to move. There are significant implications for Rochester because of the disparity in taxation across neighboring districts. In Charney's sample, no firms relocated to the jurisdiction with the highest property tax.

No Smoking Gun for Taxes – CGR's Statistical Research

CGR's research into the role of taxes in the economic health of municipalities validated the academic research we had reviewed. Taxes have a negative effect on the economy, but a small one. The data do not point to a "smoking gun" for taxes nor do they indicate that taxes are the root of all evil for municipalities in economic decline.

CGR's research was complicated by the Bureau of the Census' lengthy delay in releasing the 1992 Census of Manufactures. This contains information on employment in the manufacturing sector needed to describe the economies of the jurisdictions incorporated in our statistical analysis. Using statistical techniques, CGR tried to explain how taxes and other measurable data influence local economies. The statistical model explains the change in total employment in a set of municipalities in terms of demographic and economic information, including taxes.

The Data

The data set was limited to four northeastern states: New York, New Jersey, Connecticut and Ohio. CGR selected these states because of their proximity, their general similarities in urban, suburban and rural settlement, and for the quality of state taxation information. CGR excluded cities and suburbs in the New York City metropolitan area because of the extreme concentration of financial services employment in New York City and other unique features of the region's economic and physical infrastructure.

For a location to be included in the statistical analysis, it had to have sufficient economic activity to be included in the Economic Census, which includes information by economic sector at the city and town level. CGR used data from the manufacturing, service and retail sectors, which constitute the bulk of economic activity for most places. The resulting data set included information from 155 cities and towns.

The Economic Census is published at five year intervals, the most recent being 1992. CGR decided to examine the change in total employment at the municipal level between 1982 and 1992 based on demographic and taxation information.

The Results

CGR used a statistical technique called multiple regression which measures the degree to which changes one variable (called the "dependent" variable) can be explained by changes in other variables (called "independent" variables). CGR's dependent variable was the percentage change in total employment between 1982 and 1992, capturing the success of the community at preserving or expanding its base of employment. The independent variables were

~ the percentage change in the poverty level between 1980 and 1990 (these are the years in which the Census of Population and Housing was published),
~ the median age of housing units in the location,
~ the percentage change in median home values between 1980 and 1990,
~ the percentage change in population between 1980 and 1990, and
~ the effective tax rates in 1982 and 1992, measured in 1992 dollars.

Additionally, CGR used variables to reflect whether or not the location is a city, and to reflect whether or not the location is in New York State. The following is a summary of the statistical analysis

Adjusted R^2 .29252

Standard Error .21884

Analysis of Variance

	DF	Sum of Squares	Mean Square
Regression	8	45770.96538	5721.37067
Residual	2311399	110696.80995	.04789

F = 119464.78366 Signif F = .0000

------------------ Variables in the Equation ------------------

Variable	B	SE	B Beta	T	Sig T
POVERTY	-.019304	7.8227E-04	-.019740	-24.677	.0000
AGEHOUSE	-.007996	2.5388E-05	-.283024	-314.967	.0000
MHVDIFF	-.015659	6.1776E-04	-.027597	-25.349	.0000
POPCH	.840567	.002318	.310604	362.689	.0000
CITY	-.011419	4.1607E-04	-.018026	-27.444	.0000
NY	.080603	4.3262E-04	.116514	186.313	.0000
82TAX	-3.17670E-05	3.9431E-07	-.099686	-80.563	.0000
92TAX	-1.69021E-05	2.4342E-07	-.094886	-69.437	.0000

The Adjusted R^2 is a measure of the model's explanatory power. In other words, the number tells us how much of the percentage change in total employment is explained by the independent variables. In this case, the dependent variables explain about 29 percent of the change in employment. The rest is explained by other factors not included in the model. These may include global factors related to ascendant economies in North Carolina or Asia, tariffs and trade regulations, or other factors such as process innovations that would be difficult if not impossible to measure.

The variables in the equation are all highly significant in a statistical sense, which is to say their influence on employment change is almost certainly not zero, even if the influence is small. The sign on the coefficient, "B," indicates if this influence is positive or negative. This model shows that

- An increasing poverty rate (POVERTY) is related to the loss of jobs in a community, and the effect is strong. The model indicates a one percent increase in the poverty rate will lead to a 1.9% decline in total employment over ten years.
- The age of the housing stock (AGEHOUSE) is negatively related to job growth. Age of housing was used as a proxy for the overall age of the community. The sign and significance of the variable confirm our expectation that older communities have been losing to newer communities in terms of job creation.

