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Testimony of
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Before the

Senate Finance and Assembly Ways and Means Committees

Joint Public Hearing on
Taxes

February 9, 2015

Thank you for inviting me to testify today on the tax proposals in the 2015-16 Executive Budget and Financial Plan. My name is Ron Deutsch and I am the Executive Director of the Fiscal Policy Institute.

Governor Andrew Cuomo's Executive Budget proposal takes some positive steps forward in clearly acknowledging, for the first time in his tenure, the incredible child poverty and income inequality that exist in our generally affluent state and recognizing the need to give greater property tax relief to those who need it most rather than spreading it too thinly. However, for every step forward the governor takes in addressing some critical issues, he takes two steps back by continuing his austerity spending at a time when we need to be investing in New York and by conditioning positive proposals on toxic and often unrelated requirements.

New York's Tax Structure Further Benefits the Wealthy

Those in the wealthiest one percent are taking home the lion's share of income gains, yet they nevertheless pay a smaller share of their income in combined state and local taxes than do lower- and middle-income families, according to a recent report from the Institute on Taxation and Economic Policy.[1] New York households with incomes under $100,000 pay higher effective state and local tax rates, ranging from 10.4 percent to 12 percent, than the richest 1% of households, who pay 8.1 percent.

The fact that high-income people pay a lower share of their income in taxes than the rest of us is what makes New York's state and local tax system by definition regressive. One reason the cumulative impact of state and local taxes is regressive is that most low- and middle-income New York families pay more in sales and property taxes than they do in income taxes. Our state income tax is mildly progressive but not enough so to offset the effects of highly regressive sales and local property taxes.

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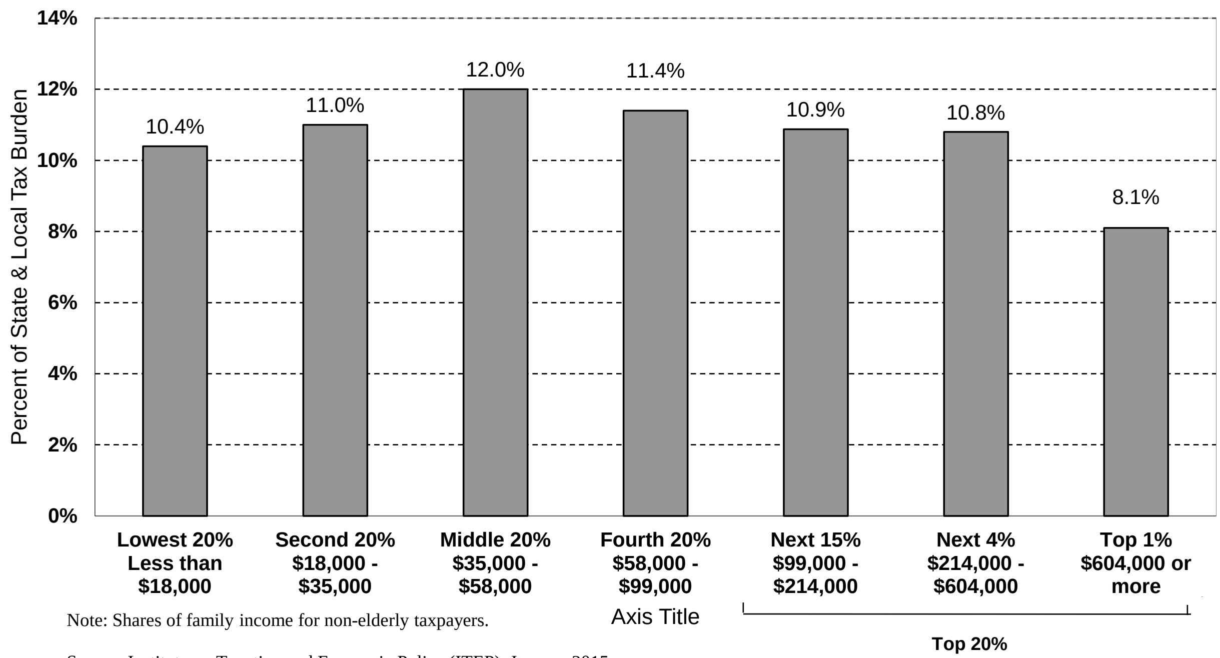
[1] Institute on Taxation and Economic Policy, *Who Pays*, January 2015.

And, compounding this problem, compared to other states, New York funds a lower portion of joint state and local expenses, which pushes localities to raise the only taxes they can raise on their own authority, regressive sales and property taxes. Among the 50 states, New York funds the third-smallest share of combined state and local spending.

Highly regressive sales and property taxes mean that New York State has a regressive overall state and local tax system.



Note: Shares of family income for non-elderly taxpayers.

