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ONE LEAR JET LANE, LATHAM, NEW YORK 12110
(518) 786-3156 • www.fiscalpolicy.org

Testimony of
Frank Mauro, Executive Director
Fiscal Policy Institute

Before the

Senate Standing Committee on Finance

and the

Senate Standing Committee on Investigations and Government Operations

Joint Public Hearing to

Review Existing Tax Policy and Discuss Reform Initiatives

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Thank you very much for the opportunity to present this testimony on New York State's tax system and some options for reforming that system.

A thorough review of the tax system is certainly in order from a number of perspectives. Back in December 2011, the Governor and the legislative leaders joined in calling for a thorough review of the fairness of the New York tax system,[1] and that is certainly one important basis for evaluating the workings of any tax system. But two other criteria—adequacy and stability—are also important. It is difficult to say that one of these three criteria is more important than the other two. Governors and legislators have to try to achieve all three objectives simultaneously. The result is that making state tax policy is a very difficult balancing act.

In addition to these three traditional values of a high-quality tax system, policymakers also yearn for a tax system that will encourage the creation and retention of jobs and broadly shared prosperity. This is easier said than done. Just because a policymaker's heart is in the right place doesn't mean that the policies that he or she advances will work as intended. Just think of the legacy costs that New York was left with when it moved to correct and later when it moved to end failed programs like the Job Incentive Board program and the Empire Zones program.[2]

Hopefully, we have learned from these experiences and will be careful before launching new programs that can incur significant obligations with little to show for it. We are on the verge of doing that right now unless we take a deep breath and rethink the Start-up New York program before launching it.[3] The same goes for the minimum wage reimbursement credit that was enacted as part of the 2013-14 budget agreement and which is scheduled to take effect in January 2014.[4]

From the perspective of family tax burdens, policymakers also need to rethink the $350 family rebates before those checks are put in the mail. If we have $410 million to spend on family tax relief in each of the next three years, wouldn't it be better to focus on an effective form of relief for those homeowners and renters who are most overburdened by residential property taxes.

It is good that you are having public hearings at which organizations like ours and the others that are speaking to you today have a chance to share ideas with your two committees. But it is also important to hear from both the public and from academic experts in the relevant fields of study. It is also important that you consider the work of the Governor's Tax Reform and Fairness Commission. In some cooperative way, the Senate, the Assembly and the Governor should review the overall revenue adequacy and stability of New York State's state-local tax system along with a review of the overall distributional impact of that system on people at different income levels.

It is also important to remember two additional points. First, both sides of government budgets—the revenue side and the expenditure side—have an impact on the economy and we sometimes forget that government provides the basics—education, infrastructure, clean water, etc.—that allow the free market economy to flourish.[5] Second, and very related to the first, the state-local tax system is one system, not two separate and independent systems. In the American system of government, it is the states that determine the division of labor between themselves and their local governments.

New York's tax system (like every state's tax system) is a combination of some state taxes and some local taxes with some of those taxes being regressive and others being progressive. While it is interesting to examine the distributional impact or fairness of individual taxes, the much more important question is the fairness or distributional impact of the state-local tax system as a whole.

In New York, local governments are responsible for raising a large share of the revenue necessary to support needed public services and this places great pressure on the property tax base. With the imposition by the state in 2011 of a cap on local property tax levies, it is more important than ever for the state government to honor its traditional commitments to cover a reasonable share of the costs of essential public services through adequate funding of "revenue sharing" with general purpose local governments and adequate state aid to school districts. Decisions about state tax rates and tax credits indirectly determine how much pressure is placed on the property tax base and whether or not local governments will be able to meet their service responsibilities.

The Personal Income Tax (PIT) Bracket and Rate Structure

It is important to recognize that a progressive income tax is good, not bad for the economy; and that a progressive income tax makes it possible to reduce the pressure on the property tax. In the early 1970s, New York State had a personal income tax system with 14 brackets with rates ranging from 2 percent to 15 percent. In some of those years, the state also had a 2.5 percent surcharge making the system's top marginal rate 15.375 percent.

By 1997, that top rate had been reduced by more than 50 percent to 6.85 percent. The "permanent law" tax system since 1997 has had five brackets—all within a very narrow range, from 4 percent to 6.85 percent, with the top rate applying to taxable income (i.e., income after adjustments, exemptions and deductions) above $20,000 for single individuals and above $40,000 for married couples filing joint returns.

