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Considering Tax Cuts: Current Proposals by the Mayor and the City Council

OVERVIEW

Both the Mayor and the City Council have made tax reductions a significant part of their proposals for the city's upcoming budget. The Independent Budget Office estimates that the Mayor's proposals for new tax cuts would cost $532 million in lost revenue in fiscal year 2002, growing to $1.275 billion in 2005. The Council's tax reduction plan would cost somewhat less, growing from $368 million in 2002 to $776 million in 2005.

Each set of proposals share some common targets for tax relief. Both the Mayor and the Council call for extending the co-op and condo tax abatement program. The Council's plan, however, also deepens the existing abatement particularly for lower-value apartments that are concentrated outside the prime Manhattan residential neighborhoods. The Mayor and the Council also have proposals for altering the commercial rent tax (CRT). While the Mayor's plan calls for phasing out the CRT by 2004, the Council's proposal would reduce the number of firms that must pay it.

The Mayor's other major tax proposal is for further reductions in the personal income tax (PIT) surcharge. This is a new proposal, and was not part of his Preliminary Budget presented in January. Another new item is the plan to extend the lower Manhattan revitalization program through 2004, although it would exclude leases in the World Trade Center from qualifying.

Other Mayoral changes since January include scaling back or delaying a number of tax reductions. These changes include delaying the repeal of the $2 hotel fee and a PIT credit for "S" corporations until 2003; holding off the implementation of an earned income tax credit (EITC) for low-income working families until 2004; and postponing business tax reductions until 2005. The terms of the business tax cut are no longer defined and the amount of the reduction is smaller.

The Council's other proposals, which were presented in March and would take effect in 2002, include the EITC and a child care tax credit as well as the elimination of the mortgage recording tax for many first-time home buyers. The Council also has proposed ending the sales tax on all clothing and footwear beginning in 2002, and the Mayor now concurs.

All of these proposals deserve careful consideration, particularly at a time when the local economy is showing signs of a slowdown and the city must confront large budget gaps beginning as early as 2003. Except for the changes in the PIT surcharge and the CRT, all of these proposals would require state legislation in addition to local action. IBO has prepared this fiscal brief to assist those considering the various proposals.

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PIT SURCHARGE REDUCTION

The Executive Budget proposal. The major new item introduced to the tax reduction program in the Executive Budget is the proposal to cut the rates of the personal income tax (PIT) surcharge, beginning July 1, 2001. This tax cut would build upon the PIT surcharge restructuring and reduction originally agreed to as part of last year's Adopted Budget and enacted into law last fall. Based on specific details about the cut not presented in the Executive Budget but provided by OMB, IBO estimates that the new surcharge cut would cost the city $179 million in 2002 and slightly more in the out-years of the financial plan. As with last year's surcharge restructuring, lower-income taxpayers would receive the largest percentage reduction in their tax burdens. Still, two-thirds of the benefits would be received by the 10 percent of filers with incomes above $100,000.

Background of the surcharge. Initially established in tax year 1991 as a temporary measure that would expire in three years, the PIT surcharge has been renewed several times. Under current law, the surcharge is in effect through the end of 2001. Until the beginning of this year, the PIT surcharge simply equaled 14 percent of non-surcharge liability. From 1991 through 1998, when the 12.5 percent "Safe Streets, Safe City" surcharge was also in effect, the 14 percent was assessed on that surcharge's liability as well.

As a result of last year's restructuring which became effective January 1, 2001, there are now two surcharge rates: 7 percent of base liability on income up until the highest tax bracket and 14 percent on liability from the top bracket. (The highest bracket starts at $50,000 of taxable income for singles, $60,000 for single parents, and $90,000 for married couples filing jointly.) The restructuring halved the surcharge for taxpayers whose incomes did not reach the top bracket and gave smaller percentage cuts to higher income taxpayers because the 14 percent surcharge rate was retained for income in the top bracket. All top-bracket filers received the maximum possible tax cut: $105 for single filers, $126 for single parents, and $189 for joint filers. IBO estimates that when its full fiscal impact is felt, the enacted restructuring will reduce annual PIT collections $192 million to $200 million from 2002 to 2005, roughly one-fourth of total surcharge revenues prior to restructuring.

Cost of Tax Reduction Proposals
Dollars in Millions

	2002	2003	2004	2005
Mayor's Tax Reduction Program				
PIT Surcharge Reduction	$ 179	$ 188	$ 200	$ 212
Extension of Coop/Condo Tax Abatement	190	203	215	227
CRT Elimination	125	274	430	459
Sales Tax Clothing Exemption	31	109	113	116
S Corp Credit on PIT	--	26	53	56
Hotel Tax Cut	--	21	42	43
Earned Income Tax Credit on PIT	--	--	57	58
Extension of Lower Manhattan Revitalization Program	8	19	31	30
Business Tax Reductions	--	--	--	75
Total	**$532**	**$840**	**$1,141**	**$1,275**
City Council's Tax Reduction Program				
Extension & Increase of Coop/Condo Tax Abatement	$ 232	$ 248	$ 263	$ 278
CRT Elimination	17	18	178	279
Sales Tax Clothing Exemption	31	109	113	116
Earned Income Tax Credit on PIT	56	57	57	58
Child Care Credit on PIT	20	20	20	20
Mortgage Recording Tax Reduction	12	24	25	25
Total	**$368**	**$476**	**$ 656**	**$ 776**

SOURCE: IBO.
NOTES: Numbers may not add due to rounding.
Items in the Mayor's tax reduction program are based on the Executive Budget proposals and subsequent adjustments. Items in the City Council's program are based on the proposals presented in the March 2001 Preliminary Budget Response and subsequent adjustments.

