Restructuring New York City's Personal Income Tax

A proposal from the Drum Major Institute for Public Policy

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The economic downturn will mean tough times for many New Yorkers. The City Comptroller's office recently projected that New York will lose 170,000 private sector jobs in the next two years.[1] Unemployment is likely to rise, and personal incomes will decline. With tax revenue falling, the city faces service cuts that will affect all residents. But some New Yorkers are better equipped to weather the slump than others. In the boom years, Wall Street profits soared, housing values skyrocketed, and the city's population of multimillionaires increased. Yet, even in 2006, with the economy in full swing, nearly a fifth of New York's population – 1.5 million people – lived below the federal poverty threshold. Nearly half of the city's poor families were headed by a working person who earned wages too low to lift their families out of poverty. Just above these working poor households, an additional 19% of city residents lived on the borderline of poverty, striving to earn a middle-class standard of living for their families.[2] As the economic picture darkens, these struggling low- and moderate-income households must be a special focus of public policy.

The city tax code offers one avenue for ensuring that the pain of a poor economy is shared fairly. Recognizing the difficulty low- and moderate-income working families face making ends meet in our high cost city, New York has taken a number of steps in recent years to reduce taxes on these households. For example, New York introduced its own Earned Income Tax Credit in 2002 and added a Child Care Tax Credit in 2007.[3] But despite these efforts, the city's tax base still relies on revenue from households with such modest incomes that the federal and state governments have exempted them from taxation entirely. **Currently 224,200 low- and moderate-income New York City households are obligated to pay New York City income taxes even though they owe no federal and/or state income taxes.[4] The Drum Major Institute for Public Policy (DMI) proposes eliminating New York City personal income taxes on these aspiring middle-class households.**

We pay for this tax cut with a small marginal tax increase on New Yorkers with a taxable income of more than $500,000 a year – the 1.4% of city households who benefited most from New York's economic boom. The tax increase would affect a projected 43,400 households in 2008. These changes to the New York City tax code would require approval of the New York City and New York State governments.

New York City Personal Income Tax Reform

- Eliminate New York City personal income taxes for all households that currently owe no state and/or federal taxes.*

- Institute a new tax bracket for households with a taxable income greater than $500,000 with a base tax rate of 3.285% (compared to the current base rate of 3.2%).

