NEW YORK CITY COMPTROLLER
BRAD LANDER

Spotlight

What Risks Does the Office Market Pose for the City's Finances?

BUREAU OF BUDGET

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Introduction

An enduring legacy of the pandemic has been a transformational shift to remote or hybrid work for many office jobs. Given the important role that commercial real estate, and the office market in particular, plays in New York City's economy and tax base, this Spotlight focuses on recent, longer term, and projected trends in the city's office market. Following a brief overview of market data, we estimate—across a range of scenarios—the impact of changes to office buildings' market values on the City's property tax levy.1 The stakes are high – the City typically draws more than one-fifth of its property tax levy, and [roughly 10% of its total taxes] from office buildings alone. Table S.1. shows that office Class A buildings make up 7% of the total property tax levy.

Table S.1. Office Properties: FY 2024 Share of Total Levy

Office Class	Percentage of Total Property Tax Levy
Class A	7%
Class B	5%
Other	5%
Trophy	4%
Total	**21%**

In the NYC property tax system, office buildings are part of Class 4 properties, along with hotels, stores, garages and gas stations, warehouses, and others.[2]

SOURCE: Department of Finance (DOF) FY 2024 Final Roll

NOTE: Office Classes are DOF Designation.

Despite improvement in return-to-work trends, office attendance appears to be stabilizing at a rate substantially below pre-2020 levels (as shown in Chart 5 of this month's newsletter).

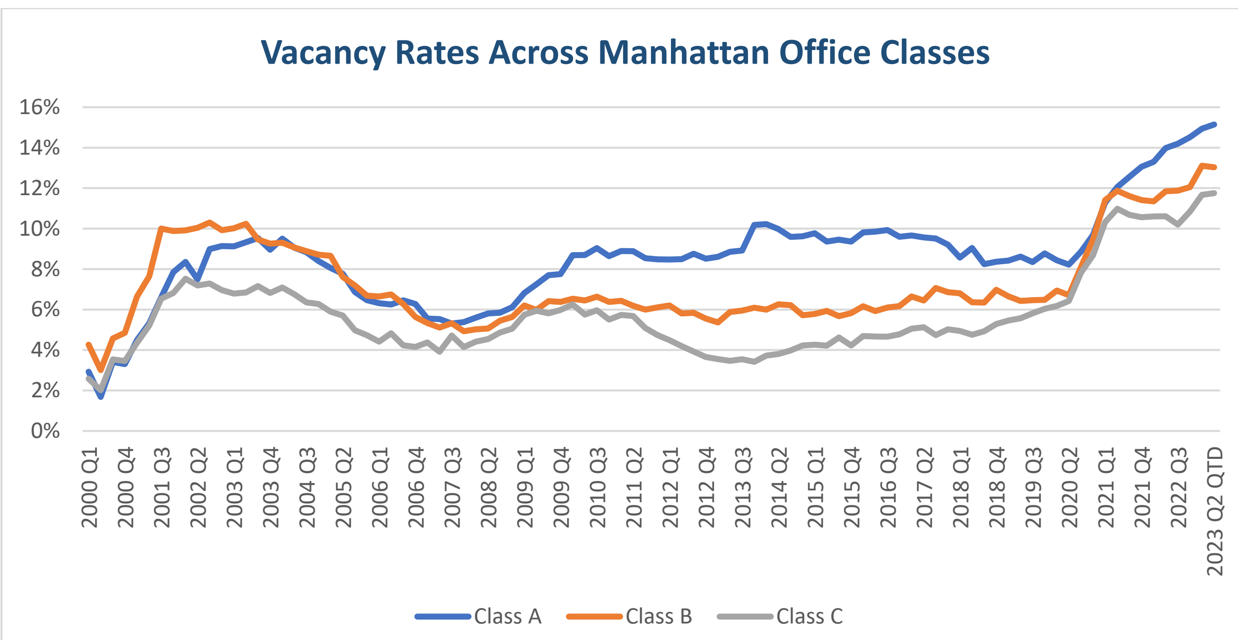
Low office attendance may reduce companies' demand for office space when leases are up for renewal. The decrease in the demand for office space would put downward pressure on office rents. These changes would in turn result in a long-lasting drop in office property valuations by the NYC Department of Finance (DOF), with potentially significant consequences for the City's property tax levy. Downward pressure on office building valuations could also adversely affect lenders if a significant number of property owners were to default on their loans or mortgages.

