

**FINANCIAL OVERSIGHT AND MANAGEMENT BOARD
FOR PUERTO RICO**



José B. Carrión III
Chair

Members

Andrew G. Biggs
Carlos M. García
Arthur J. González
José R. González
Ana J. Matosantos
David A. Skeel, Jr.

Natalie A. Jaresko
Executive Director

BY ELECTRONIC MAIL

August 26, 2020

The Honorable Wanda Vázquez Garced
Governor of Puerto Rico

The Honorable Thomas Rivera Schatz
President of the Senate of Puerto Rico

The Honorable Carlos J. Méndez Núñez
Speaker of the House of Representatives of Puerto Rico

Dear Governor Wanda Vázquez Garced, President Rivera Schatz, and Speaker Méndez Núñez:

Puerto Rico's property tax regime would benefit from substantial reforms. Therefore, in accordance with Section 205(a), the Oversight Board writes to provide broad recommendations on ways the government can overhaul the Commonwealth's property tax system, with the goal of improving its efficiency, effectiveness, and, ultimately, collections. Many similar recommendations were also included in the March 2019 review conducted by the U.S. Treasury. That review was completed by Gary Cornia, Ph.D. and Lawrence Walters, Ph.D., and included a detailed assessment of property taxes in Puerto Rico, which also included recommendations.

The recommendations in this letter emphasize and should be taken jointly with those provided in the 205 letter addressed to you on June 5, 2020. That letter focused on the value of implementing a GIS system (incorporating both land registration and a property tax registry) as supported by the HUD CDBG-DR funded planning activity to develop a uniform parcel ownership registry and GIS database. Among other objectives this database will assist HUD, other parties, and the public to verify the legal and physical address associated with CDBG-MIT activities. Meeting these objectives is also critical to comprehensive and accurate inclusion of properties in the property tax registry to support effective municipal revenue mobilization and equity within the property tax system. Therefore, participation by all relevant agencies, including CRIM, the Department of Justice, and the Planning Board, will be required for the development of a "single source of truth".

Governor Vázquez Garced
President Rivera Schatz
Speaker Méndez Núñez
August 26, 2020
Page 2 of 26

Today's letter deals more directly with reforms needed to the broader property tax system. However, it is clear that the implementation of the recommendations in this letter, combined with the implementation of a GIS system, would result in a more robust and inclusive property database. A comprehensive and complete database would provide CRIM with enhanced property identification, resulting in more accurate parcel identification and record keeping, increased tax billing, and higher tax collections.

Data validation and improvements are required prior to consolidating agency databases. CRIM has historically faced inaccuracies in their data, resulting in unpaid tax bills and growing accounts receivable balances. As a first step, CRIM has already initiated improvements focused on increasing the accuracy of their database, including development of an appraisal system (SKALA), adding missing or incomplete appraisals, amending existing appraisals for building additions or pools and correcting erroneous classifications of properties, among others. However, once these data improvements are successfully completed, Puerto Rico will still need CRIM to collaborate with other agencies in the development and validation of a comprehensive land and property registry. The increased accuracy could aid in elimination of unpaid tax bills, which as time progresses, diminish in value and may ultimately be uncollectible, as witnessed by CRIM's past efforts to sell their accounts receivable portfolio. Many of the accounts were deemed to be uncollectible due to inaccurate or dated information, making the portfolio difficult to collect and/or sell. A cleaned up and improved CRIM database is a first step towards a comprehensive property database, improving accuracy, and increasing tax revenues without increasing tax rates.

The government should work to maintain uniformity in the effective tax rates applied to different properties across the island. In general, higher valued properties should pay more in tax, but only because they are worth more, not because they face a different implicit effective tax rate. With equal effective tax rates, the tax system does not favor some activities or taxpayers over others, so that underlying economic realities, rather than tax considerations, can drive economic and business decisions. Deviations from this uniform effective tax rate structure should be made only when there is a compelling and transparent case for granting some types of property or taxpayers a lower rate or imposing a higher rate on others.

Puerto Rico's valuations for real property tax assessments do not follow this general principle. Property tax is currently based on the replacement cost value of the property as if it were constructed in 1957, which was the last time a full valuation assessment was performed in Puerto Rico. This approach has resulted in an inequitable tax burden on Puerto Rico's population, creates incentives for businesses to avoid and evade taxes, and yields only a fraction of potential property tax revenues that could be generated to invest in economic development and growth. As an example of this outdated system, there are numerous beachfront properties with the same assessed values as much more modest properties located inland.

The effective real property taxable base also varies inequitably from property to property and jurisdiction to jurisdiction because of differing exemptions and exonerations. These differential

valuation and exemption/exoneration practices convert what might seem to be fairly uniform statutory tax rates into effective tax rates that vary significantly across properties and asset types. In addition to having a real property tax base that is significantly below market value, Puerto Rico has very high statutory tax rates. Statutory rates are typically around 10% for real property and around 8% for personal property. However, because of the very low tax base for real property, the effective tax rate (the ratio of property taxes to market value) is, on average, very low in Puerto Rico but varies substantially across properties.

The Oversight Board recommends addressing problems with the property tax system by first broadening the tax base through the removal and reduction of exemptions and exonerations. In addition, the Oversight Board recommends reforms to improve the accuracy of the measurement of the tax base by tying assessed and taxable values to the true market value of a given property. Taking one or both of these steps would substantially increase tax revenue and tax burdens unless statutory rates were reduced. Therefore, these reforms will also necessitate a review of the statutory rate structure, with an eye towards setting statutory tax rates that provide the appropriate level of tax revenue. The combination of these measures would substantially improve the equity and efficiency of the current property tax system.

Although not dealt with explicitly in this set of recommendations, the HUD CDBG-DR funded registry and GIS database will function as an implicit pre-requisite to property tax reform, through providing the infrastructure for an improved land and property registration system. To be effective this system will also require process and institutional reforms, as outlined in the letter dated June 5, 2020. A rationalized land and property registration system (electronic or otherwise) is indeed implicit in the property tax reforms discussed below under all four categories of recommendation. It is, in fact, a central requirement of any modernized property tax system.

Four categories of recommended change

The recommended reforms consider the following four categories of changes:

1. Reduce exemption and exonerations

- a. Conduct a review of all property tax exoneration and exemptions with the goal of promoting a comprehensive tax base and equal treatment of taxpayers
- b. Repeal legislation authorizing current exemptions and establish a moratorium on the creation of new exemptions, taking into account a transition period for contractually agreed tax exemptions
- c. Adopt formal policy guidance and regulations specifying the circumstances under which exemptions might be considered desirable, with the default position that all exemptions will be denied unless a compelling justification exists

2. Establish a market value basis for property valuation

- a. Scenario 1: Refresh real property valuation approach to a “market-informed” system based on current market prices and construction methods
 - i. Revise quality and materials classification categories, coefficients, and baseline costs
 - ii. Revise land valuation to, at a minimum, reflect market valuation banding
- b. Scenario 2: Establish a true market value (transaction data) approach to property valuation
 - i. Establish a mass appraisal process to revalue properties on a recurrent basis
 - ii. Establish multiple methods for valuing improvements based on existing use
 - iii. Set land values equal to the market value of individual parcels of land

3. Levy appropriate property tax rates

- a. Increase and improve the uniformity of the effective tax rate on residential real property
- b. Evaluate increasing the effective tax rate for business real property

4. Use classification to transparently vary effective tax rates between residential, commercial, and industrial properties, if such variation is justifiable

- a. Instead of using exemptions and exonerations, effective tax rates can be adjusted across a broad category of property (to achieve explicit policy objectives) using differing assessment ratios or statutory tax rates based on the property type