Temporary higher rates, kicking in at various income levels, have been adopted for the 2003 through 2005 tax years and the 2009 through 2017 tax years. The bracket structure for 2009 through 2011 had two temporary higher rates: 7.85 percent for taxable incomes between $300,000 and $500,000 and 8.97 percent for incomes above $500,000. In December 2011, the first, but not the second, of these temporary rate increases was continued—at the slightly reduced level of 8.82 percent—for the 2012 through 2014 tax years; and in March 2013 the 2012 - 2014 rate structure was extended for 3 more years, 2015 through 2017.

The 2012 through 2017 rate and bracket structure (a) reduces the temporary top PIT rate slightly (from 8.97 percent to 8.82 percent) and eliminates the temporary 7.85 percent; and (b) increases the starting point for the top (now 8.82 percent) rate from $500,000 to $2 million for married couples and from $500,000 to $1 million for single taxpayers. The result was threefold. First, the state's highest income families saw their tax rate decline modestly from 8.97 percent in 2011 to 8.82 percent in 2012. Second, a substantial tax cut (a 23.6 percent reduction from 8.97 percent in 2011 to 6.85 percent in 2012) went to families with taxable incomes between $500,000 and $2 million and individuals with taxable incomes between $500,000 and $1 million—roughly the bottom half of the top one percent of the income distribution. Third, families with incomes between $300,000 and $500,000 and individuals with incomes between $200,000 and $300,000 received a 12.7 percent reduction from 7.85 percent to 6.85 percent.

Families with taxable incomes below $300,000 (and individuals below $200,000) were not affected by the temporary rate increases put in place for 2009 through 2011. But the temporary rate structure now in place (for 2012 through 2017), provided rate reductions for those families with incomes between $40,000 and $300,000 and continued the longstanding rates (4 percent, 4.5 percent, 5.25 percent, and 5.9 percent) for families with taxable incomes of $40,000 or less. The rate reductions were 5.8 percent (from 6.85 percent to 6.45 percent) for families with incomes between $40,000 and $150,000 and 2.9 percent.

At the time that the temporary PIT rates for 2012 through 2014 were enacted, Governor Cuomo was particularly critical of the state's "permanent law" bracket structure for applying the same top marginal PIT rate of 6.85 percent to families with taxable incomes slightly above $40,000

(and individuals with taxable incomes slightly above $20,000) as it applied to families with incomes of $20 million.

While praising the temporary rates put into place for 2012 through 2014,[6] the Governor and the legislative leaders also called for a thorough study to recommend a set of PIT brackets and rates for the long haul. We urge you to develop a more graduated rate structure for families with taxable incomes within the $300,000 to $2 million range (and for single individuals with taxable incomes between $200,000 and $1 million). All taxpayers in these income ranges are currently at a single marginal rate of 6.85 percent. The 8.82 percent rate only applies to married couples with taxable incomes above $2 million and to individuals with taxable incomes above $1 million.

We also recommend that you consider additional brackets and rates for taxable income ranges above $2 million for families—such as $2 to $5 million, $5 million to $10 million, $10 million and above—and above $1 million for individuals—such as $1 to $2.5 million, $2.5 million to $5 million, $5 million and above. It should be noted that a very high share of top bracket personal income tax revenues is paid by non-residents and that raising more from the personal income tax is the best way to provide increased local aid (to reduce the pressure on the property tax generally) and to provide need-based property tax relief to those homeowners and renters who are most over-burdened by residential property taxes. In addition, there is no evidence that high-income New Yorkers move away due to New York's personal income tax rates. While migration files show that New York had a high rate of net domestic out-migration from 2000 to 2010, the IRS's bottom line income tax data shows that New York's share of the highest income taxpayers and its share of the income of the highest income taxpayers increased over this same period. Over this ten year period, the number of federal taxpayers with AGI above $1 million increased 17.1 percent nationally but 38.9 percent in New York State; and the amount of these taxpayers' AGI increased 20.8 percent nationally but 57.4 percent for federal taxpayers from New York.

New York State should not provide tax subsidies for companies that outsource jobs or otherwise reduce employment in the state. Economic development tax breaks should only go to businesses that create and maintain "good paying" jobs in the state.