Source: Institute on Taxation and Economic Policy (ITEP), January 2015.

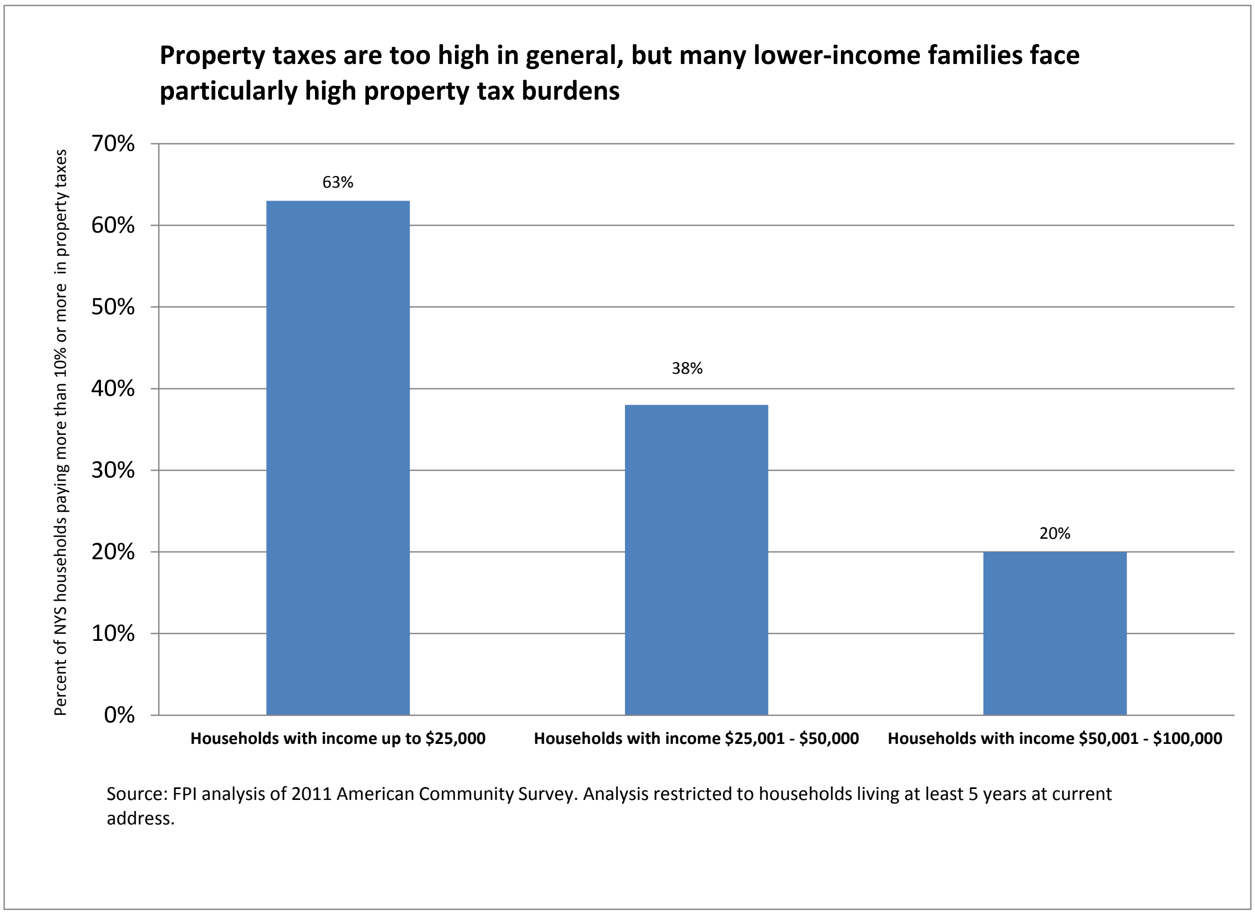
Tax Proposals

In most years since he assumed the office, Governor Andrew Cuomo has proposed a tax policy package very heavily weighted toward tax cuts, with some cuts for households and some for businesses. In his FY 2016 Executive Budget, the governor is proposing three major tax changes: a household property tax circuit breaker, an education tax credit, and a modest reduction in taxes on small corporations. The circuit breaker is a good idea, though linking it to a locality's compliance with the property tax cap is highly problematic. The education tax credit is a fundamentally misconceived giveaway, and is also cynically linked to passage of the Dream Act. A tax rate reduction for small corporations has a modest cost that will be offset by three welcome measures to reduce tax avoidance and tighten up on a business sales tax credit.

