

New York City's Property Tax Problems in an Era of Changing Price Trends

From 1979 to 1981, New York City property tax revenues barely grew though inflation and economic growth pushed property values sharply upward. What retarded the growth of these tax revenues was the state-imposed ceiling on the amount of revenues the city may raise from its property tax. Over this period the ceiling actually dropped slightly. As a result, the city lost out on some \$1.2 billion in property tax revenues it would have been able to collect if the ceiling had kept pace with property values. While some analysts might argue that this slow response of property tax revenues to an increase in property prices was a healthy restraint on expenditures, the revenue shortfall came at a particularly bad time for New York City. Not only was the city trying to balance its budget, but also it was faced with the higher costs of providing public services as a result of inflation. Under the present system, the city will continue to lose revenues during periods of inflation as increases in the ceiling lag the upturns in property prices. Thus, if responsiveness of revenues to property price increases is considered to be a desirable attribute for the tax system, changes are needed in the method for determining the property tax ceiling.

The ceiling: five-year averaging and full values

The state constitution restricts the amount of property tax revenues that New York City may raise yearly

for operating purposes.¹ This ceiling is set at 2½ percent of the full (market) value of taxable real estate in the city, averaged over the latest five years. With the amount of property taxes collected by the city at or near the maximum allowed by the ceiling, changes in its level effectively determine the city's ability to raise revenues from this tax (Chart 1). If the ceiling grows at a slower rate than property prices, the city must either delay increasing assessed values or lower the statutory tax rate.² If the ceiling rises faster than property prices, the city can capture this increase in taxing power through either higher assessments or tax rates.

The movement in the ceiling from one year to the next is critically affected by two factors: the constitutional requirement for five-year averaging and the method used to estimate full values. These factors result in a ceiling which varies widely as a fraction of the current full value and responds poorly to changes in property price trends.

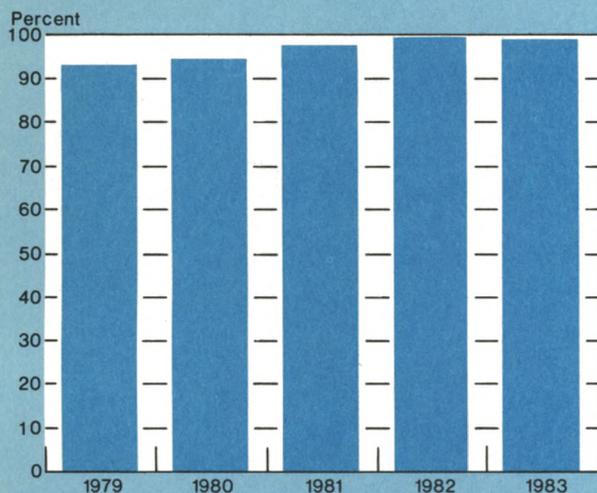
¹ New York State Constitution, Article VIII, Section 10. Property tax revenues raised for debt service—approximately two fifths of the total levy—are not covered by this restriction. These debt-service revenues have stayed fairly constant lately and so have not had much impact on year-to-year changes in the total property tax levy. (It should be noted that the state constitution does place restrictions on the total amount of debt the city may have outstanding.)

² Property tax liability is determined by multiplying the statutory tax rate by the assessed value recorded on the city's tax rolls for the particular piece of property.

Mark A. Willis, on leave from the Bank, is an assistant to New York City's Deputy Mayor for Finance and Economic Development.

Chart 1

Property Tax Levy for Operating Purposes as a Percentage of the Ceiling
1979-83



Source: New York City Council Tax-Fixing Resolutions for fiscal years 1979, 1980, 1981, 1982, and 1983.

Averaging would not be a problem if property prices were basically trendless. In fact, under such circumstances, averaging would help smooth out short-term fluctuations. But, when prices are on an upward (downward) trend, the averaging requirement imparts a downward (upward) bias to the ceiling. The faster prices are rising over the five years spanned by the average, the lower the ceiling as a percentage of the latest full value. For example, when property prices grow at a steady 10 percent per year, the five-year average is almost one-sixth smaller than the latest full value, thus lowering the effective level of the ceiling from 2.5 percent to 2.1 percent.

Averaging also slows the response of the ceiling to changes in price trends. New full values are only gradually incorporated into the average. As a result, the average is slow to reflect the new growth rate. For example, the first year of 10 percent price inflation following a period of stable prices triggers a mere 2 percent rise in the average. Prices must grow at the same rate for five consecutive years before the average will move in step.

