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

Testimony of Edmund J. McMahon
Senior Fellow, Manhattan Institute for Policy Research
Director, Empire Center for New York State Policy

Before the Senate Committee on Budget and Tax Reform
March 12, 2009

Thank you, Senator Krueger. I would like to begin by recalling two points from my testimony a month ago to the joint legislative fiscal committees:

First, this economic and fiscal crisis is not just another cyclical downturn. What we have witnessed over the past year is the end of an era. The old Wall Street – the industry that directly and indirectly generated much of the growth in state tax revenues over the past 15 years – is dead and gone. It won't be coming back in its old form anytime soon, if ever.

This leads to the second point: in the long run, the goal of state tax policy should be to build a more sustainable and diverse economic base in New York. In the short run, as you grapple with massive budget gap, your goal should be Hippocratic: do no harm. At the very least, do as little harm as possible.

Unfortunately, in my opinion, the tax proposals on which you focus today fail to recognize the implications of the profound structural change that has occurred at the heart of New York's income tax base. These tax proposals will do real economic harm, hindering New York's recovery in the long term.

In addressing the key questions in your hearing announcement, I think it's vitally important to get some historical perspective on the evolution of New York's personal income taxes.

New York's personal income tax dates back to 1919, when it was introduced at a rate of 3 percent. During the Great Depression, it peaked at 8 percent on incomes equivalent, in today's dollars, to about $140,000 a year. Starting a half-century ago under then-Governor Nelson Rockefeller, New York State's personal income tax structure grew increasingly more complicated as the personal income tax was raised from a level of 7 percent in 1958 to 15 percent by the end of the 1960s. Including a temporary surcharge, the marginal rate peaked at 15.375 percent during the fiscal crisis of the mid-1970s. During the same period, New York City imposed its own resident personal income tax, which by the late 1970s had risen to 4.3 percent. Thus, the combined city-state rate peaked during the fiscal crisis era at nearly 20 percent.

While the city and state income taxes have never been deductible from each another, in the late 1970s they were fully deductible, for most taxpayers, on federal tax returns. At the time, the top federal rate was 70 percent. That meant, from a taxpayer's standpoint, the net, post-deduction cost of the 15 percent New York State rate was 4.5 percent (i.e., a 70 percent discount).

Flash forward to 2008: our current rate of 6.85 percent is deductible under a federal income tax code whose maximum marginal rate is 35 percent. Thus, the net rate last year, assuming full deductibility, was 4.45 percent—virtually the same as 30 years earlier. (Figure 1 in the Appendix.)

By the late 1970s, there was widespread bipartisan agreement here in Albany that New York's very high tax rates had been a major factor in the economic decline of the state and city over the previous decade. It was Governor Hugh Carey who thus spearheaded the process of reducing marginal rates as part of the state's strategy for economic recovery from the fiscal crisis.

During Carey's last term, from 1979 through 1982, the marginal rate on earned income was reduced from 15 percent to 10 percent. This process continued during Governor Mario Cuomo's first term, when the governor signed a bill to phase in a rate reduction from 10 percent to 9 percent.

Meanwhile, under President Reagan's reforms, the top federal rate was being reduced between 1981 and 1985 from 70 percent to 50 percent. In another change with far-reaching consequences, the federal tax code was indexed to rise with inflation, halting the bracket creep that had pushed millions of middle-income payers into higher brackets during the late 1970s.

In 1986, President Reagan reached a landmark, bipartisan agreement to significantly reform the federal tax code. The base of income subject to tax was significantly broadened, and the structure was made flatter, peaking at a rate of 28 percent (with a "bubble" that effectively imposed a 33 percent rate on some taxpayers).

Because the state income tax, then as now, was tied closely to the federal tax base, the 1986 federal tax reform would have produced an automatic $1.7 billion "windfall" increase in state income tax revenues if there had been no change in the state tax.

To prevent such a windfall from occurring, Governor Cuomo all four conferences of the Legislature kicked off the 1987 session by proposing serious, sophisticated plans designed to both reform the state PIT in a way that would further reduce taxes on New Yorkers, and to introduce a greater element of simplicity and equity into the tax code. All of these proposals called for reducing the state PIT's complex graduated rate structure, which had as many as a dozen brackets beginning at very low rates on low incomes.