Taken as a whole, the new tax package is projected to reduce tax collections by $400 million in FY 2017, $900 million in 2018, and $1.4 billion in 2019. The circuit breaker accounts for almost all of this cost. While the idea is long overdue, a meaningful circuit breaker should not come at the cost of additional damaging budget and local assistance cuts. Instead, to pay for the circuit breaker the state needs to curtail some of its mushrooming business tax credits, fix some of the problems with last year's corporate tax "reform", and reject or roll back tax cuts benefitting wealthy households.

Property Tax Relief Credit: Circuit Breaker

The governor takes a positive step forward in delivering property tax relief to homeowners and renters whose property taxes are high relative to their income. New York has many high-income households, and many of those who own expensive homes do pay high property taxes. However, relative to their incomes, such taxes likely are not burdensome. On the other hand, over 700,000 of New York's lower and middle-income households, those making less than $100,000 per year, are paying more than 10 percent of their income in property taxes, according to a Fiscal Policy Institute analysis of American Community Survey data. Of households with income of $25,000 or less, 63 percent pay more than 10 percent of their income in property taxes. Nearly 240,000 households with income below $50,000 a year pay more than 20 percent of their income in property taxes, and almost two-thirds of those have income below $25,000.



Currently, 33 states and the District of Columbia provide some type of property tax circuit breaker relief to their residents. Most of these states provide circuit breaker relief with credits or rebates that reduce the amount of state income tax owed. A few administer stand-alone rebate programs. Most extend tax relief to both property owners and renters.

Over one million homeowners whose property taxes exceed six percent of their income would benefit from the governor's proposal, which would cost $1.66 billion per year when fully phased-in. The circuit breaker further targets the most relief to lower-middle income households by capping the amount of the credit at a lower level for taxpayers with higher income and by excluding taxpayers with incomes over $250,000. For example, a family making $50,000 per year and paying $6,000 annually in property taxes would see a $1,500 annual credit—or a 25 percent reduction in their property tax burden.

The Fiscal Policy Institute has long supported the enactment of a property tax circuit breaker and believes the governor's proposal is a good starting point. However, the proposal should not be linked to compliance with the local property tax cap, which among other problems will make tax relief for struggling homeowners contingent on circumstances they cannot control. The renter's credit should be redesigned to targeted more relief to lower-income renters.

