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Testimony of

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I greatly appreciate the opportunity to present this testimony to you today. While the federal government can run deficits during recessions and other downturns as a way to stimulate the economy, the states must balance their budgets in both good times and bad. In this testimony, I will focus on the challenges that state governments face in balancing their budgets during such periods with particular attention being given to New York's experiences during the early 1990s and in 2003 when Governor Pataki finally addressed the deficit that the state government faced as a result of the recession and the "job-loss" recovery of 2001 through 2003. In addition, I am attaching to this testimony, two short briefing papers on issues of relevance to economic development and taxes: (1) how New York State can use its economic development resources most effectively; and (2) how New York State can provide effective property tax relief in both the short run and the long run.

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Less than a month ago, in submitting his second Executive Budget for the 2008-09 state fiscal year, Governor Eliot Spitzer faced a much larger projected budget gap (\$4.42 billion) than the one (\$1.6 billion) that he faced when he first took office in January 2007. These are "projected" budget gaps in that they represent the difference between the Division of the Budget's best estimates, at the time that the Executive Budget was being prepared, of (a) what state expenditures would be during the ensuing fiscal year if all state funded programs

were continued as required by the laws currently on the books; and (b) what state revenues would be during the ensuing fiscal year under the laws currently on the books.

Only a very small portion of the \$1.6 billion gap that the state faced a year ago was attributable to differences between the underlying growth in state revenues (\$3.8 billion) and the increase in expenditures necessary to maintain services at their 2006-07 level (\$3.9 billion). Instead, that gap was attributable primarily to the scheduled implementation of previously enacted tax cuts (\$954 million) and the net difference between nonrecurring revenues received and nonrecurring expenditures incurred during 2006-07.

In addition to this \$1.6 billion “inherited” gap, Governor Spitzer’s first Executive Budget proposed new initiatives that were estimated to cost \$1.9 billion in 2007-08 (and more in subsequent years), thus increasing the projected gap to \$3.5 billion. The governor then proposed to close the \$3.5 billion gap with \$2.8 billion in cost savings and tax loophole closers, and the use of \$671 million of prior year surplus revenues.

The legislature, in acting on the 2007-08 budget, added \$1.2 billion in estimated spending increases and \$1.2 billion in estimated revenue increases. But given the nonrecurring nature of some of the additional revenues and the projected growth in the cost of the added expenditures, the Budget Division estimated that the impact on the state’s finances in 2008-09 would be \$900 million on the revenue side and \$1.7 billion on the expenditure side, increasing the projected gap for that year from \$2.3 billion to \$3.1 billion.

Since last April the economic situation had weakened and the governor’s Budget Division gradually increased its projected gap to \$4.4 billion by the time that the 2007-08 Executive Budget was being finalized for submission on January 22. The governor, in that budget proposal, also proposed \$416 million in new initiatives, thus increasing the size of the projected gap to \$4.838 billion. To make the challenge even more daunting, by February 10, 2008, the governor’s Budget Director was announcing to the press that the state’s revenue picture had worsened since the preparation of the Executive Budget and that, as part of his “21-day amendments” to the Executive Budget, the governor would be proposing to increase the service cuts that he had proposed back in January.

The governor and the legislature now face the challenge of closing a budget gap of close to \$5 billion as the national economy is weakening and in recognition of the fact that almost 40 percent of this gap is actually due to the weakening of the economy. This “projected” budget gap would be even larger if the state government was actually addressing the important unmet needs that the state faces. Before examining the governor’s plan for closing the projected budget gap for 2008-09, it should be noted this gap would be nonexistent, if New York State had been only slightly less generous in its multi-year tax cutting during the 1990s. For example, if the state had enacted only 96 percent of the tax cuts that it actually enacted during its 1994 to 2000 tax cutting spree, there would be no budget gap at all, even with Governor Spitzer’s proposed new initiatives.

