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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 12, 2013

Thank you very much for the opportunity to present this testimony on tax issues related to your consideration of the 2013-2014 Executive Budget. In this testimony, I will make the following six points.

1. New York State should not cut taxes while the resources provided for education and other essential services are being hit with “Gap Elimination Adjustments” and other austerity measures.
2. New York State should not provide tax subsidies for companies that outsource jobs or otherwise reduce employment in the state. Economic development tax breaks should only go to businesses that create and maintain jobs in the state.
3. Loopholes and tax breaks that allow large, multi-state and multi-national corporations to pay proportionately less in state income taxes than small businesses should be fixed or eliminated. And the integrity of the Corporate Alternate Minimum tax should be restored so that large, profitable corporations are not able to reduce their tax liability below a reasonable percentage of net income.
4. Provisions of law that allow investment management income to be taxed less than wages or other business income should be eliminated.
5. New York State should reduce the pressure that it places on the local property tax by increasing revenue sharing (now called Aid and Incentives for Municipalities) and by increasing (on an “ability to pay” basis) the state share of the cost of both education and Medicaid.
6. New York State should provide targeted tax relief to long-time residents for whom, through no fault of their own, property taxes on their primary residences have come to represent an inordinate share of their income.

1. New York State should not cut taxes while the resources provided for education and other essential services are being hit with “Gap Elimination Adjustments” and other austerity measures.

The Executive Budget is an austerity budget on the expenditure side of the ledger. Agency operations are again hit the hardest with a proposed 0.0% rate of growth. Local assistance spending, in the aggregate, is held to 2.3%.

The modest overall reduction in state government staffing that is presented in the Executive Budget (a net reduction of 127 positions) masks substantial cuts and dislocations (such as the staffing changes associated with the continued underfunding of SUNY’s Downstate Medical Center). Moreover, these cuts and dislocations come on the heels of a 30 percent reduction in staffing since the late 1980s.

The Executive Budget also proposes to reduce funding for a number of important programs and services that are part of the budget’s “local assistance” expenditures. For example, the Executive Budget proposes to combine a large number of health-related grant programs into six competitive pools and to simultaneously reduce the overall funding for these programs by \$40 million or a little more than ten percent.

Turning to state aid to education, this year’s Executive Budget also proposes to once again freeze the phase-in of the “foundation aid” formula that was established as a key element of the 2007 settlement of the Campaign for Fiscal Equity lawsuit. The foundation aid formula was supposed to be phased in over a four year period, reaching full funding of \$18 billion in 2010-11 – up \$5.5 billion from the 2006-07 level of \$12.5 billion. But foundation aid was frozen at its 2008-09 level in 2009-10, 2010-11 and 2011-12. In the 2012-13 budget much was made of the fact that the state was resuming (albeit at a very slow pace and still subject to an across-the-board cut called a Gap Elimination Adjustment) the phase-in of foundation aid. But the proposed budget for 2013-14 calls for a freeze to be re-imposed.

Also within state aid to education, the Executive Budget proposes to continue prior year cuts and freezes – in some cases at prior year levels and in other cases at reduced but still daunting levels. A prime example is the “Gap Elimination Adjustment” which cuts aid to public schools in an across-the-board fashion to help eliminate the state government’s budget gap while increasing school districts’ budget gaps and forcing reductions in services and programs that are particularly important in high need school districts.

In spite of the Executive Budget proposal to reduce this “Gap Elimination Adjustment” from \$2.16 billion during the current school year to \$1.83 billion for the 2013-14 school year, it remains the mechanism for the ongoing defunding of public education in this state. The \$1.83 billion “adjustment” means that on top of the proposed freeze in Foundation Aid, there is an additional aid cut that averages 9.4 percent of districts’ operating aid and which is much higher for many school districts.

The inclusion of significant austerity measures in this year's Executive Budget raises a fundamental question: "Why does New York State have a "Budget Gap" that it needs to eliminate?" That question can be answered at several levels. In an immediate sense, New York has a "budget gap" because of the historic proportions of the Great Recession that officially lasted from December 2007 through June 2009, and the tepid nature of the subsequent economic recovery. But the New York State government was less prepared for the Great Recession than it would have been if it had not implemented such an extensive program of tax reduction during the period from 1994 through 2006. Governor Pataki's last Executive Budget characterized the tax cuts implemented during this period as follows:

Since 1995, every major State tax has been cut, making New York the preeminent tax-cutting state in the nation. The breadth and scope of these cuts are remarkable:

- *New York has cut 19 different taxes 81 separate times.*
- *In 1995, total New York State tax collections per \$1,000 of personal income were 5.3 percent above the national average. In 2003, State tax collections per \$1,000 of personal income were 3.6 percent below the national average.*

By 2006-07, taxpayers will have saved more than \$125 billion as a result of Governor Pataki's tax cuts. Cumulative savings will total nearly \$167 billion by 2008-09.

