Testimony to

Senate Select Committee on Budget and Tax Reform

New York's Personal Income Tax

Presented by

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We appreciate the invitation to provide input to the Select Committee on Budget and Tax Reform on personal income tax issues. We look forward to working with this Committee on additional agenda items as well, and sharing with you additional budget and tax reform priorities being developed by The Business Council.

We fully understand the seriousness of the economic situation facing all New Yorkers, including the businesses we represent, and the financial situation being addressed by the Administration and Legislature. We also understand the difficulty of the choices being faced as you work on the Fiscal 2010 state budget.

It is essential that the budget be developed with the objective of making the state more competitive, not less, in order to fully participate in the next national economic recovery. With permanent changes in the financial services sector, we cannot expect the full recovery of Wall Street – or its revenues – that propelled the state's economy, and budget, out of recent downturns. Therefore, we need to assure that the entire state presents attractive opportunities for re-investment in our existing business, and new investments in new and emerging businesses. We believe tax and spending policies directly and dramatically impact that competitiveness.

Various organizations are arguing for dramatic increases in personal income tax rates and levies on upper income New Yorkers. Sometimes referred to as the "millionaires tax," these proposals would affect a wide range of New Yorkers, including small business owners operating as sub-chapter S corporations (small businesses paying business taxes under the state's personal income tax law), partnerships, LLCs, and other highly productive taxpayers.

In our view, the prime objective of their efforts - pushed by ardent pro-spending advocates – is a significant increase in state tax revenues and state spending, not tax equity. If tax equity were their prime objective, we would be talking with equal passion about revenue-neutral tax code changes, such as broadening and indexing of personal income tax brackets, not a $6 billion revenue raiser.

That said, I would like to take the time available this morning to address the specific issues raised by the Committee, and to respond to any questions you have.

Progressive PIT – We agree that the personal income tax should be progressive, and, despite arguments to the contrary, New York's current personal income tax <u>is</u> progressive.

Based on our analysis of the most recent data publicly available from New York State Department of Taxation and Finance (see attached Table 1):

- The lowest 40 percent of taxpayers, as measured by NYS AGI, pay no state income tax at all, and in fact receive more than $500 million in state tax refunds under the Earned Income Tax Credit – a provision, by the way, that has been supported by The Business Council.

- Some argue that application of the same statutory rate on moderate and high income taxpayers is evidence of a non-progressive tax system. However, when you look at the effective tax rate – the actual percentage of income paid in NYS income taxes - the data clearly shows that the state PIT is progressive in practice. The effective tax rate on taxpayers with incomes over $200,000, at 6.66 percent is 94% higher – nearly double – the effective tax rate on taxpayers in the $40 to $50,000 AGI range (3.43 percent), despite "being taxed at the same rate." Overall, the effective tax rate on New Yorkers increases significantly as you move from the lowest income earners to the highest, as shown in the attached chart.

- As a final illustration, the top 3 percent of taxpayers in New York – those with AGI above $200,000 - pay 55 percent of all personal income taxes. The top 25 percent of taxpayers, by income, account for more than 89 percent of all personal income tax liability.

In short, taxpayers with progressively higher rates of income pay a progressively higher share of their income in state personal income taxes, i.e., a progressive income tax. Likewise, high income earners pay a significantly higher share of their income in state income taxes than does the middle class.

We have not had time to do any in-depth research for this hearing that compares New York's personal income tax structure with that of other states. We expect that, due to factors such as a top rate higher than the majority of states (28 of 42 other states with a PIT) and our Earned Income Tax Credit, New York's effective tax rate is relatively progressive among the states. We would also cite the Institute of Taxation and Economic Policy – an organization with a strong emphasis on progressive tax policy – which includes New York, along with California and New Jersey, as being a state, and I quote, "with particularly progressive income taxes."

Stability of Revenues – In its hearing notice, the Committee asks "how much more stable" the state's tax revenue stream would be with a progressive personal income tax.

We see two problems with that question.

First, it suggests that New York does not have a progressive personal income tax. As already discussed, data on effective tax rates indicates that we do.

Second, we believe the correct question is whether revenues would become more or less stable with higher marginal rates, not how much more stable they would become.

Data shows that a greater reliance on high income personal income tax payers will result in more, not less, volatility in income tax revenues, for two reasons.

First, there is a significant difference in the percentage of total income from wages based on income brackets; data shows that in higher income brackets, a greater share of income is from less stable non-wage income sources.

For taxpayers in the $40,000 to $200,000 range (based on NYAGI, 2005 data), 84 percent of their adjusted gross income was attributed to salary and wages, with just over 2 percent attributed to capital gains. (The percentage is very similar, about 82 percent, if you eliminate taxpayers in the $100,000 to $200,000 range from this calculation.)

For taxpayers with AGI over $200,000, the average share of income attributed to salaries and wages was 48%, a figure that drops sharply as income increases in the above $200,000 income range, to about 23% for taxpayers over $10 million. For all taxpayers in the above $200,000 range, capital gains accounted for nearly 25 percent of income in 2005.

