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Governor Cuomo's 2011-12 Executive Budget does not call for any significant state tax increases. The thrust of my testimony today is that the Legislature should not attempt to add tax increases to this budget – and should start actively working on a more competitive and growth-oriented tax policy for the future.

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 2010-11 budget added \$1.1 billion in tax and fee increases, bringing the two-year total to more than \$7 billion.

In addition to these taxes and fees, the MTA bailout plan adopted in May 2009 permanently imposed \$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 tax increases 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 the revenue package was a temporary state personal income tax (PIT) increase – the misnamed “millionaire tax” that affects income levels starting at \$200,000. The temporary tax hike raised New York's top-bracket marginal rate by 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. Last year, the state eliminated another 25 percent of the charitable deductions that can be claimed by filers with incomes over \$10 million.

Taken together, these actions represented New York's largest personal income tax increase in nearly 50 years. All states had to grapple with enormous budget gaps in the wake of recession – but New York's marginal rate hike was the second largest enacted by any state in 2009.¹ Relative to its tax base and economy, New York's personal income tax increase has been the largest enacted by any major state in the last two years. As the governor frequently points out, New York's business tax climate has been rated the worst in the country.²

Under the temporary law, New York's top state income tax rate is the fifth highest in the nation and is tied for highest among neighboring states.³ New York City residents are subject to the nation's highest combined income tax rate – 12.8 percent, including the impact of last year's change in the STAR exemption for high-income taxpayers.

But the impact of the 2009 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 the 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.⁴

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 the 2009 tax hike, the distribution of tax liability under the 1995 PIT structure has been highly progressive.

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.⁵ 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.⁶

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.

The temporary income tax increase was designed to squeeze more money out of a taxable income base that shrank by a full 40 percent during the recession. Given the small number of taxpayers targeted by the higher rates, and the exceptional volatility of their income, it's not surprising that DOB's revenue projections in this area have veered widely from one year to the next. The 2011-12 budget now projects the tax increases on the wealthiest New Yorkers will generate about \$300 million less in 2010-11 than had been projected a year ago. Much of the fluctuation stems from changes in projected capital gains realizations, reflecting changing expectations about federal tax law. When you rely so heavily on high-income filers, your revenue estimates become less reliable.

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

First, following the governor's lead, do not add any more to the state tax burden.

Second, commit now to allowing the temporary income tax increase to sunset on schedule at the end of this year. Extending the 2009 tax increases will harm New York's economic growth prospects and further undermine the stability of its revenue base.

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 – start planning for further tax reforms and reductions that can promote stronger economic growth in New York.

Over the long term, the state should be aiming for a combination of broader tax bases and lower tax rates in its major tax categories – personal income, corporate and sales taxes. The enactment of Governor Cuomo’s local property tax cap, while not directly a state revenue issue, also would be a significant step towards improving the overall tax climate in New York.

In addition, with federal budget and tax policy in flux, the Legislature needs to be especially aware of the interplay between the federal and state tax codes. One area cries out for action as soon as possible, and that is the Estate Tax. In the late 1990s, the Legislature agreed with Governor Pataki that New York’s exceptionally high estate tax was having a counter-productive impact. The result was a long-overdue shift to an Estate Tax structure designed to complement the federal law then in effect.

However, when the federal Estate Tax was gradually reduced under President Bush, New York State failed to take any offsetting action. The result was the reappearance of an exceptionally high Estate Tax rate here. After the federal Estate Tax temporarily disappeared altogether last year, Congress and President Obama agreed to re-impose it in 2011 and 2012 at a top rate of 35 percent, exempting estates smaller than \$5 million, and to change the previous tax credit for state estate taxes into a tax deduction.

If we don’t follow suit, we will be left with one of the highest effective Estate Tax rates in the country – estimated at more than 45 percent.⁷ Meanwhile, states like Florida, Georgia, South Carolina and Virginia are retirement havens imposing no estate taxes of their own. Several studies, including one by the Connecticut Department of Revenue a couple of years ago, indicate that states imposing extra-high estate taxes are essentially chasing wealth away.⁸ We should adjust our exemption to the \$5 million federal level and commit ourselves to accommodate federal changes after 2012 in ways that do not penalize the estates of New York residents, including many family-owned businesses whose future in the Empire State may be jeopardized by our current policy.

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

² Tax Foundation, *Business Tax Climate Index*, FY 2011, at <http://www.taxfoundation.org/research/show/22658.html>

³ The only states with higher rates are Hawaii and Oregon, both now 11 percent; California at 10.55 percent; and Rhode Island at 9.9 percent.

⁴ 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>

⁵ New York State Assembly Revenue report, February 2009, p. 40, <http://www.assembly.state.ny.us/comm/WAM/2009RevRep/2009RevRep.pdf>

⁶ 2010-11 Executive Budget, *Economic and Revenue Outlook*, p. 193

⁷ American Family Business Foundation

⁸ Connecticut Department of Revenue Services, *Estate Tax Study*, February 2008, at <http://www.ct.gov/drs/lib/drs/research/estatetaxstudy/estatetaxstudyfinalreport.pdf>