The Better Choice:
Meeting New York State's Economic Challenges With Fair Fiscal Policies

Testimony before the
Assembly Standing Committee on Ways and Means
Hearing on
The Impact of the Economic Crisis on the State Budget
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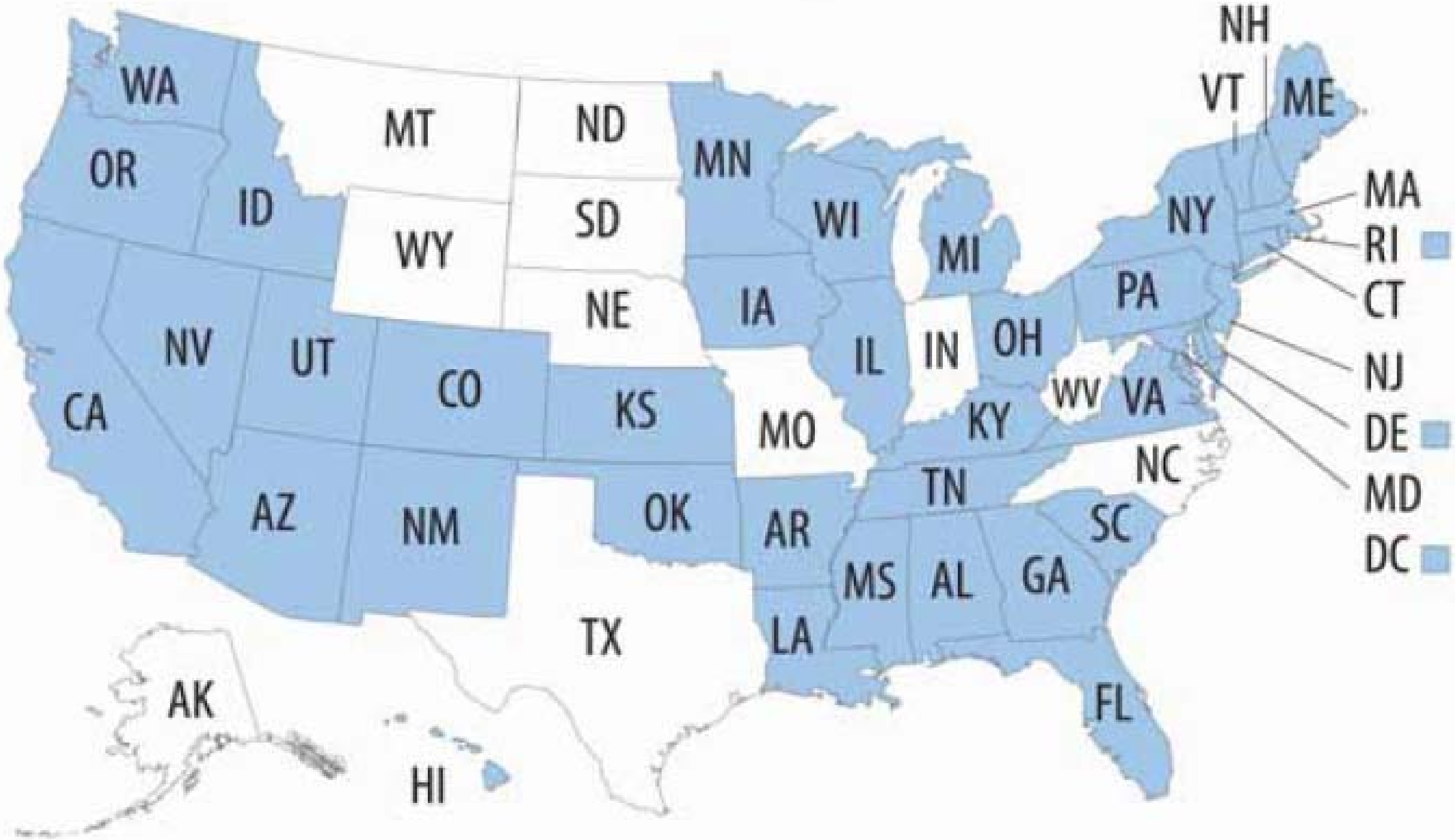
Ronald Deutsch, Executive Director
New Yorkers for Fiscal Fairness
www.abetterchoiceforny.org

Frank Mauro, Executive Director
Fiscal Policy Institute
www.fiscalpolicy.org

39 States Face Budget Shortfalls



Note: Includes states with shortfalls in fiscal 2009 or projected shortfalls for fiscal 2010.

The Last Recession Caused a F<u>our-year</u> State Fiscal Crisis

State budget shortfall in each fiscal year (billions)

*** Initial shortfall plus mid-year gap.**

Sources: National Conference of State Legislatures; CBPP surveys (various years).

Michigan

- State faced $1.4b budget gap for FY08 (beg. 10/1/07); $2.6b if Business Tax had been allowed to phase out
- Raised taxes by about $1.6 billion; cut spending $400 million
- Increased its flat PIT rate from 3.9% to 4.35% - *temporary*
- Created new, “MI Business Tax” — hybrid CIT/gross receipts tax — for repealed Single Business Tax
- Enacted 22% corporate surcharge – *sunsets 2017*

Maryland

- Confronting $1.7b budget gap in FY09
- Enacted $1.35 b tax increase package + $550m in budget cuts
- Increased PIT top rate to 5% for taxable income between $200k and $350k; added two higher tax brackets with 5.25% and 5.5% rates
- Increased sales tax rate from 5% to 6%
- Increased CIT rate from 7% to 8.25%
- Doubled cigarette tax to $2/pack

ECONOMY
The financial meltdown—what happened?

- Meltdown resulted from a combination of factors: deregulation and weak oversight by the SEC, easy credit and excessive leverage, foreign trade surpluses pouring dollars back into U.S. markets, financial “innovations” that supported massive subprime lending, and the housing bubble. It was not because of CRA or expanding homeownership.

- Unfettered and unregulated greed was the driving force, sustained by “market knows best” ideology. Former Fed Chair Greenspan now admits his mistake.

- When the housing bubble burst, declining housing prices led to massive foreclosures, triggering huge losses among holders of various mortgage-backed securities and derivatives. As steadily falling housing prices kept eroding value of bubble-generated “toxic” securities, solvency of financial institutions called into question. Eventually, their credit ratings and stock prices fell and some were taken over (Lehman Brothers filed for bankruptcy.)

- Credit squeeze worsened into a credit freeze when banks lost confidence in the viability of other banks because no one knows the value of the “toxic” assets they hold.

The financial meltdown—what does rescue cost?

- The rescue efforts involving Bear Stearns (Mar.) and Fannie Mae and Freddie Mac (early Sept.) weren't sufficient because they only pointed up how pervasive and serious the problems were. Attention then turned to the next weakest link among institutions and short-sellers then piled on and drove down stock prices.

- Even as $5.5 trillion in government rescue actions begin to operate to thaw the credit freeze, consumer and business confidence has faltered because of the recession, to which all indicators point.

- **In a span of 7 months, the U.S. government committed $5.5 TRILLION in taxpayer dollars for a variety of rescue actions.**

  - $373 billion as an investor ($123B AIG; $250B banks with half to 10 largest)
  - $808 billion in low-interest loans to large financial institutions
  - $3,879 billion in government guarantees ($2 Tr in FDIC guarantees, $1.6 Tr Fed guarantee of the commercial paper market; $50 B Treasury guarantee of money market funds)
  - Remaining $450 B from the $700 B "bailout" bill to be used to buy "toxic" bank debt.