The \$125 billion figure cited in the paragraph above is a cumulative, multi-year figure. On an annual basis, the budget at that time estimated that the impact of the 1994-2006 tax cuts would be about \$21.2 billion in 2007-08. The Fiscal Policy Institute has estimated that because of several factors (the recessionary revenue losses experienced by the state in 2009-10 and 2010-11, the temporary tax increases enacted in 2009 and the elimination of the STAR rebate checks), the impact of the 1994-2006 tax cuts in 2010-11 was down to \$13.5 billion.

The austerity measures being proposed by the 2013-14 executive Budget, such as the "Gap Elimination Adjustment" being applied to state aid for elementary and secondary education, the continuing reductions in the state workforce, and the freezing of general purpose aid for cities, towns and villages, cannot be implemented without an adverse impact on the effectiveness of the government services involved. This is well understood. But, such austerity measures will also diminish New York's economic prospects in both the long run and the short run.

Austerity measures applied to education, child development, health awareness, illness prevention, and nutrition programs, for example, negatively affect the long-term competitiveness of the economy. These measures also have an unnecessarily negative impact on the economy in the short run. In a classic 2001 paper on balancing state budgets during economic downturns, Nobel laureate Joseph Stiglitz and Peter Orszag, then of the Brookings Institution, concluded that reductions in government spending on goods and services that are produced locally (like elementary and secondary education) and reductions in transfer payments to lower-income families are most damaging to the economy since they come closest to taking dollar for dollar out of the local economy.

Since the Executive Budget is proposing to continue austerity measures on the expenditure side of the budget, it should do the same on the revenue side.

More specifically, New York State's current limits on the use of business tax breaks should not be eliminated until fiscal balance is restored and extraordinary austerity measures are no longer needed on the expenditure side of the budget.

In 2010, to help stop the erosion of business tax revenues and to reduce the magnitude of the cuts being made in essential public services, New York State enacted, for the 2010, 2011 and 2012 tax years, a cap of \$2 million dollars on the value of the business tax credits that a taxpayer could use in a single year. The caps in place for the 2010, 2011 and 2012 tax years serve to increase state tax revenue above what it otherwise would have been in the fiscal years in which payments for those tax years are made. For example, the 2013-14 Executive Budget indicates that "all funds" business tax receipts for FY 2013 "include \$384 million from the tax deferral of certain tax credits, an incremental increase of \$71 million" over FY 2012; and that "included in FY 2014 is an incremental increase of \$14 million (from \$384 million in FY 2013 to \$394 million in FY 2014) in receipts from the deferral of certain tax credits."

As the law currently stands, the \$2 million annual limit will not apply to the 2013 and subsequent tax years unless it is extended. If the cap is not extended, there will be a reduction of state revenue of at least \$1 billion in the 2014-15 state fiscal year when taxpayers file returns for the 2013 calendar year/tax year.

In regard to the Personal Income Tax, the Executive Budget reports that for the 2014-15 state fiscal year, "Total refunds are projected to increase by \$766 million (10.5 percent) from the prior years, mostly reflecting a \$748 million increase in prior year refunds due to a partial pay-back of the deferral of business tax credits."

Just as the 2013-14 Executive Budget proposes to continue the freeze on the implementation of the 2007 settlement of the Campaign for Fiscal Equity lawsuit and to subject the frozen level of Foundation Aid to a "Gap Elimination Adjustment," the 2013-14 enacted budget should (1) extend the \$2 million cap on business tax credits; (2) treat credits in excess of the cap in the same way that scheduled Foundation Aid payments in excess of the Foundation Aid caps have been treated; and (3) apply a "Gap Elimination Adjustment" to the credits.

2. New York State should not provide tax subsidies for companies that outsource jobs or otherwise reduce employment in the state. Economic development tax breaks should only go to businesses that create and maintain jobs in the state.

In recent decades there has been substantial growth in both the number of tax breaks enacted in the name of job creation and in the cost of those tax breaks. Even though New York State's annual Tax Expenditure Report excludes some very costly tax breaks enacted at the behest of corporate lobbyists, it estimated that the cost of the state's economic development tax breaks increased from \$3.48 billion in 2008 to \$4.29 billion in 2012.