Estimating full values

Another source of divergence between property price movements and those of the ceiling is the method

used to derive full values for the city's taxable real estate. To estimate full values, the State Board of Equalization and Assessment (SBEA) uses market surveys—appraisals of properties sampled from the city's tax rolls. In the past, these surveys were conducted relatively infrequently. For the 1979 fiscal year, for example, the latest available survey related to July 1974. Recently, however, surveys are being conducted annually and completed within the year. But, even now, the last two full values used in the average postdate the latest survey results.³

To bridge this information gap, the SBEA extrapolates price growth based on a weighted average of previous property price changes.⁴ As a result, full value estimates for recent years are based on price changes many years out of date. For example, the fiscal year 1979 ceiling relied on growth rates dating as far back as 1968.

This lack of up-to-date information on full values and this reliance on old growth rates to project current full values produce a ceiling which behaves poorly during periods of wide swings in property price growth. The last fifteen years were just such a period for New York City. Property prices rose rapidly in both the late sixties and the late seventies but grew very slowly in the interim period (Chart 2).

A look at 1979-83

Over the fiscal years 1979 to 1981 the ceiling fell slightly while property prices rose (Chart 3).⁵ The main reason for this decline in the ceiling was the lack of up-to-date data on property prices. Only one survey was completed during this period—in time for computing the 1980 ceiling—and it covered an earlier time when property price growth was slowing, thus leading to downward revisions of the full values previously estimated. Five-year averaging created an additional downward bias, and the ceiling dropped farther and farther below 2½ percent of actual full value. The result was a loss of taxing power of almost \$1.2 billion over these three years.

The ceiling for fiscal years 1982 and 1983 rose rapidly as survey completions revealed for the first

³ The lack of information on two years' worth of full values results because (1) the ceiling must be computed in advance of the start of the fiscal year (July 1) to which it applies and (2) surveys are conducted on July 1 while the full values used in the five-year average are dated as of January 1, the midpoint of the fiscal year.

⁴ Property prices are regressed on a time trend to obtain the growth factor.

⁵ Property taxes levied for operating purposes increased over the 1979-81 fiscal years (the fiscal year for New York City ends on June 30), but only because the city was able to tap some unused taxing power (Chart 1).

time the renewed growth of property prices of a few years earlier. The five-year averaging requirement, however, substantially dampened the rise in the ceiling. Over the 1981-83 period, the ceiling as a percentage of the latest full value then being projected fell from 95 percent to 84 percent.

Outlook: growth rates of property tax revenues and property prices likely to diverge again

Property price growth in the city is apparently entering a new, more moderate phase. If property prices should stabilize, the ceiling would not stop growing immediately but would keep on increasing for several more years (Chart 3). As a result, the ceiling would rise toward the 2½ percent level and could even surpass that level by a small margin. But any “excess” taxing power would hardly begin to offset the large losses earlier in the decade.

Continued growth of the ceiling would result from both the five-year averaging and the projection system. Even with prices holding steady at their July 1981 survey level, the five-year average would rise until all the earlier years with their lower full values were eliminated. Further pushing up the average would be full value estimates based on the previous rapid price growth. In fact, with the present projection method, property taxes may eventually exceed

2½ percent of actual full values. In 1986, for example, the average would consist of the actual values for fiscal years 1982, 1983, and 1984 and projected full values for the following two years. Even if property prices were stable from now until 1986, the growth rate used to project these latter two full values would still be positive. The result would be “projected” values which exceed their actual levels.

Although the new, faster survey schedule helps reduce the erratic movements in the ceiling, it does not eliminate them. As long as the underlying trend of property prices varies over time, the continued use of the present projection system and of five-year averaging ensures that growth of property tax revenues will diverge from property prices.

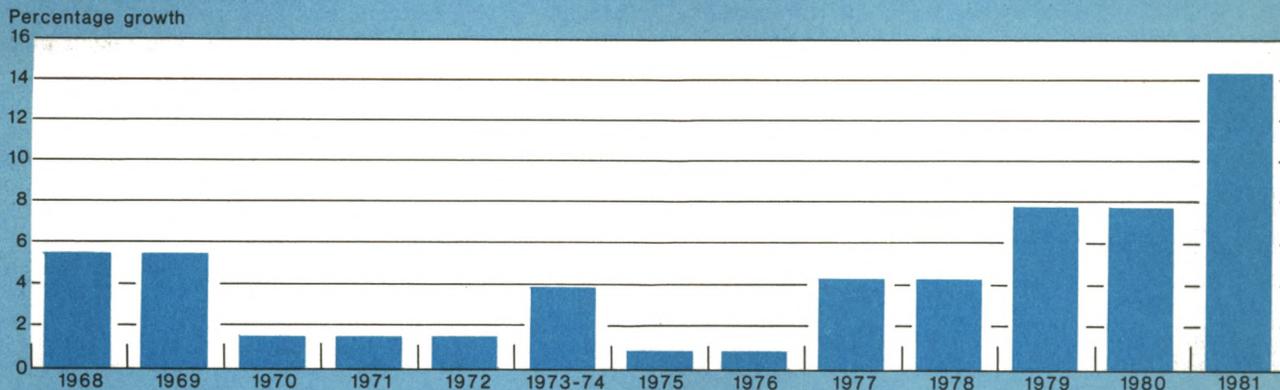
Resolving the problem

The problems caused by the present projection system could be reduced greatly through two modifications. First would be a further speedup in survey processing. Then, only the value for the upcoming fiscal year would have to be projected to set the ceiling for that year.

