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NYC May See Higher Income, Sales and Property Taxes

By Josh Barro

While the financial crisis and economic slump have been pinching state and local government budgets around the country, New York City has been particularly hard hit. With its heavy dependence on the financial industry, the city is expecting a combined total budget shortfall of approximately $4 billion for FY'09 and FY'10.

The city last faced a budget crisis in 2001, when the combination of a recession and the September 11 attacks caused a significant drop in tax revenue. Michael Bloomberg, then just starting his mayoralty, responded with a combination of budget cuts and tax increases. (Many of those tax increases were rescinded as economic conditions improved.)

Last week, Bloomberg proposed a raft of changes to close the new gap. Similar to the last go-around, the package includes something for everybody to dislike, with $1.5 billion in broadly-aimed budget cuts and nearly $1 billion in tax increases, with more tax increases likely down the road. The mayor's announced tax proposals include:

> • **Property tax increases,** including cancelling a $400-per-taxpayer rebate and accelerating a 7 percent rate increase. Property taxes rose substantially to close the budget gap earlier this decade, but New York City has made a practice of giving homeowner rebates during more recent, flusher years. The mayor is empowered to cancel the rebate by fiat, but he must get agreement from the city council to raise the property tax rate early. The city thinks all these changes combined would generate $832 million in additional revenue for FY'09.

• **Generating $123 million by "increasing certain fees and fines."** The costs of government services do change over time, providing a rationale for higher fees. And some fines are set too low, causing people to see the fine as merely incidental. Therefore, raising fees and fines can be justified on a case-by-case basis, but if motivated solely by the need for more general revenue, they are probably a bad idea.

A fee for any government service, such as admission to a park or museum, should be set to cover the cost of that service. If set much higher, it is no longer properly called a fee but rather a tax.

A fine, by contrast, is designed to punish some behavior that infringes on other people. Economists call this infringement a negative externality. For businesses, the classic example is pollution: a manufacturer reaps all the profits of his industry, but the general public bears the burden of his pollution. For individuals, speeding is one example: the speeder arrives more quickly, but the general public suffers the dangers of his driving. The fine should be set at a level where a violator's expected cost of breaking the law (i.e., the fine times the probability of being fined) equals the negative externality he imposes on others. Economists would say that such a fine causes the violator to "internalize" the negative externality.

Included in the mayor's fee and fine proposal are:

o The hiring of **234 new traffic enforcement officers** to levy fines for "blocking the box" (expected to raise $62.6 million net in FY'09 and FY'10). If a wave of new tickets will bring the expected penalty for blocking the box closer to the cost that a box-blocker imposes on other drivers, then increasing annual spending on traffic officers will be economically efficient.

o **A new five-cent-per-bag "fee" on disposable plastic shopping bags** (expected to raise $16 million in FY'10). The Bloomberg administration maintains this proposal isn't a tax, despite the fact that the proceeds do not defray costs for the government to provide a specific service but rather provide general revenue. Most authorities would call it a tax, and the distinction matters, because the city council can approve a new fee, whereas a tax would require assent from the state legislature. Other cities that have considered such proposals (including Seattle) have properly labeled them as taxes.

If current revenue estimates hold, the $1.5 billion in proposed budget cuts and $955 million in revenue-raisers listed above will still leave a budget gap of approximately $1.3 billion through FY'10. The Bloomberg administration has floated a number of other avenues for raising additional revenue, but it has not specifically endorsed them yet. Some of these proposals are likely to meet political resistance in the state legislature or the city council. They are:

• **An increase of up to 15 percent in the city income tax.** New York City residents already face the highest combined state and local income tax rate in the country: a top marginal rate of 10.498 percent, edging out California's 10.3 percent. However, while California's top rate applies only to taxable income over $1 million, New York's top rate hits many more taxpayers, becoming effective at just $50,000 in taxable income for a single person. A 15 percent surcharge would increase the top city tax rate from 3.648 percent to 4.195 percent, and the top combined city-state rate to 11.045 percent, by far the highest in the country.

• **An increase in the city portion of the sales tax, currently 4 percent, to 4.125 percent or 4.25 percent.** This would increase New York City's total sales tax from 8.375 percent to 8.5 percent or 8.625 percent. New York's suburban counties also generally have sales taxes in the eights. However, New Yorkers would continue to face substantially higher sales taxes than in nearby New Jersey (7 percent) and Connecticut (6 percent). On the bright side, New York would trail far behind the American sales tax leader, Chicago, with its 10.25 percent rate.

• **Elimination of the city sales tax exemption for clothing.** Currently, New York City exempts all human clothing from the 4 percent local portion of the sales tax, while the 4.375 percent state sales tax excludes human clothing priced under $110.[1] Eliminating the exemption from local tax is not a minor change; doing so is projected to raise an additional $436 million in FY'10, enough to close one-third of the remaining $1.3 billion budget gap. (These first three proposals are included on page 43 of the mayor's budget summary, as "options").

• **Imposition of tolls on four free bridges across the East River** (the Brooklyn, Manhattan, Williamsburg and Queensboro bridges). Currently, New Yorkers face a distortionary toll regime where five of the nine East River crossings are tolled, and the other four are free. The facts that the four free bridges are controlled by a different authority and were built earlier are not good economic reasons for eschewing tolls.

One interesting aspect of Bloomberg's proposal is that many of his "creative" sources of new revenue are not the usual fare. So-called creative revenue sources are often narrow-based taxes on economic constituents with little political power. Rental car and hotel taxes, borne by taxpayers who don't vote in the taxing jurisdiction, are common examples. Many of Bloomberg's proposals, on the other hand, such as tolling more bridges and expanding the sales tax to clothing, appear to bring the tax code closer into line with sound tax policy while raising more revenue.

The biggest and most important revenue parts of the proposal, though, are the across-the-board tax increases. Like many states, New York City is in a tough situation: the need to balance the budget means the city must raise taxes and/or cut spending at the economically worst time to do either. Whichever of these proposals gets enacted, residents of the Big Apple can expect to feel additional fiscal pain over the next handful of years.

Notes:

1. Animal clothing (not an uncommon sight on the Upper West Side) is, and would remain, taxable.

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