Anticipating the complete extent of the risk to market valuations and the property tax is challenging. The health and vitality of New York City's commercial real estate market over the next several years depend on several uncertainties. These include the durability of widespread hybrid work arrangements and their influence on future office demand; the extent to which new businesses are interested in entering the NYC market; the adaptability of the building stock to accommodate non-office uses; the efficacy of government programs and policies to promote adaptive reuse; and, critically, building owners' ability to lease space at sustainable rents without jeopardizing the viability of their properties. Given the wide range of factors, we consider a broad aperture of possibilities in our analysis.

Recent Trends in NYC's Office Market

While New York City's economy has largely rebounded from the pandemic, the commercial real estate sector, in particular the office market, has not. The gradual trend toward remote work over the past few decades accelerated to warp speed in the spring of 2020, as almost all businesses that could operate remotely were required to do so. As the pandemic faded in 2022, some of the businesses that had gone fully remote continued that way, though most transitioned to hybrid work arrangements, with many workers telecommuting for 2 to 3 days out of the week. In New York City this was apparent from office attendance rates, averaging around 50% on a typical workday *(*as shown in Chart 5 of this month's newsletter), as well as subway ridership, running about 35% below pre pandemic levels during the workweek. Initially the city's office market held up somewhat better than expected, with many tenants staying current on rents due to a combination of strong revenues, federal aid programs, and availability of credit.

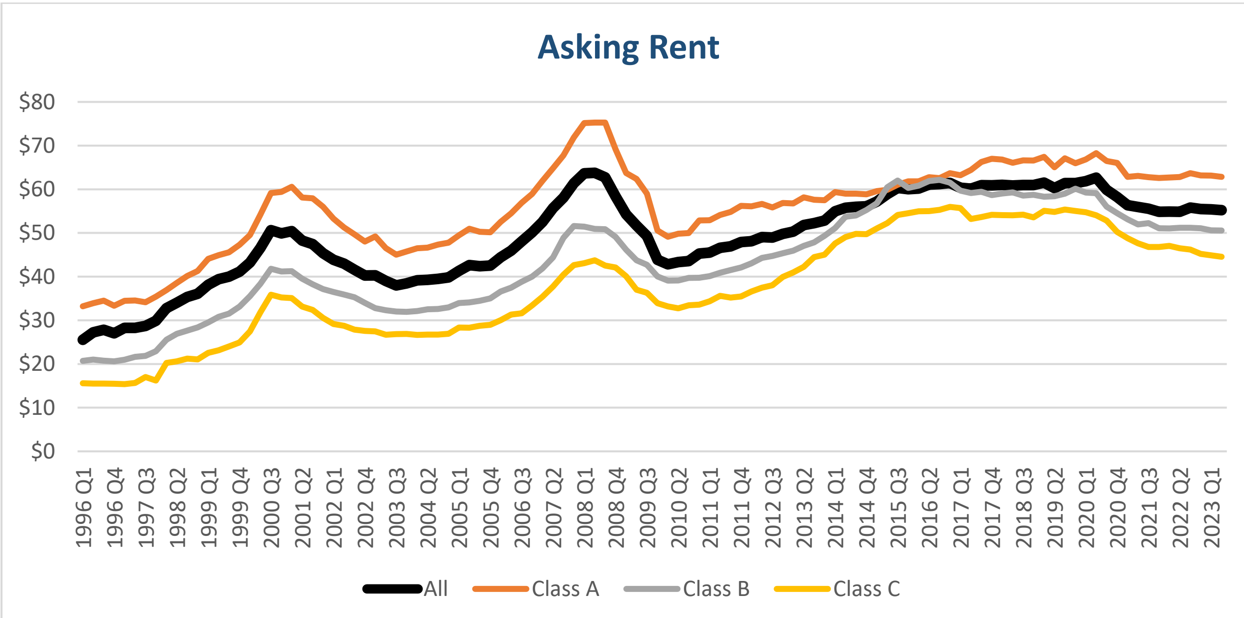
Chart S.1



SOURCE: CoStar, Manhattan south of 59th street.

