Testimony for a Hearing of the Senate Select Committee on Budget and Tax Reform

March 12, 2009

Good afternoon. I am Elizabeth Lynam, Deputy Research Director at the Citizens Budget Commission, a nonprofit, nonpartisan watchdog group dedicated to influencing constructive change in the finances and services of the New York City and State governments. My testimony today will emphasize two key points about New York's personal income tax, and then offer a framework for thinking about tax reform in the current fiscal context.

The two points I would like to emphasize are: 1) New York's personal income tax is progressive, but its overall tax structure is not; 2) New York's economic competitiveness should be an important factor in considering changes to its tax rates.

1) New York's personal income tax is progressive, but its overall tax structure is not.

Recently New York State's personal income tax has been criticized as unfair; that is, not sufficiently progressive. In fact, of all New York's state and local taxes, the PIT is the most progressive.

The poorest fifth of New York taxpayers on average do not pay state and local income taxes at all. (See Table 1.) Instead, these taxpayers receive a refund equal to 1.3 percent of family income on average due in part to New York State's Earned Income Tax Credit (EITC) which equals 30 percent of the federal EITC and New York City's EITC which equals 5 percent of the federal EITC. For a taxpayer with 2 or more children and less than $40,000 income, the combined State and City refundable credit can reach $1,688.

In comparison, the wealthiest 1 percent of New York's taxpayers pays 6.0 percent of family income in state and local income taxes. Moreover, New York's PIT is more progressive than the national average. On average, state and local personal income taxes in the nation consume 0.5 percent of the poorest fifth's family income and 4.5 percent of the wealthiest 1 percent's income. Based on a progressivity index, New York has the third most progressive state and local PIT of the 44 states (including the District of Columbia) with a PIT.[1]

In terms of marginal rates, New York State's top marginal PIT rate puts it close to the top-third of the pack. Among all the states (and the District of Columbia), nine have no income tax, and only 14 of the other 42 have higher top marginal tax rates.[2] Neighboring New Jersey's rates are 8.97 percent on income above $500,000 and 6.37 percent from $75,000 to $499,999,[3] compared to New York's top rate of 6.85 percent on income above $20,000. Connecticut imposes a rate of 3 percent on income below $10,000 and 5 percent on income above $10,000.

It is also important to remember that one quarter of the filers with incomes over $200,000 live in New York City, where the progressivity of the local personal income tax intersects with the State's.[4] New York City residents face a top combined state and local marginal rate

of 10.5 percent, significantly above that in other states and our immediate neighbors. If New York City raises its personal income tax as well, that rate will jump up significantly; in 2002-03, when there were both State and City surcharges, it reached 12.15 percent.

Table 1
State and Local Taxes, as a Share of Family Income by Income Group

	Lowest Quintile		Second Quintile		Third Quintile		Fourth Quintile		Top 1%	
	NYS	U.S. Avg.	NYS	U.S. Avg.	NYS	U.S. Avg.	NYS	U.S. Avg.	NYS	U.S. Avg.
Personal Income Taxes	-1.3%	0.5%	0.8%	1.6%	2.6%	2.2%	3.7%	2.7%	6.0%	4.5%
Total State and Local Taxes	12.7%	11.4%	11.4%	10.4%	11.9%	9.9%	11.9%	9.4%	9.1%	7.3%
Federal Deduction Offset	0.0%	0.0%	-0.1%	-0.1%	-0.3%	-0.3%	-0.8%	-0.6%	-2.7%	-2.0%
Total after Federal Offset	**12.6%**	**11.4%**	**11.3%**	**10.3%**	**11.6%**	**9.6%**	**11.1%**	**8.8%**	**6.5%**	**5.2%**

Note: Based on 2002 tax law and 2000 income levels. Does not include elderly taxpayers.

Source: Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax System in All 50 States*, January 2003.

However, New York's other regressive taxes offset the progressivity of the PIT. State and local taxes consume 12.6 percent of income for the poorest fifth and 6.5 percent for the wealthiest 1 percent. Due to its heavy reliance on regressive sales and other consumption taxes, New York ranks 28th among the 50 states and the District of Columbia for progressivity. Commercial property owners suffer from higher property taxes because they have been left out of the STAR program, and, in large urban areas, high property taxes are passed on in large part to renters, who typically have lower incomes.

2) New York's tax structure and rates are an important factor in the State's economic competitiveness.

Although the budget pressures facing New York are intense, it is important not to forget that the business climate is more competitive than ever and that New York must compete for businesses and residents in this climate. Taxes do affect the location of economic activity, and New York's are relatively high. The overall tax burden, as measured per $1,000 of personal income, is the highest among states and is 35 percent above the national average. Although the overall burden is driven by high local taxes, the State personal income tax exists in this context and proposed changes should be considered as part of the larger tax structure.

So what will happen if top marginal rates on the personal income are increased? Will there be widespread out-migration? Will the State's economic recovery be hampered? The short answer is that it is not possible to know for sure.

The evidence on whether people will leave the State is mixed. The New York City Comptroller used a reputable national data source in a recent study and presented results that showed some out-migration after personal income tax increases in 2003, but the study indicates by and large the top earners stayed put.[5] A Princeton study of New Jersey tax returns found that New Jersey's personal income tax increase on individuals earning more

than $500,000 in 2004 resulted in a slight increase in out-migration of "half-millionaires;" however, the study found that from 2002 to 2006 the number of "half-millionaires" grew 70 percent and the revenue loss from out-migration was outweighed by the strong increase in tax revenues.[6] It should be noted that the time period analyzed in both of these studies was one in which increases in state and local taxes were offset by significant federal income tax cuts for high income filers. That would not be the case now; in fact, the opposite is a strong possibility. In addition, it is questionable whether past experience is relevant to the current situation. Economic conditions are far worse now and recovery is likely to take longer than in 2002-04.

