Civic Report

No. 18 July 2001

New York's Savings from the New Tax Law: A Good Start, But Loose Ends Remain

E. J. McMahon

Senior Fellow,
The Manhattan Institute for Policy Research

CENTER FOR CIVIC INNOVATION
AT THE MANHATTAN INSTITUTE

Table of Contents

NEW YORK'S SAVINGS FROM THE NEW TAX LAW: A GOOD START, BUT LOOSE ENDS REMAIN

EXECUTIVE SUMMARY

The new federal tax law[1] is good news for New York, which bears a disproportionately heavy share of the federal tax burden. But while it rests on a solid foundation of broad-based tax relief very similar to what President George W. Bush proposed, the tax cut bill enacted by Congress left a tangle of loose ends.

With its high average household incomes, the Empire State will be a major beneficiary of the across-the-board tax rate cuts that are due to be fully phased in by 2006. New Yorkers also will benefit from the scheduled elimination (by 2010) of existing limits on itemized deductions and exemptions in upper income brackets.

According to a Manhattan Institute analysis:

- New York State households will save about $89 billion in federal income taxes over the next 10 years.[2] More than three-quarters of the savings will flow to taxpayers in New York City and the surrounding seven-county suburban region in the state.[3]

- By September 24, New Yorkers will have received a total of $2.5 billion in "advance payment" checks representing the first installment of the tax cut—of which $1 billion will flow to residents of New York City, $390 million to Long Island, $259 million to the city's northern suburbs, and $848 million to upstate counties.

- Starting in 2005, the income tax cut's value for many New Yorkers will be undermined to an increasing extent by the Alternative Minimum Tax, or AMT. If the temporary AMT relief provisions in the new tax law were extended beyond their scheduled sunset in 2004, New Yorkers would save an additional $26 billion over the next 10 years.

When the tax cut inevitably is reopened for further tinkering within the next few years, New York State's top priorities should be obvious:

- Follow through on all scheduled income tax rate reductions—preferably speeding up and deepening the rate cuts—and on the phase-out of current caps on deductions and exemptions.
- Repeal the AMT.

