

**Staff report to the New York State Senate  
Select Committee on Budget and Tax Reform  
on  
Exploring progressive changes to New York  
State's personal income tax system**

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**Chair: Senator Liz Krueger**

**Senator Neil Breslin**

**Senator Kenneth LaValle**

**Senator Kevin Parker**

**Senator Bill Perkins**

**Senator Michael Ranzenhofer**

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**Based on testimony from a March 12 public hearing at the Empire State Plaza Convention Center in Albany, prepared by James Schlett**

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**Executive Summary**

The recession and its stranglehold on New York State's traditional revenue sources have exposed vulnerabilities and inequities in the state's tax policy. New York's overdependence on tax revenues from the financial services industry, coupled with the mounting financial pressures on middle-income households, have created an imperative for lawmakers to reassess how and where the state pulls its revenues.

New York's 2003 budget crisis featured a deficit of \$12.6 billion, which prompted the Legislature to temporarily adjust the state's personal income taxes (PIT). This fiscal year, the state faced an even larger \$16.2 billion budget deficit, which once again compelled lawmakers to revisit the PIT system.

To address this and other tax and budget issues, the new Senate Majority conference adopted Senate Resolution 315, which created the Select Committee on Budget and Tax Reform. On March 12, the Select Committee held its first public hearing to hear and debate proposals for establishing a more progressive PIT system. The Select Committee focused on two bills (S.2021 and S.2654) that would create new income tax brackets for New Yorkers earning over \$250,000 annually; thus eliminating the flat marginal tax rate of 6.85 for households earning over \$40,000 per year.

Both bills estimate between \$1 billion and \$6.2 billion in new tax revenues and would set a top PIT rate of 10.3 percent for individuals earning either more than \$1 million or more than \$3 million annually. Unlike the temporary PIT surcharges that set the top rate between 2003 and 2005 at 7.7 percent for New Yorkers, the rate increases proposed by Senator Eric Schneiderman in S.2021 and Senator Jeff Klein in S.2654 would be permanent.

The bills' focus on higher earners follows a period of disproportionate wealth growth in New York. Between the late-1980s and mid-2000s, New York's top 5 percent saw their income grow by 69.9 percent while the middle 20 percent's income grew by only 8.3 percent. This wealth gap and the "good

fortune” of New York’s top earners have driven the thinking behind the so-called “fair-share tax” or “millionaire’s tax” proposals. Between 1996 and 2007, the top 1 percent’s tax liability almost tripled, rising from \$4.94 billion to an estimated \$14.21 billion.

At its public hearing in Albany, the six-member, bipartisan Select Committee heard testimony from 10 experts, who weighed the fairness of New York’s PIT system and how an adjustment to it would impact the state’s budget and economy. Key findings of the Select Committee, which is chaired by Senator Liz Krueger, are detailed in this report and they include:

- To guard against any volatility to which a PIT adjustment could expose New York’s budget, lawmakers could build large reserves or “rainy day” funds with excess revenues.
- New revenues from a PIT adjustment could also go toward a new middle-income property tax circuit breaker program, which could replace the Middle Class STAR Rebate Check Program.
- At little cost, owing to current deflationary pressures, New York could index its tax brackets to inflation, much like the federal income tax system.
- A PIT adjustment finds its greatest support when it is limited to addressing the sudden loss of revenue from a cyclical economic downturn, much like the 2003-05 PIT surcharges.
- S.2021 would place the share of income taxes paid by the top 1 percent above 40 percent or 45 percent, potentially further exposing New York’s budget to the volatility of the financial services sector and financial markets. But volatility is less of a short-term concern because the income of the top 1 percent has already fallen from its unsustainable levels reached during the economy’s boom years.

- The new tax brackets proposed in S.2021 and S.2654 would put New York's top rate in league with California's new top rate of 10.55 percent. Although opponents of both bills warned the legislation would scare away businesses and result in the flight of wealthy residents, research done on similar PIT adjustments in California and New Jersey suggests otherwise.

This report concludes with an examination of the temporary PIT surcharges that were included in 2009-10 budget the Legislature passed in April. By setting the top rate at 8.97 percent for three years, the Legislature heeded to calls that any PIT adjustment be temporary and remain far below California's top rate of 10.55 percent. But lawmakers will need to remain conscious of the volatility associated with setting higher PIT rates and the need for providing relief to middle class homeowners.

Recommendations voiced to the Select Committee could help guide the Legislature through this quest for stability.

## Introduction

For all the riches the recession is wiping out, it is in return supplying a wealth of ironies. The low interest rates that fueled the housing boom are now serving as a lynchpin for the U.S. housing market's strategy for recovery. Crude oil's surge last summer to a record of \$127 per barrel drastically reversed course just after putting Detroit's Big Three on their last limb.

Since the national recession began in December 2007, New York State has found itself to be the epicenter of the economic downturn and rife with all its ironies. None have been as glaring as the multibillion-dollar shortfall the state faced while entering the 2009-10 fiscal year, largely due to the loss of income tax revenues from Wall Street, which for years supported increasingly heavy spending obligations.

A trait common to these financial crises is that their enablers have been viewed as the vehicles of recovery, at least in the short run. For example, in New York, the state's heavy reliance on the wealthiest taxpayers is being eyed as a way to balance the budget, even after that very dependency derailed the fiscal plan in the first place.

It is a situation all too familiar to New York. One that has been built into its financing structure by tying larger and larger sums of New York's tax revenues to the financial services industries and financial markets and their high-paying jobs. In Governor David Paterson's 2009-10 Executive Budget, the top 1 percent of New York taxpayers was projected to account for 35.2 percent of the state's total income tax liability this fiscal year, down slightly from 36.5 percent last year and starkly from 40.8 percent in 2007.<sup>1</sup>

Since New York entered a recession in March 2008 – four months behind the start of the nation's recession – job losses have been mounting statewide. Between last March and a year earlier, the state's

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<sup>1</sup> 2009-10 Executive Budget Economic and Revenue Outlook, Personal Income Tax section, Table 7.

private sector employment ranks shrank by almost 162,000 jobs to 7.04 million.<sup>2</sup> Since reaching a record high in October 2007, the Dow Jones Industrial Average has lost more than half of its value and hit a 12-year low. Those stock market and labor force losses, which included many high-paying financial positions at now-defunct companies such as Bear Stearns Cos. and Lehman Brothers Holdings, contributed to the \$13.7 billion gap Governor Paterson initially forecast in his budget. That figure in less than four months grew to \$16.2 billion.

It was a record-high deficit projection for New York, but akin to the \$12.6 billion gap the state faced in 2003 in the wake of the dot-com bust and September 11, 2001 terrorist attacks. Then, Governor George Pataki proposed tackling the deficit with \$5 billion in General Fund cuts. Governor Paterson, likewise, proposed \$9.15 billion in General Fund spending cuts in his Executive Budget; and an additional \$4 billion in new taxes and fees.<sup>3</sup> However, he agreed on March 11 to eliminate \$1.3 billion of those tax proposals by tapping some of the \$6.5 billion in fiscal relief New York is receiving under the federal American Reinvestment and Recovery Act.

