Testimony of Frank J. Mauro, Executive Director, Fiscal Policy Institute, to the Senate Finance Committee and the Assembly Ways & Means Committee, February 28, 2007

On January 31, 2007, Governor Eliot Spitzer presented his first Executive Budget to the Senate and Assembly for their consideration. Put simply, this budget does a much better job of striking an appropriate balance among the state's revenues, expenditures, and human needs, than any Executive Budget submitted to the Legislature in more than a decade. This budget addresses some of the major challenges facing New York State but it ignores some others and in several cases its impact on vulnerable New Yorkers is potentially negative.

On the plus side, this budget, more than two years after the deadline set by the Court of Appeals, a New York Governor has submitted a legitimate response to that court's decisions in the Campaign for Fiscal Equity case. And that response takes the form of a statewide solution that the Governor proposes to apply to all of the state's school districts in an even-handed manner. The challenge facing the Legislature as it considers this proposal is to only change it in ways that will increase rather than decrease the likelihood that New York State will be able to succeed in preparing all New York's children for the ongoing technological revolution of the 21st Century.

New York spends a lot per pupil ***on average***. But those averages mask huge disparities. Some critics of New York's education system like to point out that New York, on a statewide average basis, is second only to New Jersey in per pupil spending but that New Jersey has the highest state average high school graduation rate in the country while New York ranks 48th on this measure. What is not noted is that New York has a poverty rate (14.7%) which is roughly double that of New Jersey's (7.4%); and that funding patterns within these two states are very different.

Of the 50 states, New York has the largest gap between the funds available per-pupil in high-poverty districts and the funds available per pupil in low-poverty districts. According to the Education Trust which does an annual report on funding gaps in each of the 50 states, the average funding gap in the United States as a whole in the 2003-04 school year was just over $1,300 but in New York it was over $2,900 (The Education Trust, Funding Gaps 2006, December 2006, page 7). New Jersey, on the other hand, was one of 15 states in which the average amount spent per pupil was actually higher in high-poverty districts than in low-poverty districts. In fact, New Jersey and Alaska were the only two states in which the spending per pupil in high-poverty districts was, on average, more than $1,000 more than the spending per pupil in low-poverty districts.

While the 2007-08 Executive Budget takes on the issue of school funding and educational accountability in a comprehensive and targeted manner, it says little else about the increasing concentrations of poverty in New York's Upstate cities. New York City has a little over 40% of the state's population and 54% of the state's poor but its poverty rate (i.e., the percent of its residents who live in households with incomes below the poverty level) is now much lower than the poverty rates of the Upstate cities. The latest data from the US Census Bureau indicates that New York City's 2005 poverty rate was 19.1% but that the poverty rates for the large and medium sized Upstate cities were all higher: Syracuse had a poverty rate of 31.3%, Rochester 30.0%, Buffalo 26.9% and Albany 26.5%.

As the Governor and the Legislature consider how to utilize the resources set aside in the budget for revitalizing the Upstate economy, they must keep in mind the plight of the Upstate cities. For the most part, the non-metropolitan counties in Upstate New York have been doing better economically than the metropolitan counties. And the metropolitan counties have been experiencing sprawl without growth with unemployment and underemployment increasingly concentrated in the central cities.

Upstate cannot do well unless its metropolitan areas (Buffalo-Niagara Falls, Rochester, Syracuse, Utica, Albany-Schenectady-Troy, Binghamton, and Elmira) do well and those metropolitan areas cannot be successful unless their central cities prosper much more than they have in recent years.

State fiscal policies have put needy cities, counties and school districts in fiscal binds. First, on numerous occasions, reducing the top rates on the state income tax was given priority over maintaining the state's commitment to revenue sharing with its general purpose local governments. Second, the share of local school budgets covered by state aid has declined, and the money that is now distributed to school districts through the STAR program is allocated in a way that exacerbates fiscal disparities rather than reducing them. Third, the method of dividing the non-federal share of Medicaid costs between the state and its local social services districts takes no account of the variations in those local districts' "ability to pay." These factors have combined to place great pressure on local property and sales tax bases in those parts of the state that have relatively weak tax bases compared to their needs. These trends can be reversed by