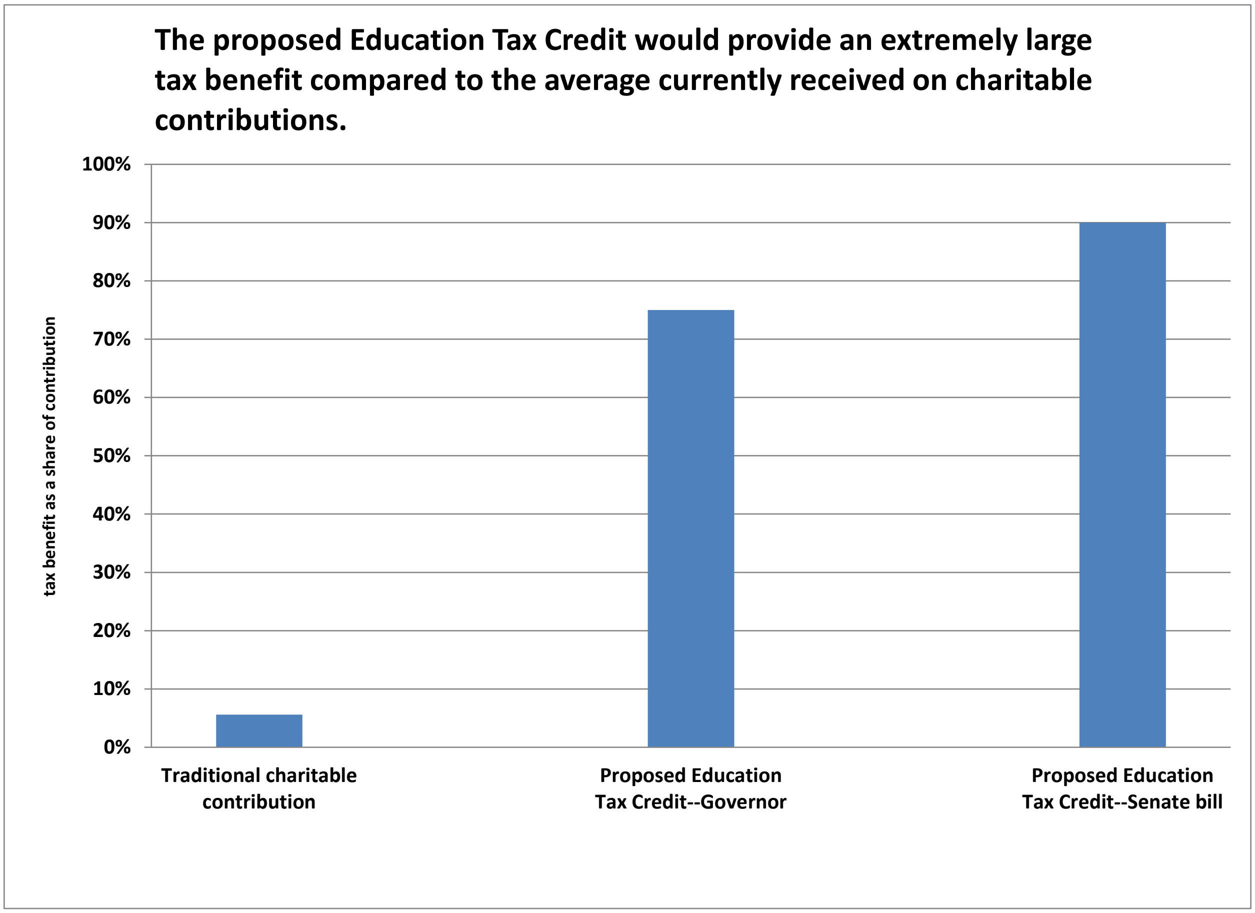
Education Tax Credit

The Executive Budget also includes an Education Tax Credit that would provide individuals and businesses with a substantial credit against income taxes owed for donations to private and public schools, or scholarship organizations. The governor's legislation proposes a 75 percent credit rate, with individual credit amounts capped at $1 million. Any unused credit could be carried over to a subsequent year but would not be refundable. Both businesses and individuals would be eligible to receive the credit on personal or corporate income tax returns. Total credits would be capped at $100 million per year. A related bill that passed the senate January 21 which would allow a 90 percent credit rate and higher total credits per year would allow credits totaling $675 million over the next three years. The governor's and the senate's proposals to divert hundreds of millions of dollars to privately determined educational uses raise serious questions. With this tax credit, the state is essentially delegating its spending authority to private individuals. The Education Tax Credit proposal represents a misuse of public resources for private purposes and could potentially be in violation of section 7 of Article 7 of the state constitution that requires all appropriations to be "distinctly specified."

Because it provides an unprecedented proportion (75 or 90 percent) of tax reduction relative to a contribution, it also has the potential to lessen charitable contributions for a wide range of worthy causes.

Since the proposed allocation process favors those submitting applications to make contributions early in the year, there is the possibility that wealthy donors, corporations or financial partnerships would be able to claim all or a lion's share of the credits early each year. An application would have to be submitted prior to making a contribution, it would have to be approved by the Tax and Finance Department and the recipient educational organization would have to be approved by the State Education Department. The allocation process and the high donation limit of $1 million would allow wealthy individuals or partnerships to potentially exhaust the $100 million annual credit pool, freezing out smaller contributors.

The Education Tax Credit proposal flies in the face of sound, long-standing New York personal income tax policies. Most existing personal income tax credits in New York available to households are geared to lower–income households, or have fairly low maximum credit amounts or income eligibility limits. For example, expenses for mortgage interest payments or charitable contributions made by households are eligible for a deduction on state personal income tax returns. The effective value of tax benefit for such deductions is a taxpayer's tax rate times the amount of the expense or contribution. Thus, at most, the effective tax credit "rate" for deductions is 8.82 percent, the state's top income tax rate. The state average effective income tax rate in 2010 was 5.6 percent—that is the benefit the New Yorkers get on average for a charitable contribution. The state has also acted in recent years to limit the deductions for charitable contributions for high-income taxpayers.



A proposed tax credit of 75 or 90 percent is so extraordinary in the context of New York's tax system that it warrants particularly careful consideration. This proposal is very nearly an outright reimbursement for a private expenditure and as such, is difficult to distinguish from an appropriation. It amounts to handing $100 million to wealthy individuals or business interests and allowing them to determine how to spend it.

Small Corporation Tax Reduction and Measures to Improve Enforcement

The Executive Budget proposes reducing the net corporate income tax rate for businesses with fewer than 100 employees and net annual income below $390,000. The tax rate on these small businesses would be reduced over three years from 6.5 percent to 2.5 percent. This would provide a savings, when fully implemented in FY 2018, of four percent of net income. Last year the state acted to lower the corporate income tax rate from 7.1 percent to 6.5 percent for all non-manufacturing companies, and to reduce to zero the tax rate on manufacturers throughout the state. The proposed rate reduction for small business would cost $26 million in foregone revenues in FY 2016, increasing to $32 million in FY2018 when the rate is reduced to 2.5 percent.

Fortunately, this tax cut would be offset by improvements in tax compliance. In response to the continued growth in online sales through marketplace providers like Amazon and eBay, the Executive Budget proposes that such providers be required to collect New York sales tax when they facilitate a sale between an out-of-state seller and a New York consumer. This measure is expected to yield nearly $60 million a year beginning in FY 2017. A package of enforcement initiatives are proposed this year that would generate an estimated $20 million in collections in FY 2016 and $30 million the following year.