- Decreasing median home values are related to job losses. MHVDIFF is the percent change in median home values between 1980 and 1990. Communities where median home values fell saw job losses over a ten year period. This variable functions, again, as a proxy for urban growth or decline. Cities with declining real estate markets are also cities with eroding economies.
- Population change (POPCH), as one would expect, is a strong predictor of employment change. Those communities that grew in population between 1980 and 1990 had more jobs in 1992 than in 1982; those that lost people also lost jobs.
- Cities lost jobs to suburbs between 1982 and 1992. The model uses a variable called CITY to show if a given place is a city or not. This designation is negatively related to employment change.
- Perhaps surprisingly, New York is better off than some other states. The model uses a variable to designate a location as being in New York State or not. When compared to Ohio, New Jersey and Connecticut, being in New York is associated with greater job growth between 1982 and 1992.
- Taxes matter, but not a lot. The effective tax rates (82TAX and 92TAX) are negatively related to changes in total employment. The effective tax rate is defined as the full value tax rate multiplied by the median home value in each community. This gives a measure of the actual taxes paid, which fluctuate with property values, as opposed to tax rates, which do not. A high effective tax rate in 1982 played a very small part in the decisions leading to job losses between 1982 and 1992. Similarly, a high tax rate in 1992 is also related to job loss, but the effect is again very small.

This research is consistent with the body of literature we have reviewed. It says that taxes do play a part in the economic health of localities, but the effect is not large and may be outweighed by other factors. The research also indicates that it is difficult for older cities to compete with newer suburbs in close proximity. Lower taxes in cities are not enough to reverse the trend of business decline in the city and growth in the suburbs.

Effective Tax Burden & Property Value

Who Pays the Property Tax?

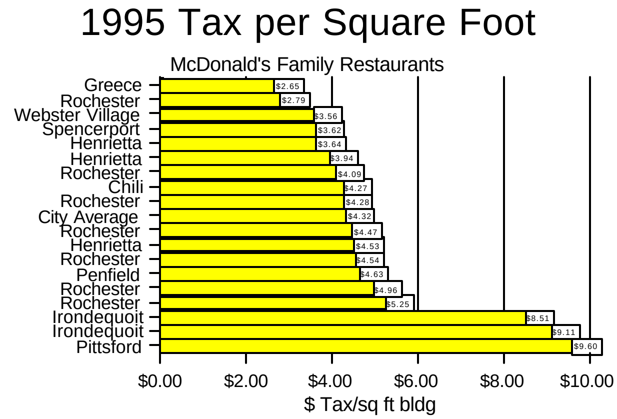
The debate over who *really* pays the property tax is the most enduring in the public finance literature. On the surface, the question is trivial. The payee is the one who writes the check. Yet in practice the problem is far more complex. Let's consider commercial office space. Leases for commercial property are frequently negotiated on a "triple net" basis, indicating that the quoted lease rate is net of the cost of taxes, utilities and maintenance. With a triple net lease, the tenant receives a bill for both the base rent and an itemized list of expenses for the remaining costs. In this case, it appears that the landlord has successfully "shifted" the burden of the tax onto the tenant. But what if the tenant is considering two buildings, Camelot Square and Guinevere Gardens, that are identical *except* for the taxes? In this case, the owner of Camelot Square, the more highly taxed building, will have a hard time convincing a prospective tenant to pay the same base rent as he or she would pay at Guinevere Gardens. The owner of the more highly taxed building usually absorbs the extra tax through a reduction in the base rent. In effect, the tenant pays only part of the taxes at Camelot Square.

Let's consider what happens when Arthur (Camelot Square's owner) wants to sell his property. It turns out that Lancelot (who owns Guinevere Gardens) is also interested in selling. The prospective purchaser (an insightful investor named Merlin) refuses to pay Arthur the same amount for Camelot Square as he is willing to pay Lancelot for Guinevere Gardens, arguing that he can't get the same base rent. In effect, Arthur pays the tax differential *in advance* by taking a loss on the property when it sells. After Merlin takes possession of both buildings, he appeals his tax assessment for Camelot Square and is successful at getting it reduced. After all, the recent market sale demonstrates that Camelot Square is worth less than Guinevere Gardens.

