FISCAL POLICY INSTITUTE
1 LEAR JET LANE · LATHAM, NEW YORK 12110
(518) 786-3156 · www.fiscalpolicy.org

Testimony
of
Frank J. Mauro
Executive Director
Fiscal Policy Institutee

before the

Senate Finance Committee and the Assembly Ways and Means Committee

Joint Public Hearing on

The 2009-2010 Executive Budget Proposal and Workforce Issues

February 4, 2009

Thank you for inviting us to present testimony on this important subject. The 2009-2010 Executive Budget as proposed by Governor David Paterson proposes to balance the state's revenues and expenditures during the upcoming fiscal year in ways that would both directly and indirectly reduce the level of employment in New York State, through cuts in state operations, aid to education, other aid to local governments, health care funding, aid to nonprofit service providing agencies. Such reductions in employment would exacerbate the current recession much more than would alternative approaches to balancing the state budget for 2009-2010 and beyond.

The financial meltdown and the recession have thrown state budgets out of whack across the country. Plummeting revenues have given New York State a projected budget gap of $13 billion for the new fiscal year that will begin on April 1, 2009. But New York is not alone in this situation. The combined deficits of state governments throughout the country through 2010 are predicted to reach a staggering $350 billion, according to the Center on Budget and Policy Priorities.

Meanwhile the recession is taking a toll on people across our state and nation. Here in New York, tens of thousands of New Yorkers have lost their jobs, their homes or their hopes for a secure retirement or a better future for their children. New York's unemployment rate jumped by a full percentage point in December to 7 percent, the greatest one-month increase on record since 1976. The state has lost 121,000 jobs since its August 2008 job peak. More than 50,000 New Yorkers lost their homes through mortgage foreclosures last year.

As the economic damage ripples out from Wall Street, Gov. David Paterson has proposed real cuts of over $9 billion in state agency spending, school aid, other aid to localities, health care, SUNY and CUNY, child care, program for the elderly, homeless prevention and numerous other programs. All of these cuts, if approved by the legislature, will mean job reductions which in turn will result in further reductions in consumer spending at a time when the economy is already declining.

Anti-government voices have mounted a steady drumbeat calling for steep budget cuts, ostensibly to rein in “out of control” state spending. The reality? State spending has increased to fund important new commitments such as providing medical care to people without health insurance and aiding urban school districts with high concentrations of children from poor families. The state government also dramatically expanded spending on property tax relief and acted to partially undo years of underinvestment in mass transit and public higher education. All of those gains are now at risk. But, aside from these major commitments, state spending from 2004 to 2008 grew at less than 2.9 percent a year, barely the pace of consumer inflation.

What the state failed to do, however, was provide the revenues needed to finance such initiatives through the ebbs and flows of the business cycle. Much of the state’s current budget crisis might have been averted had the state reversed even part of the tax-cutting spree carried out from 1994 through 2000. All tolled, these cuts now reduce the state’s tax revenues by about $20 billion a year, an amount that would erase even the huge projected budget gaps of $17 billion for 2011 and 2012.

Like the other 49 states, New York has to balance its budget in both good times and bad. Facing a sizable budget gap during a recession, states have only bad choices. Neither cutting spending nor raising taxes eases the downturn.

Many economists, however, point out that it is less harmful to the economy to raise taxes in a way that limits its effects largely to high income people than to cut state spending that mainly benefits low- and moderate-income people or that pays the salaries of teachers, police officers and other civil servants. In December, 120 economists from across the state sent a letter to Paterson saying, “Economic theory and historical experience [show] it is economically preferable to raise taxes on those with high incomes than to cut state expenditures.”

This is because high earners typically spend only a fraction of their incomes in any given year, saving the rest. On the other hand, state spending goes to pay workers, provide services and put money in the hands of New Yorkers in need. This means the money goes directly into the economy, priming the pump at a time when it is desperately needed. Nobel Prize-winning economist Joseph Stiglitz of Columbia University made the same point in a letter to the governor last March.

Public opinion across the state strongly favors increasing income taxes on high earners over cutting spending for health care and education. The governor, though, has argued that raising taxes on the wealthy will drive them from the state.

No evidence exists to support that claim. In 2003, New York temporarily raised its top income tax rate from 6.85 percent to 7.7 percent. During the three years that this increase was in effect, the number of high-income returns grew significantly. This experience in New Jersey, which permanently raised its top personal income tax rate to 8.97 percent in 2004, has been similar, according to a Princeton University study.

In addition to its investments in infrastructure, unemployment insurance modernization and other measures, the massive economic recovery bill now making its way through Congress includes about $150 billion in “state fiscal relief,” for the explicit purpose of helping states balance their budgets without putting too much additional drag on the economy. Since this legislation is likely to go to President Barack Obama for his signature in mid to late February, the sensible course would be for Paterson and the legislature to wait to see exactly how much “budget balancing” aid New York will receive under the final legislation. The chances are excellent to certain that the state will get several billion dollars it can use right away, since important parts of the “state fiscal relief” is retroactive to Oct. 31, 2008. But even if the New York receives $6 billion in budget balancing aid from the federal government that it can use in 2009-2010, this will not completely close the state’s projected budget gap for this upcoming fiscal year.

It is unlikely that the federal government will provide enough fiscal relief to the states to completely eliminate the need for some painful budget balancing actions by the states themselves and by their local governments. The key challenge for the states involves choosing that mix of spending cuts and/or tax increases that will do the least harm to the state’s economy. A sound framework for evaluating these difficult choices was provided in an important 2001 policy paper 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, then of the Brookings Institution, more recently the director of the Congressional Budget Office and now the director of the U.S. Office of Management and Budget. In that 2001 paper, 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.” Applying basic 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 (reductions in) government spending on goods and services would directly reduce consumption.”

Raising taxes on high earners would also be a step toward restoring fairness to New York’s graduated income tax, which has become significantly less graduated over the years. Today, because of the state’s increased reliance on regressive sales and property taxes, New York's middle- and lower-income households pay a higher share of their incomes in state and local taxes than the top 1 percent or the top 5 percent.

Moreover, as astounding as it may seem, data indicate that all of the income growth in New York State from 2002 to 2009 has gone to the wealthiest 5 percent. In 2009, the other 95 percent of households have roughly the same incomes they had in 2002. When you factor in inflation, the combined income of the bottom 95 percent of New Yorkers actually shrunk.

Nobel Prize-winning economist Paul Krugman recently wrote in his New York Times column that, in the absence of Obama's massive stimulus proposal, we might see 50 Herbert Hoovers in state houses across the country respond to revenue shortfalls by slashing their budgets or raising regressive taxes, making the economy worse in the process. The new stimulus program is designed, in part, to head off that result. For the part of the budget gap that cannot be closed through federal funds, the state should turn to progressive tax policies. This is the right economic policy, sound fiscal policy, and the only approach in keeping with the governor's theme of "shared sacrifice."