PUBLIC POLICY INSTITUTE

It Didn't Work The Last Time

The last time New York faced a recession, we raised taxes and delayed tax cuts. That prolonged our recession—but it didn't do much for state revenues.

New York State's economy is weak. The September 11 devastation at the World Trade Center, combined with an already noticeable decline in manufacturing and other sectors, resulted in the loss of 51,000 private-sector jobs over the year ending this October. For the first time in a year or more, employment trends in the state are lagging the nation's.

The softness in the economy is affecting tax revenues collected in Albany. Governor Pataki announced in November that tax collections for the second quarter of this fiscal year were $1.3 billion less than those for the same period a year ago. While the Budget Division still expects to end the current fiscal year with a $1 billion surplus, concerns about a potential shortfall in 2002-03 have led the Governor to announce refinancing of state debt, a partial hiring freeze and other budget-balancing steps.

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Some voices—an editorial page here, a spending lobby there—are already calling for new taxes or the deferral of tax reductions that are scheduled to occur in 2002.

But that would only make our fundamental problem—the weakness in our economy—even worse. For the evidence, we have only to examine the last time New York postponed tax cuts that were badly needed.

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THE TAX CUTS

Among the tax cuts taking effect in 2002:

- **Reduction in GRT on electricity for residential, commercial and nonprofit customers.**
- **Reduction in excise tax on transmission and distribution of gas and electricity for residential, commercial and nonprofit customers.**
- **Reduction in state and local sales tax on transmission and distribution of gas or electricity.**
- **Reduction in bank and insurance tax rates to match general corporate tax rate.**
- **Expansion of personal income tax credit/ deduction for college tuition.**
- **Increase in standard deduction for married couples.**
- **Increase in earned income tax credit.**
- **New credit for 10 percent of cost of long-term care insurance.**
- **Reduction in petroleum business tax on commercial heating fuels.**

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A bit of history

In 1986, President Reagan and Congress enacted a major reform of the federal income tax. They cut rates sharply but applied those rates to a broader range of income by eliminating numerous tax credits and deductions.

New York State's income tax is based largely on the federal tax. Elimination of federal credits and deductions meant that Albany would collect a tax windfall, because New York taxpayers would pay the same state tax rates on a newly broadened taxable income. To avoid such an unfair outcome, and to continue a drive for tax competitiveness that had begun under Governors Wilson and Carey, Governor Cuomo and the Legislature enacted a multi-year tax reduction law in 1987. The legislation reduced the top personal tax rate from 8.75 to 7 percent, among other changes.

In 1989, however, the state's economy faltered, and tax collections in Albany weakened. In crafting the state's 1990 budget, Governor Cuomo and the Legislature reacted as some voices are suggesting Governor Pataki and the Legislature should act today: Deferring scheduled tax cuts, and raising other taxes. The rate reductions that were supposed to take effect in 1990 were postponed, and a "temporary" business tax surcharge of 15 percent was imposed in an effort to produce more tax revenue.

The scheme to boost revenue by raising taxes had negative results for New York's economy–and thus, ironically, for the state's own finances.

The scheme to boost revenue by raising taxes had negative results for New York's economy—and thus, ironically, for the state's own finances. What had begun as a relatively mild downturn turned into the worst employment disaster since the Great Depression—nearly 275,000 private-sector jobs eliminated in 1991, and another 80,000 the following year. The Empire State continued losing valuable jobs more than a year after most other states were on the rebound; companies investing in the recovery simply put more of their growth in states that had not raised the cost of doing business during the recession.

The economic damage inflicted by the 1990 tax increases, including deferral of scheduled tax reductions, was one of the reasons that year's tax collections ended up more than $130 million *below* the previous year's total on a cash basis. (On an accrual basis, the increase was a fraction of 1 percent.)

Even worse, the broken promises of 1990 seemed to make it easier for state leaders to repeatedly ignore their commitment to taxpayers. The personal-income tax cuts that had been planned for 1990 were delayed again in 1991, yet again in 1992, and still again in 1993 and 1994. The damage to New York State's credibility in the marketplace was substantial.