The Governor's Approach: Paying for Tax Cuts with More Budget Cuts

The proposed property tax circuit-breaker and Education Tax Credit, on the other hand, are not paid for with offsetting tax compliance measures or tax increases. The Executive Budget makes it perfectly clear what the state would have to do to manage more tax cuts: "[the tax cuts have] been sized to absorb much of the surplus that would otherwise be expected to occur if the state adheres successfully to the two percent spending benchmark in future years." That is, another layer of as-yet unidentified spending cuts in local assistance, human services, and higher education would be necessary on top of gap-closing budget cuts that are already specified.

There is an alternative to spending cuts to finance the circuit-breaker. The state could rethink some of the tax cuts enacted in the previous years. Tax changes enacted since FY 2013 are currently reducing tax receipts by nearly $1.2 billion a year and this number will continue to grow. (This number is lower in FY 2016, but will be more in FY 2018 as a result of a change in the form and timing of the family tax relief measure first enacted in 2013.) The amount of foregone taxes related to the estate tax changes enacted last year will continue to grow as the increase in the exemption is phased in.

New York State tax cuts enacted since FY 2013, and proposed FY 2016

	FY 2013	FY 2014	FY 2015	FY2016	FY 2017	FY 2018	FY 2019	cumulative 2013-2019	
Enacted and proposed tax cuts									
Enacted FY2013-2015 tax cuts	-$45	-$516	-$1,084	-$840	-$1,213	-$1,708	-$1,022	-$6,428	
Proposed FY2016 tax cuts				$9	-$398	-$901	-$1,404	-$2,694	
Combined enacted and proposed FY 2016	-$45	-$516	-$1,084	-$831	-$1,611	-$2,609	-$2,426	-$9,122	
Tax cuts by beneficiary									share of total
Households	$0	-$410	-$789	-$451	-$775	-$1,664	-$1,344	-$5,433	60%
Businesses	-$45	-$106	-$335	-$461	-$641	-$690	-$701	-$2,979	33%
High income households	$0	$0	$43	$78	-$195	-$255	-$375	-$704	8%

Source: Division of the Budget reports, 2012-2015.

Last year was the big year for enacting business tax cuts, including corporate tax reform that combined the bank tax with the corporate franchise tax and eliminated the corporate tax for upstate manufacturers. When the state originally proposed corporate tax reform, it was advertised as “revenue neutral.” However, the “reform” package that was enacted in 2014 will cost the state $440 million or more annually in reduced taxes when it is fully phased in. Proposals to scale back the investment tax credit were rejected and the capital base alternative tax was eliminated, which could result in some very large corporations paying a miniscule amount of tax relative to the volume of business they conduct in New York. In contrast, when Mayor de Blasio recently proposed New York City’s version of corporate tax reform to conform to the state’s changes, he retained the alternative capital base tax and significantly raised the cap to $10 million. This will help make the city’s corporate reform “revenue neutral.” Retaining the capital base tax ensures that large companies will still pay a reasonable tax in years when losses or tax management maneuvers might otherwise have substantially reduced a corporation’s tax liability.

Taking the tax changes enacted since FY 2013 together with the governor’s latest tax proposals, state taxes are estimated to be lower by $1.6 to $2.6 billion over the FY 2017-19 period. Roughly 60 percent of the net value of these tax cuts benefit moderate- and middle-income households. A variety of business tax breaks average about $700 million over that period, with roughly two-thirds of that amount benefiting large financial and non-manufacturing corporations and about one-third geared toward manufacturers and small corporations. (Unincorporated businesses, which include most small businesses as well as hedge funds and private equity funds, do not pay a separate business income tax to New York State; business income that flows through to personal income tax returns is taxed.)

Included in tax changes recently enacted or proposed are various measures to reduce tax avoidance and to increase compliance, including audits that raise about $250 million a year. Two tax changes—the estate tax cut enacted last year and the governor’s proposed Education Tax Credit— which have an average annual cost of $275 million over the FY 2017-19 period benefit upper-middle and high-income households. The more expensive version of the Education Tax Credit that passed the Senate in January 2015 would provide a $300 million tax benefit that would largely go to high-income households. (The governor proposed to cap that credit at $100 million.)

The resources to pay for the circuit breaker should come from fixing some of the problems related to last year’s corporate tax reform, from eliminating or scaling back many of the state’s smorgasbord of business tax credits, and by rejecting the Education Tax Credit and limiting the increase in the estate tax exemption.