The agreed-upon state Tax Reform of 1987 was based primarily on the "Fair and Simple Tax" plan (FAST) originally proposed by then- Assembly Speaker Mel Miller. The original FAST plan called for a top rate 6.75 percent; the adopted plan called for a five-year phased-in transition to a two-bracket structure with a top rate of 7 percent on taxable incomes over $20,000 for single filers, $30,000 for heads of households and $40,000 for married couples.

It is important to remember two things: First, nearly half the 1987 "tax cut" was not a cut at all, but avoidance of a windfall tax hike. Second, the 1987 reform was enacted in the name of <u>improving</u> equity. And it succeeded.

In a law review article entitled "Tax Justice for New York Families After New York State Tax Reform," a leading non-partisan tax scholar wrote of the change in this way:

> "Prior to the reform acts, the New York personal income tax employed a quixotic mixture of separate and joint filing provisions to adjust tax burdens imposed on individuals. Its relief mechanisms for low-income families were complex and inadequate. Its separate filing rule was impossible to administer fairly and imposed unjustifiable penalties on marital partners who earned substantially unequal incomes. Single parents with dependent children were taxed far more heavily than their economic condition warranted.
>
> "The reformed system, when fully effective … will provide simple and fair tax relief to the poor and will impose substantially equal tax burdens on family members enjoying comparable standards of living. By any reasonable standard, the reform should be judged a success."[1]

The phase-in of the 1987 reform was interrupted and repeatedly postponed, beginning in 1989, in the face of a worsening fiscal crisis. By the time Governor Pataki took office in 1995, the top rate had been frozen at 7.875 percent for five years. During his campaign, Pataki had proposed a simplified, four-bracket structure with a top rate of 5.9 percent. The compromise Taxpayer Reform Act of 1995 went about halfway to these goals, reducing the top rate to 6.85 percent and raising the top bracket for joint filers to $40,000.

From the outset, Pataki's 1995 plan was specifically designed to drop 500,000 low-income filers from the rolls, partially through expansion of the Earned Income Credit first enacted under Governor Cuomo. It also targeted a cut of 25 percent to middle-income families—roughly twice the average cut for high-income households.

Figures 2-4 in the appendix to my testimony illustrate the results of this policy:

- The New York State personal income tax structure is functionally quite progressive. Measured as a share of incomes, without even considering those with negative tax liability, the income tax burden at the top is more than twice as high as the burden at the bottom.
- The tax code is especially favorable to married couples with children. The enactment of the Empire Child Credit has accentuated this tendency, so that effective rates for a family of four are considerably less than half those for a family of four with high income
- New York offers one of the most generous Earned Income Credits in the nation. More than 1.3 million New York low-income workers qualified for credits of roughly three-quarters of a billion dollars. For a typical single parent of two children working in a low-wage job, the EIC can be worth 8-10 percent of income – which also effectively cancels the cost of other state and local taxes she may pay.
- The state has become more heavily reliant on taxes generated by the highest-income households. At the peak of the boom, the top 1 percent was paying 41 percent of the taxes. Those with incomes of over $1 million were, the latest year for which we have data available, reporting 26 percent of adjusted gross income and generating 35 percent of all tax liability, while the two-thirds of filers earning less than $50,000 were paying less than 5 percent of the total.

I have dwelled on this historical background at some length in order to dispel a rash of misstatements and misconceptions that have been promoted in connection with the so-

called "fair tax" proposal—and which have even found their way into the statement of legislative intent for S.2021.

For example, the bill says that "over the last 30 years, New York's personal income tax laws have become increasingly unfair and inequitable." In fact, as I've just explained, the truth is precisely the opposite. By any reasonable standard, the tax code has become more equitable.

It's also repeatedly claimed that the wealthiest New Yorkers don't pay a "fair share." Fairness is a subjective concept, which can be manipulated to serve a variety of policy ends, but there's no denying that the wealthy actually pay a very large share of the income taxes collected in New York – a share which has increased substantially since the mid-1990s in part as a direct and deliberate result of state tax policy.