Second, reflecting these sharp differences in income categories, experience in the post-September 11th downturn illustrates the significant volatility in incomes and tax revenues at the high end of the income scale.

From 2000 to 2003, total earnings in the $40,000 to $200,000 income range increased by 3.1 percent, and wage income increased by 9.3 percent in aggregate.

In sharp contrast, from 2000 to 2003, total earnings for taxpayers with AGI of $200,000 and greater decreased by more than 23 percent – or just over $40 billion. This sharp fall is based largely on reductions in their non-wage income. While their wage income decreased by about 12 percent, their capital gains fell by more than half – 51.1 percent, from $48.5 billion to $23.7 billion from 2000 to 2003. A rough calculation suggests this drop in capital gains income resulted in more than $1 billion in lost revenues to the state.

To conclude, if a policy objective is stability in revenues, that objective would not be achieved through increased reliance on upper income PIT revenues.

Tax Policy / Economic Competitiveness – The Committee asks how "a more progressive PIT" would impact the state's economy, job creation, and competitiveness.

There are different ways to make the state's personal income tax rates more progressive, including broadening – and indexing – tax brackets in a way that is revenue neutral. We would expect this approach would have a moderate positive impact on the state's competitiveness, to the extent that it reduced the impact of personal income taxes on wages paid to a majority of current and potential new employees.

The Executive Budget proposes a different approach, whose effect would be to further increase the progressive impact of the personal income tax. Part M of

S.60/A.160 would limit the use of itemized deductions by an individual whose adjusted gross income is over $1 million (except for charitable deductions), allowing these individuals to claim only the standard deduction, and makes similar changes to the Administrative Code of the City of New York to make similar changes in the city's income tax. This change is expected to subject these upper income taxpayers to about $140 million in additional tax liability.

On the other hand, we have S.2021/A.5912, which would impose an estimated additional $6 billion in tax liability on upper income taxpayers. The Business Council is on record as opposing this legislation, the "quarter millionaire tax," that would establish three new income brackets at tax rates, beginning at 8.25 percent for incomes over $250,000, a second rate of 8.97 percent for income over $500,000, and 10.3 percent for income over $1 million.

We believe that a significant, permanent increase in marginal PIT rates would have a negative impact on the state's economy and competitiveness for several reasons.

First, we see consideration of a significant increase in marginal PIT tax rates, and in PIT tax revenues from upper end taxpayers, as simply one more symptom of the state's excessive appetite for spending growth. To the extent that a significant increase in PIT rates allows the state to continue to adopt unsustainable increases in state spending, we believe it would have a significant adverse impact on the state's economic competitiveness.

As illustration, even if the legislature were to impose $4.2 billion in new tax and fee measures - as recommended by the Executive Budget – it would still leave the state with $11 billion in an accumulated structural budget gap over the next five years; a figure that will likely grow given the ongoing deterioration of state tax collections. Whether new revenues are in the form of a PIT, or some combination of the numerous revenue measures proposed in the Executive Budget, it is clear that we cannot tax our way out of our current budget shortfalls.

Second, the state's recent sharp increase in spending was fueled by significant, but cyclical, surges in upper income personal income tax revenues. These revenues send a misleading signal to decision-makers in Albany, and have led to permanent, unsustainable increases in baseline spending – a "feast or famine" cycle of budgets driven by the health of Wall Street. Today, with a dramatic reduction in Wall Street bonus eroding income tax revenues, and a permanent retrenchment of the financial services sector, we have "permanent" spending levels without the revenue stream on which they were based.

Finally, we believe that tax policy and tax rates <u>do matter</u> in business investment decisions. In a state with other significant anti-competitive cost factors – energy, real property taxes and others – every additional increase in our cost structure adds to our competitiveness gap.

If adopted, S.2021 would leave New York with the second highest maximum income tax rate of any state in the nation, at 10.3%. It would also establish a top rate that is about 60% higher than the median top rate of all states with a personal income tax.

Only North Dakota having a higher marginal rate, and theirs is an elective, optional rate, that we are told is used by upper income taxpayers with sufficient credits and exemptions to bring their effective rate below the standard rate of 5.54 percent.

Proponents of S.2021 suggested that at 10.3 percent, our top rate would be "competitive" with states such as California and New Jersey. 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 within New York.

California's top rate is variously listed at 9.3 and 10.3 percent. Their tax tables show a top rate of 9.3 percent applicable at taxable income over $47,000. Its so-called "millionaires tax" is interestingly disguised as an additional 1 percent "Mental Health Services Tax" applicable to all taxpayers, but subject to a $1 million income exclusion. From this, one could conclude that the California legislature did not consider a 10.3% top rate to be particularly "competitive," either.

