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Progressive Improvement

The impact of income tax cuts on New York's taxpayers and tax competitiveness

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Executive Summary

By any standard, the 1995 tax cut represents a significant improvement in New York's competitive position

As of 1994, New York State's personal income tax combined high marginal rates and low taxable income thresholds, placing a comparatively heavy tax burden on all but the poorest families and individuals. New York's average income tax rate* remained among the highest of any state's, creating a disincentive for work, savings and investment. And on the heels of the State's worst job losses in half a century, the overall income tax burden was poised to grow once again towards record levels.

This was the environment in which Governor George E. Pataki proposed a four-year, $6.8 billion State income tax cut program designed to spark a turnaround in New York's economic competitiveness and job creation potential. The $3.6 billion, three-year plan ultimately adopted by the Legislature embodied the principal goals of years one through three of the Governor's original proposal. The marginal rate is being reduced, from 7.875 percent to 6.85 percent, and taxable income thresholds are being raised. The result will be a tax savings of at least 25 percent for the vast majority of New Yorkers.

By any standard of analysis, New York's 1995 Taxpayer Relief Act represents a significant improvement over the previous system, both in terms of tax cuts for individuals and competitiveness for the New York State economy as a whole. If this tax cut had not been enacted, most New Yorkers would have experienced a State income tax increase over the next three years, our study reveals.

This report examines the impact of the 1995 law and the personal income tax trends that made it necessary. It also points to needed further changes in tax policy.

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* State income taxes as a percentage of total adjusted gross income.

Key findings fall into three categories:

1. **The shortcomings of previous tax "cuts"**
   - A series of personal income tax reductions enacted by New York between 1978 and 1987 did not produce lasting tax relief for most New Yorkers. New York's average tax rate remains substantially higher than it was 20 years ago.
   - The benefits of the 1987 cut began to melt away during the "freeze" of income tax law after 1989. By 1994, most taxpayers were realizing little benefit from the 1987 cut; many, in fact, were paying slightly *higher* taxes than they had before the cut.
   - High State income taxes have contributed to high wage rates and business costs in New York, cutting into both the profits and growth potential of small, closely held businesses.

2. **The benefits of the 1995 Taxpayer Relief Act**
   - By 1997, New York's top marginal rate will drop from 11th highest to 24th highest among the 43 states that have a broad-based income tax.
   - The competitive gap between New York and neighboring states with lower income taxes will grow considerably narrower.
   - The combined maximum state and local personal income tax rate in New York City will reach its second lowest level ever.

3. **Progressivity and economic impacts**
   - The share of State income taxes paid by wealthy New Yorkers, already disproportionately large, will grow larger over the next three years as a result of the latest tax cut.
   - By 1997, the bottom 40 percent of income earners in New York will have no net tax liability; most, in fact, will be getting a check from the State.
   - High marginal tax rates and heavy average tax burdens -- the outcome of New York's traditional emphasis on progressivity -- have discouraged job creation, ultimately hurting the very low-income workers that progressive taxation was designed to favor.

While the 1995 Taxpayer Relief Act marks a significant step towards a truly competitive tax structure, this report also points out the need for further improvements. The latest cut does not represent nearly as significant an improvement as the plan originally proposed by the Governor.

As New York's State income tax structure shifts to an even greater dependence on high-income taxpayers, it also will have more to lose if these taxpayers decide to invest, spend and create their wealth in one of the many other states that continue to offer them much lower tax rates. Particularly in New York City, where wealthy taxpayers are concentrated, the combined income tax burden will remain far out of line with neighboring states even after the 1995 cuts are fully effective.

Finally, because the New York State income tax law makes no allowances for inflation, the overall income tax burden inevitably will resume its upward trend within the next decade, unless steps are taken to permanently stabilize that burden.

Legislative Mandate

Legislation enacted in 1990 directed the Department of Taxation and Finance to study New York's personal income tax. The legislative mandate provided that:

> *Such report shall include, but not be limited to: an examination of the effectiveness and efficiency of the household credit and standard deduction for providing low-income tax relief; an examination of the progressivity of the state's income tax with those of other states and the federal government; and any recommendations for reform of the personal income tax.*

In 1994, legislation was enacted expanding the scope of the study to address inadequacies in the 1987 personal income tax reduction program and to examine options for further tax reductions.

This study examines New York State's personal income tax structure. The background section, and report overall, review the evolution of the personal income tax structure and the major factors that have shaped its development. After examining historical conditions, the report concentrates on the current environment by examining the impact of recent law changes. The report concludes by analyzing additional options for reducing income tax burdens and increasing competitiveness in the future.

Background

In 1919, New York became the eighth state to enact a personal income tax, imposing a top rate of 3 percent on taxable income greater than $50,000 (equivalent to about $400,000 in 1995 dollars). Table 1 provides a history of New York's top income tax rates and the income levels where the top rate becomes effective.

The State income tax evolved in much the same way as the federal income tax, imposed a few years earlier. Over time, the State's top rate increased and the level of taxable income at which it applied decreased. After hitting 8 percent during the Depression years, the maximum rate was dropped to 3.5 percent between 1945 and 1946, then steadily rose back to 7 percent by 1954.

In 1959, New York lawmakers increased the top rate to 10 percent on taxable income greater than $15,000. They also restructured the income tax to be based on the federal Internal Revenue Code. Over the next ten years, the top rate rose to 15 percent, applied to taxable income greater than $25,000.

Table 2 provides an inflation-adjusted perspective on the history reflected in Table 1. During the 1960's, the top rate kicked in at incomes of more than $100,000 in real terms (1995 dollars). In recent years the top rate has been applied to significantly lower incomes. As recently as the 1960's, very few middle-income New Yorkers had any income taxed at the highest State rate. Since the 1980's, by contrast, the top rate threshold has been low enough to affect most middle-income taxpayers.

Table 1: New York State Personal Income Tax Top Rates and Thresholds

1919-1997				
	Earned Income		Unearned Income	
Year	Top Rate (%)	Taxable Income in Excess of:	Top Rate (%)	Taxable Income in Excess of:
1919-1930	3	$50,000	*	*
1931-1933	6	50,000	*	*
1934-1940	8	9,000	*	*
1941-1944	5.25	9,000	*	*
1945-1946	3.5	9,000	*	*
1947	4.2	9,000	*	*
1948-1953	6.3	9,000	*	*
1954-1957	7	9,000	*	*
1958	No tax (a)			
1959	10	$15,000	*	*
1960	9.1	15,000	*	*
1961-1968	14	23,000	*	*
1969-1972	15(b)	25,000	*	*
1973-1974	15	25,000	*	*
1975-1976	15(b)	25,000	*	*
1977	15(c)	30,000	*	*
1978	12	21,000	15	30,000
1979	12	21,000	14	23,000
1980	11	19,000	14	23,000
1981-1984	10	17,000	14	23,000
1985	9.5	15,000	13.75(d)	23,000
1986	9.5	16,000	13.5	26,000
1987	8.75	S-14,000/ M-23,000/ H-	8.75(e)	
1988	8.375	S-17,000/ M-34,000/ H-	8.375(f)	
1989	7.875	S-13,000/ M-26,000/ H-	*	*
1990	7.875	S-13,000/ M-26,000/ H-	*	*
1991-1994	7.875(g)	S-13,000/ M-26,000/ H-	*	*
1995	7.59375(g)	S-12,500/ M-25,000/ H-	*	*
1996	7.125(g)	S-13,000/ M-26,000/ H-	*	*
1997	6.85(g)	S-20,000/ M-40,000/ H-	*	*

* No difference between earned and unearned income.
**S denotes single, M denotes married, and H denotes head of household.
Note: The top rates between 1933 & 1957 reflect various statutory reductions and surcharges.
(a) General Withholding of tax from wages commenced in 1959. Because this withholding would have required payment of two years' taxes within one year, taxes for calendar years 1958 and fiscal years ending 1959 were canceled. Taxes on capital gains and the income of estates and trusts were not canceled.
(b) An additional 2.5% surcharge was imposed on tax liabilities prior to adjustment for credits for years 1972-1976. This means the top rate was 15.375%. The surcharge was suspended for 1973 and 1974.
(c) Governor Carey signed legislation on 5/20/77 repealing the 2.5% surcharge effective 1/77. In 1976, Governor Carey had the surcharge extended until 4/1/77.
(d) Effective rate. The rate was lowered from 14% to 13.5% on 7/1/85.
(e) An additional tax of up to 3% on unearned income was imposed on taxpayers with NYAGI in excess of $100,000.
(f) An additional tax of up to 2% on unearned income was imposed on taxpayers with NYAGI in excess of $100,000.
(g) A supplemental tax recaptures the tax benefits of tax rates below the top marginal rate, creating a flat tax on taxable income where NYAGI exceeds $150,000

Table 2: New York State Personal Income Tax Top Rates and Income Thresholds Adjusted for Inflation

Thresholds Adjusted for Inflation 1942-1997				
	Earned Income		Unearned Income	
Year	Top Rate (%)	Taxable Income in Excess of:	Top Rate (%)	Taxable Income in Excess of:
1942	5.25	84,751	*	*
1947	4.2	61,249	*	*
1952	7	52,162	*	*
1957	7	49,192	*	*
1962	14	116,971	*	*
1967	14	105,765	*	*
1972	15.375	91,859	*	*
1977	15	76,034	*	*
1982	10	27,057	14	36,607
1987	8.75	S-18,928/ M-31,096/ H-20,821**	8.75(a)	*
1988	8.375	S-22,071/ M-44,142/ H-23,759**	8.375(b)	*
1989	7.875	S-16,102/ M-32,204/ H-21,056**	*	*
1990	7.875	S-15,277/ M-30,553/ H-19,977**	*	*
1991	7.875	S-14,660/ M-29,319/ H-19,170**	*	*
1992	7.875	S-14,150/ M-28,301/ H-18,504**	*	*
1993	7.875	S-13,738/ M-27,476/ H-17,965**	*	*
1994	7.875	S-13,390/ M-26,780/ H-17,510**	*	*
1995	7.59375	S-12,500/ M-25,000/ H-19,000**	*	*
1996	7.125	S-12,609/ M-25,218/ H-16,489**	*	*
1997	6.85	S-18,815/ M-37,631/ H-28,223**	*	*

* No differential between earned and unearned income.
**S denotes single, M denotes married, and H denotes head of household.
Note: Thresholds adjusted for inflation based on 1995 base year using CPI-U data from the Economic Report to the President (1993) and DRI Forecast (April 1995).
(a) An additional tax of up to 3% on unearned income was imposed on taxpayers with NYAGI in excess of $100,000.
(b) An additional tax of up to 2% on unearned income was imposed on taxpayers with NYAGI in excess of $100,000.

The State's top tax rate last reached its highest point in 1975, at 15.375 percent,[1] including a surcharge that was lifted in 1977. At that time, the steeply graduated rate structure featured 14 different tax brackets.

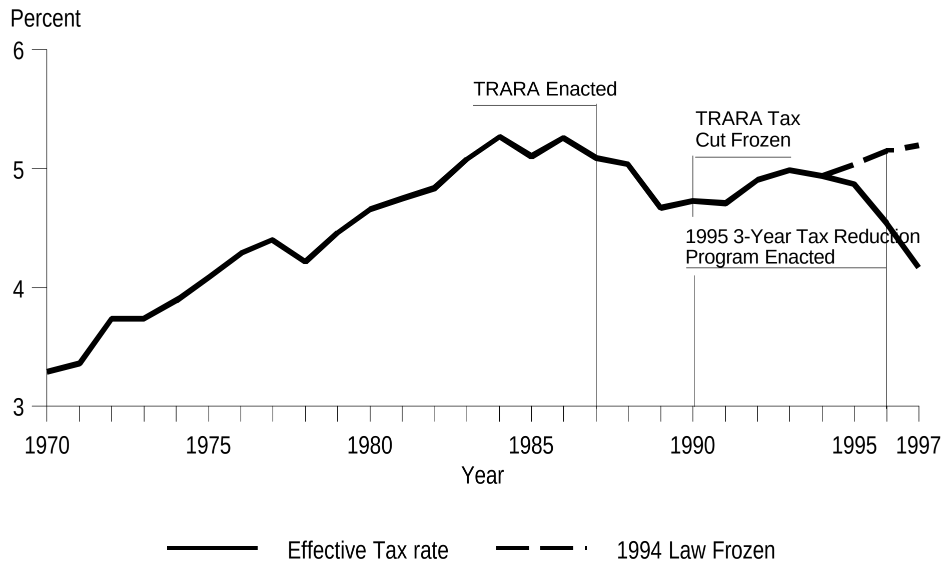
After a series of small, temporary steps during the State and City fiscal crises of 1974-76, efforts to reduce the State personal income tax burden began in earnest in 1978. The State substantially reduced the top rate on earned income (e.g., wages) from 15 percent to 12 percent. However, the State retained a higher rate on unearned income (e.g., dividends and interest), which in 1979 was reduced from 15 percent to 14 percent. In 1981, the top rate on earned income was reduced again, to 10 percent.

