State of Pay

Fiscally, Albany still doesn't get it—why that should bother real estate

If you are a regular reader of Concrete Thoughts, you may be curious as to why a commercial real estate investment-sales broker like me spends so much time thinking about the state budget and the fiscal condition of the city and the state. Very simply, it comes down to real estate taxes and the impact the economic health of the state and city has on the fundamentals of our industry.

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Columnist

The April 1 deadline for a new state budget has come and gone without any agreement in Albany. The city budget, which is due June 30, is somewhat dependent upon the state budget; therefore, as the state budget is delayed, so too may be the city budget.

There are several political hot-potato issues being considered, not the least of which are the stifling public-sector employment contracts that are jeopardizing the long-term viability of our city and state. Given the considerable impact of these contracts on our balance sheets and the political implications for legislators who believe fundamental modifications of these contracts are necessary, many believe we may not see a budget agreement until after the fall elections.

Meanwhile, as state and city spending continues to rise, real estate taxes continue to skyrocket. Real estate taxes on multifamily properties are a perfect example. When I started in the business, in 1984, real estate taxes on walk-up apartment buildings averaged slightly less than $1 per square foot, at 97 cents. Taxes on elevator apartment buildings averaged slightly above $1 per square foot, at $1.04. Today, these levels range from $6 to as much as $13 per square foot, indicating 600 percent to 1,300 percent increases over a 26-year period.

This rise greatly exceeds the increase in revenue on multifamily buildings and even further exceeds rent-regulated increases permitted by the Rent Guidelines Board over the same period. One-year RGB increases aggregate to 97 percent over this period and total only 127 percent when compounded.

The real estate tax burden is, by any account, excessive. In fact, real estate taxes and real estate-related municipal tax revenues approached 50 percent of total tax revenue collections in New York last year. Real estate taxes, mortgage-recording taxes, transfer taxes, commercial rent taxes and hotel taxes totaled $17.86 billion out of our $36.99 billion of tax revenues collected. Unfortunately, real estate taxes will continue to face upward pressure to the extent that our Legislature is unable to agree on balanced budgets that reduce spending.

The history of our state budget is troubling. Last year, the budget was increased by $12.1 billion, of which $6.2 billion was federal stimulus money and $5.9 billion was simply additional spending. This year, there is no $6.2 billion stimulus package. In addition, though state legislators on both sides of the aisle claimed they would cut spending, add no new taxes and come up with a comprehensive plan to reduce our $9 billion budget deficit, the preliminary budgets that have been proposed increase spending from $131.8 billion to approximately $138 billion this year. This $6.2 billion increase means that, rather than having to fill a $9 billion deficit, we need to bridge an even greater shortfall.

One of the major reasons why spending continues to increase is that public-sector-organized labor contracts, which are such a significant component of city and state budgets, are oblivious to market conditions. Compensation, particularly for unionized public-sector workers, is significantly greater than average pay in the private sector. Additionally, fringe-benefit packages for public employees are excessive relative to those available in the private sector.

In the decade leading up to 2008, public employee compensation grew by 28.6 percent compared with 19.3 percent for private workers, according to U.S. Bureau of Labor statistics. The recession impacted nearly everyone in 2009, a year in which we had very modest inflation and record budget deficits. Notwithstanding these conditions, public-sector obligations steadily rose.

In 2009, state and local public employees received an average total compensation per hour of $39.66 versus $27.42 for those working in the private sector. This breaks down to $1.45 received for state and local government workers as opposed to $1 in pay and benefits for private-sector employees.

It was once thought that in order to encourage citizens to work in the public sector, enhanced compensation and benefits were necessary, because such jobs, while providing more job security, provided less compensation than found in the private sector. This trend has reversed itself, and these public payroll and pension obligations are bringing many municipalities to the brink of insolvency.

Clearly, unions play a vital role in our society. Ensuring that working conditions are fair and that ownership does not take unfair advantage of their workforce is critically important and socially justified. But there must be reality checks built into the system that allow for adapting to changing market and economic conditions.

Public-sector employees now earn salaries approximately 33 percent above what private-sector employees earn. Moreover, the real inequity for government workers is in their excessive benefits packages. Here public-sector employees are compensated 70 percent higher than what standard private-sector employees are offered. Government health benefits are more than twice as generous as those granted to workers in the private sector.

