THE CITY OF NEW YORK
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March 14, 2002

The Honorable William Perkins
Council Member
New York City Council
City Hall
New York, NY 10007

Dear Council Member Perkins:

As you requested, the Independent Budget Office has analyzed the impact on New York City tax revenues of the federal stimulus act (officially the "Job Creation and Worker Assistance Act of 2002") passed by Congress last week. Our main findings include:

- IBO estimates that the act will reduce city income tax collections by $93 million in city fiscal year 2002 and $204 million in 2003. The losses will grow smaller each year from 2004 to 2007. New York State's income tax collections will also be reduced by an even greater amount.
- To avoid these revenue losses, the city would have to appeal either to Congress to amend the newly enacted law or to the state legislature in Albany to break the link between the federal tax and the city tax.
- There is precedent for breaking the link. In 1982, New York "de-coupled" the state and city from a particularly generous depreciation bonus enacted by the federal government.

It should be noted that over time economic growth stimulated by the legislation will likely have a positive effect on city tax collections. What follows is an explanation of why there will be losses over the first few years the act is in effect.

The losses will occur because the city's four income taxes (general corporation tax, financial corporation tax, unincorporated business tax, and personal income tax) are closely linked to corresponding taxes at the federal level. As a result, the cuts in federal taxes included in the stimulus act will also reduce business and personal income tax collections in New York City and State. For each of these taxes, calculation of city tax liability begins with federal taxable income. The legislation in question has several provisions designed to stimulate economic activity by allowing firms extra tax deductions if they make investments in certain types of new business equipment and buildings. The larger deductions lower the company's net income which in turn lowers their federal tax liability. These lower net incomes become the basis of the city's tax calculations, resulting in lower city tax liabilities as well.

The most significant feature of the stimulus act is a provision to increase the deduction for depreciation in the first year of an asset's useful life to 30 percent of the acquisition price providing the investment occurs by 2003. In addition to this general provision covering new investment throughout the country, the stimulus act also contains additional benefits for investment in the New York Liberty Zone (essentially Manhattan below Canal Street). In the Liberty Zone, the depreciation bonus is available for investments made before 2007. The expected revenue loss for the city results from both the general depreciation bonus as well as the provisions that pertain only to the Liberty Zone, although firms can claim the bonus depreciation only once for each new asset.

To avoid these revenue losses, the city would have to appeal either to Congress to amend the law or to the state legislature in Albany to break the link between the federal and the city tax. Although Congress ignored a plea from the National Governor's Association last week to find other ways to stimulate the economy without undermining states' tax revenues, a concerted effort to change the law might yet be effective. New York State is only one of at least 41 states plus New York City and Washington, DC that are believed to face revenue losses stemming from the stimulus act. According to the Center for Budget Policy and Priorities, virtually all of the effected states are already facing significant revenue losses as a result of the national recession.

Assuming that the federal law is not changed, the tax laws for the city could be changed to require businesses to ignore the bonus depreciation deductions when computing their net income. Instead net income would be computed using the depreciation deduction that was in effect prior to the passage of the stimulus act. This is known as de-coupling the city tax system from the federal system, at least as it pertains to the depreciation provisions. As with most city tax laws, de-coupling would require state legislation. Given that the state is also facing a revenue loss from the stimulus act, the Governor and legislature may move to de-couple the state system as well. Indeed, if that were to happen, the city would almost certainly follow, since it is considered desirable to keep the city and state tax systems in sync whenever possible.

There is precedent for de-coupling from federal depreciation changes. In 1981 the first Reagan tax cut included an extremely generous depreciation bonus. With very large depreciation deductions eroding the city's and state's income tax base, the city and state de-coupled in 1982. The federal government eventually reduced the generosity of the depreciation deduction and the state re-coupled beginning with the 1986 tax year, while the city maintained its separate treatment through 1994.

If you would like more detail on how we did our estimates, or if you have any further questions regarding this matter please feel free to contact me.

Sincerely,

Ronnie Lowenstein
Director