Finally, it is alleged, in various ways, that middle-income New Yorkers pay the same rate as the wealthiest households. Sometimes, but not always, such claims note that a middle-class filer may be subject to the same "marginal" rate on taxable income as a million-dollar household. In any case, such statements misleadingly confuse taxable income with adjusted gross income, and ignore the impact of standard deductions, exemptions and credit. In reality, a single individual with income just above the $20,000 top bracket threshold for single filers of income does not "pay the same tax rate as Donald Trump." Not even close. In fact, the tax bite on someone in Trump's presumed taxable income range is 77 percent higher than that of the single guy who also is, technically, a dollar into the same top marginal bracket.

Our pronounced dependence on high-income taxpayers is actually a big part of our current fiscal problem. As noted in the recent Revenue Report of the Assembly Majority Ways and Means staff, during the past decade or so:

> "…[T]he State increased its reliance upon sources of revenue that are inherently unstable. However this mix of volatile tax receipts sources – such as the bonus component of wages and capital gains – has also proved to be unsustainable. The transformation in the financial markets – with the disappearance of investment banks and what promises to be new safeguards and oversight in lending practices – will have significant implications for the State's future revenues. To the extent that incentive compensation in Wall Street changes, as most observers tend to think, with more internal restriction in bonus pools and allocations, it is doubtful that New York will experience going forward the same unprecedented growth in PIT receipts, especially from wealthier income groups.''[2]

In support of the claim that a significant income tax increase would have no impact on the behavior of affected taxpayers, it has also been asserted that New York was able to impose temporary higher brackets from 2003 through 2005 with no negative economic consequences. But that statement, too, is highly misleading. The temporary tax hikes of 2003 took effect at the same time as much larger federal income tax *cuts*, including deep capital gains and dividends tax reductions that helped fuel a strong economic recovery. The positive effect of federal tax cuts overwhelmed most—but not all— of the negative impact of New York's temporarily higher income taxes. Despite the boost from federal tax cuts, private job growth in New York State was far below national average during the three years the temporary tax hikes were in effect.

Today's economic situation is very different from 2003. All current economic trends point to a prolonged severe recession for 1-2 more years, followed by massive federal tax *increases* targeted at high-income households in high-tax states like New York. And as

illustrated in Figure 1 of my appendix, the impact of these changes will be to raise the effective net marginal rate in New York even if no change is made in our own tax law.

In considering the impact of these proposed tax increases, it is vitally important to remember that New York's largest concentration of wealth, income and capital can be found in New York City, where the marginal income tax rate on city residents already rivals the highest in the country. The proposed legislation would raise the combined state and city marginal rate to nearly 14 percent – its highest level in nearly 30 years (Figure 5). This would come as a severe blow at a time when the city will be struggling to recover from what is likely to be a permanent—or at least, very long-term—loss of hundreds of thousands of well-paying jobs.

High-income taxpayers by definition include many of our most dynamic economic decision-markers, entrepreneurs and employers – the very people New York needs to rebuild a sustainable and diverse economy for the future. They are the most mobile people in our society. Many have considerable discretion in simply shifting their domicile even while retaining a residence in New York. And economists and tax policy analysts alike agree that tax rates, especially at the margin, can have important incentive effects.

For footloose employers, investors and entrepreneurs with a choice of where to locate, the state's marginal rate is also an important signaling mechanism. The signal sent by enactment of either of these proposals would be the equivalent of a vivid red flag, waving over a flashing neon sign conveying an unequivocal message in flashing capital letters:

STAY AWAY

There is a substantial economic literature on the question of how state and local taxes affect economic development. The consensus is that taxes matter; the only difference is how much, and in what circumstance. Based on tax model developed for the Manhattan Institute's Empire Center, economists at the Beacon Hill Institute of Boston's Suffolk University have concluded that enactment of S.2021 would result in a loss of about 22,000 private sector jobs.[3] Depending on what assumptions are made about how the resulting revenue would be used, in the best case the model also indicates such a tax hike might sustain or create a slightly larger number of public-sector jobs (about 25,000)—so you would essentially be choosing to sacrifice private employment in New York in order to maintain or grow government employment.