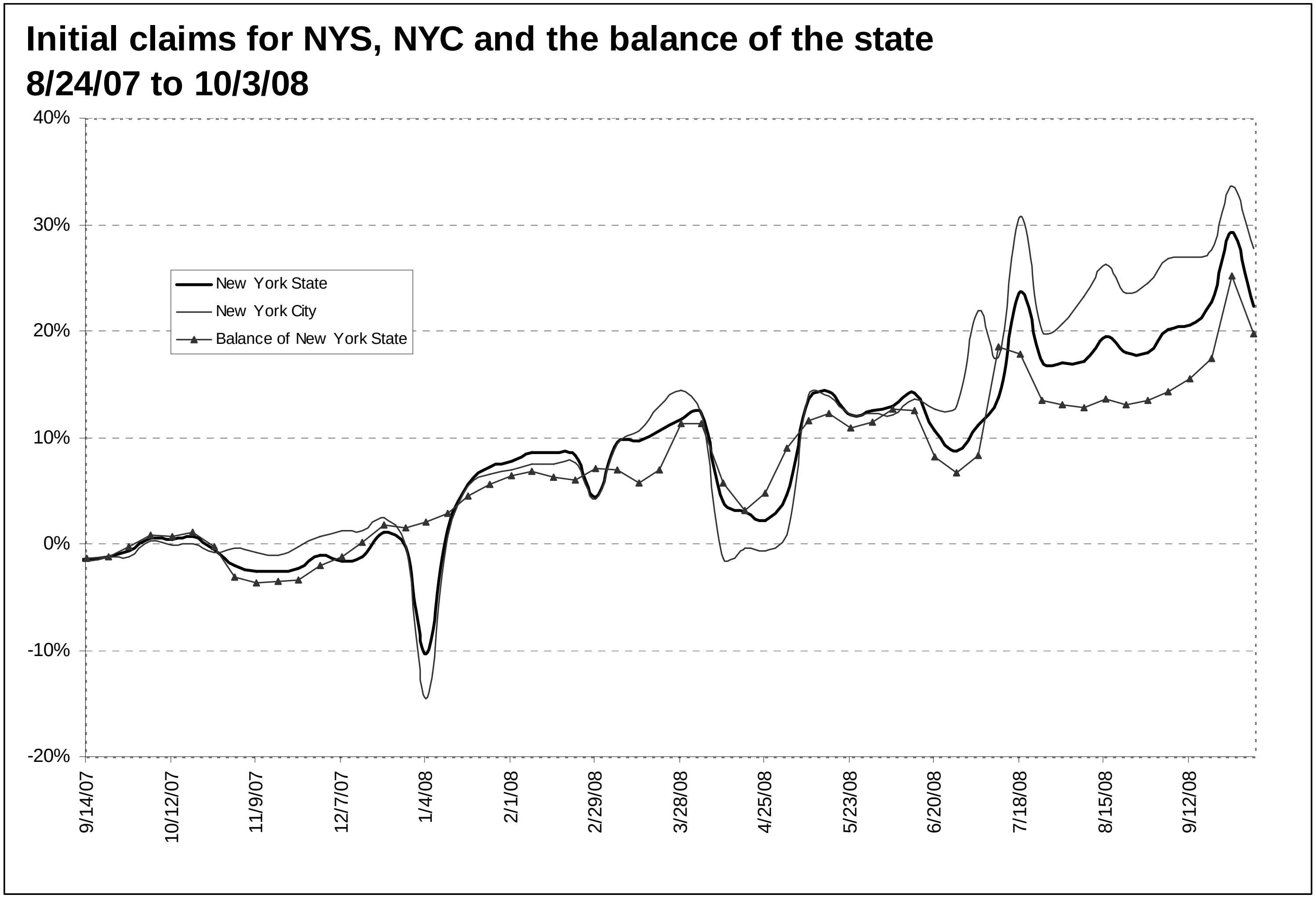
How is the NYS economy being affected?
… NYS job losses lag the U.S. …

Source: Current Employment Statistics data analyzed by FPI.

NY economic indicators show weakness but not rapid deterioration … at least so far, anyway …

- Since the likely start of the recession in Dec. 2007 (the peak month for employment before national job losses began) 29 states have lost proportionately more jobs than NYS.
- Payroll employment in the NY securities industry is down about 13,000, although there are predictions that Wall Street will lose as many as 40,000-50,000 jobs.
- Since Dec., job losses concentrated in finance & insurance, mfg., construction, trade, and headquarters.
- Total NYS tax collections through the 1st 6 months of the state FY are still up by 8.8% over a year ago. Witholding is up by 5.9%. Business taxes are down.

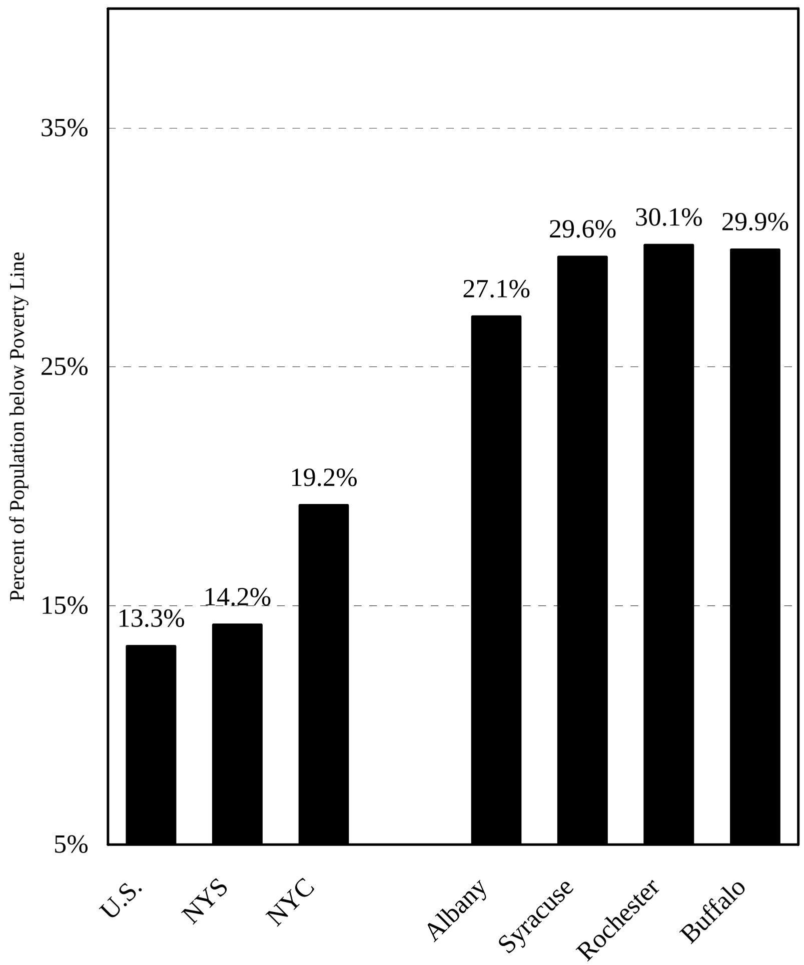
However, initial unemployment claims starting to rise, paced by NYC. . .

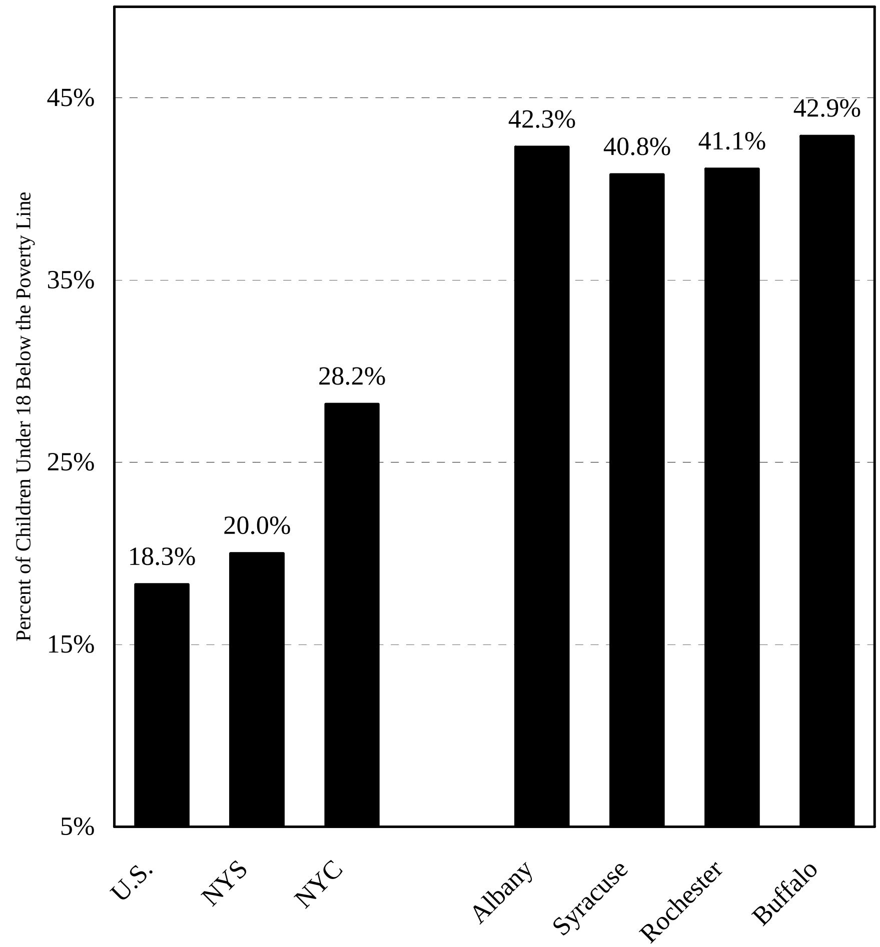


Foreclosures are skyrocketing … accompanied by adverse effects on property values … leading eventually to lower property tax collections.