In recent decades there has been substantial growth in both the number of tax breaks enacted in the name of job creation and in the cost of those tax breaks. Even though New York State's annual Tax Expenditure Report excludes some very costly tax breaks enacted at the behest of corporate lobbyists, it estimated that the cost of the state's economic development tax breaks increased from $3.48 billion in 2008 to $4.29 billion in 2012.

At the same time, however, very few of the tax breaks enacted in the name of job creation actually require that the recipients create additional employment opportunities in the state; or that they even maintain their level of employment in the state to benefit from these tax breaks. To the maximum extent possible, the laws governing each of the state's economic development tax breaks should be amended to require that a business has to, at the very least, maintain its level of employment and compensation in the state to qualify for those breaks.

New York State should reduce the value of the initial Investment Tax Credit (ITC) while increasing the number of additional years (currently set at two) in which ITC beneficiaries can qualify for an Employment Incentive Credit by maintaining or increasing employment in New York. This will reduce (and, in some cases, eliminate) the benefits available to businesses that reduce employment but it will increase benefits to businesses that maintain or increase their levels of employment in New York State over time.

New York State should also enact legislation like the proposed Congressional legislation, the "Bring American Jobs Home Act," that eliminates the deductibility of expenses incurred in the off-shoring of American jobs. New York State should also enact legislation that discourages the off-shoring of call centers. In addition, New York State should make businesses that off-shore American jobs ineligible for economic development tax breaks.

Loopholes and tax breaks that allow large, multi-state and multi-national corporations to pay proportionately less in state income taxes than small businesses should be fixed or eliminated. And the integrity of the Corporate Alternate Minimum tax should be restored so that large, profitable corporations are not able to reduce their tax liability below a reasonable percentage of net income.

A 1959 federal law (P.L. 86-272) prohibits a state from taxing any portion of the net income or profits of a multi-state corporation that has sales of goods in a state but no property or payroll in that state. To the extent that (a) the location of a firm's sales is one of the factors used in apportioning that firm's income among the states for tax purposes; and (b) some of that firm's sales are to customers in a state in which it has no property and no payroll, some of that firm's profit is not taxable by any state. This untaxed profit is known as "nowhere income."

As an increasing number of states, including New York, have moved to apportioning income solely on the basis of the portion of a firm's sales in the state (i.e., the Single Sales Factor approach initially adopted by New York in 2005 and phased in over the course of the next several years), a decreasing portion of the U.S. net income of multi-state and multi-national firms is taxable by any state.

For the last several years, many of the same multi-state and multi-national corporations that have lobbied for Single Sales Factor apportionment in the states in which they have substantial property and payroll have been lobbying at the federal level to expand P.L. 86-272 to make even less corporate income subject to taxation by the states. This legislation, which is misleadingly named the Business Activity Tax Simplification Act (BATSA), would allow a firm to have some property or payroll in a state and still escape taxation of any portion of its income by that state.

New York officials should work with officials from other states to advance federal legislation repealing or substantially reforming P.L. 86-272. New York officials should also work with officials from other states to oppose federal legislation that would increase the portions of multi-state and multi-national corporations' domestic net income that can be shielded from state corporate income taxation.

Recognizing the problem of "nowhere income," tax experts seeking to establish a uniform and fair system of state-level corporate taxation have long recommended that states adopt either a "throwback" or "throwout" rule. Under a "throwback" rule, sales made in states where a firm's income is not taxable are "thrown back," for apportionment purposes, to the state from which the sales were made. A "throwout" rule is a variation that excludes "nowhere sales" from entering into the apportionment calculation at all.

New York should put a "throwback" or "throwout" rule into place until the federal government repeals or substantially reforms P.L. 86-272.

New York State's corporate Alternate Minimum Tax (AMT) was enacted in 1987 to make sure that large profitable firms paid some minimum amount in state taxes. That 1987 law, which was enacted with the active support of the Business Council of New York State, reduced the state's main corporate income tax rate from 10 percent to 9 percent (and to a lower level for small businesses). It also eliminated and/or limited a number of corporate tax preferences. The Investment Tax Credit (ITC), for example, was reduced from 6 percent to 5 percent rather than being eliminated but the AMT was established at a 3.5 percent rate. Credits, like the ITC, could still reduce a firm's tax liability but not below 3.5 percent of its income.

