IBO

New York City Independent Budget Office

Fiscal Brief

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Albany Budget Relief: How Much in City Gap-Closing Help?

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New York City
Independent Budget Office
Ronnie Lowenstein, Director
110 William St., 14th floor
New York, NY 10038
Tel. (212) 442-0632
Fax (212) 442-0350
e-mail: ibo@ibo.nyc.ny.us
http://www.ibo.nyc.ny.us

SUMMARY

While the form of budget relief Albany is providing to the city is quite different from what the Mayor had wanted—most importantly the decision by the Legislature to allow the city to raise taxes on its own residents rather than commuters—the amount of assistance may exceed the aid the city was looking for.

Based on an analysis by IBO of the various state measures, the total package is worth roughly $2.3 billion in help towards closing the city's 2004 budget gap: $1.3 billion in new tax revenue and $1.0 billion in other assistance. This may be as much as $210 million more than anticipated in the Executive Budget for gap closing from the state.

Some of the key budget relief measures include:

- An increase in personal income tax rates for approximately 135,000 high-income tax filers that based on IBO's projection will raise $784 million in additional revenue in 2004.
- An eighth of a percent increase in the city sales tax that will raise as much as $123 million in 2004.
- A surcharge on absentee landlords that will result in up to $70 million more in revenue in 2004.
- A restoration of $363 million in education aid, although only $33 million of it will provide help towards closing the city's budget gap.

With the state assistance secured, for the moment it appears that the Mayor will not have to turn to the contingency cuts he threatened if Albany did not provide assistance. But the city still faces a number of other risks in the Executive Budget plan for balancing the 2004 budget. In addition, much of the state assistance is temporary. As a result the amount of budget relief begins to decline in fiscal year 2005 to $1.9 billion and falls to only $1.2 billion by 2007.

BACKGROUND

The Mayor's Executive Budget included a request of aid from the state totaling $2.7 billion. Last month the state Legislature passed—over the Governor's veto—a series of measures that will bring additional revenue to New York City. The measures include local tax increases that will provide the city with more tax dollars, restorations of cuts proposed by the Governor, and other initiatives such as the state takeover and refinancing of debt service on bonds still left from the 1970s fiscal crisis.

While the form of help Albany is providing is quite different from what the Mayor had wanted—most importantly the decision by the Legislature to allow the city to raise taxes on its own residents rather than commuters—the amount of budget relief may exceed the aid the city was looking for. Based on an analysis by IBO of the various state measures, the total package is worth roughly $2.3 billion in help towards closing the city's budget gap: $1.3 billion in new tax revenue and $1.0 billion in other assistance. This may be as much as $210 million more than anticipated in the Executive Budget for gap closing.

State Aid: Wanted and Received for 2004
Dollars in millions

	Overall Value	Gap-Closing Value
What the City Wanted from the State		
Tax Revenue	1,400	1,400
Transportation Initatives	200	200
Education Aid Restorations	478	152
State Aid for Teacher Contract	275	0
Other State Restorations	100	100
Menu of Possible State Actions	252	252
Total	***2,705***	***2,104***
What the City Got from the State		
Tax Revenue	1,334	1,336
Transportation Initiatives	0	0
Education Aid Restorations	363	33
State Aid for Teachers Contract	62	0
Other State Restorations	360	140
Menu of Possible State Actions	65	65
MAC Debt Service Relief	530	530
Battery Park City Financing	165	165
Speed-up of State Aid Payment	73	73
Other State Actions	(28)	(28)
Total	***2,924***	***2,314***
Differences		
Tax Revenue	(66)	(64)
Other Items in Executive Budget	(455)	(466)
Items in State Budget and Aid Package	710	710
Total	***219***	***210***

SOURCE: IBO.

An additional $600 million from Albany restores proposed cuts in the state budget the city did not plan on shifting its own resources to cover—such as funding for pre-kindergarten and class-size reduction—and enables the city to close some tax loopholes and increase certain tax rates, changes that were already assumed in the Mayor's budget. None of the $600 million from these changes helps close the city's gap.