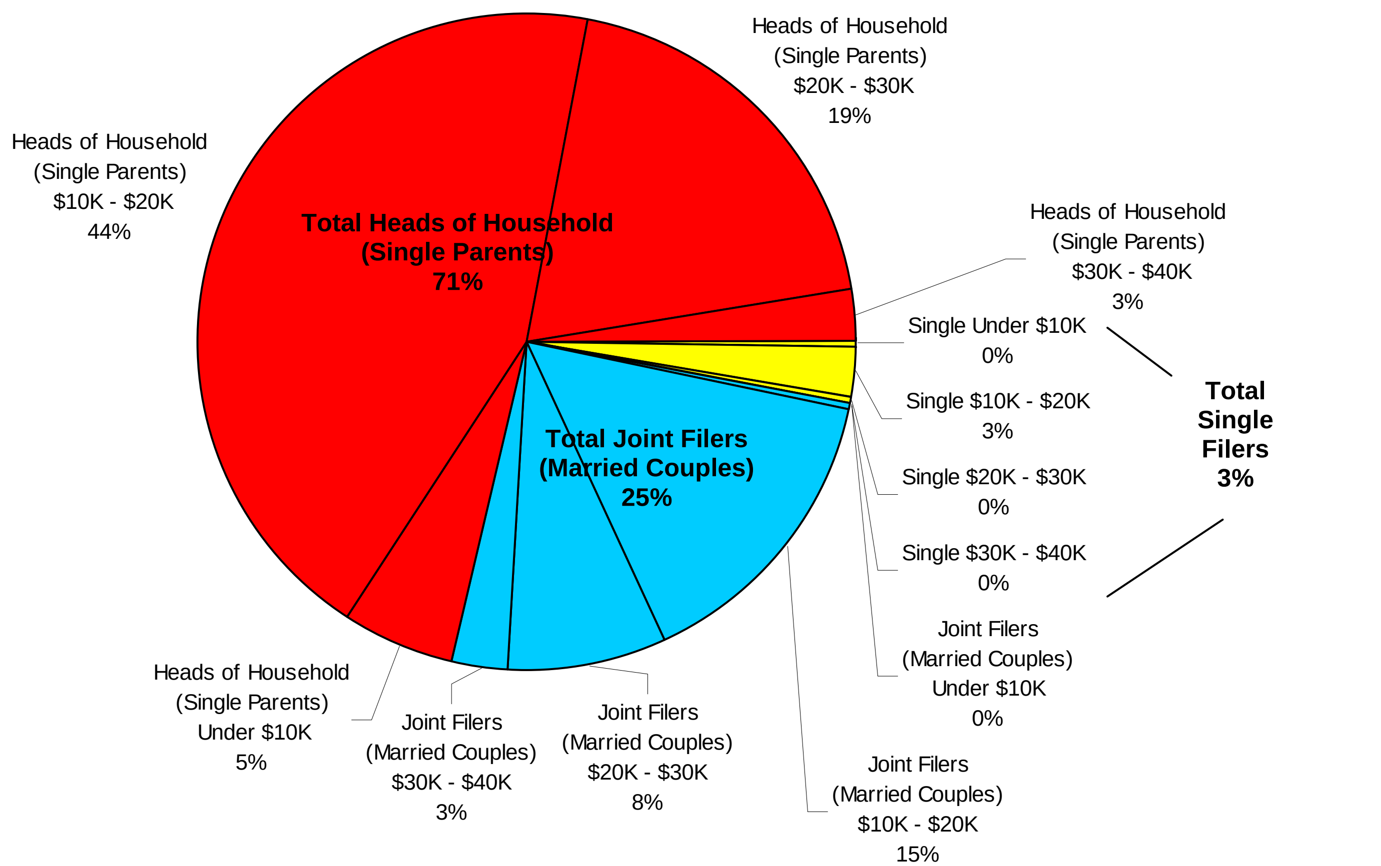
[1] William Thompson, "The State of the City's Economy and Finances, 2008," NYC Office of the Comptroller, December 2008.
[2] U.S. Census Bureau, 2006 American Community Survey.
[3] The Earned Income Tax Credit (EITC) is a tax benefit for certain low-income workers. The credit is refundable, meaning that beneficiaries can receive more money back from the IRS than they owe on their taxes. New York City's EITC is equal to 5% of the federal credit. The Child Care Tax Credit it available to NYC families with a federal adjusted gross income of $30,000 or less who pay to care for a child under age 4.
[4] Unless otherwise specified, all figures cited are from 2008 income tax projections by the New York City Independent Budget Office based on 2005 Personal Income Tax Sample File, Office of Tax Policy Analysis, NYS Department of Tax and Finance.
* In order to exclude a small number of upper-income households from benefiting from this reform, households with a taxable income greater than $40,000 are ineligible for this benefit. The cutoff is indexed to inflation.

DMI's plan would eliminate city taxes for approximately 717,700 New Yorkers, including 281,000 adults and 436,700 dependent children. The proposal applies only to households that both owe no federal and/or state income taxes *and* have a taxable income of less than $40,000. Roughly two-thirds of the beneficiaries have taxable incomes of less than $20,000. Virtually all the beneficiaries are households with children – in fact, nearly one in four New York children lives in a household that would receive a tax cut. Single parents, struggling to raise a family on their own would be the largest group to benefit. On average, affected households would get a $321 tax cut as a result of eliminating their city income taxes. Households with a taxable income between $20,000 and $30,000 would see $533 in annual city taxes eliminated.

