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T E S T I M O N Y

Stability and Volatility in New York's Income Tax

**Testimony of Donald J. Boyd
Before the New York State Senate
Select Committee on Budget
and Tax Reform**

Good afternoon and thank you for inviting me. My name is Don Boyd. I am a senior fellow at the Rockefeller Institute of Government, the public policy research arm of the State University of New York. We study the management and finances of state and local governments in the United States. We do not have a horse in the race: We try to educate, not advocate.

I have seen and worked on New York tax issues from several perspectives. In the early 1980s, I was the director of a tax staff in the Assembly Ways and Means Committee. In the late 1980s and early 1990s, I was in charge of the economic and revenue analysis staff in New York's Budget Division. There I played a major role in projecting revenue, helping to manage budgets gone bad, and developing and negotiating options to close budget gaps. From the mid-1990s through now, I have studied finances in the 50 states in different capacities at the Institute. My Ph.D. is in managerial economics from Rensselaer Polytechnic Institute. I have been around, and I am thankful to be in my seat instead of yours.

I will talk today about the often-competing goals of tax policy, with a special focus on revenue stability — one of the Committee's areas of interest. I will relate these issues as much as I can to Senate bills 2021 and 2654.

Competing Goals of Taxation

Economists and analysts often posit several broad goals of good tax systems: (1) taxpayer equity or "fairness," (2) tax

neutrality, (3) revenue adequacy, and (4) low-cost administration and compliance.

- Tax fairness usually has two dimensions: horizontal equity and vertical equity. Horizontal equity means treating like taxpayers similarly – if I have \$50,000 of income and you have \$50,000 of income, are we taxed the same? Vertical equity means treating different taxpayers in different, but fair, ways – if I have \$50,000 of income, and you have \$500,000 of income, should you pay 10 times as much (a proportional system), or 20 times as much (progressive), or 5 times as much (regressive)? Unfortunately, it is impossible to make an objective statement on whether a tax should be proportional, progressive, or regressive. Economists can provide measures that help you judge a system, but in the end your values about vertical equity will rule the day. Much of the debate about these two bills centers on vertical equity.
- Tax neutrality means that, with rare exceptions, tax systems should not distort or alter economic behavior. Broad tax bases and low rates follow this principle. When we do the opposite – high rates on narrow bases – we create incentives to avoid and evade, and to alter behavior in ways that are damaging to the economy. Tax neutrality is often honored in the breach, as when we enact tax credits to favor some kinds of activities at the expense of others. Sometimes there are good reasons to deviate, as when we impose taxes on tobacco, not just to raise revenue, but also to discourage smoking and its huge societal costs. Another aspect of tax neutrality relates to geographic differences in rates – how badly is behavior distorted if our tax rates are much higher than states we consider competitors? How much incentive is there to carry economic activity on in places other than here? I wish I could answer that, but it is complicated and despite some contrary assertions, economists are not in a position to answer it definitively. It depends in part on what the state does with the money – for example, is it maintaining services and investment that are essential to economic growth? For today, I will pass on this.
- Revenue adequacy: This, in fact, is the reason we have taxes in the first place – to support what we think government should do. Adequacy usually has two dimensions: First, adequacy over the long run – can the tax structure sustain services the citizenry seem to want? And second, will it support this level of services year by year, in good times and bad – is the system volatile or stable? I will return to this in the context of the Senate bills. In my judgment, revenue adequacy gets little weight in policy debates.
- Administration and compliance: Along with revenue adequacy, this is the stepchild of tax policy. Taxes should be inexpensive for the government to administer, and

inexpensive for taxpayers to comply with. This is not always a high priority in the scramble for a tax increase that can garner a majority.

