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I'm sure the witnesses following me today will have a lot to say about the specific tax proposals contained in Governor Paterson 2010-11 Executive Budget. I would like to concentrate on the broader economic and fiscal context in which you will be shaping the final budget and revenue package for next year.

Let me begin by reminding everyone that the 2009-10 state budget included tax and fee increases that were initially valued at $6.1 billion, or 7.4 percent of total state fund revenues. This was the largest tax and fee increase in New York State's history.

The MTA bailout plan, adopted last May, permanently imposed an additional $1.8 billion in taxes and fees throughout the 12-county downstate region, where most of the state's personal and business income taxes originate. These statewide and regional taxes and fees created a further drag on an economy that was already being clobbered by the most severe downturn of the post-war era.

The largest item in last year's revenue package was a temporary state personal income tax (PIT) increase that raised New York's top-bracket marginal rate by more than 31 percent, to its highest level in a quarter-century, along with the permanent elimination of remaining itemized deductions for tax filers earning at least $1 million in taxable income. Taken together, these actions represented New York's largest personal income tax increase in nearly 50 years. In percentage terms, New York's marginal rate hike was the second largest enacted by any state in 2009.[1]

New York's top state income tax rate is the sixth highest in the nation and the second highest among neighboring states.[2] New York City residents are subject to the nation's highest combined top rate on state and local income taxes—12.6 percent. Governor Paterson's STAR proposal in the 2010-11 budget will effectively raise this even further, to over 12.8 percent.

But the impact of last year's state tax increase was even larger than it appeared. That's because the 2009-10 state budget expanded a pernicious provision of New York's income-tax law, which imposes the top rate on every dollar of taxable income earned by filers in the highest three brackets. This quirk—found in no other state with a supposedly graduated income tax--is expected to generate fully 20 percent of the added revenue projected from last year's temporary tax increase.

Higher income taxes create a disincentive to work, save and invest in New York. They sap the working capital of small businesses, and they provide the state's most successful and mobile taxpayers with another reason to consider shifting their base of operations to lower-taxed states. [3]

Raising income taxes is also unwise as a matter of fiscal policy. New York has long been more dependent on income taxes than almost any other state—and that dependence actually increased after the enactment of the Pataki tax cuts in 1995. Contrary to the claims made by proponents of last year's tax hike, the distribution of tax liability under the 1995 PIT structure has been highly progressive.

Last year at this time, before the latest PIT increase was adopted, the annual Revenue Report of the Assembly Ways and Means Committee cited New York's "inherently unstable," "volatile" and "unsustainable" dependence on a small number of high-income taxpayers.[4] According to updated figures contained in Governor Paterson's 2010-11 budget documents, the highest-earning one percent of New York income taxpayers generated 43 percent of total income tax receipts in 2007—the highest such share on record.[5]

The 2009 income tax increase is effectively designed to squeeze more money out of taxable income base that has shrunk by a full 40 percent over the past two years. Under the circumstances, it's not surprising that DOB now projects the tax increases will generate about $400 million less than originally expected. Some of this shortfall may be due to quirks in the timing of tax payments, rather than changes in taxpayer behavior, and DOB has also raised its estimated revenue return from affected taxpayers in 2010-11. This increase appears to stem largely from a sharp projected increase in capital gains realizations, resulting from the expectation that federal capital gains rates are likely to increase a year from now.

In general, the tax climate at the federal level in the near future is not going to be friendly to New York. President Obama today released a budget reaffirming his desire to restore the higher, pre-2001 marginal rates for the highest federal tax brackets. The president also is seeking to impose further limits on the value of itemized deductions—including state and local tax deductions—for taxpayers in the highest brackets.[6] All of these changes have flow-through implications for New York's tax base, which will translate into less money for the state treasury.

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, by shifting their tax "domicile" to lower-tax jurisdictions, and by using legal strategies to shift or shelter income in tax-exempt investments.