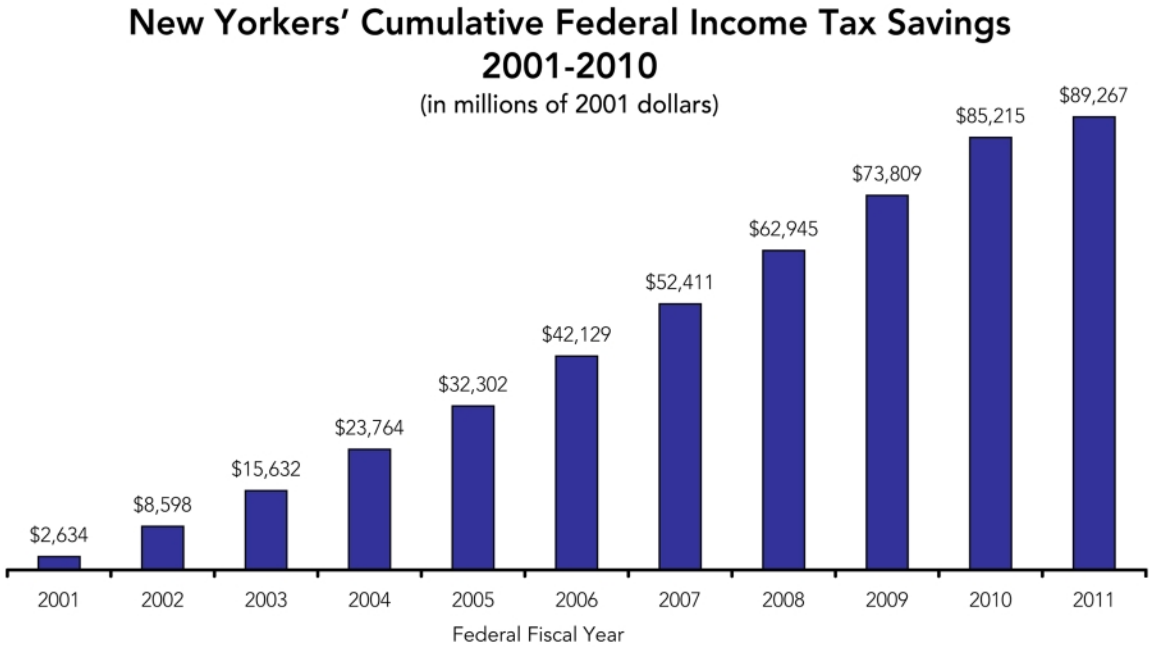
OVERVIEW OF ENACTED TAX CUT

The 2000 presidential campaign posed a clear choice between two conflicting visions of how to redirect federal tax policy in an age of budget surpluses. The foundation of George W. Bush's original plan was an across-the-board cut in income tax rates, designed to promote economic growth through greater incentives to work, save and invest. Vice President Al Gore's much smaller tax proposal featured an array of income tax credits and preferences, targeted primarily at low-income individuals and families.

Elements of the tax cut enacted by Congress this spring include:

- A rate cut in every tax bracket, beginning in 2001 with the creation of a new bottom bracket of 10 percent, with the changes fully effective in 2006. There were two significant changes in Bush's original proposal, however. The top rate will drop from 39.6 to 35 percent, instead of his original target of 33 percent. In addition, the 31 percent bracket will be retained; Bush originally had proposed its elimination.
- The child credit will be doubled, from $500 to $1,000 by 2010. In addition, the credit will become partially refundable for taxpayers who have no income tax liability.
- The so-called "marriage penalty," which results in working spouses paying more in taxes than if they remained single, will be eliminated through an increase in the standard deduction and a broadening of the 15 percent tax bracket for joint filers.
- Existing limits on itemized deductions and personal exemptions will be eliminated by 2010.
- The estate and gift tax will be repealed by 2010.

Not counting the estate tax repeal, which is not a focus of this analysis,[4] the income tax cuts enacted by Congress will cumulatively total $1.2 trillion by federal fiscal year 2011. As shown in the graph below, New York State's share of the tax cut will reach nearly $89.3 billion over the 10-year period, about 7.4 percent of the total.



The first installment of the tax cut is scheduled to be distributed to taxpayers in the form of "advance payment" checks beginning in late July. These payments—ranging from a maximum of $300 for single taxpayers, $500 for heads of household, and $600 for married couples—reflect the value of the new 10 percent bracket on the first $12,000 of income.

New York's share of the advance payments will total just over $2.5 billion this year, according to the Internal Revenue Service (IRS). About two-thirds of this amount—some $1.6 billion—will flow to residents of New York City, Long Island and the northern suburbs of Westchester, Rockland, Putnam, Orange and Dutchess counties, with upstate households collecting the remaining $848 million. The table below shows a breakdown of how advance-payment checks will be distributed among these regions.

2001 Advance Income Tax Cut Payments by Region (dollars in millions)

New York City	$1,004
Long Island	$390
Northern Suburbs*	$259
Rest of State	$848
Total NYS share	$2,500

*Westchester, Rockland, Orange, Dutchess, and Putnam counties

POSITIVES FOR NEW YORK

Living costs and households incomes in New York City and its surrounding suburban counties are considerably above the national average. In addition, New York is home to an exceptionally large concentration of high income taxpayers. As a result, it generates a disproportionate share of income tax revenue. In 1999, the state generated 6.6 percent of income tax returns but 8.5 percent of income taxes paid to the federal government, according to the Internal Revenue Service (IRS).

