Tax Tales: The City’s Changing Tax Revenue Mix Over 25 Years

With the city facing its largest budget gaps since the 1970s fiscal crisis, both the Mayor and City Council are talking about tax increases. As policymakers ponder which taxes may need to rise, it is useful to consider how the city's tax mix has changed over time. Economic and tax policy changes over the last quarter century have shifted the relative importance of the city's major taxes; the share of city revenue coming from the property tax shrank by nearly 25 percent while the share coming from the personal income tax (PIT) more than doubled.

Despite the shrinking of the property tax share, it remains the city's single largest revenue source, accounting for $8.6 billion of the $23 billion in taxes that IBO estimates were collected in 2002. The increase in the PIT share has pushed its ranking from fourth to second. The sales tax share changed little over the 25 years. Similarly, the portion of revenue from business income taxes (general corporation tax, unincorporated business tax, and financial corporation tax) remained fairly constant. (All years in this report refer to city fiscal years.)

PIT revenue share grows significantly. Revenue from personal income taxes is quite sensitive to changes in local employment levels and—particularly in recent years—to changes in individuals' investment profits. Thus, the share of total tax revenue from this source tends to grow very strongly during periods of economic growth and bull markets. Moreover, the city's tax brackets, although altered several times, are not indexed for inflation so that over time more taxpayers are subject to higher tax rates. This “bracket creep” contributes to the long-term growth in PIT revenues and the rise in its share of total tax revenue.

Personal income tax revenue, as well as its share of total tax revenue, has grown almost every year since 1977, when the share was 9.9 percent. The biggest changes came in periods of strong growth, such as 1995 through 1998, when the PIT’s share peaked at 25.3 percent of total tax revenues. Although PIT revenues continued to grow through 2001, it was at a slower rate. The slower growth is partially attributable to the expiration of a 12.5 percent surcharge after 1998 and the elimination in 1999 of the commuter tax (accounted for under the PIT). There was an actual decline in PIT revenue in 2002, due to the local recession and the decline in investment profits. With the PIT revenue contraction, its total share fell to 20.2 percent.

Property tax revenue share declines. A major factor in the decline in the property tax's share of total revenues is the December 1981 restructuring of the city's property tax system, which limited growth in assessments, particularly for one-, two-, and three-family homes, and for coop and condo apartments. As a result of these limits, assessments and tax bills for owner-occupied properties have lagged the rise in property values and local economic growth. These constraints on revenue growth when the economy is expanding, along with the tendency of the PIT to grow faster when the economy is booming, account for the periods of declining property tax share such as 1982 to 1987 and 1993 to 2001, when the share reached a low of 34.6 percent.
But another 1981 provision helps ensure property tax revenue remains stable even in times of shrinking property values and a slowing economy. Assessment changes for commercial and rental properties are phased in over five years. This means that when the local economy begins to contract and property values begin to fall there is still a "pipeline" of assessment increases remaining to be phased in. The pipeline helps to sustain property tax revenue increases even while revenue growth from other tax sources slows or reverses. The effect of the pipeline can be seen in the 1987-1992 period, when the property tax revenue share grew from 39.2 percent to 45.9 percent. It appears that a similar period is currently underway. IBO estimates that the property tax revenue share grew in 2002 to 38 percent –– while the PIT share fell –– and will expand slowly through 2005 while other more cyclically sensitive tax sources continue to reflect the impact of the current downturn in the local economy.

The property tax rate remains a lever available to city policymakers seeking to maintain revenue growth in the face of legislated assessment limits. (Property tax liability equals assessed value times the tax rate.) Since 1992, however, an informal freeze in the overall property tax rate has further limited property tax revenue growth.

Sales tax share fluctuates in a narrow range. Like the PIT, the city's sales tax is sensitive to local economic activity, although the swings are not as sharp, and, with no equivalent to "bracket creep," there has been no long-term growth in the tax's share of total tax revenue. The share was 13.9 percent in 1977, and grew to over 17 percent by 1984. During the mid-1980s expansion, sales tax revenues continued to grow strongly, but the share fell in the face of stronger PIT revenue growth. Sales tax growth slowed in the 1988-1992 period and the tax's share of total revenue shrank to 13.4 percent. In the mid-1990s expansion, the share once again grew, although it only reached a high of 15.9 percent in 2000 before declining.

Business income taxes show little change. The city's business income taxes are sensitive to the local economy, and, to a greater extent than the city's other taxes, the national economy as well. Revenue from these taxes is much more volatile than the city's other major sources, with year-to-year swings often exceeding 15 percent for the group; the financial corporation tax is the most volatile of the three. Revenue growth was very strong in the early 1980s, and then again in the mid-1990s. But this growth occurred at the same time that the PIT also rose, so the business income tax revenue share changed only slightly from 11.5 percent in 1977 to 14.4 percent in 1987. Growth in business taxes was very brisk in 1996 and 1997, but then it slowed due to a series of tax cuts enacted by the city and difficulties in world financial markets. With slower revenue growth, the revenue share trended down slightly, so that by 2002, the share was 12.7 percent, similar to the share in 1977.

Policy implications. As policymakers consider tax increases to close the city's immediate budget shortfall, longer term tax policy issues also need to be considered. The decline in the property tax as a share of revenue over the past 25 years suggests that the city should look at ways to better capture increases in property values over time. Similarly, the fact that the business income tax share remained flat rather than grow as the PIT share did, particularly during economic booms, suggests that the city needs to examine its business taxes in light of changing ownership structures and shifts in the amount of income multistate and multinational firms apportion to the city.

Written by George Sweeting