Even after taking into account the federal stimulus aid, New York still faced a massive budget deficit. As Governor Pataki did in 2003, Governor Paterson initially opposed suggestions to increase New York's top personal income tax rate (PIT), saying that action would stifle the state's economic recovery and drive away wealthy residents. Then the state Legislature, much like this year, called for such restructuring of the PIT system.

In 2003, to enact a three-year PIT surcharge included in the state budget, the Legislature had to override Governor Pataki's veto.<sup>4</sup> At the time of the public hearing on March 12, it was not clear

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<sup>2</sup> UNew York State Department of Labor statistics.

<sup>3</sup> Fiscal Policy Institute, testimony to the Senate Select Committee on Budget and Tax Reform on "Exploring Progressive Changes to New York State's Personal Income Tax System" (March 12, 2009).

<sup>4</sup> The temporary surcharge raised the top PIT rate for New Yorkers earning over \$500,000 annually from 6.85 percent to 7.7 percent. It also changed PIT rates for singles earning over \$100,000 and married couples earning over \$150,000 annually. Their rates gradually declined from 7.5 percent in 2003, 7.375 percent in 2004 to 7.25 percent in 2005.

whether any PIT adjustment would be included in the 2009-10 budget. But between February 11 and March 12, at least two bills were introduced in the New York Senate proposing to establish new personal income tax brackets for the highest-earning New Yorkers. Unlike the 2003 surcharges, these bills propose permanent rate changes. They included the so-called “fair share tax” or “millionaire’s tax” legislation presented by Senator Eric Schneiderman (S.2021)<sup>5</sup> and Senator Jeff Klein (S.2654).<sup>6</sup>

Both bills aim to set new tax brackets starting at the \$250,000 taxable income level and spreading to incomes exceeding either \$1 million or \$3 million. The bills propose to set the top rate at 10.3 percent and promised to generate between \$1 billion (S.2654) and \$6.2 billion (S.2021) in new revenues, with the projections varying greatly because Senator Klein’s bill included a middle-class tax relief provision.<sup>7</sup>

It is in these bills where the irony deepens: the notion of increasing New York’s reliance on volatile top-tier income to resolve a volatile fiscal situation. Progressive taxation supporters, such as the Fiscal Policy Institute and the New Yorkers for Fiscal Fairness, claimed that strategy worked in 2003 and was worth revisiting. Anti-tax organizations, such as the Empire Center for New York State Policy and the Business Council of New York State argued against that tactic, saying that a temporary PIT surcharge cost the state dearly by stunting job creation and driving wealthy New Yorkers out of the state.

Yes, there were similarities between New York’s 2009-10 budget crisis and its predecessor six years ago. But the parallels broke when taking into account the depth and breadth of the economic downturns that spawned them. The 2001-02 recession lasted eight months while the nation’s present

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<sup>5</sup> S.2021 would create new personal income tax brackets for New Yorkers earning over \$250,000 annually. It has been dubbed the Fair Share Tax Reform Act of 2009 for its plan to modify the state’s top tax rate, which plateaus at 6.85 percent for married couples earning more than \$40,000 annually and singles earning over \$20,000. The Fair Share Tax Reform would set higher income tax rates for the state’s wealthier residents, ranging from 8.25 percent for New Yorkers earning over \$250,000 annually and 10.3 percent for those with an annual income of at least \$1 million.

<sup>6</sup> S.2654 proposes new tax brackets ranging from 6.85 percent to 8.97 percent for New Yorkers earning between \$250,000 and \$1 million annually; plus a 10.3 percent rate for residents whose annual income is at least \$3 million. The bill also calls for tax cuts for New Yorkers earning less than \$250,000 annually. Money from the cuts would be delivered to taxpayers in the form of debit cards. They could be used during a finite time to help stimulate the economy.

<sup>7</sup> Revenue generation projections are detailed in the sponsor memos accompanying S.2021 and S.2654.



recession is in its 16th month with no bottom in sight. The magnitude of the proposed PIT increases now before the Legislature are vastly larger than what lawmakers passed in 2003.

Given these similarities and differences, the Senate’s newly-formed Select Committee on Budget and Tax Reform held on March 12 a public hearing exploring the proposals to establish a more progressive personal income tax system in New York. The six-member, bipartisan committee, chaired by Senator Liz Krueger, heard testimony from 10 experts in Albany.<sup>8</sup> Highlights from their testimony include:

- *Volatility*: Enactment of S.2021 could generate up to \$5 billion, though it would also place the share of income taxes paid by the top 1 percent “well above 40 percent, perhaps above 45 percent, and well above anything seen in more than 10 years,” said Donald Boyd, a Senior Fellow with the Rockefeller Institute of Government. “This would be likely to raise the volatility of New York’s income tax considerably: busts and booms would likely be larger than now.”<sup>9</sup> But Frank Mauro, the Executive Director of the Fiscal Policy Institute, said PIT-related volatility should not be a concern in the short run because top-tier income has already fallen from its unsustainable peak levels.
- *Temporary measures*: Given the volatility associated with a greater reliance on income tax revenues from the top 1 percent, a PIT surcharge should be limited to carrying the state through its current budget crisis. Ken Pokalsky, the Senior Director of Affairs for the Business Council of New York State, said “Any revenue adjustments should be designed to address

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<sup>8</sup> The public hearing’s witness list included Donald Boyd of the Rockefeller Institute of Government, Ken Pokalsky of the Business Council of New York State, Frank Mauro of the Fiscal Policy Institute, E.J. McMahon of the Empire Center for New York State Policy, Jessica Wisneski and Bob Cohen of Citizen Action of New York, Elizabeth Lynam of Citizens Budget Commission, Ron Deutsch of New Yorkers for Fiscal Fairness, Jason Angell of the Center for Working Families and Marina Marcou-O’Mailey of the Alliance for Quality Education.

The Select Committee also received written testimony from The Reverend Daniel Hahn of Lutheran Statewide Advocacy, Fran Turner of CSEA, The Reverend Richard Gilbert of Interfaith Impact of New York State, Brian McDonnell of AFSCME New York, and Dan Jacoby.