A Financial Plan Based on Unforced Austerity

Boosted by $5.7 billion in bank settlement funds, the total FY 2016 state budget includes $150 billion in spending. On a state operating funds basis, excluding federal funding and spending on capital projects, next year’s budget is projected at $94 billion. Since the state had already allocated $275 million of settlement funds when the FY 2015 budget was adopted, there is $5.4 billion in bank settlement-related surplus this year. (The state’s proposed uses of those funds will be discussed in a later section.) Current-year tax collections through December were significantly greater than forecast, resulting in a FY 2015 General Fund operating surplus of $525 million, which is being added to the state's rainy day reserves and used to prepay $200 million in FY 2016 debt service.

State operating expenditures are projected to increase by only 1.7 percent in FY 2016 from the current year. Within the context of very slight overall spending growth, there are continued cuts in many areas of local assistance and most state program spending. This slight spending growth takes place at a time when tax receipts are projected to grow by 5.1 percent in FY 2016 and economic hardships continue to mount and probably affect more New Yorkers than ever before following five years of economic recovery.

This stark juxtaposition between moderate economic and tax receipt growth on the one hand, and a two percent spending limit on the other, define a budget policy best characterized as unforced austerity. It is austerity driven by a policy choice, not by a faltering economy.

Since he came into office four years ago Governor Cuomo has sought to tightly limit the growth in state spending to 2 percent a year or less, irrespective of growth in tax collections and total personal income. This unforced austerity budgeting has severely restrained services in many critical areas affecting New York's children and families and their communities. When coupled with the governor's 2 percent local property tax cap, this unforced austerity has meant that local government spending in most parts of the state has suffered, and this has resulted in deteriorating services and an inadequate public response to rising hardships afflicting many families.

- State spending on local assistance for social welfare, public health, housing programs, and people with disabilities has fallen by 10 percent or more in inflation-adjusted terms over the past four years, while a growing number of families with children experienced hardship. Outside of New York City, the number of people receiving aid from the Supplemental Nutrition Assistance Program (food stamps) has jumped by 75 percent (576,000 people) since the recession. Meanwhile, the number of people receiving safety net assistance, which is mainly funded by local governments, rose by almost half in the six years since the recession began.

- Although state-funded local school aid rose this year (FY 2015), it is still nearly nine percent, or $2 billion, lower in inflation-adjusted terms than in was in fiscal year 2011, and $5.7 billion below where it should be according to the state's 2007 response to the final court ruling in the Campaign for Fiscal Equity (CFE) case.

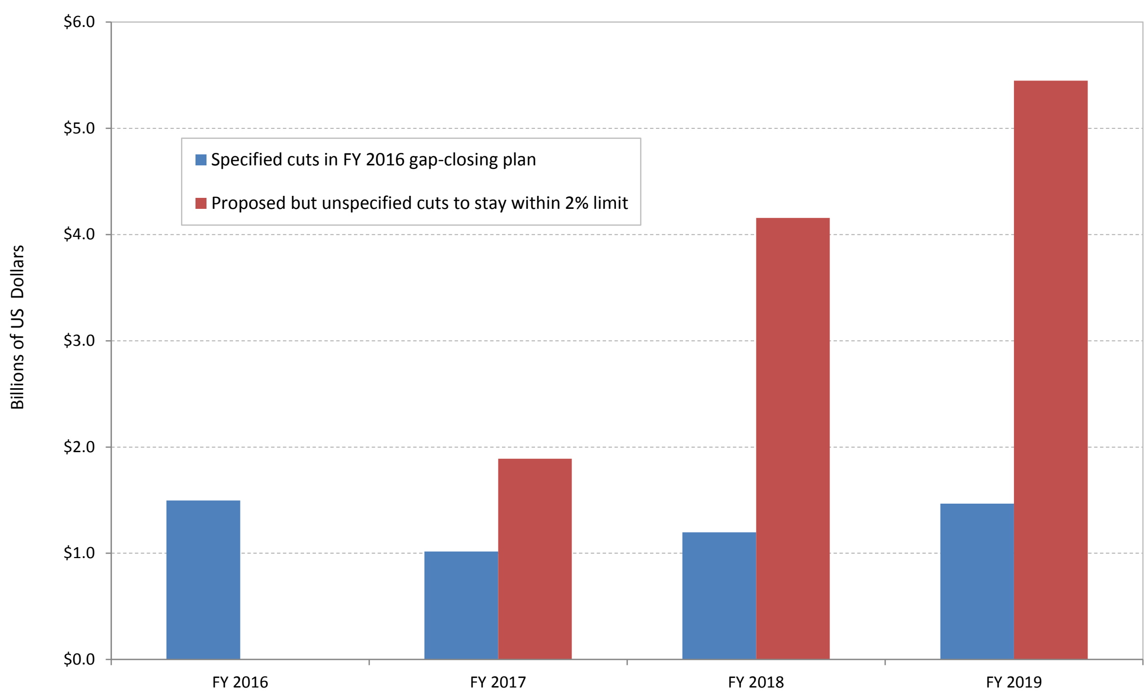
- Local tax collections have fared poorly in most of the state, partly due to the property tax cap. However, state funding for local government assistance has not responded to rising needs even though state tax collections have increased 4 percent annually on average. On an inflation-adjusted basis, local government aid has fallen by nearly 8 percent over the past four years.