Most of us can agree that these are good goals, at least until we get to the particulars. But the goals often conflict. A broad-based sales tax on almost everything, including medical care and food, could be imposed at a low rate, creating few distortions. And because it taxes necessities, it would be stable, too. But such a tax bumps up against most New Yorkers' notions of fairness and so we exempt medical services and much food. This makes the tax more costly to administer and easier to evade, it distorts economic behavior, and it is more volatile than a broad-based tax. But many people think it is fairer than a tax on all goods and services.¹

It is easy to come up with dozens of illustrations of conflicts in tax policy goals. Property taxes are stable, but people must pay them even when their income declines, creating a sense of unfairness. Progressive income taxes usually grow faster over the long run than flat-rate taxes and in many people's minds they are fairer, but the latter are more stable. As policymakers you must weigh one goal against another.

Stability and Volatility

Let's look at stability and volatility more closely. When large budget gaps or surpluses appear or disappear suddenly, it forces governments to change plans rapidly. This is bad: It creates uncertainty in the minds of taxpayers about future tax rates and can dampen investment. It creates uncertainty among people who depend on services governments provide. It makes parents wonder about the quality of education their children will receive. And it makes it hard for those who implement government policies to stay on course. All else equal, a steady path is better than a zig-zaggy course that ends in the same place.

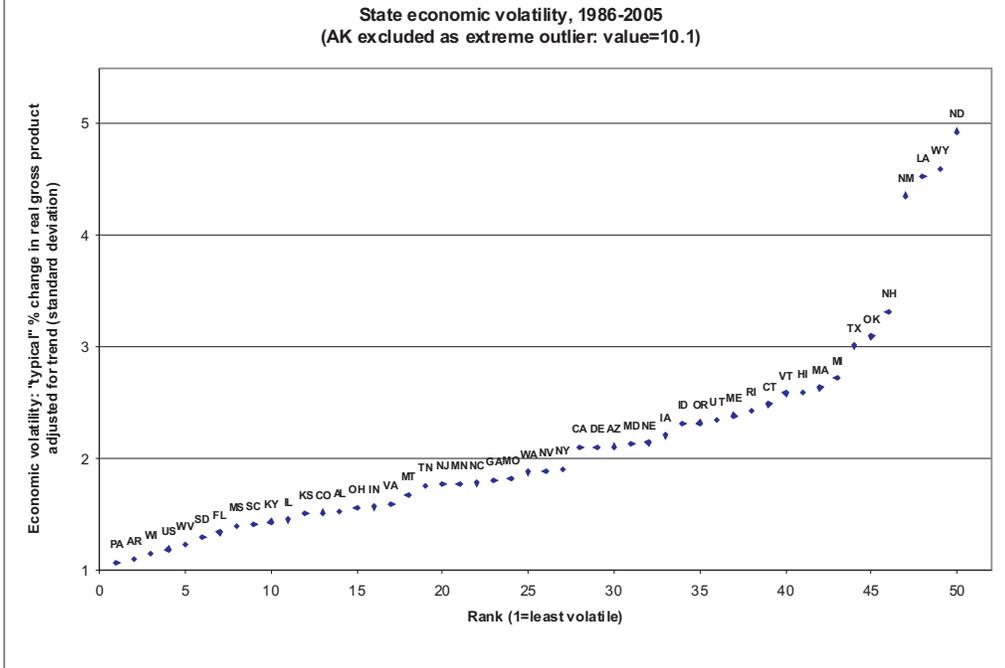
Sudden cyclical budget crises are driven primarily by declining tax revenue. Spending can play a role, too, but it is much less important. In *theory*, states can address revenue volatility several ways, but in practice options are limited:

- *Accept it, but manage it* — Build large reserve funds in good times, and draw them down in hard times. But there are practical limits to how large these funds can get (never large enough).
- *Accept it, but hedge it(!)* — Some economists have suggested states might someday purchase hedging instruments to insure against revenue volatility, much the way some large businesses hedge oil-price and exchange-rate risk. Not in our lifetimes.
- *Accept volatility in individual tax sources, but diversify* — This is much more practical, and states do this. A state with an income tax and a sales tax will have a more balanced and stable "tax portfolio" than a state that relies primarily on one or the other.

- *Structure individual tax sources to be less volatile* — Add food, medical services, and other necessities to the sales tax. Flatten out the income tax. Base a corporate tax on gross receipts rather than income, or add a stable “backstop” such as a tax on capital or assets. Which leads us to the question at hand — how would the Senate bills affect tax volatility?