- Foreclosures are up by 159% in NYS from 2006 to 2008. This ranks NY 19th among all states. CA, AZ and FL top the list.
- NY's ranking may increase since housing prices kept rising in the downstate area for some time after they started to drop in the worst-hit areas.
- In NYC and Long Island, foreclosures from subprime lending are particularly severe in minority neighborhoods.

Poverty rates are much higher in the major upstate cities than in New York City or the national average.





Source: American Community

What is the outlook for NYS in a recovery?

- The finance and insurance sector will be smaller in NY but not because it will move someplace else—a large part has failed.
- Difficult adjustment period but over time, rents/prices will decline making NYC a more affordable place to live and to start a new business.
- NYC's long-term prospects are bright. Despite the driving role played by Wall Street, the city has a diversified economy with several sizable sectors to fall back on: arts & culture, tourism, media, design & fashion, professional services, and higher education.
- Suburbs face fewer high incomes and declining housing prices.
- Upstate likely will experience proportionately less decline because the recovery largely passed it by. Still faces challenges posed by outward sprawl and further decline in its manufacturing base.
- In this crisis, the pace of NY's recovery—and the well-being of its workers—depends largely on national economic policy.

What other government actions are needed for a recovery to get underway?

- **Substantial "economy recovery" package ($300B-$400B).**
  More is needed than just short-term cyclical stimulus. It should include state fiscal relief, extended UI, increased food stamps and low-income heating assistance, and a major job-creating infrastructure component.

- **Stabilize the housing market**.
  While housing prices have come down 20-25%, forecasts are that they will fall further. However, falling housing prices will continue to destabilize the finance sector and impede recovery. Some banks (e.g. JPMorgan Chase) acting to re-negotiate mortgages. Legislation may be needed to force the re-negotiation of mortgages (including forced de-securitization if necessary). Lending institutions should absorb most of the losses.

- **Shore up battered retirement savings.**
  New School economist Teresa Ghilarducci has proposed that workers should be able to trade their 401(k) and 401(k)-type plan assets (valued at pre-crash prices) for a Guaranteed Retirement Account composed of government bonds earning a 3% return, adjusted for inflation.

Need to re-orient NYS economic development

- Between NYS and local bodies, billions of dollars annually spent in the name of economic development with poor results.
- Need to re-vamp programs to add accountability and wage (prevailing and living wage) and anti-sprawl standards.
- Promote green jobs development.
- Where NYS invests heavily in new technology, such as the $1 billion AMD facility, taxpayers should get an ownership share.
- NYS needs to work with new Fed. administration to re-orient econ. dev. to prioritize investing in workers and in revitalizing manufacturing (still the core of the upstate economy).
- NYS can't have an economy that is globally competitive without a strong manufacturing sector.
- But NYS also needs new national economic policies that will help re-build the middle class and generate sustainable economic growth.

Need new economic model at national and state levels …

- Not only did the financial system fail but the underlying economic model (that produced polarization and squeezed the middle class) collapsed.
- We need a new model of public investment-led growth where American workers and communities share in the prosperity they create and do not have to rely on debt to maintain living standards. We need a model that rebuilds the middle class and supports sustainable communities.
- With the federal deficit soaring because of the various financial rescue actions, there will be intense pressure to limit further federal spending. We can't let that prevent the federal government from providing sufficient stimulus to kick start a sustainable recovery and address long-standing investment needs.

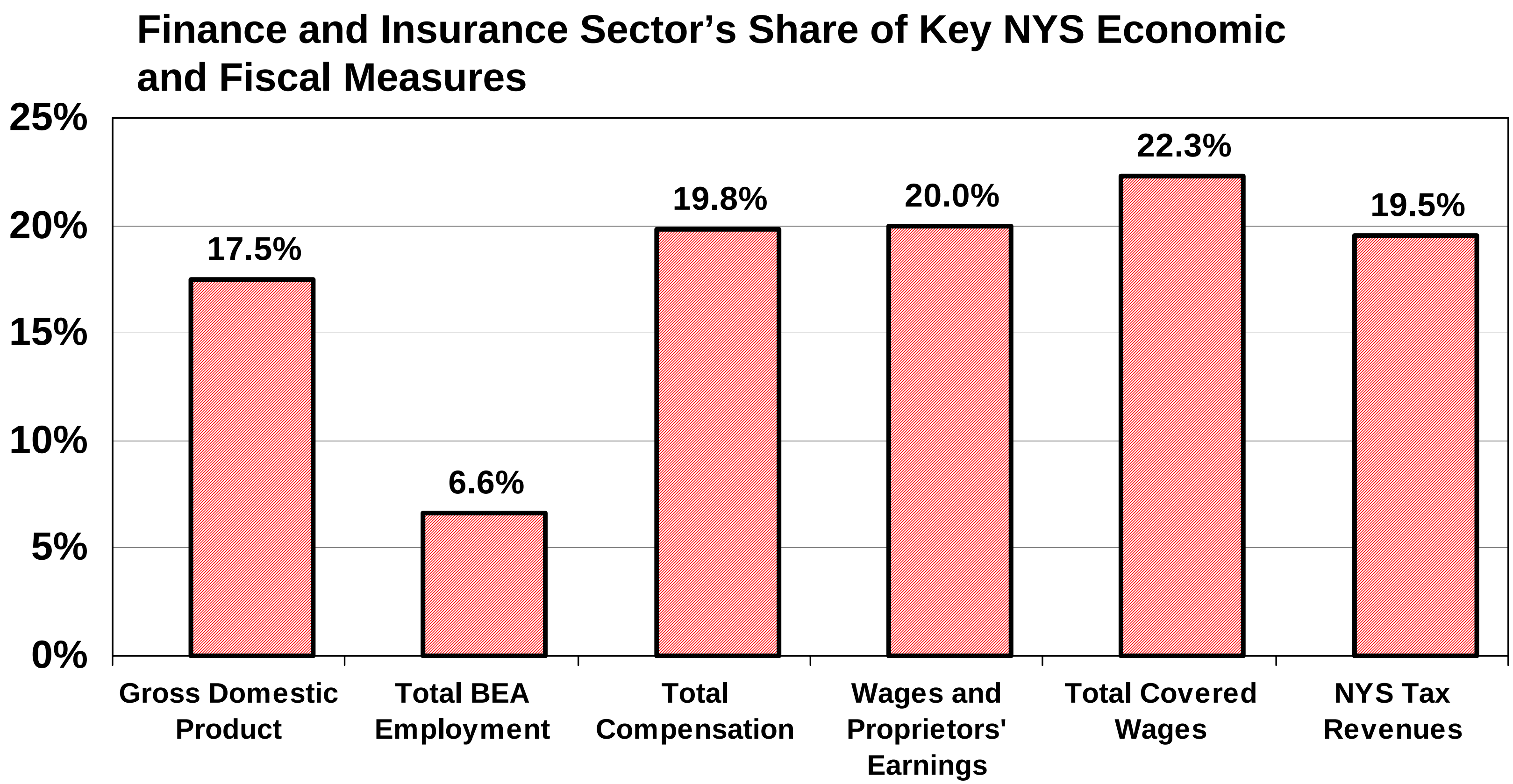
FISCAL
NYC facing growing budget gaps …

- Mayor Bloomberg says NYC is facing a $500 M budget gap for the current year and $3.3 B budget gap in City FY 2010. Gaps $5+ B in 2011 and 2012.
- On its own NYC can rescind the 7% property tax cut effective 1/1/09 and generate $600 million. Beyond that, Albany must approve City tax increases.
- Albany facing 3 simultaneous budget challenges: closing the state budget gap, stabilizing MTA revenues over the next 10 years, and helping the City balance its budget.
- The NYC-based One New York Coalition is pressing for a progressive increase in the NYC Personal Income Tax.