With the state assistance secured, for the moment it appears that the Mayor will not have to turn to the contingency cuts he threatened if Albany did not provide assistance. But the city still faces a number of other risks in the Executive Budget plan for balancing the 2004 budget. In addition, much of the state assistance is temporary. As a result the amount of budget relief begins to decline in fiscal year 2005 to $1.9 billion and falls to only $1.2 billion by 2007.

What follows is an explanation of the major pieces of assistance granted to the city.

TAX CHANGES

The Legislature rejected the Mayor's personal income tax (PIT) proposal to broaden the city's tax base by including the income of commuters. Instead, the city was given permission to raise for three years both the income tax on its high-income residents and the local sales tax by one-eighth of a percent. (Local legislation to enact the PIT increase was still pending in the City Council when this report was published.) Several business loophole closing and tax enforcement changes were also included in the Legislature's city aid package. In addition, city tax revenue will increase as a result of the repeal of the sales tax exemption for clothing and other tax law changes in the state's budget. IBO estimates that these changes will result in $1.3 billion in new tax revenue in fiscal year 2004. Because some of these changes are scheduled to be reduced and then expire, or "sunset," within three years, the revenue gains will largely disappear by fiscal year 2007.

Personal Income Tax Increase. The Legislature approved temporary increases in the city PIT paid by high-income taxpayers: married couples with more than $150,000 of taxable income, single filers with incomes greater than $100,000, and heads of household (single parents) with incomes above $125,000 would all see their marginal tax rates increase 16.5 percent; for filers with more than $500,000 in taxable income, marginal rates will increase 22 percent. IBO estimates that 135,000 households (about 4.1 percent of all taxpaying households) will be subject to the higher rates. An additional feature in the law "recaptures" the benefit of the progressive rate table with its lower rates charged on the first $150,000 of income. As a result, many filers subject to the higher surcharge rate will pay their top marginal rate on every dollar of income. (See the special supplement on our Web site *What the Income Tax Changes Mean to New York City Filers*.)

IBO expects that the PIT increase, which is retroactive to January 1, 2003, will raise $784 million in additional tax revenue during fiscal year 2004. While the top rate, paid by filers with income above $500,000, will remain the same for the three years, the marginal tax rate in the next highest bracket will be reduced on January 1, 2004 and then again on January 1, 2005. Both higher rates are scheduled to expire on December 31, 2005. With the declining rates, the additional revenue raised is expected to fall to $551 million in fiscal year 2005 and $285 million in 2006.

A parallel New York State personal income tax increase on high-income households was enacted as part of the state budget, with the additional revenue used to help close the state's budget gap, pay for the Legislature's restorations of spending cuts proposed by the Governor, and fund portions of the city aid package. The state PIT increase applies statewide, although about 40 percent of the households that will be subject to it reside in the city (most of the rest live in the suburbs around the city) and will also be subject to the city surcharge.

City Sales Tax Increase. The Legislature authorized the city to increase its local sales tax by one-eighth of a percentage point from 4.0 percent to 4.125 percent. The increase took effect June 3, 2003. The increase is temporary and is scheduled to end on May 31, 2005. IBO estimates that the increase would bring in $123 million of additional revenue for fiscal year 2004 and $130 million for 2005. With the rate scheduled to sunset, there would be no additional revenue in fiscal year 2006 and beyond. A similar temporary increase in the state's sales tax rate of one-quarter of a percent was also enacted as part of the state budget, bringing the total sales tax rate to 8.625 in the city — 4.25 percent for the state, 0.25 percent for the Metropolitan Transportation Authority, and 4.125 percent for the city.

Repeal of Clothing Sales Tax Exemption. One of the Governor's proposals accepted by the Legislature in adopting the state budget was to end the sales tax exemption for clothing items costing less than $110. The repeal took effect June 1, 2003. When the statewide exemption was enacted in 2000, counties had the option of extending the exemption to cover their county sales tax as well. New York City, which had been the main advocate for establishing the exemption, joined many counties in dropping its tax.