- Implementing a legitimate statewide solution to the court decisions in the Campaign for Fiscal Equity lawsuit.
- Gradually increasing the state share of Medicaid costs and basing each county's share of Medicaid costs on objective measures of its relative "ability to pay."
- Restoring the state's commitment to "revenue sharing" with its local governments through a transparent needs-based formula that is honored over time.
- Eliminating the fiscal disparities in the state's School Tax Relief (STAR) program, which (1) disadvantage city school districts with high percentages of needy children, and (2) give different amounts of relief to taxpayers with the same incomes and the same property tax bills, if they happen to live in different parts of the state
- Completing a comprehensive reevaluation of all of the state's real property tax relief programs (STAR, Circuit Breaker [IT-214], the local option real property tax exemption, the Farmers School Property Tax Credit) and the relationships among them, and working toward an integrated circuit-breaker variation of STAR that treats all taxpayers with the same incomes and the same property tax burdens the same regardless of where they live

In the 2007-08 Executive Budget, the Governor has taken many important steps in these areas. In school finance, he has proposed a legitimate statewide solution to the CFE case. In regard to this plan, please keep in mind that when moving from an inequitable distribution to an equitable distribution, some of the changes will seem inequitable. So keep your eyes on the end points in per pupil aid, not on the year-to-year changes in getting to the fully-implemented distribution.

In regard to revenue sharing, the Governor has proposed a multi-year increase in general-purpose aid (now called Aid and Incentives for Municipalities or AIM) to general-purpose local governments. But New York City has been dropped from the program and the formula that has been proposed increases current allocations by formula-determined percentages rather than

working toward an ultimately logical distribution.
In budgeting for Medicaid, the Governor is proposing some sensible cost savings but freezing hospital and nursing home reimbursement rates across-the-board could severely limit the availability and quality of care throughout the state. But this budget continues the annual percentage cap on local Medicaid costs, thus serving to increase the disparities between counties with relatively large concentrations of poor and elderly residents relative to their property tax bases and counties with small concentrations relative to their property tax bases.

In regard to property tax relief, the Governor's proposed reform of STAR id a step in the right direction but it does not go far enough. The governor's proposal would vary STAR benefits by income, thus addressing one of the major flaws in STAR as it is currently structured. But it does not base a family's STAR benefit on the relationship between a family's income and its property tax bill. Thus, two middle-income families with the exact same income and living in the same school district would get the same STAR benefit even if one family has a property tax bill of $3,000 a year and the other a bill of $6,000 a year. In addition, the governor's proposal does not address the problem of two families with the exact same income and the exact same property tax bill getting substantially different benefits if they happen to live in different part of the state.

New York's Budget Situation and Governor Spitzer's Cost Savings Plan

New York State's budget situation is improving but substantial challenges remain. State revenues are growing fast enough to cover the growth in state expenditures but they are not growing fast enough to make up for the loss of the nonrecurring resources that were used to balance the state's 2006-07 budget **and** to cover the cost of implementing the new multi-year tax cuts that were enacted into law last year.

New York faces a $1.6 billion budget gap for the state fiscal year scheduled to begin on April 1, 2007, but according to Governor Spitzer's 2007-08 Executive Budget less than 3% of that gap is attributable to differences between the underlying growth in state revenues ($3.8 billion) and the increase in expenditures necessary to maintain services at their 2006-07 level ($3.9 billion). Instead, the gap is attributable primarily to the scheduled implementation of previously enacted tax cuts ($954 million) and the net difference between nonrecurring revenues received and nonrecurring expenditures incurred during 2006-07.

In addition to this $1.6 billion "inherited" gap, the Governor's Executive Budget proposes new initiatives that are estimated to cost $1.9 billion in 2007-08, thus increasing the gap to $3.5 billion. The Governor is proposing to close this gap with $2.8 billion in General Fund cost savings and the use of $671 million of prior year surplus revenues. The value of the cost savings plan is projected to grow to $4.7 billion in 2010-11.

In the upcoming fiscal year, the Governor proposes to generate $1.3 billion or 46% of the total $2.8 billion in savings from what the Executive Budget refers to as health care reform. A little over $1 billion or 38% of the total is projected to come from a variety of efficiency and other cost reduction measures. And, $449 or 16% of the $2.8 billion is projected to come from the closing of tax loopholes, primarily loopholes that have been created by aggressive tax planning efforts by multi-state corporations.

