F I S C A L P O L I C Y I N S T I T U T E
1 LEAR JET LANE / LATHAM, NEW YORK 12110
(518) 786-3156 - www.fiscalpolicy.org

Testimony

of

Frank J. Mauro
Executive Director
Fiscal Policy Institute

before the

Senate Finance and Assembly Ways and Means Committees

Joint Public Hearing on

Economic Development/Taxes

February 26, 2002

In presenting his Executive Budget for the 2002-2003 state fiscal year, Governor Pataki said that "no challenge has ever been so great as the one before us now." This is a statement with which virtually all New Yorkers and all Americans can wholeheartedly concur.

The destruction of the World Trade Center on September 11th has had an incredible impact on New York's economy and on the finances of the New York State and New York City governments. While the exact magnitude of the state tax revenue losses attributable to this disaster can not be calculated with any degree of precision or certainty, we know that they are substantial.

In early October, Governor Pataki unveiled a comprehensive $54 billion plan to "Rebuild NY - Renew America" that called on the Federal government to assist New York in recovering from the September 11 attacks on the World Trade Center. $12 billion of this $54 billion related to what the Governor referred to as "Economic Restitution for New York City and State."

According to the Governor, "The destruction in lower Manhattan disrupted or eliminated revenue sources that support the day-to-day functions of the City and the State. The financial services industry, which were most directly and profoundly impacted by the attacks, is by far the most important industry to the State and the City in terms of generating taxable incomes for both individuals and corporations, and is one of the primary engines for the national economy."

After indicating that the New York state and New York City governments could experience revenue losses of as much as $12 billion -- $3 billion for the City and $9 billion for the State --

during the next 18 months, Governor Pataki argued that “both will require unrestricted Federal aid to maintain . . . the level of vital public services that existed prior to September 11th as required under State and City statutes, while also addressing the extraordinary needs in the wake of the terrorist attacks.” The Governor’s 2002-2003 Executive Budget clearly underscores the foresightedness of his October 2001 request to the federal government. In the absence of federal reimbursement for tax revenue losses directly attributable to the international attacks, the Governor is having to propose such extraordinary actions as freezing the major components of state aid to education at their 2001-2002 “bare bones budget” levels. It is eminently clear that the state’s school districts (particularly high needs school districts that rely on state aid for significant portions of their budgets) will not be able to provide the same level and quality of educational services in 2002-2003 as they provided in 2000-2001 under such an arrangement unless they substantially increase local real property taxes. As the Governor’s October plan indicated, local school boards should not be put in the position of having to choose between two such unacceptable alternatives.

The dollar amounts presented in the Governor’s October 2001 plan, were based on the NYS Budget Division’s initial estimates of the impact of the September 11th attacks on state revenues. At that time, the Budget Division was estimating that the revenue losses during the remainder of the current fiscal year (September 11, 2001 to March 31, 2002) would be between $1 and $3 billion and that the losses during the 2002-2003 state fiscal year would be between $2 and $6 billion. Adding these two figures together, the Budget Director pegged the tax revenue losses for the two fiscal years at between $3 and $9 billion. In ordinary times, such a range in revenue estimates would be unacceptable. But in attempting to estimate the impact of the World Trade Center disaster, all analysts both in and outside of government, were operating in uncharted territory. They were trying to estimate the impact of factors that were unprecedented and which just a few months earlier would have been unimaginable.

As time has passed and more data has become available, the Budget Division has sharpened its estimates - now estimating that state revenues will be down by $1.1 billion during the current fiscal year and by about $4 billion during 2002-2003 as a result of the World Trade Center disaster, for a two-year total of $5.1 billion. Within the context of President Bush’s reaffirmation of his commitment to providing at least $20 billion to New York for World Trade Center-related losses and recovery and rebuilding costs, New York’s public and private sector leaders and the members of the state’s congressional delegation should work expeditiously to secure federal funds for the estimated revenue losses. As detailed in greater detail in the recommendations section of this report, those funds should be provided on an advance basis so that the state does not have to implement greater than necessary spending cuts and/or tax increases. The actual amount of federal reimbursement should be based on the careful and cooperative application of statutorily established standards. The enactment of such legislation would ensure that New York State is treated fairly in the aftermath of the World Trade Center disaster and that if any other state is ever the subject of such an attack, that it will also be treated fairly.