Not surprisingly, state budget austerity has led to a steep decline in state and local government employment in recent years—the number of state and local jobs is down by 74,000 since 2009. In addition to resulting in reduced services, government layoffs cost jobs that provide solid middle incomes with benefits. Total job growth upstate has averaged only 0.4 percent a year during the recovery, one-fourth of the rate of job growth downstate or in the United States overall.

To keep within the unnecessarily self-imposed 2 percent spending cap, the governor proposes further cuts in many areas of local assistance in the FY 2016 budget. Even in areas where state spending in nominal dollars is increasing, it is often nonetheless lower in real terms after adjustment for inflation. In most cases, the state is committing less in real funding support compared to FY 2011, despite five years of a recovering economy. Continued adherence to a 2 percent spending cap in the later years of the state's financial plan—FY 2017, 2018 and 2019—means that, unless the policy is changed, unforced austerity will continue.

Some of these future-year cuts to social welfare, public health, and support for people with disabilities are built into the proposed financial plan as a result of the state's gap-closing plan. On top of these cuts, however, substantial further budget cuts will be layered on in order to keep within the 2 percent spending limit. These as-yet unspecified cuts total $11.5 billion or an average of $3.8 billion a year. **The chart below** shows the budget cuts that are detailed by program area as part of this year's proposed gap-closing program, as well as the additional unspecified cuts in future years that will be needed to stay within the state's 2 percent spending cap.

Steep spending cuts in local assistance and state agencies are part of the FY 2016 gap-closing program and further cuts will result from the Governor's 2% spending limit.

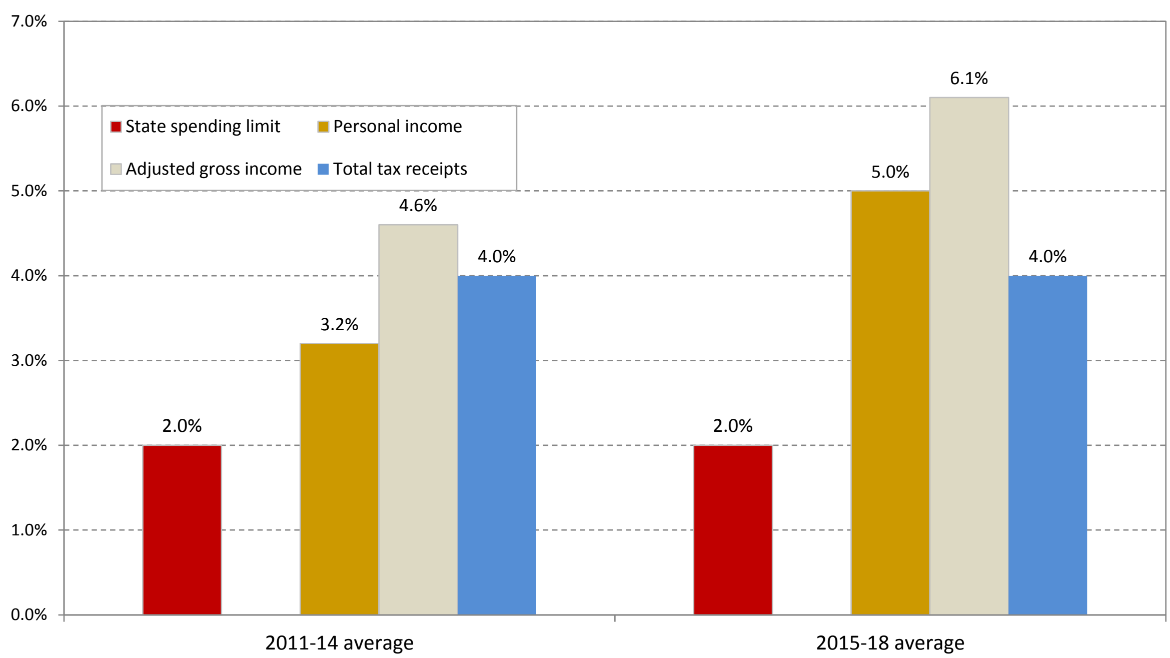


Source: Source: FY 2016 Executive Budget Financial Plan, January 2015.