At the same time, however, very few of the tax breaks enacted in the name of job creation, actually require that the recipients create additional employment opportunities in the state; or that they even maintain their level of employment in the state to benefit from these tax breaks. To the maximum extent possible, the laws governing each of the state's economic development tax breaks should be amended to require that a business has to, at the very least, maintain its level of employment and compensation in the state to qualify for those breaks.

New York State should reduce the value of the initial Investment Tax Credit (ITC) while increasing the number of additional years (currently set at two) in which ITC beneficiaries can qualify for an Employment Incentive Credit by maintaining or increasing employment in New York. This will reduce (and, in some cases, eliminate) the benefits available to businesses that reduce employment but it will increase benefits to businesses that maintain or increase their levels of employment in New York State over time.

New York State should also enact legislation like the proposed Congressional legislation, the "Bring American Jobs Home Act," that eliminates the deductibility of expenses incurred in the off-shoring of American jobs. New York State should also enact legislation that discourages the off-shoring of call centers. In addition, New York State should make businesses that off-shore American jobs ineligible for economic development tax breaks.

3. Loopholes and tax breaks that allow large, multi-state and multi-national corporations to pay proportionately less in state income taxes than small businesses should be fixed or eliminated. And the integrity of the Corporate Alternate Minimum tax should be restored so that large, profitable corporations are not able to reduce their tax liability below a reasonable percentage of net income.

A 1959 federal law (P.L. 86-272) prohibits a state from taxing any portion of the net income or profits of a multi-state corporation that has sales of goods in a state but no property or payroll in that state. To the extent that (a) the location of a firm's sales is one of the factors used in apportioning that firm's income among the states for tax purposes; and (b) some of that firm's sales are to customers in a state in which it has no property and no payroll, some of that firm's profit is not taxable by any state. This untaxed profit is known as "nowhere income."

As an increasing number of states, including New York, have moved to apportioning income solely on the basis of the portion of a firm's sales in the state (i.e., the Single Sales Factor approached initially adopted by New York in 2005 to be phased in over the course of the next several years), a decreasing portion of the U.S. net income of multi-state and multi-national firms is taxable by any state.

For the last several years, many of the same multi-state and multi-national corporations that have lobbied for Single Sales Factor apportionment in the states in which they have substantial property and payroll have been lobbying at the federal level to expand P.L. 86-272 to make even less corporate income subject to taxation by the states. This legislation, which is misleadingly named the Business Activity Tax Simplification Act (BATSA), would allow a firm to have some property or payroll in a state and still escape taxation of any portion of its income by that state.

New York officials should work with officials from other states to advance federal legislation repealing or substantially reforming P.L. 86-272. New York officials should also work with officials from other states to oppose federal legislation that would increase the portions of multi-state and multi-national corporations' domestic net income that can be shielded from state corporate income taxation.

Recognizing the problem of "nowhere income," tax experts seeking to establish a uniform and fair system of state-level corporate taxation have long recommended that states adopt either a "throwback" or "throwout" rule. Under a "throwback" rule, sales made in states where a firm's income is not taxable are "thrown back," for apportionment purposes, to the state from which the sales were made. A "throwout" rule is a variation that excludes nowhere sales from entering into the apportionment calculation at all.

New York should put a "throwback" or "throwout" rule into place until the federal government repeals or substantially reforms P.L. 86-272.

New York State's corporate Alternate Minimum Tax (AMT) was enacted in 1987 to make sure that large profitable firms paid some minimum amount in state taxes. That 1987 law, which was enacted with the active support of the Business Council of New York State, reduced the state's main corporate income tax rate from 10% to 9% (and to a lower level for small businesses). It also eliminated and/or limited a number of corporate tax preferences. The Investment Tax Credit (ITC), for example, was reduced from 6% to 5% rather than being eliminated but the AMT was established at a 3.5% rate. Credits, like the ITC, could still reduce a firm's tax liability but not below 3.5% of its income.

In addition, the "Double Weighting of Sales," a tax break that had been enacted in 1975 at the behest of the Business Council, was not repealed in the calculation of the main tax at the 9% rate, but the traditional 3-factor formula (that involved the equal weighting of property, payroll and sales and which had applied the main tax before the 1975) change was made applicable to the new AMT.

The intended purpose of this set of changes was to provide that a firm would pay state taxes on its income at 9% with preferences or 3.5% without preferences, such as the ITC. Since 1987, however, the state's main corporate income tax rate has been reduced to 7.1% and the AMT rate has been reduced to 1.75%. But, perhaps even more significantly, tax breaks have been added to the AMT. Single Sales factor apportionment (an even juicier prize for multi-state corporations than the Double Weighting of Sales) now applies to both the main tax and the AMT. And, an increasing number of tax credits are allowed to reduce a firm's taxes below the AMT level.