New York City taxable income for all filing statuses	Number of NYC households with city taxes eliminated	Average tax cut per beneficiary
Under $5K	Fewer than 100	$39.00
$5K - $10K	13,200	$49.00
$10K - $20K	137,100	$204.00
$20K - $30K	61,900	$533.00
$30K - $40K	12,000	$856.00
TOTAL	**224,200**	**$321.00**

Who Benefits:

Households listed by filing status and taxable income, as a percentage of all beneficiaries



Note: Due to rounding, percentages do not add up to 100

New York City currently brings in approximately $71.9 million in annual revenue from its personal income tax on low- and moderate-income households who owe no state and/or federal taxes. To replace this revenue, and provide a cushion should revenue projections fall short, DMI advocates raising an additional $100 million. This is a tiny amount in the scope the City budget. It amounts to approximately 1.3% of projected revenue from the city's personal income tax in 2008, and just under two tenths of one percent (0.17%) of total projected city revenue in 2008.

To generate the necessary tax revenue, DMI proposes a new tax bracket on incomes greater than $500,000. Wealthy households in the new bracket would pay taxes at a base rate of 3.285% – a 0.085 percentage point increase from the current top base tax rate of 3.2%.[5] This amounts to a tax increase of less than one tenth of one percentage point on these households. For example, households making $550,000 a year would owe about $48 more in taxes under the proposal, while those with an income of $600,000 annually would owe the city just $97 more per year.

This tax reform is particularly timely in today's grim economic climate. It will provide direct tax savings to working families with modest incomes that may otherwise have little to cushion them during the downturn. But the benefits will spread beyond the households that are direct beneficiaries: by putting more money into the hands of squeezed low- and moderate-income families likely to spend it immediately, New York can stimulate the economy in its neighborhoods and citywide. Meanwhile, studies suggest that the wealthy households called to pay increased taxes are unlikely to reduce their consumption much, if at all, as a result.[6] What's more, because the tax increase on households making more than $500,000 is very small, it is highly unlikely that any household would consider relocating outside the city to avoid it. The end result provides both economic stimulus and assistance to vulnerable New York City households, paid for by those New Yorkers who benefited most from the city's expansion.

The largest group of beneficiaries of DMI's proposal are single parent households, which make up 71 percent of all households that benefit. 98,400 single parent households that would receive a tax cut have taxable incomes between $10,000 and $20,000 a year.

The typical beneficiary is a single mother with two children. She earns about $27,500 working full-time in a large clothing store. After factoring in all available tax credits, her taxable income is about $15,000. Her household is not poor – they live at 156 percent of the federal poverty line. Yet she struggles to meet basic expenses. Rent on the family's two-bedroom apartment in Brooklyn is $817 a month, comparable to the borough's median rent. This alone accounts for more than a third of the family's monthly budget. In addition, she strains to afford high monthly health insurance premiums and cope with the rising cost of electricity and food for growing children. As the recession looms, she is fearful that her hours at work will be cut. When all tax credits are factored in, she owes no federal and/or state taxes. Yet even after New York City's Earned Income Tax Credit and Child Care Tax Credit are factored in, she owes the city about $230 a year. DMI's proposal would eliminate that tax, allowing our hypothetical single mom to buy new school clothes and supplies for the kids.

Yet DMI's income tax reform is more than a short-term response to hard times. It is an enduring statement of principles: New York's tax code should rely most heavily on those households that have profited most from the city's substantial public investments in goods like efficient transportation, an educated workforce, low crime, clean streets, and livable neighborhoods. New York is the most unequal

[5] Factoring in the 14% personal income tax surcharge currently in operation, the effective tax rate would increase from 3.648% to 3.745%.