The Stafford Act - the law that establishes the Federal Emergency Management Agency and governs the provision of federal disaster assistance - has been refined over the years to deal with floods, earthquakes and hurricanes. This law, as currently written, does not provide an appropriate framework for federal assistance in the case of war-like attacks such as those of September 11th. As Governor Pataki and other state leaders have emphasized, the attack on the World Trade Center was an attack on the entire country and not just on New York.

There is also an important constitutional distinction between the federal government's responsibilities in the case of emergencies of the kind that are covered by the Stafford Act and its responsibilities in regard to war-like events such as the World Trade Center attacks. In drafting and agreeing to the U. S. Constitution, the founding states ceded significant powers to the new national government. One of the important considerations that the states received in return was that the new national government would "provide for the common defence." More specifically, in regard to instances such as those of September 11th, Article IV Section 4 of the Constitutions guarantees that the United States shall protect every state in the union against invasion. It is clearly a good thing that the federal government provides assistance to state and local governments in the case of fires, floods, explosions and natural catastrophes that are determined by the President to be major disasters. But the obligation of the federal government to the states in the case of a foreign attack is of a higher constitutional order.

The loss of lives, the closing of businesses - some temporarily and some permanently, the loss of customers and revenue, and the relocation of some businesses to New Jersey and Connecticut in order to keep operating in the face of the loss of over 25 million square feet of prime office space, and related reductions in important parts of the state's tax base, such as Wall Street bonuses, have combined to cause major reductions in the state's main revenue source - the personal income tax. Corporate and sales taxes have also been hit hard. To accommodate the losses involved without federal assistance would mean that New York would have to enact spending reductions and/or tax increases taxes by that amount thus causing additional damage to the state's economy. It is neither logical nor consistent with the federal government's responsibilities under the U. S. Constitution for a single state to have to run its economy into the ground in order to deal with the fallout from a national defense disaster.

This does not mean that New York should be given special treatment. While we have never before had to deal with such terrorist attacks on American soil, we now know that such attacks are possible. And, we should put into place laws that will treat New York, and any other areas that might bear the brunt of such attacks in the future, in a fair and equitable manner.

Rather than thinking about this as if it is a matter of dealing with a single state with a special problem, Congress and the President should agree on a general law that specifies the kinds of costs that the federal government will pick up in the case of a war-like invasion of this type. Such a general law should then guide what the federal government does in the current New York case and what it would do in case any other part of the country is ever the target of such a foreign attack.

The Current Challenge. The Executive Budget estimates that New York State faces a $5.7 billion budget gap during the upcoming 2002-2003 state fiscal year. The bulk of this gap (about $4 billion) is attributed to the revenue shortfall resulting from the September 11, 2001, attacks on the World Trade Center. It is essential that the federal government reimburse New York State for the revenue losses that are directly attributable to this international incident. In the absence of such assistance New York State and New York City will have to do additional damage to their economies by increasing taxes or cutting services more than would otherwise be necessary. No state should have to run its economy into the ground to compensate for what is clearly a national responsibility.

To the extent that there are budget gaps that are not closed with federal assistance, the state should close those gaps in ways that do the least possible damage to the state's economy during the current economic downturn. Recommendations for actions of this type are also outlined below.

In addition to the revenue shortfall that the state faces as a result of the September 11th disaster, it also faces a so-called structural deficit - estimated by the Executive Budget at about $1.7 billion for the upcoming state fiscal year. A "structural deficit" is the difference between the revenues that the present tax system is likely to generate during a future fiscal year and the expenditures that are necessary during that year to continue to provide services at their current levels. The Governor's Executive Budget, using somewhat conservative methodology for calculating future baseline expenditures, estimates New York's structural deficit for 2002-2003, before taking the effects of September 11th into consideration, at about $1.7 billion.