On the demand side, as office leases across New York City have come up for renewal, many companies have vacated their spaces, reduced their footprint, or moved to smaller (and sometimes higher quality) spaces. On the supply side, a large volume of high-quality office space has come on the market over the past years—particularly in Hudson Yards. All this has led to an upward trend in vacancy rates (see Chart S.1). Meanwhile, as shown in Chart S.2, rents across office space classes have declined from their recent peaks to varying degrees: ranging from a roughly 7% decline for Class A space to nearly 20% for Class C. This likely understates the true decline in effective rents, as many commercial landlords have thrown in concessions, ranging from upgrading space to providing up to 15 months of free rent (source: Costar).

Chart S.2

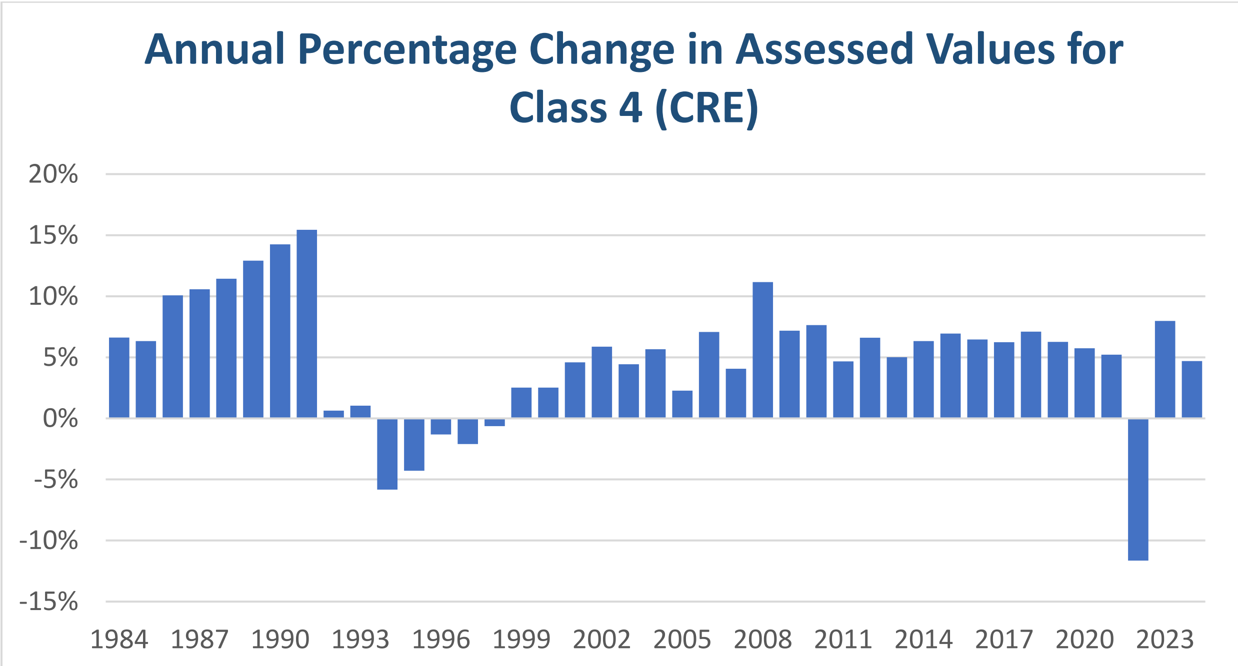


SOURCE: CoStar

How Does This Compare with Past CRE Downturns?

The current slump in the city's office market has been cited as having "record high" vacancy rates, which are indeed more severe than during the 2001 and 2008 recessions. But during the city's early 1990s downturn, office vacancy rates exceeded current levels, surging above 17%, with rents off by more than 20%.[3] That earlier slump was driven by a "perfect storm" of oversupply, a steep downturn in the finance sector and local economy, and a widespread shrinkage and outflow of back-office operations to remote locations. From peak to trough, property tax assessed values for commercial space fell by 13% between FYs 1993 and 1998 (Chart S.3). In contrast to the current slump, during the 1990s the housing market also sharply contracted, further reducing tax revenues. The recovery took a number of years, but by the late 1990s, the city's office market was booming once again.