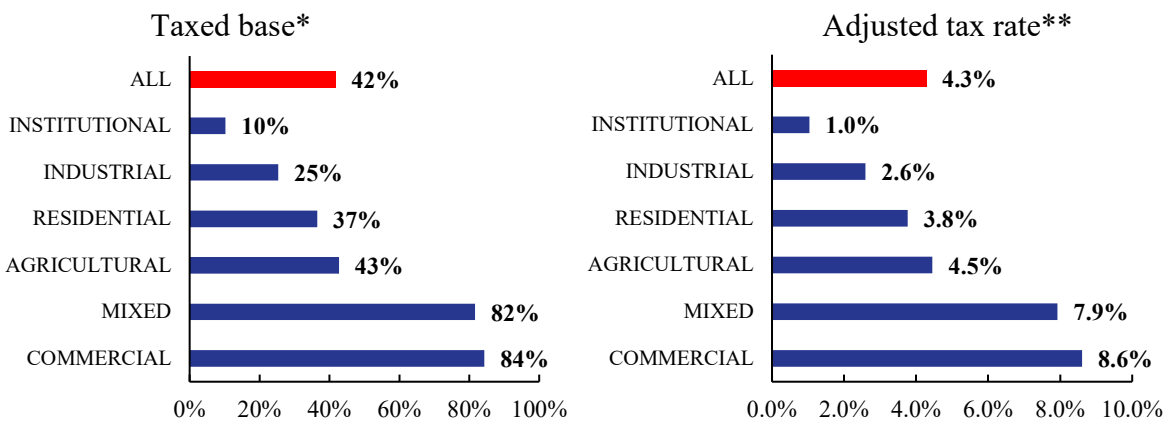
These recommendations represent pathways to a reformed tax system with a broader and more transparent base and lower statutory tax rates. They do not specify the specific parameters of a new property tax system. In designing such specifics, it will be important to keep both efficiency and equity considerations in mind. Undeniably, this will involve tradeoffs and the balancing of competing goals.

Finally, because of the interactions of the different features of the property tax system, including tax base and rates, multiple types of property being taxed, and tax burdens being shifted from those who make the payments, the effects of the new system as a whole should be analyzed carefully and compared against the effects of the existing tax system. A casual and piecemeal comparison can be misleading. As an example, some residential property owners who might pay higher taxes because of a reduction in exonerations may pay lower prices for products or earn more income because some business property taxes are reduced. It is the net effect of all these changes that matters to them, not just the increase in taxes on residential properties.

Recommendation #1: Reduce Exemptions and Exonerations

The property tax base in Puerto Rico is too narrow and variable. Almost 60% of the real property tax base in Puerto Rico is exempt or exonerated from taxation. In addition, exemptions and exonerations vary significantly across property classes, across jurisdictions, and across individual properties within the same class. This variation is illustrated in the figures and tables below.

Taxed base and Adjusted tax rate¹, by class of property



Source: CRIM data and own calculations

* Equal to the taxable base (after exonerations and exemptions) as a percentage of total assessed property value

** Equal to tax liability as a percentage of total assessed property value

As a whole, exemptions and exonerations remove 75% of the industrial total assessed property base from taxation, 63% of the residential base, 57% of the agricultural base, and 16% and 18% of the commercial and mixed commercial-residential base. These are staggering figures and are much higher than virtually all other jurisdictions in the United States. The institutional tax base, composed of government, religious, non-profit, and health-related properties are 90% exempt. Correspondingly, the taxes paid as a portion of the full value of the tax base are lowest (with the exception of institutional property) for industrial properties, followed by residential, agricultural, mixed-use, and commercial properties. As a portion of its assessed value, the implied tax rate on a commercial property is more than three times that of an industrial property and more than twice that of a residential property.

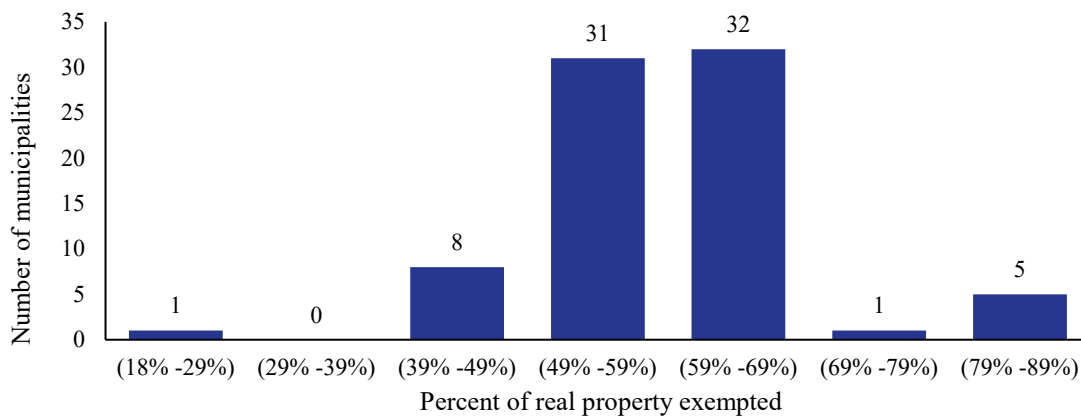
A common practice in U.S. states is to favor agricultural land and residential property in property tax treatment. The property tax treatment in Puerto Rico implies similar treatment for some residential property, with \$15,000, based on 1957 value, exonerated for owner-occupied housing.

¹ The tax amount collected divided by the assessed value (1957 \$) is referred to as the adjusted tax rate in this letter. We use this measure because it is the most reasonable conceptual substitute for an effective tax rate (ETR) which is not possible to calculate because data on actual market value of property is not available and the current property valuation system is so divorced from market valuation. The ETR is intended to reflect the true burden of the tax which is not possible in the Puerto Rico because of deviations between assessed value from the true market value.

This exoneration equates to approximately \$215,000 in current value. However, the ad hoc granting of exemptions, primarily for industrial properties, occurs to such an extent that only 25% of the industrial tax base remains as taxable. Exemptions are far less widespread for commercial properties. These relative exemptions and implied tax rates can, however, be quite misleading. The 1957 base valuation for real estate combined with the treatment of machinery, equipment, and inventory makes comparisons both within and between classes difficult. Still, these results do strongly suggest the need to rationalize the property tax system.

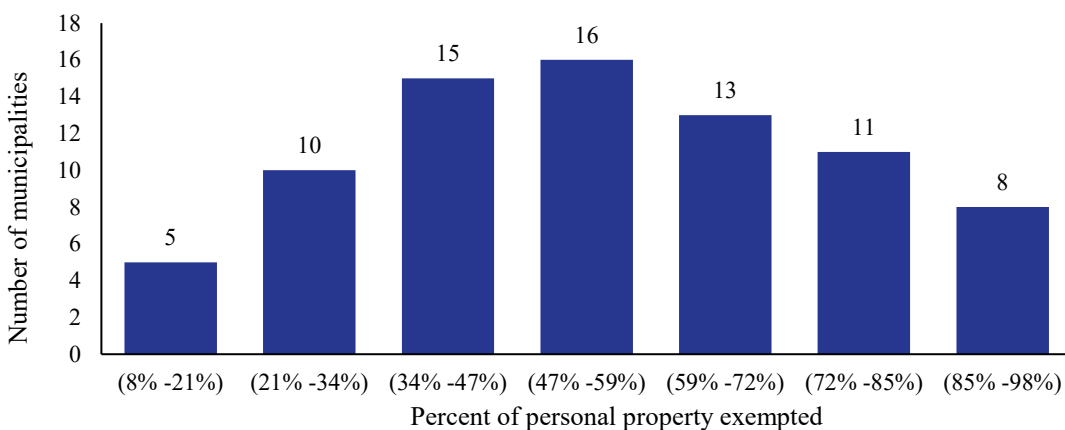
There are also substantial variations across municipalities in the levels of both real and personal property exemptions. The figures and table below show (in numbers of units and in dollars) the extent of the erosion of the property tax base in recent years due to exemptions and exonerations across municipalities for both personal and real property.

