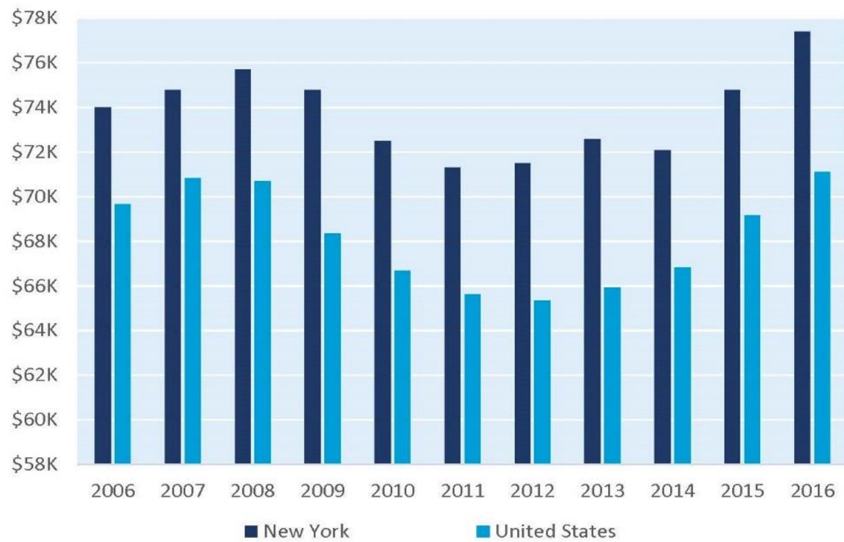
New York’s Pronounced Income Inequality and Evolving Tax Structure

The sweeping changes introduced by this year’s very partisan federal tax bill drastically altered the tax environment for individuals and businesses. One-way congress held down the already enormous expense of the tax bill to the federal government was to grab revenues from the states by significantly limiting the deductibility of state and local taxes. These changes compel states to adapt and pursue defensive fiscal reforms that can protect and potentially benefit their residents. The need to react is especially pronounced in New York, whose taxpayers may face additional tax-related costs of over $14 billion annually unless something is done at the state level. The new federal tax law also puts New York’s tax system progressivity at risk, and has the potential to severely impact the state’s investments, services and economy as a whole. To address these problems the state’s leadership must demonstrate a bold vision for innovative strategies and sensible, realistic solutions in the arena of fiscal policy.

Inequality

New York State has a pronounced income inequality that has been getting drastically worse over the past 35 years. The dimension across which inequality manifests itself are geographic and ethnic. Vastly more high-paying jobs are created in NYC than upstate New York. While household incomes recovered from the Great Recession, with median household incomes showing positive growth since 2008, if broken down by demographic categories the picture looks mixed and uneven.

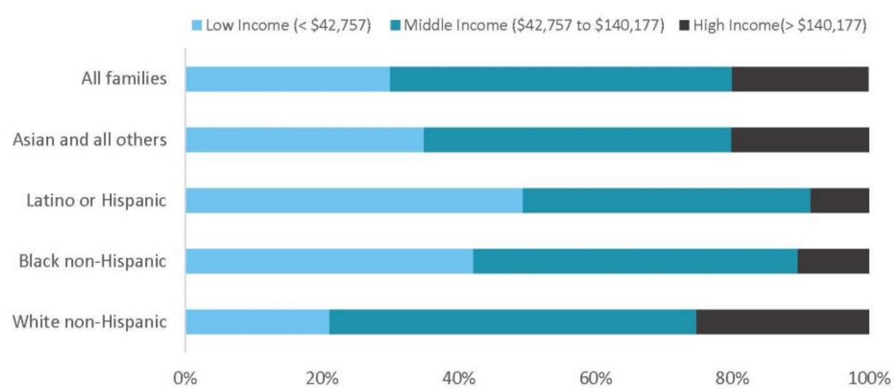
Fig 6. NYS Median Family Real Income



Source: American Community Survey data, Income in 2016 constant dollars.

The income of a typical (median) white family is almost double that of a typical black family. Black families are in fact twice as likely to be low-income. The state of New York has increased its minimum wage to boost the incomes at the low end of the income structure, but it needs to do more. Most directly it should increase the progressivity of the state taxes.