Lawmakers approved additional tax cuts in 1985 and 1986, reducing the top rate on earned income to 9.5 percent. The top rate on unearned income was reduced to 13.75 percent in 1985 and to 13.5 percent in 1986.[2]

New York's average income tax continued to rise in the 1970's and '80's, despite big marginal rate cuts

Despite these large reductions in marginal rates, particularly on earned income, the average state income tax rate in New York continued to rise during the late 1970's and early 1980's, as shown in Figure 1. High inflation rates during this period account for a large part of the increase. Taxpayers were required to contribute a larger share of their income to taxes as inflation pushed them into higher brackets -- the phenomenon known as "bracket creep." Other factors that contributed to shifts in average rates include changes in real incomes and statutory changes to the income tax structure.

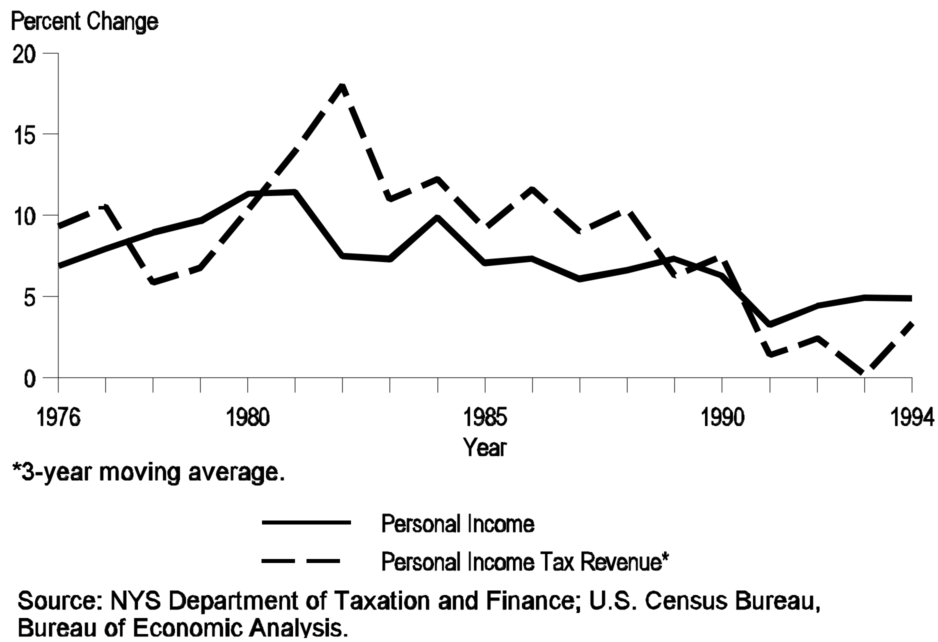
Figure 1: Average Personal Income Tax Rates* - 1970-1997



Source: NYS Department of Taxation and Finance.
*Tax as a percentage of New York adjusted gross income.

Figure 2 illustrates changes in personal income and tax revenue growth from 1976 through 1994. Because of the volatility in income tax receipts due to federal and State law changes, tax growth is averaged over a three-year period. Significant increases in income took place over this time frame as shown by the solid line. However, for most of the period under examination, income tax growth exceeded -- and, in some years, far exceeded -- growth in personal income.

Figure 2: Changes in Personal Income and Personal Income Tax Revenue



Roughly half the value of the 1987 program was not dedicated to cutting taxes but to preventing a federally driven tax increase

As New York taxpayers saw their real incomes rise during the economic expansion of the 1980's, State income taxes continued to claim a rising share due to bracket creep. The trend briefly reversed itself in the early 1990's, when personal income growth exceeded tax growth for several years. This was largely the result of the severe recession in New York, which saw employment decline by close to 500,000 jobs.

The tax reduction associated with the first stages of the 1987 tax program was probably only a minor factor in the reduced growth in receipts. This is because about half of the program was intended to offset a projected revenue "windfall" from federal tax reform. Indeed, more than half of the first three years' tax cuts went toward preventing a State tax increase, because federal base broadening occurred immediately.

Net personal income tax receipts actually increased by 8.5 percent during the first three years of the tax cut. It was not until the first “freeze” year that receipts growth began to slow down. This coincided with the onset of the 1990-91 national recession. As the State economy shrank, income tax receipts growth stagnated. In fact, income tax revenues in 1991 were slightly lower than in 1989, when the recession began in New York.

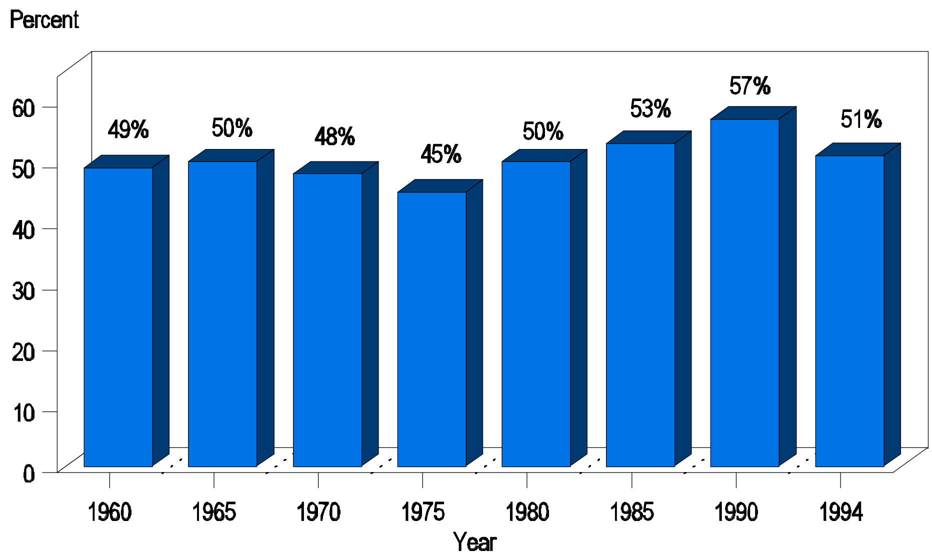
Another reason for the rise in average tax rates during the 1970-86 period was action taken by State lawmakers to reduce the level of taxable income at which the top rate applied. For example, the 15 percent rate applied at $25,000 in 1975, while for earned income, the 1986 top rate of 9.5 percent applied at $16,000 of taxable income.

During this period, New York increased its standard deduction from $2,000 to $2,500. However, the increase failed to keep pace with inflation. In fact, the real value of the standard deduction (in 1994 dollars) fell from $5,508 in 1975 to $3,515 in 1986.

The combination of a lower income level at which the top rate applied, and the decline in real value of the standard deduction, produced substantial income tax increases for New York’s lower- and middle-income workers.

The rising burden of the income tax is reflected in its growing contribution to total State taxes. Figure 3 shows that the income tax accounted for about 45 percent of all taxes in the mid-1970's, but climbed to 57 percent by 1990.

Figure 3: Share of Total Tax Revenue from Personal Income Tax



Source: NYS Department of Taxation and Finance.

The history of the income tax in New York before 1987 was one of growing reliance on this tax as a revenue source. This was a result of both high rates and the natural elasticity[3] of the income tax as constructed in New York. Periodic changes in the law to reduce rates and increase the standard deduction were effective only in reducing the rate of growth in average tax burdens, but not in permanently making the burden lighter.

Tax Reform and Reduction Act of 1987

In 1986, Congress enacted a comprehensive reform of the federal income tax. In exchange for across-the-board rate reductions, the reform significantly broadened the tax base, eliminated certain exclusions from income, repealed certain itemized deductions and closed loopholes in the law.

Because New York automatically conforms to most federal definitions of income and itemized deductions, federal reform substantially expanded the State's tax base. Without State action, New York taxpayers would have faced significant tax increases that would have generated a revenue "windfall" for the State. The broader tax base allowed New York policy makers to radically restructure the income tax reduction program enacted in 1985.

The Tax Reform and Reduction Act of 1987 (TRARA) represented New York's response to federal tax reform. The 1987 tax law was designed to return the anticipated windfall of $2.3 billion to State taxpayers and to provide significant tax relief beyond the windfall. Fiscal analysts at the time estimated the net tax reduction to be $2.1 billion over a five-year period from 1987 through 1991.

The 1987 tax law's objectives included furthering the basic goals of tax reform: improved tax fairness, simplification of the tax structure, creation of a more competitive tax structure, and removal of low-income New Yorkers from the tax rolls.

New York's tax on capital gains increased sharply after 1986

In its first three years of implementation, the 1987 tax reform made progress toward all these goals. As shown in Figure 1, between 1987 and 1989, average tax rates fell during this period.

The 1987 law broadened the tax base by permitting fewer exclusions and deductions. By eliminating deductions that benefitted only taxpayers with certain characteristics (i.e., large amounts of non-mortgage interest), the reforms increased the likelihood that taxpayers with similar incomes pay the same tax. In addition, by eliminating exclusions or deductions that disproportionately benefitted wealthier taxpayers, the 1987 law increased the progressivity of the tax structure.

The 1987 law also eliminated the differential rates of tax on earned and unearned income. This provision was necessitated, in part, by Congress' elimination of the partial exclusion for capital gains income. Even with the rate reduction, State income taxes on long-term capital gains jumped dramatically as a result of the 1987 reform. However, the effective rate on long-term capital gains remained virtually unchanged for taxpayers previously subject to the add-on minimum tax on the capital gains exclusion preference.

The 1987 law was originally intended to reduce the top tax rate from 13.5 percent on unearned income and 9.5 percent on earned income in 1986 to a single rate of 7 percent by 1991. This would have brought the State's tax rates closer to the top rates imposed in neighboring states at the time. Finally, the sizable increases in standard deduction amounts successfully removed many low-income taxpayers from the tax rolls. The number of brackets was to be reduced from 13 in 1986 to 2 by full implementation of the law.

In addition, the law introduced a new joint tax rate schedule for married taxpayers. Beginning in 1988, the tax brackets for married couples reflected full income splitting. This means that the brackets for joint filers are twice as wide as the single rate schedule. Before 1988, married taxpayers used the same rate schedules as those that applied to the "single" and "married filing separately on one return" filers. This meant that most married taxpayers paid more tax when they filed joint returns; therefore, most did not. However, the introduction of full income splitting effectively converted the old marriage penalty into a marriage subsidy for certain taxpayers.[4]

Lawmakers originally scheduled the 1987 legislation to phase in over five years, from 1987 through 1991. However, the new tax schedule was frozen at its 1989 levels each year between 1990 and 1994. Legislation enacted in 1990 stretched out the final two years of the 1987 law into three years. This action effectively reversed the progress made by the State in reducing its tax burdens between 1986 and 1989. Average tax rates crept back up, from 4.7 percent in 1989 to 4.9 percent in 1994, as shown in Figure 1.

Income Tax Policy in the Early 1990's

Other than the repeated postponement of the remaining 1987 reforms, several other changes enacted between 1990 and 1994 significantly affected tax liabilities and the distribution of the tax burden.

First, New York automatically conformed to the federal limitation on itemized deductions enacted in 1990 and effective in 1991. The federal limitation reduces the itemized deductions of taxpayers with federal adjusted gross income (FAGI) above an annually indexed threshold amount ($114,700 in tax year 1995). It reduces itemized deductions by 3 percent of the amount by which their FAGI exceeds the threshold amount.[5] The federal limitation cannot reduce the deductions subject to the limitation by more than 80 percent.