<sup>9</sup> Rockefeller Institute of Government, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

cyclical downturns in income.”<sup>10</sup> Elizabeth Lynam, the Deputy Research Director of Citizens Budget Commission, likewise called such a tax increase “justifiable” so long as it is accompanied by significant spending cuts along with contractual changes to with public employee unions.<sup>11</sup>

- *PIT evolution*: New York’s PIT system dates back to 1919, when its rate was set at 3 percent. From there, the top rate gradually increased until peaking at 15.375 percent in the mid-1970s. Starting in the late-1970s, lawmakers in Albany embarked on what became a three-decade-long campaign that gradually lowered the top rate down to its present level of 6.85 percent. E.J. McMahon, the Director of the Empire Center for New York State Policy, said those actions created a more progressive and simplified PIT system. By the time of the public hearing, the state had a five-bracket structure, compared to a structure with as many as a dozen brackets beginning at very low rates and very low incomes.<sup>12</sup> But Mauro said the declining PIT rates in the early 1990s contributed to a “massive shift from the income tax to property tax.”
- *Fairness*: With New York’s top income tax bracket set at 6.85 percent for married couples earning over \$40,000 annually and singles earning \$20,000 annually, there was a perceived inequity in the distribution of New York’s tax burden. A rate that plateaued at 6.85 percent created the impression that “working and middle class New Yorkers continue to bail out those who can afford to pay more,” said Brian McDonnell, the Legislative Director for AFSCME

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<sup>10</sup> Business Council of New York State, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>11</sup> Citizens Budget Commission, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>12</sup> Empire Center for New York State Policy, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

New York.<sup>13</sup> But McMahon refuted the claim that low- to middle-income New Yorkers pay the same taxes as millionaires, largely because of the impacts of standard deductions, exemptions and credits.

- *Competition:* At 6.85 percent, New York in 2008 had the nation’s 15<sup>th</sup> highest PIT rate. The top rate increases proposed in S.2021 and S.2654 would put New York’s top rate in league with California’s new top rate of 10.55 percent – the highest in the nation.<sup>14</sup> McMahon warned that the rate increases proposed in the two bills “would represent a very significant further deviation from relevant competitors, such as Connecticut and New Jersey.” Research done on similar PIT adjustments in California and New Jersey suggested those actions did not drive away wealthy residents.
- *Strategies and Alternatives:* With the threat of heightened volatility tied to increases to New York’s top PIT rate, both Boyd and Mauro suggested building large reserves to guard against cyclical economic downturns. Other strategies suggested by Boyd included using hedging instruments to insure against revenue volatility and structuring individual tax sources to be less volatile by flattening the income tax or adding new items to the sales tax. Mauro said revenues from a PIT rate increase could best be used for a middle class property tax circuit breaker that would provide more relief to homeowners than the doubling of the standard deduction, as proposed in S.2654. The indexing of New York’s tax brackets to inflation is another option, which lawmakers could now implement “at zero cost” due to current deflationary pressures, McMahon said.
- *Conclusion:* Shortly after the Select Committee held the public hearing, the Legislature passed a \$131.8 billion budget, which also set a new top PIT rate of 8.97 percent for all New Yorkers

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<sup>13</sup> AFSCME New York, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

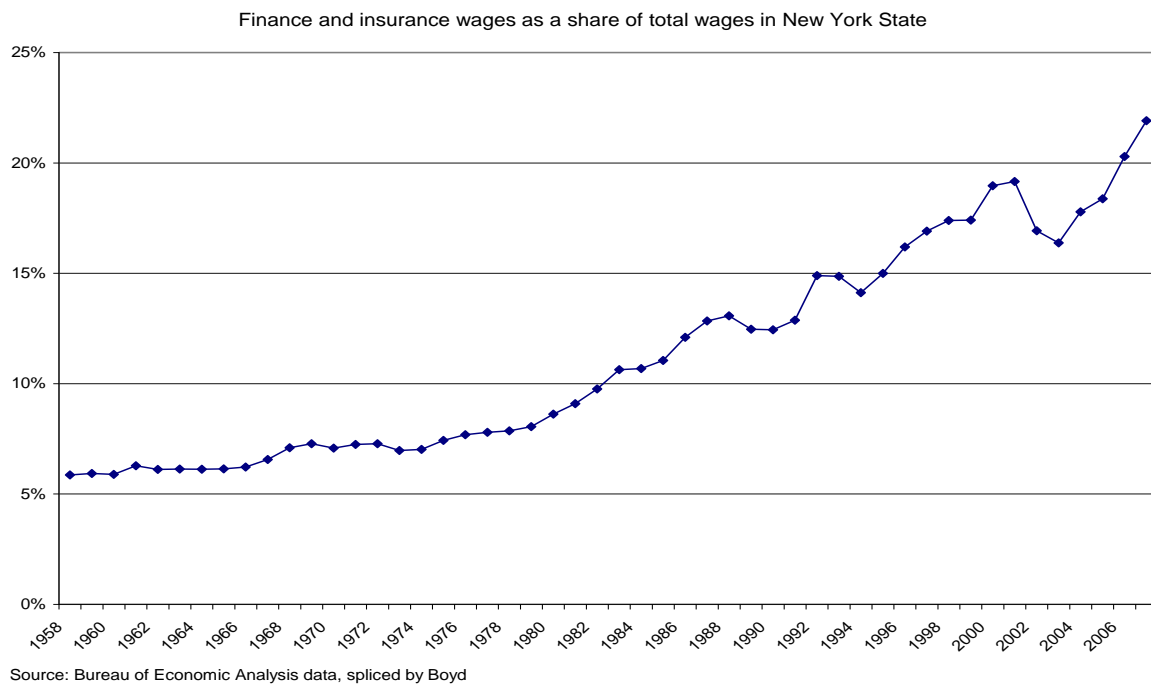
<sup>14</sup> Empire Center.

earning over \$500,000 annually. This budget provision met the calls for any PIT adjustment being temporary and is set to expire in three years. It also does not make New York run neck-and-neck with California for having the nation's highest PIT top rate. But the surcharges push to the forefront questions over New York's vulnerability to financial industry volatility and ways to provide effective relief to middle class homeowners. The experts' recommendations detailed in this report's Conclusion could help bring the state closer to the relative stability it has historically enjoyed.

# Volatility

Stability. It is what New York now craves and what the state has largely enjoyed historically. A Pew Center of the States survey of economic volatility between 1986 and 2005 found New York ranked “squarely in the middle” when compared to the other 49 states. Volatility was highest in states that relied heavily on petroleum and mineral extraction industries, such as North Dakota, Wyoming and Louisiana.<sup>15</sup>

The past several years have seen New York’s economy grow increasingly volatile – a trend owed not to the discovery of crude oil reserves on state lands but to a growing reliance on the financial services sector centered around Wall Street. Between 1958 and 2007 in New York, finance and insurance sector wages grew from about 6 percent of total wages to 22 percent.<sup>16</sup>



“Most of this money is taxed at New York’s top rate. And of course it has disappeared quickly ... So although historically-based tax-volatility measures do not suggest that New York’s tax system is

<sup>15</sup> Rockefeller Institute.

<sup>16</sup> Ibid, slide 4.

extremely high, in the right kind of recession – this one or the last one – its sensitivity to the business cycle is way too high,” said Boyd.