The Corporate Alternate Minimum Tax (AMT) rate for firms other than manufacturers should be restored to the 3.5% level and the loopholes that have been added to the AMT should be eliminated. New York State should also eliminate the \$1 million cap for firms other than manufacturers on the amount due under the Corporate Franchise Tax's alternate capital base tax. This cap results in small and medium-size businesses paying a much higher effective tax rate than large corporations.

4. Provisions of law that allow investment management income to be taxed less than wages or other business income should be eliminated.

Carried interest refers to the profit share received by the managing partners of private equity funds and hedge funds, usually 20 percent of the profits generated by the pooled investment of the limited partners. At both the federal level and at the New York City level, this income received favorable treatment.

Even though the recipients of carried interest income have not put any of their own capital at risk to earn that income, the federal government currently treats that income as capital gains income and taxes it at a lower rate. And, by state law, this carried interest income is exempt from the New York City Unincorporated Business Tax.

While not a state revenue item, it would be important in helping New York City to close its projected budget gaps for the State Legislature to eliminate the carried interest exemption loophole in the City's Unincorporated Business Tax (UBT). This would put the taxation of private equity and hedge funds on the same footing as that of the thousands of smaller businesses subject to the NYC UBT. The New York City Independent Budget Office estimated that eliminating the carried interest exemption for the Unincorporated Business Tax would yield \$200 million a year for New York City.

If the federal government were to end its treatment of carried interest income as capital gains income, it would resolve the anomalous situation under which New York fund managers who live in New York pay taxes on their carried interest income but New York fund managers who commute in from other states do not.

5. New York State should reduce the pressure that it places on the local property tax by increasing revenue sharing (now called Aid and Incentives for Municipalities) and by increasing the state share of the cost of both education and Medicaid.

For New York's cities, towns and villages, the outlook is dire. While these providers of basic municipal services are now covered by a property tax cap that is much more rigid than the Massachusetts cap, this year's Executive Budget reminds them that the administration's intention is for years of flat funding of general purpose aid – what used to be called “revenue sharing” and what is now called Aid and Incentives for Municipalities or AIM.

To reduce the financial pressure being placed on school districts, it is essential that the state government begin increasing the share of school costs that are covered by state aid. But the state is moving in the opposite direction. The Executive Budget complains about what it sees as a state wide high school graduation rate that is too low, but it ignores the fact that the statewide graduation rate is a weighted average of many districts with high graduation rates and a smaller number of large districts with low graduation rates. Ironically the Contracts for Excellence and the largest aid increases under the settlement of the Campaign for Fiscal Equity lawsuit were targeted at those very districts with low graduation rates.

If New York State wants to increase its statewide graduation rate (and it should want to) it has to provide the needed resources to the high need districts and reinvigorate the accountability mechanisms envisioned by the Contracts for Excellence. While it makes sense to target aid increases to high need districts, average need and low need districts must not be placed on a downward spiral. If New York State is going to cut aid to many such districts, as it is doing, it should exempt local contributions to make up for the reductions in state aid from the property tax cap. Requiring a 60% vote to make up for cuts in state aid is an incredibly wrong-headed and perverse policy.

New York's counties are receiving some real relief through the state government's assumption of a greater portion of the non-federal share of Medicaid costs. But the approach that is being employed does not address the great disparities that exist between (1) counties' Medicaid costs, and (2) the strength of their local tax bases. Governor Cuomo frequently points to the fact that many Upstate counties have among the nation's highest property tax rates relative to home values but his proposal does not address this "problem." The most direct way to reduce the high property tax rates relative to home values in many Upstate counties would be by providing additional relief to those counties whose Medicaid costs are high relative to the strength of their property tax bases.

6. New York State should provide targeted tax relief to long-time residents for whom, through no fault of their own, property taxes on their primary residences have come to represent an inordinate share of their income.

