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High-Stakes Taxing

New York's Prospects Under the Next President's Tax Agenda

E.J. McMahon
Senior Fellow
Manhattan Institute for Policy Research

EMPIRE CENTER
FOR NEW YORK STATE POLICY
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EXECUTIVE SUMMARY

This report reviews the impact of federal tax cuts on New York State since 2001 and looks at how the Empire State would be affected by the sharply divergent tax policy agendas of the 2008 presidential candidates, John McCain and Barack Obama. Estimates are provided for the direct New York impact of the candidates' principal individual income tax proposals over the next two years.

The starting point for both McCain and Obama is the Jobs and Growth Tax Relief Reconciliation Act of 2003, or JGTRRA, which expanded and accelerated the tax cuts first enacted in 2001 under President George W. Bush. Most of the JGTRRA cuts are slated to expire at the end of 2010, creating uncertainty about future federal tax policy that the next president must take the lead in resolving.

Citing economic growth as his priority, McCain would seek to make the Bush cuts permanent. He also is proposing a significant reduction in corporate taxes and expanded Alternative Minimum Tax (AMT) relief.

Obama's income tax changes, by contrast, are primarily aimed at "restoring fairness to the tax code." He would accomplish this by immediately raising ordinary income, capital gains and dividends tax rates on all taxpayers earning more than $250,000, restoring the top two rate brackets in effect before 2001 while preserving Bush's tax cuts and credits in lower brackets. At the same time, Obama would target significant new and expanded tax credits to low- and middle-income workers. He has not made explicit promises concerning the AMT.

The comparative analysis in this report focuses on the cumulative impact of the candidates' tax plans in 2009 and 2010. Over the next two years, we estimate:

- McCain's proposal would drive about $675 million in added tax cuts to low- and middle-income families in New York.
- Obama would provide low- and middle-income New Yorkers with new or expanded tax credits worth about $13 billion. But at the same time, he would increase taxes on the state's high-income residents by at least $16 billion.
- Obama would count on New York's high-income households to help finance a large portion of his proposed tax credits nationwide. With just 6.4 percent of the nation's tax filers, New York State's share of the Democratic candidate's tax increases would come to nearly 11 percent—more than any state except California. *
- Changes in taxpayer behavior induced by Obama's proposed tax increases would reduce New York State personal income tax revenues by $800 million to $1.1 billion. New York City's potential revenue losses over the same two-year period are estimated at $144 million to $285 million.

* This does not include Obama's proposal to nearly double federal taxes on the "carried interest" income of private equity firms and hedge funds. Nor does it reflect his proposal to apply Social Security payroll taxes to all incomes above $250,000, starting in 2018.

About the Author

E.J. McMahon is director of the Empire Center for New York State Policy, a project of the Manhattan Institute for Policy Research. He also is the Manhattan Institute's senior fellow for tax and budgetary studies. His recent work for the Institute and its Empire Center has focused on state government reform, tax policy, public pensions, collective bargaining, competitive contracting of public services and the fiscal record of the Pataki and Spitzer administrations. McMahon's professional background includes more than 25 years as a senior policy maker and analyst of New York government. He has served as Deputy Commissioner for Tax Policy Analysis and Counselor to the Commissioner in the state Department of Taxation and Finance; Director of Minority Staff for the state Assembly Ways and Means Committee; vice chancellor for external relations at the State University of New York; and Director of Research for The Business Council's research arm, the Public Policy Institute. His articles have appeared in the *Wall Street Journal*, Barron's, the *Public Interest*, The *New York Times*, the *New York Post*, the *New York Daily News*, *Newsday* and the *New York Sun*, among other publications.

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Methodology

The estimates of direct individual tax impacts contained in this report were derived largely from a microsimulation model developed in 2004 by the Manhattan Institute and Fiscal Economics, Inc. of Alexandria, Virginia. The model uses a large database of tax return data available from the Internal Revenue Service (IRS) as well as information from the Congressional Budget office, New York State Department of Taxation and Finance, the state Division of the Budget (DOB) and the City of New York to calculate all of the income and demographic variables needed to compute the federal income tax liabilities for statistically representative samples of the national, New York State and New York City filing populations. Results from the model were first presented in "The $36 Billion Bonus: New York's Gains from Federal Tax Cuts," a report issued in August 2004 by the Manhattan Institute's Center for Civic Innovation.

