

# BEWARE THE GROWING TAX GAP

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EMPIRE  CENTER





## **EXPERT TESTIMONY**

The following is testimony presented before the Joint Legislative Fiscal Committees by the Empire Center's founder and research director E.J. McMahon on February 12, 2019.

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## BEWARE THE GROWING TAX GAP

Governor Cuomo’s Executive Budget for fiscal year 2020 includes a short list of state revenue actions. By far the most significant tax proposal on the list would extend, for five years, the temporary added personal income tax (PIT) rate also known as the “millionaire tax.”

The effective tax burden imposed by the PIT, the state budget’s largest single revenue source, has been significantly increased by the new federal tax law, not least by the cap on deductions for state and local taxes, or (SALT). Just last week we heard Governor Cuomo blame the tax law and the SALT cap for an unexpected decline of \$2.3 billion in personal income tax receipts.

Several points to keep in mind:

- Despite New York’s higher average SALT deductions under previous law, the major individual income tax provisions enacted by Congress in 2017 will produce a tax cut for at least 61 percent of New York taxpayers, with the cuts averaging \$2,400—compared to 65 percent and \$2,180 nationally.<sup>1</sup> Even those who previously itemized will see offsetting benefits from lower federal tax rates, a doubling of the standard deduction, expanded child credits, and the partial rollback of the Alternative Minimum Tax. Only 8.3 percent of New York taxpayers will pay more, with the increases averaging \$3,340—compared to 6.3 percent and an average increase of \$1,630 nationally.<sup>2</sup>

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<sup>1</sup> Frank Sammartino, Philip Stallworth, and David Weiner, “The Effect of The TCJA Individual Income Tax Provisions Across Income Groups and Across the States,” Tax Policy Center, March 2018, <https://www.taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states>

<sup>2</sup> *ibid*



- The negative impact of the SALT cap is concentrated among New York’s highest earners—especially those with incomes topping \$1 million a year, nearly 30 percent of whom will pay higher taxes under the new law.<sup>3</sup> Despite a cut in the top federal rate, top-bracket taxpayers living in New York City now face a higher combined federal-state-city marginal tax rate than they did under previous law, as shown in Table 1.
- New York is exceptionally reliant on a small number of high-earning taxpayers most likely to face higher taxes due to the SALT cap. As repeatedly pointed out by the Assembly Majority Ways & Means staff in past reports, high-earning individuals are an “inherently unstable,” “volatile” and “unsustainable” revenue source, because they depend on investment income for a larger share of their incomes. In fact, it’s highly likely that market volatility affecting higher-bracket capital gains income played a role in the state’s current revenue shortfall, which followed a sharp drop in stock prices in the fourth quarter of 2018.

The share of New York income taxes generated by the highest-earning 1 percent has jumped significantly over the past 20 years. In recent years, it’s averaged roughly 40 percent of total personal income tax liability, up from 25 percent in 1994, Mario Cuomo’s last year as governor, as shown in Figure 1. Among state residents alone, the top 1 percent accounts for 46 percent of tax liability, according to the governor.

The New York State personal income tax turns 100 this year. Through the PIT’s first 99 years of existence, the net marginal cost of the tax was offset to a significant degree by full deductibility on federal tax returns. Now, however, the SALT cap has laid bare an enormous competitive tax gap between New York and many other states.

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<sup>3</sup> *ibid*



Figure 2 illustrates the effective combined top rate of income tax for New York City residents during the 50 years following adoption of the city income tax in 1967. As shown, the effective state and city rate, net of federal deductibility, was already near an all-time high before the new federal law was enacted. Under that federal law, the net-of-deductibility state and city tax rate for high earners is nearly 13 percent – second highest in the country.

Residents in the highest New York personal income tax brackets now have a much stronger financial incentive to consider relocating to states and cities with lower taxes – by no means limited to Florida. For example, neighboring Massachusetts offers much lower property taxes and a higher-rated overall business tax climate than New York’s, including a flat income tax rate that just decreased to 5.05 percent (and is scheduled to drop next year to 5 percent).

It wouldn’t take an exodus of high earners to put a dent in New York’s revenues. Even a small degree of out-migration within the top 0.1 percent “tippy top” of the income pyramid would have a noticeable impact.