In addition, the "Double Weighting of Sales," a tax break that had been enacted in 1975 at the behest of the Business Council, was not repealed in the calculation of the main tax at the 9 percent rate, but the traditional 3-factor formula (that involved the equal weighting of property, payroll and sales and which had applied the main tax before the 1975) change was made applicable to the new AMT.

The intended purpose of this set of changes was to provide that a firm would pay state taxes on its income at 9 percent with preferences or 3.5 percent without preferences, such as the ITC. Since 1987 however, the state's main corporate income tax rate has been reduced to 7.1 percent and the AMT rate has been reduced to 1.75 percent. But, perhaps even more significantly, tax breaks have been added to the AMT. Single Sales Factor apportionment (an even juicier prize for multi-state corporations than the Double Weighting of Sales) now applies to both the main tax and the AMT. And, an increasing number of tax credits are allowed to reduce a firm's taxes below the AMT level.

The Corporate Alternate Minimum Tax (AMT) rate for firms other than manufacturers should be restored to the 3.5 percent level and the loopholes that have been added to the AMT should be eliminated. New York State should also eliminate the $1 million cap for firms other than manufacturers on the amount due under the Corporate Franchise Tax's alternate capital base tax. This cap results in small and medium-size businesses paying a much higher effective tax rate than large corporations.

Provisions of law that allow investment management income to be taxed less than wages or other business income should be eliminated.

Carried interest refers to the profit share received by the managing partners of private equity funds and hedge funds, usually 20 percent of the profits generated by the pooled investment of the limited partners. At both the federal level and at the New York City level, this income receives favorable treatment.

Even though the recipients of carried interest income have not put any of their own capital at risk to earn that income, the federal government currently treats that income as capital gains income and taxes it at a lower rate. And, by state law, this carried interest income is exempt from the New York City Unincorporated Business Tax.

While not a state revenue item, it would be important in helping New York City to close its projected budget gaps for the State Legislature to eliminate the carried interest exemption loophole in the City's Unincorporated Business Tax (UBT). This would put the taxation of private equity and hedge funds on the same footing as that of the thousands of smaller businesses subject to the NYC UBT. The New York City Independent Budget Office estimated that eliminating the carried interest exemption for the Unincorporated Business Tax would yield $200 million a year for New York City.

If the federal government were to end its treatment of carried interest income as capital gains income, it would resolve the anomalous situation under which New York fund managers who live in New York pay taxes on their carried interest income but New York fund managers who commute in from other states do not.

New York State should reduce the pressure that it places on the local property tax by increasing revenue sharing (now called Aid and Incentives for Municipalities) and by increasing the state share of the cost of both education and Medicaid.

For New York's cities, towns and villages, the outlook is dire. While these providers of basic municipal services are now covered by a property tax cap that is much more rigid than the Massachusetts cap, this year's budget and the financial plan for the next several years reminds them that the state's intention is for years of flat funding of general purpose aid—what used to be called "revenue sharing" and what is now called Aid and Incentives for Municipalities or AIM.

To reduce the financial pressure being placed on school districts, it is essential that the state government begin increasing the share of school costs that are covered by state aid. Regrettably, the state is moving in the opposite direction. The Governor sometimes complains about what he sees as a statewide high school graduation rate that is too low, but he ignores the fact that the statewide graduation rate is a weighted average of many districts with high graduation rates and a smaller number of large districts with low graduation rates. The Contracts for Excellence and the largest aid increases under the settlement of the Campaign for Fiscal Equity lawsuit, both of which have been inordinately delayed, were targeted at those districts with low graduation rates.

If New York State wants to increase its statewide graduation rate (and it should want to) it has to provide the needed resources to the high need districts and reinvigorate the accountability mechanisms envisioned by the Contracts for Excellence. While it makes sense to target aid increases to high need districts, average need and low need districts must not be placed on a downward spiral. If New York State is going to cut aid to many such districts, as it is doing, it should exempt local contributions to make up for the reductions in state aid from the property tax cap. Requiring a 60 percent vote to make up for cuts in state aid is an incredibly wrong-headed and perverse policy.