Comparing Effective Tax Burden

Tax rate and property value together determine the actual taxes paid for a piece of real estate. Even if figuring out who actually bears the burden of the tax is difficult, we can measure actual tax paid for different properties. We attempted to measure the tax paid per square foot of space for two different types of commercial real estate, McDonald's Family Restaurants and commercial office space.

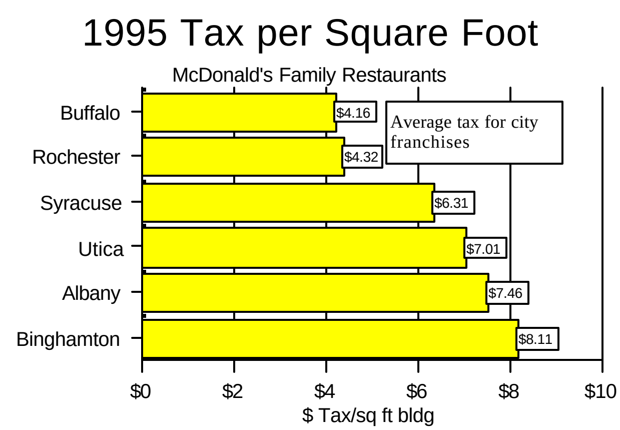
McDonald's: Tax Per Square Foot



Source: Local Assessors

McDonald's has several locations across different taxing jurisdictions in Monroe County's towns and villages. Also, every McDonald's is essentially the same in that the menu does not vary considerably from place to place, and there are no "mega" or "mini" McDonald's. The value of different locations varies, of course, but the underlying assessment should adjust for these differences. To control for any differences in size, CGR compared the tax paid per square foot of building across Monroe County.

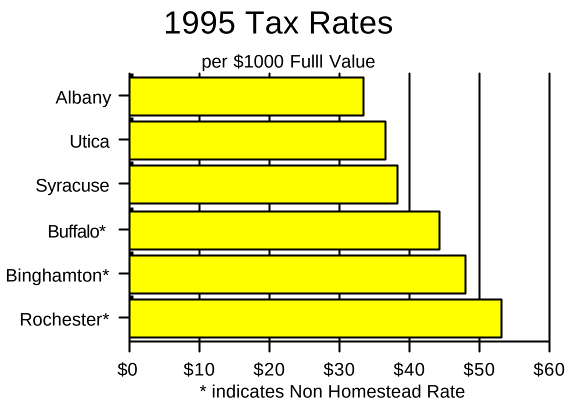
The figure shows the tax per square foot of building paid by eighteen different McDonald's franchise operations. On this basis, the Town of Greece has the lowest taxes at $2.65 per square foot and the Town of Pittsford has the highest taxes at $9.60 per square foot. Taxes within the City of Rochester vary from $2.79 to $5.25 per square foot with an average rate of $4.32 per square foot.



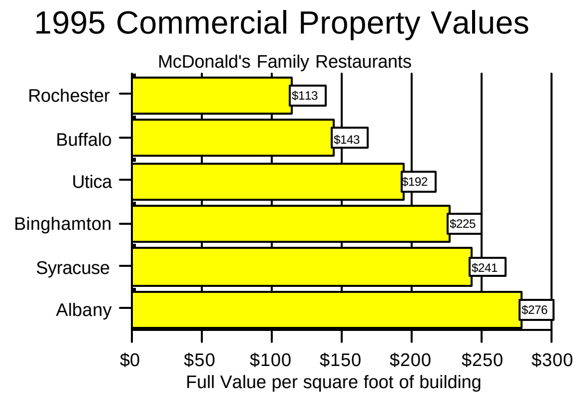
Source: Local Assessors

One interesting feature of this graph is the high rates of taxation in Irondequoit and Pittsford, roughly double the other towns and the city average. Furthermore, the city average tax is less than that of Penfield and Henrietta and not that much different from other suburban tax rates. In fact, certain McDonald's locations in the city pay less in taxes per square foot than most suburban McDonald's.

How much tax per square foot does a McDonald's franchise owner in Rochester pay compared to his or her counterparts in cities like Buffalo and Syracuse? Surprisingly, Rochester is at the low end of the scale. Only Buffalo is lower with an average tax per square foot of $4.16. Utica, Albany, Binghamton and Syracuse all tax their McDonald's owners at substantially higher rates than Rochester.