[6] See, for example, Peter Orszag and Joseph Stiglitz, "Budget Cuts Vs. Tax Increases At The State Level: Is One More Counter-Productive Than The Other During A Recession?" Center on Budget and Policy Priorities, November 6, 2001. http://www.cbpp.org/10-30-01sfp.htm

state in the nation, and income disparities are even more extreme in New York City.[7] Over the last thirty years, income inequality in the city has grown rapidly, with the wealthiest 20% of New York City families seeing their incomes grow nearly six times faster than the bottom 80%.[8] Income is even more concentrated among the top 1% and 2% of city households. This evidence suggests that the wealthiest New Yorkers benefited disproportionately from the last two economic expansions. As New York now heads into much more difficult economic times, these households should now be asked to make a greater contribution to their city and their struggling neighbors. At the same time, the city should not put an additional barrier in the path of families struggling to make ends meet and work their way into the middle class. And finally, the city can boost these aspiring middle-class families without shifting taxes onto those New Yorkers who have already managed to attain a middle-class standard of living.

In 2007, DMI surveyed 101 prominent New Yorkers from all sectors of the city, asking about the state of the city's middle class and what policies would help to strengthen and expand it. The overwhelming majority of respondents favored making New York City's personal income taxes more progressive.[9] This modest realignment of the tax code is a first step toward a more substantial revision. For that reason, and because the reform is meant to be permanent, we propose a new tax bracket – rather than a temporary surcharge – at the $500,000 level. While the increased tax rate at this level is trivial, it signals the direction the city must go to make its tax code fairer.

57,000 married couple households would also benefit from DMI's tax reform. These joint filers make up 25 percent of all beneficiary households.

Consider the new police recruit and his wife, who is staying home with their newborn son. Thanks to the new police contract, the rookie cop expects to make nearly $42,000 in his first year. His household taxable income is about $26,000. He's excited about his new career, but his wife is concerned that she'll have difficulty returning to work during the economic downturn. When tax credits are factored in, the family has no federal or state tax responsibility, but they owe the city about $400. DMI's proposal eliminates that tax, enabling the young family to start saving to buy a home. The declining real estate market may make it easier to afford.

As another signpost for further reform, DMI proposes automatically adjusting the $40,000 cutoff point for eliminating city personal income taxes for inflation. Indexing taxes to inflation ensures that city taxes do not shift back onto low- and moderate-income households over time. Currently, most of New York's city and state taxes are not indexed to inflation: as a result, they become less progressive over time as more and more households fall into the higher brackets. The federal tax code, in contrast, is indexed to inflation – with the exception of Alternative Minimum Tax which Congress hurriedly adjusts every year to avoid raising taxes on middle-class households. To preserve the progressive elements of New York's tax code, the entire personal income tax system should ultimately be indexed to inflation.

DMI's proposed restructuring of the New York City personal income tax will not solve the city's fiscal crisis. Our proposal is designed to be revenue neutral, whereas political leaders have recognized that significant new revenue will be necessary to balance New York City's budget into the future.[10] But this rebalancing of the city's personal income taxes is an ideal complement to the necessary revenue increases: it would provide an extra boost to the low- and middle-income New Yorkers who are among the hardest hit by the poor economy, while also stimulating the city's overall economy by putting money into the

[7] Trudi Renwick, "Pulling Apart in New York: An Analysis of Income Trends in New York State," Fiscal Policy Institute, April 2008. http://www.fiscalpolicy.org/FPI_PullingApartInNewYork.pdf
[8] Ibid. p 16.
[9] http://www.drummajorinstitute.org/pdfs/merged_survey.pdf
[10] See: David W. Chen, "Mayor Cancels Rebates for Homeowners," The New York Times, November 5, 2008. http://www.nytimes.com/2008/11/06/nyregion/06budget.html. Fernanda Santos, "City Said to Explore Rise in Income Taxes," The New York Times, October 15, 2008. http://www.nytimes.com/2008/10/16/nyregion/16taxes.html

hands of those likely to spend it. Finally, it establishes principles that should guide the city's efforts to raise revenue: the wealthiest New Yorkers, who have benefited disproportionately from the city's economic boom, should be asked to contribute most now that leaner times have come.