The results from the model were updated and modified to reflect the DOB's most recently updated economic projections for New York State, as well as estimates of the revenue impacts of the presidential candidates' plans published by the Urban Institute and Brooking Institution's Tax Policy Center. The estimated New York State impact of Barack Obama's proposed "Making Work Pay Credit" also reflected data from the 2006 Public Use Microdata Sample from the U.S. Census Bureau's American Community Survey. As described in the report, alternative estimates of state and city revenue losses resulting from proposed increases in federal marginal rates were produced using the New York State CGE-STAMP 08 model, developed for the Manhattan Institute's Empire Center by the Beacon Hill Institute of Boston, Massachusetts.

The starting assumption for all estimates is a continuation of the federal income tax structure in effect for 2008, and an extension through 2010 of the latest inflation-linked "patch" on the Alternative Minimum Tax (AMT).

Descriptions of the candidates' proposals come primarily from these sources:

- "Barack Obama's Comprehensive Tax Plan," at http://origin.barackobama.com/taxes/
- "The Obama Tax Plan," by Jason Furman and Austan Goolsbee, *Wall Street Journal*, p.A13, August 14, 2008.
- McCain "Jobs for America Plan," at http://www.johnmccain.com/Issues/jobsforamerica/.
- "The McCain Budget Plan," *Washington Post*, July 14, 2008, at http://www.washingtonpost.com/wp-dyn/content/article/2008/07/13/AR2008071301643.html
- Tax Policy Center, Urban Institute and Brookings Institution, "An Updated Analysis of the 2008 Presidential Candidates' Tax Plans: Revised August 15, 2008," at http://www.taxpolicycenter.org/.

HIGH-STAKES TAXING

New York's Prospects
Under the Next President's Tax Agenda

INTRODUCTION

Federal income tax cuts played an important role in the nation's economic recovery from the 2001 recession and the 9/11 terrorist attacks. Residents of New York State derived especially large benefits from across-the-board cuts in marginal rates enacted in 2001 and accelerated in 2003. Additional cuts in tax rates on capital gains and dividends provided a timely boost to New York's vital financial sector in 2003, contributing to a Wall Street's resurgence over the next four years.

But federal tax policy for the near future is unsettled, contributing to an already murky economic outlook in the wake of the 2007 sub-prime mortgage meltdown and a financial crisis that has now seen the collapse of one of Wall Street's oldest and largest investment banks.

Under current law, virtually all of the federal tax cuts enacted since 2001 are set to expire at the end of 2010—which would lead to massive tax increases in 2011. Moreover, the Alternative Minimum Tax (AMT) remains a growing headache that perennially threatens to get much worse for many more taxpayers, especially middle-income families with children in high-taxed states like New York.

How much of the current tax code should be preserved?

Should taxes be raised on high-income households and investors?

What should be the primary aim of tax policy: economic growth, or income redistribution?

Presidential candidates John McCain and Barack Obama disagree strongly on the answers to those questions.

The next president's tax agenda will have especially large implications for New York. The Empire State has been losing people, jobs, businesses, and political influence to other, faster-growing states over the past three decades, yet it trails only California in federal income tax payments. New York State's 19 million residents generate more income tax revenue than 22 million Texans—and more than 24 million residents of Ohio and Pennsylvania combined. The Empire State's heavy federal tax burden is the fundamental reason why it has long been on the losing side of the fiscal exchange among the 50 states.

The sections that follow look at the direct benefits New Yorkers received from the Bush tax cuts—and at how they would be affected by the competing McCain and Obama tax plans.

Incomes and the eye of the beholder

Political debates over competing plans to cut or hike income taxes often devolve into arguments over who will do better—the wealthy or the middle-class. But "wealthy" and "middle class" mean different things to different people in different parts of the country and different regions of New York State.

For example, the median family income for New York in 2008 is estimated at $65,300, just 6 percent above the national median of $61,500. But on a regional basis, the median ranges from $52,700 in Elmira to $97,100 in Long Island, and reaches as high as $101,600 in Westchester County.[a] Indeed, incomes in the low six figures are squarely within the middle-class mainstream throughout the metropolitan New York area, especially among home-owning couples with children.

As of 2006, 13 percent of New York's income tax filers had incomes of more than $100,000—not much higher than the 12 percent average for the rest of the country. But among married couples filing joint returns, six-figure incomes made up a much higher percentage in the Empire State – 31 percent, vs. 25 percent in other states.

In the highest income bracket for which comparable data are published, 4 percent of all returns and 9 percent of married filers in New York had incomes over $200,000—compared to 3 percent and 6 percent, respectively, in the rest of the country.

Across-the-board cuts in marginal income tax rates, like those contained in federal tax changes enacted since 2001, tend to recognized these regional differences to a much greater extent than "targeted" tax credits, such as those favored by congressional Democrats and Barack Obama. Most current federal credits are phased out at income levels too low to benefit many New York families who probably consider themselves to be part of the middle-class (although Obama's largest proposed new credit apparently would be available to couples earning up to $150,000, as long as each spouse holds a paying job).