NYC last raised taxes in 2003 when facing $6.5B budget gap.

- Property taxes increased 18.5%.
- NYC personal income tax (P.I.T.) increased by adding new top tax bracket (4.45% up from 3.65%) for joint incomes over $150,000 (over $100,000 for single filers).
- State approved for 3-years, 2003-2005.
- From 1991-1998, the top NYC PIT rate =4.46%.
- NYC 2003 tax increases roughly offset taxes cut in mid- and late-1990s.

NYS's economic and fiscal dependence on the finance sector



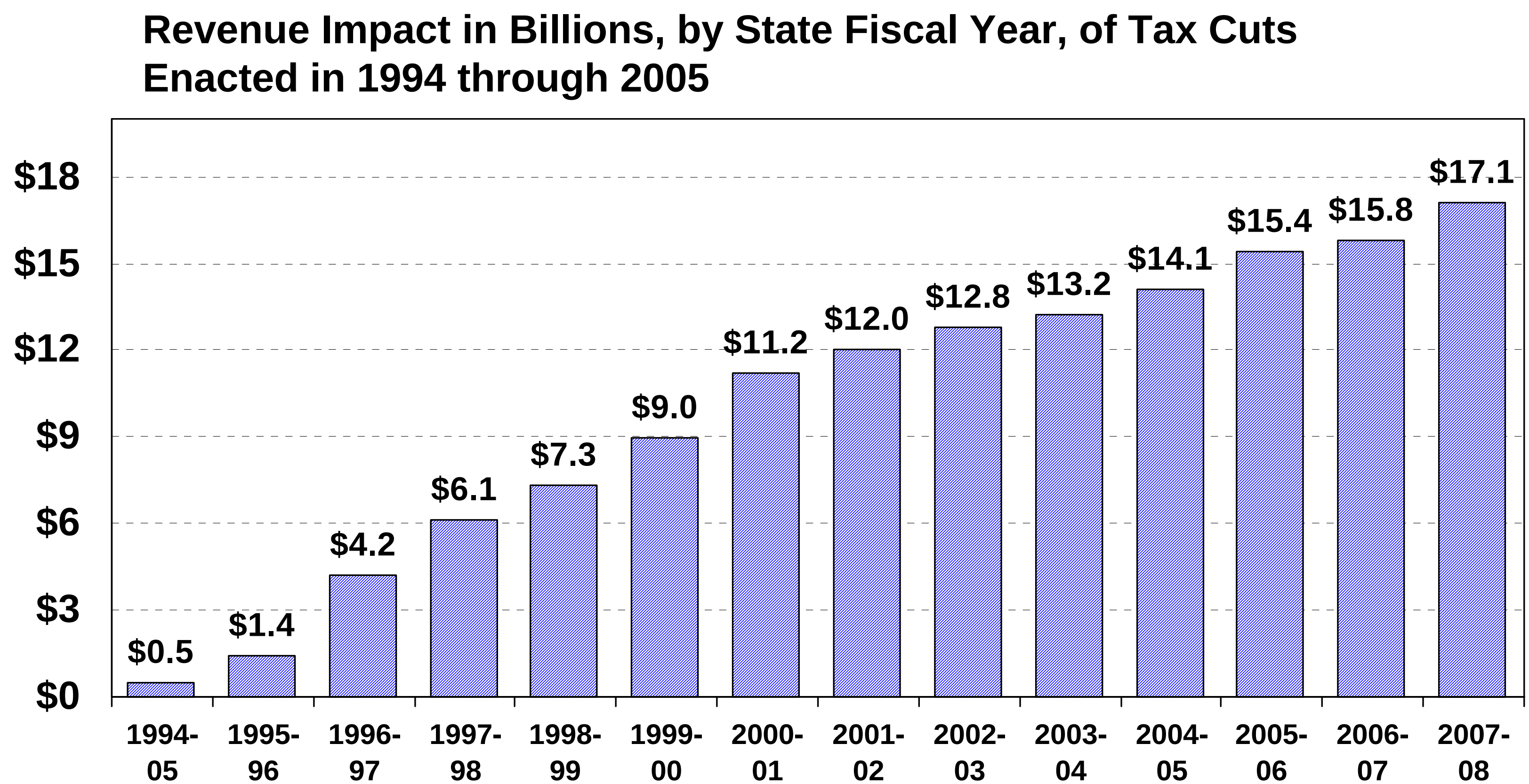
What is driving NYS's deficit? The economic downturn, new commitments without new revenues, federal disinvestment. And …

State spending in areas other than health, education, STAR, and transportation grew by less than 3% a year from 2004 to 2008.

Important (and expensive) new commitments were made in last several years without any new revenue streams to pay for them:

- Family Health Plus Takeover and Medicaid Cap - $1 billion this year; $1.35 next year and $2.5 billion in 2010-11
- STAR – From $2.5 billion in 2001-02 to $6.0 billion in 2010-11
- CFE Settlement - $5.5 billion in new foundation aid by 2010-11. Facilities investment in 2005-06 budget.
- $1.2 billion to Abu Dhabi owned Foundry Co.

… the large multi-year tax cuts enacted between 1994 and 2005 are now reducing state revenue by over $17 billion per year.



Gov. Paterson has already made substantial cuts in this year's budget

- Shortly after the Legislature adopted the 2008-09 budget, the Governor ordered 3.35% across-the-board cuts in state agencies' operating budgets. He said that these cuts were necessary to balance the 2008-09 budget and that they had been agreed to by the Legislative Leaders as part of the final budget negotiations
- At the end of July, the Governor issued the First Quarterly Update to the State's Financial Plan, saying there was now a $630 billion gap in this year's budget and a $6.4 billion gap in the upcoming 2009-10 fiscal year.
- To keep the 2008-09 budget in balance, the Governor ordered state agencies to make additional 7% across-the-board cuts in their operating budgets.
- To get a "head start" on the 2009-10 budget gap, the Governor called a special session of the Legislature for August 19 for the Legislature to make cuts in programs that the Governor acknowledged that he could not cut unilaterally.
- At the August 19 session, the Legislature enacted budget cuts that will reduce state spending by $427 million in the current 2008-09 fiscal year, and by $651 million in the 2009-10 fiscal year.

Tax increases vs. spending cuts: which is worse during a recession?

Economist Peter Orszag (now CBO director) and Nobel Prize winner Joseph Stiglitz:

- "…tax increases on higher-income families 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…"
- Stiglitz in a March letter to Paterson, Bruno and Silver: "Raising taxes and maintaining public expenditures (including investments) also helps America in meeting its long run needs."

Potential solutions

Tax Stabilization Reserve Fund

- We strongly recommend using the Tax Stabilization Reserve Fund (TSRF). It is specifically for unplanned end of year deficits and totals $1.039 billion. It is an important backstop or cushion for getting through the current fiscal year without making $2 billion in cuts to vital services, as the Governor has proposed.

- Using the TSRF also provides the state the time to have a well-informed debate over expenditures and revenues in the 2009-10 state budget. This would allow the debates to be more deliberative than usual since the Governor will be proposing his Executive Budget on December 16, 2008, which is 5 weeks earlier than required.

- The Legislature cannot pass a law transferring money from the Tax Stabilization Reserve Fund to the General Fund, nor can it pass a law requiring the Governor to use the money from this fund. The Governor simply has to borrow the amount needed from it on March 31, 2008, if disbursements exceed receipts and money available to make those disbursements.