Conformity with the federal provision increased State income tax liabilities by about $55 million. The impact of this change on individuals varied according to their income profiles. For example, in the case of a married taxpayer with $200,000 in FAGI, the itemized deduction cap produced a State income tax increase of approximately $200 a year.

The State effectively raised income taxes on upper-income New Yorkers in 1991

Second, New York enacted a "supplemental income tax," first effective for the 1991 tax year. The tax was designed to recapture the benefits of the graduated tax rates below the top tax rate. Taxpayers must add this tax to their regular tax liability. It begins at New York adjusted gross income (NYAGI) of $100,000 and reaches the maximum at NYAGI of $150,000. In 1995, the maximum supplemental tax equals $580 for married couples, $428 for heads of households and $290 for single individuals.

For many high-income couples, the combined effect of the supplemental tax and the cap on itemized deductions initially was the same as if the maximum State rate had been raised back above 8 percent.

The final significant income tax action over this period was the enactment of a refundable earned income credit (EIC), linked to the federal credit of the same name, effective in the 1994 tax year. The credit was originally scheduled to increase from 7.5 percent of the federal EIC in 1994 to 20 percent in 1997.

Income Tax Reduction of 1995

As part of his fiscal 1995-96 *Executive Budget*, Governor Pataki proposed a four-year tax reduction program, designed to combine the remaining phases of the 1987 reform with additional tax relief. The Governor's original program, when fully effective in 1998, would have reduced the top rate to 5.9 percent and provided an annual tax cut of $6.8 billion when fully implemented. Additional relief was targeted to middle-income taxpayers through a refundable $200 dependent care credit and the expansion of the maximum taxable income threshold to $50,000 for married taxpayers filing jointly.

The compromise tax cut package adopted by the Legislature features a three-year reduction package worth $3.6 billion when fully effective in 1997, plus more than $200 million in additional earned income tax payments. The enacted plan closely parallels the first three years of the Governor's original plan.

The 1995 Taxpayer Relief Act will markedly reduce average tax rates, as shown in Figure 1. Absent the tax cut legislation, assuming a freeze of 1994 law, the average tax rate would have climbed to 5.2 percent in 1997. This would have marked New York's highest average rate since the mid-1980's. By contrast, under the enacted tax cut, the average rate will drop in 1997 to 4.17 percent, its lowest level in more than 20 years.

Even after this significant tax reduction, New York's average State income tax in 1997 will still be 27 percent higher than it was in 1975. This is true despite the dramatic drop in marginal rates that will have occurred over this period. New York's income tax burden will still be high, though clearly lower than if the 1995 tax reductions had not been enacted.

Table 3 compares the provisions of the enacted program when fully phased in to those of the 1987 law. It also includes the provisions that were in effect in 1994, which served as a starting point in formulating the new law.

Table 3: Personal Income Tax Provisions

Base Year (1994)			TRARA Fully Phased-In			Income Tax Reduction of 1995 Fully Phased-In		
Single Taxpayers								
Income Bracket		Marginal Rate	Income Bracket		Marginal Rate	Income Bracket		Marginal Rate
Over	But Not Over		Over	But Not Over		Over	But Not Over	
$0	$5,500	4%	$0	$12,500	5.5%	$0	$8,000	4%
5,500	8,000	5%	12,500		7%	8,000	11,000	4.5%
8,000	11,000	6%				11,000	13,000	5.25%
11,000	13,000	7%				13,001	20,000	5.9%
13,000		7.875%				20,000		6.85%
Standard Deduction		$6,000	Standard Deduction		$7,500	Standard Deduction		$7,500
Earned Income Credit		7.5%	Earned Income Credit		20%	Earned Income Credit*		20%
Household Credit		Yes	Household Credit		No	Household Credit		Yes
Married Filing Joint								
Income Bracket		Marginal Rate	Income Bracket		Marginal Rate	Income Bracket		Marginal Rate
Over	But Not Over		Over	But Not Over		Over	But Not Over	
$0	$11,000	4%	$0	$27,000	5.5%	$0	$16,000	4%
11,000	16,000	5%	27,000		7%	$16,000	22,000	4.5%
16,000	22,000	6%				22,000	26,000	5.25%
22,000	26,000	7%				26,000	40,000	5.9%
26,000		7.875%				40,000		6.85%
Standard Deduction		$9,500	Standard Deduction		$13,000	Standard Deduction		$13,000
Earned Income Credit		7.5%	Earned Income Credit		20%	Earned Income Credit*		20%
Household Credit		Yes	Household Credit		No	Household Credit		Yes

* Note: offset by Household Credit

The fully phased-in income tax reduction program passed in 1995 retains the 4 percent bottom rate, which applies to incomes below $16,000 for a married filer. The 4 percent bracket would have been eliminated under remaining phases of the 1987 law. The program also retains the five-bracket structure, rather than moving to the two-bracket structure scheduled under previous law. It increases the taxable income bracket at which the top rate applies, from $26,000 to $40,000 for married couples. The program also reduces the top tax rate to 6.85 percent by 1997. The program follows through on increases in standard deductions originally scheduled in 1987.

The income tax reduction of 1995 accelerates the phase-in of the 20 percent EIC rate from 1997 to 1996. It also retains the household credit for taxpayers who would not benefit from the EIC.

Impact of High Personal Income Taxes

The American economy is characterized by open interstate commerce with few restraints on the mobility of capital and labor. To the extent large differentials in tax rates create differences in the earnings of labor and capital, there is an incentive for mobile factors to gravitate to jurisdictions with lower taxes. This is especially true when, as in the case of the New York City metropolitan area, lower income taxes are just across the state line.

High marginal income tax rates, imposed through steeply graduated rate structures, create disincentives for work and savings. A substantial body of recent economic literature finds a negative correlation exists between the overall tax burden and various indicators of economic performance, including employment. While exact estimates of these impacts vary, a recent review article summarizing 57 studies found that an increase in state tax burdens of one percent would reduce economic activity (employment) by between 0.15 and 0.85 percent.[6] Impacts of this magnitude mean that a 25 percent reduction in tax would lead to substantial employment gains.

The negative impact of taxes on growth is further confirmed by research conducted by the Office of Tax Policy Analysis. At a minimum, this research suggests an employment elasticity between -0.1 and -0.2 -- meaning that as the relative tax burden increases by 1 percent, employment declines by between 0.1 percent and 0.2 percent.

In fact, New York State employment growth has significantly lagged national job creation rates while the State tax burden has remained significantly above the national average. For example, from 1980 to 1993, New York employment increased by only 7.5 percent while employment in the rest of the country jumped by 23 percent. Employment growth in New Jersey, whose tax burden is close to the national average, was 13 percent during the same period. New York would have gained 1.2 million additional jobs if it had kept pace with the nation as a whole and 400,000 more jobs if it had kept pace with New Jersey's growth since 1980.

Progressivity and Economic Equity

There are two schools of thought on the issue of tax progressivity. One view holds that the only truly fair tax structure is one that taxes high incomes at significantly greater percentages than low and moderate incomes. The Tax Law in effect becomes a tool for income redistribution under this approach.

But another view holds that the quest for elusive "fairness" through progressive taxation can backfire. New empirical research suggests that the income tax structure as imposed in New York may behave counterproductively.

As confirmed by some studies,[7] businesses in high-tax states must compensate for taxes by paying higher wages, particularly for higher paying skilled jobs. By increasing the cost of hiring skilled workers in New York, high marginal tax rates increase the cost of doing business in New York. Multi-state firms have an added incentive to employ skilled workers in lower tax states, or to pay lower wages to less-skilled and less-mobile workers, who in New York also are subject to significantly lower tax rates. While this compensates businesses, it also undermines the redistributionist rationale for steep progressivity.

Our research lends further credence to these findings. When examining wage premiums paid to New York workers, we find a larger percentage differential for higher paying jobs. In most cases, lower paying sectors of the economy have a smaller differential. For example, in New York, average service sector wages exceed the national average by 20 percent, while New York financial sector average wages exceed the national average by 60 percent. Of course, many factors can influence these results. However, it is both plausible and consistent with other research that at least some of this phenomenon is caused by the income tax structure in New York.[8]

The Small Business Factor

An often neglected aspect of the State income tax structure is its impact on small business activity. Most small businesses are unincorporated and therefore pay personal income taxes on their profits. Eighty percent of the State's total business firms pay income tax directly as sole proprietorships, partnerships, limited liability companies, and S corporations. These firms account for about half of all business activity in the State.[9]

For new and expanding small businesses, New York's comparatively high personal income tax can be a drag on both profitability and viability. This is especially the case for businesses that need to reinvest most or all of their after-tax profits to grow and remain competitive. A high personal income tax level therefore acts as a particularly onerous disincentive for small firms that are relied upon to provide a large share of job growth.[10]

High personal income taxes reduce the after-tax rates of return earned by investors and unincorporated businesses. This leads to less investment in high-tax states compared with low-tax states. This occurs because only investments with relatively higher rates of returns will be profitable in a high-tax state. Other, more marginal investments may move to low-tax states.

Like all taxes, the personal income tax also distorts economic behavior and reduces the overall efficiency of the economy. It influences individuals' consumption, location, and savings decisions. It also influences taxpayer decisions on how many hours to work, whether to work, whether to work in New York State, and whether to start a business in New York.

Box: Importance of State Top Income Tax Rates After Federal Deduction

The top statutory tax rate in New York's personal income tax law does not necessarily equal the top tax rate which taxpayers face. This is because most taxpayers who pay tax at the highest rate itemize deductions for federal income tax purposes. The ability to deduct New York income tax when calculating federal income tax offsets part of the burden of the state tax. A higher federal rate results in a larger offset of state taxes.

To illustrate, consider a high-income taxpayer in the top New York tax bracket of 7.875 percent, and in the top federal tax bracket of 39.6 percent (36 percent plus the 10 percent surtax). After deducting New York tax in computing federal taxable income, the effective State marginal rate declines to 4.76 percent, or (.07875 x (1-.396)). This also means that for each additional $1,000 of income, the extra $78.75 of State tax is offset by a $31.19 ($78.7 5 x .386) reduction in otherwise-additional federal income tax.

Consideration of the federal income tax rate is particularly important when analyzing the impact of New York's income tax on businesses. Many businesses, such as sole proprietorships and partnerships, pay personal income tax on their profits. New York's nominal top income tax rate in 1994 reduced net profits by 7.875 percent. However, after accounting for the impact of deductibility, the effective top rate reduces net profits by less than 5 percent for taxpayers in the highest federal tax bracket. Although small, this three percentage point differential can be critical for some firms, especially the newest and smallest.

In addition, the federal rate is important for comparing top income tax rates across states. For example, New York's nominal top rate of 7.875 percent exceeds Connecticut's nominal top rate of 4.5 percent by nearly 3.4 percentage points. However, after factoring the impact of deductibility at the top federal rate of 39.6 percent, New York's 4.76 percent effective top rate is only 2 percentage points higher than Connecticut's top effective rate of 2.72 percent.

Federal Deductibility

New York State's tax structure was not formed in a vacuum. Both federal tax actions and developments in other states force New York policymakers to respond. As a result, historical trends in both federal and other state taxes have affected New York's tax structure.

The first issue addressed in this section deals with the interaction of the federal and State structures in determining effective top tax rates. The box on page 20 describes the impact of federal deductibility of state taxes on reducing the effect of state tax rates.

Between 1976 and 1989, New York's top income tax rate was cut almost in half, from 15.375 percent to 7.875 percent. But the real marginal rate, net of federal deductibility, did not decline by nearly as large an amount. During the same period in which State rates were declining, federal rates also were cut, reducing the net benefit of State tax cuts for taxpayers who itemize their federal taxes.

Figures 4, 5 and 6 detail the interaction of the federal and State structure in determining effective marginal tax rates. The top panel in each chart shows the top statutory income tax rate in New York in effect for the period 1974 to 1997. The bottom panel reports changes in top federal tax rates along with the net top tax rate incurred by New Yorkers who itemize on their federal returns. What is clear in each chart is that when federal top rates were high in the early 1970's the impact of very high top rates in New York was mitigated somewhat by federal deductibility. The large federal tax reductions during the 1980's reduced the benefit of federal deductibility.