Cost and distribution of benefits under the new proposal. The new proposal as outlined in the Executive Budget and detailed by OMB would reduce surcharge revenues by another fourth. The tax reduction program calls for maintaining the PIT surcharge's two-rate structure but cutting each rate by three and a half percentage points; the surcharge rate on base liability from income in the top tax bracket would be reduced to 10.5 percent, while the rate on income below the top bracket would fall to 3.5 percent. If these cuts become effective July 1, 2001 as proposed, IBO estimates that PIT revenues would decrease by $179 million in 2002, $188 million in 2003, $200 million in 2004, and $212 million by 2005; OMB estimates a slightly smaller loss of revenue each year. The average surcharge reduction per taxpayer would be $65 in tax year 2002, the first full calendar year during which the reduced surcharge would be in effect.

Because a very large share of the city's personal income tax receipts come from high-income New Yorkers, the benefits of across-the-board cuts in the surcharge rates are weighted toward the affluent. Two-thirds of the tax savings would be received by filers with incomes above $100,000, with 30 percent being received by millionaires. Nevertheless, New Yorkers with lower incomes would receive a disproportionately greater tax cut, relative to their PIT liabilities. For taxpayers whose incomes do not reach the top bracket, the PIT surcharge rate would be halved (from 7.0 percent to 3.5 percent). For higher income taxpayers, the marginal surcharge rate would fall by a third (from 14 percent to 10.5 percent).

New York State tax law authorizes the city to reduce the PIT surcharge on its own, without prior state approval, although the city must enact the surcharge cut by July 31, 2001 if it is to be effective for the current year. State legislative approval is needed, however, to renew the surcharge beyond its expiration in December 2001.

The following table illustrates the tax cuts that would be received by typical taxpayers with different filing statuses at several gross income levels. Among taxpayers with the same filing status, the value of the tax cut rises as income rises, though tax savings as a percent of the pre-cut PIT liability falls.

Filing Status, Number of Children	Adjusted Gross Income	Tax Cut	Tax Cut as Percent of Pre-Cut Liability	PIT Liability After Cut
Single, 0	$ 25,000	$ 16.68	3.7%	$ 430.68
Single, 0	$ 75,000	$ 71.96	3.3%	$ 2,104.38
Single Parent, 1	$ 25,000	$ 12.05	3.9%	$ 293.80
Single Parent, 1	$ 75,000	$ 66.78	3.4%	$ 1,919.85
Joint, 2	$ 25,000	$ 8.57	6.3%	$ 128.37
Joint, 2	$ 75,000	$ 60.76	3.5%	$ 1,671.66
Joint, 2	$ 150,000	$144.24	3.3%	$ 4,239.93

SOURCE: IBO.
NOTES: Income defined as New York State adjusted gross income. Each example assumes the standard deduction is taken.

Other considerations. The proposed reduction in the PIT surcharge would follow a number of other PIT cuts benefiting city residents enacted over the last several years—the STaR program's base rate cuts and per filer credits, the credit for resident small business owners paying the unincorporated business tax, and the elimination of the 12.5 percent PIT surcharge, in addition to last year's surcharge restructuring. In 2002, the total effect of these already enacted cuts will be to decrease PIT collections by an estimated $1.7 billion, in comparison with the forecast of $5.5 billion in PIT revenues under current law.

Because New York City levies a tax on personal income while the surrounding areas generally do not, the city's PIT creates a disincentive for people who work in the city to live here. Personal income tax cuts serve to reduce this disincentive.

EXTENSION OF COOP/CONDO ABATEMENT

The Executive Budget calls for extending the existing coop/condo abatement in its current form through 2005. IBO estimates that this would cost the city $190 million in 2002 and $227 million by 2005. The Council's response to the Mayor's Preliminary Budget includes a proposal to not only extend, but also deepen, the existing benefit. IBO estimates that deepening the abatement would cost an additional $42 million in 2002 and raise the total cost of the abatement program to $232 million in that year. By 2005, the deeper abatement would cost an additional $51 million and raise the total cost to $278 million.

Background on current abatement. The coop/condo property tax abatement is designed to reduce the disparity in tax burdens between owners of cooperative and condominium apartments and owners of one-, two-, and three-family homes. First enacted as a three-year stopgap measure in 1996 and renewed for two more years in 1999, the abatement is scheduled to expire after the current fiscal year. The city's property tax system has four tax classes, with different assessment procedures and tax rates for each class. Most coop and condo apartment buildings are assigned to tax class 2 (which also includes residential rental buildings with four or more units), while one-, two-, and three-family homes are designated as tax class 1. The city's average effective tax rate (property tax as a share of market value) for class 1 homes is 0.65. In contrast, average effective tax rates for most coops and condos are 1.18 and 1.44, respectively, both significantly higher than the class 1 rate, but less than a third of the average effective rate for most residential rental buildings.[1] Advocates for coop and condo owners have long contended that the city should treat all homeowners equally, regardless of whether they live in apartment buildings or houses. The abatement legislation aimed to narrow the gap in effective rates by reducing the tax on qualifying apartments by 25 percent in buildings with average apartment assessed values of $15,000 or less and by 17.5 percent in buildings with higher average apartment assessed values.[2]