On the one hand, this gap would be much larger if "current services" had not been cut back so much over the last decade. On the other hand, this gap would be much smaller, or nonexistent, if New York State had been only slightly less generous in its multi-year tax cutting. For example, if the state had enacted only 87% of the tax cuts that it actually adopted over the last eight years, there would be no structural deficit and Governor Pataki would still be able to brag about the largest multi-year tax reduction program in the history of this or any other state - $11.7 billion during the upcoming state fiscal year and an estimated $59 billion during his eight years in office.

In finalizing a state budget for the 2002-2003 fiscal year, the Governor and the Legislature should deal with both of these challenges. While they may attempt to sidestep the long-term problems created by the overly ambitious, overly generous multi-year tax cuts, they will not be able to avoid dealing with the immediate, and hopefully short-term, budget gaps caused by the recession and the September 11th disaster.

Balancing the state budget during the current recession. During a recession, unemployment increases, the number of hours worked declines, consumer spending declines, etc. This translates into a reduction in government tax revenues - sometimes absolutely and almost always in terms of the rate of growth. Some aspects of government spending, particularly spending on safety net programs like unemployment insurance, income support programs, and Medicaid, also increase during recessions as an increasing number of workers are laid off. With revenues declining and some expenditures increasing, states and localities almost always face increasing budget deficits during recessions.

But because of its balanced budget requirement, New York like the other 48 states with balanced budget requirements of one kind or another, is almost always forced to cut spending and/or increase taxes during a recession. Unfortunately, cutting state spending and/or increasing state taxes during a recession serves to make the situation worse rather than better. It is also the opposite of what the federal government is doing to stimulate the economy and serves to cancel out the impact of some or all of those federal actions.

Federal Assistance - for the states Generally and for New York State specifically. In the current economic stimulus debate at the national level, the National Governors Association and others have succeeded in making this dilemma, at least tentatively, part of the debate. The original economic stimulus bill advanced by President Bush and the House Republicans would have made the situation facing the states worse rather than better. It did this by including some tax deductions for business that would automatically pass through to the corporate tax systems in New York and virtually all of the other states. While these provisions are still on the table in Washington, the majority parties in both houses have included some offsetting aid for the states (in the form of temporary increase in the federal government's share of state Medicaid costs) in the latest versions of their economic stimulus packages. The challenge for New York is to work to ensure that the Congress passes an economic stimulus package that reduces rather than increases the magnitude of the spending cuts and/or tax increases that must be implemented at the state level.

The United States has never before had to deal with the effects of terrorist attacks on American soil. The country now knows that such attacks are possible. And, the Congress should put into place laws that will treat New York, and any other areas that might bear the brunt of such attacks in the future, in a fair and equitable manner.

Rather than thinking about this as if it is a matter of dealing with a single state with a special problem, Congress and the President should agree on a general law that specifies the kinds of revenue losses that the federal government will cover in the case of a war-like invasion of this type. Such a general law should then guide what the federal government does in the current New York case and what it would do in case any other part of the country is ever the target of such a foreign attack. It should include, at a minimum, restoration of tax revenues lost due to the direct impact of the attack.

Since we do not know if the Executive Budget's estimate of these revenue losses will prove to be correct, the federal and state governments should proceed in the following manner. The federal government should provide a $5 billion advance to New York State based on the Governor's estimate of the directly related revenues losses during the 18 months following September 11. The technical staffs of the appropriate federal and state agencies should then jointly apply the criteria established by Congress to determine the actual "directly related" tax revenue losses. If this figure turns out to be greater than the $5 billion advance, the additional amount should be provided to the state. If it turns out to be less, the difference should be converted to an interest free loan that New York would be required to repay over a reasonable number of years.