Given this profile, New York State has much more to gain from an across-the-board cut, such as the one proposed by Bush and approved by Congress, than from the sort of "targeted" approach favored by Gore and some congressional Democrats.[5] The most beneficial aspects of the new income tax law are the marginal rate reductions and the elimination of caps on itemized deductions and exemptions.[6]

New York will receive proportionately smaller benefits from marriage penalty relief, because the state has a smaller-than-average percentage of joint filers. And for many New York families, the benefits of the child credit expansion will be offset by Congress' failure to adopt Bush's proposed expansion of income eligibility levels for the credit, which now phases out for married couples with incomes above $120,000. The current phase-out range is not indexed to inflation, meaning that by the time the credit is fully effective in 2010, fewer families will qualify for it.

From the standpoint of New York, and of other high-income states such as Connecticut and New Jersey, the greatest shortcoming of the law is its failure to permanently address the looming effects of the Alternative Minimum Tax, or AMT. [7]

THE AMT PROBLEM

Most taxpayers don't know they are potentially subject to two different tax codes—the regular tax and the AMT—and that their final tax bill must reflect the highest amount yielded by the two approaches. The AMT was originally created in 1969 to ensure that the nation's wealthiest taxpayers couldn't use tax shelters to avoid paying taxes. Unfortunately, because its design was never altered to reflect the fundamental changes in tax policy enacted since 1981, it has already spread far beyond its originally targeted population and is poised to afflict a growing number of middle-class taxpayers in the near future.

The regular tax code—under the old and new laws—allows taxpayers to claim an exemption for themselves and their dependents (set at $2,800 as of 2000), plus itemized deductions for a wide range of expenses including state and local taxes. The lowest tax bracket previously was 15 percent, which applied to the first $43,850 of taxable income as of 2000. The new law creates a new bracket of 10 percent, applied to the first $12,000 of income for married couples (and $6,000 for singles) as of 2001.

The AMT disallows personal exemptions and a long list of common deductions and credits. Among other things, households subject to the AMT effectively lose their state and local tax deduction. This is a very costly loss for affected New Yorkers, especially suburban homeowners saddled with heavy property taxes and New York City residents, who pay both a state and local income tax.

Under the AMT, taxable income above a "unified exemption," permanently set at $45,000 for married couples and $33,750 for singles regardless of household size, is taxed at a starting rate of 26 percent. A rate of 28 percent kicks in on incomes above $175,000.

The income brackets and the exemptions under the regular tax code are indexed to rise with inflation, but the AMT parameters are not. As a result, the AMT is not just a floor but a *rising* floor relative to regular taxes. Over time, more and more people have found themselves paying it—or, at the very least, having to fill out a lengthy form to determine whether they have to pay it or not. By further reducing rates, and stretching brackets for married couples, the new tax law greatly accelerates the pace at which taxpayers will find themselves thrown under the AMT.

President Bush's original tax cut proposal had no provisions offsetting the impact of the AMT, even though it clearly would have a major impact on millions of taxpayers. The law as enacted offers some AMT relief, raising the unified exemption by $2,000 for single filers and $4,000 for married filers. However, the AMT relief provision expires after 2004—with enormous consequences thereafter.

As of 2001, there were 1.4 million taxpayers affected by the AMT, according to the Joint Committee on Taxation (JCT). Under old law, the Joint Committee on Taxation projected that 17.5 million filers would be affected by the AMT by 2010; under the new law, the number doubles to 35.5 million. As the law is now written, the number of AMT filers will jump from 3.5 million to 7 million between 2004 and 2005, according to JCT.

The Treasury Department's Office of Tax Analysis has estimated that a small group of high-tax states,[8] including New York, account for 55 percent of all AMT payers. Under previous law, that proportion was expected to drop to 51 percent in 2005 and to 45 percent in 2010, as more taxpayers were caught up in the AMT.

Based on these studies, the Manhattan Institute estimates the following:

- Approximately 162,000 New York tax filers will be affected by the AMT in 2001, rising to over 500,000 by 2004—even with the provisions designed to prevent the AMT from eroding the value of tax cuts.[9] The scheduled expiration of the AMT relief provisions under the new law would cause the number of AMT taxpayers in New York to double to more than 1 million in 2005 alone.

- By 2010, more than 3 million New York income tax filers—roughly half of all state households with any income tax liability—will be affected by the AMT if the law is left unchanged This number would include the overwhelming majority of homeowning families in New York's major metropolitan areas.