Our model's findings is not inconsistent various other studies of this subject. The consensus may have been best summed up by a 1997 report on about 100 other studies, published in the *New England Economic Review*, which concluded that the impact of state taxes on economic growth is small but statistically significant – and that "the degree to which a specific state's tax rate will affect economic activity in the state depends on the degree which the state's tax burden deviates from that in relevant comparison states."[4]

Another economist's 2002 review of 65 academic empirical studies on interstate and cross-country tax differentials and individual country cases reached these conclusions:

- The impact of taxes depends on how they are used, with welfare expenditures having a negative impact.
- "…taxes have lagged effects, with the adverse impact being realized often about after three years".
- High taxes drive up labor costs as employers must compensate employees for the burden of high taxes.

- High taxes deter business from investing capital and discourage entrepreneurs from locating in a given area.
- "Other research has demonstrated that high taxes reduce in-migration and spawn out-migration".[5]

New York's tax burden is already significantly heavier than those in neighboring and competing states. The extraordinary marginal rate increases proposed by S.2021 and S.2654 would represent a very significant further deviation from relevant competitors.

In closing, I believe the facts conclusively demonstrate that various claims made about the "unfairness" of the tax code are unfounded. Therefore, it comes down to a matter of the economic impact in the teeth of the most severe recession since the 1930s.

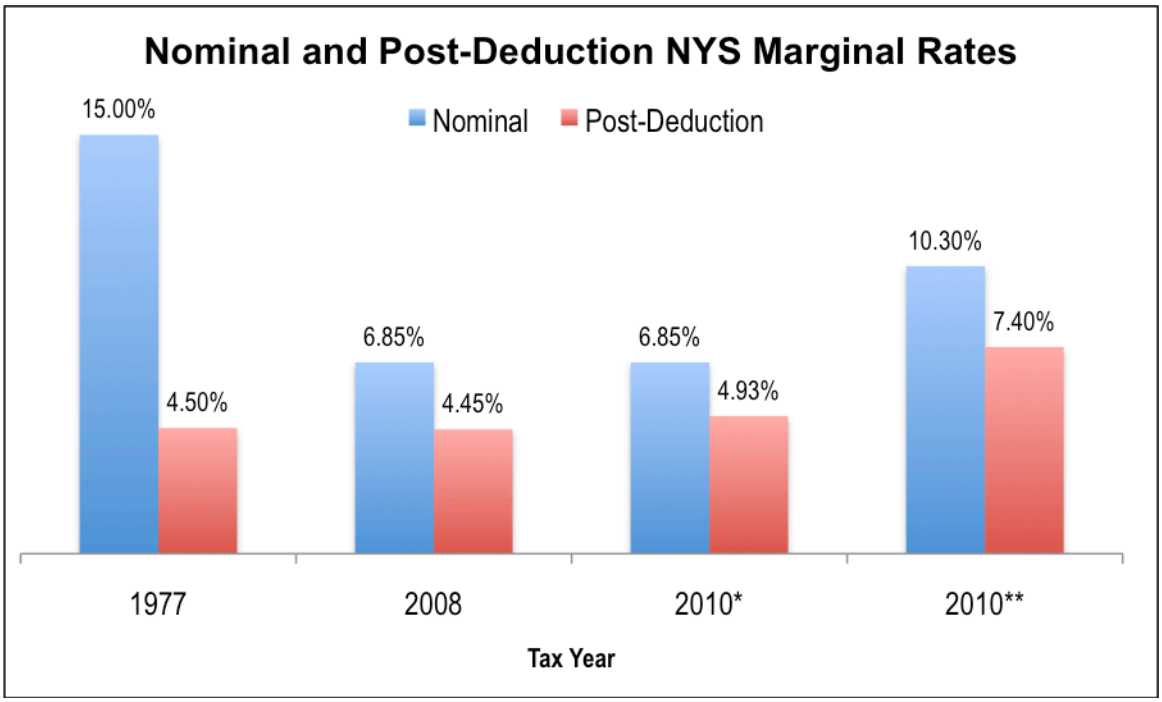
I would suggest pondering this question: How will a significant increase in the income tax boost private-sector job creation and investment in New York in years to come? The answer, I would suggest, is obvious. Therefore, I would urge you to reject these proposals and to instead concentrate on finding ways of restraining the growth the budget and using federal stimulus money to finance a soft-landing to a more affordable and stable future for state and local government in the long term.