The abatement was instituted as a stopgap to provide some relief while the city developed a long-term solution to eliminate the difference in tax burdens faced by apartment owners and class 1 homeowners. Both the original legislation establishing the abatement, and the legislation extending it for two years, included a requirement that the city deliver recommendations for permanently resolving the problem to the State Legislature. Both deadlines have been missed.[3]

Evaluation of current abatement. The current abatement suffers from a number of shortcomings that make extending it in its current form questionable from the perspective of sound tax policy. First, the abatement does a poor job of targeting benefits to the buildings with the greatest need. Effective tax rates on coops and condos—and hence the gap between class 1 tax burdens and the burdens on apartment owners—vary greatly across the city. These differences stem from distortions in the assessment process that can not be equalized by an abatement that reduces tax bills by the same percentage for all owners. The areas of the city receiving the largest reductions in the class 1 gap (the difference between the effective rate for coops and condos and the class 1 effective rate) are those with the smallest gaps to begin with, and the least need for relief. The smallest class 1 gaps are found in the prime coop neighborhoods flanking Central Park.

Second, the current abatement is inefficient. IBO found that in 1999, $29 million (19 percent) of the benefits were going to apartment owners who either already had tax burdens below the class 1 level *before* the abatement, or who needed only a portion of their abatement to reach the class 1 level.

Finally, extending the abatement for three more years postpones the promised reform that would give many apartment owners the full benefits of class 1 treatment. A report by the Department of Finance was expected to contain one or more options for achieving this goal, but it has not been released.

The City Council proposal. The City Council would extend and also increase the value of the abatement. The proposal would raise the abatement from 25 percent to 40 percent for eligible apartments under the $15,000 assessed value threshold and from 17.5 percent to 20 percent for eligible apartments above the threshold.

By offering a greater increase in the abatement percentage for apartments below the $15,000 assessed value threshold than for those above it, the Council's proposal improves the targeting of benefits towards apartments with the widest class 1 gaps. Overall, apartment owners outside Manhattan, who on average face much wider gaps than do owners in Manhattan, would get 42.2 percent of the additional benefits, compared to 22.6 percent of the benefits under the existing abatement. Manhattan, with only 10.1 percent of the under-$15,000 apartments, would see its share of the total benefits fall by 3.3 percentage points to 74.1 percent. Queens, with 53.7 percent of the lower valued apartments and a class 1 gap nearly twice as wide as Manhattan's, would see the most significant increase in its overall share of benefits, gaining 2.1 percentage points. Despite this reallocation of benefits, the Council's proposal inevitably falls short of the goal of treating all apartment owners equally because it builds on the existing abatement that in turn relies on wildly uneven assessments resulting from the workings of state law.

In addition, the current abatement's inefficiency—the flow of benefits to apartment owners whose tax burdens are below those of class 1—would become worse under the Council's proposal. Some of the apartments that would have their abatements raised to 40 percent need a much smaller increase in the abatement to eliminate their class 1 gap. In other cases, particularly in parts of Manhattan, the 25 percent abatement is already more than sufficient to close the gap. Finally, the benefits from the smaller increase in the abatement for higher valued apartments are overwhelmingly concentrated in Manhattan (87.2 percent of the total) where many such apartments already have virtually no class 1 gap. In each of these situations, the Council's proposal would result in larger benefits than are needed to achieve the stated goal of coop/condo reform: giving apartment owners tax treatment comparable to class 1.

An alternative solution. In a previously released report, IBO analyzed one solution that would have coops and condos assessed and taxed using sales-based market values subject to the same protections enjoyed by class 1 property owners. Such a reform would eliminate the differences in effective rates among owner-occupied apartments, and all coops and condos with tax burdens above the class 1 level would have their taxes brought down to that level.[4] The largest reduction in tax burdens in percentage terms would be concentrated in the areas of the city—largely outside Manhattan—that now have the largest class 1 gaps.

The cost of a long-term solution using sales-based values to tax coops and condos has declined over the past few years. In IBO's

December 1998 study, we estimated that it would cost $270 million—based on market values at that time—to completely eliminate the class 1 gap. The appreciation in coop and condo apartments since that time, which results in lower effective tax rates, has narrowed the gap. Thus, the cost of a comprehensive solution would be smaller today than it was three years ago.

COMMERCIAL RENT TAX PROPOSALS

The Executive Budget calls for eliminating the commercial rent tax (CRT) over three years by reducing the tax rate in two steps before zeroing it out entirely by 2004. The Council would also substantially reduce CRT revenue by exempting increasing numbers of firms from the tax. While removing CRT liability faster for some taxpayers, the Council's proposal would make the already steep existing cliffs in CRT tax burdens even more pronounced.

Background. If fully enacted, these would be the last in a series of reductions in one of the city's unique taxes, one that has often drawn attention from those concerned with the city's tax burden relative to other locations.

The CRT is paid by commercial tenants based on the amount of rent they pay to their landlords. Tax liability is determined by a single flat rate applied to the base rent. A sliding-scale credit that phases out as taxable rent increases helps to moderate what would otherwise be a steep rise in the marginal tax paid on rents just over the zero liability threshold.

Although the CRT tax burden has been reduced several times since its peak in 1977, in recent years the city has made much more dramatic changes, significantly decreasing both the number of firms subject to the tax and the liability of the remaining taxpayers. Since September 1995, only leases in buildings south of 96th Street in Manhattan are subject to the tax. Beginning in June 1997 only tenants with base rents above $100,000 have any tax liability. In January 2001, the City Council enacted an increase in the liability threshold to $150,000, retroactive to December 2000. For tenants still subject to the tax, the most important change has been a reduction in the effective tax rate, which has fallen from 6.0 percent to 3.9 percent since September 1995.