During the heady days of the dot-com boom, surging financial sector wages pushed the income tax liability of New York’s top 1 percent to \$9.64 billion, or a 39 percent share of total liability in 2000. But in the wake of that boom’s bust and the September 11, 2001 terrorist attacks, the top 1 percent’s tax liability shrank by \$2.96 billion to \$6.68 billion in 2002, or a 32.2 percent share of total liability.<sup>17</sup>

Now in the grip of a deeper recession, the top 1 percent’s tax liability has fallen even steeper since it peaked in 2007 at an estimated \$14.21 billion, or a 40.8 percent share of total liability. In just one year, the decline from that zenith was estimated to be \$2.62 billion, bringing the top 1 percent’s liability to \$11.59 billion in 2008, or a 36.5 percent share of total liability.<sup>18</sup>

If long-term stability is the Legislature’s sole objective, Boyd said lawmakers would be more concerned about developing a flatter income tax system – not one that tips more heavily to the top 1 percent. As Pokalsky, at the Business Council, noted: “[I]n higher income brackets, a greater share of income is from less stable non-wage income sources.” For example, taxpayers in the \$40,000 to \$200,000 range in 2005 attributed 2 percent of their adjusted gross income to capital gains and 84 percent from salary and wages. Contrarily, for all taxpayers in the above \$200,000 range, capital gains accounted for about a quarter of their income in 2005.<sup>19</sup>

But with the state facing a \$16.2 billion deficit, lawmakers this year have been more focused on a short-term solution to New York’s fiscal crisis; hence, the introduction of the “fair share” and “millionaire’s tax” bills.

Boyd warned that, while S.2021 could minimize the size of New York’s deficit by generating \$5 billion in new revenues, it would also push the share paid by the top 1 percent by at least 5 percentage

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<sup>17</sup> 2009-10 Executive Budget Economic and Revenue Outlook, Personal Income Tax section, Table 7.

<sup>18</sup> Ibid.

<sup>19</sup> Business Council.

points. Such a spike could bring the top 1 percent's share of total liability to over 40 percent and possibly above 45 percent. That level is "well above anything seen in more than 10 years."

"Tax policies involve trade-offs," Boyd said. "In this case, the increase in revenue would support spending that could benefit the economy ... Whether benefits from these changes would justify the increase in volatility of course falls in [the Legislature's] domain."

However, Mauro said concerns about long-term volatility associated with a greater dependency on the top 1 percent have become a moot issue at this time in the recession. By targeting the top PIT rate, he said the state could use revenues from income "least likely to be spent" to help preserve government stimulus initiatives that can drive an economic recovery.

"In the short-run, the least damaging kind of balancing action by a state during a recession is increasing the tax on the portion of the income over a relatively high level ... We don't have to worry about volatility in the short-term because we're already down," Mauro said.

Governor Paterson's Executive Budget projects the income tax liability from the state's top 1 percent to bottom out this year at \$10.36 billion and rebound in 2010 to \$11.43 billion. If the Legislature is very concerned about exposing the state to increased volatility by raising the top PIT rate, Mauro said it could take revenues that come in over a relatively conservative annual estimate and put the overage in a rainy day fund.

## Temporary Measures

A quick fix. Something designed to specifically address the loss of revenue due to the economy's cyclical downturn, with defined expiration dates. A PIT adjustment finds its greatest support when it met this criteria, which largely mirrors the temporary PIT surcharge the Legislature passed in 2003.

“Any revenue adjustments should be designed to address cyclical downturns in income, rather than impose a permanent increase in the state's tax burden,” said Pokalsky, at the Business Council. But any such adjustment, he added, should be contingent upon commitments to curb spending and other fiscal reforms.

Lynam, at the Citizens Budget Commission, likewise said, “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 cannot solve New York's problem.”<sup>20</sup>

As McMahon told the Select Committee, “In the short run, as you grapple with the massive budget gap, your goal should be Hippocratic: do no harm. At the very least, do as little harm as possible.” Because New York's economy recovered from the last recession despite the 2003 PIT increase, many experts attested that three-year surcharge achieved Hippocratic goal – a claim McMahon said is debatable.

In answering a direct question from Senator Liz Krueger to the panel of at Feb. 23 meeting of the Joint Economic and Revenue Consensus Forecasting Conference, Federal Reserve Bank of New York Assistant Vice President James Orr said a PIT rate increase similar to the one the Legislature passed in 2003 “might be another possibility” for the state in its current fiscal crisis. Ronnie Lowenstein, the Director of the New York City Independent Budget Office, added that an important aspect of the 2003-05 income and sale tax surcharges was that they “primarily did step down on schedule.” Though,

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<sup>20</sup> Citizens Budget Commission, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State's Personal Income Tax System” (March 12, 2009).



in commenting on Orr’s suggestion of another PIT surcharge, she said, “It makes me feel uncomfortable.”

During the three years of the PIT surcharge’s lifecycle, New York’s private employment ranks grew by a non-seasonally-adjusted 125,300 to an average 7.08 million in 2005.<sup>21</sup> During the same period, the number of New Yorkers with an adjusted gross income exceeding \$1 million increased by 10,305 or 49.8 percent to 30,989.<sup>22</sup>

“Although the surcharge did not cause these happy results, they certainly did no harm. Thus we feel that adjusting income tax brackets to deal with New York’s shortfall is just while doing no significant harm,” said The Reverend Daniel Hahn, director of Lutheran Statewide Advocacy.<sup>23</sup>

However, McMahon warned that the 2003-05 surcharges were anything but harmless, and actions on the federal level – coupled with an economic turnaround already underway – mitigated the impacts of higher top PIT rates in New York. Unlike the 2003 environment, the current recession is projected to last one or two more years, and it will likely be followed by massive federal tax increases on top earners.<sup>24</sup>

“The positive effect of federal tax cuts overwhelmed most – but not all – of the negative impact of New York’s temporary higher income taxes,” McMahon said of the 2003 surcharge.

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<sup>21</sup> New York State Department of Labor statistics: [www.labor.state.ny.us/workforceindustrydata/cesemp.asp](http://www.labor.state.ny.us/workforceindustrydata/cesemp.asp).

<sup>22</sup> New York State Department of Taxation and Finance statistics.

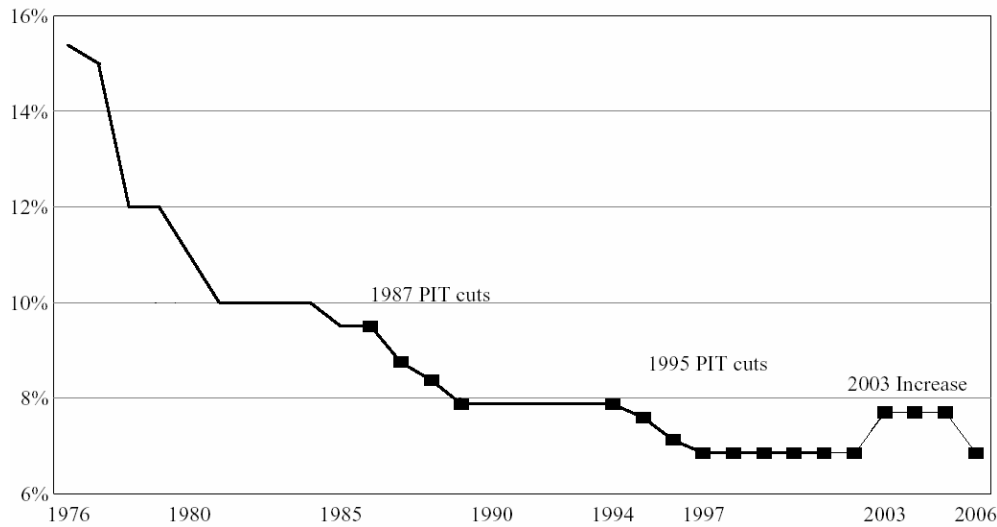
<sup>23</sup> Lutheran Statewide Advocacy, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>24</sup> Empire Center.