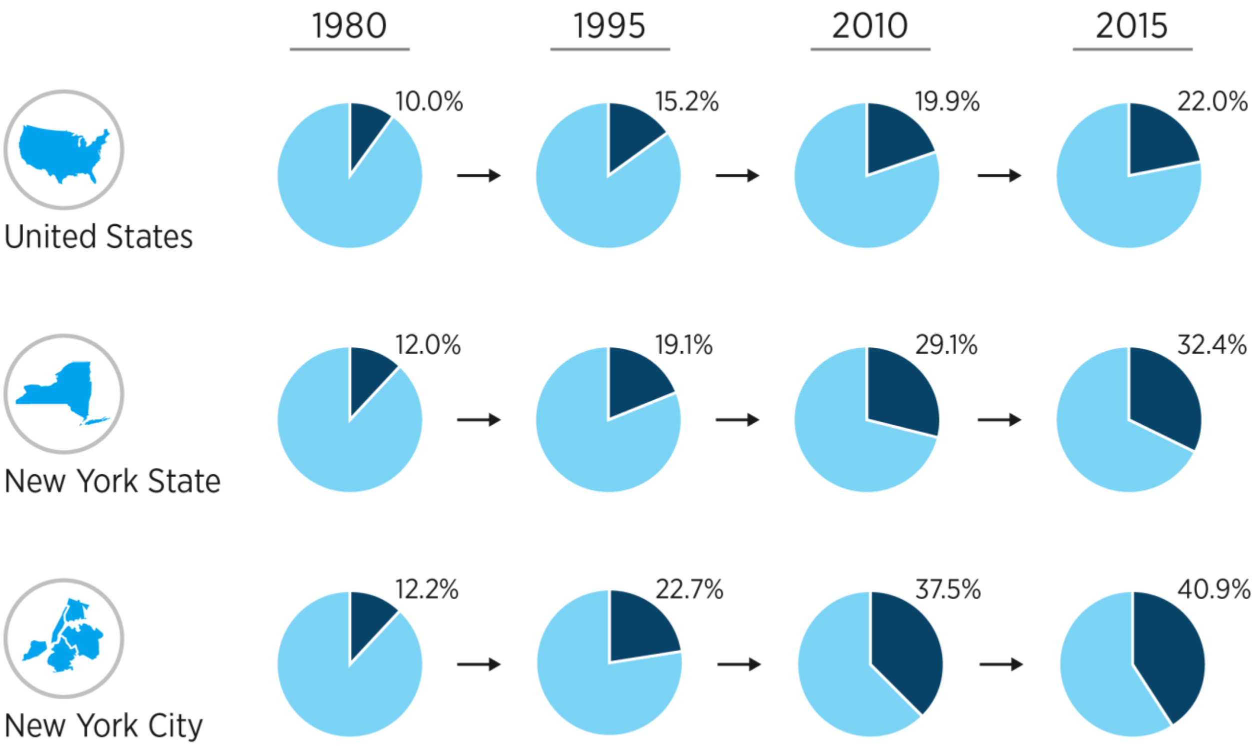
Fig 7. New York's Black and Latino Families Much More Likely to Have Low Incomes



Source: FPI analysis of 2014-2015 American Community Survey microdata. Income analysis done using 2015 constant dollars.

The share of income going to the top 1 percent has been steadily increasing since the 1980s nationally, statewide and in New York City. The upper end of the state's income distribution has benefitted greatly and disproportionately from the state's economic growth. The top one percent of New Yorkers have realized a significant portion of the income gains since 2008.

Fig 8. A Bigger Slice of the Pie
The Growing Share of All Income Going to the Top 1 Percent



Source: Emmanuel Saez, U.S. data updated June 2016; Estelle Sommeiller, Mark Price, and Ellis Waezeter, Income inequality in the U.S. by state, metropolitan area, and county, Economic Policy Institute, June 16, 2016, New York state data; Independent Budget Office data for New York City; and FPI estimates updated by Dr. James Parrott.