To help finance the cost of his proposed tax breaks for low-and middle-income Americans, Obama would significantly raise taxes on households earning $250,000 or more, or singles earning over $200,000. But while the middle-class is widely distributed throughout the nation, nearly half the households earning more than $200,000 are located in just five states, as shown below. New York had the second largest share of high-income filers, trailing only California as of 2006. The average income of New Yorkers in this category was the nation's highest.

High Tax Targets

States With Largest Concentrations of High-Income Filers

Taxpayers with adjusted gross income (AGI) over $200,000 as of 2006

	Returns	Average AGI	Tax Liability (000)	Share of US
California	618,397	$ 598,732	$ 82,397,146	14.9%
New York	327,703	$ 749,758	$ 58,050,088	10.5%
Florida	265,216	$ 725,042	$ 44,451,032	8.0%
Texas	288,621	$ 618,398	$ 43,449,462	7.8%
Illinois	193,844	$ 593,090	$ 27,086,728	4.9%
TOTAL	1,693,781	$ 3,285,020	$ 255,434,456	46.1%

Source: Internal Revenue Service, Statistics of Income, Table 2, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2006

a. U.S. Department of Housing and Urban Development, FY 2008 Income Limits, at http://www.huduser.org/datasets/il/il08/index.html

The Bush tax cuts

George W. Bush took office as president in 2001 after campaigning on a promise to reduce federal taxes. Five months into his term, Congress adopted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which incorporated most of Bush's original 2000 campaign tax proposals. Major income tax provisions included:

- A rate cut in every income tax bracket, beginning in 2001 with the creation of a new 10 percent bottom bracket to cover a portion of incomes previously taxed at the 15 percent rate. Other changes were to be more slowly phased in, becoming fully effective in 2006.
- A phased-in doubling of the child credit, from $500 in 2000 to $1,000 by 2010.
- Elimination of the so-called marriage penalty, which results in working spouses paying more in taxes than if they remained single, by increasing the standard deduction and broadening the 15 percent tax bracket for married filers. (These changes also were to be slowly phased in; the increased deduction would be fully effective in 2008, and the rate savings for married filers would be fully effective in 2009.)
- Elimination of limits on deductions and personal exemptions (known to tax technicians as "PEP" and "Pease" limits) on a phased-in basis, starting in 2006 and becoming fully effective in 2010.
- An expansion of the Alternative Minimum Tax (AMT) exemption to minimize the extent to which the tax cuts turned more regular filers into AMT payers.

The Second Step

Within months of EGTRRA's adoption, the already slumping national economy was jolted by the 9/11 terrorist attacks, followed by a further decline in the stock market. This had a particularly negative effect on New York City, which lost 120,000 private-sector jobs in the 12 months following the World Trade Center disaster. In addition, the fall in equity values led to a steep plunge in State and City tax revenues from capital gains and Wall Street bonuses.

At the beginning of 2003, Bush unveiled an ambitious package of additional tax relief to spur on the struggling economy. The president sought to immediately implement the marginal rate cuts that were still being slowly phased in under the 2001 law. He also proposed the elimination of individual income taxes on most corporate dividend payments.

In the end, Congress didn't go along with the full repeal of dividend taxes, but the resulting Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA) did go a long way toward achieving Bush's main goals. Adopted in May 2003, the new law included:

- Acceleration of the remaining EGTRRA marginal rate cuts, as well as marriage penalty relief and the child credit increase, to make all of these provisions fully effective in 2003.
- Immediate reduction of tax rates on corporate dividend payments to 15 percent.
- Reduction of the tax rates on long-term capital gains (on assets held for at least 12 months) from 20 percent in the top bracket and 10 percent in lower brackets to 15 percent and 5 percent, respectively, with the lower rate declining to zero in 2008.
- A further increase in the AMT exemption.

(The current federal income tax table can be found in the Appendix.)

What New Yorkers Saved

The impact in New York State of the 2001 and 2003 federal tax cuts reached a cumulative total of nearly $36 billion through 2004, including $15 billion for residents of New York City. Annual savings by 2004 reached nearly $14 billion, boosting the after-tax incomes of New York residents by about 2.7 percent, on average.[1]

The sheer breadth and scope of the tax cuts was sufficient to provide a solid boost for the economy of New York and for the nation as a whole. But the tax cuts also produced indirect effects that were especially beneficial to the Empire State's economy—and, by extension, to the finances of State and City government.