These enacted changes have greatly reduced the number of CRT taxpayers—approximately 10,500 remain—while increasing the share of large firms among those still paying the tax. Thus, the 230 firms (2.2 percent of current filers) with rents over $5 million account for 28 percent of the tax liability. Nevertheless, tenants with relatively modest rents still account for the majority of remaining taxpayers. IBO estimates that 67 percent of the remaining taxpayers have annual rents of $500,000 or less. The average rent for this group of taxpayers is nearly $270,000.

The Executive Budget proposal. Under the Executive Budget proposal the effective rate would be lowered in three steps. In 2002 it would be reduced from 3.9 percent to 2.6 percent, followed by a further reduction to 1.3 percent for 2003. Finally, the tax would be fully eliminated by the beginning of 2004. (The CRT liability year runs from June 1 to May 31, so the changes listed above would actually take effect on June 1, 2001, June 1, 2002, and June 1, 2003, respectively.) IBO estimates that the cost to the city of the Executive Budget proposal, including foregone audit revenue, would be $125 million in 2002, growing to $247 million in 2003, $430 million in 2004, and $459 million in 2005.[5] These estimates are essentially identical to the Executive Budget's projections, with the variance due to differences in the baseline revenue forecasts.

The rate reductions beginning in 2002 would cut the CRT owed by a firm paying $270,000 a year in rent from $10,530 in 2001 to $7,020 in 2002, $3,510 in 2003, and then to zero beginning in 2004. Although reducing the effective rate benefits all taxpayers still subject to the tax, the dollar value is concentrated at the higher end, with over 60 percent of the additional benefit flowing to taxpayers with annual rents of $1 million or more.

City Council proposal. The Council's response to the Mayor's Preliminary Budget includes an alternative proposal to reduce the CRT. Instead of cutting the rate further, the Council's proposal would raise the liability threshold to $200,000 in 2002, $1.5 million in 2004, and $5 million in 2005. Firms still subject to the tax would continue to pay the current 3.9 percent rate. IBO estimates that the proposal would cost the city $17 million in 2002, $178 million in 2004, and $279 million by 2005.

Because the distribution of CRT liability is skewed towards the top, the higher thresholds proposed by the Council would eliminate thousands of taxpayers from the rolls with a relatively modest impact on revenues, at least in the first years. Raising the threshold to $200,000 would eliminate 2,350 filers, while a threshold of $1.5 million would eliminate 9,400 filers. Raising it to $4 million would leave only about 300 taxpayers subject to the tax, with average bills of nearly $500,000. This small group would still provide 35 percent of the baseline CRT projected for 2005.

Over the cliff. One consequence of a higher liability threshold is a steep cliff in the tax burden as rents near the liability threshold. The city currently uses a credit to help reduce the impact of the cliff. The current credit yields a tax of 20 percent of the full rate for rents up to $10,000 over the threshold, 40 percent of the full rate for rents from $10,000 to $20,000 over the threshold, 60 percent of the full rates for rents from $20,000 to $30,000 over the threshold, and 80 percent for rents from $30,000 to $40,000 over the threshold

Even with the credit, however, the cliff is quite steep as rent approaches the threshold and the problem grows worse as the threshold increases. For example, if the threshold was raised to $1,500,000 of rent, no tax would be due if the rent was $1,499,999, but adding one dollar to the rent would result in a tax bill after the credit of $11,700. Using a credit with four steps creates smaller, but still significant cliffs at each $10,000 break point. For example, a one dollar rent increase that pushed a tenant from the first $10,000 range of the credit to the second $10,000 range, would result in a doubling of the tax bill (a marginal rate of 100 percent).

The cliff problem could be addressed by adopting a credit that phases in liability more smoothly. The city currently uses this approach on the UBT with a formula that adjusts liability for each additional dollar in the phase-in range.

Other considerations. New York's tax on commercial occupancies is subject to a number of criticisms. Simply because it is unique, the CRT stands out when tenants, and potential tenants, evaluate how the city's tax structure effects them. The existence of such a unique tax sends a negative signal about the city's tax policy environment. The additional burden of the CRT is also assumed to undermine economic development by reducing the city's competitiveness.

Perhaps the greatest defect of the CRT is that it pyramids one tax upon another. Commercial rents, which are the basis of the tax, already include a portion of the owner's property tax. Indeed, commercial leases in the city usually include a tax escalation clause passing all property tax increases directly on to tenants. Thus, a portion of a tenant's CRT burden is a tax on the landlord's property tax.

While the arguments against the CRT have become well known, some of the criticisms are overstated. Moreover, there has been little discussion of the positive role played by the CRT in the city's tax structure.

The economic development argument against the CRT focuses on the additional burden placed upon businesses in Manhattan that they would not face in competing localities. This would be true if the ultimate bearer of the CRT is always the tenant. However, it is unlikely that this is the case.

In a soft market, when the supply of space exceeds demand, the landlord's need to secure tenants results in the shift of much, if not all, of the true cost of the CRT to the landlord who must sacrifice some potential rent to attract and keep tenants. Although this shifting is a constraint on earnings in the real property sector of the city's economy, the tax itself presumably has little effect on the city's ability to attract and hold businesses that need to rent space in Manhattan when the market has sufficient space available.

