

FISCAL POLICY INSTITUTE

11 Park Place, Suite 701, New York, NY 10007
212-721-5624 www.fiscalpolicy.org

Testimony of
James A. Parrott
Deputy Director and Chief Economist
Fiscal Policy Institute

Before the

Senate Select Committee on Budget and Tax Reform

Public Hearing on New York State's Business and Banking Tax Structures and Their Effectiveness to Foster Economic Growth Statewide

May 21, 2009

My name is James Parrott, Deputy Director and Chief Economist of the Fiscal Policy Institute. Thank you for the opportunity to testify today.

1. The State & Local Tax Burden, Business Taxes and Economic Growth

New York's trillion-dollar economy has substantial potential as a dynamic, innovative, internationally oriented economy that richly rewards all New Yorkers. Our state is among the most highly educated in the country, with 31 percent of the adult population aged 25 and over having a 4-year college or advanced degree. New York's workforce is also highly diverse in terms of its racial and ethnic composition and it has one of the largest and most varied immigrant populations among the states. New York has a significant productivity edge over the national average and is the most productive among large state with diverse economies.¹ The state's many colleges, universities, and research facilities give it a solid technological infrastructure. New York also has the advantage of ranking very high among states for its efficient natural resource use.

Given that the subject of this hearing deals with the relationship of business tax structures to economic growth, I would urge caution in evaluating frequently voiced concerns about

New York's high tax burden. Too often, any tax is simplistically equated with a "cost" to business, and more over, a "cost" that is not associated with anything essential to the production of goods and services.

This is not to say that costs are not important, but to stress that New York needs to provide very good value for businesses, in terms of a quality workforce and in terms of the public infrastructure and services needed to sustain high value production. Too often, commentators invoke a mantra that "taxes are too high" and a hindrance to "competitiveness" without regard to the investments in infrastructure, human capital, or public services that taxes help make possible.²

CFED, a national economic development organization, argues that "measuring the standard of living and working in a state and how well the state is building foundations for future growth is just as important as how hospitable that state is to businesses." In the preface to its Development Report Card for the States, CFED writes:

Economic development is a complicated thing, but fundamentally, it should strive to serve the needs of everyone in a community. It certainly includes providing an environment in which companies can thrive, but that should not be the exclusive goal. ... [B]ecause at the end of the day, businesses share the same needs as their employees, suppliers, and customers. Both businesses and individuals benefit from dependable infrastructure, good schools, a healthy environment, a good quality of life, accountable and transparent government, financial security for households, and a lack of strong divisions across, for instance, class and race."³

Also, analyses that emphasize business cost or business climate measures often ignore the value side of the equation, failing to look at the *value of production* that a given set of costs make possible. For example, one measure often cited by the Business Council of New York is the Milken Institute Cost-of-Doing Business Index. In the 2007 Milken index, New York ranks second highest overall in the cost of doing business. However, this ranking is largely based on New York's high average wages (second highest in the country after Connecticut) and high office rents (highest among all states).

What does this actually tell us? New York's wages and salaries are high because the skills of the workforce and the productivity of our workers are both very high. Office rents are high because there are considerable economies from the dense concentration of activity in New York City. To be meaningful, costs should be related to the value of the production that the high costs make possible.

It is important to point out that, using U.S. Commerce Department data for 2007, New York has the highest value added per worker among the large states with diversified economies and, depending on how measured, the average New York worker is 15 to 37 percent more productive than the national average. In 14 of 18 major sectors, New York ranks first or second among the ten largest states in value added per worker.⁴

Sometimes analysts too readily rely on crude indicators of the total New York state and local tax burden or of various “business climate” rankings rather than looking at how typical businesses are affected by state and local taxes. For example, in its report prepared at the beginning of 2007 for the Spitzer administration’s economic development team, management consulting firm A.T. Kearney cites New York’s state and local tax burden as the first item under “exorbitant cost of doing business”.⁵

Yet, in a study for the Citizens Budget Commission, economist Don Boyd found that while businesses operating in New York City had higher effective federal-state-local tax rates than like businesses in six other neighboring and “competing” states, businesses operating upstate had the *lowest* effective federal-state-local tax burdens compared to large cities in the six other states considered (California, Connecticut, Florida, Massachusetts, New Jersey, and Texas).⁶ Boyd’s study factored in state and local corporate income taxes, sales taxes on business purchases, property taxes, unemployment insurance taxes, and the federal corporate income tax. He also considered the deductibility of state and local taxes against the federal corporate income tax. He simulated comparative effective tax burdens and rates of return for 11 industries.