Federal tax cuts thus had the paradoxical effect of significantly reducing New York State's ability to generate revenue at federal expense without undue adverse impacts on itemizing taxpayers.

Figure 4: Top New York State Personal Income Tax Rates Earned Income

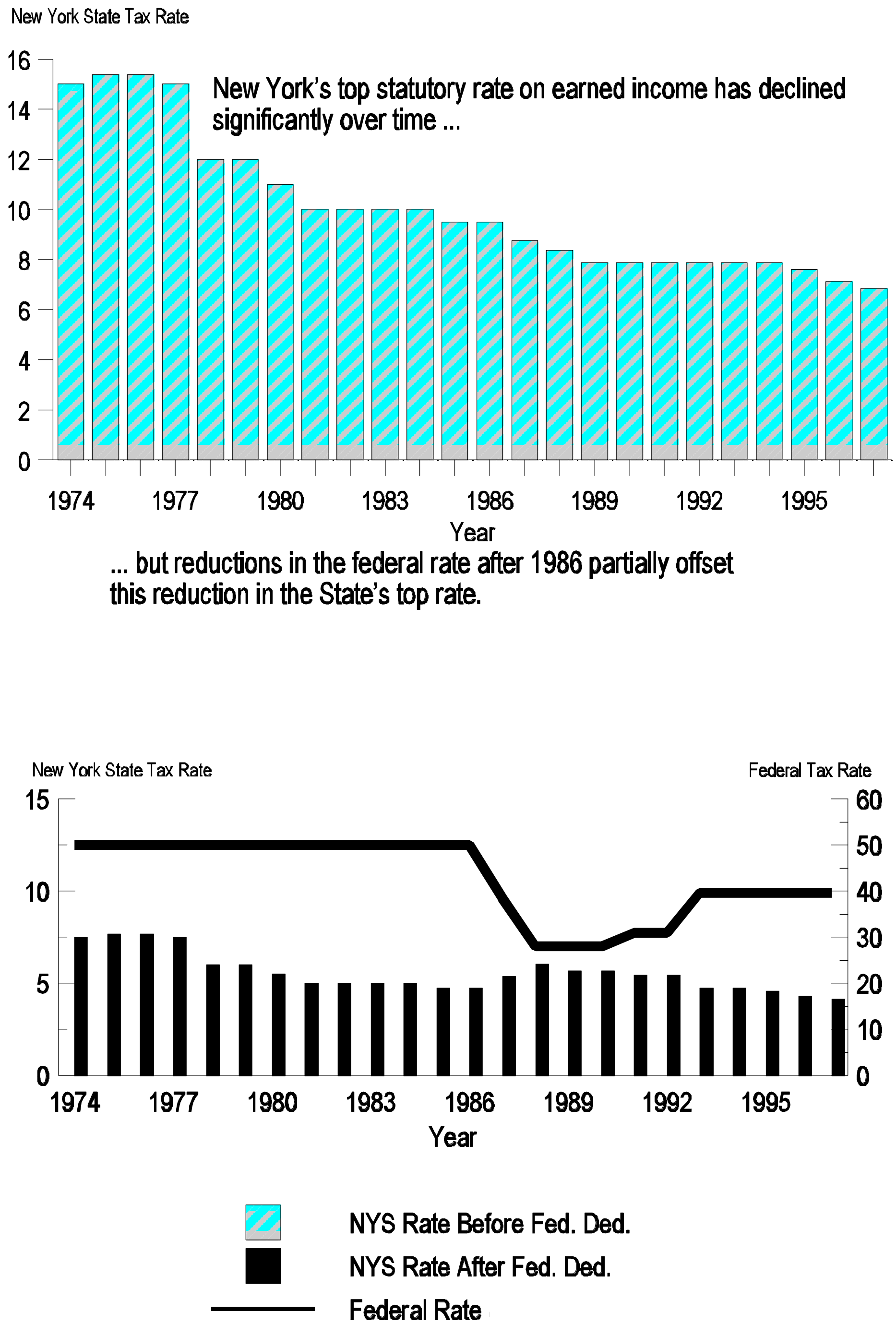
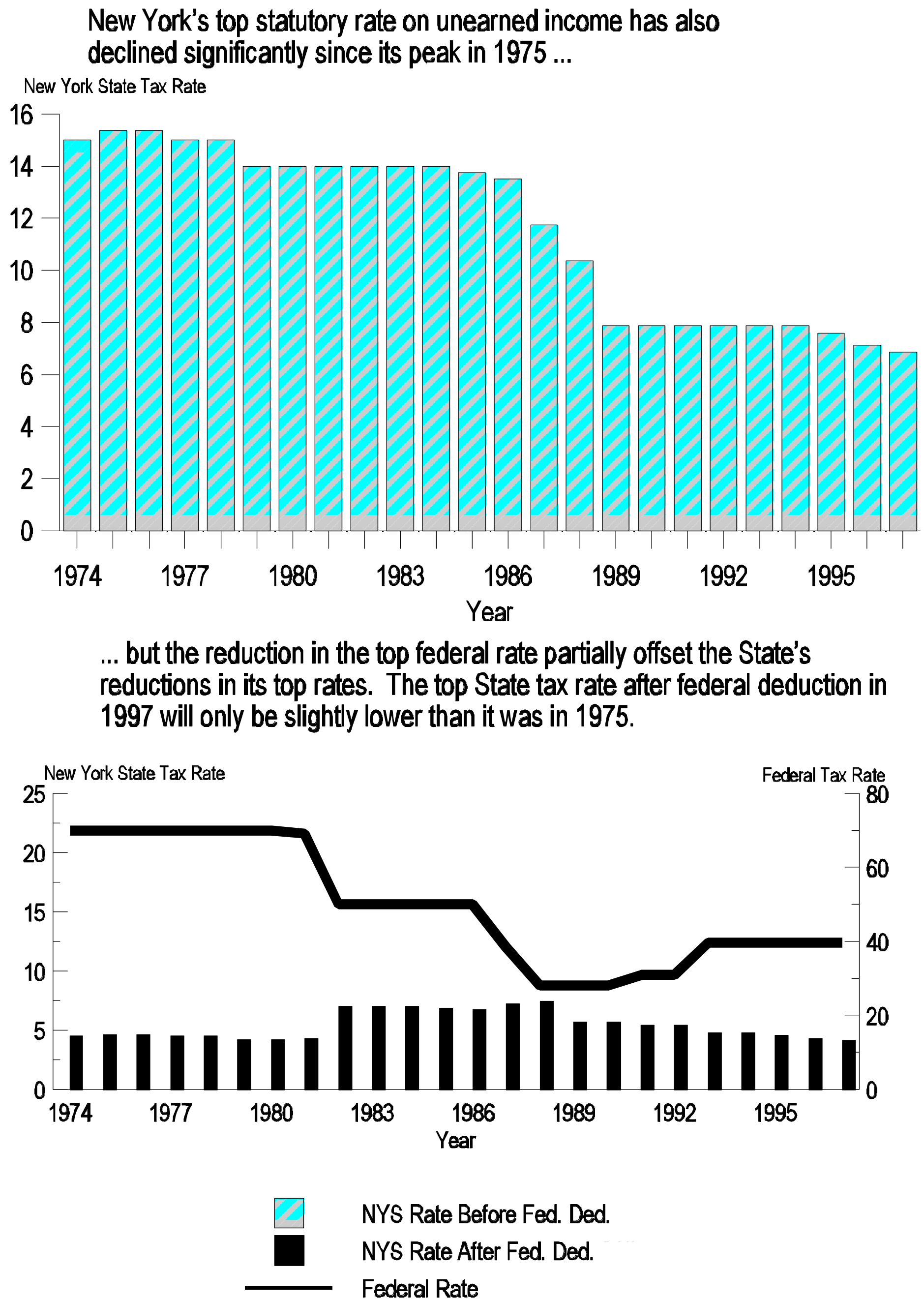
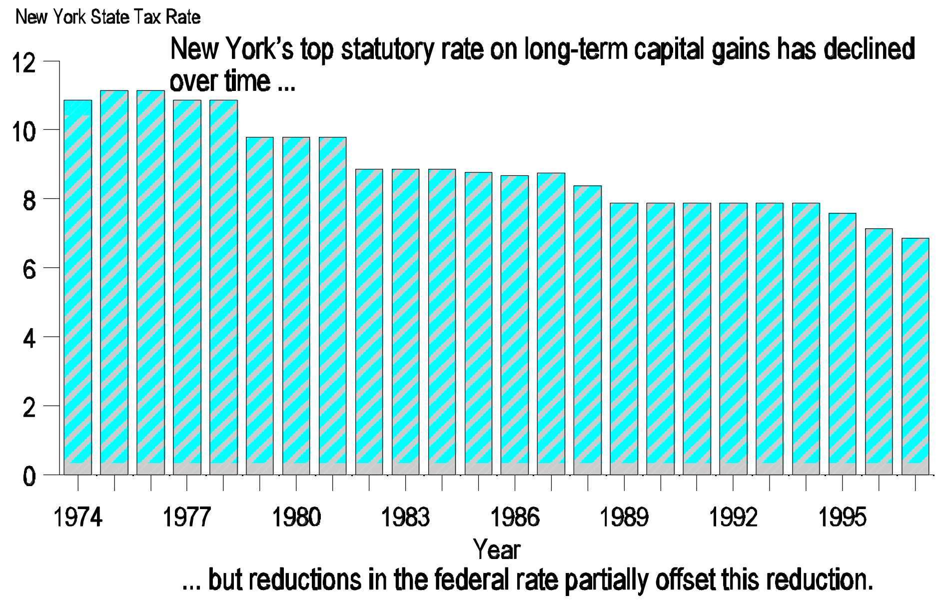


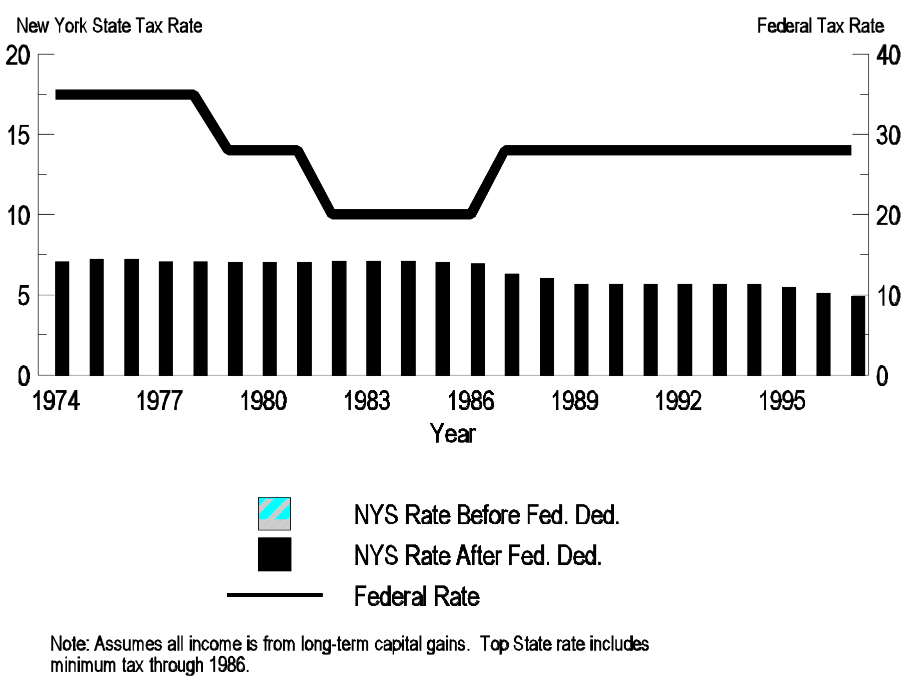
Figure 5: Top New York State Personal Income Tax Rates Unearned Income



Note: During the period 1978 to 1982 New York had the same definition of unearned and earned income as the federal government. The federal government eliminated the distinction after 1982. New York retained the distinction until 1988.