Thank you.

---

[1] McIntyre, Michael J., "Tax Justice for Family Members After New York State Tax Reform," *Albany Law Review*, Vol. 51, No.3-4, Spring/Summer 1987.
[2] New York State Assembly Ways and Means Committee, Revenue Report, February 2009, p. 40.
[3] Testimony by Jonathan Haughton at the 2009-10 Economic and Revenue Forecasting Conference, posted at http://www.budget.state.ny.us/pubs/press/2009/econRevForecastConf/NewYorkRevenueIssues_February232009.pdf .
[4] Wasylenko, Michael, "Taxation and Economic Development: The State of the Economic Literature", *New England Economic Review*, Federal Reserve Bank of Boston, March-April 1997.
[5] Vedder, Richard K., "Do Taxes Matter? A Literature Review", in ***Grinding to a Halt: Ohio's Tax Policy and Its Impact on Economic Growth.*** Columbus, OH: The Buckeye Institute for Public Policy Solutions, 2002.

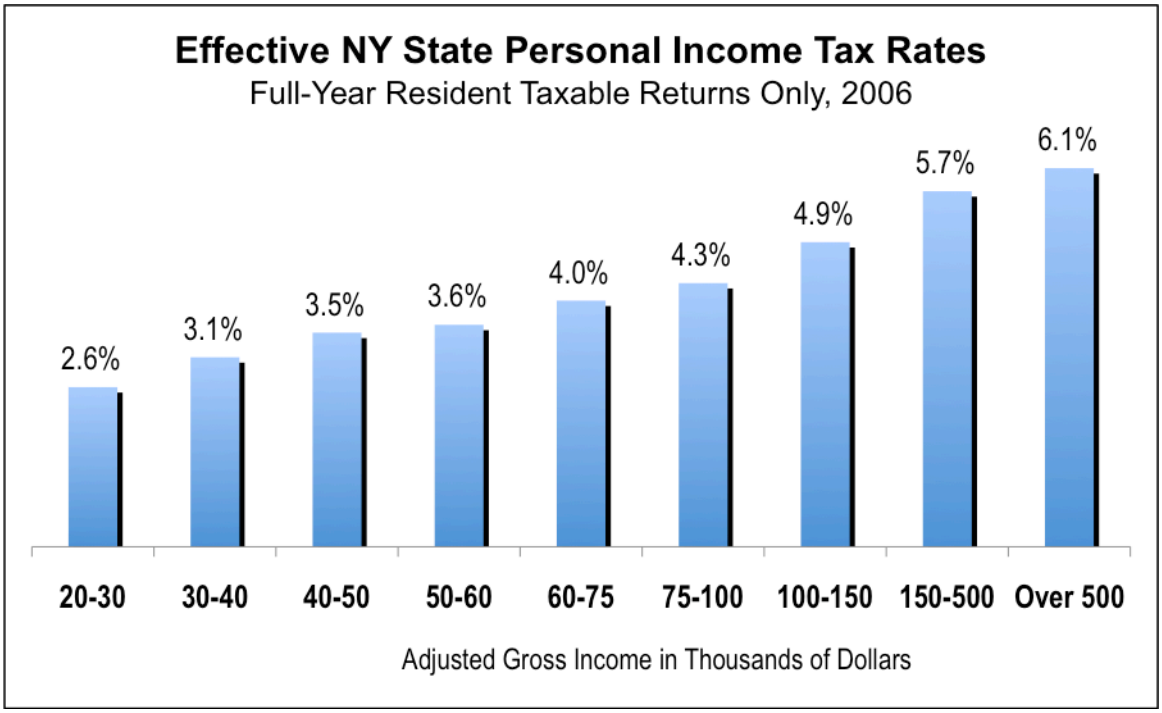
Figure 1



Source: New York State Department of Taxation and Finance; Tax Foundation; author's calculations
** President Obama's tax plan applied to current NYS rate*
*** President Obama's tax plan applied to proposed NYS top rate*