Consider: in 2016, there were 2,149 resident New York households with adjusted gross incomes of more than \$10 million, who owed \$5.3 billion in state income tax. Those taxpayers had average gross income of \$31 million and average New York PIT liability of \$2.5 million. Let’s assume the average is boosted by a few super-high earning households, and that median income for this group is actually \$15 million. If we lost just 10 percent of those median earners in the highest reported category – just 215 tax filers, or enough people to fill an average movie theater – the state would lose \$265 million in tax revenue. That’s more than the entire state-funded budget of the Department of Environmental Conservation.



There is indirect evidence that a portion of the high end already has been shrinking in relative terms, like a melting glacier. The resident share of millionaire earners in New York's PIT base has been getting smaller since 2000, including decreases every year since 2008, as shown in Figure 3. The steepest drop in the resident payer category has been among those with incomes of \$10 million or more, where the resident share was just 39 percent as of 2016. Nonresidents don't pay New York taxes on their capital gains and dividends, or wages and salaries earned outside New York, and their effective New York income tax rates are much lower.

Governor Cuomo has begun calling urgent attention to the state's heavy reliance on the top 1 percent and to the risk that more high earners will move in response to the SALT cap. Unfortunately, his budget heads in a contradictory direction by extending the millionaire tax.

In another move that would run counter to Governor Cuomo's warning against raising taxes on high earners, the governor has revived his 2018 proposal to impose an enormous state tax penalty on a particular type of income, known as "carried interest," commonly collected by managers of private equity and hedge funds.<sup>4</sup>

Part Y of the revenue bill would recharacterize carried interest as taxable New York source income from a trade or business, and further subject that income to a

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<sup>4</sup>As the Tax Policy Center describes it: "Carried interest income flowing to the general partner of a private investment fund often is treated as [lower-taxed] capital gains for the purposes of taxation. Some view this tax preference as an unfair, market-distorting loophole. Others argue that it is consistent with the tax treatment of other entrepreneurial income." The new federal tax law closed part of the so-called "loophole" by requiring a three-year holding period for investment gains to be classified as carried interest. <https://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-should-it-be-taxed-capital-gain>



17 percent “fee.” Implicitly acknowledging the likely taxpayer response to a 200 percent tax increase, the bill would not take effect unless similar legislation is adopted by the neighboring states of Connecticut, Pennsylvania, Massachusetts and New Jersey.

The governor’s bill memo does not include a revenue estimate for the carried interest proposal, and the Executive Budget financial plan apparently does not anticipate its adoption. But you don’t have to support the federal tax treatment of carried interest to spot the problem with even considering such a punitive proposal on a state level. This proposal is essentially designed to stigmatize some of the most highly paid taxpayers in New York, a relatively small group of people who collectively pay hundreds of millions of dollars a year into the state treasury. No highly portable industry can be expected to sit still for a targeted 200 percent tax increase.

In light of the structural issues I’ve cited here, the Legislature should:

- Reject the governor’s proposal for a five-year extension of the full 8.82 percent millionaire tax, and instead schedule a phased-in, multi-year reduction of the tax with the goal of returning it to the permanent-law 6.85 percent level.
- Reject the proposed carried-interest tax penalty.
- As assumed in the financial plan, continue to phase in already scheduled personal income tax reductions for middle- and upper-middle-income brackets, enacted in 2016 and due for full implementation in 2025.

In addition, the Legislature should consider:

- Recoupling the Empire Child Credit to the increased level and expanded income limits for the federal Child Credit, which would raise the maximum credit



to \$666. The \$500 million cost of this change can be covered by eliminating another state tax break that was supposedly intended to help working families but is far less effectively targeted: the sales tax exemption on clothing purchases under \$110.

- Beginning a long-term rollback of the New York Estate Tax, starting with the tax rate “cliff” inadvertently created by the 2014 reform of the law.

One final recommendation tied to the state budget deals with an issue of overriding importance to local taxpayers. Part G of the governor’s Public Protection and General Government Article 7 revenue bill includes a provision making permanent the state cap on local property tax levies, which has been a temporary provision of the rent regulation law since 2011.

The case for a permanent cap – with no added exclusions or loopholes – is clear and overwhelming. The tax cap has been working, saving property owners billions of dollars a year. The new federal tax law makes this restraint more important and valuable than ever.

The bottom line: do not delay. Make the tax cap permanent as soon as possible.