## PIT Evolution

If anything, New York’s PIT system over the past three decades has evolved into one with fewer brackets – narrowing from 14 in 1972 to five in 2008 – and with a top rate that is significantly below its mid-1970s’ peak of 15.375 percent. What is debatable is the impacts of those changes, with some arguing they unfairly favored the rich and others saying they are overly burdensome on that demographic.

One way or another, New York’s current PIT system began taking shape under Governor Hugh Carey’s leadership in the late 1970s.<sup>25</sup> That transformation followed “widespread bipartisan agreement here in Albany that New York’s very high tax rates had been a major factor in the economic decline of the state and city over the previous decade,” said McMahon.



Source: Fiscal Policy Institute

During Governor Carey’s final term between 1979 and 1982, the state’s marginal rate on earned income was reduced from 15 percent to 10 percent, and Governor Mario Cuomo continued that trend during his first term, knocking the rate down to 9 percent. In 1987, Governor Cuomo and the Legislature

<sup>25</sup> Ibid.

agreed on a tax reform plan, which was primarily designed to avoid an automatic \$1.7 billion windfall tax increase spurred by reforms to the federal tax code passed a year earlier.<sup>26</sup>

Governor Cuomo’s 1987 plan carried a five-year phase-in transition and intended to set a top rate of 7 percent for individuals with taxable incomes over \$20,000 and married couples with taxable incomes over \$40,000. McMahon said these reforms were “enacted in the name of improving equity. And it succeeded.”<sup>27</sup>

But those reforms failed to be fully implemented, largely due to the fiscal crisis that hit New York in 1989. By 1990, the rate had been frozen at 7.875 percent. It stood at that level until Governor George Pataki’s Taxpayer Reform Act of 1995. Governor Pataki gradually brought the top rate down to 6.85 percent in 1997. His plan aimed to drop 500,000 low-income filers off tax rolls by expanding the Earned Income Credit and to furnish a tax cut for middle- and higher-income families.<sup>28</sup>

All these reforms created, in McMahon’s words, a PIT structure that is “functionally quite progressive.” Mauro agreed that the PIT structure has progressive traits, but he contended that something else was happening to the PIT system amid these reforms. Mauro noted that between 1987 and 1992, local property tax revenues rose by 50 percent to \$21 billion while income tax revenues increased by 22 percent.<sup>29</sup>

“There was a clear and massive shift from the income tax to the property tax during this period,” Mauro said.

Between 1995 and 2005, local property tax levies grew by 60 percent – more than twice that period’s inflation rate of 28 percent. By 2005, local property tax levies totaled \$38 billion, up 42 percent

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<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid.

<sup>29</sup> Fiscal Policy Institute.

from \$11 billion in 2000. The property tax has become the largest tax imposed by local governments, accounting for 79 percent of all local taxes outside New York City.<sup>30</sup>

By 2006, New York's state and local property tax collections averaged \$5,154 per household, giving the state that nation's fourth highest property tax burden.<sup>31</sup> Jason Angell, the Director of the Center for Working Families, blamed New York's revenue shift away from income taxes for increasing taxpayers' property tax burden.<sup>32</sup>

“While opponents ignore this by treating income and property and sales tax policy as disconnected, this shift has led to the shockingly regressive overall tax system we have today that places the greatest burden on those with the least income,” Angell said.

Instead of creating a more progressive PIT system, the tax reforms enacted over the last 30 years actually made “a long-term structural deficit that lowered the revenue available for vital state services,” said Jessica Wisneski, the Legislative Director for Citizen Action of New York. She added that the multi-year tax cuts enacted between 1994 and 2005 reduced state revenue by \$20 billion in the 2008-09 fiscal year. “We reduced the relative tax burden on the high income people and increased the burden on middle- and low-income people.”<sup>33</sup>

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<sup>30</sup> Office of the New York State Comptroller, “Local Government Issues in Focus: Property Tax in New York State.” [www.osc.state.ny.us/localgov/pubs/research/propertytaxes.pdf](http://www.osc.state.ny.us/localgov/pubs/research/propertytaxes.pdf)

<sup>31</sup> The Tax Foundation, Tax Data: State and Local Property Tax Collections per Household and per Capita by State, Fiscal Year 2006. Feb. 9, 2009. [www.taxfoundation.org/taxdata/show/251.html](http://www.taxfoundation.org/taxdata/show/251.html).

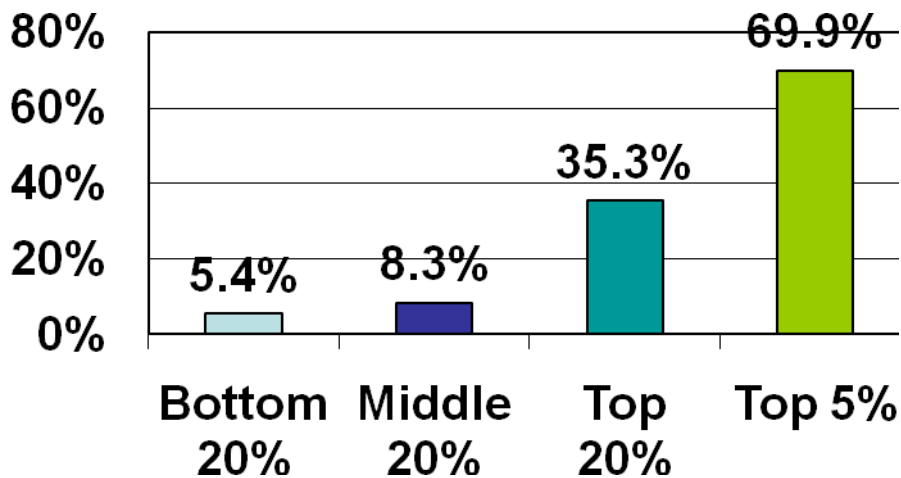
<sup>32</sup> Center for Working Families, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>33</sup> Citizen Action of New York, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

## Fairness

“I don’t well up with tears when I think about taxing millionaires,” said Ron Deutsch, the Executive Director of New Yorkers for Fiscal Fairness.<sup>34</sup>

In New York, such antipathy toward millionaires partly finds its roots in the yawning wealth gap between the rich and poor. As Deutsch noted, between the late-1980s and mid-2000s, New York’s top 5 percent saw their income grow by 69.9 percent while the middle 20 percent’s income grew by 8.3 percent.<sup>35</sup> On top of that, the Center on Budget and Policy Priorities reported that New York has the nation’s worst income inequality, with the top 5 percent having an average income 15.4 times as large or larger as the poorest 20 percent of families.<sup>36</sup>



Source: New Yorkers for Fiscal Fairness.