Chart S.3



SOURCE: NYC Department of Finance and Office of the NYC Comptroller

Looking Ahead

The question on many people's minds is: what lies ahead? It seems increasingly clear that, while companies still need and value office space, hybrid remote work arrangements are here to stay. In effect, many businesses are now able to do more with less office space; how much less space remains to be seen. If the decline in office utilization were evenly spread across the workweek—that is, if the same fraction of staff were coming in each day of the week—then, for example, a shift from a 5-day to 3-day workweek would imply something close to a 40% drop in needed office space. But this has not happened; rather, most of the drop-off occurs on Mondays and especially Fridays. In this model of hybrid work, employers still generally need space for all of the employees who come in on the busiest days.

So what will be needed to pick up the slack? On the demand side, this will require a combination of new startups, existing businesses expanding their footprint, and businesses from elsewhere establishing or expanding their presence in New York City. And on the supply side, it will require a re-purposing of some of the less desirable office space, largely residential or hospitality conversions. The City's Economic Development Corporation also recently launched a tax subsidy program for the renovation of 10 million square feet of Manhattan office space. Of course, there is a great deal of uncertainty as to how this will play out. Thus, in order to gauge the fiscal outcome, we have developed a set of plausible scenarios—a baseline, a moderately optimistic, a moderately pessimistic, and a “doomsday” path—and have estimated the effect on property tax levies of each one. We present the results of each in the next section.

Potential Impact on Property Tax Revenues

Our approach to developing the four scenarios was as follows: in the baseline projection, used in our Executive Budget Report forecast, we assume that DOF market values for Manhattan offices will grow by 3.2% in FY 2025, 2.7% in FY 2026 and 0.5% in FY 2027. These market value valuations are based on net operating income in the prior fiscal year, and any increases in the assessed values due to market values increases are phased in gradually. In the most pessimistic “doomsday” scenario, we focus on a recently published research study, which estimates that the value of office properties in New York City will settle at roughly 40% below pre-pandemic peak levels. In the moderately pessimistic path, we look at how far rents are projected to fall annually by CoStar. Finally, in the moderately optimistic scenario, we apply a historical longer-term trend in New York City office rents going forward and assume that Manhattan office rents will get back to trend. It is important to note that our estimated effect on City tax revenues does not include indirect effects, such as repercussions on lenders, or spillovers to retail or residential markets. Similarly, we also do not make assumptions on the conversion of office space to higher value and tax uses.

In the “doomsday” scenario, we calculate that DOF valuations of Manhattan offices before adjustments—which are based on prior year net operating income (NOI) rather than forward looking market valuations—will decrease by 6% annually in FY 2025 to FY 2027 from the final FY 2024 market values, which are already set and are only modestly below pre-pandemic levels. This rate of decline is derived by spreading the 40% drop in value over the years 2023 to 2029 (which translates into tax rolls for FY 2025 through FY 2031). This would result in a cumulative drop in DOF valuations of about 17% by FY 2027. In this scenario, further declines would continue into later years beyond FY 2027 (and by FY 2031 get to -40%) because of the gradual nature of valuation based on NOI. After accounting for DOF adjustments and complex assessment value transitions, we calculated the simulated effect on the levy. Relative to our baseline levy,[4] this scenario finds a shortfall of $322.7 million in FY 2025 (0.9% of the projected total levy), growing to a shortfall of $1.12 billion in FY 2027 (3.0% of the levy).

In the moderately pessimistic scenario—based on CoStar’s market rent forecasts—Class A, Class B, and all other offices[5] are assumed to decrease from their FY 2024 final market values by 1.25%, 1.93% and 1.93% respectively each year from FY 2025 to FY 2027. Relative to our baseline levy, this would result in a shortfall of $119.8 million in FY 2025 (0.3% of the levy), growing to a shortfall of $276.1 million in FY 2027 (0.7% of the levy).