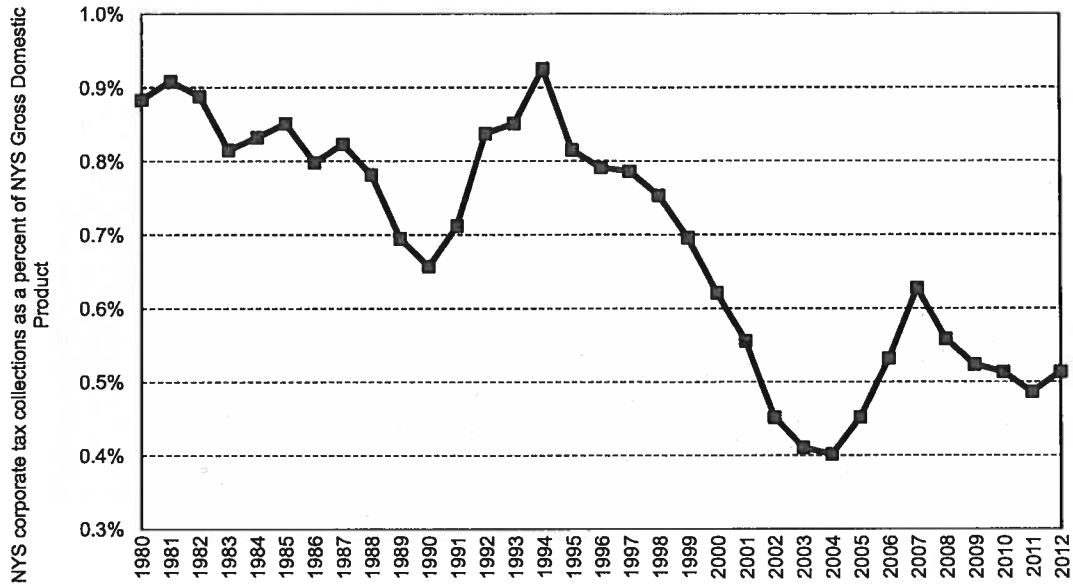
While it is important for the state government to reduce the pressure that it places on the property tax based by increasing its revenue sharing with cities, towns and villages; increasing the state share of the cost of a sound, basic education, and additional targeted Medicaid relief, there will still be hundreds of thousands of New Yorkers whose property taxes will represent an inordinate share of their income – through no fault of their own. The only cost-efficient and cost-effective way to address this problem is through a targeted middle class circuit breaker credit.

An analysis of the US Census Bureau's American Community Survey (ACS) microdata confirms that hundreds of thousands of low, moderate and middle income families in New York State are already paying an inordinate share of their income in property taxes on their primary residences. The situation in which these families find themselves will not be addressed by New York's cap on the growth of local governments' property tax levies. Only a middle-class Circuit Breaker can provide effective relief for these families in a targeted and cost-efficient manner.

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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.

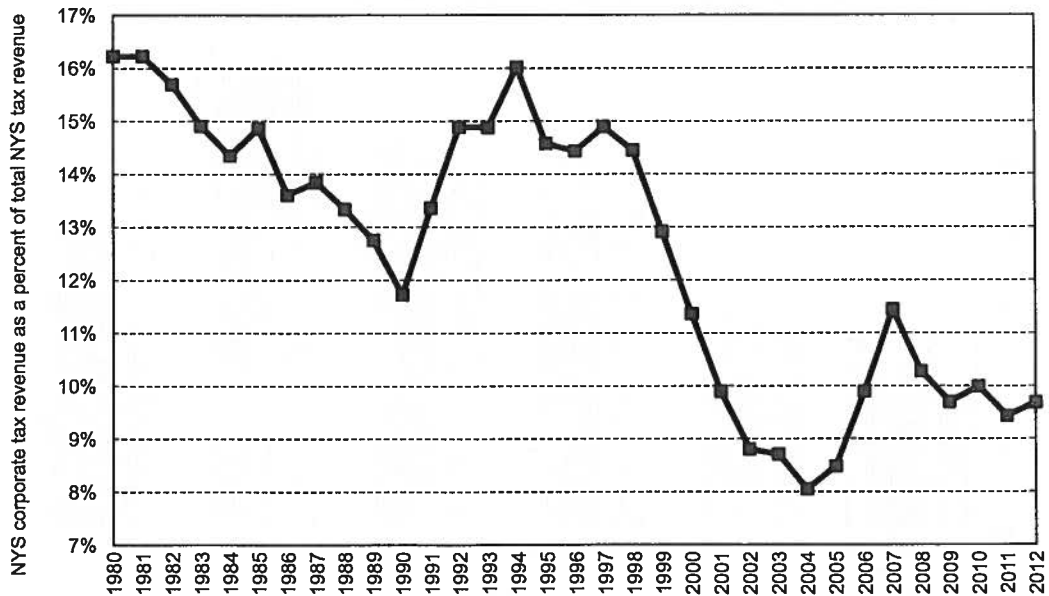
State corporate tax revenues have fallen substantially relative to the size of New York's economy.