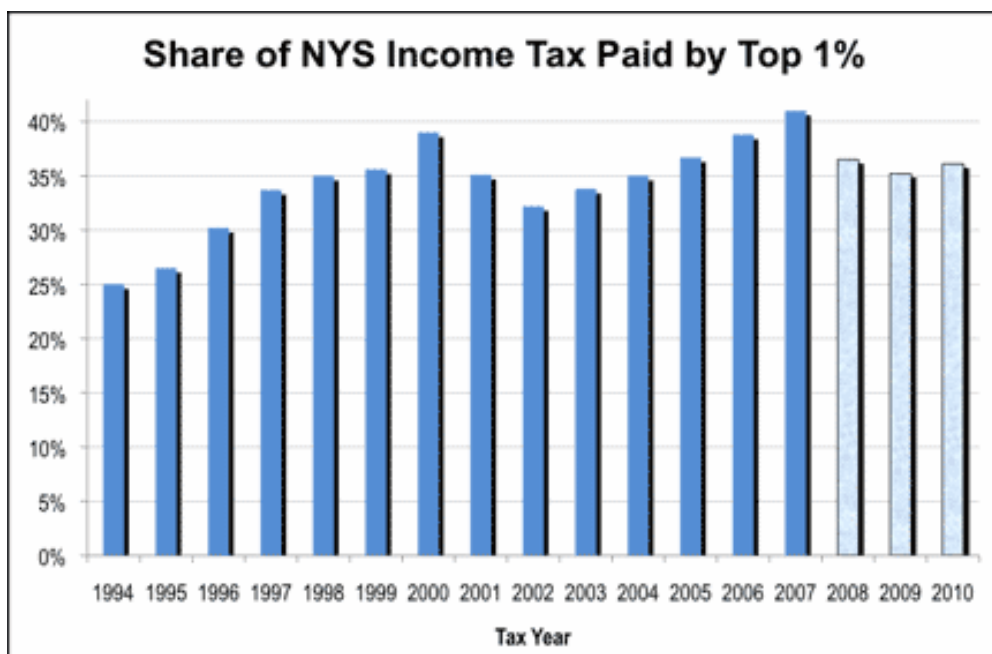
<sup>34</sup> New Yorkers for Fiscal Fairness, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>35</sup> Ibid, slide 2.

<sup>36</sup> Lutheran Statewide Advocacy, citing [www.cbpp.org/4-9-08sfp.pdf](http://www.cbpp.org/4-9-08sfp.pdf).

That disproportionate distribution of wealth drives the thinking that “good fortune obligates” and “that those of us who have been fortunate in securing life resources ... owe the pot,” said The Reverend Richard Gilbert, the Regional Vice President of Interfaith Impact of New York State.<sup>37</sup>

Between 1996 and 2007, the sum owed to the state income tax “pot” by New York’s top 1 percent almost tripled, rising from \$4.94 billion to an estimated \$14.21 billion. During the same period, that group’s share of total liability rose from 30.2 percent to an estimated 40.8 percent.<sup>38</sup>



Source: Empire Center

The robust growth in income tax liability among the top 1 percent enabled the state to take on a host of new responsibilities. They included big-ticket items, such as capping the growth of counties share of Medicaid costs, settling the Campaign for Fiscal Equity lawsuit over insufficient school aid and establishing the Middle Class School Tax Relief Rebate Checks Program.<sup>39</sup>

<sup>37</sup> Interfaith Impact of New York State, testimony to the Senate Select Committee on Budget and Tax Reform on “Exploring Progressive Changes to New York State’s Personal Income Tax System” (March 12, 2009).

<sup>38</sup> 2009-10 Executive Budget `Economic and Revenue Outlook.

<sup>39</sup> Fiscal Policy Institute.

“We were gambling that the existing revenue system would [not only] grow fast enough to cover the increasing costs of what we were doing at the time, but it would cover these new programs,” said Frank Mauro, executive director of the Fiscal Policy Institute.

In 2008, New York’s gamble went bust. As Wall Street tottered and shed thousands of high-paying jobs, the top 1 percent’s tax liability in 2008 decreased by an estimated 18.4 percent from the previous year’s peak level. To bridge the \$16.2 billion budget deficit the recession wrought in New York, Governor Paterson proposed a series of spending cuts that would significantly impact low- and middle-income families, especially through cuts to school aid, Medicaid and government programs and the elimination of 8,900 state jobs.<sup>40</sup>

“New Yorkers were told that everyone would have to pull in their belts, but the affluent were not included in that ‘everyone,’” said The Reverend Daniel Hahn, Director of the Lutheran Statewide Advocacy.

The notion that the wealthy are excluded from this picture stemmed from New York’s top PIT rate of 6.85 percent, which applied to married couples earning over \$40,000 annually and singles making over \$20,000 annually. The way this rate plateaued made it appear as though families making \$40,000 annually paid the same marginal tax rate as wealthy families making \$4 million. That structure caused “the richest 1 percent of New Yorkers pays only 6.5 percent of their incomes in taxes while the bottom 20 percent pay 12.6 percent, Wisneski said.<sup>41</sup>

However, McMahon said claims that middle-class filers paid the same marginal tax rates on taxable income as million-dollar households “misleadingly confuse[d]” taxable income with adjusted gross income and ignored the impact of standard deductions, exceptions and tax credits. For example, in 2006, the effective state personal income tax rate for full-year residents earning between \$40,000 and

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<sup>40</sup> AFSCME.

<sup>41</sup> Citizen Action.

\$50,000 annually was 3.5 percent, compared to 6.1 percent for households earning over \$500,000 annually.<sup>42</sup>

Pokalsky said the attempt to impose higher PIT rates was a “symptom of the state’s excessive appetite for spending growth” that was “fueled by significant, but cyclical surges in upper income personal income tax revenues.”

But Mauro took issue with Pokasky’s claim about the state’s gross overspending and the “feast or famine cycle of budgets driven by the health of Wall Street.” Mauro noted that outside the areas of education, health care and transportation – in which the state has made significant new investments – state spending grew by less than 2.9 percent annually between 2004 and 2008. When comparing budget projections for the 2009-10 fiscal year made by the Spitzer and Paterson administrations, Mauro said the state was not banking on “strong revenue growth” but “ordinary, run-of-the-mill revenue growth” and “things fell off the wall.”<sup>43</sup>

“We’ve had a cataclysmic event, but you can’t then just say we have an addiction to spending,” Mauro said.

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<sup>42</sup> Empire Center, figure 2.

<sup>43</sup> Fiscal Policy Institute.



## Competition

Picture this: Times Square. The crowds, the traffic. Billboard-blanketed buildings with flashing lights and digital screens touting everything from the latest Broadway play to Coca-Cola soft drinks.

Amid all the glitz, McMahon said a PIT adjustment on wealthy New Yorkers would be the symbolic equivalent of “a flashing neon sign conveying an unequivocal message in flashing capital letters: STAY AWAY.” But Deutsch, at New Yorkers for Fiscal Fairness, said he doubted wealthy New Yorkers would see that sign, either in Manhattan or elsewhere in the state. And even if they did, he questioned whether they would heed its advice.