Figure 6: Top New York State Personal Income Tax Rates on Long-Term Capital Gains





Note: Assumes all income is from long-term capital gains. Top State rate includes minimum tax through 1986.

For example, Figure 4 shows that the top rate on earned income[11] after federal deduction peaked at 7.7 percent in 1975. During this period, top rates in New York exceeded 15 percent and the top federal rate on earned income was 50 percent. Federal deductibility served to significantly reduce the effect of the high top rate. As the federal government reduced top rates, they have reduced the value of federal deductibility in keeping net rates low. When federal top rates fell to below 30 percent in the late 1980's, the net top rate after deductibility in New York remained around 5 percent. This is true even with the rate reductions associated with the first years of TRARA.

Since 1991, deductibility has regained some of its value, because the top federal rate has crept upward toward its current level of 39.6 percent. The 1995 tax reduction program reduces the effective top rate, after federal deductibility, to 4.1 percent in 1997.

The top effective tax rates on unearned income followed a different trend, as indicated by Figure 5. The top federal rate on unearned income was as high as 70 percent until 1980. Consequently, the top State rate in New York, after deductibility, remained below 5 percent. The top rate after federal deduction on unearned income was relatively low compared with the rate on earned income. However, when the top federal rate dropped to 50 percent in 1982, the top State rate after deductibility jumped to 7 percent. The top federal rate continued to decline further diminishing the effect of deductibility. However, New York ceased taxing unearned income at higher rates than earned income in 1989. As a result, the top rate on unearned income, after federal deductibility, noticeably decreased. It now equals the top rate on earned income. In addition, because of the reduction in the top federal rate, it is about the same now as it was in 1974.

Figure 6 depicts movement in the top tax rates on long term capital gains for New York and the federal government. This chart is presented to isolate the impact of federal deductibility on top effective rates for capital gains income. Therefore, the chart assumes a taxpayer whose only income is from capital gains. Through 1986, New York conformed to the federal exclusion of a portion of long-term capital gains from taxable income. The exclusion was 50 percent through 1978 and 60 percent from 1979 to 1986. New York conformity led to a consistent decrease in the top State rate on capital gains. The decreases in New York were offset somewhat because of the add-on minimum tax, imposed at a rate of 6 percent, applied to the increased exclusion for long-term gains.

Like the previous analysis in terms of earned and unearned income, Figure 6 shows that federal tax rate reductions reduced the value of deductibility. In contrast to other forms of income, capital gains were subjected to a substantially higher combined federal-state tax in New York after the 1986 federal reform. The value of deductibility has not compensated for this increase.

Increases in the standard deduction, together with the repeal and restriction of certain itemized deductions, have substantially reduced the percentage of itemizers for State tax purposes. In fact, this percentage of New York itemizers dropped from 44 percent in 1975 to 25 percent in 1992.

Comparison With Other States

In 1975, New York's top tax rate was at its highest point and was, in effect, the highest top rate in the nation.[12] With a statutory rate of 15.375 percent, it was well above the top rates of neighboring states (see Table 4). New York's highest rate occurred during a time when Connecticut and New Jersey did not have an income tax. In 1975, Massachusetts and Pennsylvania had top statutory rates of 5 percent and 2 percent, respectively. Among the neighboring states, only Vermont, with a top rate of 12.5 percent, had a tax rate comparable to that of New York's. Table 4 shows that New York's top rate was also high in 1975 compared with selected industrial states. Only California's rate exceeded 10 percent at that time.

Since 1975, both New York and Vermont have reduced their top rates. By 1997, New York's rate will decline quite significantly, to 6.85 percent. Vermont reduced its top rate to 9.9 percent in 1994.

Conversely, other neighboring states, with low personal income tax rates, increased their top rates. Those that had no personal income tax enacted one. A similar trend occurred in the rest of the nation. Of the selected states shown in Table 4, states that had low top rates in 1975 raised their top rates over time.

Table 4: Top Statutory Tax Rates on Earned Income

New York and Selected States						
State	1975	1980	1985	1990	1995	1997
New York	15.38%	11.00%	9.50%	7.88%	7.59%	6.85%
Neighboring States						
Vermont	12.50%	11.50%	13.25%	7.84%	9.90%	9.90%
Massachusetts	5.00%	5.00%	5.00%	5.95%	5.95%	5.95%
Connecticut	0.00%	0.00%	0.00%	0.00%	4.50%	4.50%
New Jersey	0.00%	2.50%	3.50%	3.50%	6.58%	6.37%
Pennsylvania	2.00%	2.20%	2.35%	2.10%	2.80%	2.80%

Other States						
California	11.00%	11.00%	11.00%	9.30%	11.00%	11.00%
Ohio	3.50%	3.50%	9.03%	6.90%	7.50%	7.50%
North Carolina	7.00%	7.00%	7.00%	7.00%	7.75%	7.75%
Illinois	2.50%	2.50%	2.50%	3.00%	3.00%	3.00%
Michigan	3.90%	4.60%	5.10%	4.60%	4.40%	4.40%

New York's top rate will be more in line with its neighboring states by 1997.[13] However, the top rate will still be higher than the top rates in all of the neighboring states, except Vermont, and much higher than in Connecticut and Pennsylvania. Compared with the other selected states, New York's top rate will be lower than in three of the five states shown in Table 4 by 1997. In particular, New York will move below California and Ohio, compared to being much higher than these states in 1975. New York's top rate of 6.85 in 1997 will rank twenty-third among the 50 states, based on current tax schedules.[14]

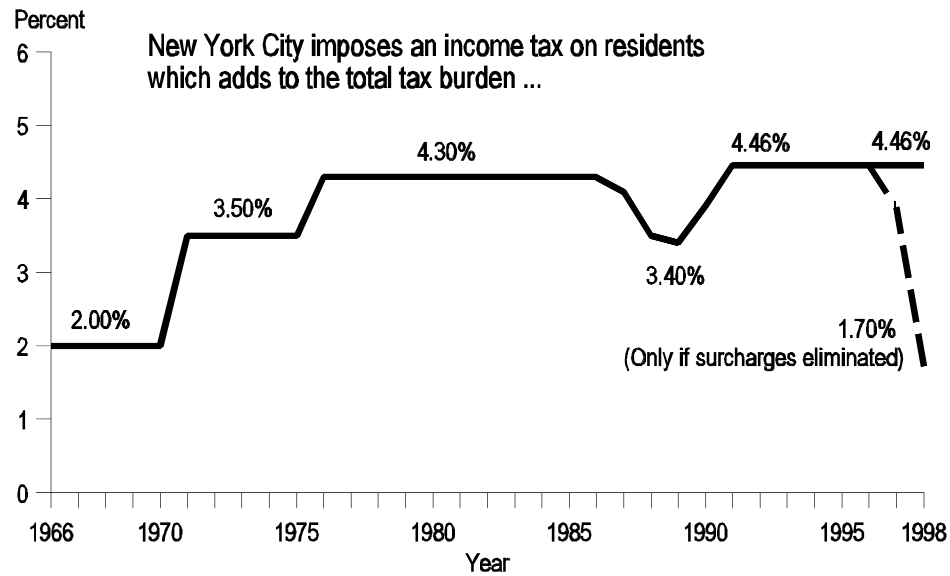
Given the significant differences in the way states define taxable income and conform to federal law, the marginal rate is often a misleading standard of comparison. A far more meaningful standard is the effective rate, calculated by applying the different state tax laws to taxpayers with the same income profile. Such a comparison is summarized in the Findings section of this report.

New York City Personal Income Tax

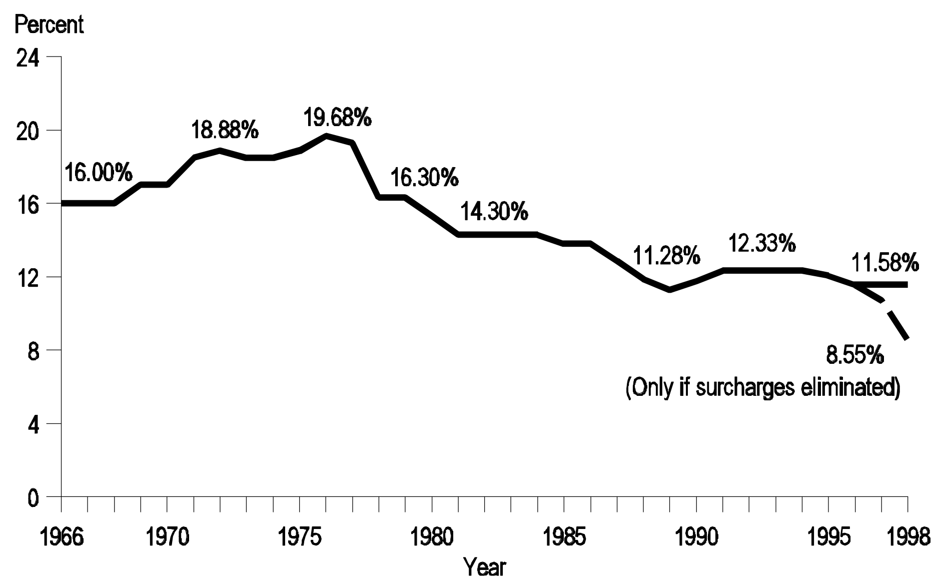
In discussing regional competitiveness, it is important to remember that New York City imposes a local personal income tax on residents in addition to the State tax. New York City competes directly for jobs and income generation with New Jersey and Connecticut. As already noted, these states impose lower personal income tax burdens than New York. In addition, local jurisdictions in these states do not impose income taxes. This section briefly summarizes the City income tax structure and the combined effect of the State and City structures on top rates.

Since 1966, New York City has imposed a personal income tax on its residents. The City also imposes an earnings tax on nonresidents who work in the City. The resident income tax is based on State taxable income, with application of a separate City tax rate schedule. Figure 7 shows that the City's top rate has tended to increase over time. The top rate reached 4.3 percent in 1976, and fell to 3.4 percent in 1989. This lower rate occurred with the base broadening associated with federal tax reform and the concurrent reduction in State rates. Beginning in 1991 a pair of temporary surcharges raised the top rate to 4.46 percent through 1996.

Figure 7: Combined New York State & City Top Personal Income Tax Rates: 1966-1998



Combined State and New York City rates have imposed a heavy burden on New York City residents. The 1995 enacted plan lowers combined top rates in New York.



Note: Top rates on earned income are shown. A State surcharge applied in 1972 and 1976. New York City surcharge and additional tax, respectively, expire after 1996 and 1997. The basic rate is scheduled to revert to the 1.70% default rate in 1998.

The bottom panel of Figure 7 shows the combined City and State rate since 1966, projected through 1998 with and without the current temporary surcharges. The combined City and State rate peaked at nearly 20 percent in 1976.

State and City rate reductions brought the combined rate down to 11.28 percent by 1989. However, the City surcharges imposed in 1991 raised the rate to over 12.3 percent. The 1995 State income tax reduction program will reduce the top combined rate through 1997. If the City were to eliminate the surcharges and allow rates to reach levels currently in statute, the combined City-State rate would fall to 8.55 percent by 1998.

Progressivity Over Time

Part of the original legislative mandate for this report required “an examination of the progressivity” of New York’s tax structure. Progressivity is viewed as one measure of the fairness of a tax structure. As discussed above, given economic behavior, this can be a misleading measure and a misplaced priority when applied to state tax systems.[15] The remainder of this section provides background material on the progressivity of New York’s income tax structure. Appendixes A and C provide a more detailed analysis.

A progressive tax system is one in which liability as a percentage of income rises with income. A proportional system is one in which the the same percentage of income is taxed for all taxpayers. A regressive tax system would result in taxpayers with lower income paying a higher share of their income in taxes.[16] Table 5 illustrates how progressive, proportional and regressive systems affect three different hypothetical taxpayers, labeled A, B and C.