When market conditions favor landlords and tenants are competing for a limited supply of commercial space—currently the case in Manhattan although rents appear to have stopped their meteoric rise of recent years—tenants bear more of the burden of the CRT and little is shifted to landlords. However, such market conditions occur precisely when the city is succeeding in retaining and attracting businesses, making an economic development rationale for eliminating the tax less persuasive.

The CRT is appropriately viewed as a companion to the city's real property tax. Indeed, it was created in 1963 when the city was approaching a constitutional limit on the size of the property tax levy.[6] Prohibited from raising the necessary revenue through the property tax, the city turned to a tax that allowed it to capture the growth in the value of commercial properties by taxing the rents that underlie the buildings' market values.[7]

Although the constitutional operating limit is no longer a significant factor in the city's overall tax structure, the CRT continues to function as a compliment to the property tax. Assessment increases for commercial buildings, excluding increases attributable to physical improvements and new construction, are phased in over five years. Thus, the city does not immediately receive the revenue benefits of improving market values. Given that most assessment increases subject to the phase-in requirement are attributable to improving rental incomes, the CRT allows the city to capture these increases earlier in the business cycle.

CLOTHING SALES TAX ELIMINATION

The Administration and City Council have reached an agreement to ask the state legislature to eliminate the city sales tax on apparel and footwear priced $110 or more starting

March 1, 2002. This new proposed start-date supersedes the March 1, 2004 start-date in the Executive Budget and the December 1, 2001 date that had been in the Preliminary Budget and was still supported by the City Council in its Preliminary Budget Response. IBO estimates that the proposed new clothing tax cut would reduce city sales tax revenues by approximately $31 million in 2002, $109 million in 2003, $113 million in 2004, and $116 million in 2005.

Sales of clothing items priced under $110 were exempted from all city and state sales taxes and surcharges in March 2000. However, several localities in the metropolitan area and elsewhere in the state opted not to drop their clothing taxes because they could not accommodate the revenue losses, and there appears to be little appetite for additional clothing tax cuts outside the city. Given the lack of statewide support, it may not be easy for the city to secure Albany's approval for its proposed new clothing tax cut. If the cut is approved, it seems unlikely that the state (or other localities) would join the city in eliminating taxes on clothing priced $110 or higher. New York City shoppers would therefore still be responsible for paying the 4.0 percent state sales tax and 0.25 percent transportation surcharge on these items.

This would mean that the boost in clothing sales and associated city economic output per dollar of city sales tax revenues lost would be considerably smaller than is the case with the existing clothing tax cut. This in turn would limit the amount of secondary city tax revenue increases offsetting the primary revenue loss. IBO has estimated that while secondary city tax increases may eventually offset up to 16 percent of the city's under-$110 clothing tax revenue loss, the maximum secondary revenue offset for a $110-and-over city clothing tax cut would not exceed 9 percent.

EARNED INCOME TAX CREDIT PROPOSALS

The Executive Budget proposal. The Mayor's tax reduction program carries over but delays a Preliminary Budget proposal to establish an earned income tax credit (EITC) against the city's personal income tax for low-income working New Yorkers. In contrast to the Preliminary Budget proposal to institute the EITC during the current calendar year, the Executive Budget delays establishing the credit until calendar year 2003. The proposed city EITC would equal 5 percent of the current allowable EITC against federal income tax liability. Like the existing federal and state credits, the city credit would be refundable, meaning that a filer whose allowable credit is greater than his or her pre-credit income tax liability would receive a check for the difference.

Based on a large sample of city tax returns and a forecast of income growth, IBO estimates that under the Mayor's proposal 588,000 households would receive $57 million in EITC benefits for calendar year 2003—an average credit of $97 per household. Virtually all of the cost to the city of the calendar year 2003 credit would occur in fiscal year 2004. Because the EITC is indexed to inflation, the cost increases by $1 million in 2005. IBO's projections of creating the proposed EITC are $9 million and $10 million greater in 2004 and 2005, respectively, than the Administration's.

In each year, IBO estimates that refunds paid would account for $43 million of the total cost of the EITC—$3 million more than OMB's estimates. The Administration proposes to use some of the Temporary Assistance to Needy Families (TANF) surplus to pay for the refundable portion of the EITC and thus offset most of the cost of providing the credit. Under U.S. Department of Health and Human Services' 1999 guidelines, states are allowed to use the federal TANF block grant either to cover the cost of EITC refunds or to count EITC refunds towards meeting maintenance-of-effort spending requirements under the federal welfare law. While the Administration proposes to fund a city EITC using TANF funds, the city's access to these funds, like the creation of the credit itself, would require state approval.

The City Council proposal. In its March 2001 response to the Preliminary Budget, the City Council proposed establishing a city EITC of the same size as proposed by the Mayor. As presented by the Council, however, low-income filers would receive EITCs beginning in calendar year 2001, with the fiscal cost to the city first felt in 2002. The Council's estimate of the cost of the city EITC is equal to the Administration's—$48 million per year—and thus generally below IBO's projection.

The structure of EITCs. Under the structure of the federal EITC—the basis for both the proposed city EITC and the existing state EITC—the amount of the credit for the lowest-income households increases as income from work rises. For calendar year 2000, a household with two or more children received a federal EITC of 40 cents for every dollar earned up to $9,720—the annual income level at which the credit reached its maximum value of $3,888. The federal EITC remained at this maximum level for incomes up to $12,290 and then declined at a rate of roughly 21 cents for each additional dollar earned until it phased out entirely for income above $31,152. (Filers with one or no children received a smaller maximum credit that phased out at a lower level of income.) Each year the EITC income thresholds and credit amounts are adjusted for inflation by the federal government, so the value of the federal credit (and by extension the state and proposed city credit) does not erode over time.