“Wealthy people live in New York because they love New York,” Deutsch said.

State legislatures have traditionally avoided increasing their PIT rates for fear of sending McMahon’s “Stay away” message to businesses and driving them off to neighboring states. But the economic downturn has forced a growing number of states to consider raising their PIT rates to close budget deficits. Michigan and Maryland followed that path amid their budget crises in 2007.

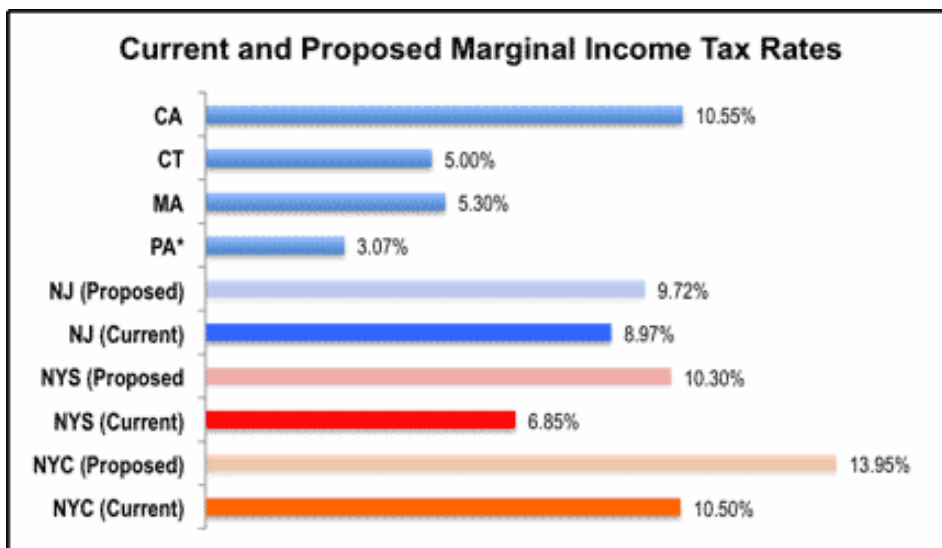
This year, as the recession sapped states’ sources of revenue, Illinois, Hawaii, Wisconsin, New Jersey, Connecticut and New York have likewise explored proposals to increase their PIT rates to help bridge much larger deficits. California Governor Arnold Schwarzenegger in February signed a package of bills, which included a quarter-of-a-percentage-point personal income tax rate increase, to help plug the Golden State’s \$42 billion budget deficit. At 10.3 percent, California last year had the nation’s highest personal income tax rate while New York had the 15<sup>th</sup> highest rate. Governor Schwarzenegger’s new budget will set California’s top PIT rate to 10.55 percent – pushing it outside the ranges proposed by Senators Schneiderman and Klein.<sup>44</sup>

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<sup>44</sup> Empire Center, figure 5.

“To us, a race to the top income tax rates in the nation is a curious ‘competition’ for anyone concerned with economic growth and job creation in New York ... Only New Jersey would challenge us for the lead in this dubious contest,” said Pokalsky.

None of these rates in neighboring states – or anywhere else in the nation – would come close to New York City’s top PIT rate should either bill be enacted. The city’s combined rate is 10.5 percent, though the legislation would push that figure to 13.95 percent.<sup>45</sup>



Source: Empire Center

Schneiderman’s bill would only affect 3.5 percent of tax filers statewide, including 7 percent of filers in Manhattan. One percent are upstate filers.<sup>46</sup> The concentration of affected tax filers in Manhattan and the surrounding areas have stoked concerns that an overly burdensome tax hike would drive them away. During a recent interview on the WOR-AM radio show, New York City Mayor Michael Bloomberg said, “we want rich people from around this country to move here. We love rich people.” He warned: “The first rule of taxation is ... you can’t tax too much those that can move.”<sup>47</sup>

<sup>45</sup> Ibid.

<sup>46</sup> Center for Working Families, based on an analysis of 2005 personal income tax returns by the New York State Department of Taxation and Finance.

<sup>47</sup> The Daily News, “Mayor Bloomberg: ‘We love the rich people’; Doesn’t want to over-tax New York’s Wealth.” March 6, 2009.

But Deutsch disagreed with the argument that S.2021 would result in an exodus of the wealthy from New York City. He even noted how Bloomberg, in a November 13, 2008 Associated Press article, said: “I can only tell you, among my friends, I've never heard one person say 'I'm going to move out of the city because of taxes. Not one. Not in all the years I've lived here. You know, they can complain, 'Oh got my tax bill, its heavy.' But they've not ever thought that. My friends all want to live here and understand the value.”<sup>48</sup>

Supporters of S.2021 pointed out that research shows recent PIT rate increases in other states, such as California and New Jersey, have not spurred large declines in their high-earning populations. In 2004, New Jersey raised its top PIT rate for earners above \$500,000 from 6.37 percent to 8.97 percent. Around the same time, California created a new top rate of 10.3 percent for earners above \$1 million.

A 2008 Princeton University study on New Jersey’s 2004 hike found that most of the Garden State’s out-migrants after the PIT adjustment were low-income and moved to states with higher income rates. Between 2002 and 2006, New Jersey’s ranks of half-millionaires grew from 26,000 to 44,000.<sup>49</sup>

In reviewing the impacts of the Golden State’s PIT adjustment, the California Tax Reform Association in 2006 reported that it found no credible evidence showing high-come taxpayers moved because of high taxes.<sup>50</sup> A 2008 report by the California Budget Project said California’s number of millionaires had jumped by 37.8 percent.<sup>51</sup>

Lynam, at the Citizens Budget Commission, suggested the recession could temporarily stave off a flight of residents. She noted that other states are likely to raise taxes during the recession, “thereby

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<sup>48</sup> New Yorkers for Fiscal Fairness.

<sup>49</sup> Center for Working Families., citing Young, Cristobal, Varner, Charles, Massey, Douglas S., *Trends in new Jersey Migration: Housing, Employment and Taxation*, The Woodrow Wilson School of Public and International Affairs at Princeton University, September 2008, [http://www.princeton.edu/prior/PRIOReconomy-Final-\(2\).pdf](http://www.princeton.edu/prior/PRIOReconomy-Final-(2).pdf).

<sup>50</sup> Ibid, citing Goldberg, Lenny, *Top Brackets*, California Tax Reform Association, 2006.

<sup>51</sup> Ibid, citing *California Budget Project Analysis*, California Budget Project, 2008

reducing the marginal harm to New York’s recovery.” Heavy losses in jobs and home prices elsewhere are also making it “increasingly difficult for residents anywhere to make a move.”

Angell, at the Center for Working Families, cast doubt on the assertion that out-of-state businesses would interpret an increase to New York’s top PIT rate as sending a “Stay away” message. He noted that a 2008 Area Development Annual Corporate Survey found that the most important factors playing into business relocations are: transportation infrastructure, the cost of labor and cost of occupancy and construction. The leading quality-of-life factors driving relocation decisions are low crime rates, health care and housing costs.