Even before the current “Great Recession,” New York was facing several critical economic challenges. The manufacturing-dependent upstate economy has been lagging, the overall quality of jobs offered in the state has deteriorated, and the growth in wages has not kept pace with the growth in productivity. This fact has contributed to the widest gap between the rich and the poor and between the rich and the middle class among the 50 states.⁷ One of the most disturbing trends has been the increase in the number and percent of workers misclassified as independent contractors, a status that thrusts workers back to the 19th century without the protection of social insurance programs or employment rights established over the past several decades. While the overall poverty rate today is about the same as it was in the early 1990s, the number of families with a worker but who remain mired in poverty has risen by 75 percent since the early 1990s.⁸

Too often, like many other states, we have succumbed to the hue and cry for business “incentives” and have created a plethora of tax expenditures ostensibly designed to attract and retain businesses. In 2007, the state spent roughly \$3.7 billion in tax expenditures in the name of economic development.⁹ When you add in local property and other tax breaks granted by Industrial Development Agencies, the total easily exceeds \$4 billion annually. Adding at least \$1.7 billion in local New York City tax breaks for economic development under the Industrial and Commercial Incentive program and other programs, the statewide total is in the \$6 billion ballpark.¹⁰ When a close look is taken at the efficacy of these economic development tax expenditures—such as in the A. T. Kearney analysis of the Empire Zones Program, the audits of IDA programs by the State Comptroller’s Office, or in the New York City Economic Development Corporation’s 2007 analysis of the Industrial and Commercial Incentive Program—taxpayers are certainly justified in asking whether public officials are being prudent managers of limited public resources.

In New York City, the economic development focus has been almost exclusively on real estate development, with the result that government actions tremendously boost the value of real estate but we do not necessarily get good jobs in return. The City practices schizophrenic development: government intervenes in the real estate market in various ways that enrich property owners and developers, but refuses to set labor standards on the grounds that it would be interfering in the market.

We need to seriously rethink economic development in New York. The overriding priority should be to focus clearly and more effectively on the objective of providing good jobs and more opportunities for New Yorkers and building strong, vibrant communities. Economic development assistance should be targeted to investments in the human capital of our workers whose productivity determines the competitiveness of our economy. The state must work to make jobs better and vigorously enforce and improve labor and employment standards to deter companies pursuing a “race to the bottom” economically.

We also need to redirect the hundreds of millions of dollars the state foregoes in tax expenditures, and more effectively coordinate state and local efforts in pursuit of a sensible statewide economic strategy. Finally, New York should work with its neighboring states to defuse the negative sum, “economic war among the states” and New York should seek opportunities to work with other states on regional infrastructure development.¹¹

2. Single Sales Factor—Need for Throwback or a Throwout Rule

Despite a dubious economic development record, the Single Sales Factor (SSF) method for the apportionment of multi-state corporate income was adopted by New York State in 2005. Its three-year phase-in was accelerated by a year in 2007. Summing up his extensive review of the research on the Single Sales Factor method, Michael Mazerov of the Center on Budget and Policy Priorities concludes: “states adopting a single sales factor apportionment formula are likely to find it a relatively ineffectual incentive for job creation and investment.”¹²

The SSF approach to corporate taxation opens the possibility that some portion of a corporation’s profit will go untaxed because some states do not have levy their business income taxes based on sales. This untaxed profit is known as “nowhere income”. The possibility of “nowhere income” opens up the potential for tax-averse companies to organize their businesses to maximize nowhere income and minimize the state taxes they owe.

Recognizing this, legal experts seeking to establish a uniform and fair system of corporate state-level taxation have long recommended the inclusion of “throwback” or “throwout” rules.¹³ Under a “throwback” rule, sales made in states or to the federal government that are not otherwise subject to state taxation are “thrown back” into the

state of origin for tax purposes. A “throwout” rule is a variation that excludes nowhere sales from entering into the sales-based apportionment calculation.

About half the states, including New York, have *not* adopted a throwback or throwout rule. This is one of the reasons that the corporate income tax share of state revenues has declined in many states.

3. Revamping New York's Investment Tax Credit

New York's Investment Tax Credit (ITC) is so generous that many large corporations pay only a nominal amount in corporate income taxes. Routinely, many companies can use only a portion of the ITC and end up paying the state's alternative minimum tax. But they are allowed to carry forward unused credits for up to ten years. For 2005, the total amount of ITC benefits carried forward was \$1.4 billion. This means that large companies could stop reinvesting in New York altogether and would still be able to reduce their tax liability to the legal minimum or close to it for another decade.