Other considerations. In addition to giving general tax relief to low-income workers, EITCs are structured to provide incentives for increased labor force participation because the amount of the credit increases as income from work rises. These incentives complement the goal of moving public assistance recipients into the paid labor force in the wake of federal welfare reform.

The creation of a city EITC would eliminate income tax liability for many city residents, including many whose incomes are too low to incur federal or state income tax liability but still owe city PIT. Under current law, IBO estimates that 133,000 filers—almost four-fifths of whom are single parents—will owe city but not state income tax in calendar year 2003. Establishing an EITC equal to 5 percent of the federal credit would reduce this number by 42 percent, to 77,300 filers. Because the underlying federal credit is indexed for inflation, the value of the city EITC and its effectiveness in eliminating city tax liability for many low-income filers would not erode over time.

Using a portion of New York State's TANF surplus to pay for most of the refunded tax credits would substantially reduce the cost to the city of providing an EITC. But it is far from certain whether state officials would make any of the TANF surplus available to the city for this purpose, especially given the state's ability to use the surplus to pay for its own EITC refunds. Even if funds are available, the use of the TANF surplus to fund EITC refunds might limit the city's ability to implement and finance other welfare reform policies, such as expanded jobs training programs or subsidized child care. Finally, because the size of the TANF block grant to New York State could be reduced significantly after 2002, when re-authorization of the grants occurs, it is far from certain that these surpluses will exist in the future.

CHILD AND DEPENDENT CARE CREDIT

The City Council proposal. In its March response to the Mayor's Preliminary Budget, the City Council called for establishing a credit against the PIT for a portion of taxpayers' child and dependent care expenses, effective for the current tax year. IBO estimates that its creation would reduce PIT collections by $20 million a year, beginning in 2002.

A piggybacked credit. At various points in the last several years, both the Council and the Mayor have included child care credit proposals in their tax reduction package, each calling for a credit that would have equaled a certain percentage of either the existing federal child care credit or the comparable state credit. (The state credit is itself defined as a certain percentage of the federal credit.)

The federal credit equals 30 percent of eligible child and other dependent care expenses for households with adjusted gross incomes of up to $10,000. For incomes greater than $10,000, the rate is reduced by one percentage point for each $2,000 of additional income up to $30,000, and remains constant at 20 percent for all incomes above that level. Eligible expenses are capped at $2,400 for one dependent and $4,800 for two or more dependents, so that the maximum amount of federal credit allowed under current law would be $1,440 (30 percent x $4,800).

The credit now being proposed by the Council would equal 15 percent of the existing child care credit against the federal income tax. Under the Council's proposal the maximum city credit for a family with two or more dependents would be $216; for families with one dependent, the maximum would be $108. There have been proposals in recent years to make the federal child care credit more generous, and enacting these would in turn boost the benefits of the proposed city credit.

Fiscal cost. Given the number of New Yorkers claiming the state child care credit, IBO estimates that 162,000 resident filers—households that contain 273,000 children—would receive a child care credit against the PIT if it were offered. Our projection of the cost of the Council's proposal assumes that the city credit would be made refundable, meaning that filers whose allowable credit exceed their pre-credit income tax liability would receive a check for the difference. The state child care credit (though not the federal one) is refundable; while the Council's March response did not address the issue, previous proposals for a city child care credit have explicitly stated that it would be refundable.

If made refundable and effective for the 2001 tax year, the proposed credit would cost the city $20 million in 2002 and subsequent years. The cost does not change significantly over time because the credit is not indexed for inflation. The average credit would equal $120. In contrast to the EITC proposal, which also is for a refundable credit, making the child care credit refundable does not greatly increase its cost. Refunds of child care credits would equal only $3 million of the total cost.

Other considerations. Because it piggybacks on the existing federal credit, the proposed city child care credit would be simple to administer and easy for taxpayers to utilize. Moreover, the creation of the child care credit, particularly if it were made refundable, would eliminate the PIT burden for many near-poor filers with incomes just large enough to incur city, but not state, income tax liability. In the current year, the number of city taxpayers owing city income tax but too poor to pay the state tax would decrease from 115,000 to 59,000.

Some observers have questioned whether the proposed child care credit is effective in providing assistance to families who are in most need. Many families paying for child care cannot take advantage of the current federal and state credits, in part because expenses associated with informal child care are not eligible for the credit under federal law. In addition, the cap on allowable expenses is well below the annual cost of child care for many families. Therefore, only a relatively small portion of a family's annual child care expenses would be offset by the credit.

SUBCHAPTER S CORPORATION-PIT CREDIT

The proposal. The Executive Budget renews a proposal to allow resident shareholders of subchapter S corporations a credit against PIT liability for their share of corporation taxes paid to the city. By reducing the double taxation of business income, the credit would make the PIT treatment of resident S corp shareholders more comparable to that of resident owners of unincorporated businesses.

The tax reduction program calls for an S corp credit that would cost the city an estimated $26 million in 2003, $53 million in 2004 (the first year in which the full effect of the credit would be felt), and $56 million in 2005. These costs are roughly equal to the estimated annual loss of PIT revenue due to the existing UBT-PIT credit.

