Impact of the ‘Fiscal Cliff’ on New York State

Sharp Tax Increases, Reductions in Federal Aid
Would Hit the Empire State Starting in 2013

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Summary

Absent Congressional action, significant revisions to federal tax and spending policies are scheduled to take effect in January 2013. Many economists warn that this combination of higher taxes and automatic cuts from baseline spending levels – widely known as the “fiscal cliff” – could push a slowly recovering national economy back into recession in 2013.

Changes in federal tax provisions would impose a total of more than $43 billion in tax increases on New Yorkers in the coming year, according to calculations by the Office of the State Comptroller. The largest impact would come from the Alternative Minimum Tax (AMT). While fewer than 500,000 New York taxpayers have been required to pay the AMT in recent years, the number of affected State residents would immediately jump by more than 3.4 million. These New Yorkers would face sharp tax increases – averaging more than $5,180 per taxpayer – in the 2012 federal income tax they must pay in full less than five months from now on April 15, 2013.

Other tax changes scheduled to take effect, including a 47 percent increase in the Social Security payroll tax, would immediately reduce paychecks for New York State residents of all income levels. Additionally, the federal child tax credit would be reduced by half, from $1,000 to $500, and refundability of this credit would be lost for many low-income families. Taken together, the pending tax increases would reduce disposable incomes and diminish New Yorkers’ ability to provide for household needs, to save for college and retirement, and to make purchases that support jobs in local communities.

On the expenditure side, the federal Budget Control Act of 2011 imposes cuts or a “sequestration” of funds in a wide variety of programs affecting state and local governments. The New York State Division of the Budget has estimated that if sequestration goes forward unchanged, New York State and its localities could lose approximately $5.0 billion in federal aid over nine years. Federal Funds Information for the States has identified $609 million in aid reductions for New York State that would occur in the federal fiscal year ending September 30, 2013. That total includes an estimated $210 million in education programs, $137 million in health and human services, $128 million for housing programs in the Empire State, and $134 million in other reductions. The fiscal cliff also includes an end to extended unemployment benefits for as many as 100,000 unemployed New Yorkers.

Each of these cuts from scheduled funding levels would reduce support for programs that are essential to families and individuals across New York State.

What Is the Fiscal Cliff?

For some time, there has been widespread agreement across the political spectrum that the United States needs to take serious action to rein in chronic budget deficits. There is now considerable agreement that such action must involve both increased revenues and decreased spending. The optimal mix of additional revenues and spending cuts, however, remains hotly debated, along with many related particulars. The metaphor of the "fiscal cliff" arose to express the idea that the various attempts to address this challenge scheduled to take effect in 2013 cumulatively create a risk of significant damage to the economy. To understand the threat posed by the fiscal cliff, we need to appreciate the combined effects of numerous proposed tax and spending changes.

Large federal budget deficits over the past decade have convinced many economists, policy makers, and others that continuation of longstanding fiscal policies in Washington may harm the national economy in the long term. Enactment of the Budget Control Act of 2011 (BCA), requiring automatic spending reductions starting in 2013 if no alternative deficit reduction actions were taken, was one outgrowth of such concerns.

Under the BCA, automatic cuts ("sequestration") would begin in January 2013 and continue through 2021, translating into reductions in defense spending, mandatory programs, and non-defense discretionary programs.

Although not part of the BCA of 2011, many of the Bush-era tax cuts initially enacted in 2001 and 2003, as well as the more recently enacted payroll tax cuts and provisions to extend unemployment benefits, expire as of December 31, 2012. Furthermore, new taxes enacted as part of the Patient Protection and Affordable Care Act are scheduled to go into effect at the beginning of 2013.

In addition, the Treasury Department has indicated that the United States is again nearing the debt ceiling imposed by current law, and will reach the limit in the coming months.

The Congressional Budget Office estimates that the fiscal cliff involves $375 billion of tax increases and $88 billion of spending reductions that will take effect in 2013 if Congress takes no action to change current law. Those tax increases reflect the expiration of temporary Internal Revenue Code changes enacted at various times from 2001 through 2011. The spending reductions are driven by sequestration of federal expenditures under the BCA, and expiration of extended unemployment compensation benefits that Congress most recently approved in February 2012.