Note: Tax collections (including collections on audit) for each state fiscal year are compared to NYS GDP for the prior calendar year. Includes bank tax, insurance tax, corporate franchise tax, and corporations & utilities tax.

Source: New York State Department of Taxation and Finance; U.S. Bureau of Economic Analysis (NYS GDP data).

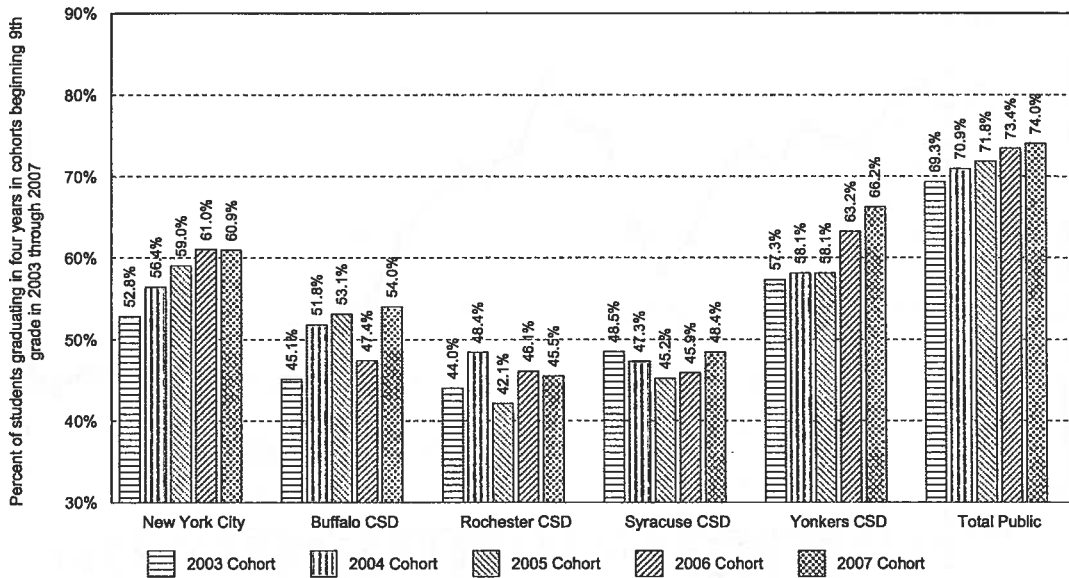
State corporate tax revenues have also declined significantly as a share of total state tax revenues.



Note: Includes bank tax, insurance tax, corporate franchise tax, and corporations & utilities tax.

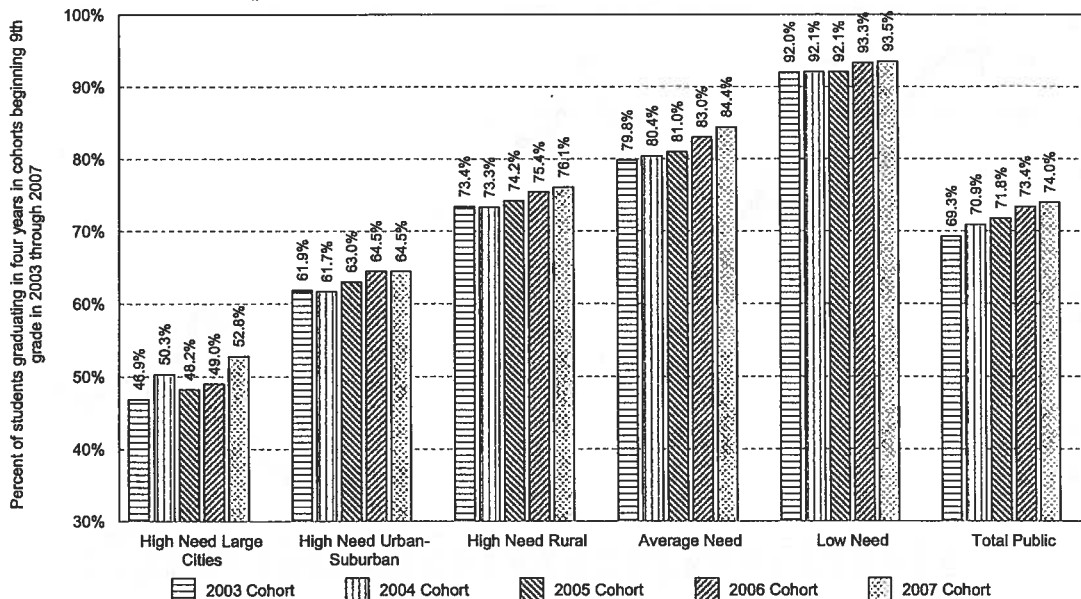
Source: New York State Department of Taxation and Finance; U.S. Bureau of Economic Analysis (NYS GDP data).