Distribution of 78 municipalities in level of real property exemptions



Source: CRIM data and own calculations

Distribution of 78 municipalities in level of personal property exemptions



Source: CRIM data and own calculations

Property tax base (2014-2018)

	2014	2015	2016	2017	2018
Real Property					
Number of property units	1,264,317	1,274,012	1,285,694	1,297,307	1,308,599
Total assessed value (millions)	\$18,532	\$18,610	\$18,750	\$18,951	\$19,141
Number of taxable property units	642,524	651,059	659,001	669,803	679,930
Total taxable value (millions)	\$7,653	\$7,702	\$7,666	\$7,787	\$7,990
Taxable value as a percent of total value	41%	41%	41%	41%	42%
Exempted value	\$10,879	\$10,908	\$11,084	\$11,164	\$11,151
Personal Property					
Number of accounts	72,485	72,188	70,948	70,725	68,465
Total personal property value (millions)	\$11,980	\$12,796	\$13,292	\$13,395	\$12,533
Number of taxable accounts	50,190	49,712	50,372	50,178	46,971
Taxable personal property value (millions)	\$5,360	\$5,384	\$5,328	\$5,176	\$4,662
Taxable personal property value as a percent of total value	45%	42%	40%	39%	37%
Exempted value	\$6,620	\$7,412	\$7,964	\$8,219	\$7,871
Real and Personal Property					
Total taxable value as a percent of total property value	43%	42%	41%	40%	40%

Source: Table adapted from Cornia and Walters (2019)

In 2018, only 52% of real property units and only 68% of personal property accounts were taxable. As a portion of assessed value, these percentages reflect a tax base of approximately 40%.

One result of the eroded property tax base is that all else being the same, the tax yield is substantially suppressed. Exemptions and exonerations also create unfair and inefficient non-uniformity of tax burdens both within and between property classes and across jurisdictions and lead to higher effective tax rates on the remaining base, which further distorts economic decisions. The haphazard and variable nature of exonerations and exemptions is not transparent and complicates tax compliance and enforcement.

Exonerations: Yield and Accountability

Taxpayers are granted a tax exemption on real residential property for the first \$15,000 of the 1957 assessed value on one owner occupied residence, which represents more than \$215,000 in current prices.² This exemption is substantially higher than the homestead exemption provided in any U.S. state.³ This exemption results in extremely low effective tax rates for residential properties and encourages overinvestment in residential housing at the expense of other, more productive investments. By dramatically lowering tax collections, the residential property tax breaks require higher taxes elsewhere, which adds to overall tax-induced economic distortions and inequities. Owner-occupied residential properties⁴ valued at or below the eighth decile of assessed value pay no property taxes. Only the most expensive residential properties are valued at more than the exonerated amount so that 84% (roughly 570,000) of residential properties are assessed with no property taxes. Even those very expensive properties that pay some tax benefit from the high levels of exonerations. While property tax relief could be justified for lower-income families, it is difficult to justify for those who own houses at or above the 50th percentile of value, and especially difficult to justify for those who own the most valuable properties. This is the case for all categories of owner-occupied housing, single-family, condominiums, and others.

Further, exemption policies negatively affect lower-income households. Exemptions do not apply to residential rental properties, which are disproportionately occupied by lower-income families. A substantial portion of the property tax burden on residential rental properties is expected to be borne by the tenant in increased rent. This means that low income Puerto Ricans who cannot afford to buy a house are in fact, contributing more in property taxes than are relatively more affluent homeowners. In all categories of rental housing, the property tax is levied on a higher portion of the property's assessed value. Given that the value of rented residential property tends to vary directly with income, this suggests that the tax levy is regressive even within the rental property classification as well as between rental and owner-occupied property categories.⁵

² This is based on US construction cost increases. Depending on the construction index used (Census Single-Family construction cost estimated Lespeyres or Fisher indexes or Engineering News-Record construction cost index) and extended from 1957 average costs to October 2019 costs, a \$15,000 exemption in 1957 would be equivalent to an exemption of between \$215,222 and \$234,658 in October of 2019. (Note: Cost increases were greatest under the ENR index. Because historical Census indexes were unavailable prior to 1964, the change in the ENR index between 1957 and 1964 was used to proxy the implied change in the Census index between 1957 and 1964, this resulted in an implied Census 1957 index equal to 0.77 of the 1964 index).

³ In U.S. states, when general homestead exemptions are provided, they generally exempt a quite limited portion of a property's value from taxation, and the amounts provided are generally far less than 1/10 of the value of the exemption provide by Puerto Rico.

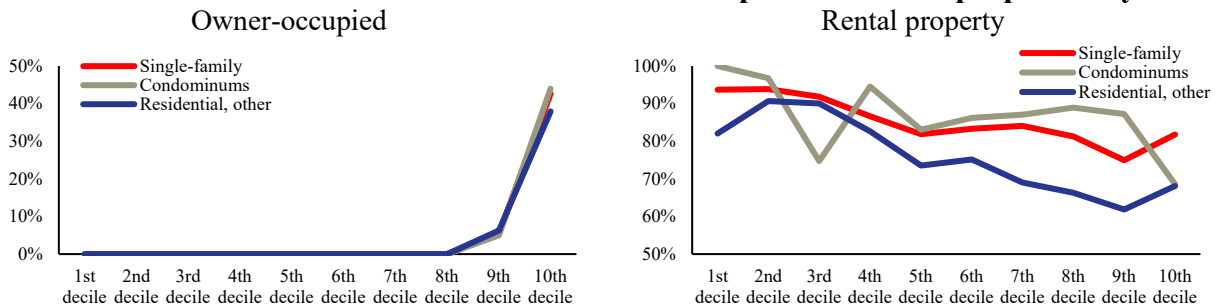
⁴ The CRIM data extract used for this analysis included 1,308,599 properties. However, no flag was present for residential housing to indicate if it is owner occupied. Because owner occupied housing is eligible for a \$15,000 exemption, all properties receiving this \$15,000 exemption were identified in this analysis as owner occupied along with residential properties receiving an exemption of less than \$15,000 but equal to the total value of the property. This resulted in 676,415 residential properties classified as owner occupied primary residents and 388,954 classified as rental, and an additional 189,572 properties are vacant for a total of 1,254,941 residential properties.

⁵ Caution is required regarding this interpretation as property assessed values vary considerably from any market standard associated with capacity to bear the tax burden.

Exemptions

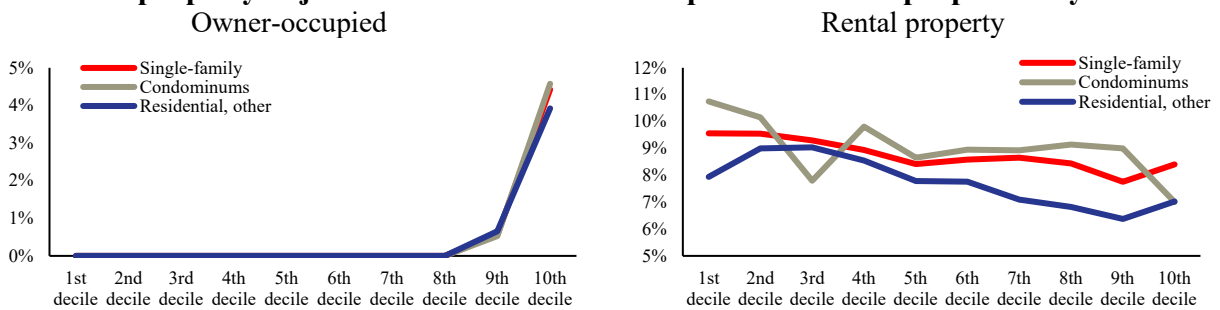
On average, 75% of the industrial assessed tax base is exempted from taxation. However, the most highly valued properties in the tax base have 80% of their value exempted, with lower-valued industrial property facing taxes as a portion of value that is four to five times higher than the tenth decile. The same occurs with agricultural and institutional properties; the most highly valued are exempted at a level far above lower valued property.