Governor Spitzer's Cost Savings Plan				
(amounts in millions of dollars)				
Fiscal Year	2007-08	2008-09	2009-10	2010-11
Health Care Reform	1,299	958	1,924	1,738
Government Efficiency	1,062	1,858	1,999	2,384
Revenue Loophole Closures	449	567	537	537
Total Savings	2,810	3,383	4,460	4,659

While some of the proposed savings from health care reform may make sense, freezing reimbursement rates across-the-board will jeopardize the health of many hospitals and nursing homes. The November 2006 final report of the Commission on Health Care Facilities in the 21st Century (which was referred to as the Berger Commission), like Governor Spitzer, called attention to the fact that there are underutilized beds in a number of hospitals in New York State. But the Berger Commission report also made the following important points:

> [P]roviders are in weak financial condition. For the past eight years, the state's hospitals as a group have lost money. A majority of the state's nursing homes, even some that are fully occupied, operate at a loss. Such losses cannot be sustained indefinitely.
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> Negative or inadequate fiscal margins limit the ability of providers to reinvest in their systems, obtain the latest technologies, access capital, and upgrade their physical plants. Many of our hospitals and nursing homes are outdated and in need of capital improvements.
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> Turbulence afflicts our health care providers; facility closures and declarations of bankruptcy are too common. Since 1983, 70 hospitals and over 63 nursing homes have closed in New York State. Some of our oldest and proudest names in health care struggle under the unintended consequences of bankruptcy proceedings. Patient access to stable health care services is at risk.

An across-the-board freeze in hospital and nursing home reimbursement rates is a very "blunt instrument" approach to health care reform and could very well result in the closure of needed facilities. According to the Berger Commission report, the state's current reimbursement mechanisms "distort patterns of service delivery and induce facilities to pursue high margin services, sometimes at the expense of more essential community needs." Freezing that system in place may, in the short run, reduce costs but it will exacerbate rather than ameliorate the problems identified by the Berger Commission report.

As with the proposed health care reform savings, the "government efficiency" category also includes some blunt instrument expenditure reductions, the most significant of which ($328 million) is the Executive Budget's proposal to simply dropping New York City from the state revenue sharing program (now called Aid and Incentives to Municipalities or AIM). Revenue sharing should be distributed through a rational, needs-based formula that is applied to all the state's municipalities in an even-handed manner. If such a formula indicated that New York City and any one or more other cities were not in need of assistance this year, a decent argument could be made for dropping New York City from the program; but that is not the case.

Corporate Tax Reform

The third category of cost savings, closing corporate loopholes, includes proposals that address a number of specific abuses – some that have been around for a while and others that are newly minted - that have come to be used by multi-state corporations that can engage in transfer pricing and income shifting among subsidiaries. Some of the loopholes that are proposed for closure were invented by tax planners to take advantage of provisions of the law that were never intended for the purposes for which they are now being used. Others are the result of provisions of law that tax businesses differently if they design their corporate structures one way rather than another. This should not be the way the taxes of businesses in a competitive free market are determined.

In addition, the Executive Budget proposes an important and systematic reform, known as combined reporting, that has the greatest potential for leveling the playing field among firms in any given industry and making it harder for tax planners to invent new ways for multi-state corporations to avoid paying state taxes. By adopting combined reporting would join the 17 states other states, including California, Colorado, Illinois, New Hampshire and Texas, that require multi-state and multi-national corporations to file a combined return for their entire "corporate family" rather than being able to use inter-subsidiary transactions to move income to countries or states where that income is not taxable. Under combined reporting, a corporate family files a single tax return covering the income of all of its subsidiaries, with that income apportioned among the states based on a common formula. Most states use three factors (property, payroll and sales) in apportioning corporate income. But, New York is in the final year of a transition to a system in which it will apportion corporate income solely on the basis of the share of a firm's sales in New York State.

Rather than closing newly invented "income shifting" loopholes one at a time, as they are invented by tax professional, combined reporting provides a systematic approach to stopping income-shifting schemes. Combined reporting also has the advantage of protecting the state from new methods of transferring profits among subsidiaries that invariably arise once a single loophole is closed.

According to the Message from the Budget Director in the Executive Budget, "Consistent with Governor Spitzer's commitment, this Budget does not increase taxes. The Budget does reflect an increase in revenues from closing certain tax loopholes and tax shelters that allow certain taxpayers to reduce their tax obligations. All of these provisions have been carefully reviewed to determine that the actions proposed do not represent tax increases, but rather limit the ability of certain taxpayers to take advantage of unintended provisions in law to reduce their tax exposure through sophisticated tax planning techniques." In this message, the Budget Director also pointed out that many of these tax loopholes have already been addressed by other states and the federal government.

In the long term, the state should restore progressivity to its personal income tax.