The budget legislation removes the local option so that all counties will be required to follow the state in once again taxing all clothing sales. As a partial offset to the repeal, two weeklong clothing tax holidays will be instituted, during which clothing items costing less than $110 will be exempted from both city and state sales taxes.[1] IBO estimates that net of the impact of the tax holidays the city will receive $277 million additional revenue for fiscal year 2004 and $291 million in 2005. There is no sunset provision on the repeal so the city will continue to receive additional revenue in following years as well. These estimates assume that no sales are lost to readily accessible retail options with lower sales taxes on clothing (i.e. New Jersey, mail order, and the Internet). In reality, some sales will be lost, resulting in a lower net revenue gain for the state and city.

Conforming to State Loophole Closing. The Legislature's budget includes a number of business tax changes aimed at closing loopholes and bringing the state more than $150 million in new revenue. The city will conform to some of these changes, most significantly by curtailing deductions for payments of royalties and licensing fees to subsidiary businesses created in states with no business income tax. IBO estimates that these changes will yield the city $65 million in additional revenue annually.

Absentee Landlord Surcharge. The Legislature's city aid package authorizes a new surcharge on owners of one-, two-, or three-family houses (designated as class 1 under the city's property-tax system) who are renting all of the units in a house rather than residing in one of them.[2] Class 1 properties have the lowest property tax burdens in the city, a benefit conferred to encourage homeownership and preserve neighborhood stability. The City Council, which initially raised this issue, has argued that since absentee landlords do not reside in their properties, they are not entitled to homeowner benefits, although the property tax law classifies properties simply on the number of units and whether a building is residential or commercial. The legislation authorized the city to add a 25 percent surcharge to fiscal year 2004 property tax bills of absentee landlords and a 50 percent surcharge for 2005 and subsequent years.

The amount of additional revenue expected to result from this surcharge is particularly difficult to estimate. The city's Department of Finance does not maintain an inventory of absentee landlords (a situation that will make administration difficult as well). Estimates of the number range from 75,000 to as many as 280,000. The city's revenue estimate, which appears to have been used by the Legislature in preparing the bill, assumed that 75,000 properties would be subject to the surcharge, resulting in $44 million in revenue for 2004 and $88 million in 2005. IBO's analysis suggests that the number of parcels could be closer to 130,000. If this higher estimate proves true, then the additional revenue for the city would be $70 million in 2004 and $141 million in 2005.

Other Tax Changes in the State Budget. Several other items in the state budget will yield the city additional tax revenue. The state moved to include the city's cigarette excise tax in the state's sales tax base. Thus, the state and local sales taxes on cigarettes will now be calculated with the city's excise tax included in the amount subject to sales tax. This tax on a tax will result in $7 million in new sales tax revenue for the city in 2004 and $13 million in 2005. The state is also allowing liquor stores to remain open on Sundays, provided they close on another day during the week. The Legislature expects this to result in additional sales tax and liquor excise tax revenue for both the state and localities. The city is expected to receive $10 million annually in new revenue from Sunday liquor sales. In addition, the state and the city business tax laws were decoupled from federal provisions that encourage businesses to purchase large SUVs. This will provide the city with approximately $1 million per year.

Tax Enforcement Provisions. The Mayor's Executive Budget included a number of minor tax enforcement provisions and a business tax amnesty program expected to result in $20 million in collections from delinquent taxpayers who would otherwise not have come forward to settle their bills. In exchange for paying their outstanding liabilities, taxpayers would have the associated penalties and interest charges waived. The Legislature's city aid package includes the amnesty and most of the other tax enforcement provisions, although technically these actions do not count as budget relief. Although the city's Executive Budget presentation included these items in the menu of possible changes out of which the city was looking for $252 million, the city had already assumed these provisions would be enacted when it estimated the size of the 2004 budget gap that remained to be closed. Thus, enactment of these changes does not contribute to closing the city's budget gap.