Finally, in the optimistic scenario, office rents would not only stop declining but would revert to their historical trend rates of growth (albeit from the current depressed levels) in line with trends in New York City office rents from 1998-2020, while vacancy rates would level off. Class A, Class

B, and other offices are assumed to increase by 2.6%, 3.6% and 4.5% respectively each year from FY 2025 to FY 2027 from the FY 2024 final market values. Relative to our baseline levy, this would imply upward revisions starting at $29.7 million in FY 2025 (0.1% of the levy) and growing to $310.1 million by FY 2027 (0.8%).

Table S.2. Trends in Total Property Tax Levy Under Alternative Scenarios for Office Valuations

	FY 2024	FY 2025	FY 2026	FY 2027
Baseline forecast				
Estimated total property tax levy ($ mil.)	35,350	35,691	36,244	37,415
Annual percentage change		1.00%	1.50%	3.20%
Optimistic forecast				
Estimated total property tax levy ($ mil.)	35,350	35,721	36,248	37,725
Annual percentage change		1.10%	1.50%	4.10%
Deviation from baseline forecast ($ mil.)		30	5	310
As percentage of total property tax levy		0.10%	0.00%	0.80%
Pessimistic Forecast				
Estimated total property tax levy	35,350	35,572	35,952	37,139
Annual percentage change		0.60%	1.10%	3.30%
Deviation from baseline forecast ($ mil.)		-120	-292	-276
As percentage of total property tax levy		-0.30%	-0.80%	-0.70%
Doomsday Forecast				
Estimated total property tax levy	35,350	35,369	35,498	36,293
Annual percentage change		0.10%	0.40%	2.20%
Deviation from baseline forecast ($ mil.)		-323	-746	-1122
As percentage of total property tax levy		-0.90%	-2.10%	-3.00%

Conclusion

While New York City's economy overall has rebounded from its pandemic lows, office space utilization remains depressed. This, of course, has adversely affected the many businesses in Manhattan's central business districts—theaters, bars, restaurants, nail salons, etc.—that rely heavily on office workers. Going forward, though, a major and growing concern is its effect on tax revenues and thus the City's fiscal situation. By simulating a range of scenarios, we have attempted to gauge both downside and upside risks to our revenue forecast in what appears to be the most vulnerable sector of New York City's economy, the office market, going forward.

Even in our "doomsday" scenario, we find that the estimated revenue shortfall relative to our current projections of $1.1 billion in FY 2027 constitutes only 3% of the total property tax levy, or 1.4% of City tax revenues, and 1.0% of total revenues, which include state and federal grants. To put this amount in context, it is slightly smaller than the amount of tax revenue "offsets" estimated in the Comptroller's most recent forecast for FY 2027—i.e., the amount the Comptroller expects tax revenue to exceed the Mayor's tax revenue forecast. While not a small amount, it is well within the range in which tax revenues can ordinarily vary.

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Endnotes

[1] The property tax levy aggregate tax due by property owners for a given fiscal year. The levy is higher than actual collections because of delinquencies, cancellations, tax abatements, and other components collectively referred to as the property tax "reserve." NYC Department of Finance (DOF) FY 2024 assessment guidelines and summary of Real Property Income and Expense (RPIE) reports provide information on the data underpinning the latest valuations. For a concise introduction to the property tax system, see the Advisory Commission on Property Tax Reform Preliminary Report, issued in 2020. NYC IBO also recently published an analysis of commercial assessments.
[2] In more formal terms, Class 4 includes properties that are not classified as residential or owned by regulated utilities and special franchise properties such as, for instance, equipment owned by cable television providers.
[3] See *The City of New York Executive Budget, Fiscal Year 1998: Message of the Mayor*, page 25.
[4] We cannot compare to NYC Office of Management and Budget tax revenue forecast and potential impact on the financial plan because published data does not break down the levy forecast by property type.
[5] This market segmentation is based on DOF's classification of office properties in the tax rolls and in the assessment guidelines. In the analysis, class A building include so-called trophy buildings. The "other" category includes class C buildings.

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