Indeed, it would have been difficult to come up with a tax policy better tailored than JGTRRA to meet the needs of New York City, in particular, under the economic conditions of 2001–03. The accelerated marginal rate cuts pumped billions of dollars into the pockets of New Yorkers who might be considered "wealthy" elsewhere, along with tens of thousands of entrepreneurs and small-business owners. The reduction in taxes on dividends and capital gains were a tonic for the securities industry, which at the time accounted for an estimated one-quarter of the City's economic activity and nearly one-fifth of its wage income.[2]

At the end of February 2003, a little over a month after President Bush unveiled his latest tax cut plan, the Dow Jones Industrial Average stood at just over 7,891. By the time the JGTRRA cut was adopted at the end of May, the Dow had gained nearly 1,000 points, and over the following year it rose another 1,338. There were similar trends in the other broad stock indexes and NASDAQ. Meanwhile, the pretax profits of New York Stock Exchange member firms rose from a seven-year low of $6.9 billion in 2002 to $15.3 billion in 2003, and reached new record levels of over $20 billion in succeeding years.

In the absence of a thorough independent study weighing all factors driving the market in 2003, it's difficult to say precisely how much of those gains could be attributed to the tax cut. But there's no denying that lower taxes on dividends and capital gains make corporate stocks a more attractive investment—always good news for Wall Street.

A tax bailout for state and city government

The timing of the 2003 federal tax cut was fortuitous for New York in another sense. That's because the federal changes were signed into law just two weeks after the State Legislature in Albany, overriding Governor George E. Pataki's vetoes, enacted significant temporary increases in both State and City income taxes.

Retroactive to January 2003, the top combined State and City income tax rate was raised by 1.65 percentage points, to 12.15 percent from the 2002 level of 10.5 percent. As a way to recapture more cash from taxpayers for income earned in the first half of the year, the State and City withholding tax rates were initially raised by an even larger amount—effectively doubling the initial impact of those tax increases.[3] But at

precisely the same time—the beginning of July 2003—the federal government changed its own tax withholding tables to reflect JGTRRA's accelerated rate cuts.

For New York State filers with adjusted gross incomes over $125,000—the group primarily affected by the legislature's tax hike—the net additional savings generated by accelerated federal tax cuts in 2003 was four times as large as the State income tax increase. For New York City residents in the same brackets, the added federal tax cut was roughly two and a half times the combined State and City tax increases.[13] Thus, in the short term, the positive impact of the large federal tax cut helped to offset the negative economic impacts of State and City tax hikes.[4]

The federal tax cuts also helped to pump up state and local revenues in other ways. With very few differences, the New York State and City income tax base is the same as the federal income tax base—and therefore it can be greatly affected when taxpayers alter their behavior in response to changes in federal tax rates. The most vivid past example of this phenomenon was the sharp upward spike and then drop in State and City revenues when the federal government raised its capital gains rates in the late 1980s. Likewise, the 1990 and 1993 increases in federal income tax rates in upper brackets led to slower growth in taxable incomes, which in turn would have suppressed the growth in State and City income tax revenues.[5]

By the same token, sharp and immediate decreases in federal rates generally encourage households—especially the wealthy—to expose more income to taxation. Federal tax rate discounts on income from dividends and long-term capital gains have encouraged more taxpayers to make money in these categories, which the State and City continue to tax at the same rates as wage income.

The predictable result: even after adjusting for rate hikes, projected State and City income tax receipts increased sharply. By 2006, the coffers of state and city government were overflowing—making it possible for the temporary tax hikes to "sunset" on schedule.

THE CAMPAIGN '08 TAX PLATFORMS

Senators John McCain and Barack Obama have laid out competing plans to tie up the many remaining loose ends of the 2001-03 Bush tax cuts. Both presidential candidates have pledged to make permanent all provisions reducing taxes and tax rates for families earning less than $250,000, including the $1,000 child credit. This is good news for median-income families in New York, who typically saw their federal income tax bills drop by more than one-third as a result of these cuts.

Otherwise, however, the McCain and Obama income tax proposals differ in some very significant respects—with conflicting implications for New York State.

What follows is a summary description and analysis of the competing income tax plans as they would affect New York residents. To simplify matters, this analysis focuses on estimates of cumulative tax impacts on state taxpayers in the next two tax years, 2009 and 2010. (See the Methodology section at the beginning of this report for further details.)

The focus is solely on the individual income tax because it affects the most people and is easiest to evaluate on a state level. McCain and Obama also have proposed significant changes in corporate taxes and estate taxes, which are noted below, but the state-by-state incidence of these proposals is much more difficult to estimate.