New York's counties are receiving some real relief through the state government's assumption of a greater portion of the non-federal share of Medicaid costs. But the approach that is being employed does not address the great disparities that exist between (1) counties' Medicaid costs, and (2) the strength of their local tax bases. Governor Cuomo frequently points to the fact that many Upstate counties have among the nation's highest property tax rates relative to home values but his proposal does not address this "problem." The most direct way to reduce the high property tax rates relative to home values in many Upstate counties would be by providing additional relief to those counties whose Medicaid costs are high relative to the strength of their property tax bases. And the best way to finance such a reform is through the progressive personal income tax.

New York State should provide targeted tax relief to long-time residents for whom, through no fault of their own, property taxes on their primary residences have come to represent an inordinate share of their income.

While it is important for the state government to reduce the pressure that it places on the property tax base by increasing its revenue sharing with cities, towns and villages—increasing the state share of the cost of a sound, basic education, and additional targeted Medicaid relief—there will still be hundreds of thousands of New Yorkers whose property taxes will represent an inordinate share of their income—through no fault of their own. The only cost-efficient and cost-effective way to address this problem is through a targeted middle class Circuit Breaker credit.

An analysis of the U.S. Census Bureau's American Community Survey (ACS) microdata confirms that hundreds of thousands of low, moderate and middle-income families in New York State are already paying an inordinate share of their income in property taxes on their primary residences. The situation in which these families find themselves will not be addressed by New York's cap on the growth of local governments' property tax levies. Only a middle-class Circuit Breaker can provide effective relief for these families in a targeted and cost-efficient manner.

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The Fiscal Policy Institute (www.fiscalpolicy.org) is an independent, nonpartisan, nonprofit research and education organization committed to improving public policies and private practices to better the economic and social conditions of all New Yorkers.

ENDNOTES

[1] See Frank J. Mauro, New York's Leaders Join the Quest for Tax Fairness; Governor Cuomo Emphasizes the Need to Close Loopholes, January 12, 2002, http://www.99percentny.org/2012/01/12/new-york%E2%80%99s-leaders-join-the-quest-for-tax-fairness-governor-cuomo-emphasizes-the-need-to-close-loopholes/

[2] The Urban Job Incentive Board Program (JIB) was created in 1968 and terminated in 1983. The Empire Zones program was created as the Economic Development Zones (EDZ) program in 1986. In 2000, the program was greatly enriched and renamed as the Empire Zones program. Both the Urban Job Incentive Program (which became the Job Incentive Program) and the Economic Development Zones (which became the Empire Zones) started out as geographically targeted programs. But as the benefits became richer there emerged both (1) unstoppable pressure to expand the geographic coverage of these programs and (2) the application of great amounts of creativity on the part of many businesses and their lawyers to figure out ways to get into those programs. In retrospect, it is shocking that the EDZ program was created in 1986 only three years after the JIB was closed to new entrants; and that a new tax-free zones program was created, in a rush, at the end of the regular session of the 2013 legislature only three years after the Empire Zones program was closed to new entrants.

[3] See Fiscal Policy Institute, *"Tax-Free NY" is now "Start-Up NY" – Still Bad Tax Policy, Still Bad Economic Development Policy*, July 9, 2013, http://fiscalpolicy.org/tax-free-ny-is-now-start-up-ny-still-bad-tax-policy-still-bad-economic-development-policy

[4] See Fiscal Policy Institute, *Walmart and other large, low-wage employers will benefit financially from New York's new Minimum Wage Reimbursement Credit*, April 5, 2013, http://fiscalpolicy.org/walmart-and-other-large-low-wage-employers-will-benefit-financially-from-new-york%E2%80%99s-new-minimum-wage-reimbursement-credit, and Fiscal Policy Institute, *The Many Problems with New York's Proposed Minimum Wage Reimbursement Credit*, March 25, 2013, http://fiscalpolicy.org/the-many-problems-with-new-york%E2%80%99s-proposed-minimum-wage-reimbursement-credit

[5] In *A Well Educated Workforce is Key to State Prosperity*, August 22, 2013, http://www.epi.org/publication/states-education-productivity-growth-foundations/ , Noah Berger, president of the Massachusetts Budget and Policy Center, and Peter Fisher, research director at the Iowa Policy Project, analyze data for all 50 states and find a strong link between the educational attainment of state workforces and both productivity and median wages. The study concludes that further raising educational attainment is the best way for New York and other states to bolster state economic performance and job creation.

[6] These rates have subsequently been extended for an additional three tax years (2015, 2016 and 2017).