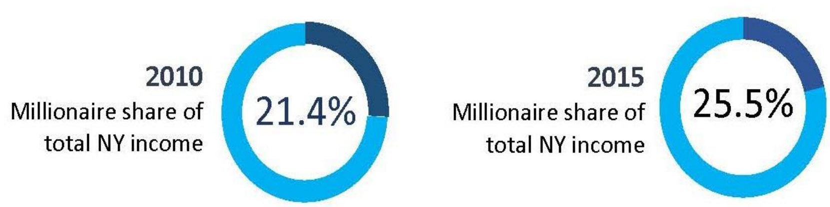
Income inequality and social polarization are serious problems and as the state seeks to create opportunities for shared prosperity and equitable growth, it must also pursue meaningful measures aimed at enhancing the progressivity of its tax regime. Moreover, forcing the state into austerity, by depriving state agencies of resources in order to make the top one percent better off is not a sign of good governance, but rather the opposite. An enhanced millionaire's tax and various federal recapture taxes should be applied to generate the much-needed revenues, to fund essential services and make progress in addressing income inequality issues.

[2] Cristobal Young, Charles Varner, Ithai Z. Lurie, and Richard Prisinzano, "Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data," *American Sociological Review*, 2016, vol. 81(3), pp. 421-446.

Contrary to the conservative insistence that progressive taxation will drive away the wealthiest taxpayers, recent research on "millionaire taxes" by Cristobal Young of Stanford University and colleagues shows the rich are generally so tied to local economic and social networks that they have largely not moved out of the states that have imposed higher income taxes.[2] New York's experience corroborates these academic findings. Since the enactment of the millionaire's tax in 2009, the number of millionaires in New York has climbed, and their incomes have grown much faster than that of non- millionaires. The number of resident millionaire returns grew by 40 percent from 2010 to 2015—10 times the four percent growth in the number of non-millionaire returns. The total income on millionaire returns grew by 49 percent nearly three times faster than all other New York tax returns. Needless to say, this is contrary to the predictions of opponents of the millionaire's tax who claimed wealthy people would flee the state in the face of higher taxes.

Fig 9. Number of Millionaire Tax Returns Increased by Forty Percent from 2010 to 2015

	2010	→	2015	% Change
Number of millionaire tax returns	35,802	→	50,080	40%
Total income on millionaire returns	$134.5 billion	→	$199.8 billion	49%
Number of non-millionaire tax returns	9,236,260	→	9,564,530	4%
Total income on non-millionaire returns	$493.9 billion	→	$582.8 billion	18%
All NYS tax returns	9,272,062	→	9,614,610	4%
Total income on all returns	$628.4 billion	→	$782.6 billion	25%



Source: Internal Revenue Service, Statistics of Income data.

New Tax Law

The federal Tax Cuts and Jobs Act of 2017 disrupted the tax regime. This will cause a massive readjustment in the behavior of individuals and businesses as they start to consider and gradually adapt to the new set of incentives and stimuli. The changing environment will produce its winners and losers, and the role of the state is to mitigate unnecessary losses while maintaining fairness and opportunity for all New Yorkers.

Who Gains?

Corporations
The main beneficiaries of the new tax law are corporations. The corporate tax rate has been lowered substantially and permanently: the top rate was slashed from 35 to 21 percent—without closing the loopholes that allow many corporations to escape the tax entirely. In this new regime, corporations exist in a "territorial" tax system: they are no longer liable to pay taxes for their worldwide income. The corporate alternative minimum tax has been repealed. Previously, corporations were subject to an Alternative Minimum Tax of 20 percent, exempting only those with 3-year average annual gross receipts of less than $7.5 million. Additionally, the federal tax law features several generous asset expensing and depreciation provisions.

People with Limited Liability Company's (LLCs) and other vehicles for pass-through income
Most people with pass-through business income, a group that is sure to rapidly bloat, benefit from a 20 percent deduction. Pass-through companies with a substantial quantity of qualified property are set to benefit greatly. As an industry, real estate, where businesses that own and operate properties are routinely set up as LLCs and partnerships to generate this kind of pass-through business income, is poised to gain from the structure of the provision and the definitions it supplies.