EDUCATION AID

The Governor had proposed reducing school aid by $1.1 billion statewide. The city estimated that, if enacted, the Governor's budget would have resulted in $478 million less state aid for city schools in school year 2003-2004 than they had received in the current school year. One of the Legislature's main goals in this year's budget showdown was to avoid the Governor's proposed education cuts, and this was largely achieved, with over $900 million in school aid restored statewide.

For the city, the adopted state budget restores $363 million of the $478 million the city was seeking; a shortfall of $114 million. Much of these restorations were to specific or "categorical" programs, however, and therefore do not contribute towards closing the city's budget gap. IBO estimates that only $33 million of the $363 million restored for the city offers gap-closing help.

Categorical Aid Restorations. The Governor had proposed eliminating funding for universal pre-kindergarten ($147 million for the city), early grade class-size reduction ($88 million for the city), minor building maintenance ($33 million for the city), and teacher support aid ($42 million for the city), among other changes. The Legislature's budget restored full funding for each of these programs.

Operating Aid Restructuring. The Governor's budget included a proposal to consolidate state operating aid currently distributed through nine different formulas and distribute it as a block grant with fewer constraints on how school districts spend the aid. The State Education Department estimated that the Governor's restructuring would have reduced the city's operating aid for school year 2003-2004 by $110 million from this year's level. The Legislature's budget rejected the block grant approach, choosing to rely on the nine formulas to distribute the aid. After accounting for this and changes to other formula aids, the total amount of non-categorical aid for the city for 2003-2004 is $33 million higher than under the Governor's budget. Because the aid was only partially restored, the city faces a shortfall of approximately $78 million in operating aid that will have to be covered through a combination of city tax-levy funds and/or additional budget savings.

State Aid for Teachers Contract. The Mayor had requested $275 million in new state aid to cover the cost of the extended day portion of the contract with the United Federation of Teachers that was signed last summer. The enacted budget provides only $62 million in new resources to meet this expense, leaving a shortfall of $213 million to be covered with city funds and/or spending reductions. Moreover, the $62 million in new resources are in effect borrowed from the state, and will result in lower state aid payments in future years.

When the contract was signed last year, the Governor and the

Legislature provided one-time funding to cover the extended day costs for school year 2002-2003. For subsequent years the city's Financial Plan covered the costs with city tax-levy funds, It has become clear, however, that the city funding for extended day beginning in 2003-2004 was not the result of adding resources to the Department of Education's budget but instead a reallocation of city money within the baseline education budget. This created the need for new state aid or additional city funding to maintain the same level of education services in 2003-2004. In his Executive Budget, the Mayor included cuts of $275 million to the education budget as part of his contingency plan if the state and other parties did not come through with the assistance he was seeking.

In order to provide some assistance towards the extended day costs for the coming school year, the Legislature's budget continued one of the most problematic initiatives from last summer's package of state actions. The state has built up a large backlog of approved but unpaid claims for prior year state aid owed to the city. As an alternative to appropriating sufficient state funds to pay the state's obligations to the city, the Governor and the Legislature choose to borrow money to cover the cost and have the city pay the debt service out of future state school aid.

Last summer the state approved the sale of bonds by the Municipal Bond Bank, a state-controlled agency, to pay off the outstanding claims and to provide approximately $200 million to be used towards the first-year cost of extended day. The debt service on the bonds will be paid by intercepting a portion of the city's annual state aid. This year, $33 million in state aid is being redirected to cover principal and interest payments by the bond bank with $62 million planned to be redirected for 2003-2004. This year's enacted state budget authorizes the bond bank to add the $62 million to the principal being financed. Although the result is to give the city an additional $62 million in bond proceeds for the coming fiscal year, borrowing to pay debt service will require even larger intercepts of state aid in the future.