- The Governor and the Legislature should not make more cuts during the current fiscal year than are necessary, given this $1 billion cushion. **And, most importantly, the state should not make additional cuts in services until we know the size and scope of a possible federal relief package from Washington.**

Potential solutions

- **Advocate strongly for a Federal Relief Package:**

  The Governor and Legislative leaders must work with the NYS Congressional delegation to put together a federal relief package—as was done in 2003 when the state was facing an $11.5 billion deficit. In 2003, the federal government provided $20 billion in fiscal relief to states: $10 billion as enhanced FMAP (Federal Medicaid Assistance Percentage) and $10 billion as a block grant. New York received $1.5 billion in enhanced FMAP and $645 as flexible block grant, which greatly helped the state's financial situation
- Collect taxes that are due – especially cigarette taxes on reservation sales to non-native americans – estimates of the revenue currently being lost range from $400 million to $1.6 billion a year
- Pass the Bigger Better Bottle Bill and close the bottle bill loophole so the state receives deposits from unreturned bottles rather than the industry keeping the money - about $200 million a year is currently being lost to bottlers because of this loophole.

Potential solutions

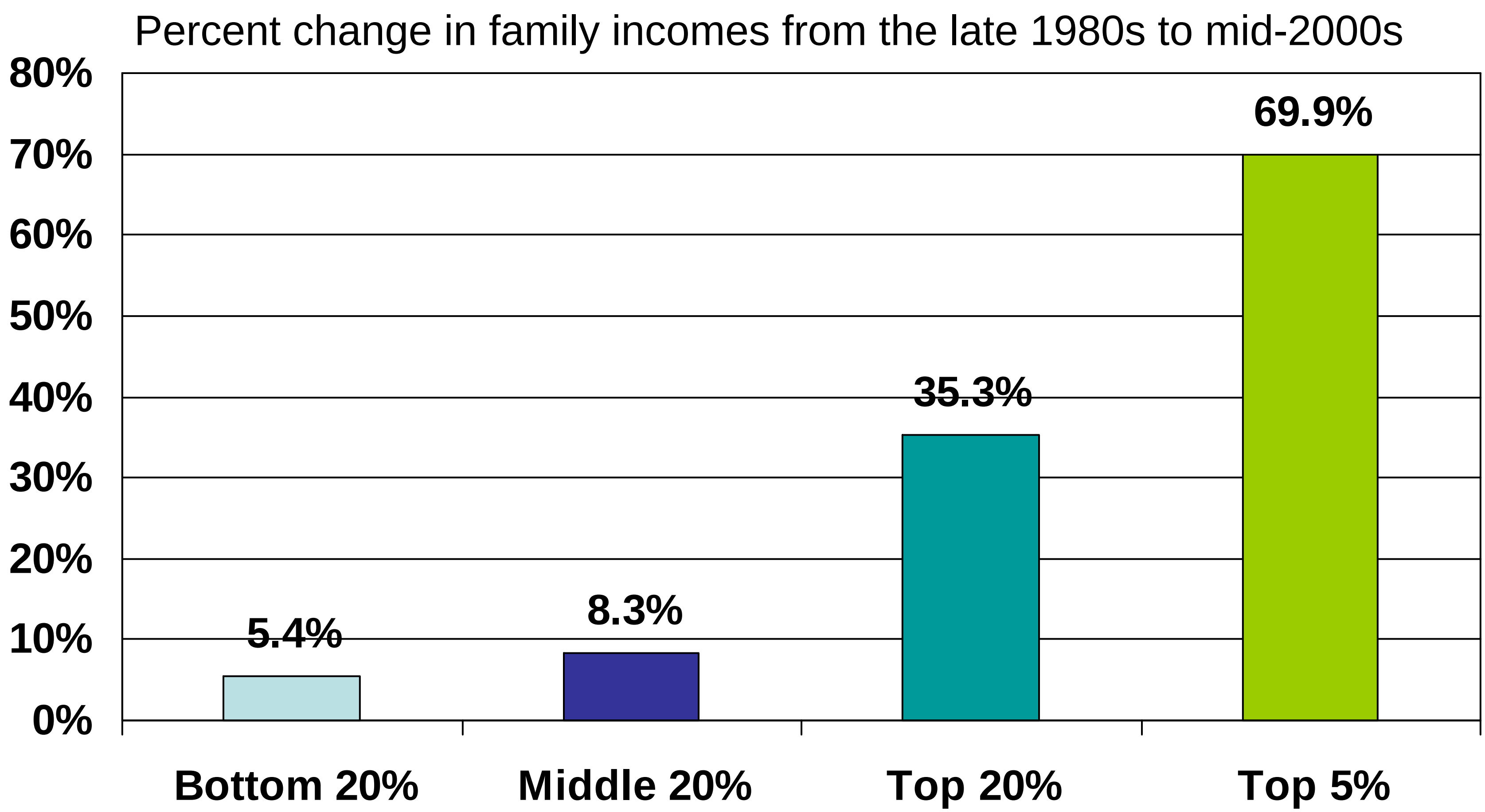
- Improve the effectiveness and accountability of the state's Industrial Development Agencies; Apply the Brownfield Clean-Up Program reforms to "grandfathered" projects; and Allow the Empire Zones program to expire.
- Buy prescription drugs in bulk for Medicaid, state employees, and other state programs – FPI has estimated that **this would save at least $100 million a year; other estimates of potential savings are much higher**.
- Reduce the use of high priced consultants for work that state employees can do as well at much lower cost. Last year the state moved to hire more highway design engineers and to reduce the use of outside consultants for this work. The state needs to move in the same direction for computer programming and other professional services. **FPI has estimated that this could save $500 million over the next three years, and $500 million a year thereafter.**

Potential solutions

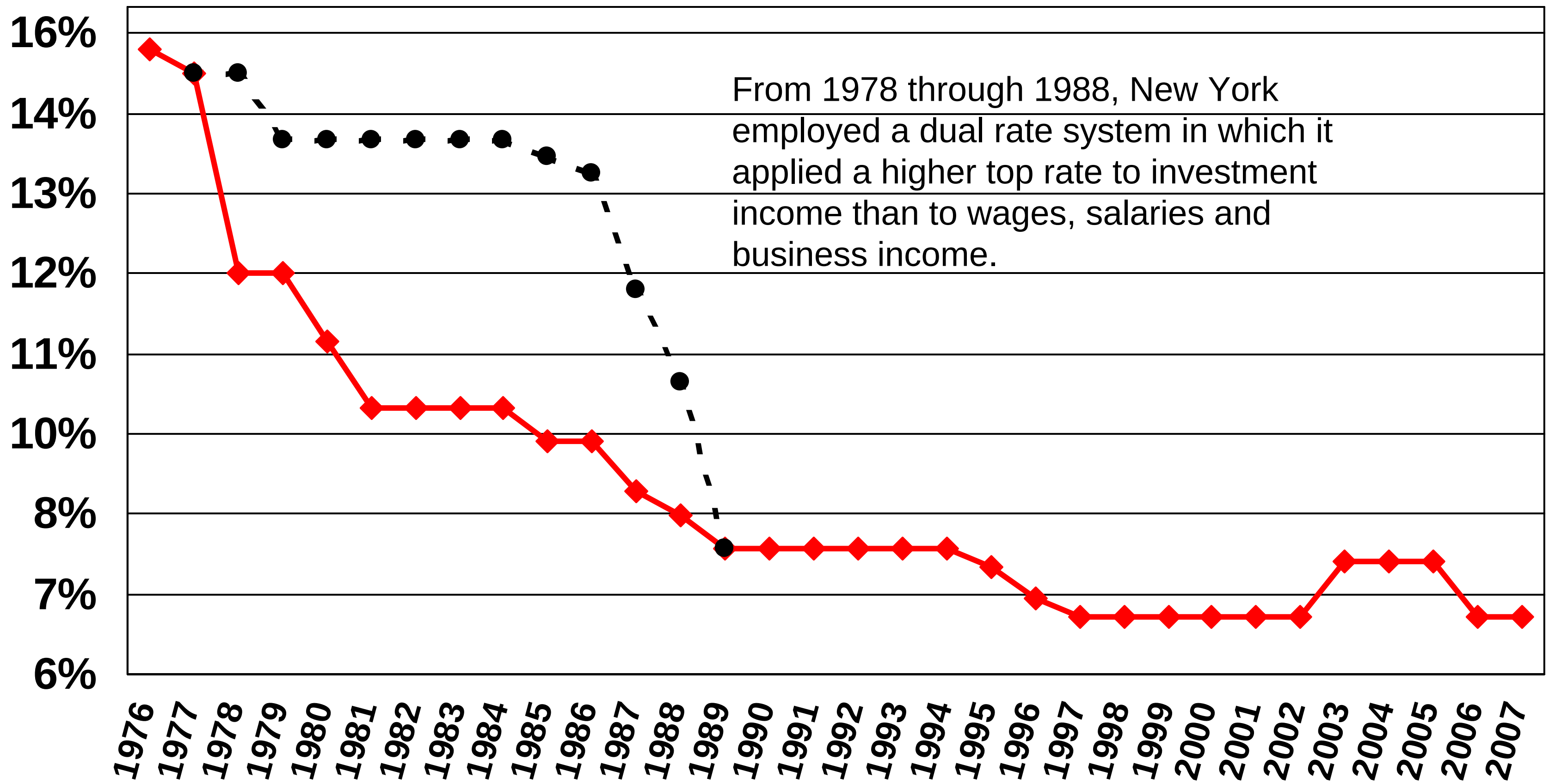
- Adopt a temporary increase in the tax rates on the highest-income New Yorkers, as was done in 2003 – would yield between $2 to $7 billion, depending on the income levels and rates
- While income is increasingly concentrated at the top of the income distribution, the state tax system has moved in the opposite direction - - eliminating brackets from the top and the bottom and moving to a virtual flat tax with 5 brackets in a very narrow range – from a low of 4% to a high of 6.85%