The figures cited exclude two provisions – $18 billion in tax increases and $10 billion in reduced Medicaid payments to physicians – that some analysts include in descriptions of the fiscal cliff. Both provisions are intended to help pay for expanded health insurance coverage under the Patient Protection and Affordable Care Act and not as part of the array of deficit-trimming measures analyzed in this report.

Impact of Tax Changes on New York

While the fiscal cliff's tax changes will affect families, individuals and businesses across the country, several major elements would hit New Yorkers especially hard.

Table 1 shows the estimated impact that tax changes associated with the fiscal cliff will have on New York's taxpayers, by major tax category, in Federal Fiscal Years 2013 and 2014.

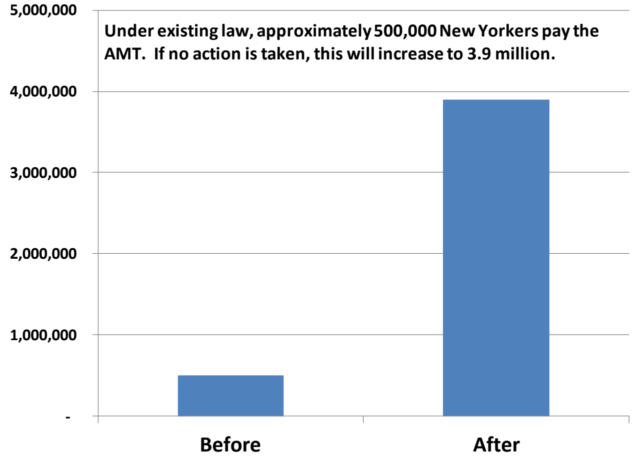
Table 1: Fiscal Cliff Impact on New York's Taxpayers

Tax Change	**New York Cost - 2013** *(millions)*	**New York Cost - 2014** *(millions)*
Alternative Minimum Tax	$20,800	$14,200
Social Security payroll tax	$7,600	$7,700
Top marginal rates	$2,900	$4,300
Capital gains/dividends	$2,400	$300
Elimination of 10% rate	$2,300	$3,300
Child tax credits	$200	$2,700
Estate/gift tax	$300	$2,100
Earned income tax credit	$0	$400
Other	$6,900	$9,900
Total New York impact	**$43,400**	**$44,900**

Note: "Other" includes changes to deductions and exemptions for high-income earners

Source: Office of the State Comptroller

Figure 1: Alternative Minimum Tax Payers in New York, Before and After Fiscal Cliff



Source: Congressional Research Service

Alternative Minimum Tax

Taxpayers whose incomes are above the AMT exemption level – $74,450 for couples and $48,450 for others in 2011 – must calculate their federal income tax using both the regular system and the AMT, and pay the higher of the two. The AMT most commonly applies to married couples or individuals with large families who have taxable income in the range of $100,000 to $500,000, and pay comparatively high state and local taxes.[1]

In 2010, the latest year for which data are available, 5.3 percent of New York taxpayers were subject to the AMT – a higher proportion than in any state except New Jersey and Connecticut. According to the Internal Revenue Service, 493,556 New Yorkers paid the AMT in 2010.

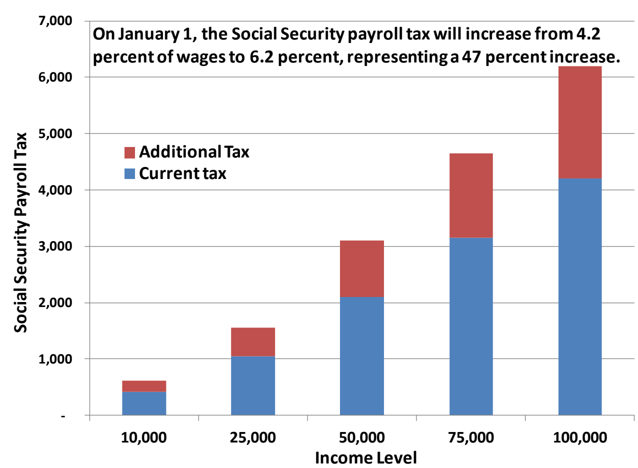
Under existing law, the AMT exemption is set at $45,000 for couples and $33,750 for others (individuals and heads of households) for the 2012 federal tax year. If Congress takes no countervailing action, the lower exemption level means that the number of New Yorkers paying the alternative minimum tax will jump to 3.9 million – more than half of all federal income taxpayers in the State – for 2012 returns due in April 2013.[2] The Office of the State Comptroller estimates the overall impact on New Yorkers at $20.8 billion in the coming year, an average of more than $5,180 per tax filer.[3]

Social Security payroll tax

Legislation enacted in 2010 reduced the employee share of the Social Security payroll tax from 6.2 percent to 4.2 percent for calendar year 2011, as one of numerous steps intended to stimulate the national economy. Subsequent Congressional action extended the rate reduction through 2012.