The super-wealthy
The federal tax law also vastly increases the amount wealthy individuals can transfer to others—their children, for example—tax free. In a stunningly regressive manner, the new law reduces the estate tax exposure for high net worth individuals by doubling the amount of their "applicable exclusion amount" for both gift tax and estate tax purposes. Under the prior law, the amount in 2018 would have been $5.6 million per person but it will now be approximately $11.2 million per person. The tax provisions benefitting individual taxpayers are set to expire in 2025, in order to avoid triggering different senate rules needed to pass measures that vastly increase the deficit after 10 years.
The new federal tax law allows many individuals to enjoy some modest temporary tax benefits, such as lower top tax rates or increased child deduction. But despite short term gains for many, most taxpayers will see their taxes increase in the end.

Who Loses?

Itemizers, who pay more than $10,000 in State and Local Taxes. **T**he new federal tax law has a starkly negative impact on many middle-class taxpayers in New York. The new cap on the state and local tax (SALT) deductions of $10,000, unless appropriate measures are taken, will hurt financially many of the state's taxpayers whose state and local tax liability exceeds the new cap, effectively exposing them to double-taxation on a part of their income. It will also hurt the state itself, and local governments, by effectively doubling the impact of any tax increases for the many taxpayers who previously would have been able to deduct them from their federal tax returns. The immediate overall annual cost to New Yorkers is an estimated $14.3 billion.

Everyone Who Is Affected by Inflation Indexing
The new federal tax law's use of the chained Consumer Price Index (CPI), effectively a lower gauge of inflation, will have a lasting negative impact on taxpayers by pushing some prematurely into higher tax brackets— "bracket creep." The standard deduction and the Earned Income Tax Credit are also set to this lower inflation index. The difference is significant: since 2000, the regular CPI grew by 45.7 points while the chained CPI grew by 39.7 percent, a difference of 6 percentage points. People at the lower end of income distribution as well as the middle class tend to rely more on these deductions and tax credits and will as a result of this
suffer the most in the long run. This has the potential to become a major hidden federal tax increase. An estimated $5

billion will be generated by 2020, $128.2 billion over the next ten years, and $500 billion in the decade that follows. As a major economic center in the nation and one of the top drivers of growth, New York will be disproportionately negatively impacted.

What's the Problem?

In the final analysis, many New Yorkers will pay more in taxes unless the state reacts appropriately and provides relief to the taxpayers who may be negatively affected, while some New Yorkers reap enormous and unwarranted tax decreases. The state must also protect its own budget revenue. New York already pays far more to the federal government than it gets in return. That's as it should be; New York is a wealthy state. But this goes far beyond the pale in restricting New York's capacity to raise and keep its own tax revenue. The kind of reform that is needed presents the governor and legislature with a major legislative and policy challenge by its scope, complexity, and timeframe. If nothing is done, we may expect the adjustment to be mainly made in the economy. If the SALT situation isn't resolved, it could depress property prices and therefore *property tax revenues*—creating pressure for higher *property tax rates*. If low- and middle-income families are negatively impacted in the long run that will take money out the state economy causing it to stagnate or even shrink, limiting opportunities and growth.

Proposed Solutions

The new federal tax law is clearly disruptive, but it also presents a valuable opportunity for the state to reevaluate its tax system. While a sudden and complete revamping of New York's taxation could yield unpredictable and undesirable results, a sensible and staged approach designed to advance the vital economic interests of all New Yorkers would work best. New York has historically been a progressive state. Its economic and tax policies reflect that, and must continue to do so in the future.

The challenge now is to recognize the changing fiscal landscape at the national level and adapt promptly. This ought to be done, in part, by reacting to the federal pressures, but mostly by reexamining tried and trusted methods and proactively advancing new solutions and ideas for ensuring the state's economic success through inclusive growth and shared prosperity. Policymakers must prioritize measures and policies whose distributional effects provide lower- and middle-income New Yorkers with opportunities to succeed in the state's highly dynamic economy. Otherwise, the state's aggressive pro-growth, business friendly "state of opportunity" agenda rings hollow against the background of rapidly deteriorating and chronically underfunded local services. Those in New York who lose in the economic competition keep falling behind, while the winners win more. New York's Gini coefficient, a measure of economic inequality, is 0.5129, the highest among all fifty states. There must be a better balance of winners and losers across the policies New York State adopts; and its tax policy is a key element in the mix.