How Volatile Is New York's Tax System?

Figure 1. New York's Economic Volatility — Perhaps Surprisingly — Is Not Typical



We have to start with the economy. Figure 1 shows a measure of economic volatility for each of the 50 states over the 1986 to 2005 period, based on work I did previously for the Pew Center on the States. As you can see, New York is squarely in the middle. The states with the greatest volatility are those that rely heavily on petroleum and mineral extraction industries, which explains why North Dakota, Wyoming, Louisiana, and New Mexico are near the

top. (Alaska is so volatile that it would be way off the chart and so it is excluded.) Small states, too, tend to be more volatile because they can be buffeted easily by the large world around them.

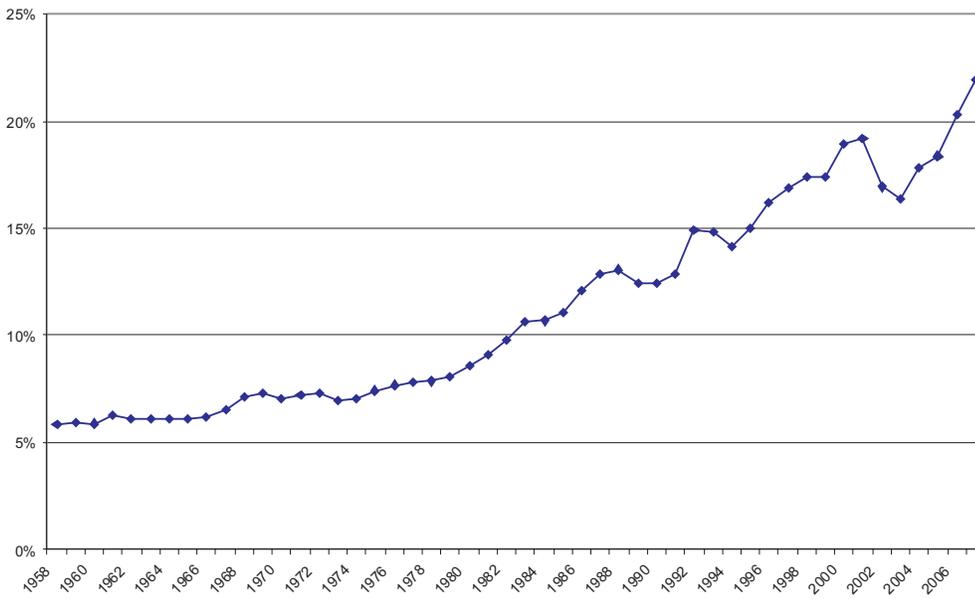
Similarly constructed measures of tax (rather than economic) volatility also place New York near the middle. But that's partly an artifact of the measures.

First, volatility measures themselves are volatile — they change as the structure of the economy changes, and as the character of recessions changes. If we measured volatility solely from the 2001 recession through the current one, New York would be extremely volatile because of its large and growing reliance on increasingly volatile financial services industries — industries that accounted for 22 percent of all wages in New York in 2007 (Figure 2). Financial services are more than twice as important to the New York economy as they are to the U.S. economy as a whole.

Second, New York's tax structure relies heavily on financial services industries, and on financial markets. The income tax is almost 60 percent of New York tax revenue. Wages are about 70 percent of adjusted gross income, the starting point for New York's income tax. Financial sector wages are about 22 percent of New York

Figure 2. Excelsior! New York's Rising Reliance on the Financial Sector

Finance and insurance wages as a share of total wages in New York State



Source: Bureau of Economic Analysis data, spliced by Boyd

wages, and the average financial sector wage at \$207,000 in 2007 was more than four times the average wage in other sectors. Most of this money is taxed at New York's top rate. And, of course, it has disappeared quickly. Three small industries in employment terms — securities brokerage, investment brokerage, and portfolio management — account for only 1.9 percent of New York employment but 30 percent of all of the growth in wages during the

boom from 2003 to 2007. Those wages are now largely gone, along with the top-rate tax revenue they generated. Meanwhile, capital gains account for more than 13 percent of New York's adjusted gross income — far more than the average state. This is top-bracket income that is going away.