S corps under current law. S corps are a special type of small business eligible for certain tax benefits at the federal and state levels. In order to organize as an S corp, a firm must meet several qualifications under federal law, the most important of which are that it have no more than 75 shareholders and that its shares not be publicly traded. Under federal law, most earnings of an S corp must be distributed to shareholders and not be retained by the company itself. In return for requiring earnings to be distributed, the federal government exempts S corp earnings from corporate income tax; the earnings distributed to individual shareholders, however, are subject to the federal personal income tax.

Under New York State law, S corps can elect "New York S corporation" status and receive various tax benefits. The most important benefit is that although S corps are subject to the state's corporate franchise tax, they pay at a much lower rate—0.825 percent of net income rather than the regular rate of 8 percent for the current year.

Under New York City law, however, S corps are treated like all other corporations and subject to either the city's general corporation tax (GCT) or banking corporation tax (BCT) with no preferential treatment. They pay the regular GCT or BCT rates.

Executive Budget proposal. Rather than directly changing the corporate taxation of S corps, the proposal would instead benefit city residents who are shareholders in S corps. Starting in calendar year 2002 (a year later than the start date under the Preliminary Budget proposal) these taxpayers would be permitted a credit against PIT liability for a portion of GCT and BCT payments attributable to the taxpayer's stake in the S corp. The proposal is patterned after the existing UBT-PIT credit and would be structured similarly, with the percent of business tax liability that could be claimed as a PIT credit decreasing as the taxpayer's income rises. With this structure, moderate and middle-income residents would receive proportionately greater benefits. By matching information reported on S corps' federal tax returns with information obtained from local GCT, BCT and PIT returns, the Department of Finance has estimated that 49,000 resident taxpayers would qualify for an S corp-related PIT credit.

Other considerations. The proposal would help address one of the unusual aspects of the city's business tax structure—the double taxation of S corp income—while confining the benefits to residents and giving proportionately greater benefits to moderate and middle-income taxpayers. Because the city's income tax treatment of S corps would themselves remain unchanged, the proposed credit would not hinder the city's ability to tax S corp business income generated in the city. The new credit would also make the treatment of resident shareholders in local S corps more similar to the treatment of city residents who are business partners and proprietors paying the UBT, enhancing conformity among the city's business income taxes. Finally, the proposed credit would benefit owners of small, New York City-based businesses, because S corps—like most unincorporated businesses—are generally small firms.

MORTGAGE RECORDING TAX

The City Council proposal. In its March response to the Preliminary Budget, the City Council reprised a proposal to reduce the mortgage recording tax (MRT) for first-time homebuyers. The tax is levied on mortgages used to purchase or refinance real estate in New York City. The proposal calls for eliminating a portion of the tax for first-time buyers of one-, two, and three-family homes (class 1 houses) and condo apartments whose mortgages do not exceed $300,000, beginning in calendar year 2002.[8] IBO estimates that if enacted, the tax cut would cost the city $12 million in 2002 and $24 million to $25 million in subsequent years.

Structure of the MRT. For all mortgages under $500,000, the MRT burden equals 2 percent of the mortgage amount; larger mortgages are taxed at higher rates that vary depending on whether the mortgages are for commercial or residential properties. This burden is composed of two separate taxes: a state tax of 1 percent and a city tax of 1 percent. Half of the state's tax is dedicated to the Metropolitan Transit Authority (MTA) and the State of New York Mortgage Agency (SONYMA), with the other half devoted to New York City's general fund. Because the city's portion of the tax is devoted entirely to its general fund, three-quarters of every dollar of the MRT collected on mortgages under $500,000 accrues to the city's general fund.

In the last few years there have been a number of proposals by both the Council and the Mayor to reduce the MRT for first-time buyers. The current proposal would benefit those buyers whose mortgages do not exceed $300,000 by reducing the MRT rate from 2 percent to 0.5 percent on the first $150,000 of the mortgage. Only the 0.5 percent of the tax dedicated to the MTA and SONYMA would remain on the portion of the mortgage under $150,000, and the tax on the portion of the mortgage between $150,000 and $300,000 would be unaffected. The tax cut would take effect at the beginning of calendar year 2002. If enacted, this tax cut would save the city's first-time buyers up to $2,250 in MRT costs (1.5 percent of $150,000).

Cost to the city. The estimates of the annual fiscal cost of the proposed MRT cut depend on both the number of mortgages not exceeding $300,000 subject to the tax and the percent of these that are taken by first-time homebuyers. City data on MRT payments indicate that nearly 31,000 mortgages up to $300,000 were made for condos and class one homes in calendar year 1999. Given that IBO projects real estate activity and MRT collections to slow, we expect the number of these mortgages to decline in the near future.

The share of these mortgages obtained by first-time homebuyers is less certain, and for our projections we have used an average of available estimates from the Chicago Title Insurance Company's most recent survey of New York-area homebuyers and the U.S. Census Bureau's Housing and Vacancy Survey, taken specifically for the city's Department of Housing Preservation and Development. From this average we expect that 44 percent of class 1 and condo buyers are first-time buyers, and that 12,000 homebuyers would benefit from the MRT cut each year. Because the tax cut would begin in the middle of the upcoming fiscal year, the projected cost is $12 million in 2002. From 2003 to 2005, when impacts are felt for the entire year, the cost rises from $24 million to $25 million. The average tax cut received by first-time buyers would equal $1,995.

At $10 million in 2002 and $20 million per year from 2003 to 2005, the Council's own estimates of the cost of their MRT proposal are lower than IBO's. Their estimates are based on the relatively high rate of first-time home-buying (52 percent) but relatively lower number of potential beneficiaries (9,700).