When New York State's top personal income tax rate peaked at over 15 percent in the 1970s, it was fully deductible for most taxpayers against a top federal rate of 70 percent. The net marginal rate in 1977 was 4.5 percent; as of 2008, it was almost identical at 4.45 percent. President Obama's plan to limit itemized deductions will raise the net marginal rate in New York to a minimum of 4.92 percent – not including the separate "Pease" limitation on deductions, which can carve away up to 80 percent of deduction value. A proposed 10.3 percent top rate in New York would have a net, post-deductibility cost of 7.4 percent – far above the 1970s net marginal rate. For roughly a half-million New York residents taxpayers subject to the federal Alternative Minimum Tax (AMT), state and local tax deductions cannot be claimed at all; the AMT today affects many more filers than it did in the 1970s.

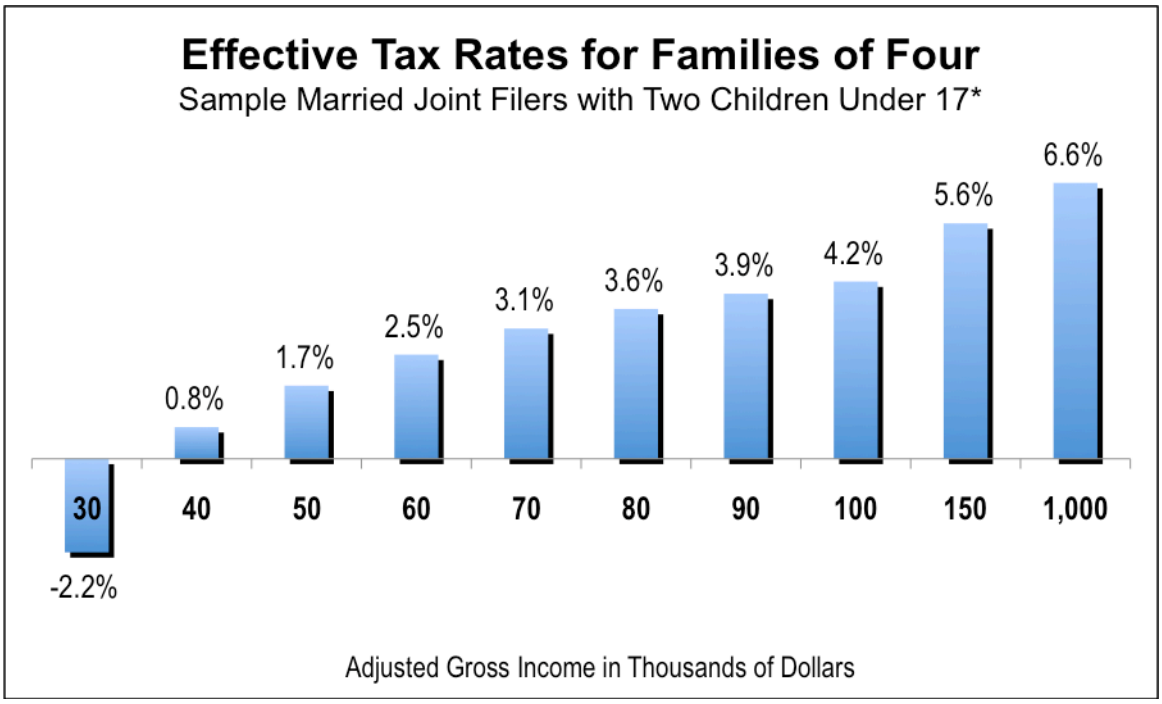
Figure 2



Source: New York State Department of Taxation and Finance

Measured as a share of adjusted gross income, the average New York State personal income tax burden is more than twice as high at the top of the income scale as it is at the bottom. This chart includes all types of filers—single, married and heads of households, with and without children. However, it excludes hundreds of thousands of New York residents who pay no income tax at all but receive a net refund from the state, mainly due to the Earned Income Credit.