Percent of residential tax base that is taxed: owner-occupied and rental properties by decile



Source: CRIM data and own calculations

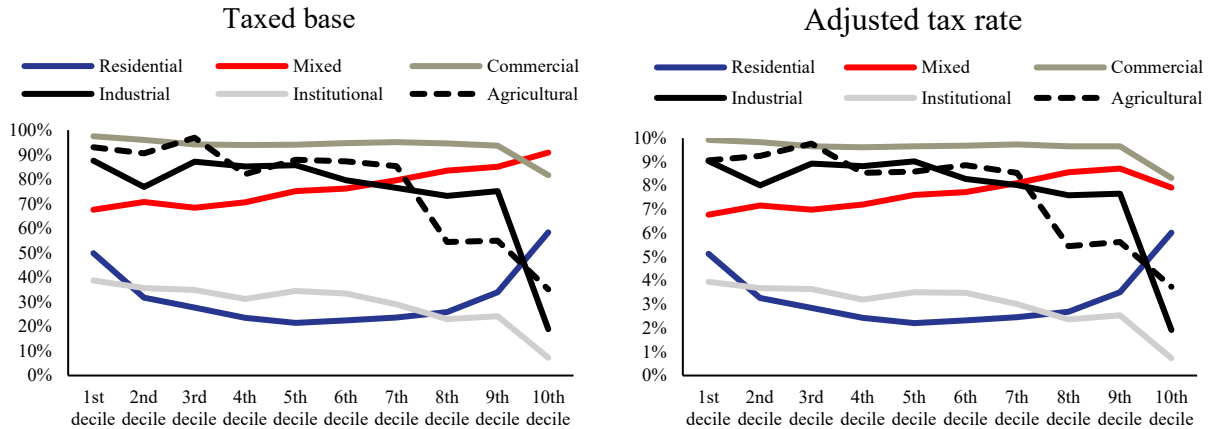
Residential property adjusted tax rate⁶: owner-occupied and rental properties by decile



Source: CRIM data and own calculations

⁶ The tax amount collected divided by the assessed value (1957 \$) is referred to as the adjusted tax rate in this letter. We use this measure because it is the most reasonable conceptual substitute for an effective tax rate (ETR). ETR is not possible to calculate because data on actual market value of property is not available and the current property valuation system is too divorced from market valuation.

Classes of property: taxed base and adjusted tax rate by decile



Source: CRIM data and own calculations

In total, ad hoc exemptions granted by the government and municipalities eliminate 21% of the tax base. Ninety-seven percent of exemptions are provided by the government and affect the revenue stream to municipal governments at little cost in direct Commonwealth resources. This creates a substantial burden on the municipal governments who must pay for local services used by the property tax-exempt businesses. It divorces the exemption granting government from the fiscal pain of its decisions and provides an incentive for excessive exemptions that can cripple local municipal finances. Because many of the exemptions are granted on a company by company basis, the system is far from transparent and seems rife for abuse.

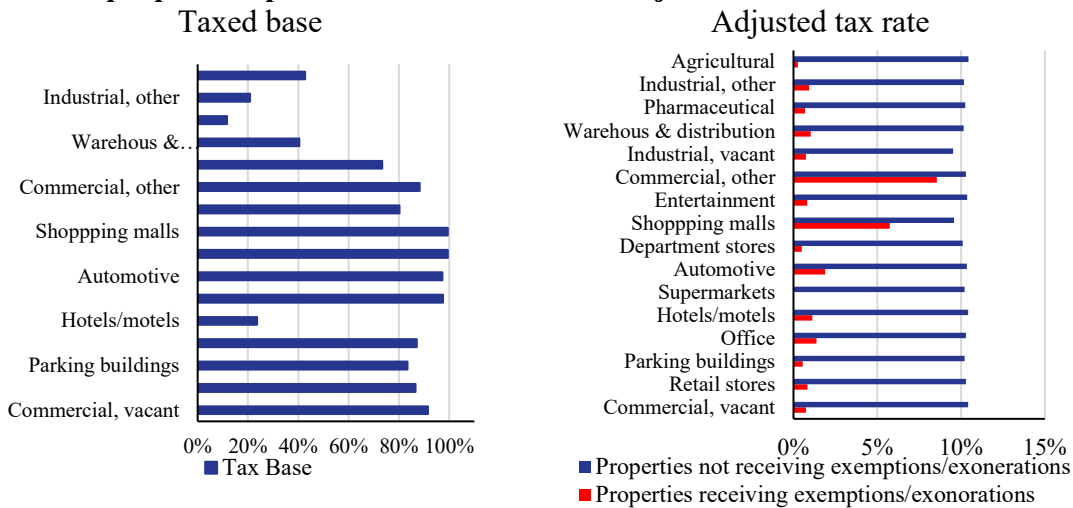
Discretionary exemptions favor some business activity and, as a result, disfavor others by altering effective property tax rates. This may inefficiently promote some activities over others and may be inequitable. It also reduces property tax yields, all else equal, and increases effective and statutory tax rates across the remaining base in order to raise needed revenue.

According to data presented in a study completed by Cornia and Walters, and reproduced in the figures below, exemptions on real property vary substantially across industries. For example, exemptions lower the real property tax base by 88% for pharmaceuticals and by over 76% for hotels,⁷ in contrast to base reductions of about 1% for office buildings and essentially zero for shopping malls and department stores. In addition, about 63% of the tax base for single-family residential properties is exempt. This pattern would seem to promote the pharmaceutical industry while discouraging shopping malls and department stores. It also may promote investment in residential housing at the expense of business investment. Unless supported by a strong economic or social rationale, such tax differences discourage a productive allocation of capital and other resources by substituting tax considerations for underlying economic factors.

⁷ The large exemptions for hotels seem especially misguided because presumably a large share of the tax would be paid by foreign tourists and visiting businesspeople, not by Puerto Ricans. Indeed, many of the exemptions seem targeted to property taxes that would not be paid by Puerto Ricans, which may be undesirable unless there are substantial countervailing benefits for Puerto Rico.

Exemptions also appear to be granted unevenly across types of properties. For example, only about 0.6% of the value of office buildings is exempt, but properties that receive an exemption typically have their tax base reduced by over 90%. The figure below shows the difference in the adjusted tax rate for properties that receive exemptions or exonerations and those that do not. The pattern is similar in other industries: when exemptions are granted, they are very large.

Classes of properties: percent of base taxed and adjusted tax rate



Source: Calculated from (Cornia and Walters, Figures A7.5 and A7.6, pp. 96 and 97).

Recommended Actions & Key Considerations

To move toward uniform tax burdens within and between property classes and perhaps across jurisdictions, the table below identifies actions that should be taken to address the distortionary nature of ad hoc exemptions and exonerations in Puerto Rico’s current property tax system. These actions should be considered in the context of the recommended reforms in scenarios 1 and 2 in the section below. However, they are a necessary first step in any reform of Puerto Rico’s property tax system.

Topic	Recommended actions & key considerations
Review, reduce and eliminate exonerations and exemptions	<ul style="list-style-type: none"> Conduct a review of all exonerations and exemptions. Exemption or exonerations should only be granted with compelling policy justification. The burden of proof should be on those seeking the exemption or exonerations. The rationale for exemptions and exonerations should be reviewed periodically.
Moratorium	<ul style="list-style-type: none"> Legislation authorizing current exemptions should be repealed and a moratorium established on the creation of new exemptions.

Topic	Recommended actions & key considerations
Policy guidance / regulation	<ul style="list-style-type: none"> • Agencies with authority to grant exemptions should be required to adopt formal policy guidance and administrative regulations specifying the circumstances under which an exemption might be considered desirable. <ul style="list-style-type: none"> ○ These regulations should be adopted by both the government and municipalities. ○ Procedures to assure their adherence should be established. • Establish review/approval procedures for any subsequently authorized exemptions.
Reimbursement	<ul style="list-style-type: none"> • The Commonwealth should compensate municipal governments in full for any revenue losses associated with Commonwealth grants of exemptions or exonerations. • Upon successful reform of the property tax system, this requirement should be established in law and provide certainty that the reimbursement will occur.
Residential Exoneration	<ul style="list-style-type: none"> • The existing level of exoneration of residential property value should be reviewed. • Ideally, this would occur with the simultaneous adoption of real property valuation reform (i.e., Scenario 1 or Scenario 2 property tax reform noted above).

Recommendation #2: Establish a true market value approach to property valuation using transaction data

The existing property tax system in Puerto Rico departs from many widely accepted practices in the United States and in most developed countries as well. It is antiquated, opaque, distortionary, and inequitable. By moving towards a market value approach to property valuation and aligning with prevailing practices used in the United States, Puerto Rico would produce more accurate valuations and, in doing so, improve the efficiency, equity, and potential yield of the property tax system.

Market values reflect the real value of the property, and so would form the proper basis upon which to build the property tax system, even if that system includes differences in taxation across individuals and activities. Moving towards a market value-based system requires fundamental structural reform and is not an incremental change. However, it is well worth the effort; the move would not be technically difficult, and the new system would not be more complicated or administratively burdensome than the current system.