The new policy direction must deal with the issue of an anticipated reduction in federal funding for state programs, as well as the loss of deductibility of state and local taxes. Therefore, the state must creatively take strong preemptive action in the realm of its fiscal policy in order to resolve its problems successfully, rather than relying on either an array of disconnected piecemeal solutions or a dogmatic adherence to austerity.

Three Problems Require a Threefold Solution

The new federal tax law impacts New York in three important ways that should all be addressed as the state tax code is revamped.

The new federal tax law affects taxpayers directly

Many of New York State's taxpayers face new set of tax liabilities under the new federal law. The most prominent issue is that state and local tax deductions, previously unlimited, are now capped at the maximum of $10,000. As a result, residents of many areas in New York will end up paying more in taxes unless something is done legislatively to provide relief. In Nassau, Rockland, and Westchester counties, some of the most severely affected, more than half of taxpayers have a property tax bill alone that is greater than $10,000.

There will be positive direct effects for some taxpayers as well. Not everyone itemizes deductions such as the one for state and local taxes; some residents take a standard deduction, and that has in fact been increased by the federal tax law. The standard deduction has been increased to $12,000 from $6,500 for single filers, to $18,000 from $9,550 for heads of household, and to $24,000 from $13,000 for joint filers in 2018.

Some individual taxpayers stand to gain through this combination of lost deductibility and higher standard exemptions and some stand to lose a lot, the aggregate added cost to New York taxpayers overall is an estimated $14.3 billion. The state should look into providing tax relief wherever possible or prudent.

The new law affects the New York state and local government revenues

This impact is multifold. Local tax collections may shrink, for example, if loss of state and local tax deductibility translates into lower home values and thus reduced property tax revenues. It is also clear that the other shoe that has not yet dropped in congress is large cuts to funding for states to accommodate loss of federal revenue associated with the massive tax cut. That looming cut is sure to put a major strain on New York's budget; Medicaid funding is a particularly high risk. The new tax code also moves corporations to a "territorial" tax system. Under such a system foreign earnings are not subject to domestic tax. Since New York has a border with Canada, some firms may decide to relocate some or part of their operations to Canada for tax advantages. Canadian net corporation tax rate is 15 percent at the federal level; adding in Ontario's 11.5 percent province-level tax gives a total rate of 26.5 percent, compared to 27.5 percent in New York—the new federal corporate tax rate of 21 percent plus New York's top marginal rate of 6.5 percent. New York has invested a lot of time and resources in economic and industrial development in upstate New York; corporate tax-optimization schemes that involve capacity transfer to Canada resulting in job destruction in New York would undermine that effort.

The new law affects New York's tax system progressivity

The law introduces changes to the child tax credit (CTC) by both increasing the maximum credit to $2,000 and making it available singles with incomes up to $200,000 and couples with incomes up to as much as $400,000. This move helps some lower-income New Yorkers, but it is also expensive to the federal government because it extends well past the middle class into the upper income echelons, thereby also reducing the measure's intended progressivity. The federal measure also has impact on New York's tax revenues, which will suffer considerably as a result of a higher number of claims. To save the state an estimated $500 million annually, it would be reasonable to decouple from the federal law in this instance and provide an enhanced version of the state-based child credit for low-income families along with changing the age of eligible children to include children under the age of four.

In response to these challenges, Governor Cuomo has proposed several different approaches

Lawsuits

Governor Cuomo has pledged to sue the federal government for the restricted deductibility of state and local taxes, as have several other Democratic governors in states adversely affected by the tax law, arguing that the SALT cap is unconstitutional. Historically, the federal government has not taxed residents on their taxes paid to state and local government. This arrangement is older than the federal income tax itself. The federal claim to primacy in the matters of taxation may thus violate the Constitution and upset the traditional balance of power between the federal government and the states.

Charitable Organizations

Since the federal tax law still allows for charitable deductions, Governor Cuomo has floated the idea that charitable organizations could be set up that would let taxpayers finance local services (normally paid for with state and local taxes) and still retain deductibility. It may be argued that the charitable intent is not evident given what appears to be a veiled quid-pro-quo nature of the arrangement. This method could work to help at least partially restore the dollar value of deductions lost due to the SALT cap. However, creating charitable organizations to fund public services seems to open the door to unpredictable funding levels for essential services.