At the time he submitted his Executive Budget, Governor Spitzer was proposing to close the projected \$4.838 billion budget gap with \$2.253 in spending cuts, \$1.109 billion in revenue

increases, and the use of \$1.139 billion in “non-recurring actions (i.e., one-shots) and \$337 million of the state’s accumulated reserves. This plan did not rely as heavily of service cuts as the budget balancing strategies used during the recession of the early 1990s or the budget balancing strategy proposed by Governor Pataki in 2003 when he finally addressed the deficit that the state faced as a result of the recession and the “job-loss” recovery of 2001 through 2003. But Governor Spitzer’s plan was not as balanced as the budget-balancing plan that the state legislature adopted over Governor Pataki’s vetoes in May 2003. If additional service cuts are proposed in the 21-day amendments as press reports are indicating, the 2008-09 Executive Budget will be moving closer to the budget balancing strategies of the early 1990s.

Governor Pataki’s 2003-04 Executive Budget proposed \$5.2 billion in General Fund spending cuts including a \$1.27 billion cut in school aid, a \$1.02 billion cut in Medicaid, a \$1 billion cut in other local assistance programs, a \$1 billion cut in state government operations, and the use of over \$500 million of federal family assistance funds to cover portions of the cost of the Tuition Assistance Program and other programs that were traditionally funded with state revenues.

At the time, Governor Pataki attempted to justify these policy choices by (1) asserting a relationship among taxes, government spending and the economy that is inconsistent with basic economic principles, and (2) presenting a mythical and incorrect rendition of New York State’s economic history.

The 2003-04 Executive Budget’s policy choices were premised on an incorrect assumption—that tax increases generally have a more negative effect on the economy than service cuts. This is particularly mistaken during a recession.

In reality, neither tax increases or service cuts are desirable during a recession. Both take demand out of the economy—making recessions longer and deeper, and making recovery more difficult. But New York, like most other states, is required to balance its budget in both good times and bad.

So the states face a real dilemma during economic downturns—having to figure out what mix of spending cuts and tax increases will do the least harm. Ideally, during such periods, the federal government, which is not required to run balanced budgets and which is responsible in our governmental system for overall macroeconomic management, will assist the states with some form of counter-cyclical financial assistance.

But what are the states to do during economic downturns absent federal aid or sufficient federal aid to avoid spending cuts and/or tax increases? Joseph Stiglitz, winner of the 2001 Nobel Prize in Economics, and Peter Orszag, then of the Brookings Institution and now the director of the U.S. Congressional Budget Office, in a paper that they co-authored on this subject (*Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?*) conclude that a temporary increase in the tax on the portions of income over some relatively high level is the least damaging mechanism for balancing state budgets during recessions. On the other hand, they conclude that basic

economic reasoning indicates that reductions in government spending on goods and services that are produced locally (like education and healthcare) 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. Increases in consumption taxes and fees will take more demand out of the economy than tax increases on the tax on the portion of income over some relatively high level but less demand than cuts in locally-produced goods and services or transfer payments to lower-income families.

The strategy that Governor Pataki proposed for balancing the 2003-04 budget was very similar to the ways in which New York State balanced its budget during the recession of the early 1990s. Governor Pataki claimed that New York State balanced its budgets during the recession of the early 1990s with massive tax increases. And, he implied that these tax increases were of the kind that he was implicitly characterizing as "job killing" tax increases. A check of the budgets of the early 1990s shows quite a different story: there were tax and fee increases during the early 1990s, but they represented less than 25 percent of the budget balancing actions taken during those years AND those tax and fee increases were overwhelmingly consumption and other regressive taxes and fees rather than taxes based on the "ability to pay" principle.

In 1989, the Coalition for Economic Priorities, a broad-based coalition co-chaired by the heads of the NYS Council of Churches, the NYS Association of Counties, and the NYS AFL-CIO, came together to lobby for the deferral of the remaining steps of the large, multi-year personal income tax cuts that had been enacted in 1987. This coalition consisted of organizations that foresaw the huge shift to local property and sales taxes that were inherent in the governor's budget proposals, as well as organizations that were worried about the impact of the proposed budget cuts on the state's most vulnerable populations and on the quality of life for all New Yorkers. But the governor and the legislature refused to take the advice of this coalition. Instead, in 1989, the state government implemented a very large reduction in the state's personal income tax.