Over the long term, a move to a true market value system should serve as the objective. However, Scenario 1, which is less ambitious, may provide a useful bridge until Scenario 2 can be fully implemented. Achieving successful results here presupposes a review of the existing exemptions and exonerations and a repeal of many of them.

Scenario 1: Refresh the existing real property valuation approach to the level of a “market-informed” system.

Scenario 1 represents a movement towards a valuation system rooted in current market values. But it stops short of going all the way. As such, it may be an interim measure, perhaps of long duration if the movement to a full-fledged market value-based system proves difficult to attain. Steps needed to implement Scenario 1 are outlined in the box below.

Topic	Description / other considerations
Improvements	<p><i>Update the current cost/summation methodology used to value real estate. Valuations are currently based on outdated (approximately 60-year-old) classifications and outdated pricing schedules and do not resemble the actual value of property improvements today. Residential construction costs have increased as much as 12 times over this period⁸, and construction techniques have changed, resulting in valuations that need to be updated.</i></p> <ul style="list-style-type: none"> • Revise quality and materials classification categories to reflect present construction technologies/methods and establish construction cost schedules which reflect present-day construction/replacement costs • Incorporate a depreciation schedule that is tied more closely to actual levels of depreciation • Update cost/value coefficients for improvements and land on a three-year cycle to reflect evolving economic conditions
Land	<p><i>Modify land valuation methodologies. Currently, the land is valued at 1957 prices. As a result, properties with market values that differ by more than a factor of ten may have the same taxable value. Overall, land values have increased by as much as 40 times since 1957, with some municipalities seeing increases of a factor more than 100⁹.</i></p> <ul style="list-style-type: none"> • Revise land valuation to better reflect present-day market prices. A land value banding structure could be developed to classify land by: <ol style="list-style-type: none"> a) Physical characteristics (related to development/building potential, such as grade) b) Physical location and access to infrastructure and populations c) Amenities such as proximity to the ocean and aesthetic desirability of location d) Current and permitted uses/zoning • These characteristics could form the basis of a <i>market value informed</i> banding structure, where tax values are based on where a property fits within these broad bands

Anticipated Result: Scenario 1 is expected to increase the base assessed values on real property improvements by a factor of 10 and increase the base valuation of land markedly more. Updating cost estimates to reflect present pricing schedules would substantially improve both the efficiency and equity of the property tax structure and provide the capacity for significant increases in the yield of collections. By adopting the changes suggested in Scenario 1, property tax revenue yields

⁸ Cornia, Gary C. and Lawrence C. Walters, *Property Taxes in Puerto Rico: Assessment and Recommendations*, March 2019.

⁹ Cornia and Walters, *op cit*.

could easily be more than doubled without increasing the actual tax rates, and average property tax burdens in Puerto Rico would remain among the lowest in the United States.

Scenario 2: Establish a true market value (transaction data) approach to property valuation

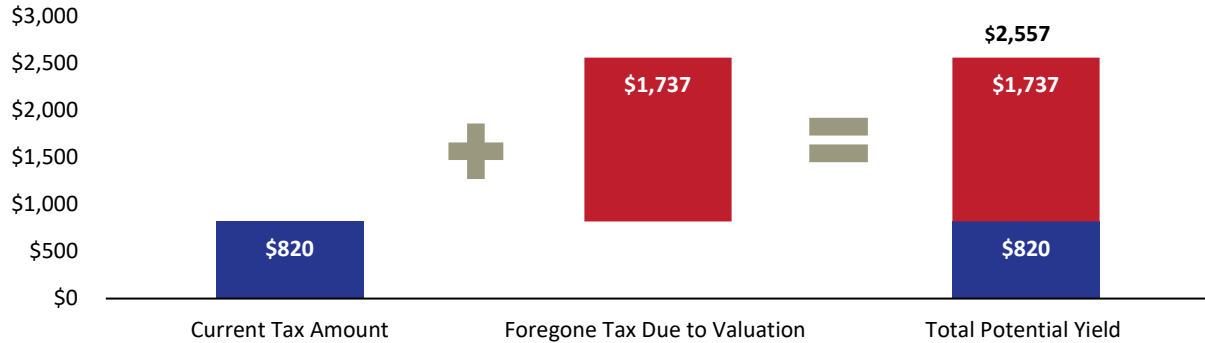
Scenario 2 represents a fundamental reform that explicitly would determine property values on the basis of actual or estimates of current market values wherever available. The box below outlines the steps needed to make this fundamental and highly desirable change.

Topic	Description / other considerations
Improvements	Establish multiple methods for valuing improvements based on existing land use. Possible methods include: <ul style="list-style-type: none"> • Market-data/comparative sales approach for residential and frequently exchanged classes of properties • Replacement cost/summation approach for unique and seldom exchanged properties, such as specialized manufacturing plant and facilities, and • Net income / capitalized value approach for income-producing properties, such as commercial office space, hotels, and larger retail spaces
Land	<ul style="list-style-type: none"> • Set land values equal to the market value of individual parcels of land • Valuation could be based on comparable sales of land • In cases where sales data may be lacking (or for more general administrative convenience, e.g., annual updates), properties could be valued using a statistical analysis of land value based on observable characteristics.
Mass Appraisals	<ul style="list-style-type: none"> • Setting and maintaining market values requires establishing a mass appraisal process which would revalue properties on a recurrent basis to maintain consistency with market values and prices • A database and a statistical model would need to be established to link land and property improvement’s detailed characteristics (including location) to market conditions and changes in market value • Full reassessment/revaluation of each parcel should take place every four to six years, with the possibility of a statistical refresh of valuations every three years

Anticipated Result: Scenario 2 would align Puerto Rico’s property tax structure with prevailing best practices used in the United States. This scenario would also produce the most accurate property tax valuations and, in doing so, further improve the efficiency, equity, and potential tax yields. It would also provide the most valid estimates of the relative revenue capacity between Puerto Rico’s municipal governments and provide an accurate foundation for the development of a more equitable and efficient intergovernmental transfer (equalizing) framework.

A reformed property tax structure has the potential to substantially improve the fiscal position of Puerto Rico municipalities. As shown in the table below, certain estimates suggest that bringing Puerto Rico’s property tax structure in line with the median practice of other U.S. states could comfortably triple the yield of the tax, providing desperately needed revenue for the municipalities.

Potential increase in real property tax yield (\$ millions)



Several assumptions are made in this calculation. The estimates assume that current assessed values are roughly 10% of the market value. This figure is estimated by Cornia and Walters using a sample of parcels from 10 municipalities where they compare sale value as reported by the Department of the Treasury to assessed values from CRIM database. We also assume that Puerto Rico would adjust its effective tax rate (ETR) to 1.26%, a level similar to the median in the States.

Existing property tax structure compared to the recommended structures

The table below provides a summary of how the current property tax system compares to the proposed system based on criteria commonly used for evaluating tax systems. The comparison is across a number of metrics relevant for assessing tax policy: data requirements, administrative complexity, equity, revenue yield, elasticity and buoyancy,¹⁰ and economic efficiency.

Comparative Evaluation of Property Tax Systems (Current and Proposed)

Method used to determine the taxable value		Data req.	Admin. complexity	Equity/fairness		Revenue buoyancy	Economic efficiency
Approach	Description			Horiz.	Vertical		
Current	Antiquated land area and real property replacement cost	L	L	L	L	L	L
Scenario 1	Varying land value (based on size, location, characteristics, and permitted use) +	M	L to M	M	M	M	M

¹⁰ Revenue buoyancy refers to the extent that the yield from a given tax is responsive to economic growth without taking into consideration changes in tax policy. A similar measure is revenue elasticity, which is different because it reflects yield changes associated with changes in the tax base with tax policy held constant.