At the same time, we have seen the emergence in New York in this decade of a gap between the growth in productivity and the growth in wages. The ITC could be changed to, in part, address this gap. The ITC should be modified to reduce the amount of credits provided without any requirement for job creation or retention, and increasing the amount of credits that can be earned through job creation and retention. For example, the five percent ITC could be linked to job growth and reduced in value in the first year along with increasing the value of the credit under the Employment Incentive Credit in subsequent years, with the credit directly linked to job retention and creation. The enhanced Employment Incentive Credit would replace the ability to carry forward ITC credits independent of employment levels.

4. Adjust taxation of unincorporated businesses to reflect changes within the financial sector and the increasing use of LLC status

One of the ways in which New York's tax structure has not kept pace with economic and other changes is in the area of unincorporated businesses. Typically, people tend to think that the universe of unincorporated businesses is dominated by small businesses, the self-employed, sole proprietorships, and fledgling partnerships. Numerically, that might be the case. But in New York State there are a very large number of very large unincorporated businesses with substantial receipts and business income. In New York City, which does tax the business income of unincorporated businesses, Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs) paid \$800 million in taxes in 2005, nearly three fourths of the total unincorporated business tax liability, and an amount equal to 40 percent of the total collected under the City's General Corporation Tax.¹⁴

Within the finance sector, the role played by private equity and hedge funds has increased dramatically in recent years. These entities typically are organized as LLCs or LLPs, and to some extent, the strong growth in the City's UBT liability in recent years stemmed from LLCs and LLPs in the finance sector. Eleven of the world's largest private equity firms are headquartered in the city. Thirteen of the world's top 50 performing hedge funds are based in New York City.¹⁵

Large LLCs and other business partnerships benefit from state public services and from state laws that grant them special legal advantages not available to other forms of businesses.¹⁶ The State should seek to tax appropriately these large business entities. New York City's 7,600 LLCs and LLPs had combined taxable income in New York City in 2005 of \$20 billion, which works out to an average of \$2.6 million in business income per entity. These are not small businesses. Yet, the State has gone in the other direction in terms of appropriately taxing these large businesses. Obviously, since New York City already imposes a four percent business income tax on unincorporated businesses, there are limits to how much the State could tax such entities. But the current state fee structure is extremely nominal.

The State should consider action in three areas involving unincorporated businesses.

A. Increasing filing fees for large LLCs and other partnership entities.

In 2003, the maximum Limited Liability Company (LLC) filing fee was increased from \$10,000 to \$25,000. Initially authorized for two years and then extended for two more, the higher maximum was in effect for tax years 2003-2006. The fee structure was still on the member basis at this point. Filing fee collections, which are paid as part of New York State's Personal Income Tax, increased from \$26.5 million in 2002 to an average of about \$72 million for 2003-2006.

In 2008, however, the member basis was replaced with a fixed fee structure and the maximum lowered to \$4,500, even for entities with New York source gross income of \$25 million or more. (The same fee structure applies to the fixed dollar *minimum* tax for S and C corporations.)

In 2009, filing fees were established for non-LLC general partnerships on the same fee structure as for LLCs. The revenue projection for this change was estimated by the State Tax and Finance Department at \$50 million.

The State should consider restoring the \$25,000 maximum filing fee and have it apply to both LLCs and general partnerships over some very high business receipts or income threshold. An alternative would be to add one or more additional brackets at the top end of the graduated fee structure. Given the number and size of such entities in New York, such a change might generate \$50 million to \$100 million in additional revenue.

B. Taxing Nonresident Hedge Fund Management Fees

In his 2010 Executive Budget proposal, the governor proposed to “expand the nonresident personal income tax to include income received from hedge fund management fees.” The revenue impact was estimated at \$60 million. This was not included in the enacted budget but should be considered. As the governor’s proposal explained, “Currently, only a small portion of such income is taxed as compensation, with the remainder deemed tax-free capital gains. This proposal would result in equal treatment of this income for residents and nonresidents.”¹⁷