The McCain Plan

Although John McCain was originally a critic of Bush's tax cuts, he is now committed to preserving the entire current individual income tax structure—including all cuts in the upper brackets. With regard to the income tax, in particular, he has proposed two further changes:

- The dependent exemption for married couples would rise from its current level of $3,500 to $7,000 per dependent. The increase would take effect immediately for couples earning $50,000 or less, and would be phased in for all other taxpayers starting after 2010.
- The temporary increases in the AMT exemption would be continued and increased in line with inflation over the next five years, then expanded starting in 2014 (see "The AMT Time Bomb" on page 8). Thus, McCain's proposal in this area would not provide more AMT relief over the next two years, beyond what is contained in temporary "patch" bill that is likely to be renewed.

Tax Cuts and "the Fisc"

During his 24 years in the U.S. Senate, the late Daniel Patrick Moynihan did much to raise public awareness of the ongoing transfer of income from wealthier states such as New York State to the federal government. As documented in a series of annual reports on what Moynihan called "the Fisc," the Empire State perennially sends billions of dollars more in taxes to Washington than it gets back in the form of federal spending.

Other comparative measures of income flows between the federal government and the states have consistently confirmed Moynihan's analysis. According to the most recent Tax Foundation estimate, New York gets back 79 cents in spending for every dollar in federal taxes paid, a rate of return that ranks 42nd among states (New Jersey, at 61 cents per dollar, is at the bottom).[a]

The imbalance is ultimately a consequence of the federal government's well-established income redistribution policies, including a progressive income tax structure that subjects higher incomes to steeply higher marginal and effective rates.

"A near quarter century of data analysis has pretty well established that New York's balance of payments deficits is structural," Moynihan observed in his 1998 report. "It is not the result of one administration, one party, one business cycle, whatever. In good times it only gets worse, owing to our high tax brackets which in measure reflect our high cost of living."

The imbalance of payments deficit hasn't been reduced by the billions in tax cuts flowing to New Yorkers since 2001; in fact, the gap is now as large as it's ever been. That's because total federal spending has continued going up even while tax rates were going down. In the long run, as Moynihan pointed out, "Anything that grows the size of the Federal government will grow the deficit of New York and other such [high-income] states."[b]

a. Tax Foundation, "Federal Spending Received per Dollar of Taxes Paid by State, 2005," at http://www.taxfoundation.org/taxdata/show/266.html .
b. Moynihan's 1995-99 annual reports, entitled "The Federal Budget and the States" and produced jointly with the Harvard University Taubman Center for State and Local Government and Kennedy School of Government, can be found at http://www.hks.harvard.edu/taubmancenter/publications/fisc/index.htm .

We estimate New Yorkers' share of the increased dependent exemption proposed by McCain will total **$675 million** in 2009 and 2010, or $337 million a year.[6]

McCain also would reduce the federal corporate tax rate, from 35 percent to 30 percent by 2010, and ultimately to 25 percent by 2015. These rate reductions, plus accelerated depreciation provisions, would have positive effects on financial markets and on New York-based owners of corporate equities. However, those impacts are also beyond the scope of the impacts estimated in this report.

The federal estate tax has been slowly phased out under and is due to disappear entirely in 2010 – only to reappear, at 2000 levels, in 2011. For 2009, the current law features a $3.5 million exemption and a 45 percent tax rate. McCain would not allow the tax to disappear but would the raise estate tax exemption to $5 million per and cut the rate to 15 percent. He also would replace the old dollar-for-dollar state death tax credit with a deduction for state estate taxes paid. This potentially would create a new competitive disadvantage for New York other states that have continued to impose their own estate taxes at rates pegged to the federal credit.

The Obama Plan

Compared to McCain's proposals, Barack Obama's tax plan would have a much broader and more immediate impact on much larger number of individual taxpayers in New York and across the country. The key elements are the following:

- The top brackets will be raised back to their pre-2001 levels of 36 percent and 39.6 percent, from their current levels of 33 percent and 35 percent.
- For taxpayers in the highest two tax brackets, the capital gains and dividends rates will be raised to 20 percent, from the current maximum of 15 percent.
- Taxpayers in the top two brackets would be subject to the personal exemption phaseout (PEP) and the limit on itemized deductions for taxpayer sin the highest brackets, which are currently scheduled for elimination by 2010.

These tax increases would be accompanied by the following:

- A new "Making Work Pay" credit of up to $500 per worker, or $1,000 per couple, intended to offset a portion of each worker's Social Security taxes[7]
- A modified tax credit to encourage savings
- Expansion the maximum tax credit for college tuition, from $1,800 to $4,000
- Elimination of income taxes for senior citizens earning less than $50,000
- Expansion of the existing Child and Dependent Day Care Credit to increase income threshold for full credit from $15,000 to $30,000, and increase the maximum credit from $2,100 to a maximum of $3,000
- Expansion of the earned income credit for low-income workers

All of Obama's new and expanded tax credits would be "refundable" – meaning that taxpayers who owe less in taxes than the amount of the credit will receive a check for the difference from the federal government.