Method used to determine the taxable value		Data req.	Admin. complexity	Equity/fairness		Revenue buoyancy	Economic efficiency
Approach	Description			Horiz.	Vertical		
	updated construction cost/materials						
Scenario 2	True market value approach based on comparable sales/transactions	M to H	M to H	H	H	M to H	H

As is apparent from the table, scenarios 1 and 2 represent substantial improvements across many dimensions without imposing significantly higher costs. While data requirements and administrative complexity of the current system are low, the current structure also results in low levels of performance for equity, efficiency, and revenue elasticity and buoyancy. Adopting reforms would require more data and administrative capacity compared to current levels. However, the costs of this added complexity are not prohibitively high and technical assistance is widely available given this approach is used in most property taxing jurisdictions in the U.S. Scenario 2 reforms will result in high levels of equity, efficiency, and buoyancy, and will position Puerto Rico’s property tax structures squarely within the framework of prevailing practice.

Moving to a market-based system would alleviate erroneous valuations. As mentioned before, because of the dated and inaccurate assessment process for residential housing, in many cases, beachfront properties have assessed land values similar to properties further inland, which is inconsistent with current relative market valuations. Based on an informal sample of 21 residential properties located in five jurisdictions with beachfront residential development, land values were found to not vary systematically according to location. Single-family residential housing land prices on the beach, four blocks from the beach and approximately 1 mile from the beach were, on average, valued at \$5.5, \$5.3 and \$5.2 per square meter, respectively. Land used in residential housing 1 mile from the water was valued at (on average) only 6% less than a property with direct beachfront water access and water views.¹¹

¹¹ It should be noted that variations in land values across this collection of 7 sets of comparison properties is not uniform and these results are only indicative of inaccurate relative valuations, not proof. A more exhaustive study should be conducted to clearly identify levels of relative valuation.

Land assessed value: beachfront and inland

	Property location		
	<i>Beachfront</i>	<i>4 blocks from the beach</i>	<i>~1 mile from the beach</i>
Average land value per meter sq*	\$5.5	\$5.3	\$5.2
Value compared to beachfront property		-\$0.23	-\$0.34
Value compared to beachfront property (%)		-4%	-6%

Source: CRIM data and own calculations
 *Informal sample of 21 residential properties.

Recommendation #3: Levying appropriate property tax rates

The statutory property tax rates in excess of 10% that characterize many of Puerto Rico’s property taxing jurisdictions are only viable because of the extreme undervaluation of property for tax purposes in the present system and are indicative of the current problem of undervaluation. They provide a false impression of high property tax burdens and mask the realities of the effective tax rates. The average statutory property tax rate across municipalities in Puerto Rico is 10% for real property and 8.06% for business personal property. These statutory rates translate into real effective tax rates substantially less than 1% for both residential and commercial real property, although effective rates are many times higher for business personal property even though the statutory rate is lower (as identified in sections below).

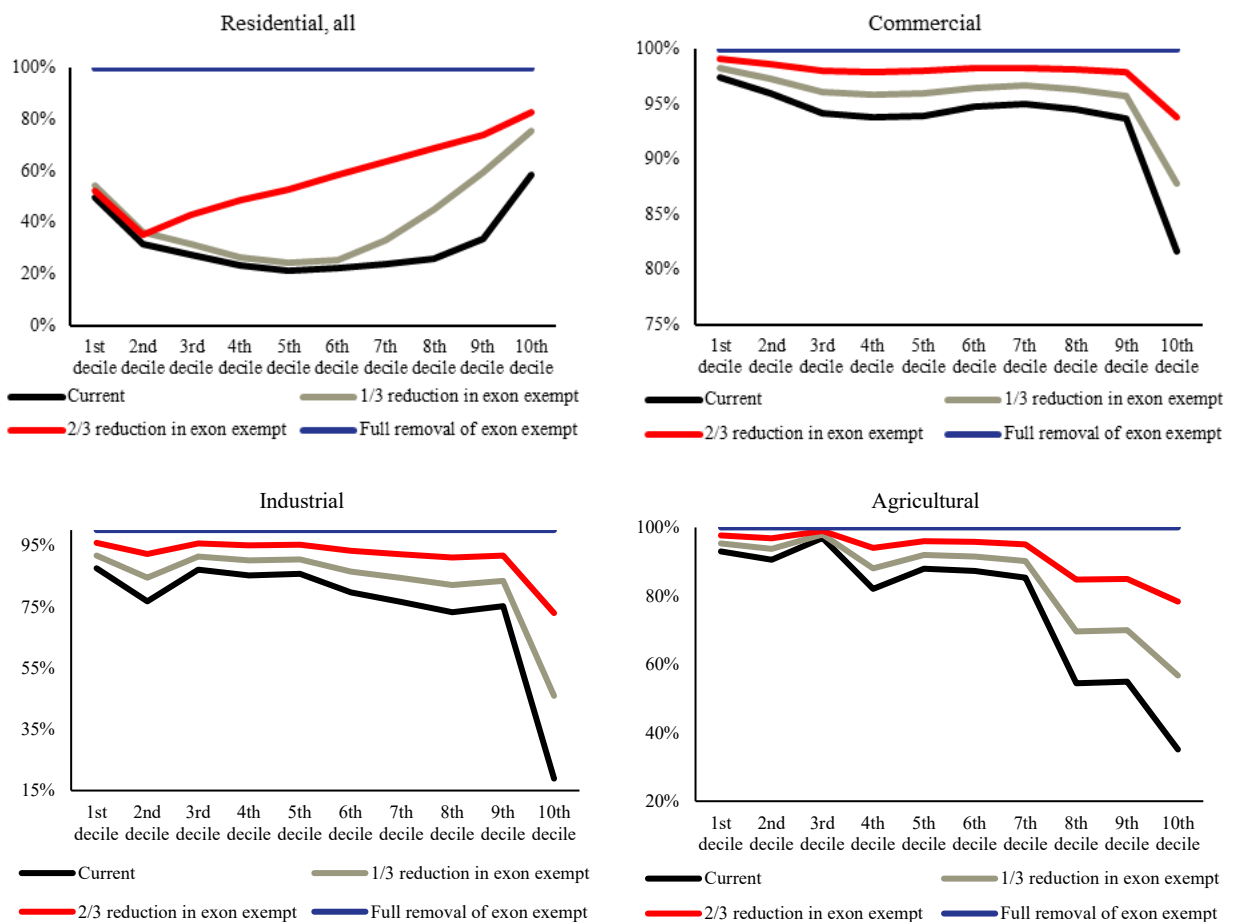
As discussed above, the valuations used to measure the base of the current property tax system are disconnected from the reality of market values. This presents substantial uncertainty regarding the burden distributions and the efficiency implications of any increase in current property tax statutory rates. On the real property side, nonetheless, there is likely room for considerable statutory rate increases, possibly for business property, but certainly for residential real property under current valuation and exoneration levels. The high levels of exonerations for residential property provide for a current effective tax rate that is far below that of business property and effectively zero for the median household.¹² Even under a partially rationalized system of valuing property, some statutory tax rate adjustments may be necessary for securing efficient and equitable effective tax rates.

The figures below clearly demonstrate the variations in taxable base by property category and by property value decile and the clear favorable treatment of owner-occupied residential property and larger-scale commercial, industrial, and agricultural real property. These figures also show the effect of a scaling back of exemptions and exonerations. Three scenarios are depicted as one-third,

¹² The effective rate is the tax paid divided by the market value of the property, and so differs from the statutory rate.

two-third, and 100% reduction in exemptions and exonerations.¹³ In all categories, scaled back exemptions and exonerations create more uniformity in taxable base (and thus more uniformity in the effective tax rate) across property categories and across deciles in the same category. The equity profile of the taxable base also improves. Most pronounced, at a two-thirds removal of exonerations, the residential tax base takes on a progressive profile after the second valuation decile. The profile for all property classes improves.