Second would be an improvement in the projection method. The present reliance on an average of past price movements to project into the future makes little sense during periods of changing price trends.

Chart 2

Property Price Growth Rates as Determined by the State Board of Equalization and Assessment 1968-81



Growth rates for 1968 through 1972 are for calendar years, determined from surveys conducted in January of 1968, 1970, and 1973. The growth rate for 1973-74 is the annual rate of change from January 1973 through July 1974, determined from surveys conducted in those two months. Growth rates for 1975 through 1981 are for fiscal years (July 1 to June 30), determined from surveys conducted in July of 1974, 1976, 1978, 1980, and 1981.

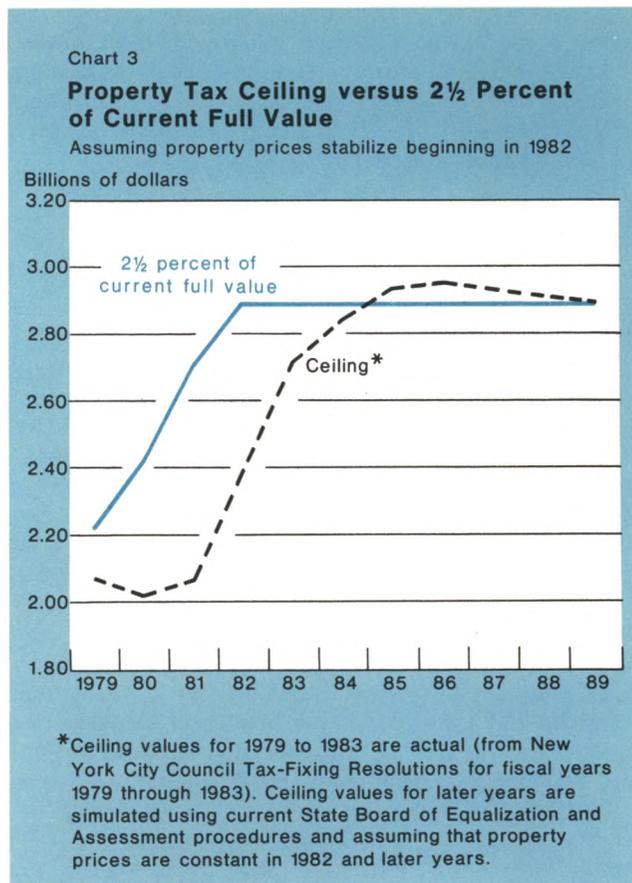
Source: New York State Board of Equalization and Assessment, computer printouts of Table A1 on the computation of special state equalization ratios, selected years.

A great deal of data is available on current inflation trends and levels of economic activity. Use of this more up-to-date information should reduce the likelihood of missing changes in price trends and so would help eliminate this source of divergence between movements in property prices and those of the ceiling.

Improved estimates of full values would still leave the ceiling with problems caused by five-year averaging. Unless changes are made in this requirement, the ceiling will continue to fall below 2½ percent of the current full value during periods of rising prices and fail to respond quickly to changing price trends. Such behavior is particularly troublesome during inflationary times.⁶

The ceiling could in fact be made more inflation neutral. One way would be to eliminate the averaging requirement, thus basing the ceiling only on the latest full value. Another way to deal with the problem would be to base the average on full values which are adjusted for subsequent changes in the overall price level. For example, if the general price level increased by 10 percent from 1981 to 1982, then the 1981 full value would be revised up by 10 percent before being used in computing the 1982 average. With this approach, therefore, year-to-year changes in the relative price of real estate would be smoothed, but general inflation would not affect the city's property taxing power. Combining either of these options with an improved method for estimating the full value for the

⁶ New York is not alone in having a property tax ceiling which can limit the growth of revenues below that of inflation. Both California and Massachusetts, for example, have adopted property tax restrictions which, not only roll back tax levies, but also establish maximum growth rates for any subsequent increases. Proposition 13 in California limits the annual increases for an individual property to 2 percent a year, unless the property is sold, and Proposition 2½ in Massachusetts sets the limit on growth at 2½ percent a year.



current year would produce a ceiling which holds closely to 2½ percent of the current full value and reflects more quickly the actual changes taking place in the full value of the city's taxable real estate.

Mark A. Willis and Daniel Chall