As you know, our PIT structure piggybanks (with few exceptions) on the federal individual income tax. Based on a U.S. Treasury Department analysis of taxpayers' responses to the Bush tax cuts, we have estimated that a return to the pre-2001 top federal tax rates will have the side effect of depressing New York's state tax revenues by $400 million a year. Larger increases in federal rates will have a larger flow-through effect on state revenues from the PIT, and on New York City revenues as well.[7]

In sum, the impact of federal tax increases is another important factor to consider as you weigh alternative tax policies. If you maintain the higher top rates enacted in 2009, the disincentive to work, save and New York will be stronger than it has been in many years. Indeed, given changes in the federal deductibility of state and local taxes, the tax cost of New York will be even higher than it was when our statutory marginal rates peaked in the late 1970s.[8]

In closing, here are three immediate priorities for the Legislature's consideration:

First, do not add any more to the state tax burden.

Second, commit now to allowing the temporary PIT increase to sunset on schedule at the end of 2011—if not sooner.

Converting the 2009 tax increases into permanent law will be a drag on New York's economic recovery. What you gain in short-term revenues will be lost in long-term economic growth.

Third -- index PIT brackets to inflation as part of 2010-2011 budget.

New York should follow the federal governments lead and index its own tax brackets to inflation. Because inflation is near zero today, this reform has negligible short-term fiscal cost, but would protect New Yorkers from bracket creep over the long term—when many economists feel an upturn in inflation is quite possible. If New York tax brackets had been indexed to inflation starting in 1997, the permanent top bracket would now be $53,467 instead of $40,000, personal exemptions would be $1,337 instead of $1,000.

And fourth -- eliminate unwarranted tax credits and preferences.

In 1986, the federal government implemented reforms that greatly simplified the income tax and broadened the tax base, while sharply cutting tax rates. Many of these reforms flowed through to New York's income tax due to the state's adoption of many federal definitions. Unfortunately, since 1986 the trend has been to create new credits and exclusions and make New York's taxes more complicated.

Some of these tax credits are simply another name for outright subsidies of favored industries. The most glaring example in this category is the fully refundable film tax credit.

More than a half-billion dollars in credits were allocated through the program between 2004 and 2008 – meaning that all other New York taxpayers will pay an average of $4 million more in taxes for each of the 120 productions supposedly attracted to the state during that period. The governor now proposes allocating an additional $2.1 billion more to the film credit program over the next five years.

Proponents of the credit frequently argue that it has been effective in creating jobs. This is probably correct in a narrow sense; on the other hand, it would be surprising if a labor-intensive industry did <u>not</u> create jobs when the government was subsidizing 30 percent of its production costs. Most other industries would also no doubt welcome a 30 percent taxpayer subsidy – but that's hardly an argument for expanding it.

Ending the film credit program will preserve resources that could be more wisely devoted to support of broad and permanent state tax reforms designed to promote enduring economic growth in New York. Paving the way for such reforms should be the Legislature's highest tax policy priority during the years ahead.

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[1] Exceeded only by Hawaii's 33 percent rate increase. For more, please see http://taxfoundation.org/taxdata/show/25537.html

[2] The only states with higher rates are Hawaii and Oregon, both now 11 percent; New Jersey at 10.75 percent; California at 10.55 percent; and Rhode Island at 9.9 percent.

[3] For further discussion of the economic impact of higher income tax rates, please see the testimony at http://www.empirecenter.org/testimony/2009/03/EJMTaxTestimony31209.cfm

[4] New York State Assembly Revenue report, February 2009, p. 40, http://www.assembly.state.ny.us/comm/WAM/2009RevRep/2009RevRep.pdf

[5] 2010-11 Executive Budget, *Economic and Revenue Outlook*, p. 193

[6] See p.40 of *The Budget Message of the President* at http://www.whitehouse.gov/omb/budget/fy2011/assets/message.pdf

[7] E.J. McMahon, "High Stakes Taxing: New York's Prospects Under the Next President's Tax Agenda," Empire Center for New York State Policy, September 2008. http://www.empirecenter.org/Special-Reports/2008/09/highstakestaxing091708.cfm

[8] E.J. McMahon and Josh Barro, "Empire of Excess," *City Journal*, Winter 2010, Vol. 20, No. 1, p. 62.