Moreover, in a state with significant economic competitors at our borders, we believe it is more important to compare state tax rates to our neighboring states. The top rate proposed in S.2021 at 10.3 percent, would leave New York with a top rate well above those in most neighboring states – Pennsylvania at 3.07 percent, Connecticut at 5 percent and Massachusetts at 5.3 percent. Only New Jersey would challenge us for the lead in this dubious contest, at 8.97%.

Likewise, increases in the personal income tax have a direct impact on businesses organized as subchapter S corporations, partnerships and limited liability corporations. Department of Tax and Finance data shows that, for the 2005 tax year, 357,000 S corporation tax returns were filed in New York, 95 percent of which had three or fewer shareholders. In 2006 tax year, 62,000 returns with corporation net income had federal adjusted gross income over $250,000 and 14,500 had AGI over $1 million. These small businesses would see sharp increases in their income tax liability under legislation such as S.2021/A.

This proposal would make New York's already uncompetitive tax climate even less so. New York already ranks at or near the bottom in national assessments of economic and tax climates. As example, the Tax Foundation's annual ranking of state tax climates rates New York's at 49th, sandwiched between California at 48th and New Jersey at 50th, two of the states that some S.2021 proponents would have us emulate. The Tax Foundation evaluates states' tax climates using a comparison of overall state and local tax payments as a percentage of personal income.

Address Excess Spending - We recognize that state revenues are down due to the national recession. The Executive Budget proposal for FY 2010 projected a 5 percent, or $1.8 billion, year to year decline in net personal income taxes. Even so, next year's PIT revenues would still be $4 billion, or 12 percent, higher than just four years ago.

However, The Business Council has repeatedly stressed that the real cause of our current and project budget gaps is our excessively high spending.

Consider the evidence. From Fiscal 2000 to the end of Fiscal 2008, the state funds-supported budget grew by 62 percent, from $50.6 billion to $81.7 billion - nearly 2.5 times the inflation rate (about 24 percent) over the same period. If the budget had grown at merely double the inflation rate, the FY 2008 budget would have been $4 billion less, $77.7 billion, versus $81.7 billion, and New York would have entered the current fiscal year facing a manageable downturn in revenues, not a massive, $15 billion, two year gap between our rapidly increasing spending trend line and declining revenues.

Even so, the Executive Budget contains too few major reforms and modest overall spending constraint, while the state's massive Medicaid budget grows by another 4.5 percent.

These numbers clearly illustrate the need to reduce the size of the state budget, not just reduce or limit the rate of growth.

To balance the state's budget over the long term, we first need to bring spending under control, and within our means.

Conclusion - The Business Council believes that any permanent increase in any of the state's broad-based taxes during an economic recession is bad economic policy, and a bad message to send to current business and investors considering projects in New York State.

Any revenue adjustments should be designed to address cyclical downturns in income, rather than impose a permanent increased in the state's tax burden. We note that, in stark contrast to S.2021, the state imposed temporary, three year surcharges on both the personal income tax and the state sales tax in response to the post-September 11th recession – surcharges that expired as state revenues grew with the national economic recover.

Finally, we strongly oppose any temporary increase in, or surcharge on, any of our broad based taxes without a prior commitment to significant spending restraint and other fiscal reforms to provide long term stability, and affordability, to the state's budget. As stress above, New York's spending has increased to unsustainable levels; dealing with our current and future budget gaps requires significant adjustments on the spending side before we commit to new, burdensome taxes and fees.

We look forward to the Senate and Assembly budget resolutions, and evaluating them against our objectives of additional spending constraint, rejection of anti-competitive business taxes, effective use of federal stimulus dollars and – if necessary – reasonable revenue actions.

Again, I appreciate this opportunity to share our views with the Committee, and welcome any questions or comment you may have.

TABLE 1
NYS PIT LIABILITY BY INCOME RANGE, 2005 TAX YEAR

Income Range	Number of Taxpayers	NYAGI	Tax Liability	Effective Tax Rate	%of PIT Liability
Under $19,000	3,247,211	$27,172,376	-$504,744	NA	
$20 TO 29,000	1002581	$24,906,833	$294,028	1.18%	1.23%
$30 TO 39,000	814589	$28,335,019	$789,437	2.79%	3.31%
Under $40,000	**5064381**	**$80,414,228**	**$578,721**	**0.72%**	2.42%
$40 TO 49,000	629992	$28,194,154	$968,166	3.43%	4.06%
$50 TO 59000	469666	$25,730,772	$973,557	3.78%	4.08%
$60 TO 75000	528785	$35,486,534	$1,456,936	4.11%	6.10%
$75 TO 100000	574255	$49,571,081	$2,191,923	4.42%	9.18%
$100 TO 200,000	637544	$84,964,373	$4,451,432	5.24%	33.61%
Above $200,000	257867	$198,859,447	$13,244,481	6.66%	55.50%
Total		$503,220,589	$23,865,216		

Source of Date: NYS Department of Taxation and Finance

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