Secondary impacts. The MRT cut could have secondary impacts that boost other tax revenues over time. If more people buy homes in response to the decline in the MRT, the city would collect additional revenue from the real property transfer tax. In addition, the proposed MRT cut provides an incentive to those buyers working in the city to choose to live in the city and not commute; to the extent that some potential homeowners respond to that incentive, the city's revenue base from the personal income tax would increase, especially now that the incomes of commuters can no longer be taxed by the city. Moreover, to the extent that the rate of homeownership is increased, cutting the MRT would also have the intangible benefit of giving more residents a stake in the city's welfare.

HOTEL OCCUPANCY TAX CUT

The proposal. The Executive Budget renews a proposal to cut the city's hotel room occupancy tax by eliminating its $2 per day component, beginning December 1, 2002, a year later than the proposal in the Preliminary Budget. The tax on hotel room rentals, which is levied in addition to city and state general sales taxes, currently equals 5 percent of the room rent plus a flat fee of $2 per day for rooms renting for $40 or more (a lower fee applies to rooms renting for less than $40). With the average hotel room rate now equal to $237 per day, the flat fee is equivalent to a tax rate of less than 1 percent of hotel room charges.

Because virtually all hotel rooms rent for at least $40 a day, revenue from the flat component of the tax basically equals $2 multiplied by the number of hotel room rentals (that is, the number of rooms available times the number of nights they are rented). IBO estimates that eliminating the $2 per room flat fee in December 2002 would reduce hotel occupancy tax revenues by $21 million in 2003, when revenue would be lost for only half of the fiscal year, and by roughly $42 million annually thereafter. These estimates are about $3 million a year higher than the Administration's and, like the Administration's, do not include any secondary revenue impacts from economic activity that the hotel tax cut might stimulate. These impacts are discussed below.

Background. Since the tax's inception in 1970, the hotel occupancy tax rate has varied over time. Between 1986 and 1990, the rate matched its current level. Then, in 1990, a series of tax increases by both the city and state sharply increased the overall tax rate on hotel rooms costing $100 a night from 15.25 percent to 21.25 percent—the highest rate in the country. Pressure to reduce these taxes led the state to eliminate its 5 percent hotel occupancy tax in September 1994, with the city following suit by cutting the variable component of its hotel tax rate from 6 percent to 5 percent in December of the same year.

Other considerations. To the extent that cuts in hotel occupancy taxes increase the number of overnight visitors to New York, the direct loss of revenue would be offset in part by secondary revenue impacts. These impacts include a boost in hotel and sales tax revenue resulting from a rise in the number of hotel stays; more sales tax revenues due to the increase in non-hotel spending in stores, restaurants, and other city businesses that would accompany the increase in overnight stays; and additional sales tax and business and personal income tax revenue resulting generally from the induced increase in city economic activity.

It is unclear, however, if enacting the current proposal would lead to substantial increases in hotel stays, economic activity, and tax revenues. In a 1997 fiscal brief, IBO developed an econometric model to examine the economic and revenue impacts of the near concurrent 1994 state and city hotel tax cuts. We found that above and beyond the very significant influences of factors such as domestic and foreign economic growth and the city's crime rate, the large tax cuts of 1994 had a role in boosting hotel stays and tourism in the city and thus generated substantial secondary revenue impacts, although not nearly enough to offset the cost of the tax cut. The size of the tax cut now being proposed, however, is much smaller than the combined state and city cuts of 1994 and it is unclear if the current proposal would induce much of an increase in tourism. As a result, IBO expects that revenue impacts under the current proposal to reduce the hotel occupancy tax would be more modest—relative to the proposal's cost—than was the case for the 1994 tax cut.

Another factor to consider in evaluating the proposal is who pays the hotel tax. Almost all of the tax is exported—directly borne by individuals who reside outside New York or by businesses located elsewhere. With the increase in tourism in recent years, the tax has been a growing source of revenue without contributing to the tax burden on city residents and businesses.

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END NOTES

[1] This 1998 measure of the effective tax rates for coops and condos is based on true market value rather than the official city market value, which is artificially lowered under section 581 of the real property tax law. See IBO, *The Coop/Condo Abatement and Residential Property Tax Reform in New York City,* December 1998. With the appreciation in coop and condo units since 1998, effective rates based on true market value would be lower if measured today.

[2] Apartments that have not been sold by the sponsor or developer are excluded, as are apartments in buildings enjoying J-51 or 421-a benefits.

[3] Rather than submitting a plan to the legislature, the city instead sent a letter asserting that given the large deficits in the out-years of the Financial Plan, the fiscal cost of a long-term solution was prohibitive.

[4] Those with burdens already below the class 1 level could be held harmless from the reform.

[5] In order to be consistent with the Preliminary Budget's presentation of CRT elimination, these estimated costs include reductions in audit revenues attributable to the proposal. Note that all other tax program costs are estimated without accounting for their impact on audit revenues.

[6] The New York State Constitution limits the amount of the city's operating budget funded from the property tax to 2.5 percent of the full value of the property tax base. In 1963, the property tax accounted for a much greater share of tax revenues than in more recent years. At that time the city did not have a personal income tax, and the gross receipts tax accounted for a smaller share of revenue than do the business income taxes that have replaced it.

[7] The market value of commercial properties is made up of the discounted value of current and future rents earned from the property.

[8] A purchase of a coop apartment is financed with a type of loan that is not a mortgage, so there is no MRT liability for such transactions.