Hypothetical Graduated Rate Options					
$200,000 to $500.000	**$500,000 to $1 million**	**$1 million to $5 million**	**$5 million to $10 million**	**Over $10 million**	**Estimated Annual Revenue**
1.00%	2.00%	3.00%	3.00%	3.00%	$4.3 Billion
1.50%	2.50%	3.50%	3.50%	3.50%	$5.2 Billion
1.00%	2.50%	4.00%	4.00%	4.00%	$5.5 Billion
1.00%	2.00%	3.00%	4.00%	5.00%	$5.1 Billion
1.50%	2.50%	3.50%	4.50%	5.50%	$6 Billion

The richest New York families have had the greatest income gains.



But, over the last 30 years, New York State has cut its top personal income tax rate by more than 50 percent, from 15.375% to 6.85%.



New York's top state personal income tax rate is at an historical low relative to New Jersey and Connecticut.

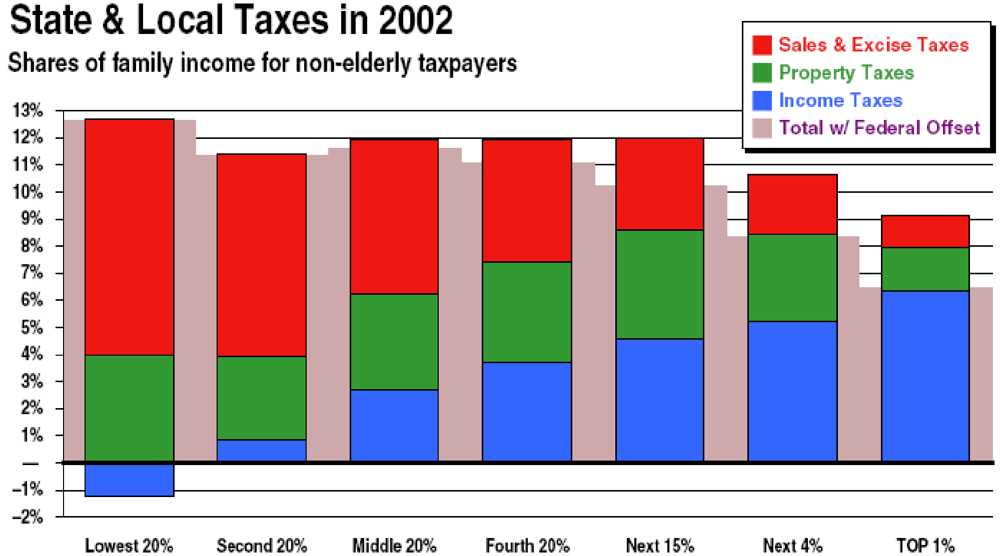
	1976	1985	2003	2004	2006
New York	15.375%	9.5%	7.7%	7.7%	6.85%
New Jersey	2.5%	3.5%	6.37%	8.97%	8.97%
Connecticut	0	0	5.0%	5.0%	5.0%

Note: The tax rates shown above are for wages, salaries and business income. Prior to 1991, Connecticut taxed the interest, dividends and capital gains of high income residents but it did not tax business income, wages, salaries and other income. From 1978 through 1988, New York employed a dual rate system in which it applied a higher top rate to investment income than to wages, salaries and business income. For 1985, the top rate applicable to investment income was 13.5%.

New York

State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: TOP 1%
Income Range	Less than $15,000	$15,000 – $27,000	$27,000 – $44,000	$44,000 – $74,000	$74,000 – $160,000	$160,000 – $634,000	$634,000 or more
Average Income in Group	$8,700	$20,700	$34,900	$56,800	$102,000	$250,000	$1,663,000
Sales & Excise Taxes	**9.5%**	**7.5%**	**5.7%**	**4.5%**	**3.4%**	**2.2%**	**1.2%**
General Sales—Individuals	3.9%	3.6%	2.9%	2.5%	1.9%	1.3%	0.7%
Other Sales & Excise—Ind.	2.7%	1.6%	1.1%	0.7%	0.5%	0.3%	0.1%
Sales & Excise on Business	2.9%	2.3%	1.7%	1.3%	0.9%	0.6%	0.4%
Property Taxes	**4.4%**	**3.0%**	**3.5%**	**3.7%**	**4.1%**	**3.2%**	**1.6%**
Property Taxes on Families	3.9%	2.7%	3.1%	3.2%	3.5%	2.7%	0.7%
Other Property Taxes	0.5%	0.4%	0.4%	0.5%	0.5%	0.6%	0.9%
Income Taxes	**–1.2%**	**0.8%**	**2.7%**	**3.7%**	**4.6%**	**5.2%**	**6.3%**
Personal Income Tax	–1.3%	0.8%	2.6%	3.7%	4.5%	5.1%	6.0%
Corporate Income Tax	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.3%
TOTAL TAXES	12.7%	11.4%	11.9%	11.9%	12.0%	10.6%	9.1%
Federal Deduction Offset	–0.0%	–0.1%	–0.3%	–0.8%	–1.8%	–2.3%	–2.7%
TOTAL AFTER OFFSET	**12.6%**	**11.3%**	**11.6%**	**11.1%**	**10.2%**	**8.4%**	**6.5%**

Note: Table shows 2002 tax law at 2000 income levels.

INSTITUTE ON TAXATION & ECONOMIC POLICY, JANUARY 2003

Lessons Learned from Past Recessions

- 1990s recession – relied on a strategy of only massive budget and service cuts.
- In January of 2003, New York State built up a combined deficit of $11.5 billion for the upcoming 2003-04 fiscal year and the close-out of 2002-03; and Governor Pataki proposed closing that gap primarily through service cuts.

Déjà Vu All Over Again

- In response to the Governor's proposal, Senate Majority Leader Bruno and Assembly Speaker Sheldon Silver led the Legislature in adopting, over the Governor's vetoes, a much more practical approach to balancing the state budget including a temporary three-year income tax increase of less than one percent on taxpayers with taxable incomes above $500,000, and a smaller increase on families with taxable incomes above $150,000.

Temporary Surcharge

- 2003, 2004, 2005 – tax years enacted
- Rate changes:

  Income over **$500,000** – **7.7% fixed for 3 yrs**.