“If the state fails to enact [the Fair Share Tax Reform Act] and proceeds with severe budget cuts, all of these things will suffer and make New York less competitive to attracting businesses,” Angell said.

## Strategies and Alternatives

So long as New York's income tax revenue sources reside on Wall Street, the state's budget cycles will likely continue to follow the same erratic path blazed by the stock market. Although New York's tax system has historically not demonstrated extremely high levels of tax volatility, its growing reliance on high earner's income has gotten to the point where "even average volatility is too much for policymaking purposes," said Boyd, at the Rockefeller Institute.

Boyd warned that raising New York's top PIT rate would likewise increase the state budget cycle's exposure to volatility. One way or another, cyclical budget crises "are primarily driven by declining tax revenue" and "[s]pending can play a role, too, but it is much less important." To address revenue volatility, he suggested the following practice options:<sup>52</sup>

- *Accept it, but manage it:* Build large reserve funds in good times, and draw them down in bad times. Mauro also recommended this tactic. He suggested taking revenues that come in over a relatively conservative annual estimate and putting the overage in rainy day fund. "But there are practical limits to how large these funds can get," Boyd said.
- *Accept it, but hedge it:* The state could purchase hedging instruments to insure against revenue volatility, similarly to the way some large businesses hedge oil price and exchange-rate risk. "Not in our lifetime," Boyd said.
- *Structure individual tax sources to be less volatile:* Add food, medical services and other necessities to the sales tax. Flatten the income tax. Base a corporate tax on gross receipts rather than income.

As Governor Paterson's decision in mid-March to pull \$1.3 billion in proposed taxes and fees off the table demonstrated, lawmakers faced significant political hurdles when attempting to

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<sup>52</sup> Rockefeller Institute.

further diversify New York's tax system during a recession. Some experts argued that the state has already shifted too much burden from personal income taxes. They said the recession increased the need to alleviate the greater tax burdens initially shifted onto property taxes when the state started lowering its top PIT rates in the early 1990s.

“In regard to the personal income tax, New York should consider approaches that will ensure that the wealthiest New Yorkers pay their fair share in state and local taxes, and which will allow the state to reduce the pressure that is currently placing on local property and sales tax bases,” said Mauro.

To ease those property tax burdens, Mauro recommended a middle class property tax circuit breaker. The circuit breaker would set a soft ceiling on how much homeowners should pay on their property taxes based on their income, leaving the state to pick up the bill for a significant portion of taxes over that maximum. The circuit breaker would replace the Middle Class STAR Rebate Check Program, which Governor Paterson proposed to eliminate in his Executive Budget.

Mauro suggested modifying S.2654's relief provision, which would provide middle- and lower-income taxpayers with tax cuts in the form of limited-term debit cards with values based on a doubling of standard deductions. Revenues raised by a PIT adjustment, instead, could go toward the circuit breaker, which would not play into the state's budget until the 2010-11 fiscal year. Therefore, Mauro said, it “would in no way detract from the governor's proposed use of this money [from the eliminated STAR rebate program] in the upcoming 2009-10 fiscal year for deficit reduction.

“A property tax circuit breaker, particularly one that includes renters, is a much better approach to providing middle class relief than an increase in the personal income tax's standard deduction,” Mauro said.

Another option endorsed by experts, such as Mauro, McMahon and Angell, was indexing New York’s tax brackets to inflation, making it more like the federal tax code. In the early 1980s, the federal tax code was indexed to rise with inflation, preventing millions of middle-income taxpayers from being pushed into higher brackets, as they were in the 1970s.

“One of the most significant things done to the federal tax code [over] 25 years ago was the indexing of federal income taxes. It was never done in New York. Most states with rates as high as ours do have indexes. As a result, families now, even compared to 1997 and after a time of low inflation, middle income families now pay hundreds more a year because you did not index the tax code,” said McMahon.<sup>53</sup>

Citing Fiscal Policy Institute data, Angell noted that had New York indexed its tax code, 90 percent of New York families would be paying lower taxes and the state would collect \$8 billion more in revenue each year.<sup>54</sup> Also, McMahon said, the deflationary pressures wrought by the recession have created a window for lawmakers to index the tax code.

“Right now, we are probably living in deflationary times. At zero cost, you can index the tax code and guard against the return of galloping bracket increases if and when inflation returns, which I fear will be quite strong in the next few years,” McMahon said.

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<sup>53</sup> Empire Center.

<sup>54</sup> Center for Working Families.

## Conclusion

About three weeks after the Select Committee held its public hearing, the Legislature approved a \$131.8 billion budget for the 2009-10 fiscal year. The budget included a three-year PIT adjustment that created two new tax brackets for high-earning New Yorkers, much like the temporary PIT surcharge established in 2003.

The PIT surcharges retroactively took effect on January 1, 2009 and are expected to generate \$4 billion annually. The budget provision created a top rate of 8.97 percent for all tax filers earning over \$500,000 annually. That is the highest top rate New York has seen since 1986, when it stood at 9.5 percent, though that rate applied to New Yorkers earning approximately an inflation-adjusted \$30,000 annually. A rate of 7.85 percent was also set for married couples earning over \$300,000 annually and singles earning over \$200,000 annually.

In some ways, the PIT surcharges' inclusion in the 2009-10 budget partially satisfies concerns raised by both progressive income tax adjustment supporters and opponents at the March 12 public hearing. Firstly, the surcharges address the loss of revenues caused by a cyclical economic downturn; they are temporary and set to expire before 2012. Secondly, at 8.97 percent, the top rate is no longer jockeying to be the highest in the nation. Based on 2008 data, California, Rhode Island, Vermont, Oregon and Iowa have higher rate. New York's new top rate rivals New Jersey's rate, though Garden State lawmakers are considering raising it to 9.72 percent.

Looking forward, lawmakers wanting to distance the state budget from Wall Street's boom-and-bust cycles could further explore some experts' recommendations to the Select Committee. For instance, any tax revenues from the PIT surcharges that exceed the state's target of \$4 billion could go toward a rainy day fund.



A window also remains open for New York to index its PIT tax brackets to inflation, though the opportunity to make that change at a minimal cost could pass when the global economy recovers and deflationary trends reverse themselves. In a recent Wall Street Journal article, Roger Ibbotson, manager of the Zebra Capital hedge fund, said, “Between the bailouts and stimulus, it’s pretty clear that we’re going to have some inflation when we get out of this mess.”<sup>55</sup>

Finally, the elimination of the Middle Class STAR Rebate Check Program provided the New York with \$1.42 billion in savings this fiscal year. But it also left a hole in the state’s property tax relief initiatives. The demise of the regressive STAR rebate checks provides the Senate with the opportunity to provide effective relief to middle class homeowners through a need- and income-based program such as the progressive circuit breaker that is based on both households’ income and need.

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<sup>55</sup> The Wall Street Journal, “Reflation and how to Exploit It.” March 31, 2009.