Based on Governor Pataki's expositions on the relationship between state tax policy choices and the economy, those large personal income tax reductions should have somehow stimulated the state's economy and insulated it from the accelerating recession. But, as we know, that did not happen. Instead, the state's economic situation got worse.

In 1990, the main budget, which was adopted in May, included a deferral of the scheduled income tax cuts but it did not include any increases in the progressivity of the state income tax. There were real and substantial state tax increases in the originally adopted 1990-91 budget but those tax increases were particularly misguided as the Fiscal Policy Institute stated in its analyses and its budget testimony during the remaining years of the Cuomo administration.

In December of 1990, the legislature enacted a mid-year \$1 billion deficit reduction package, with all the gap closing being done on the expenditure side of the ledger. In 1991, the state continued this approach to budget balancing with one small exception, a relatively small increase in the tax on incomes over \$100,000, that paled in comparison to the

emphasis during this period on closing the state's budget gap through service cuts and increases in fees and regressive taxes.

One important result of the state's budget balancing strategies during this 1989 to 1991 period was to place incredible pressure on the local property and sales taxes. From 1987 to 1992, local property tax revenues were up by 50 percent from \$14 billion to \$21 billion, while state income tax revenues increased by only 22 percent. There was a clear and massive shift from the income tax to the property tax during this period.

Learning from experience: The legislature's 2003 better choice

In May 2003, the legislature passed the governor budget bills but with significant changes from what the governor had originally proposed. By then, the two-year budget gap had grown to \$12.6 billion, due to revenue and spending re-estimates. Despite the growth in the size of the gap, the legislature adopted a much more balanced approach to balancing the state budget, relying more heavily on revenue increases than the governor had originally recommended and reducing many of the spending cuts that had been recommended by the governor.

Ten days after the original legislative passage of its budget package, the governor vetoed the legislature's bill to raise state taxes, authorize transitional borrowing and allocate school aid and line-item vetoed 118 spending additions. Within 20 hours, the legislature overrode every one of the governor's vetoes on a bipartisan basis. The veto override votes were virtually unanimous in the Senate and overwhelming in the Assembly.

The governor originally argued that the revenue increases enacted by the legislature would not cover all of its spending restorations. But, shortly thereafter, the Congress adopted a significant but temporary "state fiscal relief package." With this infusion of federal "budget balancing" aid, the governor concluded that the 2003-04 state budget, as adopted, was credibly balanced.

The budget package adopted by the legislature in May 2003 avoided the extremes that had characterized the budget balancing packages of the early 1990s and the plan proposed by Governor Pataki in January 2003.

As part of the 2003 enacted budget, the legislature adopted a temporary three-year increase in the state's top income tax rate from 6.85 percent to 7.7 percent on taxpayers with taxable incomes above \$500,000 regardless of filing status, and 7.5 percent in 2003, 7.375 percent in 2004, and 7.25 percent in 2005 on married couples with incomes above \$150,000 and single individuals with incomes above \$100,000. The revenue raised from these temporary rate increases (\$1.162 billion in the 2003-04 state fiscal year, \$1.535 billion in 2004-05, \$1.482 billion in 2005-06, and \$435 million in 2006-07) contributed significantly to New York State being able get through the economic downturn without economically counterproductive service cuts of the magnitude that Governor Pataki had proposed. Moreover, these tax increases did not have the negative impact on the state's economy or on the number of high-income taxpayers in the state that Governor Pataki had predicted in

vetoing these temporary tax increases. In fact, the number of high-income returns (defined by the Budget Division as returns with Adjusted Gross Income of \$200,000 or more) grew steadily from about 245,000 in 2002 to an estimated 450,000 in 2008; and the taxes paid on those high-income returns grew from about \$9.2 billion in 2002 to an estimated \$21 billion in 2008.

Does New York State have a spending problem or a revenue problem?

Some critics like to say that the state's structural budget gap is proof that New York State has a "spending" problem and that state spending is growing faster than state revenues. Their implication is that New York State agencies are not managed well and that spending is out of control. But a careful analysis of changes in the state revenues and expenditures over the last decade shows that revenues would have grown faster than expenditures if the state had not enacted multi-year, back-loaded tax cuts plans annually from 1994 to 2000, and then again in 2006; and if the important new spending commitments that have been made since 1997 were accompanied by new revenues. Among the most important of these new commitments are the following.