Taxable base as a percent of total value under four reform scenarios: by property class



Source: CRIM data and own calculations

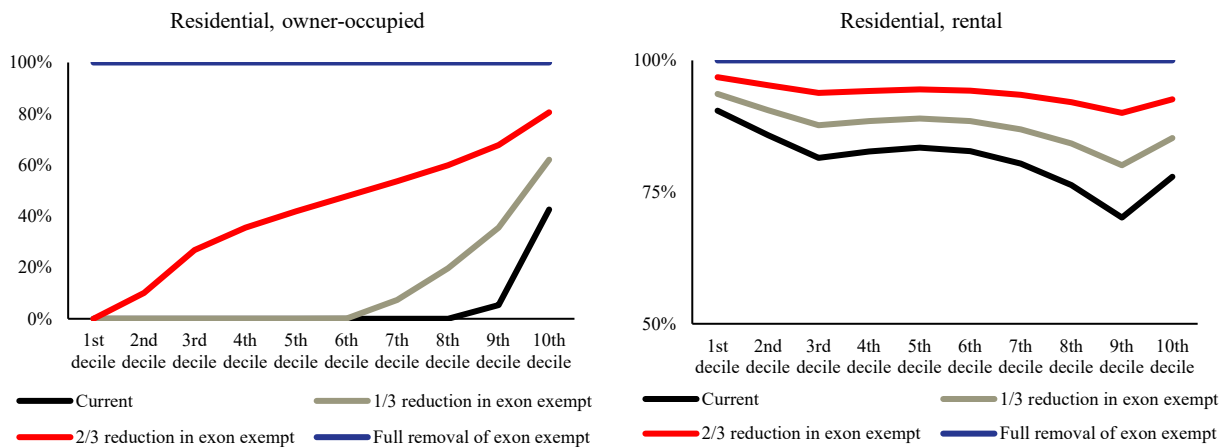
Comparing the implications of reductions in exonerations and exemptions by the class of residential property is also illustrative (figures below). The current profile of taxable base for rental properties shows a decidedly regressive pattern, as less of the base is taxable for more

¹³ For residential owner-occupied housing, this is depicted as a reduction of the \$15,000 exemption to \$10,000 and then \$5,000 and then zero.

valuable properties through to the ninth decile. This regressively declines as exemptions and exonerations are progressively eliminated, improving the implicit burden profile.

For owner-occupied residential property, the taxable base is zero under the current exemption levels until the ninth decile. This is highly progressive, but unjustifiably so for reasons discussed above. As the value of the maximum exemption is reduced from \$15,000 to \$10,000 to \$5,000, the profile becomes recognizable as reflective of a more common and defensible tax profile. It remains decidedly progressive at an exemption level of \$5,000, as properties in the lowest decile of value still have zero taxable value, and the proportion of the value which is taxable becomes positive for the second decile and ultimately (and gradually) reaches 81% by the tenth decile. The result is a tax system in which the vast majority of property owners contribute to revenue generation but do so in a manner that significantly increases that contribution as a portion of property value as property value increases. There can be disagreement about the steepness of this profile, and some may legitimately argue that it remains too steep, and others argue that it is not steep enough, but it is clearly an improvement over the profile with a \$15,000 exemption for reasons stated above.

Taxable base as a percent of total value under four reform scenarios: residential by ownership type



Source: CRIM data and own calculations

A change in the level of exonerations and exemptions directly affects the scale of the taxable base and the adjusted tax rate. At 100% removal, the adjusted tax rate is equal to the statutory tax rate. The figures above can also be directly interpreted as the resulting adjusted taxed rate by property class and decile as a percent of the statutory tax rate. The figures below show the change in the proportion of total real property tax generated by different property categories under the three exemption/exoneration scenarios. As exemptions/exonerations are reduced, a larger share of revenue comes from residential, industrial, and agricultural, and a smaller share comes from commercial. These outcomes can be changed and controlled through a transparent classification system.

Even under the current property valuation system, statutory tax rates can be adjusted to distribute the property tax burden in a more efficient and equitable manner and increase revenue yield. For example, under the existing system, raising the statutory tax rates on residential real property would not affect the typical Puerto Rican homeowner, who would remain shielded from a tax increase by the \$15,000 exemption. Given a less extreme level of exonerations and a market value-based system, sustainable statutory tax rates could be set at much lower levels, yet still, produce tax revenue sufficient to fund budgetary needs and to justify investment in administering a property tax system. The rates simultaneously would not be so high that they resulted in low public acceptance of the reformed system, undesirably increase incentives for delinquency or tax evasion, or put undue pressure to reinstate the exonerations and exemptions/discounts that plague the current system.

As a basis of comparison, it is helpful to examine effective property tax rates in Puerto Rico compared to those imposed by other U.S. states. The table below makes that comparison based on the property tax systems in place in the largest city in each state.¹⁴ In general, effective property tax rates on residential and commercial properties are much lower than rates on similar properties in Puerto Rico. In contrast, the effective rate on industrial personal property is higher in Puerto Rico.

Summary of Effective Property Tax Rates Across the U.S.*

	Effective tax rates		
	<i>Residential (median valued home)</i>	<i>Commercial (\$1 million value + \$200K fixtures)</i>	<i>Industrial (1 million value + \$1 million personal property)</i>
Puerto Rico	0% - 0.15%**	0.60% ***	3.00%****
Maximum	3.81%	4.24%	2.84%
75th quartile	1.93%	2.75%	1.95%
Median	1.26%	2.05%	1.46%
25th quartile	1.03%	1.39%	1.13%
Minimum	0.31%	0.61%	0.49%

*From a sample of 53 cities inclusive of the largest city in each state

**The median home price in PR in 2013-17 is \$115,3000, with an exoneration of \$15,000 (1957 \$) currently equal to approximately \$215,000, the median-valued home is likely to face a 0% effective tax rate. However, the estimate of U.S. Treasury Advisors suggests that a home with a \$200,000 market value (\$84,700 above the median value) would face a 0.15% effective tax rate. This difference is due to differences in the estimate of the current value of the 1957 \$15,000 exoneration.

***For Puerto Rico this reflects real property alone (w/o fixtures) based on \$200,000 market value

**** For Puerto Rico this reflects total personal property taxes / personal property assessed value

Source: Lincoln Institute’s 2018 “50-State Property Tax Comparison Study”; Cornia and Walters (2019); American Community Survey (2017)

¹⁴ Lincoln Institute’s 2018 “50-State Property Tax Comparison Study”

Residential Tax Rate Headroom

Informed in part by the comparison in the table above, as well as the prior discussions of exemptions and exonerations, the Oversight Board judges that effective tax rates on residential property in Puerto Rico could be substantially increased without serious economic cost. One highly desirable way to do this would be to expand the base by reducing exonerations. Alternatively, the tax rate could be increased, although this would not spread the burden in an efficient or equitable way without an expanded base. For example, a rate increase with no other changes would not affect taxes on an owner-occupied property whose value remained below the exonerated level.

Business Property Tax Headroom

While business real properties are also subject to significant undervaluation for tax purposes, they are already paying a considerably higher relative effective tax rate (relative to residential property) because of Puerto Rico’s personal property tax structure. As a result, less capacity exists to increase the tax rates on commercial and industrial properties.

Recommended Actions & Key Considerations

Topic	Recommended actions / key considerations
Residential tax rate	<ul style="list-style-type: none">• Serious consideration should be given to evaluating residential property tax rates• While an increase in the statutory tax rate could be considered, it may be desirable to prioritize a reduction in the value of exemptions and exonerations while simultaneously revising the permissible range of property tax rates• Analysis of actual effective tax rates and the distributional and efficiency implications of altering rates should be conducted
Business property tax	<ul style="list-style-type: none">• Consideration should be given to evaluating corporate property taxation• Analysis should be conducted to evaluate the implications of current nominal/statutory tax rates for effective tax rates (and their variance across properties) to determine the potential for any increase in statutory and effective tax rates

Recommendation #4: Use classification to transparently vary effective tax rates between residential / commercial / industrial properties

It is common in the U.S. for property tax systems to vary taxes by category/type of property (commercial, industrial, utilities, and telecommunications, residential, and agricultural). Some States use these classifications as a vehicle for altering effective tax rates across categories of property by varying statutory tax rates or assessment ratios. In contrast, in Puerto Rico, much of the variation in effective rates is accomplished through exemptions and exonerations, which are much less transparent than would be a system based on the type/classification of property.

As mentioned above, Puerto Rico’s owner-occupied properties are exonerated from approximately \$215,000 in value at current prices. Consequently, most of the value of an owner-occupied residential property is tax-exempt, and the amount which is taxable faces a substantially lower effective tax rate than most commercial and industrial properties. In addition, as illustrated above, Puerto Rico’s ad hoc exemptions, also generate avenues for non-uniformity of taxation within broad classes of property like commercial and industrial classes. Overall, in FY2018, exemptions for all property (residential and business) granted at the Commonwealth and municipal levels eroded 21% of the real property tax base, and exonerations eroded 37% of the base. This has created non-uniformity of effective tax rates across and within classes of property.