New York's tax system benefited greatly from these and other volatile income sources during the boom and we are paying the price now. In the unprecedented bust of 2001 and 2002, New York's income tax liability declined by an astounding 8.5 percent and 7.5 percent, respectively. The governor's budget office now projects similar declines of 8.9 percent and 7.3 percent in 2008 and 2009 income tax liability.²

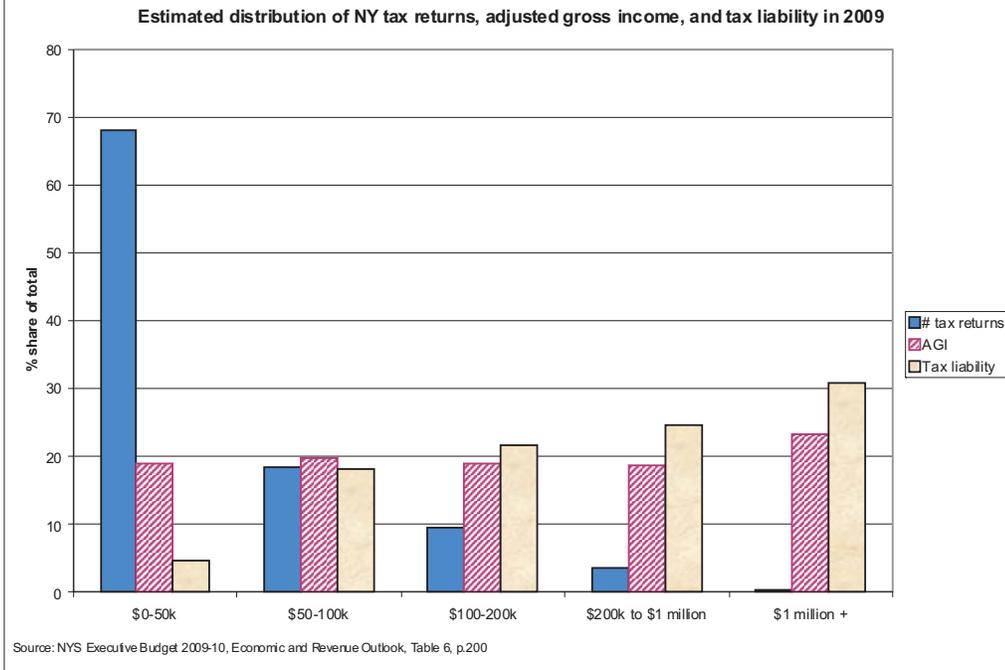
The final reason that tax volatility seems so bad in New York despite measures placing New York near the average is that even average volatility is too much for policymaking purposes. Declines in tax revenue of even a few percentage points create fiscal stress when spending pressures are rising.

So although historically based tax-volatility measures do not suggest that New York's tax system is extremely high, in the right kind of recession — this one or the last one — its sensitivity to the business cycle is way too high.

Income Concentration, Volatility, and the Senate Bills

By many measures the income and tax liability of New York's households is highly concentrated at the upper end. Recent data from the Internal Revenue Service show that the share of federal adjusted gross income received by the top 1 percent of households

Figure 3. Top .5% of Tax Returns Have an Estimated 23% of AGI and 31% of Tax Liability



in New York in 2006 was second-highest in the nation, after Wyoming.³

According to the Division of the Budget, the top 0.5 percent of tax returns in New York (those with income of \$1 million or more) are forecasted to have 23 percent of the adjusted gross income and 31 percent of tax liability in 2009 (Figure 3).