Closing the remaining budget gap in a fair, balanced and economically sensible manner. While federal assistance and one time revenues (from rainy day funds or "gimmicks" such as tax amnesty programs) can reduce the size of the recession-generated budget gap that the state must close, it is unlikely that New York will be able to get through the current recession without some spending cuts and/or tax increases. In this context, the key challenge involves choosing that mix of spending cuts and/or tax increases that will do the least harm to the state's economy during the current economic downturn.

A sound framework for evaluating these difficult choices is provided by Joseph Stiglitz, a professor of economics at Columbia University and one of the recipients of the 2001 Nobel Prize in economics, and Peter Orszag of the Brookings Institution. In a recent paper published by the Center on Budget and Policy Priorities, Siglitz and Orszag point out that while some state officials apparently believe that reducing spending is preferable to raising taxes, "economic analysis suggests that tax increases would *not* in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption."[1]

For example, if taxes increase by $1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is reduced in the short run. By contrast, some types of spending reductions would reduce demand in the economy on a dollar-for-dollar basis and therefore would be more harmful to the economy than a tax increase.

Applying this basic set of economic principles, Stiglitz and Orszag conclude that "direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction. The reason is that some of any tax increase or transfer payment reduction would reduce saving rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption."

In comparing tax increases and reductions in transfer payments, the impact on the economy depends primarily on the propensity to consume of the households affected. A recent Congressional Budget Office report noted that, "As a general proposition, higher-income households save more of their income than do lower-income households. Although occasionally some data emerge to indicate otherwise, a large accumulation of evidence continues to show that as a household's income rises, the proportion of that income that is consumed falls."[2] The more that tax increases and transfer payment reductions are focused on those with lower propensities to spend (that is, on those who spend less and save more of each additional dollar of income), the less damage is done to the weakened economy. Since higher-income households tend to have lower propensities to spend than lower-income households, the least damaging approach in the short run involves tax increases concentrated on higher-income households.   Across the board tax increases and reductions in transfer payments to low-income families would generally be more harmful to the economy than increases in taxes on higher-income families.

Stiglitz and Orszag also point out that these arguments are even stronger for state policymakers who are more interested in the impact of policy options on their own state's economy than on the national economy. "In particular, government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses. . . . By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers – since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced *out of state*." They also point out that this is particularly true for expenditures by high-income households, who "appear to consume

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[1] Peter Orszag and Joseph Stiglitz, ***Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?***, Center on Budget and Policy Prioriteis, November 6, 2001.

[2] ***Economic Stimulus: Evaluating Proposed Changes in Tax Policy***, U. S. Congressional Budget Office, January 2002.

relatively more goods and services produced in other regions of the country (or abroad) than lower-income families do."

As New York policy makers consider options for balancing the state's budget during the current economic downturn, Stiglitz and Orszag present the following policy relevant conclusions:

> 1. Tax increases on higher-income households are the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run.
>
> 2. Given the existence of balanced budget rules at the state level, some form of federal fiscal relief to states is warranted since state spending reductions or tax increases would be counter-productive at this time - restraining the economy at a time when it is already slowing.

Reestablishing a Fair Tax System. Suggestions for pursuing the second of these two conclusions were presented above. An approach to implementing the first of these two conclusions can be drawn from North Carolina. Last Fall, North Carolina policymakers, as part of an effort to deal with the impact of the recession on their state's budget, adopted legislation increasing that state's top personal income tax rate from 7.75% to 8.25% for three calendar years - 2001, 2002 and 2003. New York's top personal income tax rate is currently 6.85%.

We estimate that a surcharge of seven tenths of one percent (.007) on the portions of a taxpayer's New York Adjusted Gross Income above $100,000 and another seven tenths of one percent (.007) on the portions above $200,000 would generate between $2.7 and $3 billion per year (depending on the accuracy of the Division of the Budget's projected decline in personal income tax receipts) . Imposing such a surcharge for two years (2002 and 2003) would temporarily raise New York State's top tax rate to the same level as North Carolina's top rate.