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## APPENDIX

TABLE 1

<b>Marginal Effective Tax Rates in New York City</b>		
Federal-state-local tax on added dollar of earned income in highest bracket		
	Current Law	Tax bill
Top state-local rate net of deductibility	7.67%	12.70%
Impact of Pease deduction limit	1.18%	0.00%
Regular federal income tax rate on labor income	39.60%	37.0%
<b>Combined top rate on salary, wages, bonus income</b>	<b>48.45%</b>	<b>49.70%</b>
<i>For self-employment income in highest bracket, add</i>		
MTA mobility tax	0.34%	0.34%
Net Medicare tax on self-employed	3.23%	3.23%
<b>Combined top rate on self-employment income</b>	<b>52.02%</b>	<b>53.27%</b>

FIGURE 1

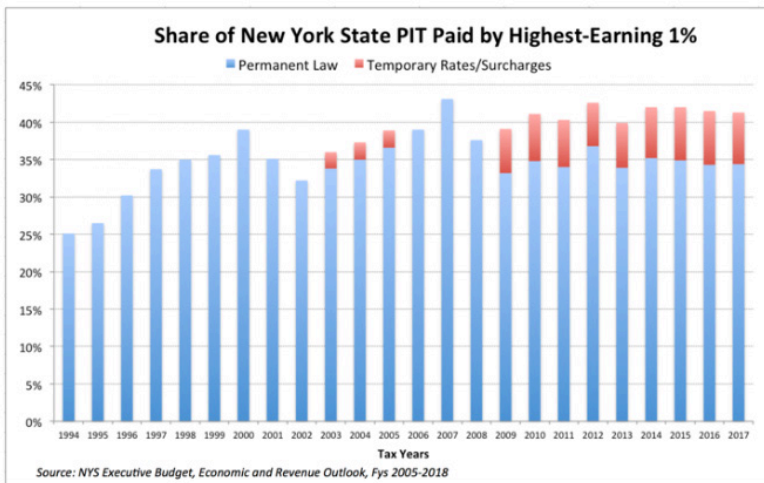




FIGURE 2

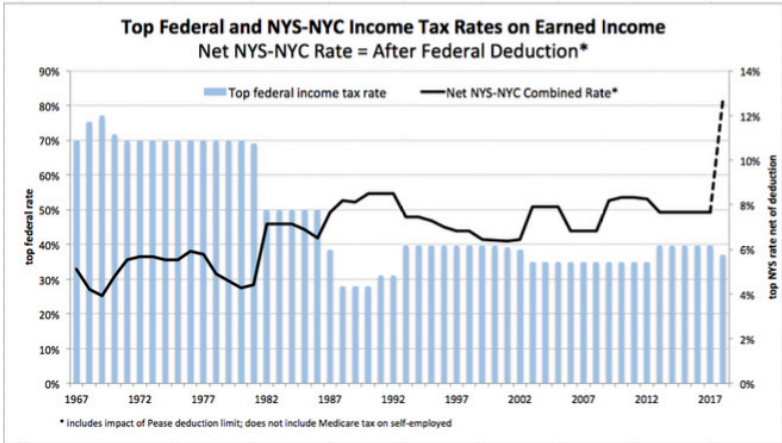
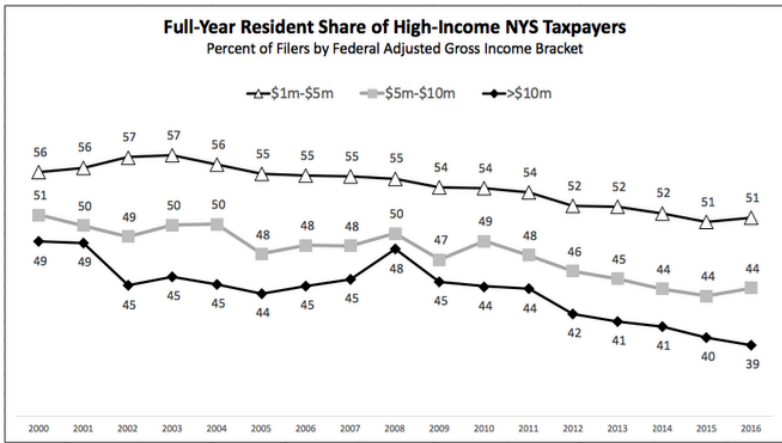


FIGURE 3





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