Figure 3



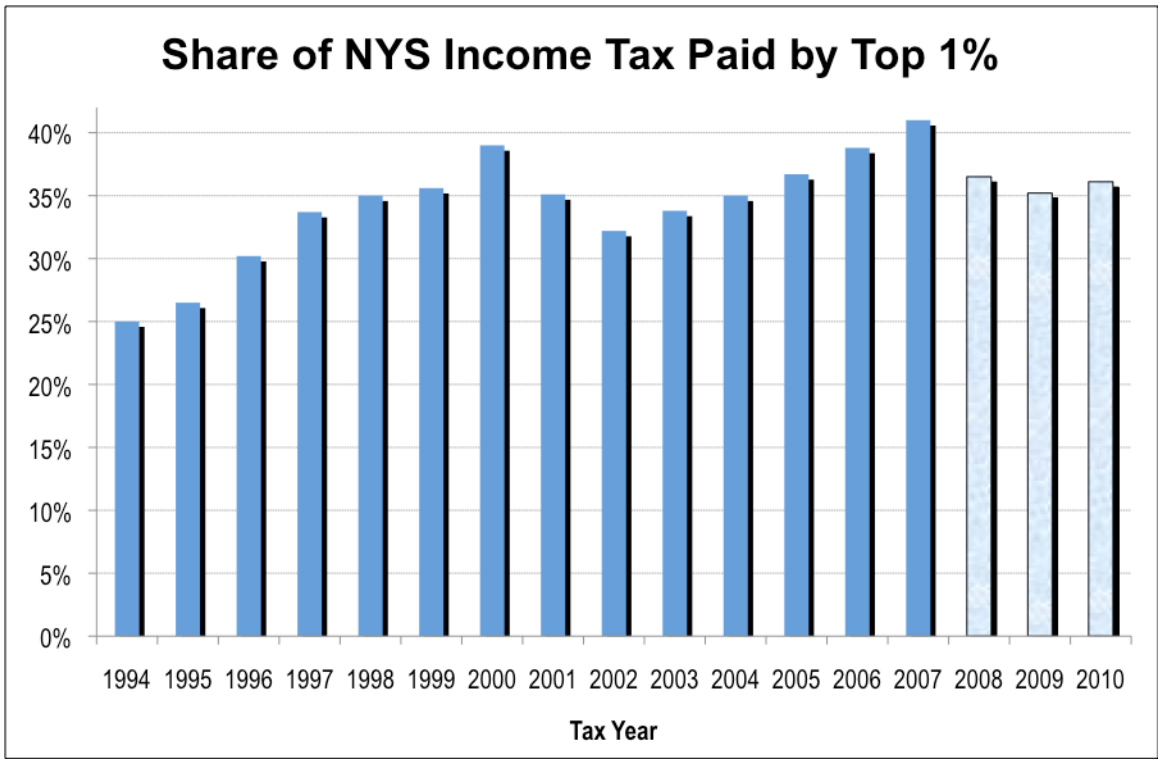
Taxes calculated using Internet TaxSim Version 8.2 at http://www.nber.org/~taxsim/taxsim-calc8/index.html. Incomes from $30,000 to $100,000 assumed to use standard deduction; typical itemized deductions assumed for higher income taxpayers.

With the creation of the Empire Child Credit in 2006, the New York State personal income tax code became more favorable than ever to families with children. As shown above, for example, a typical family of four with income of $70,000 pay taxes at less than half the rate of a family of four earning $1 million. Tax payments in dollars for each hypothetical filer are shown below:

Tax Liability for Families Of 4
(Married, 2 Children Under 17)

AGI	Income Tax
30,000	(670)
40,000	303
50,000	873
60,000	1,492
70,000	2,177
80,000	2,862
90,000	3,547
100,000	4,232
150,000	8,431
1,000,000	65,871