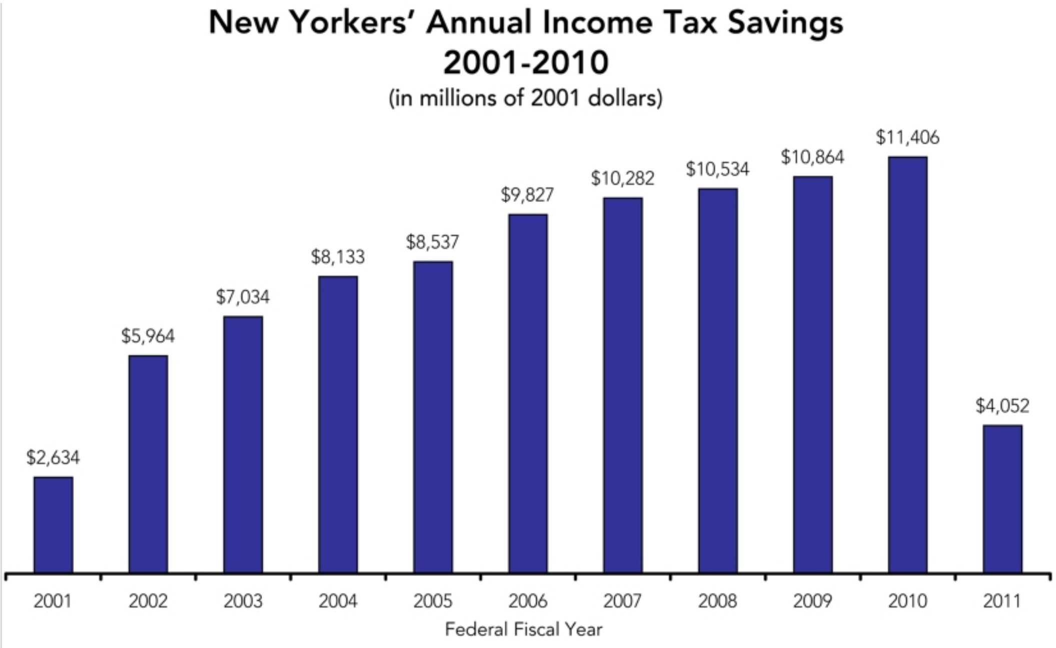
To understand how the AMT will increasingly affect even families at modest income levels by New York City area standards, consider a hypothetical homeowning couple with three children and income (in 2001 dollars) of $80,000 a year. By 2010, their tax savings should amount to $2,259, or 32 percent. But the AMT will reduce their savings by $295.