Source: Local Assessors

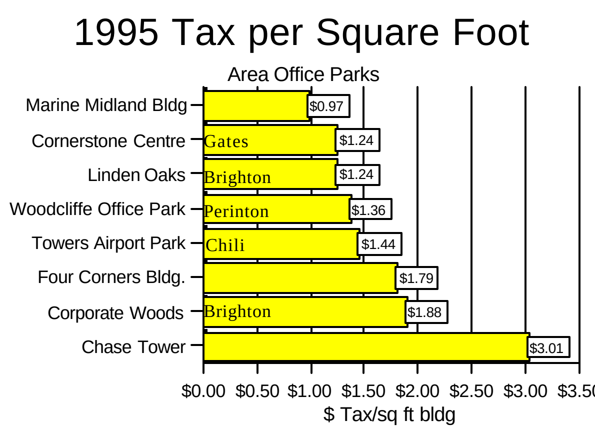


Source: Local Assessors

What could explain this? As tax *rates* are higher in Rochester, commercial property asset values must be lower. The next graph compares the full value of a square foot of McDonald's franchises across Rochester and other cities. McDonald's properties appear to be worth significantly less in the city of Rochester than in Albany and Syracuse and even Binghamton and Utica. Determining whether the value of commercial property is broadly lower in Rochester would require more exhaustive analysis.

Office Space

CGR also considered office space as a class of property to observe any effects of dual tax rates. CGR chose certain large office properties in the city and surrounding suburbs: the Marine Midland and Four Corners buildings and the Lincoln First Tower in downtown Rochester, Cornerstone Center in Gates, Linden Oaks and Corporate Woods in Brighton, Towers Airport Park in Chili, and Woodcliffe Office Park in Perinton. Using the same comparison of tax paid per square foot, CGR found wide variation in the three city properties, but a general confirmation of the finding in the McDonald's example. Property values appear



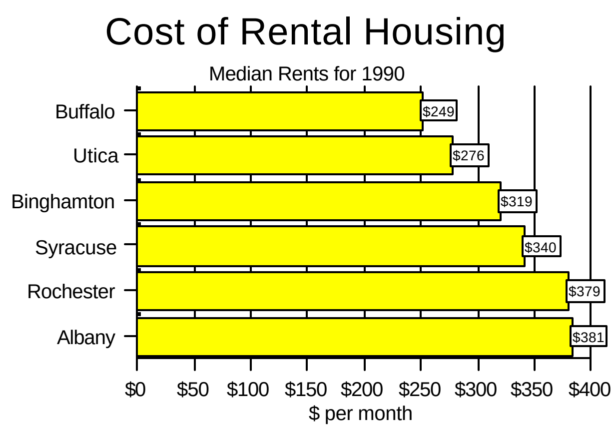
Source: Local Assessors

to adjust to keep taxes paid roughly comparable across taxing jurisdictions. As prestige buildings like Chase Tower have limited substitutes in the suburbs, property values are more robust.

Of course, comparing city and suburban office properties is difficult, at best. Many downtown properties are already paying significantly lower taxes due to payment-in-lieu-of-tax agreements with the city, so our downtown sample is small. A more exhaustive comparison is desirable. As we were less familiar with properties in other cities, we did not conduct a comparison of Rochester commercial office space and that of other cities.

So, Who Pays the Tax?

In the case of commercial real estate, our data suggest that it is the owners of real estate who bear the burden of Rochester's higher real property tax rates. Or, in the case of property that has changed hands in the last decade or so, the former owners. A businessperson seeking property to lease is likely to find base rents adjusted down (in accordance with lower underlying property values) to offset the higher non homestead tax rate. Those who seek to purchase commercial property find that the market price of the property has been discounted to reflect the higher tax cost.



Source: U. S. Bureau of the Census

Unfortunately, the high non homestead tax rate has a perceptual, as well as a real, effect on business location decisions. While the actual carrying costs on a specific property may have been adjusted to reflect the higher tax rate, the business has a recurring reminder of the tax rate in the form of its annual tax bill. While a more comprehensive analysis of the comparative cost of doing business may suggest otherwise, the immediate perception of the property owner or triple net lessor may urge a move out of the city.