If the legislature wanted, for example, to fund a $1 billion increase in school aid, it could do so with surcharges of one third those levels. Or, if it wanted to fund a restoration of the Governor's proposed $235 million cut in the TAP program, it could do so by enacting surcharges of this type of six one hundredths of one percent (.0006) on the portions of a taxpayer's Adjusted Gross Income above $100,000 and another six one hundredths of one percent (.0006) on the portions above $200,000. (Ask any economist to compare the impact on the economy and on society of $1,156 per year reductions in the tap awards of SUNY students from families with annual incomes of $20,000 with the impact of increasing the income taxes of a family with income of $150,000 by $30 per year.)

New York State has a great deal of room within which to implement a "fair tax" solution, because tax changes that made the system less fair and less adequate are at the root of the problem. The personal income tax cuts enacted in the last several decades have proven to be both unfair and unaffordable. The cuts were basically "off the top," reducing New York's highest marginal tax rate from 15.375 percent to 6.85 percent. Before the 1987 tax cuts, the state's top rate was 13.5 percent on investment income and 9.5 percent on wages, salaries and business income. By restoring only a small portion of the progressivity that was eliminated by the 1987 and 1995 tax cuts, approximately $2 billion could be generated for socially and economically productive investments in the state's human and physical infrastructure. The personal income tax is still progressive but it is less progressive than in the past and, thus, less able to balance out the regressivity of the local property and state and local sales taxes.

In 1960, New York State had 10 brackets, running from 2% through 10%. In 1968, the state added four additional brackets (11% through 14%) and, in the early 1970s, it added a 15% bracket and a temporary surcharge that effectively increased the top rate to 15.375%. Today, the state has five brackets running from 4% through 6.85%. For most taxpayers, this bracket compression, together with the erosion of the value of the dependent exemption and the elimination of the personal exemption for taxpayers' themselves, has more than offset the benefits of the increases in the value of the standard deduction.

Comparing New York State's current personal income tax system with the system that existed in the 1960s, we find that the benefits of the personal income tax cuts of the last twenty years went overwhelmingly to those with the highest incomes. For the purpose of evaluating the impact of these changes, we adjusted the 1960 bracket structure, and the personal exemptions and standard deductions that existed in 1960, for the changes that have occurred in the value of the dollar between 1960 and 2001. The result is that moderate and middle income taxpayers pay more under the current system than they would pay under an updated "1960 system" and the state's wealthiest taxpayers pay much less. One change of recent years, the adoption of a State Earned Income Tax Credit EITC), has given substantial tax relief to low income taxpayers with children. Our analysis finds that if the current State EITC were added to the updated "1960 system" that only high income taxpayers are better off under the current system. Outside the EITC range, the differences are stark. For example, a typical single parent with two children earning $50,000 in 2001 will be paying approximately $1,820 in taxes under current law. Under an updated "1960 system," this taxpayer would pay $690.

Eliminate Corporate Loopholes That Don't Create Jobs. The state's corporate income taxes have become more and more like swiss cheese. General business corporations for example, have gone from carrying over 10% of New York State's tax load in the late 1970s to less than 4% today.

The state's annual Tax Expenditure Report shows that business corporations receive an over $1.6 billion in tax breaks each year. The Pataki Administration has attempted to solve this "problem" by dropping many of the state's corporate loopholes from this annual accounting. In addition, untold millions more are lost via transfer pricing and other techniques used by large, multi-national corporations to avoid paying their fair share of taxes. New York could reduce leakage from these tax preferences if it strengthened its Alternative Minimum Tax (AMT).

New York's current AMT was enacted in 1987 as part of a general corporate tax reform. The AMT was intended to curb the impact of specific loopholes but not allowing their use to cut a corporation's franchise tax below a certain level. Beginning in 1994, however, the state began to add loopholes to the AMT itself and to cut the AMT rate. The state should eliminate all of the loopholes that have been added to the AMT and restore the AMT rate to 3.5% from the current 2.5%.