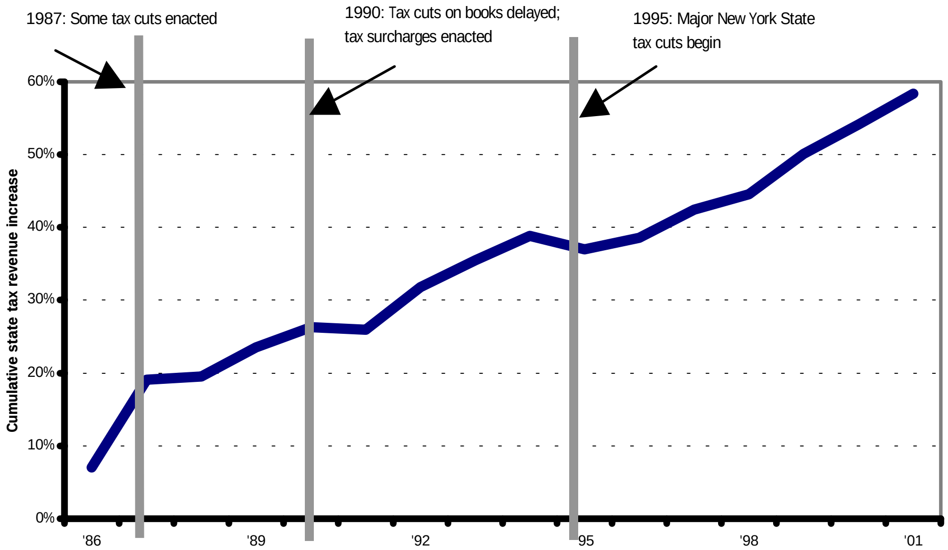
A new era

In 1994, New York began a new era of cutting taxes. The scheduled phase-out of the corporate tax surcharge finally went ahead, and a reduction in the alternative minimum tax significantly increased the incentive for manufacturers to invest capital and create jobs in the state.

Governor Pataki's dramatic reductions in personal income taxes, begun in 1995, fulfilled the promise of the 1987 law and went significantly further. For seven straight years, the Governor and the Legislature cut taxes. Rather than lead-

Tax Revenue Growth for NYS, 1986-2001

Source: Office of the State Comptroller



Tax cuts have been followed by robust revenue growth.
But the 1990 delay in tax cuts (and tax increase) did not do much for revenues.

ing the nation in tax increases, New York became the Number One tax-cutter year after year.

The tax cuts paid off. Newly energized businesses created jobs by the hundreds of thousands. After trailing far behind other states for years, the Empire State's job-growth rate started catching up—and jumped ahead of the national average in 1999, and again in 2000.

The burgeoning economy created both high-paying jobs for highly skilled individuals, and entry-level positions for those just starting their way up the ladder. Poverty fell sharply—from 16.6 percent in 1996 to 13.8 percent in 2000. The numbers represented dramatically better lives for tens of thousands of lower-income New Yorkers.

In a virtuous cycle, the economic growth that had been brought about partly by lower taxes produced ever-greater revenue for important state services. Governor Pataki and the Legislature were able to provide record increases in state aid to education, and major new funding for social services, even while setting aside billions in reserve funds and winning higher credit ratings for state borrowing. They also continued to cut taxes.

Tax cuts previously enacted and scheduled to take effect in 2002 include reductions in taxes on commercial and residential utility customers, necessary to help bring down our high energy costs. (In 2000, energy utilities began paying tax on their corporate income as well as their gross receipts; without the scheduled tax reductions, taxes on some utility operations could actually be higher than they

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As they cut taxes, Governor Pataki and the Legislature were able to provide record increases in state aid to education, and major new funding for social services, even while setting aside billions in reserve funds.

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A Special Report:

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were several years ago.) Other scheduled tax cuts include reduction of the bank and insurance tax rates, expansion of the earned income tax credit and the deduction for college tuition, and a reduction in the marriage tax penalty.

Will we go back—or forge ahead?

Given the normal ups and downs of the national economy, it's no surprise that the boom years could not go on forever. Most economists are forecasting better times within the coming year, though.

There is every reason to believe that New York will share in whatever new growth takes place in 2002. Thanks to the tax cuts and other reforms Governor Pataki and the Legislature have enacted in recent years, our business climate is enormously more competitive today than it was the last time we confronted a slowdown.

The main threat to a brighter future for working New Yorkers is the prospect that we could repeat the mistakes made in an earlier era. Deferring tax cuts and raising taxes didn't help the last time. Why would they this time?