Rental Housing

The non homestead tax rate applies to rental housing in buildings with four or more units. Based on 1990 Census data, we estimate that about 40% of the city's rental housing is in such units.[5] Thus 40% of landlords (by total units) are paying non homestead tax rates. While we have insufficient data to reach a firm conclusion, several observations are in order:

- There is little suburban competition for affordable housing. Were all city rental housing taxed at the non homestead rate, landlords would be able to shift a significant portion of the tax differential to renters.
- Rents are substantially higher in the city of Rochester than in most upstate cities. The one exception, Albany, has a relatively large core of "upscale" rental housing in its downtown that likely inflates the average. The number of upscale rental units in Rochester is fairly small in comparison.
- Higher Rochester rents must reflect a more limited supply of units, permitting landlords to charge higher prices.

Rochester landlords appear to have relatively greater market power than their fellows in other upstate cities. Greater market power enables them to shift a larger share of their underlying costs to tenants. In such a market, we believe that a significant share of the burden of overall property taxes—including a substantial share of the non homestead differential on 40% of the rental units—is being shifted to renters.

Recommendations

Stabilize or Reduce Non Homestead Tax Rate

All other things being equal, the city should work to reduce tax rates on non homestead property. High tax rates have the following effect on the business sector of the city:

[5] The Census reports three and four unit structures together. If 75% of these are three unit buildings, then 42% of total rental housing is in buildings with four units or more. We've been told anecdotally by City Assessment staff that the difference in tax rate has stimulated a large number of conversions of four unit buildings to three unit occupancy. This is why we assumed that three-quarters of the combined total was in three unit buildings.

- High tax rates drive down the taxable value of non homestead real estate, imposing a net loss on the owners of non homestead real property in the city, particularly nonresidential property.
- Over time, the loss in market value will reduce the tax base of the city, eliminating some or all of the increased revenue gained from the increase in tax rate.
- A reduction in the net asset value of business property reduces the incentive for business property owners to invest in maintenance and renovation of existing property.
- New structures are likely to hold their value less well in the city than in tax jurisdictions with lower tax rates, reducing the return on investment from new construction, thus discouraging business investment in the city.

Of course, all other things are *not* equal. A reduction in rate for non homestead property would come only at the expense of an increase in rate for homestead property. Furthermore, a reduction in tax rate would be only one factor working to improve the city's ability to retain and attract business investment. Our research indicates that a reduction in tax rate will, by itself, *not* have a dramatic effect on business investment in the city.

A gradual reduction in tax rate is desirable as the city can afford to do so. Nonetheless, this reduction in rate should not come at the expense of fundamental improvement in other important aspects of the business climate, including public safety and quality infrastructure.

Seek Revision of Homestead Tax Law Permitting Separation of Residential & Non Residential Non Homestead Property

Higher tax rates on residential *non homestead* property almost certainly have the effect of increasing rents for residents, not reducing returns to landlords. With little competition from the suburbs for affordable rental housing, city landlords can shift much or all of the burden of taxation to their tenants. Rather than forcing suburban landlords to bear part of the burden of taxation in the city, the homestead/non homestead rate differential shifts part of the burden from owner occupants of single family housing to renters in multifamily housing. As rental housing in multifamily structures serves as a close substitute for rental housing in single or small multifamily buildings, the high non homestead tax rate may enable owners of single or small multifamily rental real estate to charge higher rents. Lowering the tax rate on non homestead residential housing would likely, over time, reduce the cost of rental housing in the city.

A shift of the burden from residential non homestead property to homestead property would likely reduce the cost of rental housing for the city's poorer residents while shifting a portion of the burden to more affluent owner occupants. Alternatively, the city could choose to shift more of the burden to non residential non homestead property, although this could reduce the city's ability to retain and attract employers, as discussed elsewhere in this report.. As noted above, the effective tax burden on owner occupants in the city is below that of all suburban communities and well below that of many. While an increase in tax burden on middle class residents would increase the incentive for middle class residents to flee the city for suburban housing, factors other than the level of taxation are also influential. In stable, middle class neighborhoods of the city, a small increase in the share of the tax levy borne by homestead property owners would be unlikely to tip the balance for more than a few residents. This is, of course, an empirical question on which CGR has not gathered data.