MEDICAID AND HEALTH RESTORATIONS

The Mayor's Executive Budget also sought at least $100 million in restorations or other aid to offset some of the cuts in other parts of the state budget besides education. The largest such cuts in the Governor's proposed budget were in Medicaid and health services.

The Governor proposed altering fiscal burdens for major pieces of the state's Medicaid program. The state would have absorbed all of the local costs for prescription drug coverage under Medicaid in return for the localities increasing their share of hospital and clinic costs from 25 percent to 37.5 percent. This swap would have eventually benefited every county across the state with the exception of New York City. The city would have been a net loser because of the high cost of delivering hospital care here. IBO estimates that the swap would have added $140 million to the city's Medicaid budget, but with the Legislature's rejection of the swap the city will avoid this cost.

The Governor had also proposed a variety of initiatives to contain the cost of Medicaid by lowering reimbursement rates, "taxing" providers, and limiting eligibility for Family Health Plus and children's Medicaid. These changes, which would have yielded savings for the city budget by reducing total spending on Medicaid, would have had a major impact on the city's Health and Hospitals Corporation, which as a Medicaid provider was projected to lose $200 million through lower reimbursements and increased assessments. The Legislature rejected these changes as well. As a result, the city will not get the benefit of the cost containment. But the potential savings had not been assumed in the city's budget, so their absence has no impact on the city's budget gap.

Yet another set of health care changes proposed by the Governor would have reduced state matching funds for local public health programs. The city's Department of Health and Mental Hygiene had estimated that this proposal would have reduced support for these programs in the city by $50 million. The Legislature rejected most of the changes sought by the Governor, although the city will still see an estimated reduction of $20 million in public health matching funds. Because these are matching funds, however, this change will only affect the city's budget gap if the city chooses to replace the lost state funds.

MAC TAKEOVER AND OTHER ASSISTANCE

MAC Debt Service Takeover. The city is still responsible for approximately $2.5 billion of outstanding Municipal Assistance Corporation (MAC) debt and had planned on making debt service payments of about $500 million per year through 2008. The MAC debt had originally been issued during the 1970s fiscal crisis when the city was unable to sell its general obligation bonds. The Legislature's adopted budget would shift the remaining debt to a new city-controlled corporation that would then refinance it. The debt service on the new bonds would not be the responsibility of the city. As a result, the city would save $530 million in 2004 and slightly less in the following four years, while state resources will be committed to annual payments of approximately $170 million for 30 years.

***Battery Park City Authority Financing* .** Another debt refinancing action authorized by the Legislature to assist the city will yield the city a one-time benefit of $165 million in fiscal year 2004. The Battery Park City Authority will refinance bonds of the Housing New York Corporation, which are secured by the authority's revenue. The refinancing takes advantage of current low interest rates, so that the new bonds will require smaller debt service payments. This will in turn free up certain reserves that the authority is required to maintain as security for the bonds, and these reserves will be transferred to the city.

Other Assistance. The Legislature's budget and aid package included a number of other measures to assist the city. Four of these produce significant nonrecurring gap-closing benefits. The state will accelerate state aid payments to produce a one-time windfall of $73 million in fiscal year 2004. The Legislature also authorized the city to sell additional taxi medallions over the next two years. These sales are expected to produce $65 million annually in new revenue in 2004 and in 2005. The city's authority to use variable rate financing when selling bonds was extended for another year, producing $10 million in savings in 2004. Finally, the Legislature's city aid package will allow the city to redirect some state aid intended for individual teacher recruitment grants towards more general recruitment and retention expenses. This will free up $12 million of city funds in 2004 for other purposes.

Written by George Sweeting

END NOTES

[1] The Governor had proposed that the exemption remain in effect during four "tax free" periods each year. The Legislature accepted the Governor's proposal of a general repeal, but limited the "tax free" periods to twice a year: the first in January near the observation of Martin Luther King's birthday and the second the week preceeding Labor Day.

[2] This proposal was part of the Mayor's $252 million menu of potential state actions.