C. Eliminating the Carried Interest Exemption under New York City’s Unincorporated Business Tax

While not a state revenue item, it would be important in helping New York City to close its Fiscal Year 2010 budget for the State Legislature to eliminate the carried interest exemption loophole in the City’s Unincorporated Business Tax. This would put the taxation of private equity and hedge funds on the same footing as that of thousands of smaller businesses. The City taxes the fees received by managing partners in private equity and hedge funds but exempts “carried interest” from taxation. Carried interest refers to the profit share received by managing partners, usually 20 percent of the profits generated by the pooled investment of the limited partners.¹⁸

In his Executive Budget for FY 2010, the Mayor has proposed generating over \$900 million by increasing the city sales tax rate by half a percent and by eliminating the sales tax exemption for clothing and footwear. This proposal is extremely regressive, and would impose an effective tax burden on low- and moderate-income households that is twice that for high-income households. Eliminating the carried interest exemption is needed on tax equity grounds but it would also help the City avoid or at least lessen its reliance on extremely regressive taxes. While any estimate of the possible yield of such a change is very rough, eliminating the carried interest exemption could generate upwards of \$50 million annually.

Thank you for the opportunity to testify today.

Endnotes

¹ Fiscal Policy Institute, *The State of Working New York 2007: Encouraging Recent Gains but Troubling Long-Term Trends*, September, 2007, pp. 32-33.

² Robert G. Lynch, "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development," Economic Policy Institute, 2004.

³ CFED, "Economic Development: Of the People, By the People, For the People," <http://www.cfed.org/focus.m?parentid=2346&siteid=2346&id=2406>.

⁴ U.S. Department of Commerce, Bureau of Economic Analysis, Gross Domestic Product by State, 2007. Analysis by the Fiscal Policy Institute.

⁵ The A.T. Kearney report also cites the "Economic Freedom Index," prepared by the Pacific Research Institute. In his study, *Grading Places: What Do the Business Climate Rankings Really Tell Us?*, economist Peter Fisher concludes: "The Economic Freedom Index is a sometimes bizarre collection of policies and laws libertarians love, or love to hate, but few have any plausible connection to a state's economic potential." Peter Fisher, *Grading Places*, Economic Policy Institute, 2005.

⁶ Donald J. Boyd, "A Simulation of Business Taxes in New York City and Other Locations," Final Technical Report, Prepared for the Citizens Budget Commission, June 2, 2007.

⁷ See *The State of Working New York 2007*.

⁸ See *The State of Working New York 2007*, p. 27/

⁹ New York State Division of the Budget and Department of Taxation and Finance, *Annual Report on New York State Tax Expenditures, 2007-2008*.

¹⁰ The New York City total includes local property and sales tax breaks provided granted by the New York City Industrial Development Agency, the Urban Development Corporation and the Battery Park City Authority. City of New York, Department of Finance, Office of Tax Policy, *Annual Report on Tax Expenditures, FY 2007*, August 2007.

http://www.nyc.gov/html/dof/html/pdf/07pdf/ter-2007_final_rev_9-5-07.pdf

¹¹ See the classic essay, "Congress Should End the Economic War among the States" by Melvin L. Burstein and Arthur J. Rolnick in the 1994 Annual Report of the Federal Reserve Bank of Minneapolis, <http://minneapolisfed.org/pubs/ar/ar1994.cfm>. At the time, Burstein was executive vice president and general counsel and Rolnick was senior vice president and director of research at the Minneapolis Federal Reserve.

¹² Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes. A Boon to Economic Development or a Costly Giveaway?* Washington, D.C.: Center on Budget and Policy Priorities, 2001, revised September, 2005.

¹³ Institute on Taxation and Economic Policy, "*Nowhere Income*" and the Throwback Rule, Policy Brief # 38, 2008.

¹⁴ The amount of UBT taxes paid by LLPs and LLCs exceeded the total bank tax collections for that year. See, City of New York, Department of Finance, Office of Tax Policy, *Statistical Profiles of New York City Business Income Taxes, Tax Year 2005*.

¹⁵ Fiscal Policy Institute, *Re-thinking the New York City Business Tax Treatment of Private Equity Fund and Hedge Fund "Carried Interest,"* April 15, 2008.

¹⁶ Michael Mazerov, *Reforming the Tax Treatment of S-Corporations and Limited Liability Companies Can Help State Finance Public Services*, Center on Budget and Policy Priorities, April 8, 2009.

¹⁷ Governor David Paterson, *2009-10 New York State Executive Budget*, p. 127.

¹⁸ Fiscal Policy Institute, *Re-thinking the New York City Business Tax Treatment of Private Equity Fund and Hedge Fund "Carried Interest,"* April 15, 2008.