New York depends heavily on the personal income tax and in particular on the top payers of the tax. In 2006, the PIT comprised 56.5 percent of total State tax collections—the second highest of any state.[7] Two-thirds of this PIT revenue came from the wealthiest 15 percent of taxpayers. Many of them were employed in the financial services sector, which comprised 28 percent of total private sector wages in the State but only 10.2 percent of jobs.[8] Clearly, the loss of even a small group of the wealthiest taxpayers would be costly in the state that is also the epicenter of the financial service meltdown.

On the plus side for New York's competitiveness, other states are likely to raise taxes during this period too thereby reducing the marginal harm to New York's recovery. And with jobs in other states scarce and home prices down it is increasingly difficult for residents anywhere to make a move.

It is difficult to know precisely or with certainty how much a personal income tax increase at this time would adversely affect New York's prospects for economic recovery. What we can certainly say is that it will not help. The radically restructured financial services sector that emerges from this period is likely to be fragile, and less able to support New York's high costs, as it once did. Competition among states for growth industries that could be encouraged to blossom here, particularly in green tech, will be fierce. If it hopes to compete, New York will have to send a message that its tax policies will not place new entrepreneurs and businesses here at a competitive disadvantage.

Becoming more competitive is not just about the tax burden, of course, it is also about the cost and caliber of public services. Keeping that in mind, what is a reasonable framework for addressing the question of whether to increase the personal income tax at this time?

A Proposed Framework for Considering Tax Increase Proposals

Often, and in particular in states with a volatile revenue base like New York's, economic downturns reduce revenues more abruptly than expenditure cuts can be implemented. These circumstances may require immediate revenue measures to bring one or more years' budgets into balance. However, the need to cover an abrupt shortfall can, and should, be separated from the longer run goal of designing a tax system that is appropriately progressive, stable, and sufficient to support the government New Yorkers desire.

A tax increase that responds to the rapid loss of revenue from a cyclical downturn may be justifiable under the following conditions: 1) If it is temporarily imposed with a fixed set of dates for phase out or expiration *and;* 2) It runs in tandem with significant measures to lower expenditures in ineffective and low priority programs and with contractual changes with public employee unions that support improved productivity and a spirit of shared sacrifice.

Both conditions are critical. Any income tax increase should be temporary only. And it must be accompanied by serious, sustained reductions in government spending. The budget the Governor sent you made a start in some key areas. Still the inevitable resistance from constituent groups has developed, and the Legislature has yet to tackle some of the really hard questions that will come with balancing the budget. New York does not just have a cyclical problem; it also has a *structural* problem. Even under fairly optimistic economic and revenue assumptions, the budget gap in year three of the financial plan grows to $18.7 billion.

To deal with its underlying structural budget problems—and the fact that the financial services industry upon which the State has depended so heavily is permanently contracting—New York needs to get on a path to higher-quality, lower-cost government. It will take time, effort, and serious leadership to get there. Temporary tax increases and short-term infusions of federal aid can buy time and prevent the most harmful of the short-run actions available to leaders, but they cannot solve New York's problems.

With respect to improving the progressivity of New York's tax burden, if that were the only issue then the solution could be revenue neutral so that the already high burden on New Yorkers would not be worsened. The issue of making the State tax system "fairer" goes well beyond having a "millionaires' tax" or a "fairer share" tax that deals only with the personal income tax. Whatever solution is devised to address progressivity should address New York's tax system as a whole. Proposals that would merit serious consideration would include a rearrangement of the state and local tax systems (including reform of the property tax system) to balance equity and stability in their design.

The best way to address these complex issues is to form a bipartisan commission to examine tax reform from the dual perspective of fairness and competitiveness with recommendations for consideration in 2010. In that way the subject can be examined more comprehensively and outside the context of the immediate need for new revenue.
Thank you for your time. I am happy to answer any questions.

The progressivity index equals the average difference in tax burdens between the wealthiest 1 percent and the poorest 20 percent, the wealthiest 1 percent and the middle 20 percent, and the middle 20 percent and the poorest 20 percent. This is a modified version of the index developed by the Institute on Taxation and Economic Policy, with the modification necessary to accommodate available data.

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[2] Government of the District of Columbia, *2006 Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison*, November 2007. The New York State top marginal rate does not include New York City income taxes.

[3] *Ibid.* The top marginal tax rate in New Jersey increased from 6.37 percent to 8.97 percent in June 2004.

[4] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, *Analysis of 2005 State Personal Income Tax Returns by Place of Residence*, July 2008.

[5] Office of the New York City Comptroller, *Economic Notes*, September 2007.

[6] Cristobal Young, Charles Varner, and Douglas S. Massey, *Trends in New Jersey Migration: Housing, Employment and Taxation*, Policy Research Institute for the Regions, Woodrow Wilson School of Public and International Affairs, Princeton University, September 2008.

[7] U.S. Department of Commerce, U.S. Census Bureau, *State and Local Government Finances, 2005-06*, as reported in the New York State Department of Taxation and Finance, *Electronic New York Tax Sourcebook*, Accessed on August 25, 2008 < http://www.tax.state.ny.us/statistics/policy-special/tax_sourcebook/new_york_state_tax_sourcebook_electronic.htm>. Nationwide states on average derived 34.6 percent of their tax revenues from a PIT. Among neighboring states the PIT comprised 36.6 percent of New Jersey's revenues, and 47.6 percent of Connecticut's.

[8] Based on projected annual data for 2007 from the U.S. Department of Labor, Bureau of Labor Statistics, *Quarterly Census of Employment and Wages*.