Table 5: Examples of Regressive, Proportional and Progressive Tax Systems

		Regressive System		Proportional System		Progressive System	
Taxpayer	Income	Tax Liability	Tax as a Percent of Income	Tax Liability	Tax as a Percent of Income	Tax Liability	Tax as a Percent of Income
A	$ 10,000	$ 600	6%	$ 400	4%	$ 200	2%
B	30,000	1,200	4	1,200	4	1,200	4
C	100,000	2,000	2	4,000	4	6,000	6

New York’s personal income tax structure has historically remained highly progressive. The tax structure has combined features such as graduated tax rates and income brackets with a standard deduction and personal and dependent exemptions to shift tax burdens to the more wealthy.

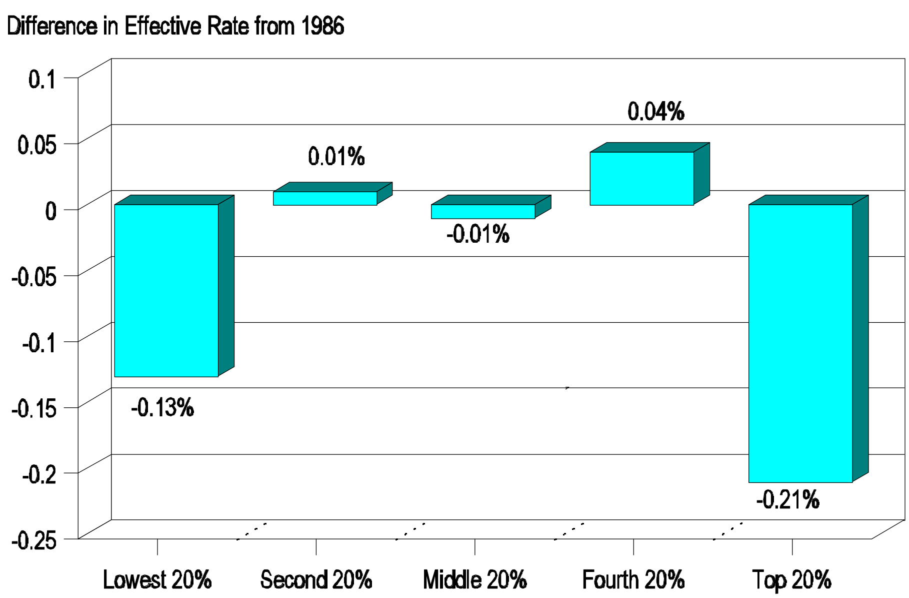
The numerous statutory changes enacted in recent decades, combined with economic and demographic movements, make it difficult to determine whether the current tax structure is more or less progressive than the structure in place 20, 30 or 40 years ago. The analysis that follows concentrates on the change in progressivity since TRARA was enacted in 1987.

Postponing full implementation of TRARA effectively shifted more of the burden to middle-income taxpayers, as illustrated by Figure 8. It shows the change in effective tax rates from 1986 to 1994 by income quintile.[17] This graph was produced from data and law in effect before enactment of TRARA, and data and law reflecting TRARA as in effect in 1994.

New York made significant progress in reducing its tax burden between 1986 and 1989. However, by 1994, effective tax rates had risen back to the levels that existed in 1986. Compared with 1986, taxpayers in the highest and lowest income groups benefitted from very slight tax reductions. Middle-income taxpayers received virtually no tax relief and sometimes experienced increases in average effective rates.

Tax relief did not materialize primarily because the State froze the1987 tax relief program after the 1989 phase. The personal income tax remained virtually

Figure 8: 1994 Effective Tax Rate Changes from 1986



Source: NYS Department of Taxation and Finance.

unchanged for five years, save for enactment of the EIC in 1994. In the meantime, inflation and real income gains offset the tax reduction provisions that occurred between 1986 and 1989. For example, the standard deduction increased from $3,000 in 1986 to $9,500 in 1989 for married taxpayers. However, because lawmakers froze the $9,500 standard deduction level through 1994, its real value, after accounting for inflation, fell. The $9,500 standard deduction amount was worth only $6,175 in 1986 dollars. In addition, inflation pushed many taxpayers into higher marginal tax brackets.

Low Income Provisions

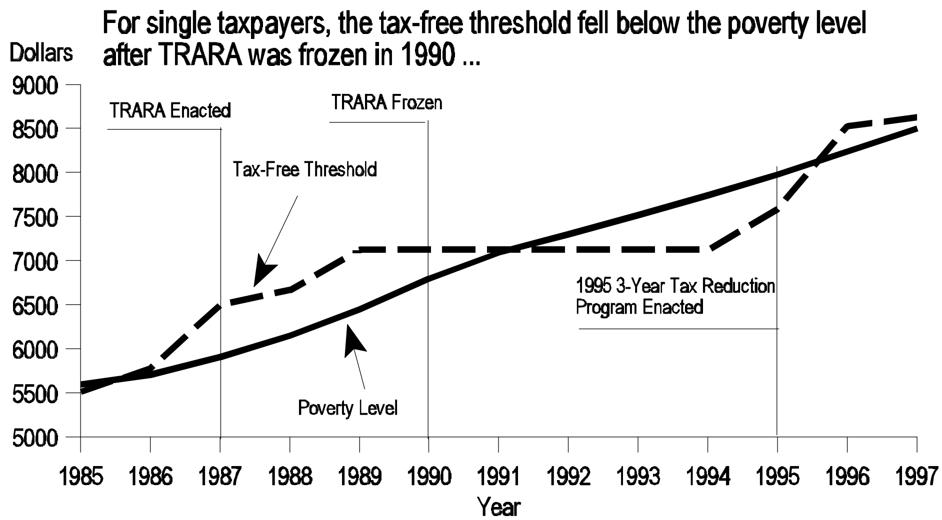
New York's personal income tax contains several provisions that provide tax relief to low-income taxpayers. The legislative mandate requires the Department to examine the effectiveness of these provisions in achieving tax fairness.

The combination of the standard deduction, personal and dependent exemptions, credits, and tax rate schedule creates a level of income below which there is no tax liability ("tax threshold"). Taxpayers classified to be under the poverty level, as defined by the federal government, generally do not owe New York personal income taxes. The poverty level is adjusted each year for increases in the cost of living.

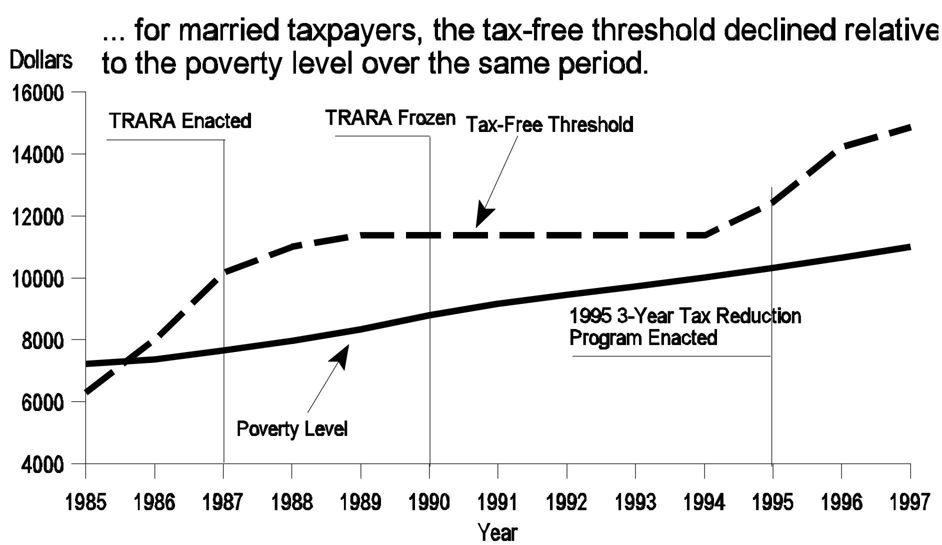
As reflected in Figure 9, the tax thresholds in New York became less effective in keeping poor taxpayers off the tax rolls after 1989. Some single taxpayers with incomes below the poverty level paid taxes. For married taxpayers, the difference between the tax threshold and the poverty level has narrowed since 1989. This was largely the result of the freeze in standard deduction amounts.

Figure 9: Tax Thresholds and Poverty Levels: 1985-1997

Single Taxpayers



Married Taxpayers, No Children



Note: Poverty level after 1994 is calculated by applying the consumer price index for the years 1995 thr 1997 to the 1995 poverty level.
Source: NYS Department of Taxation and Finance; U.S. Census Bureau, Current Population Survey, v years; Bureau of Labor Statistics; NYS Division of the Budget.

TRARA was scheduled to eliminate or reduce tax relief provisions that benefitted poor households. This included elimination of the household credit and the collapsing of the rate schedule. These changes were designed to compensate for the real reductions brought about by the increased standard deductions during the early years of the tax cuts. Since the benefits of the low-income tax reductions have been eroded by inflation since 1990, the 1995 Taxpayer Relief Act retained the household credit and lower rate schedule provisions.

A description of low-income tax relief provisions follows.

Household Credit

To provide targeted tax relief to low-income and moderate-income taxpayers, New York enacted a household credit in 1978. It provides nonrefundable tax relief to taxpayers whose deductions and exemptions do not bring their taxable income to zero. The credit increases as family size increases. Also, the value of this credit decreases as income rises. It phases out at $28,000 of federal adjusted gross income (FAGI) for single taxpayers and $32,000 for all others.

Earned Income Credit

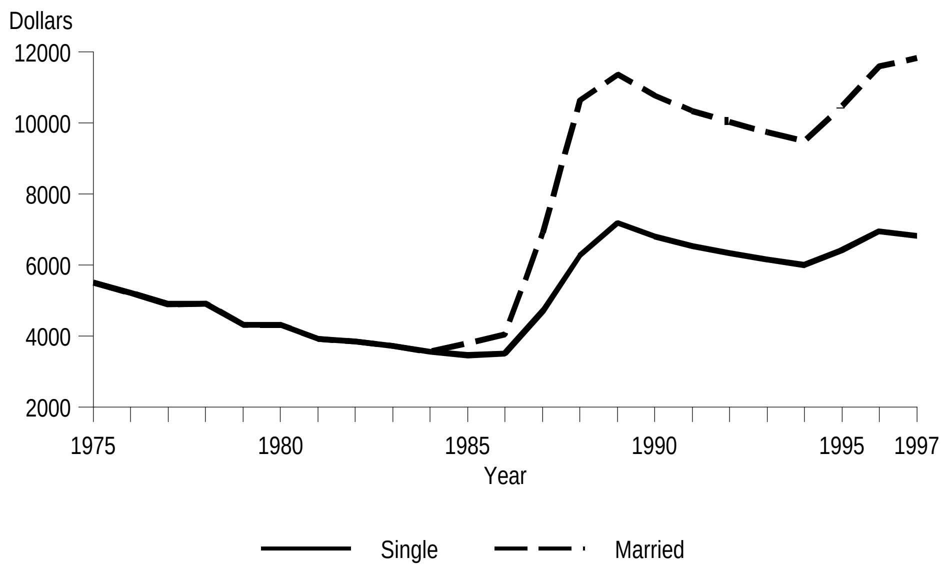
In 1994, New York enacted an earned income credit to provide additional tax relief to low-income and moderate-income taxpayers with earned income. The credit equals a percentage of earned income, up to a maximum amount, and then declines as income increases. (See Table A-4 in Appendix A for detail.) The 1994 legislation originally scheduled the EIC to grow from 7.5 percent of the federal credit in 1994 to 20 percent of the federal credit in 1997. The tax reduction plan enacted in 1995 modified this credit and accelerated the 20 percent rate to become effective in 1996. The credit is refundable. About 84 percent of its total cost to the State represents cash grants to working families.

Standard Deduction

The standard deduction is a fixed deduction available to all taxpayers. It serves several different purposes. First, it provides a minimum tax-free income level for all taxpayers, as a deduction for personal expenses. Second, it serves as a tool to keep many taxpayers off the tax rolls (those with incomes below the threshold). Third, it provides progressive relief to persons on the tax rolls. This results because the standard deduction is a smaller share of total income for taxpayers with higher income levels.[18]

Absent statutory increases or indexing provisions, the standard deduction will, over time, lose value because of inflation. Lawmakers increased the standard deduction under the 1985 tax reduction program and TRARA. For example, lawmakers increased the standard deduction for single taxpayers from $2,500 to $6,000 by 1989. Standard deduction levels remained unchanged until the legislation enacted this year. As a result, between 1989 and 1994, inflation eroded the real value of the standard deduction by nearly 20 percent (see Figure 10). The 1995 legislation increases standard deduction levels significantly as originally anticipated under TRARA. The real values of the standard deduction are even higher than they were in 1989, when they were at their peak.