Add Accountability to the State's Wide Array of Tax Incentives. Many of the tax cuts enacted in recent years were sold as efforts to encourage the creation of jobs in areas of New York State where job creation is needed and where it would otherwise not occur. While this goal is obviously laudable, it ignores the experiences of this and other states with such efforts to use the tax code for "social engineering." Even more shocking has been the Pataki Administration's use of the rulemaking process to allow Empire Zone boundaries to be amended to include noncontiguous parcels in prosperous suburban areas. A program designed to steer development into socioeconomically distressed urban and rural areas is now being used to reward favored firms in areas that would never on their own meet zone criteria.

As part of a general clean up of the state's tax laws, it is essential that certain basic "common sense" safeguards be added to the state's growing list of economic development tax incentives:

> Tax credits created in the name of job creation should include accountability mechanisms to ensure that the promised job creation actually materializes.
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> Tax credits designed to help areas with poorly performing economies should have logical criteria and should not write into permanent law criteria that make permanent some notion of what those underperforming areas may be at a particular point in time.
>
> Tax credits or other government largesse should not be used to encourage or to reward the creation of jobs at or below the poverty level. Doing this only drives more money out of the federal, state and county treasuries in the form of the income supports that our society appropriately provides to the working poor.
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> Subsidies should not go to firms that violate environmental, worker safety, or other laws.
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> In the new information-based economy, investing in K-12 education; ESL, GED, and adult literacy programs; and, training for incumbent workers has greater pay-off than subsidies for low-wage jobs. Education must be protected from corporate welfare.
>
> Retail and service businesses that serve local markets should not be subsidized except in extreme cases.
>
> No subsidies should be given for intrastate relocations.

Enact a Corporate Disclosure Law. A growing number of corporations use transfer pricing and a variety of other subterfuges to minimize the percentage of their net income that is subject to tax by any state. New York State should require every publicly-traded corporation that does business in the state to report its gross and net income, deductions and credits, and the amount of New York state taxes paid, much as corporations already do at the federal level. This would allow taxpayers and policy makers to identify companies in the state that may be making profits but, through the use of clever business structures and tax expenditures, are paying little or no New York taxes. Only with that information can the state truly know how well its tax policies are working. The Securities and Exchange Commission, as part of its response to the Enron scandal, should require every publicly-traded corporation to file, as a supplement to its annual report to stockholders, a 50-state spreadsheet that shows its allocation of property, payroll and sales among the states and its tax payments to each of the 50 states.

Defer the scheduled tax cuts to minimize the amount of real service cutting and tax and fee increasing that will be necessary to balance this year's budget. The tax cuts that are currently on the books will reduce state revenues by $13.3 billion during the state fiscal year that begins on April 1, 2002, and by an estimated $15.6 billion when fully implemented in 2005-06. The Executive Budget that Governor Pataki recently submitted (and the budget that the State legislature is charged with adopting over the course of the next several months) has to accommodate about $310 million in new tax cuts. Most of these tax cuts are attributable to cuts in the NYS corporate income taxes, already among the least onerous and most loophole-ridden of any state's corporate income taxes.

At the very least, the Governor and the Legislature should temporarily suspend the new corporate income tax cuts that are scheduled to take effect during 2002 and during subsequent years. Alternatively, they could leave these tax cuts on the books but eliminate their implementation dates pending a thorough review by a Blue Ribbon commission consisting of representatives of the executive and legislative branches as well as independent experts from outside of government. This review should include an analysis of the overall fiscal and economic implications of the tax cuts implemented over the last eight years and of those scheduled to take effect in the future. It should also include a review of the interaction of the increasing number of special economic development credits that have been established in recent years for businesses that are involved in particular types of economic activity and/or that locate in particular parts of the state. Many of these credits are for related purposes and have similar but not identical requirements. The result is that some firms, for the same activity, may be eligible for several different credits, all of which may have job creation as their goal, but with no (or inconsistent) accountability or reporting requirements. If the state is going to provide tax breaks in the name of "job creation," it should work to ensure that the state's taxpayers get what they are supposedly paying for.