  Incomes over: **$100,000** – single

  $125,000 – HOH

  $150,000 - Married

Gradually reduced each of the 3 years:

7.5%(2003) - 7.375% (2004) – 7.25% (2005)

Governor Pataki Predicts Dire Consequences

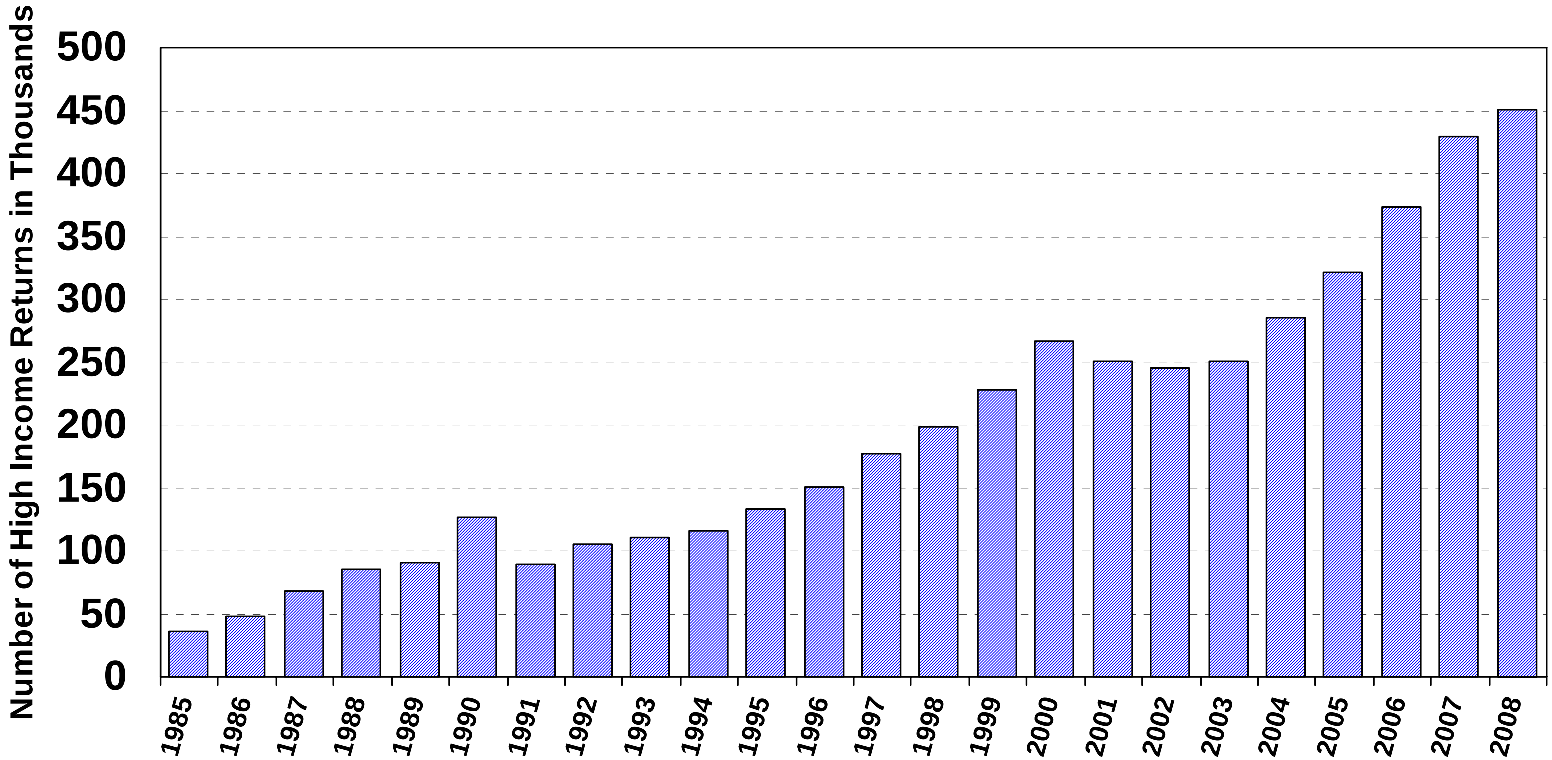
- Millionaires will be forced out of NYS
- The economy will crumble

New Study on Migration Looks at Effect of New Jersey's "half-millionaires" Tax

The states with migration patterns most similar to New Jersey are California, New York, and Massachusetts. These states, like New Jersey, are experiencing net out-migration driven by lower-income individuals. All of these states have a high cost of living and high housing prices. Factors such as tax rates, climate, and crime rates do not appear to explain the migration patterns in these states.

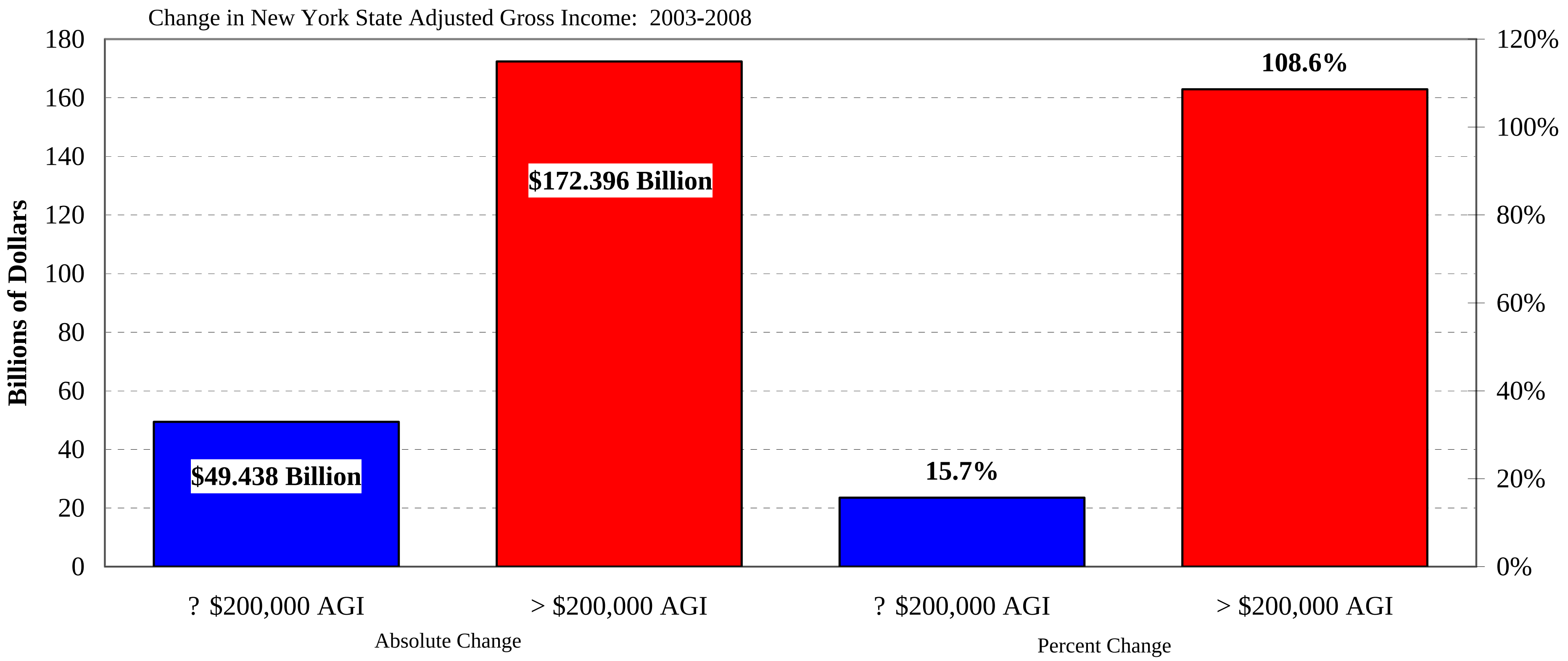
Young, Varner, and Massey, *Trends in New Jersey Migration: Housing, Employment, and Taxation*, Princeton University Policy Research Institute, September, 2008.

Following the adoption, in 2003, of the 3-year temporary increase in the top rate on New York State's Personal Income Tax, from 6.85% to 7.7%, the number of high-income returns and the amount of income reported on those returns both grew significantly.