- The state takeover of the full cost of the non-federal share of Family Health Plus and the capping of the growth in the counties' share of Medicaid costs will cost almost \$1 billion during the current fiscal year, an estimated \$1.35 billion in the fiscal year that begins on April 1, 2008, and more than \$2.5 billion in 2010-11.
- The STAR program which began a decade ago cost \$582 million in the first year (1998-99) of its implementation, \$2.5 billion in the first year in which it was fully phased-in (2001-02), and \$4 billion in 2006-07 (\$3.32 billion for the original STAR exemptions as enriched, and \$673 million for the first year of STAR rebates. The new Middle Class STAR rebates authorized in 2007, further enrichments to the original STAR exemptions, and underlying growth are estimated to increase the annual cost of the STAR programs to more than \$6 billion in 2010-11.
- In 2007, Governor Spitzer proposed, and the legislature adopted with a few modifications, a legitimate statewide solution to the court decisions in the Campaign for Fiscal Equity lawsuit. These reforms replaced approximately 30 individual aid programs (under which \$12.5 billion was distributed in 2006-07) with a "foundation" formula that bases districts' aid on a calculation of the amount necessary to provide all pupils with a sound basic education. As enacted, the 2007 reforms called for a 4-year phase-in that would increase this general operating aid in four annual steps to \$18 billion in 2010-11; and required districts receiving substantial aid increases to enter into Contracts for Excellence with the State Education Department to ensure that these new resources are used effectively to increase student performance. Another part of this initiative increased funding for the state's Universal Pre-Kindergarten program by 50 percent.
- In finalizing the 2005-06 state budget, the legislature put into place a solution to the school facilities part of the Campaign for Fiscal Equity law suit.

While there may have been better ways of designing some of these new commitments, it is clear that they all addressed important priorities. But by adding these important new

commitments to the state budget without adding revenue to pay for them, the state will have structural deficits unless current revenues grow fast enough to cover both the ordinary growth in the cost of existing programs and these new commitments. As this year's budget indicates, such rapid growth is not likely to be sustained.

Establishing a fair, adequate and economically sensible state-local tax system

In the short run, New York State should balance the state budgets during the current economic downturn in ways that will not make economic conditions worse. The governor and members of the state legislature should carefully analyze the budget balancing strategies of the early 1990s and those of 2003 and make policy choices that will take the least amount of demand possible out of the state economy. Among the many ways in which New York could move in this direction would be by temporarily adopting the top brackets from New Jersey (8.97 percent on income above \$500,000) or North Carolina (8.25 percent on income above \$200,000), while considering a long run plan for the future.

In the long run, the goal of state policymakers should be to reestablish a fair, adequate and economically sensible tax system rather than neglecting the state's human and physical infrastructure by not investing in the state's future. To address the state's unmet needs, and to avoid those costs savings proposals that are likely to have negative effects on the state's economy or on the health of New York residents, state policymakers should consider steps that would make the tax system fairer while raising the revenue necessary to balance the budget in an economically sensible manner.

The most important steps in this direction would be for New York to reform its personal and corporate income tax structures. The corporate loopholes that Governor Spitzer is proposing to close will make substantial improvements in the state's corporate income tax structure—even the playing field between those who abide by the spirit as well as the letter of the law and those who are using provisions of the tax law for purposes that were never intended. 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 it is currently placing on local property and sales tax bases.

It is also important that New York's government, labor, business and civic leaders work with their counterparts in other states and at the national level to ensure that the United States Congress passes a state fiscal relief package similar to that which was adopted by the Congress in 2003. Such assistance will reduce the amount of budget cutting and/or tax increasing that the states will need to do in order to balance their budgets during the current downturn. Because the states have to balance their budgets in both good times and bad, such federal assistance during downturns is necessary so that the states are not forced to take actions that will counteract the federal government's efforts to stimulate the economy.