In the long run, reestablishing a fair, adequate and economically sensible tax system is a far preferable approach to balancing the New York State budget than either putting more and more pressure on local property and sales taxes or neglecting the state's human and physical infrastructure needs. State policymakers should consider steps that would make the overall state-local tax system fairer while raising the revenue necessary to balance the budget in an economically sensible manner.

The most important step in this direction would be for New York to reform its personal income tax structure in a way that ensures that the wealthiest New Yorkers pay their fair share in state and local taxes. Among the many ways in which New York could move in this direction would be by (a) adopting the top brackets from New Jersey (8.97% on income above $500,000) or North Carolina (8.25% on income above $200,000); or (b) replacing New York's current bracket structure with its 1972 brackets (2% through 15%) adjusted to reflect the changes in the cost of living over the past 30 years. Under this latter option, 90 to 95% of New Yorkers would pay less than under current law while the state would collect $7.7 billion more in revenue. This indicates how far and in what direction New York's tax system has changed over the past 30 years.

Reforming the STAR Property Tax Relief Program

In 1997, Governor Pataki got the message that by cutting the top rate on the state's progressive personal income tax, he was cutting the wrong tax, in the wrong way, at the wrong time. In his 1998 State of the State Address, he put a positive spin on this recognition of the fact that the income tax is a fair tax and that the overwhelming majority of New Yorkers do not feel oppressed by it. "Last year we knew it was time to build on the tax cuts of the first two years. From this podium, I told you that it was time to cut taxes again. Different taxes. Oppressive taxes. Property taxes." It is, however, unfortunate that this focus on oppressive taxes did not take center stage until after the state had cut the income tax by over $4.5 billion a year (now $7 billion a year) with only half of this amount, at most, staying in the New York economy.

While STAR was aimed at an important problem, it works in an inefficient and ham-handed manner. By allocating property tax relief in a way that is unrelated to the amount of a household's property tax bill relative to its income, it delivers much less relief to those who are truly overburdened by property taxes than would a substantial expansion of the state's circuit breaker tax credit, in a much more efficient (i.e., less costly) manner than STAR which provides substantial amounts of money to homeowners for whom property taxes represent a very small percentage of their income.

Under STAR, the amount of tax relief to which a homeowner is entitled can vary with the median home value in his or her county of residence, but not with the magnitude of that homeowner's property tax burden relative to his or her income. The plan's one income test (whether a senior homeowner's income is above or below $60,000 a year, with that amount now adjusted annually to reflect changes in the cost of living) creates an illogical notch effect, while begging the question of a rational sliding scale based on income. While Governor Pataki argued for STAR on the basis that some people were literally being taxed out of their homes, STAR does not target its relief to such households. In addition, two taxpayers with the same income and the same size property tax bill could get widely varying levels of relief depending on where they happen to live.

The STAR plan is also flawed in that it provides relief only to homeowners. This ignores the fact that tenants also pay property taxes. While homeowners pay property taxes directly, tenants, through their rental payments, carry a substantial portion (usually estimated as being more than one-half) of the property taxes paid by the owners of their buildings. But under STAR, neither tenants nor landlords receive any relief. Only the owners of owner-occupied dwellings are helped by STAR. The result is extreme racial disparities. Over 62% of white households live in owner-occupied dwellings, while the comparable figure for black households is 29%. Replacing STAR with an expanded circuit breaker credit would also eliminate such unequal treatment since it provides relief to renters as well as homeowners.

To ensure fairness, property tax relief should not discriminate on the basis of geography or on the basis of whether someone is a renter or a homeowner. STAR fails on both of these counts. Enriching the state's real property tax circuit breaker credit would provide a more targeted, cost-effective means of providing property tax relief to those who are truly overburdened by the current system.

As a key part of his 2007-08 Executive Budget Governor Spitzer has proposed an increase in STAR benefits based on income. Under this proposal, no homeowner would see a reduction in benefits, but homeowners with incomes below $235,000 a year would see their STAR benefits increased by at least 30%. The largest increases (a doubling of STAR benefits) would go to homeowners whose incomes are $80,000 or less a year if they live in New York City or one of its five main suburban counties, or $60,000 or less a year if they live elsewhere in New York State. Some of these increases would be fully effective during the upcoming 2007-08 school year while others would be phased in over a 3-year period.