New York's relatively low statewide graduation rate is driven by the low graduation rates in districts such as Buffalo, Rochester and Syracuse which were scheduled to receive large aid increases under the settlement of the CFE lawsuit.



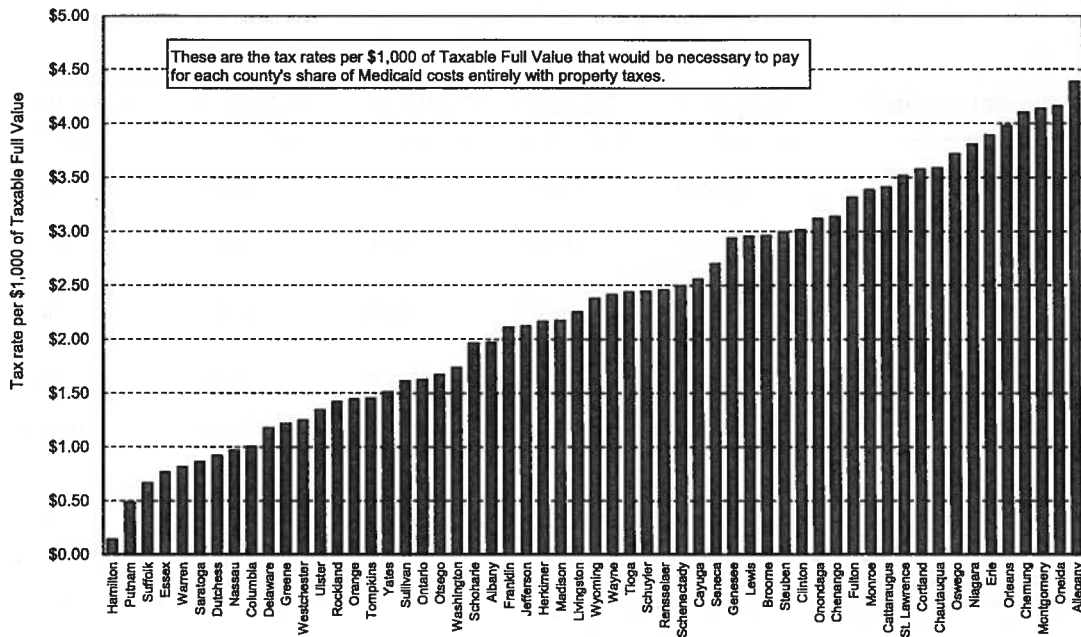
Note: The year of each cohort is the year in which the students in that cohort began ninth grade. For example, students in the 2007 Cohort who finished high school in four years, graduated in June 2011.
 Source: New York State Education Department, *Graduation Rates: Students Who Started 9th Grade In 2003, 2004, 2005, 2006, and 2007*, June 2012. See this report for explanation of recent changes to Buffalo's cohort size.

New York's relatively low statewide graduation rate is a weighted average of many districts with relatively high graduation rates and a smaller number of large districts with very low graduation rates. To increase the statewide graduation rate, New York State must provide sufficient resources to high need districts.



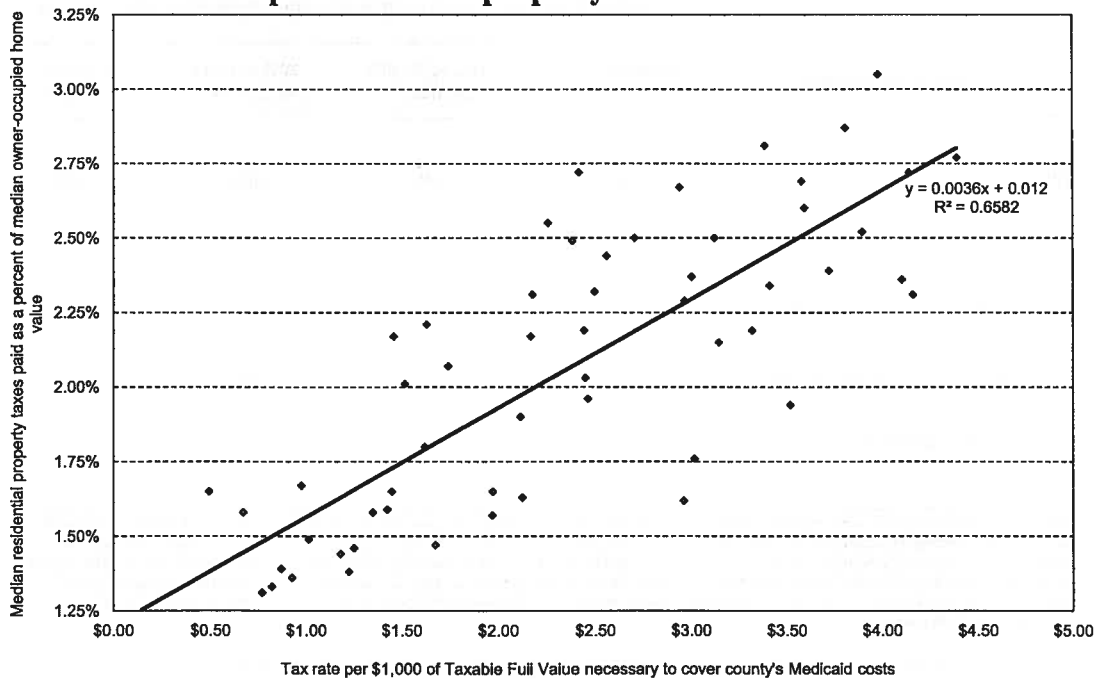
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 Source: New York State Education Department, *Graduation Rates: Students Who Started 9th Grade In 2003, 2004, 2005, 2006, and 2007*, June 2012.