Figure 4



Source: Division of the Budget; 2008-10 are projections

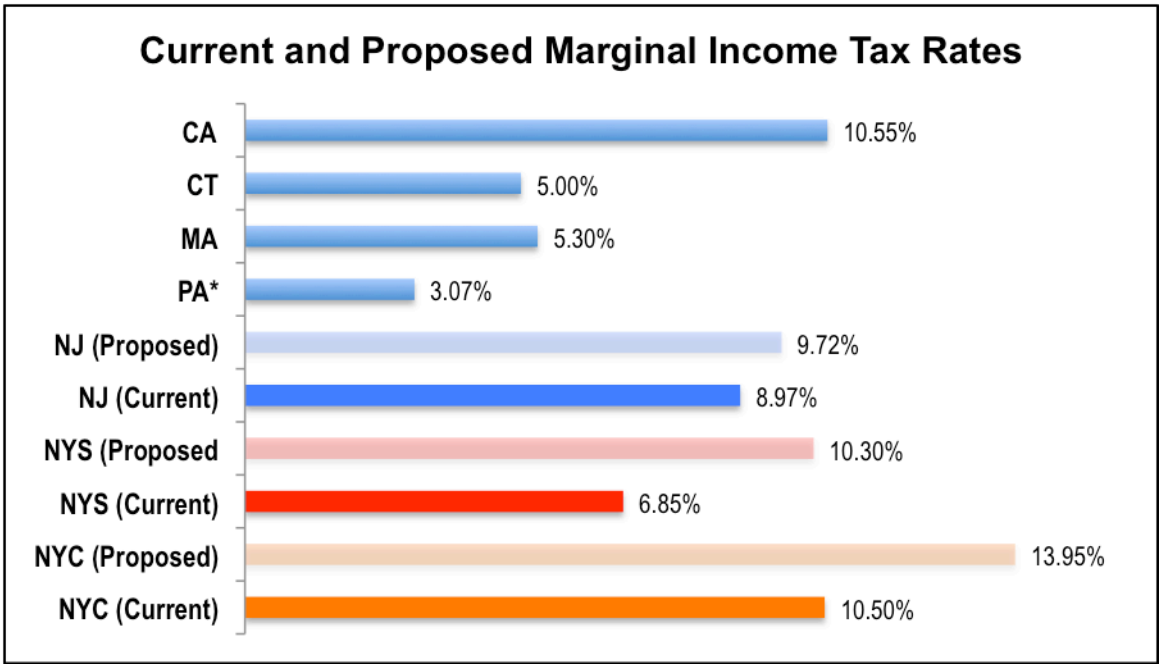
The share of New York State personal income tax collections generated by the highest-earning 1 percent of filers rose from 25 percent in 1994 to a peak of 41 percent in 2007. Most of the increase occurred during the three-year phase-in of the state's 1995 Taxpayer Relief Act, which targeted larger savings to low- and middle-income households, effectively shifting more of the remaining burden to higher brackets. As shown below, in the wake of the financial sector meltdown, households with income above $1 million are expected to represent one-half of one percent of all filers in 2009, but will still generate 31 percent of tax liability based on 23 percent of reported AGI — while the 68 percent of households with incomes below $50,000 will report 19 percent of income but pay less than 5 percent of income taxes.

Distribution of Tax Returns, Adjusted Gross Income and Tax Liability by Income Groups, 2009 Forecast

Income in $1,000s	Returns	AGI	Liability
0 - 50	67.9%	19.1%	4.8%
50- 100	18.5%	19.9%	18.2%
100 - 200	9.6%	19.0%	21.8%
200 - 1,000	3.5%	18.8%	24.5%
1,000 and above	0.5%	23.2%	30.8%

Source: Division of the Budget

Figure 5



Source: Federation of Tax Administrators;
** Statewide rate; some cities also impose wage rates. In Philadelphia, for example, combined income tax and wage rate is 6.98 percent.*

New York's statewide marginal income tax rate currently is the second highest in the region; the combined rate in New York City is only slightly below California's newly increase rate, the highest in the nation. Under proposed state legislation, New York's statewide rate in the top bracket would be more than *twice* as high as neighboring Connecticut's, more than *three times* as high as Pennsylvania's statewide flat rate, and nearly *double* the Massachusetts flat rate. The marginal rate in New York City would be just under 14 percent — highest in the nation, fully one-third higher than the marginal rate in California.