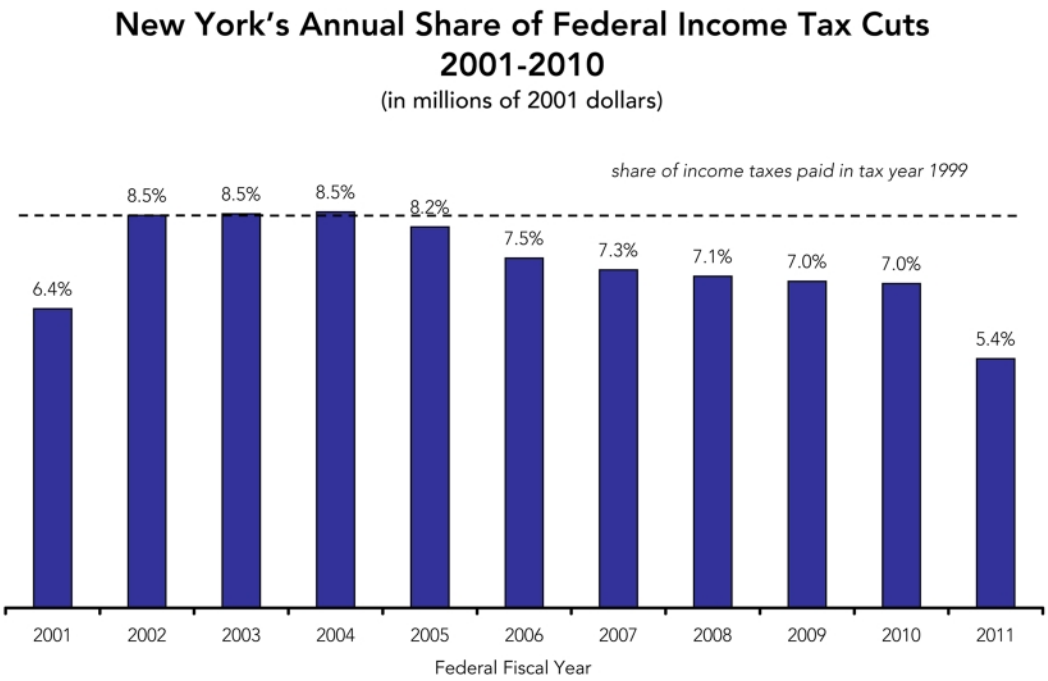
An even larger effect can be noted for a hypothetical homeowning couple with two children and income of $135,000—roughly equivalent to the combined salaries of a New York City public school teacher married to a police lieutenant. When the new law is fully implemented, their annual tax savings under the new law should amount to a total of $4,261, or 20 percent—but the AMT will steal away a whopping $1,885, nearly half the cut. (See the hypothetical taxpayer tables in the Appendix for more details and examples).

The AMT's effect on New York State's total share of the income tax cut scheduled over the next 10 years is illustrated by the following two graphs.

The first graph shows that the annual value of income tax cuts for New Yorkers rises quickly to $8.5 billion in the first four years of the phase-in period. Over the next six years, however, the annual value will increase by just $2.9 billion as more and more New York taxpayers find their savings partially offset by the AMT.

The second graph shows New York's annual share of the tax cut is nearly equal to its share of tax payments through 2004, but drops steadily thereafter—also reflecting the impact of the AMT.





At the request of Rep. Charles Rangel, D-New York, the JCT estimated the impact of extending AMT relief provisions through the life of the tax cut. This would not prevent the AMT from growing as projected under previous law. But it would prevent the AMT from undermining the newly enacted tax cuts for most families. According to the JCT, the added AMT relief provisions would have an additional budgetary impact of just over $200 billion through 2011.

We estimate that New York's share of this potential added relief would amount to $26 billion from 2005 through 2011. In other words, New Yorkers would save $26 billion more if protected from the full impact of the AMT. This would raise the state's share of the total tax cut from 7.4 percent to 8 percent—much closer to its current share of taxes.[10]

Of course, repealing the AMT would yield significantly greater tax savings for many more taxpayers. While no official estimate is yet available of the fiscal impact of complete AMT repeal under the new law, the JCT previously estimated that AMT liability by 2011 would total $36 billion under the old tax law.[11] The separate estimates provided to Congressman Rangel for extension of AMT relief provisions would indicate that the total cost of eliminating the problem would be in the neighborhood of $240 billion over 10 years.

THE TAX CUT AND "THE FISC"

Thanks largely to its heavier-than-average income tax burden, New York sends considerably more revenue to Washington than it gets back in the form of federal spending. According to the most recent edition of "The Federal Government and the States," an annual study of federal funding flows originated by former Sen. Daniel P. Moynihan, New York's "balance of payments deficit" with the federal government stood at $16.2 billion as of 1999.

As presently constructed, the new tax law would ultimately leave New Yorkers paying a slightly larger share of the overall income tax burden. However, by reducing the growth in federal spending—where the difference between New York and the national average is even more disproportionate—the tax cut will still lead to at least a small net reduction of the balance of payments deficit, as calculated in Moynihan's study.