Because of the great disparities that exist among the state's counties in their "ability to pay" for the local share of Medicaid, the state government should take over a greater share of Medicaid costs in counties with significant Medicaid "over-burdens."



Sources: Fiscal Policy Institute analysis of data from the New York State Department of Health; and, the NYS Office of the State Comptroller.

There is a very strong correlation between (a) counties' Medicaid costs relative to the strength of their tax bases and (b) the relationship of residential property tax bills to home values.



More than 700,000 New York lower- and middle-income households* pay 10 percent or more of their income in property taxes. A quarter million pay 20 percent or more.

Household income range	Estimated number of households whose property taxes paid in 2011 were:				Total number of households in income range
	Less than 10% of income	10% to 19.99% of income	20% or more of income**	10% or more of income	
\$50,000 or less	539,479	250,948	237,677	488,625	1,028,104
\$25,000 or less	152,513	101,865	153,013	254,878	407,391
Above \$25,000 but not above \$50,000	386,966	149,083	84,664	233,747	620,713
Above \$50,000 but not above \$100,000***	832,026	N/A	N/A	213,667	1,045,693
TOTAL: All \$100,000 or less	1,371,505	N/A	N/A	702,292	2,073,797

Notes: *Estimates are for homeownership households with income of \$100,000 or less and who meet the 5-year residency requirement in the Galef/Little and Krueger/Engelbright Circuit Breaker proposals. **This column, for the \$25,000 or less income category, includes households with zero or negative income that paid property taxes in 2011. *** The subtotal of all households in this income range paying 10% or more of income in property taxes in 2011 includes (a) households that paid between 10% and 19.99% of income in property taxes; and (b) households that paid \$10,000 or more in property taxes and who, because of top coding, can not be apportioned between the "10% to 19.99% of income" category and the "20% or more of income" category.

Source: Fiscal Policy Institute analysis of microdata from the U.S. Census Bureau's 2011 American Community Survey.

Nearly half of New York households* with incomes of \$50,000 or less pay 10 percent or more of their income in property taxes.

Household income range	Estimated percent of households whose property taxes paid in 2011 were:			
	Less than 10% of income	10% to 19.99% of income	20% or more of income**	10% or more of income
\$50,000 or less	52%	24%	23%	48%
\$25,000 or less	37%	25%	38%	63%
Above \$25,000 but not above \$50,000	62%	24%	14%	38%
Above \$50,000 but not above \$100,000***	80%	N/A	N/A	20%
TOTAL (All) \$100,000 or less	66%	N/A	N/A	34%

Notes: *Estimates are for homeownership households with income of \$100,000 or less and who meet the 5-year residency requirement in the Galef/Little and Krueger/Engelbright Circuit Breaker proposals. **This column, for the \$25,000 or less income category, includes households with zero or negative income that paid property taxes in 2011. *** The subtotal of all households in this income range paying 10% or more of income in property taxes in 2011 includes (a) households that paid between 10% and 19.99% of income in property taxes; and (b) households that paid \$10,000 or more in property taxes and who, because of top coding, cannot be apportioned between the "10% to 19.99% of income" category and the "20% or more of income" category.

Source: Fiscal Policy Institute analysis of microdata from the U.S. Census Bureau's 2011 American Community Survey.