Figure 10: Standard Deduction in 1994 Dollars - 1985-1997



Source: NYS Department of Taxation and Finance.

Tax Rates

The tax rate schedule, along with the standard deduction and credits, also affects whether or not low-income taxpayers pay taxes. Taxpayers deduct credits after computing their tax liability. Therefore, the lower the bottom rate, the smaller their tax liability, and the greater the likelihood that the taxpayer will owe no taxes after credits. New York's bottom rate was at 4 percent from 1989-1994. The 1995 legislation returns the bottom rate to 4 percent in 1996.

Findings

Historically, New York's personal income tax structure has been one of the most burdensome in the country. Several times in the past 20 years the Legislature attempted to alleviate this burden with statutory tax reduction programs. The most ambitious of the 1980's was the tax reduction program of 1987, passed in the wake of sweeping federal tax reforms.

The 1987 legislation was intended to provide significant tax relief over a five-year period. However, implementation of the 1987 legislation was halted in 1990 after only three of the five years of the plan were completed. As a result, many of the goals of the 1987 plan have not been fully realized. The "freeze," between 1990 to 1994, increased the number of taxpayers on the tax rolls, increased the tax burden on all taxpayers, and hurt New York's competitive position with respect to other states.

The 1995 income tax reduction plan is a significant step forward in reducing income tax burdens in New York. It eliminates the problems caused by delayed implementation of the 1987 plan. It also goes beyond the 1987 program to provide further reductions in the top rate and significant stretching of the income level where the top rate takes effect.

When fully implemented, the 1995 tax relief program will reduce taxpayers' personal income tax by an average of over $300. Over 450,000 taxpayers, most of whom have low incomes, will pay no taxes, or receive tax refunds. Higher income taxpayers will face a top marginal rate that is over one percentage point lower than it was in 1994. In addition, the 1995 tax reduction plan will maintain fairness. Percentage reductions in tax will be largest for the poorest taxpayers.

Economic Climate

The income tax reduction of 1995 reduces the top tax rate from 7.875 percent in 1994 to 6.85 percent in 1997. This results in a top rate, after deduction from federal tax, of 4.137 percent in 1997, down from 4.757 percent in 1994. The 1995 legislation helps to bring New York's top rate in line with those of other states. It reduces New York's rank in terms of top rate from thirteenth in 1994 to twenty-fourth in 1997. As discussed in the previous section, the top rate is an important factor in economic decision-making.

Highly mobile high-income earners are compensated for tax differentials between states, as recent literature on this issue demonstrates. This means high top rates are passed through in terms of higher business costs or wage reductions for lower earning, less mobile workers. Our own research suggests this may, in fact, be the case in New York.

In addition, many small businesses are not corporate taxpayers but organized as S corporations, sole proprietorships, limited liability companies (LLC's) or partnerships. These entities pay personal income taxes on a flow-through basis -- i.e., on the profits shared with owners and partners. Reducing top income tax rates will encourage the formation and retention in New York of such enterprises, which account for a significant fraction of new investment and employment opportunities. As a result, the reduction in top rates enacted in 1995 sends a strong signal to the State's business community that New York policy makers are serious about improving the State's business climate.[19]

To provide some perspective on comparative income tax burdens, Table 6 shows a commonly cited measure of income tax burden -- collections per $1,000 of personal income. While a somewhat crude proxy for measuring tax burden, it does allow for fairly meaningful inter-state comparisons. For fiscal 1992, New York ranked fourth among the states, at $37 per $1,000. This was 59 percent above the all-states average of $22 per $1,000 of personal income.[20]

Table 6: Personal Income Tax Per $1,000 Personal Income

Fiscal Year 1992					
	All States	21.75			
Rank	State	Amount	Rank	State	Amount
1	Oregon	43.26	26	Nebraska	23.13
2	Massachusetts	38.70	27	Indiana	22.86
3	Hawaii	37.72	28	Ohio	22.67
4	**New York**	**36.75**	29	Connecticut	21.78
5	Minnesota	35.38	30	New Jersey	20.59
6	Delaware	35.16	31	Pennsylvania	20.31
7	Idaho	33.61	32	Arizona	19.95
8	Wisconsin	32.62	33	Missouri	19.94
9	North Carolina	31.56	34	New Mexico	19.65
10	Utah	30.18	35	Alabama	19.44
11	Iowa	29.18	36	Illinois	19.15
12	Kentucky	28.93	37	Michigan	18.55
	New York*	**27.88**	38	Kansas	18.24
13	Maine	27.45	39	Louisiana	13.56
14	Maryland	26.96	40	Mississippi	12.73
15	California	26.89	41	North Dakota	12.07
16	Georgia	26.69	42	New Hampshire	2.88
17	Vermont	26.61	43	Tennessee	1.14
18	Virginia	26.31	44	Washington	(X)
19	South Carolina	25.63	45	Florida	(X)
20	Montana	25.37	46	Texas	(X)
21	Rhode Island	24.80	47	South Dakota	(X)
22	Oklahoma	24.69	48	Alaska	(X)
23	Colorado	24.66	49	Nevada	(X)
24	Arkansas	24.50	50	Wyoming	(X)
25	West Virginia	23.79			

Source: U.S. Census Bureau, State Government Tax Collections: 1992
(X) Does not impose tax
*Includes effect of fully phased-in Taxpayer Relief Act of 1995.

Overall, the new law reduces the share of personal income that must be paid in taxes from $37 per $1,000 to $28 per $1,000. This lowers New York's rank, compared with other states, from fourth to twelfth. With a growing number of studies confirming a negative correlation between tax burdens and economic performance, the reductions enacted in 1995 should induce increased economic activity in New York.

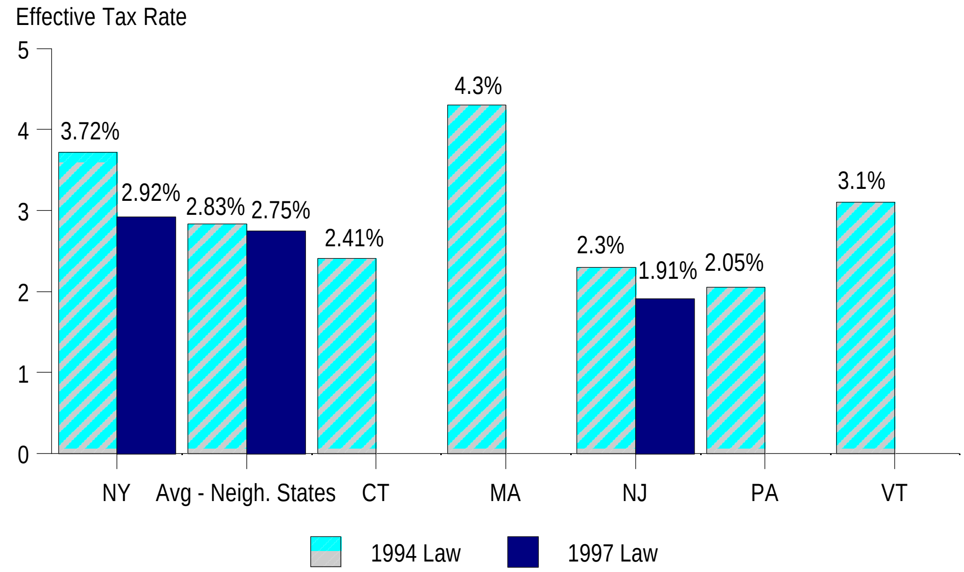
New York's top tax rate on earned income is now higher than all but one of our neighboring states. This will still be the case in 1997. When the 1995 cut is fully effective, New York's top rate will be lower than Vermont's -- with which it has the least direct economic competition -- and higher than those of New Jersey, Pennsylvania, Connecticut and Massachusetts.[21]

The top marginal rate, while a crucial economic consideration, is only one indicator of the personal income tax burden. A more meaningful measure of the overall burden is the effective tax rate, calculated by applying different tax systems to the same groups of taxpayers.

Using such measures, New York's income tax system in 1994 was clearly not competitive with other states, especially those in the immediate region. Using the most recent data on income tax returns, we found that the effective tax rate in New York exceeded the average of our neighboring states by close to a full percentage point (3.72 percent in New York versus 2.83 percent for the average of other state tax laws). The differential was calculated by applying other state tax laws to New York taxpayers. For a hypothetical family of four with income of $50,000, New York's 1994 income tax burden amounted to $1,340 more than New Jersey's, $914 more than Pennsylvania's, and $1,243 more than Connecticut's.

When the tax cut is fully implemented, the differential will be dramatically reduced. The difference in effective tax rates between New York and the average of other state tax laws will be less than a quarter of a percentage point (2.92 percent versus 2.75). This is illustrated in Figure 11 which compares effective tax rates for New York and its neighboring states.

Figure 11: Effective Personal Income Tax Rates - New York and Neighboring States



Source: NYS Department of Taxation and Finance.
Note: New York and New Jersey have scheduled law changes which will reduce 1997 rates.

The 1995 legislation takes a significant step in reducing New York's personal income tax burden. However, unlike the federal system, New York's income tax is not indexed to allow for inflation. As a result, increases in the cost of living will eventually erode the statutory tax reductions enacted in 1995.

Inflation will reduce the tax relief provided by the 1995 legislation by the time it is fully implemented in 1997. Table 2 in the "Background" section of the report illustrates this point. The table shows that the real value of the top tax brackets established for 1995 will have declined by 6 percent when they go into effect.

Over the past several decades, the New York tax structure has exhibited significant progressivity.[22] As income increases, effective tax rates increase. Prior to 1987, this was accomplished with a steeply graduated rate structure featuring a large number of tax brackets. Since 1987, the number of tax brackets has been reduced, but progressivity has been preserved through the enactment of large standard deductions. The income tax structure, as amended by the 1995 tax changes, retains this feature of the personal income tax while reducing tax burdens for all taxpayers. The poorest taxpayers, who were carrying little or no income tax burden to begin with, will now receive larger net refunds and credits from the State.

The 1995 actions maintain the progressivity of the tax, in part, by retaining low-income provisions that were scheduled to expire under 1987 law. It provides a markedly larger tax cut than previously scheduled, particularly for middle-income taxpayers. This results mainly from the stretching of tax brackets, retention of lower tax rates, and increases in the standard deduction amounts.

By 1997, the enacted tax program will reduce the average effective tax rates of all income groups by between 0.5 and 0.9 percent of their income. Overall, the average effective tax rate reduction is larger for higher income groups. This result occurs because the proportion of households paying the personal income tax rises with income. Most taxpayers in the lower income groups have zero or negative tax liability.[23] In contrast, the majority of taxpayers in higher income groups pay personal income taxes.

Table 7 shows the percentage of the total tax paid by quintile -- i.e., taxpayers, distributed by income into one-fifth segments of the whole. The columns of the table refer to different tax regimes. The base for comparison was tax law in effect in 1994. This was compared to the fully implemented Taxpayer Relief Act and the Governor's original budget proposal. The table reports the percentage of total tax liability accounted for by a quintile. Poor taxpayers may actually owe no tax and receive refundable credits. This means a quintile may show a 'negative' share.

Table 7: Distribution of New York State Personal Income Tax Under Base Law (1994), Enacted Plan (1997) and Original Governor's Plan (1998)

		1994 Base Law	1997 Enacted Plan	1998 Governor's Plan
Quintile	Expanded AGI Range**	Percent of Total	Percent of Total	Percent of Total
First	Under $10,462	-0.13%	-0.68%	-1.62%
Second	$10,462 - $18,301	0.61%	-0.62%	-2.09%
Third	$18,302 - $30,161	4.95%	3.49%	2.10%
Fourth	$30,162 - $51,641	16.83%	15.74%	15.35%
Fifth	Over $51,641	77.73%	82.07%	86.26%
Total		100.00%	100.00%	100.00%

* Based on 1992 income data.
** Expanded AGI includes such items as nontaxable compensation (fringe benefits) and certain nontaxable transfers (welfare, workers compensation).
***Includes taxpayers with negative tax liabilities due to refundable credits.