With Medicaid and school aid likely to increase moderately over the next three years, most of the $3.8 billion annually in further cuts almost certainly will be concentrated in the remaining areas of the state budget—social welfare, higher education, public health, parks and environment, housing, and aid to local governments. For these budget areas taken as a whole, further spending reductions of $3.8 billion a year translate into a staggering 17 percent reduction.

This unforced austerity means the state is not making up for several years of harmful budget cuts and not addressing a host of critical human needs that have mounted in the wake of the Great Recession and the historically weak recovery. The chart below illustrates that New York clearly has the overall income and tax receipt wherewithal to do better. Various measures of the state's tax capacity have been growing considerably above 2 percent over the past four years, and these measures are projected to grow even more on an annual basis in 2015 and the following three years. Personal income and adjusted gross income, the starting point for determining state personal income tax liability, are projected to grow by 5 to 6 percent annually from 2015 to 2018. New York's total tax receipts, including the tax cuts already enacted and assuming the various proposed tax cuts were enacted, are projected to grow by four percent annually, twice the 2 percent spending limit. Without the proposed tax cuts, tax collections would be increasing by 4.8 percent annually. The difference between 2 percent and 4 percent growth in tax receipts translates into $1.5 billion a year.

New York's economic ability to pay well exceeds the Governor's 2% state spending limit.



Source: Personal income and adjusted gross income (AGI) , NYS Divison of the Budget; tax receipts (before tax cuts) from NYS Department of Taxation and Finance and Division of the Budget. Personal income data for calendar years, AGI for tax years, tax receipts for subsequent fiscal year.

Tax Policy/Revenue Recommendations

- **Add progressivity to the Personal Income Tax (PIT):** New York's overall state and local tax system is regressive. The state personal income tax should be made more progressive to lessen the overall tax system's regressivity. The top personal income tax bracket and the slightly-lowered middle income brackets are set to expire in 2017 and should be made permanent, along with an additional bracket for incomes between $500,000 and $2 million at 7.85 percent (which was removed in the 2011 changes to the "millionaires tax").

- **Reject the misguided Education Tax Credit:** This proposal is nothing more than a $100 million diversion of taxpayer resources to privately determined educational uses. It would provide an unprecedented 75 percent tax reduction relative to a contribution and has the potential to lessen charitable contributions for a range of worthy causes. There is no provision to avert a situation where wealthy donors, corporations, and financial partnerships would claim all or a lion's share of the credits.

- **Fix "corporate tax reform":** Changes should be made to improve the corporate tax reform that was enacted last year. The changes were meant to be revenue neutral, but in fact wound up costing nearly $500 million. To make up for this lost revenue, the state should make permanent the 0.15 percent capital base alternative tax rate and raise the cap to $10 million, and should enact the investment tax credit reforms Governor Cuomo proposed last year.

- **Reform and curtail business tax credit programs:** Reduce the amount of money ill-used in the name of economic development and redirect it to bolster economic growth. Tax credits have tripled to $1.8 billion in the past decade, yet they have a negligible impact on job creation. The governor's own tax commission recommended curtailing the scattershot use of tax credits. These funds can be better used as investments in smart economic development.

- **Enact circuit breaker tax relief**: Build on the governor's proposed circuit breaker property tax relief program for homeowners and renters. Do not link the circuit breaker to local compliance with tax cap. Increase the residency requirement to more than 6 months, so that aid is targeted to families who have bought homes and then seen their property value, and property tax, rise. Increase the maximum credit so that the circuit breaker provides meaningful aid. Target more relief to low-income renters.

- **Eliminate or amend the property tax cap:** The property tax cap is the wrong solution to the state/local tax problem, and it should be eliminated. Short of being eliminated, there are modifications that would at least minimize its damage to schools and local governments. The cap should be amended to allow for a simple majority override rather than requiring a 60 percent supermajority. The cap should also have exclusions for local expenditures for emergencies, capital improvements, infrastructure, and enrollment.

- **Eliminate the exemption for carried interest under the New York City Unincorporated Business Tax:** Authorize New York City to tax private equity and hedge funds on the same footing as that of thousands of smaller businesses, and modify the state nonresident personal income tax to include New York income received from investment management services that is not now taxed.

- **Redirect $1.5 billion in bank settlement funds:** Instead of the governor's plan to pit upstate regions against each other, this valuable one-time funding source should be directed to infrastructure repairs across the upstate area. Infrastructure repairs are desperately needed throughout the entire region and those improvements will help attract business by improving local conditions.

- **Scrap the state spending cap:** Eliminate the governor's self-imposed two percent cap on state spending. State tax revenues, total wages, and personal income are projected to grow by four to six percent annually over the next four years. There is no reason to hold annual spending growth below two percent if it means that we are under-investing in education and poverty reduction. This unforced austerity will cause large unspecified cuts to local governments, education and human service programs.

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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.