Importantly, nearly the entire benefits gap is due to unionized public employees (non-union public workers are paid similarly to private-sector employees). These overly generous pension plans are not sustainable, as stated by Michael Bloomberg last week: "The issue that we have is that the whole pension system is something we cannot afford."

Pension obligations are growing at an incredible rate. This is due mainly to a practice called "spiking," where union employees tack on massive amounts of overtime and are compensated for unused paid-vacation time as they are about to retire. Numerous cases have been documented recently showing that public-sector employees who had salaries of $70,000 to $80,000 per year are on pensions in excess of $150,000 per year, and will be for life. The pervasiveness of these abuses has caught the attention of Attorney General Andrew Cuomo, who is currently investigating these practices.

The implications are disastrous for the city. For example, rising pension obligations and the plunging performance of pension-fund investments over the past two years has placed the New York City Fire Department pension fund in a precarious position. The fund is only about 55 percent funded, and the city pays about as much to the 17,500 FDNY retirees as it does to the 11,000 firefighters currently on the job.

The FDNY is not alone in its predicament. The New York City comptroller's office indicates in its fiscal 2009 report that our five pension funds have a deficiency in unfunded employee pension and health benefits that tops $105 billion. A real solution here would be to transition all new hires and as many current employees as possible from the traditional "defined benefit" plan (which pays a defined amount regardless of investment performance) to a "defined contribution" plan, similar to a 401(k), which is the most prevalent plan in the private sector.

In most states, taxpayers are on the hook for these unfunded obligations. Not surprisingly, the states with the largest budget deficits are those that have the biggest gap between compensation packages for public employees versus those for private employees. In fact, if public workers earned the average of what workers in the private sector earn, states and other municipalities would save an estimated $339 billion a year from their more than $2.1 trillion budgets. These savings would be larger than the combined estimated deficits for the next two years in every state in America. It is clearly time to look at these compensation packages and bring them down to earth.

The massive deficits that have been created in New York are starting to take their toll. It is time for legislators to bring spending on public-sector jobs in line before a rash of public-sector layoffs creates quality-of-life issues for the city. The reality is that if labor won't help out, workers will be terminated: Simply stated, terminated workers do not contribute to future pension obligations. Unfortunately, these layoffs, while helpful economically, would not be good for the city.

Two weeks ago, we became concerned to learn that violent crime in the city is rising. Murders are up 22 percent, and shootings rose 21 percent. When asked about this troubling trend, the mayor said, "We have fewer police officers than we did before." Without union concessions, we could have even less in the not-too-distant future.

We also recently saw significant service cuts from the M.T.A., which is saddled with higher labor costs thanks to our legislators in Albany. The M.T.A. budget is being cut to the bone, and fares will be hiked for a third time in four years.

The mayor, to his credit, has been negotiating with unions and urging lawmakers to pass reforms that would substantially cut benefits, not for today's workers but for new employees. These consist of increasing the years of service required before collecting a pension from 20 to 25, and setting a minimum retirement age for police and firefighters. The city's own Comprehensive Annual Financial Report shows that the five pension systems are positioned at less than 80 percent of the generally accepted thresholds for healthy funds.

In an interview on Fox Business News last week, Comptroller Tom DiNapoli claimed that New York's budgets were "in good shape" and that they were not underfunded. But whether plans are technically "funded appropriately" is dependant upon hocus-pocus math that assumes an annual 8 percent rate of return on pension fund investments. Public-pension accounting rules incorrectly assume that plans can earn high investment returns without risk. These practices leave pension-plan advisers fooling themselves with unrealistically low deficit projections.

This mechanism allows our legislators to avoid having to make difficult choices today at the expense of massive burdens on taxpayers in the future. Even though the 8 percent target rate is unrealistic, government officials do not want to change the law to lower the required earnings, as this would mean bigger upfront payments, discontented unions and political upheaval.

This year presents an opportunity for elected officials to stand up and fix this economically destructive problem. Our legislators control the future of these contracts. The Legislature could change significantly after this fall's elections. Aggressive support for fiscally responsible candidates who promise to modify unreasonable labor agreements and their resultant pension problems would well serve the interests of the city and state.

The more in line these costs are with the realities of the marketplace, the less upward pressure we will see in real estate tax obligations moving forward. The new state budget will tell us if legislators are willing to stand up to politically powerful unions and set sustainable spending levels.

The answer to this question will tell us a lot about real estate tax obligations moving forward.

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