To improve transparency and, hopefully, equity and efficiency, the Oversight Board suggests that if Puerto Rico chooses to vary tax rates across different types of economic activities and property, that such variation be accomplished through a publicly debated, established, and reviewed property classification system. The box below summarizes steps that would facilitate the development and implementation of such a system. As mentioned above, it is not helpful to look at a comprehensive reform proposal in a piecemeal manner. The overall effect of all the changes has to be considered.

Recommended Actions & Key Considerations

Topic	Recommended actions / Key considerations
Classification	<ul style="list-style-type: none"> • Instead of using exemptions and exonerations, vary tax rates by broad category of property using differing assessment ratios or statutory tax rates • Care must be taken that differentials are justified by underlying economic factors and do not become excessively large
Non- Uniformity in Exonerations / Exemptions	<ul style="list-style-type: none"> • A review should be conducted of all exonerations and exemptions (as discussed in more detail in the preceding sections)
Non-Uniformity in Assessment Methods	<ul style="list-style-type: none"> • Implement procedures outlined in scenarios 1 and 2 above (as it relates to real property assessments)
Caution Against Business Base Overgrazing	<ul style="list-style-type: none"> • Any attempts to further shift burdens to business property is not advisable

Summary

The property tax system in Puerto Rico needs serious reform if the Commonwealth is to be competitive as a place of business and provide for the resource capacity necessary to deliver effective public services.

The existing property tax system in Puerto Rico is out of date and generally departs from widely accepted practices in the U.S. Evaluation of the tax system exposes significant shortcomings that present opportunities for substantial improvement. The current tax system:

- Imposes inequitable tax burdens across owners of properties within the same class and across classes and jurisdictions;
- Fosters an environment that is distortionary regarding investment, business operations and location and damaging to the competitive position of the Commonwealth;
- Yields a fraction of the revenue that could be generated, and revenue buoyancy is almost nonexistent;
- Sacrifices the virtue of administrative simplicity and high compliance due to various ad hoc exemptions

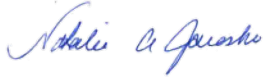
Being economically competitive will provide a major avenue to achieving fiscal sustainability for Puerto Rico. Sustainability is achieved through rational tax systems that promote efficiency (as well as equity). The present property tax structure in Puerto Rico does not achieve this. Ad hoc exemptions, possibly as an intended offset, are excessive and do not provide an effective substitute for a rational tax structure. Ad hoc exemptions provide uncertainty and confer advantages on some businesses for a reason unrelated to market requirements. Taxable real property values are calculated based on prices and construction techniques that are over 60 years old. As a result, real property is substantially misvalued, resulting in inequities and inefficiencies, such as beachfront residences being significantly undervalued compared to similarly-sized subdivision residences. In addition, owner-occupied residences receive a valuation exemption of approximated \$215,000 in current value, which completely removes nearly all properties from the tax rolls and lowers taxes on the few high-value residences that are taxed, no matter how valuable.

The Oversight Board believes that implementation of the recommendations outlined above, following the detailed economic analysis thereof, will result in a property tax system that is more effective, equitable, and increases Puerto Rico's overall revenue yield. In addition, the resulting property tax system would provide a stronger foundation for more robust economic growth, including an opportunity to replace the inventory tax while easing the cost and complexity of transacting business in Puerto Rico. The Oversight Board is dedicated to working with the Government and Legislature to facilitate effective and efficient economic development and repopulation.

Governor Vázquez Garced
President Rivera Schatz
Speaker Méndez Núñez
August 26, 2020
Page 24 of 26

We look forward to your response to this letter within 90 days.

Sincerely,



Natalie A. Jaresko

CC: Mr. Reinaldo Paniagua
Hon. Javier Carrasquillo

Appendix: Property Taxable Base and Adjusted Tax Rate by Property Category and Decile

Residential: by type of residence and ownership

Deciles of total property value	Taxable Base	Adjusted tax rate	Deciles of total property value	Taxable Base	Adjusted tax rate
Residential: Presumed owner-occupied			Residential: Presumed rental property		
Single-family			Single-family		
1st decile	0%	0%	1st decile	94%	10%
2nd decile	0%	0%	2nd decile	94%	10%
3rd decile	0%	0%	3rd decile	92%	9%
4th decile	0%	0%	4th decile	87%	9%
5th decile	0%	0%	5th decile	82%	8%
6th decile	0%	0%	6th decile	83%	9%
7th decile	0%	0%	7th decile	84%	9%
8th decile	0%	0%	8th decile	81%	8%
9th decile	5%	1%	9th decile	75%	8%
10th decile	43%	4%	10th decile	82%	8%
All	11%	1%	All	81%	8%
Condominiums			Condominiums		
1st decile	0%	0%	1st decile	100%	11%
2nd decile	0%	0%	2nd decile	97%	10%
3rd decile	0%	0%	3rd decile	75%	8%
4th decile	0%	0%	4th decile	95%	10%
5th decile	0%	0%	5th decile	83%	9%
6th decile	0%	0%	6th decile	86%	9%
7th decile	0%	0%	7th decile	87%	9%
8th decile	0%	0%	8th decile	89%	9%
9th decile	5%	1%	9th decile	87%	9%
10th decile	44%	5%	10th decile	69%	7%
All	17%	2%	All	77%	8%
Residential, other			Residential, other		
1st decile	0%	0%	1st decile	82%	8%
2nd decile	0%	0%	2nd decile	91%	9%
3rd decile	0%	0%	3rd decile	90%	9%
4th decile	0%	0%	4th decile	83%	9%
5th decile	0%	0%	5th decile	74%	8%
6th decile	0%	0%	6th decile	75%	8%
7th decile	0%	0%	7th decile	69%	7%
8th decile	0%	0%	8th decile	66%	7%
9th decile	6%	1%	9th decile	62%	6%
10th decile	38%	4%	10th decile	68%	7%
All	16%	2%	All	66%	7%

By category of property

Deciles of total property value	Taxable base	Adjusted tax rate	Deciles of total property value	Taxable base	Adjusted tax rate
Residential			Industrial		
1st decile	50%	5%	1st decile	88%	9%
2nd decile	32%	3%	2nd decile	77%	8%
3rd decile	28%	3%	3rd decile	87%	9%
4th decile	24%	2%	4th decile	85%	9%
5th decile	21%	2%	5th decile	86%	9%
6th decile	22%	2%	6th decile	80%	8%
7th decile	24%	2%	7th decile	76%	8%
8th decile	26%	3%	8th decile	73%	8%
9th decile	34%	4%	9th decile	75%	8%
10th decile	58%	6%	10th decile	19%	2%
All	36%	4%	All	25%	3%
Mixed			Institutional		
1st decile	68%	7%	1st decile	39%	4%
2nd decile	71%	7%	2nd decile	36%	4%
3rd decile	68%	7%	3rd decile	35%	4%
4th decile	71%	7%	4th decile	31%	3%
5th decile	75%	8%	5th decile	34%	4%
6th decile	76%	8%	6th decile	33%	3%
7th decile	80%	8%	7th decile	29%	3%
8th decile	84%	9%	8th decile	23%	2%
9th decile	85%	9%	9th decile	24%	3%
10th decile	91%	8%	10th decile	7%	1%
All	82%	8%	All	10%	1%
Commercial			Agricultural		
1st decile	97%	10%	1st decile	93%	9%
2nd decile	96%	10%	2nd decile	91%	9%
3rd decile	94%	10%	3rd decile	97%	10%
4th decile	94%	10%	4th decile	82%	9%
5th decile	94%	10%	5th decile	88%	9%
6th decile	95%	10%	6th decile	87%	9%
7th decile	95%	10%	7th decile	85%	9%
8th decile	95%	10%	8th decile	54%	5%
9th decile	94%	10%	9th decile	55%	6%
10th decile	82%	8%	10th decile	35%	4%
All	84%	9%	All	43%	4%