Tax-Free New York - Bad Tax Policy, Bad Economic Development Policy

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From a tax policy perspective, the Tax-Free New York proposal is inconsistent with the two long-established pillars of tax fairness—horizontal equity and vertical equity. "Horizontal equity requires those that have similar ability to pay be treated similarly. Vertical equity requires that those with greater ability to pay, pay more." (2008-09 Annual Report on New York State Tax Expenditures, page 22). In addition, New York State's past experience with targeted business incentives should raise huge red flags regarding the efficacy of the proposal as an economic development strategy.

A Special Class of Taxpayers

Under the Tax-Free NY proposal, some people who work in New York State (whether or not they live in New York State) would be exempt for five years from paying any personal income taxes on their New York wages. For an additional five years, that exemption would apply to the first $200,000 of wages for a single individual, $250,000 of wages for a taxpayer filing as a head of household and $300,000 for a taxpayer filing a joint return. That favored status would be bestowed on the wages received from Tax-Free NY businesses by people who (1) work for a business that has been approved for participation in the Tax-Free NY program, and (2) work for that business at a location that has been designated as Tax-Free land or as Tax-Free building space. All other people who live and/or work in New York State would be subject to the regular income tax laws. This approach, if enacted, would be diametrically opposed to the principles of horizontal equity and vertical equity.

More Costs Than Benefits

Exempting the personal incomes of the employees of favored businesses from the Personal Income Tax would also undercut one of the main arguments for state-level business tax breaks—that businesses receiving those tax breaks might not be paying full taxes but by those businesses locating in our state rather than somewhere else, we benefit from a broader and stronger personal income tax base.

But even if the Governor's Tax-Free New York proposal were revised to exclude this unprecedented exemption of favored employees from Personal Income Taxation, it would still have more risks and costs than benefits. Along these lines, one of the most important (and misleading) arguments made for the Tax-Free New York plan is that it has no cost. The basis for this claim is that under this proposal business income, sales and property taxes would only be forgiven for earnings, purchases and property usage that would not exist if it were not for the lure of the tax exemption. This claim is incorrect for several reasons.

First, the "no cost" claim assumes that none of the business activities that will be certified for Tax-Free New York treatment would have been undertaken in New York if it were not for the new program's tax exemptions. This assumption is fundamentally inconsistent with the argument that Tax-Free New York will result in the replication of the business development that has occurred at the nanotech complex associated with SUNY's College of Nanoscale Science and Engineering in Albany. Leaving aside the fact that the development of the CNSE-related nanotech complex was made possible by hundreds of millions of state government investments, if Tax-Free New York had been in place in recent years, none of the thousands of employees working for private businesses located in the nanotech complex would be paying personal income taxes today.

For many businesses, being able to locate on a college campus with related research and educational activities would be, in and of itself, a tremendous business opportunity. It is illogical to give tax breaks to a business for locating in a place that, if made available without tax breaks, is already more attractive than alternative locations.

Second, the net increase in the number of businesses in a state or region is a result of a larger increase in the gross number of new businesses offset by the closure of some number of existing businesses. Similarly, the net change in the number of jobs in a state or region is the result of a larger number of new jobs offset by the elimination of some existing jobs. Thus, a requirement that Tax-Free New York benefits will only go to new businesses (or to new jobs at existing businesses) does not ensure that those benefits only go to net new jobs. In any state, if all new hires were exempted from taxation, the overall income tax base would be severely eroded over time.

Third, when it comes to property taxes, Tax-Free New York will change many parcels from being subject to property taxes to not being subject to property taxes. This is because the proposal does not just provide for tax exemptions to go for businesses located on college campuses (which are currently exempt from property taxes) but to off-campus lands or buildings purchased or leased by the participating colleges. And there is nothing in the proposal to prohibit participating colleges from leasing or buying land or buildings that are currently on the tax rolls for use in conjunction with the Tax-Free New York program.

Fourth, by giving very favorable tax treatment to some business activities, the Tax-Free New York proposal is likely to reduce the market share of some existing New York businesses that do not receive this favored treatment. This, in turn, will reduce the profitability of those existing businesses and, thus, their tax liability. The favored businesses will not be paying taxes on their covered activities; and the negatively-affected existing businesses will be paying less because of diminished income or closure. This will mean some combination of tax increases and service cuts for other businesses and for residents—a costly, downward spiral rather than a no-cost nirvana.

Fifth, over time, Tax-Free New York status is likely to be extended to existing businesses or to new businesses that would have begun without the new Tax-Free New York benefits. New York State has never been able to sustain the integrity of a geographically-targeted business incentive program, and it is very unlikely that this would change anytime soon. This has been particularly true when the tax breaks involved became so rich that businesses and economic developers

throughout the state wanted—and demanded—a piece of the action.

With the Tax-Free NY proposal, however, the program would begin with an unprecedented level of benefits and with the ability (from the very inception of the program) for program administrators to bestow benefits on businesses located in off-campus lands and buildings. The boundary amendment process that ultimately led to the death of the Empire Zones (EZ) program did not begin until that program's 14th year of operations. And, ironically, it began in the same year (2000) that the program's potential benefits were so enriched that getting into the program became virtually irresistible for "smart" businesses.