Even if viewed solely in the context of the Moynihan analysis, the new tax law is vastly preferable to the alternatives. If there had been no change, both federal spending and New York's federal tax payments would inexorably continue to rise, adding significantly to the state's balance of payments deficit. If Gore had been elected president, Congress would have been asked to consider a much smaller package consisting of "targeted" tax credits, which would expand the amount of income transferred from high- to low-wealth states via the tax code.

CONCLUSION

When then-Governor Bush pledged during last year's campaign that his tax cut would "treat all middle class families more fairly," he surely meant to include *all* families, no matter where they happen to live. Residents of New York will not get their fair share of the tax cut unless the AMT is repealed—or, at the very least, offset by continuation of the relief provisions now set to expire under the tax bill.

Given the likely impact of the AMT, not to mention other messy loose ends in the bill, it appears inevitable that the tax law will be reopened for further action within the next four years. When that happens, New York's congressional delegation will have an opportunity to ensure that the Empire State is treated fairly by pursuing two priorities:

- Follow through on all scheduled income tax rate reductions—preferably speeding up and deepening the rate cuts—and on the phase-out of current caps on deductions and exemptions.
- Repeal the AMT.

APPENDIX:
TAX SAVINGS FOR HYPOTHETICAL NEW YORK FAMILIES
(2001 DOLLARS, IN MILLIONS)

Single Parent, Two Children Under 17
Income: $35,000

	Old		*New*		
	2001	***2001***	***2004***	***2005***	***2010***
Tax	1,948	1,248	1,248	1,048	448
AMT	—	—	—	—	—
Savings		700	700	900	1,500
		36%	**36%**	**46%**	**77%**

Married Couple, Two Children
Income: $58,400 (Statewide Family of Four Median)

	Old	*New*			
	2001	***2001***	***2004***	***2005***	***2010***
Tax	4,478	3,678	3,678	3,478	2,778
AMT	—	—	—	—	—
Savings		800	800	1,000	1,700
		18%	**18%**	**22%**	**38%**

Married Couple, Three Children (two under 17)
Income: $80,000

	Old	*New*			
	2001	***2001***	***2004***	***2005***	***2010***
Tax	6,984	6,163	6,098	5,620	5,020
AMT	—	—	—	101	295
Savings		821	886	1,364	1,964
		12%	**13%**	**20%**	**28%**

Married Couple, Two Children Under 17
Income: $135,000

	Old 2001	*New 2001*	*2004*	*2005*	*2010*
Tax	20,976	20,073	19,002	19,200	18,600
AMT	—	—	—	772	1,885
Savings		903	1,974	1,776	2,376
		4%	**9%**	**8%**	**11%**

Married Couple, Two Children Under 17
Income: $650,000

	Old 2001	*New 2001*	*2004*	*2005*	*2010*
Tax	188,088	185,046	177,721	177,342	165,300
AMT	—	—	—	—	8,719
Savings		3,041	10,366	10,745	22,787
		2%	**6%**	**6%**	**12%**

Single Person (Renter)
Income: $50,000

	Old 2001	*New 2001*	*2004*	*2005*	*2010*
Tax	8,398	8,020	7,788	7,788	7,583
AMT	—	—	—	—	—
Savings		378	610	610	815
		5%	**7%**	**7%**	**10%**

Single Person (Homeowner)
Income: $100,000

	Old 2001	*New 2001*	*2004*	*2005*	*2010*
Tax	20,650	20,064	19,205	19,205	18,583
AMT	—	—	—	—	—
Savings		586	1,445	1,445	2,067
		3%	**7%**	**7%**	**10%**

NOTES

1 Formally known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836).

2 Estimate derived from income distributions in a model of New York State's taxpaying population based on the Internal Revenue Service (IRS) Public Use File for 1997 and on IRS Statistics of Income breakdown of Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 1999, with adjustments for the estimated annual impact in New York of the Alternative Minimum Tax (AMT) and of actual and potential AMT relief provisions.

3 Geographic distribution of tax cuts from 2001 through 2011 is estimated in proportion to adjusted gross income by county as reported by the IRS in County Income Data for 1998, with the exception of 2001 advance payments, for which the estimated distribution is in proportion to number of returns filed by county.