Under the tax structures compared in this table the Governor's original plan was the most progressive. The wealthy contribute the largest share of tax under the Governor's plan while the bottom two quintiles actually receive the largest tax rebates. The Taxpayer Relief Act of 1995 improves progessivity over 1994 law. The most well off pay a higher percentage share of tax than under 1994 law while the poorest taxpayers are better off under the 1995 changes.

In addition, the share of tax paid by the 5 percent of the population with the highest incomes (which roughly includes all those earning more than $100,000 in current dollars) will rise significantly due to the 1995 law changes. With 1994 law these taxpayers accounted for 18.5 percent of tax paid, compared to 19.8 under fully implemented 1995 law. If the Governor's original proposal had been enacted, the share of tax paid by the top 5 percent would have increased to 22.9 percent.

Figure 12 shows that the percentage reduction in tax is greatest for the poorest segments of the population. The lowest-earning 20 percent will save on the order of 300 percent. The percentage reductions decline for higher income groups. The top one-fifth of income earners receive a tax cut of approximately 25 percent.

Figure 12: Tax Savings Resulting from Adopted Tax Plan - Comparison of 1997 to 1994

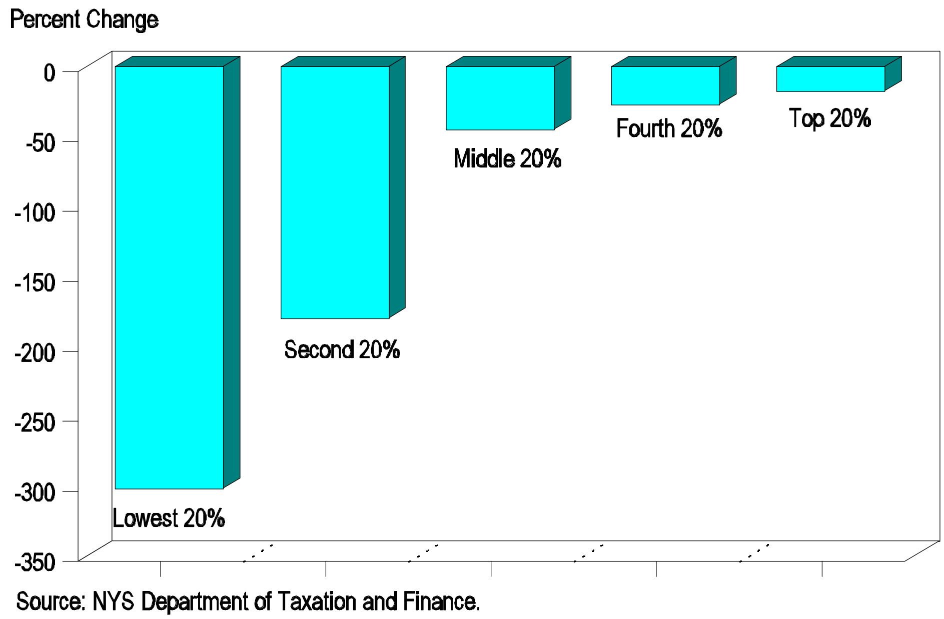


Table 8 compares effective rates in New York, neighboring states and at the federal level for two years -- 1994 and 1997. To reduce ambiguity in comparisons, the income tax laws of other states were applied to New York taxpayers. The results show New York was clearly out of line with its neighboring states in terms of middle and upper income effective tax rates under 1994 law. For the top 60 percent of income earners, New York imposed a higher effective tax rate than all other states except Massachusetts. New York, in 1994, was competitive only in low-income categories, where the average tax burden was insignificant.

Table 8: Effective Personal Income Tax Rates

New York and Neighboring States

1994 Tax Laws

Quintile	First	Second	Third	Fourth	Fifth	Total
Expanded AGI Range	Under $10,462	$10,462-$18,301	$18,302 - $30,161	$30,162 - $51,641	Over $51,641	
New York: 1994 Law	-0.17%	0.31%	1.54%	3.11%	5.02%	3.72%
Connecticut	0.00%	0.06%	0.57%	1.74%	3.44%	2.41%
Federal	-1.35%	1.28%	5.47%	9.72%	15.77%	12.82%
Massachusetts	1.88%	1.86%	2.96%	3.95%	5.13%	4.30%
New Jersey	0.34%	0.38%	0.80%	1.35%	3.29%	2.30%
Pennsylvania	0.67%	1.02%	1.66%	2.11%	2.30%	2.05%
Vermont	-0.27%	0.20%	1.27%	2.41%	4.25%	3.10%
New York - 1997	-0.69%	-0.25%	0.85%	2.28%	4.15%	2.92%
New Jersey - 1996	0.25%	0.23%	0.53%	0.96%	2.83%	1.91%

In 1997, when the current structure is fully implemented, New York will have the lowest effective rate for taxpayers in the bottom two quintiles of the income distribution for the tax laws examined. New York's effective tax rate will fall below the average of the neighboring states for the bottom four income groups. Nonetheless, New York law would still impose a relatively high effective rate on the most mobile taxpayers, those in the top one-fifth, who pay the largest share of taxes and whose economic decisions have the greatest bearing on overall growth and job creation. Only Massachusetts' income tax would yield a higher effective rate for those in the top one-fifth of the income distribution.

Table 8 also indicates that all of the states impose progressive income tax structures, though to varying degrees. Under both 1994 and 1997 laws, New York's income tax structure is generally more progressive than those in neighboring states (also see Figure 11).

The appendix to this report provides more detail on the progressivity of the tax structure. In addition, there is a full discussion of the provisions of the income tax structure that affect low-income taxpayers, and a detailed analysis of the way these provisions are affected by the 1995 tax reduction program.

Low Income Tax Relief

The new law contains several provisions that significantly benefit low-income taxpayers. These provisions also work to increase the progressivity of the tax. For low-income households, these provisions will make New York the most favorable state in the region, in terms of income tax. By 1997, almost half of all taxpayers will either pay no taxes or receive tax refunds. Over 90 percent of the lowest quintile of taxpayers in the State will either pay no taxes or receive tax refunds by 1997.

One of the goals of the new legislation was to eliminate the scheduled tax increases that would have affected many low-income taxpayers. Another goal was to provide tax relief to moderate-income taxpayers, who would not have benefitted significantly from the scheduled changes. The income tax reduction program of 1995 accomplished these goals by retaining the provisions that benefitted low- to moderate-income taxpayers in 1994. Some of these provisions, such as the household credit and the bottom rate of 4 percent, would have been eliminated by 1997 under the previous law. The enacted program also implemented the scheduled tax changes that would have benefitted low-income taxpayers. These provisions include the increase in the standard deduction amounts and the rise in the EIC. These provisions, and the impact of the 1995 tax reduction plan on them, are discussed in more detail in Appendix A.

Endnotes

1. The top tax rate reached 15 percent by 1969, but a temporary 2.5 percent surcharge increased the top rate to 15.375 percent for the years 1972, 1975 and 1976.

2. The top rates would have fallen in 1987, to 9 percent for earned income and 13 percent for unearned income. However, this was replaced by subsequent legislation.

3. Revenue elasticity is defined as the percentage increase (decrease) in tax revenue for a one percent increase (decrease) in income.

4. For example, under 1994 law, the tax before credit for a single taxpayer taking a standard deduction with $25,000 of income is $1,138. If that taxpayer marries an individual with no income, that taxpayer's tax liability would be reduced to $665. See H. Rosen, "The Marriage Tax Is Down But Not Out," *National Tax Journal* 40 (December 1987) for a discussion and examples of marriage penalties and marriage subsidies.

5. The limitation excludes medical expenses, casualty and theft losses, investment interest, and gambling losses.

6. For a thorough review of the literature, see T. Bartik, *Who Benefits From State and Local Economic Development Policies?* (Kalamazoo, Michigan, W.E. Upjohn Institute, 1991). Most research has focused on aggregate business tax variables, such as after-tax rates of return or overall tax burden levels. However, personal income tax burdens have received more attention recently.

   More recently, in "Taxes and Local Economic Development: What Do We Know and What Can We Know?," *National Tax Journal Proceedings of the 87th Conference on Taxation* (1994), Bartik reports that 70 percent of the studies he reviewed (75 in all) contained at least one tax variable which indicated a negative relationship between taxes and economic development.

7. See, for example, M. Feldstein and M. Vaillant, *Can State Taxes Redistribute Income?* (Cambridge, Mass., NBER Working Paper No. 4785, June 1994).

8. Research being conducted by the Office of Tax Policy Analysis suggests that, even after controlling for differences in productivity across states, tax differentials account for a portion of wage differentials across states.

9. As measured by the proportion of total New York allocated business receipts reported on tax returns attributable to New York's S corporations and unincorporated firms.

10. D. Birch, *The Job Generation Process*, MIT Program on Neighborhood and Regional Change, Cambridge, Massachusetts, 1979.

11. Until 1982, the federal income tax imposed a higher top rate on unearned income than on earned income, 70 percent versus 50 percent. Likewise, New York imposed higher rates on unearned income between 1978 and 1988.

12. At this time, Delaware had a higher statutory top rate, but allowed for deductibility of federal taxes, significantly reducing the effective rate of the tax.

13. This statement is based on the assumption that the other states do not reduce their top tax rate from what is currently in law.

14. Note that seven states have no personal income tax.

15. If taxpayers, by altering their behavior, can shift taxes imposed on them to others, then the legal incidence of the tax is not reflective of who actually bears the burden. If wealthy income earners can shift incidence of the income tax to lower-income taxpayers by virtue of their greater mobility, this mutes the power of state tax systems to construct progressive tax structures.

16. For a detailed discussion of progressivity and the rationale for a progressive system, see R.A. Musgrave and P. B. Musgrave, *Public Finance in Theory and Practice* (New York, N.Y.: Mcgraw-Hill, 1973); A. B. Atkinson and J. E. Stiglitz, *Lectures on Public Economics* (London: McGraw-Hill, 1980); and J. B. Slemrod, ed., *Tax Progressivity and Income Inequality* (New York, N. Y.: Cambridge University Press, 1994).

17. Quintiles in this context take the population of taxpayers (including those with zero tax) and divide them into equal groups of twenty percent each based on income. The 20 percent of the population with the lowest incomes are found in the first quintile. The 20 percent with the highest income are in the fifth quintile. This method of dividing a population into equal groups based on incomes and comparing tax burdens is common in the analysis of progressivity. The measure of effective tax rates in this analysis uses “expanded income” as the denominator. Expanded income equals federal adjusted gross income plus certain components either not taxed or not reported on tax returns. These include, for example, transfer payments, certain fringe benefits, and tax-exempt interest. Expanded income also includes the income of persons not required to file tax returns. Appendix B provides a more detailed discussion of the concept and its measurement.

18. This progressivity effect is partly offset by the fact that the standard deduction’s value is higher for taxpayers in higher tax brackets. However, as income increases, taxpayers are more likely to itemize deductions and therefore less likely to benefit from the standard deduction.

19. Economist Stephen Kagann has projected that the tax cut will result in the creation of 200,000 additional jobs over the next few years. See Public Policy Institute, “The 1995 Taxpayers’ Guide to the New York State Budget,” (August, 1995), pp. 6-8.

20. It bears noting here that this measure of income tax burden differs from other measures used in this report. It relates tax *collection*s (which include the effects of refunds, overpayments, and audits) to personal income, whereas the other measures relate tax *liability* to either adjusted gross income or to expanded income. In general, personal income represents a broader and thus larger income measurement.

21. Massachusetts has a top rate on unearned income of 12 percent. However, Massachusetts provides beneficial tax treatment for capital gains. The benefit increases with the holding period. This treatment is not reflected in our comparisons. Further, Massachusetts limits property tax increases. As a result, the income tax has become a more important revenue source in recent years.

22. Readers are referred to Appendix B for detailed descriptions of the terms used and for a full explanation of data sources and construction.

23. Some taxpayers have negative tax liability because of refundable credits, such as the earned income credit.