Our modeling and estimation of the Obama income tax proposals indicates his targeted tax credits would deliver a total of about **$13 billion** in additional refunds and subsidies to New York residents over the next two years. The largest share of the total— **$7.6 billion** in 2009 and 2010—would be attributable to the "Making Work Pay" credit.

The AMT Time Bomb

More and more New York State residents have been discovering in recent years that they are potentially subject to two different tax codes—the regular tax and the Alternative Minimum Tax (AMT). The 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. 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 hitting a growing number of middle-class taxpayers.

The AMT disallows all personal exemptions and a long list of common deductions and tax credits, including dependent exemptions and deductions for state and local taxes. This is a very costly loss for New Yorkers—especially suburban families with children, who pay some of the nation's highest property taxes, and New York City residents, who pay both state and local income taxes.

Nearly a half-million New York taxpayers—including one-quarter of those earning between $100,000 and $200,000—owed $3.3 billion under the AMT in 2006, according to Internal Revenue Service (IRS) data. New Yorkers represented just over 6 percent of all tax filers but accounted for 12 percent of the nation's AMT returns and 15 percent of AMT payments that year.

Under the AMT, all income above a "unified exemption"—most recently set at $66,250 for married couples and $44,350 for most other taxpayers —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 significantly reducing rates and by stretching tax brackets for married couples, the Bush tax cuts had the paradoxical effect of many more of these taxpayers into AMT filers, costing them a portion of the full tax savings that they would otherwise realize as a result of the cuts. Additional AMT liability effectively had stolen away 38 percent of the tax cut savings for New York households earning between $150,000 and $500,000 as of 2005.[a]

Avoiding permanent solutions, Congress has enacted a series of last-minute, temporary bills to "patch" the AMT by raising the unified exemption, which prevents even more households from getting caught up in the tax. If the higher AMT exemption had not been extended last year, the number of AMT taxpayers across the country would have more than quintupled, from 4 million to 23 million.[b]

John McCain has proposed locking in a unified exemption over the next five years, linking the exemption to the inflation rate. Starting in 2014, McCain's plan would raise the unified exemption an added 5 percent a year above inflation, until it reaches $143,000. At that point, with the number of AMT payers greatly reduced, those still subject to the AMT could avoid it by filing a new "Alternative Simplified Tax," which the McCain campaign has not otherwise detailed.

Barack Obama has not made any specific proposal concerning the AMT; indeed, the Obama-Biden campaign's latest summary of its "comprehensive tax plan" does not even mention the AMT.[c] In its widely cited independent analysis of the presidential candidates' tax plans, the Tax Policy Center of the Urban Institute and Brookings Institution assumes Obama would extend the AMT patch—but the candidate's reticence on this front is not reassuring for New York.

a. Manhattan Institute, Empire Center for New York State Policy, "Another Middle-Class Tax? How the AMT Affects New Yorkers," SR 01-05.
b. The Urban Institute and Brookings Institution, Tax Policy Center, "The Individual Alternative Minimum Tax: 11 Key Facts and Projects," *Tax Topics*, Dec. 1, 2006.
c. See summary and linked documents at http://origin.barackobama.com/taxes/

However, the tax increases Obama has targeted at the top two brackets would raise the taxes of New York's high-income households by at least **$16 billion** in 2009 and 2010, our model estimates. The result: a net tax increase in New York of at least **$3 billion** over the two-year period.[8]

This estimate comes with a *caveat*: Although Obama previously had implied that the tax hikes would take effect immediately, the candidate recently said that he might delay them if it is clear the nation is in a recession at the beginning of the next presidential term. [9]

Obama's tax and budget plans include a total of at least $400 billion in revenue raisers over the next decade. While not fully specified, these include a proposal to apply ordinary income tax rates to the "carried interest" income of private equity and hedge funds, which are now taxed at the lower capital gains rate. This would nearly double taxes on key participants in an industry that is heavily concentrated in New York, with an impact potentially reaching into hundreds of millions or even billions a year. He also has discussed the possibility of imposing payroll taxes on salaries above $250,000 — another change with a potentially large impact in New York — although his campaign now says this would not happen until 2018.[10]

In addition, Obama's tax plan says he will "use savings to lower corporate tax rates for companies that expand or start operations in the United States." No further details are provided. It also says Obama will "eliminate capital gains taxes on investments in small and start-up firms." In the absence of further details, it is not possible to estimate New Yorkers' share of the potential savings from this proposal.