This reform plan is a step is a step in the right direction but it does not go far enough to make the STAR program fair to all of New York’s residential property taxpayers. While the governor’s proposal would vary STAR benefits by income, so that a millionaire would get less than a middle-income family, it does not vary the benefit based on the relationship between a family’s income and its property tax bill. Thus, two families living in the same school district would get the same benefit if they both made $50,000—even if one has a property tax bill of $3,000 a year and the other had a bill of $6,000 a year. In addition, the governor’s proposal does not address the problem of two families with the exact same income and the exact same property tax bill getting substantially different benefits if they happen to live in different parts of the state. And, STAR would continue to provide benefits only to homeowners even though it is clear that property taxes are paid on rental properties (frequently at a higher effective rate than owner-occupied residences) and that those property taxes are divided in some proportion or other between landlords and tenants.

Seeking federal policies that make it easier rather than harder for the states to balance their budgets

New York's government, labor, business and civic leaders should work with their counterparts in other states and at the national level to secure the enactment of federal policies that will make it easier rather than harder for the states to balance their budgets.

1. New York leaders should work to ensure that deductibility of state and local taxes on federal income tax returns is maintained. To eliminate this deduction would mean that taxpayers would be paying a tax on a tax. Federal deductibility of state and local taxes paid is essential to the workings of a federal system such as that which exists in the United States.

2. New York leaders should urge Congress to eliminate the current treatment, under the federal Alternative Minimum Tax, of the deduction for the state and local taxes paid. As Senator Kay Bailey Hutchinson has pointed out, "For those in states with income taxes, their tax deduction benefit has been diminished by the alternative minimum tax, AMT. People can deduct their state and local income taxes when calculating their regular taxes, but not when determining the AMT. The difference often is the reason people must pay the higher alternative tax. In fact, state and local taxes account for 54 percent of the difference between the AMT and the regular tax calculation. This particularly hurts the 60 percent of AMT payers who are from states with higher income tax rates. Eliminating this discrepancy would go a long way toward reducing the number of people affected by the AMT." *Congressional Record*, February 27, 2003, Page S2924.

3. New York leaders should work to secure Congressional approval of the Streamlined Sales Tax Project Agreement. This would provide the states' with the authority to tax internet and other remote sales. Until this issue is clarified, Main Street retailers who are required to collect sales taxes will continue to face unfair competition from the internet and other remote sellers who under current court decisions cannot be required by the states to do so. Clarifying this issue will also protect state and local treasuries from the loss of increasing amounts of sales tax revenue.

4. New York leaders should work for the repeal of the federal law (P.L. 86-272) that prohibits the states from taxing the income of corporations that have sales but no property or employees in a state. As more states, including New York, move to apportioning income solely on the basis of the portion of a firm's sales in the state (i.e., the Single Sales Factor proposal adopted by New York in 2005 to be phased in over the course of the next three years), P.L. 86-272 (an outdated 1959 law which was supposed to be temporary) has the affect of making an increasing portion of the U.S. income of multi-state and multi-national firms not subject to taxation by any state. At the present time, many of the same corporations that have lobbied for the Single Sales Factor at the state level are working to expand P.L. 86-272 to make even less corporate income subject to taxation by the states.

5. New York State leaders should build regional and national coalitions in support of legislation that would (a) repeal the limit that the Congress enacted in 2000 on the size of the loans that the federal government can make to state and local governments for tax revenue losses directly attributable to presidentially-declared major disasters, and (b) waive the requirement for the repayment of such loans when the losses involved are the result of terrorist attacks. This could provide both New York State and New York City with at least $1.6 in aid to make

up for September 11-related tax revenue losses during the 2001-02 fiscal year. No reimbursements have yet been received for these losses even though a review by the U.S. Government Accountability Office (GAO) validated the reasonableness of the Pataki Administration's estimates of the amounts involved.

6. New York leaders should work for a change in the Federal Medicaid Assistance Percentage (FMAP). That percentage which determines the federal share of a state's Medicaid costs is currently based on only one factor – per capita income. On this one factor, New York is a relatively wealthy state and receives the minimum federal share of 50%. But New York's unusual demographics underscore the problems with this formula. While New York, Connecticut and New Jersey, for example, are all among the 10 wealthiest states in the nation in terms of per capita income, when it comes to poverty rates, there is a wide divergence among the three states' situations. According to the Census Bureau's 2005 American Community Survey, New York had the 11th highest poverty rate among the 50 states (14.7%), while New Jersey had the second lowest poverty rate among the 50 states at 7.4% while New Jersey was ranked 49th among the states with a 9.6% poverty rate.