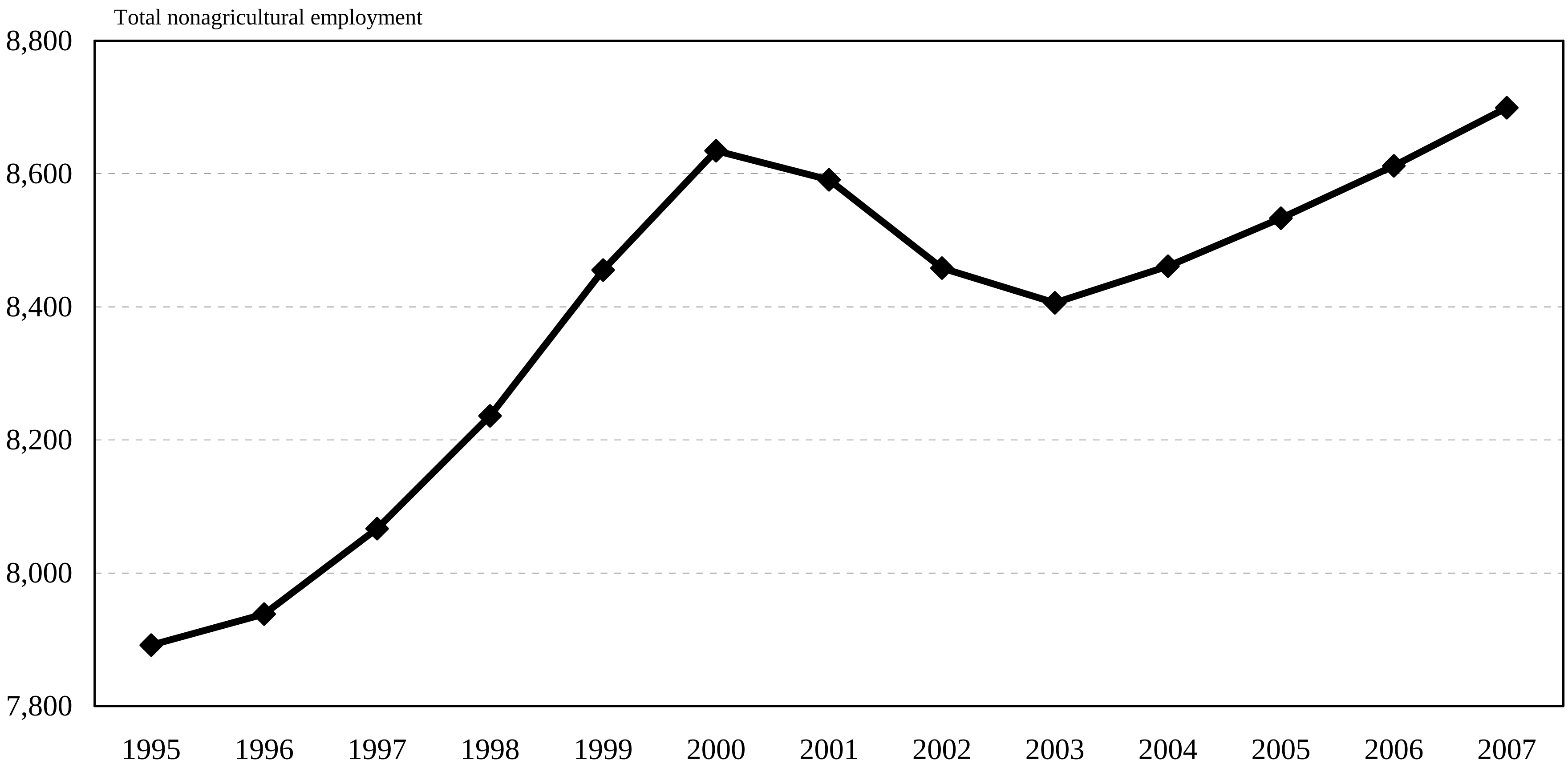
Source: New York State Executive Budget for 2008-09, Economic and Revenue Outlook, Figure 57

New York's income growth since 2003 has been concentrated among the top five percent.



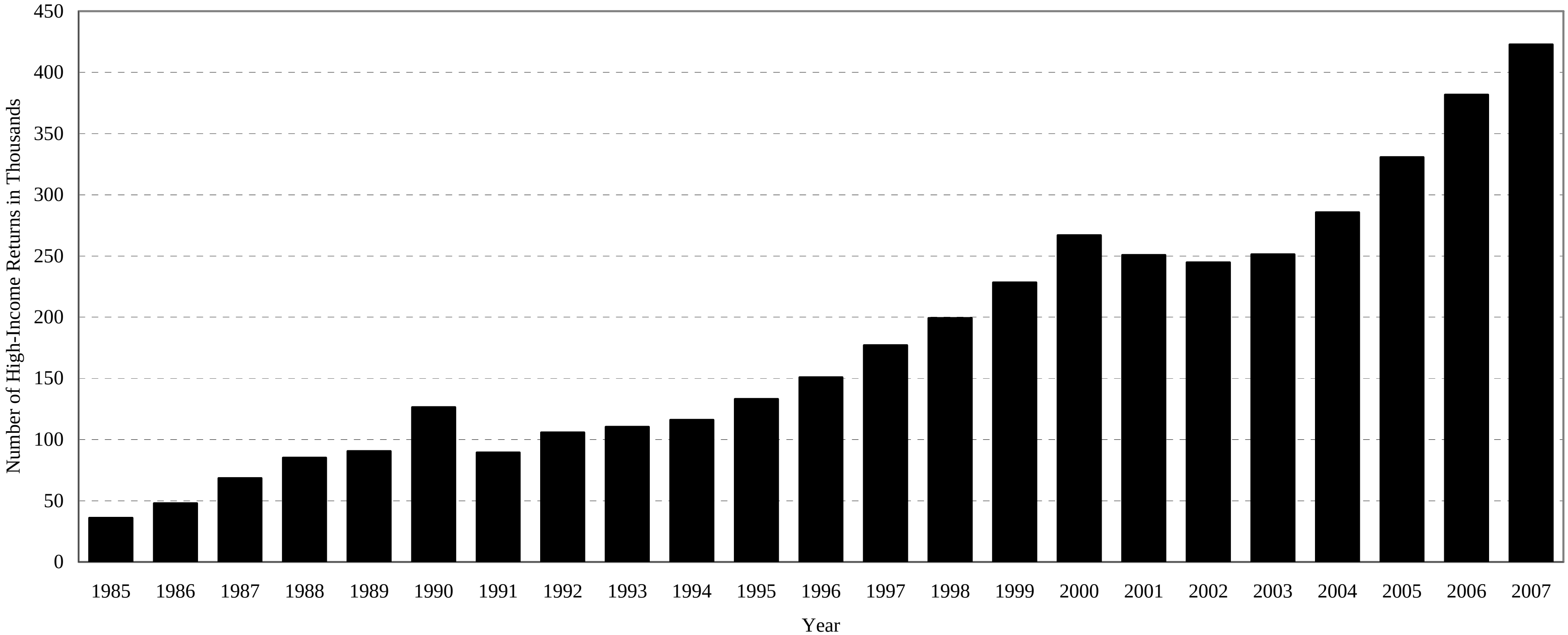
Source: New York State Division of the Budget.

The 2003 tax increases did not have the negative economic effects that Governor Pataki predicted.



Source: US Department of Labor. 2007 annual employment level projected based on 11-month change.

Following the 2003 adoption of the 3-year temporary increase in the top rate on the personal income tax, the number of high-income returns grew significantly.



Source: New York State Division of the Budget, , Economic and Revenue Forecast, Executive Budget 2007-08

YESTERDAY OVER 200 NON PROFITS, SERVICE PROVIDERS, UNIONS AND FAITH-BASED GROUPS TO GOVERNOR PATERSON: CUTS ALONE WILL DEVASTATE NEW YORK'S FUTURE

Groups Providing Critical State Services Call on Paterson to Stop Exempting Wealthy New Yorkers from Budget Pain and to Use the Tax Stabilization Reserve Fund to Fill the Gap!

(Albany, N.Y)— On the day Governor Paterson is announcing billions in budget cuts, the Better Choice Budget Campaign and the One New York: Fighting for Fairness joined together to call on the Governor and legislative leaders to abandon a budget policy that calls on working families and vulnerable New Yorkers to bear the burden of the state's fiscal crisis.

Together the two coalitions represent more than 200 non-profit organizations, faith-based groups, service providers and unions that supply front line services to many of New York's most vulnerable citizens. The two coalitions called on Paterson to examine revenue options rather than gutting services to close the state's huge budget gap. Similar events are also occurring today in New York City, Buffalo, Rochester, Utica, Binghamton, and in Central Islip on Long Island.

The groups called on Paterson to use the Tax Stabilization Reserve Fund (a "Rainy Day Fund" that currently has $1.039 billion) to bridge the mid-year budget gap, to wait for a state fiscal relief package from Washington before making massive cuts in services, and to ask the wealthiest New Yorkers to take part in the "shared sacrifice as we did in 2003.