4 New York State generated 12.6 percent of federal estate taxes as of 1998, according to Tax Foundation estimates. At that rate, beneficiaries of New York-based estates will save $17.4 billion when the law is fully implemented.

5 For example, the state's newly elected U.S. Senator Hillary Clinton favored a targeted approach that would effectively shift more of the tax burden to New York, as documented in the October 2000 Manhattan Institute report "Campaign 2000 Tax Proposals: What They Mean for New Yorkers," which is posted at www.manhattan-institute.org.

6 These caps were by no means limited to the wealthiest households. As of 2000, for example, the limit on itemized deduction kicked in at a relatively low income level of $128,950 for married couples—within the definition of middle class, especially for downstate homeowners.

7 Another major shortcoming of the tax law, as noted by many commentators, is that it technically is scheduled to expire after 2010. This quirk reflects the desire of House and Senate negotiators to avoid exceeding the agreed-upon target of a 10-year federal budget impact of $1.3 trillion for the entire package. However, no one seriously believes that, having just completed a 10-year phased in tax cut, Congress would, in effect, follow it up in 2011 with the largest tax hike in history.

8 In addition to New York, the states in the high tax group include California, Connecticut, Maryland, Massachusetts, Minnesota, New Jersey, Oregon, Rhode Island and Wisconsin, plus the District of Columbia.

9 As its title would indicate, a study by Treasury Department tax analysts—"Who Pays the Individual AMT?", OTA Paper 87, June 2000—is the best available source of information on how the tax is distributed. The paper includes estimates of the disproportionate number of current and projected AMT payers in New York and a handful of other high-tax states, based on estimates made prior to passage of the 2001 tax cuts.

10 This estimate is based on the assumption that New York's share of all AMT liability—and of the savings to be realized from extending AMT relief provisions—remains at the same ratio to the estimated number of AMT filers as was the case in the last year for which state data are available. In particular, the estimate is built on the assumption that under the prior tax law, 55 percent of AMT returns from 1998 and 1999 came from New York and other "high tax" states, as the Treasury Department's OTA study (see note above) estimated for 2000; the number of AMT returns imputed to each state in the high-tax group is assumed to be proportionate to that state's share of total income tax returns. It is assumed, further, that the proportion of AMT returns from high-tax states under the new law will decline to 51 percent by 2005 and to 45 percent by 2010, as the Treasury Department study had projected would occur under the old law. Thus, the estimates in this paper begin from a baseline estimate that New York State generated 12 percent of AMT returns and 15.7 percent of AMT revenue in 1998.

11 Joint Committee on Taxation, "Overview of Present Law and Economic Analysis Relating to the Marriage Penalty, the Child Tax Credit and the Alternative Minimum Tax," JCX-8-01.

Would you prefer to receive this publication via e-mail? If so, please supply us with your e-mail address by contacting us at mi@manhattan-institute.org or 212-599-7000. Previous publications are also available.

The Center for Civic Innovation's (CCI) purpose is to improve the quality of life in cities by shaping public policy and enriching public discourse on urban issues.

CCI sponsors the publication of books like The Entrepreneurial City: A How-To Handbook for Urban Innovators, which contains brief essays from America's leading mayors explaining how they improved their cities' quality of life; Stephen Goldsmith's The Twenty-First Century City, which provides a blueprint for getting America's cities back in shape; and George Kelling's and Catherine Coles' Fixing Broken Windows, which explores the theory widely created with reducing the rate of crime in New York and other cities. CCI also hosts conferences, publishes studies, and holds luncheon forums where prominent local and national leaders are given opportunities to present their views on critical urban issues. *Cities on a Hill*, CCI's newsletter, highlights the ongoing work of innovative mayors across the country.

MI

MANHATTAN INSTITUTE FOR POLICY RESEARCH

52 Vanderbilt Avenue • New York, NY 10017
www.manhattan-institute.org

Non-Profit
Organization
US Postage
PAID
Permit 04001
New York, NY