As part of the simplification in the Homestead Tax Law recommended below, **CGR recommends that the city support a change in law permitting separate tax treatment of residential and non residential non homestead property. With such authority, CGR recommends that the city implement a phased-harmonization of tax rates on all residential real property.**

Support Simplification of the Homestead Tax Law

Office of Real Property Services staff have discussed the value of a much-simplified homestead tax law that would permit jurisdictions to set tax differentials for different classes of property without the needless complication of historic levy shares. This would free Rochester and other cities from the arcane rules governing the present rate determination. They also recommend that the differential in rate between property classes be limited within a range (as an example, business property tax rates might be limited to perhaps 150% of the residential rate). This would save other municipalities from the difficult position in which Rochester finds itself. **We recommend that the city of Rochester support simplification of the Homestead Tax Law.**

The city should work with the Office of Real Property Services to ensure that this change permits separate treatment of residential and non residential non homestead property, as discussed above.

Seek Special Legislation Permitting Rochester to Reduce Non Homestead Rate Prospectively

The best alternative for the city of Rochester and the state of New York is a radical simplification of the Homestead Tax Law that would permit significantly greater freedom for individual taxing jurisdictions in the administration of tax rate differentials across property classes. If such sweeping reform is not politically feasible, it may be possible for Rochester to receive special tax treatment enabling it to implement change on its own.

Rochester may wish to consider special legislation permitting the city to reduce its non homestead tax rate substantially for all new construction, providing long-term or permanent tax abatement for new entrants. The 485b exemption permits only a 50% reduction in tax and that only for a 10 year period. While the 485b exemption is helpful, the resulting rate is still higher than the homestead tax rate and begins to increase fairly quickly. A more substantial reduction for new construction would complement an intentional policy to slowly reduce the homestead/non homestead differential. **CGR recommends that Rochester seek special legislation permitting all new non homestead real property investment to be taxed at a rate below the non homestead rate.**

Provide Incentives for Expansion/Retention/Attraction

The city of Rochester already allows generous payment-in-lieu-of-tax agreements for large-scale new business construction. While we have not studied the magnitude of the incentives in the context of suburban competition, **we believe that continued use of incentives is necessary if the city is to continue to attract new business and retain established firms.**

The city already takes advantage of section 485b of the Real Property Tax Law, permitting an exemption from taxation for all business property. We endorse this practice as it extends some of the tax savings often available to large firms to small and medium-sized business enterprises. The city does not avail itself of new provisions in 485b allowing a slower reduction in the value of the exemption. **CGR recommends that the city administration work to establish an Industrial and Commercial Incentive Board in order to adopt the more generous exemption.**

Conclusions

The differential in taxation between homestead and non homestead property presents a particular policy challenge to the city of Rochester. The charge to CGR in conducting this analysis was to determine the extent of damage caused to the city economy by the policy of taxing non homestead property at a rate 2.5 times that of residential property.

Our analysis of employment and payroll trends in 155 Northeastern cities confirms the findings of a large number of empirical studies: Tax rate differentials do affect business location decisions, but only at the margin. Few firms will make a location decision based solely on tax rates. More significantly, other factors such as the quality of the local infrastructure, public safety considerations and the quality of the workforce have been shown to be far more important to the location decision of the firm.

Tax rates and property values are not determined separately from one another. When there are close substitutes readily available in an adjacent community, an increase in property taxes will reduce the value of real estate. While all factors relating to the business location decision contribute to the market value of property, the relatively high non homestead tax rate has probably also had an effect. Thus the burden of taxation for nonresidential business property is generally borne by the property owner. Renters of business property have many alternative sites outside the city and are able to force the owner of property to absorb the tax rate differential through a reduction in base rent.

Residential rental of non homestead property is very different. As virtually the entire market supply of affordable rental housing in the metropolitan area is concentrated in the city, landlords have sufficient market power to shift the burden of the non homestead tax rate onto tenants. We believe that this has also bid up the market price of rental homestead property, creating the widely observed disparity between the carrying costs of single family housing in the city and the rents charged by Rochester landlords.

CGR recommends against a rapid shift of tax burden from non residential to residential real estate, although we do recommend that the differential be reduced over time. We endorse the practice of providing tax abatement to new construction as a way of slowly closing the gap. We also recommend that the city explore changes in state law that would rationalize the Homestead Tax Law and facilitate a reduction in the tax rate differential between homestead property and residential non homestead property.