Obama, like McCain, would also reinstate the federal estate tax. His plan would raise the exemption to $7 million and keep the rate at 44 percent, with no indication of any intention to change the state death tax credit.

Obama plan's impact on the state and city

New York State and New York City jointly levy their own income taxes, which apply largely to same taxable incomes that New Yorkers report on their federal returns. Thus, their revenues can be significantly affected by any federal tax changes that lead to changes in the taxable income base.

Economists and tax policy analysts have long recognized a link between taxpayer behavior and changes in marginal rates, especially in higher income brackets where taxpayers have more control over the timing and nature of their incomes. When rates rise sharply, taxpayers respond by working and earning less, and by choosing from a wide variety of legal strategies for shifting or sheltering income in tax-exempt investment. Conversely, when marginal rates fall, upper-bracket taxpayers have less incentive to hide or shift income.

Based on results from the 2001 and 2003 tax cuts, a U.S. Treasury Department analysis found that taxable incomes increased 0.4 percent for every percentage point of increase in after-tax incomes.[11] If this is true, it should also be true that for each percent *decrease* in after-tax incomes, taxable income will *decrease* by 0.4 percent.

Applying that elasticity of response to New York's taxable income base (including non-residents) suggests that higher federal rates will lead to a $400 million annual

reduction in state income tax revenues, or at least **$800 million** over the next two two years. Applying the same technique to New York City's resident income tax base points to an annual revenue loss of $72 million for the city, or at least **$144 million** over the full two years.[12]

The NYS-CGE-STAMP model, developed for the Manhattan Institute by the Beacon Hill Institute of Boston, Mass., uses a different methodology to produce estimates of state and city tax responses to changes in federal income tax rates. The CGE-STAMP model predicts that Obama's proposed rate increases would reduce income tax revenue by $944 million on the state level, but only $30 million on the city level, over the next two years. But the STAMP model also estimates losses in other revenue categories, including sales and business taxes, which would bring the two-year revenue decrease to just over **$1 billion** for the state and **$285 million** for the city.

Putting aside the economic consequences of increased marginal tax rates on investments, dividends and ordinary income—which are likely to slow growth in New York more than in most states—a further erosion in the state and city tax bases would come at a bad time.

Both Governor David Paterson and Mayor Michael Bloomberg are forecasting sizeable budget gaps for fiscal years beginning in 2009.[13] Both also have recently hinted that they will resort to tax hikes as well as spending increases to close those gaps. The result could be the reverse of 2003: a situation in which state and local income taxes are raised *on top of* higher federal taxes. This would create an even stronger incentive for taxpayers to minimize their taxable incomes, feeding the cycle of both fiscal and economic decline. Since federal deductions for state and local taxes would once again be limited, it would also prompt more top-bracket earners to question their continued presence in New York.

CONCLUSION

There is little dispute that McCain's tax proposals would promote economic growth while doing comparatively little to bolster the income redistribution already inherent in the tax code. By the same token, Obama's individual income tax changes will achieve a significant additional redistribution of income, roughly from the highest-earning 5 percent of tax filers to the other 95 percent (including millions who already pay little or no income tax), while doing much less to boost economic incentives.

Because the Empire State is home to such a large concentration of successful and wealthy investors and business owners, its entire economy benefits when federal policy tax policy is focused on economic growth and wealth creation. By the same token, the net flow of federal revenue out of New York invariably increases under a policy geared to income redistribution—even when low- and middle-income New Yorkers are among the numerous direct beneficiaries of income shifts.

As a global financial capital, New York is also especially sensitive to changes in tax policy affecting the value of and volume of trading in investments. Higher marginal income tax rates on ordinary incomes, combined with higher tax rates on investments, would thus hit New York especially hard in the current economic environment.