These same estimates show that the share of tax liability paid by the top 1 percent of returns in New York reached nearly

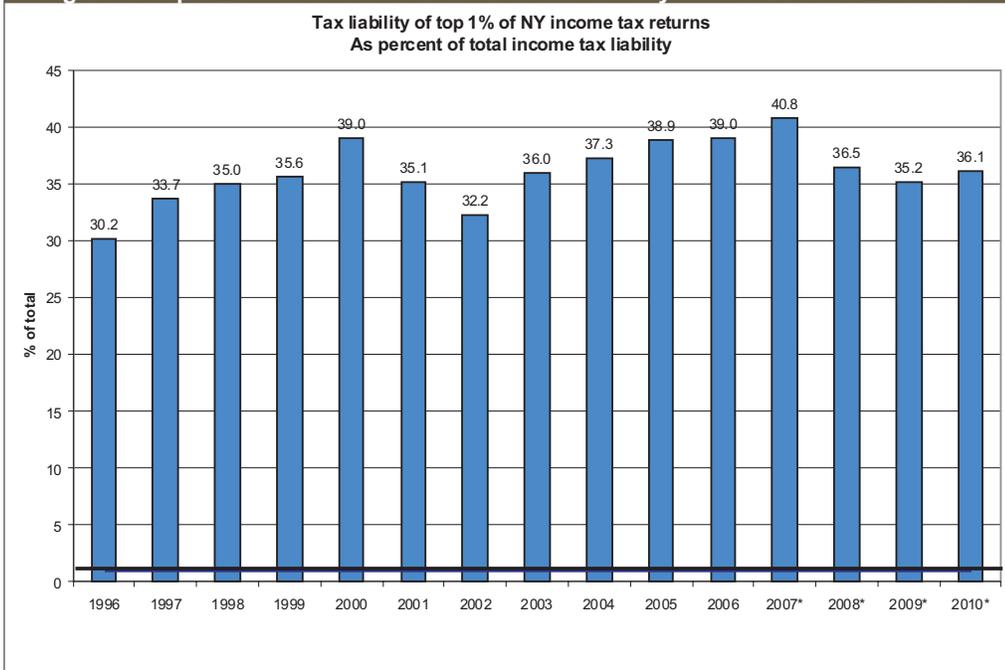
41 percent of total income tax liability in 2007, and has been above 30 percent for at least 10 years. It is expected to fall somewhat in 2008 through 2010 due to the huge drop in investment income and other factors associated with the recession, but will remain above 35 percent.

The huge share of income tax liability paid by the top 1 percent of returns is a major contributor to income tax volatility in

New York. These top 1 percent taxpayers contribute more to New York's income tax volatility – year to year swings in tax revenue – than the other 99 percent of tax returns combined.

The Senate bills both would increase the share of income paid by the top 1 percent dramatically. Based on preliminary analysis, I believe that the share paid by the top 1 percent would rise by at least 5 percentage points under S.2021 (the "Fair

Figure 4. Top 1% of NY Income Tax Returns Historically Have Paid 30-40% of Total



Tax"), the larger of the two tax increases. This could place the share paid by the top 1 percent well above 40 percent, perhaps above 45 percent, and well above anything seen in more than 10 years. This would be likely to raise the volatility of New York's income tax considerably: busts and booms would likely be larger than now. If we increase income-tax volatility we might also want to consider steps to enhance long-term balance — larger reserve funds, or more conservative budgeting, or offsetting reductions in volatility in other taxes, or other steps.

Concluding Remarks

While preparing estimates of the revenue impact of S.2021 and S.2654 is beyond the scope of what I can do here, it is clear that either bill would raise billions of dollars — probably \$5 billion or more for the former; S.2654, as I read it, would raise less than S.2021. Either would lead to a very large increase in the share of tax paid by the top 1 percent of taxpayers and to increases in income tax revenue volatility. Tax policies involve trade-offs. In this case, the increases in revenue would support spending that could benefit the economy, and would change the vertical equity of the income tax substantially. Whether benefits from these changes would justify the increase in volatility, of course, falls in your domain.

Endnotes

- 1 In truth, there can be ways to counteract the fairness issue — for example, by allowing an income tax credit to low-income families based on typical purchases of necessities, although this can raise its own concerns.
- 2 New York State Executive Budget for 2009-10, Economic and Revenue Outlook, Table 7, p. 200.
- 3 Statistics of Income 2006, as reported by the Institute on Taxation and Economic Policy