Payroll Tax

Swapping a payroll tax for the personal income tax could be a very large project. There are plenty of complexities and nuances to address. But, done right, there are also potential advantages both in addressing the new federal fiscal environment and in improving the New York State tax code.

The objectives and design requirements of a tax swap are clear. Shifting the tax incidence from the employee to the employer allows the employer to deduct the payroll tax while the employee could still enjoy the same take-home pay as before. In order to preserve a progressive system a payroll tax should vary depending on the size of earned income, or should be supplemented by a progressivity-enhancing mechanism. The latter is more reasonable and fully falls under the widely accepted definition of a payroll tax: a flat tax on a firm's wage bill.

If a flat payroll tax is set above the average income tax rate, the additional funds collected may be channeled to support low-income New Yorkers and fund essential services. Daniel Hemel, a law professor at the University of Chicago, estimated the average income tax rate in New York to be 4.76 percent in 2015, while the state's wage income was $516.8 billion. Accounting for inflation that would be $ 537.7 billion in wages and $25.59 billion in tax revenues in 2017. While this figure is low relative to the entire PIT, what is important to note is that increasing the tax by 0.2 percent the corresponding revenue increases by $1.07 billion; that is more than the entire list of revenue raisers proposed by the governor.

Progressive alternatives: fair-share tax proposals for New York 2018-2019

The plans outlined above and presented by the governor in his Executive Budget fall short of generating the kind revenue that New York needs to remain competitive in the future. FPI suggests considering the following list of additional pro-revenue fair share proposals that could raise billions in estimated new revenue.

Close the carried interest loophole at the state level (approximately $3.5 billion annually)
Billionaire real estate investors got a special loophole in the new federal tax law. Hedge funds and private equity funds are using the loophole too – they'll all pay lower tax rates than teachers and truck drivers.

Recapture – Unincorporated Business Tax (UBT)
A state surtax on high-dollar pass-through LLCs could raise over a billion per year without negatively impacting small businesses or freelancers. At a time when many people will be looking to start such corporations to game the new tax law, this should be coupled with an increase in LLC filing fees both to raise revenue and discourage gaming.

Claw back the federal tax cut for large corporations that do not raise pay or create jobs
Multinational corporations are executing hundreds of billions of dollars in stock buybacks, providing returns to rich investors – not their workers. New York should impose a "claw-back tax" on publicly traded companies that received tax breaks but do not create jobs or raise pay of workers. The state should exempt small businesses or start ups from this measure that could raise a billion per year and/or compel companies to do the right thing for New York's working families.

Fee on opioid medication and windfall profits tax on opioid wealth
New York is facing a deadly public health crisis of addiction and overdose, driven by prescription painkillers and other narcotics. Pharmaceutical companies and pharmacy benefits managers have abused the prescribing system to explode sales and distribution of dangerous painkillers beyond their proper use. A state surtax on prescription painkillers, as the governor suggests, and an assessment on company fortunes built on opioids could raise billions for treatment, public health and overdose prevention.

Reinstitute Stock Transfer Tax
Large banks and Wall Street traders get the biggest benefits from the new federal tax law. In fact, New York still collects a multi-billion-dollar ($13.8 billion per year) Stock Transfer Tax, but it is currently fully rebated back to the brokers. It is possible to exempt small investors while imposing a negligible transfer tax on high-frequency and high-dollar trades. Rebating 60 percent of the tax, rather than the full 100 percent could raise $5.5 billion per year.

Multi-millionaires tax
New York's tax brackets are antiquated and should be made more progressive. It makes sense to adjust brackets upward for the wealthiest residents, to reflect explosive income gains of the recent decades—as well as some of the newly created gains from the new federal tax law. New progressive brackets at $5 million, $10 million and $100 million per year would raise over $2 billion annually and would still leave these multi-millionaires as the big winners in the economy of these last years.

New York City land tax to fund transit, jobs and climate adaptation
New York City real estate has soared in value, while the transportation, infrastructure, housing and energy systems that make it so valuable have suffered. We can create thousands of jobs all over New York with funding from a reasonable land tax on just the most valuable Manhattan office buildings and speculative luxury housing that could well over a billion dollars.

The best course of action is one that combines multiple approaches sketched above and applies them simultaneously in parallel. The best approach is decidedly pro-growth and pro-revenue