The experience with the EZ program is fresh in many observers' minds but what may be glossed over is the fact that the expansionary pressures were relatively mild from 1986 through 2000. But, in 2000, the benefits were greatly increased by legislation enacted as part of the 2000-01 budget—with rhetoric about businesses being able to "operate tax free" being used and the name of the program being changed from Economic Development Zones to Empire Zones. Almost simultaneously with the legislative enactment of enriched benefits, the Pataki administration misused an expedited rulemaking process (authorized for "noncontroversial" changes in agency rules) to allow for zone boundaries to be amended to include noncontiguous parcels.

A virtual "land rush" ensued with a flood of boundary amendments being adopted to bring zone benefits to numerous non-contiguous parcels that did not meet the distressed area criteria on which the program was originally based. This was followed by an ultimately-successful campaign by the Business Council and others that every county in NYS should have at least one zone whether or not it was justified on objective criteria. There were annual efforts to "reform" the zones program but economic developers succeeded in stopping any real reforms until the program died of its own weight.

NYS went through a similar "life cycle" with the Job Incentive Program (JIP) that began in 1968 as a very targeted effort enacted as part of Nelson Rockefeller's "urban agenda" response to the assassination of Dr. Martin Luther King. The JIP went from being limited to the poorest census tracts in the state to being available statewide with such loose criteria that firms could get their corporate franchise tax fully exempted by increasing their floor space by a certain percentage. As with the EZ program several decades later, economic development professionals were able to stop reform efforts in the early 1980s. But the news surrounding the program became so negative that Mario Cuomo, in his first year as Governor (1983), proposed repealing the program outright rather than trying to fix it. And the forces that had stopped reforms during the previous years were unwilling to defend the program any more.

In retrospect, it is shocking that the Economic Development Zones program was established in 1986 only three years after the Job Incentive Program was closed to new entrants. But now, with the experience of the Empire Zones program clearly in mind, it is even more shocking that a new tax-free zones program is being proposed only three years after the EZ program was closed to new entrants. To paraphrase the philosopher George Santayana, those who fail to learn the lessons of history are doomed to repeat the mistakes of their predecessors. Or, as former Assembly Speaker Stanley Fink frequently said, “Fool me once, shame on you. Fool me twice, shame on me.”

Appendix

Excerpt from the 2008-09 edition of the "Annual Report on New York State Tax Expenditures."

Location-Specific Tax Incentive[1]

In 1968, the State also sought to target tax incentives to certain areas in an attempt to address regional economic concerns. The eligible business facility credit's objective was the retention and expansion of businesses and job opportunities in depressed urban areas. The Job Incentive Board administered the credit and to qualify, a facility had to meet location and employment tests and operate an approved training program. In 1971, the credit was expanded to eligible business facilities in low-income rural counties. Eventually, the program expanded to encompass the entire state. By the late 1970's, the program had become unwieldy and benefits were being provided without a well-defined justification of overall economic benefits. After newspaper accounts appeared revealing that Tiffany's qualified for the credit, the program was repealed prospectively. After April 1, 1983, no more credits were issued under the program. After the program was repealed, the Department continued to administer the credit during the years of continued taxpayer eligibility.

It was three years before the legislature returned to the concept of a location-specific tax incentive. In 1986, it enacted the Economic Development Zone (EDZ) Program. The Program designated certain areas of the State consisting of several acres where businesses could be eligible for particular credits. Credits included a 10 percent ITC, a three-year additional ITC (later EIC) equal to 30 percent of the EDZ ITC, and a five-year wage tax credit that declined in value each year. Taxpayers could also receive a tax credit for investing in zone capital corporations. In 1994, the zone equivalent area wage tax credit was created to allow the EDZ wage tax credit in areas that met zone criteria but were not designated as such. Also, the EDZ capital credit was expanded to include investments in certified businesses and contributions to community development projects.

Beginning in 2001, the EDZ Program was radically expanded in scope to create virtual "tax free" areas in distressed communities. The wage tax credit doubled in value to $3,000 for targeted and $1,500 for nontargeted employees, and the EIC was allowed against the alternative minimum tax (AMT). The Empire Zones Program Act changed the name of EDZs to Empire Zones and created two new credits. Businesses that met an annual employment test could become certified as qualified Empire Zone enterprises (QEZEs) and claim a real property tax credit (RPTC) and a tax reduction credit. The RPTC can potentially equal the amount of a taxpayer's real property taxes and is fully refundable. The tax reduction credit is based on employment increases and zone presence and can be used against the AMT and, in certain circumstances, the fixed dollar minimum tax to reduce tax to zero.

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[1] This excerpt is from pages 16 and 17 of a "Case Study: Growth in Tax Expenditures" that began on page 15 of the state's 2008-08 tax expenditure report.

After enactment, it became clear the EZ/QEZE Program provided opportunities for taxpayers to use legal maneuvers to make their businesses appear new or reconfigure their business structures and thus claim greater amounts of credit. As originally drafted, the credit formulas allowed minimal job increases to generate large tax credits. In addition, the program was expanded beginning in 2005 to include County Zones and "Regionally Significant Projects" with no specific ties to an economically distressed area. As of today, all New York counties have a designated zone. There was also debate over whether areas designated as EZs were in line with the original intent of the Program of targeting incentives to economically distressed areas. In an attempt to address criticisms and loopholes, changes have been made to the Program nearly every year since 2001.

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