ENDNOTES

[1] See more detailed estimates for impacts on hypothetical families in "The $36 Billion Bonus: New York's Gains from Federal Tax Cuts," Manhattan Institute, Center for Civic Innovation, CR-43, August 2004.
[2] Securities Industry Association, "The Street, the City, and the State: The Securities Industry's Importance to New York City and State," Securities Industry Trends 40, no. 2 (March 22, 2004), from cover page highlights.
[3] Required quarterly estimated income tax payments were also temporarily increased by the State and City on an accelerated basis.
[4] In the aggregate, a Manhattan Institute model calculated that households throughout New York State with incomes above $125,000 saved about $3.8 billion more in federal taxes while paying about $900 million more in new state income taxes in 2003. In New York City alone, households in the same bracket saved nearly $2 billion in federal income taxes while paying about $410 million more in City income taxes and about $420 million more in State income taxes.
[5] For more on this phenomenon, see Robert Carroll, "Do Taxpayers Really Respond to Changes in Tax Rates?," U.S. Treasury Office of Tax Analysis, OTA Working Paper 79, November 1998.
[6] McCain also proposes a new, refundable health insurance tax credit of $2,500 for individuals and $5,000 for families. The credit would be the centerpiece of McCain's health care reform program, replacing an existing tax exclusion. It would be paid directly to insurers, not individuals, with the excess available for deposit in personal health savings accounts. While the credits are potentially quite valuable to individuals, they are not counted in this report as part of his plan's direct impact on New Yorkers, because (a) the plan is complex and its state-level incidence is difficult to evaluate, and (b) it is meant mainly to create new incentives for health care insurance purchases and utilization, not tax savings.
[7] Analysts for the Tax Policy Center say they assume, based on Obama campaign estimates, that this credit would be phased out for individuals earning over $75,000, or couples earning over $150,000.
[8] Our final estimate assumes that adjusted gross income among New Yorkers in the top two federal tax brackets is already shrinking as a result of Wall Street layoffs, reduced securities industry profits, and reductions in capital gains income, but makes no further assumption concerning the changes in the timing of capital gains transactions due to tax increases.
[9] Asked in an ABC "This Week" interview broadcast Sept. 7 whether he would go ahead with tax increases even if the nation is in a recession when he takes office, Obama replied: "I think we've got to take a look and see where the economy is. The economy is weak right now. The news with Freddie Mac and Fannie Mae, I think, along with the unemployment numbers indicates that we're fragile. I want to accelerate those tax cuts through a second stimulus package, get more money into the pockets of ordinary Americans, see if we can stabilize the housing market, and then we're going to have to reevaluate at the beginning of the year to see what kind of hole we're in." Quote cited from *Wall Street Journal*, "ObamaTax 3.0," Sept. 9, 2008, pA24.
[10] Specifically, Obama's economic advisers say he is "considering" a plan to impose a payroll tax of 2 percent to 4 percent on those making over $250,000 a year starting "a decade or more from now" (see "The Obama Tax Plan," by Jason Furman and Austan Goolsbee, *Wall Street Journal*, p.A13, August 14, 2008.) The tax now applies only to the first $102,000 of wage income, a figure adjusted annually with inflation.
[11] Office of Tax Analysis, Department of the U.S. Treasury, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," July 25, 2006, at www.treasury.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf , as further explained by Robert Carroll in "The 2001 and 2003 Tax Relief: The Benefit of Lower Tax Relief," Tax Foundation *Fiscal Fact*, Au 2008, No. 141, at http://www.taxfoundation.org/publications/show/23534.html .
[12] Reversing the Bush cuts in the top two brackets would reduce after-tax incomes (calculated as 1 minus the marginal rate) by 7.1 percent in the top federal bracket and 4.5 percent in the second highest bracket. Applying an elasticity of 0.4 to these figures suggests a decrease of 2.8 percent in taxable income in the top bracket and 1.8 percent in the second highest bracket. These figures were then applied to taxable income estimates derived from data published in the 2008-09 Executive Budget, Economic and Revenue Outlook, assuming incomes at the 2007 tax year level. The estimate for New York City is based on 2005 resident tax data compiled by the city's Independent Budget Office, also assumed at 2007 levels.
[13] "Dave and Mike Put Taxes on the Table," *New York Post*, Sept. 10, 2008.

APPENDIX

Federal Individual Income Tax Brackets, 2008

	Filing Status and Bracket Threshold Starting Points ($)			
Rate	Single Individuals	Heads of Households	Married Filing Joint	Married Filing Separate
10%	0	0	0	0
15%	8,025	11,450	16,050	8,025
25%	32,550	43,650	65,100	32,550
28%	78,850	112,650	131,450	65,575
33%	164,550	182,400	200,300	100,150
35%	357,700	357,700	357,700	178,850

Source: Internal Revenue Service

The starting point for figuring income taxes is adjusted gross income minus personal exemptions for self, spouse and dependents. The next step is to claim either the standard deduction or itemized deductions.

Personal exemption:
$3,500

Standard Deduction:
$5,450 for single individuals and married individuals filing separate returns, $8,000 for heads of households, $10,900 for married individuals.

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EMPIRE CENTER
FOR NEW YORK STATE POLICY
A project of the Manhattan Institute for Policy Research

P.O. Box 7113 Albany, New York 12224 • PH: 518-434-3100 • FAX: 518-434-3130 • info@empirecenter.org
www.empirecenter.org