The pending return of the payroll tax rate to 6.2 percent will cost New York workers $7.7 billion in 2013. Virtually all 8.9 million working individuals in the State will see higher withholding from their paychecks as a result.

Figure 2: Fiscal Cliff Impact on Social Security Payroll Tax



[1] Congressional Budget Office, "The Individual Alternative Minimum Tax," January 15, 2010.

[2] Steven Maguire, "Alternative Minimum Taxpayers by State: 2008, 2009, and Projections for 2012," Congressional Research Service, December 15, 2011.

[3] Many of the tax returns subject to the AMT are from married couples filing jointly, so the number of affected individuals is significantly higher than the number of tax returns.

Top marginal rates, capital gains, estate tax

Under legislation enacted in 2001 and 2003, and extended for two years in 2010, the top federal income tax rates were reduced from 39.6 percent, 36 percent, 31 percent and 28 percent to 35 percent, 33 percent, 28 percent and 25 percent, respectively. The fiscal cliff includes a return of these tax rates to the higher, pre-2001 levels.

Such changes will increase federal taxes paid by higher-income New Yorkers by $2.9 billion in 2013. The additional cost would rise further, to $4.3 billion, in 2014.

New York's comparatively higher numbers of wealthy individuals means its taxpayers would also bear a larger share of the cost of scheduled increases in taxes on capital gains, dividends, and estates. While New York residents filed 6.4 percent of federal tax returns in 2010, taxpayers in the State generated 7.8 percent of federal adjusted gross income (AGI) and 14.6 percent of AGI from taxpayers with incomes above $1.0 million.

As part of the fiscal cliff, the top tax rate on long-term capital gains would rise from 15 percent to 20 percent, while the tax on qualified dividends would increase from 15 percent to the rate a taxpayer pays on ordinary wages. (The Patient Protection and Affordable Care Act imposes an additional 3.8 percent tax on capital gains and dividends for high-income individuals. As noted above, these taxes are not included in this analysis.) The maximum estate tax rate will rise from 35 percent to 55 percent. These and related changes would increase New Yorkers' federal estate and other taxes by a total of $2.7 billion in 2013 and $2.4 billion in 2014.

Elimination of 10 percent rate

Federal tax changes enacted in 2001 also reduced the lowest income tax rate from 15 to 10 percent. Absent Congressional action, this rate will revert to 15 percent. The cost to New Yorkers, including many lower-income workers, would total $2.3 billion in 2013 and $3.3 billion the following year.

Other tax impacts

Some of the scheduled changes in federal tax law would automatically be reflected in New York State's tax structure because the State's Personal Income Tax is based largely on the federal income tax.

New York State's Earned Income Tax Credit (EITC) provides 30 percent of the amount that taxpayers receive from the federal EITC. Because the value of the federal EITC will decline as part of the fiscal cliff, New York filers would also lose part of the value of their State-level credit. The Office of the State Comptroller estimates this change would increase State revenues modestly, by several tens of millions of dollars.

Similar impacts may also occur with other federal tax credits, although the dollar value of such changes is likely to be comparatively small.

How Typical Taxpayers May Feel the Impact of the Fiscal Cliff

The tax changes that make up much of the fiscal cliff will have varying impacts on individuals and couples who pay federal income taxes.

The 47 percent increase in employees' Social Security payroll tax from 4.2 to 6.2 percentage points will have the widest-ranging impact, both in New York and nationally. It will reduce workers' take-home pay by 2 percentage points for salaries and wages up to $113,700. While the tax rate is the same for workers at various income levels, the impact on disposable income will be more significant for lower- and moderate-income earners than for those at higher income levels. As shown in Figure 2 on the preceding page, the payroll tax for a worker earning $25,000 will rise by $500, or nearly $10 a week

– making a noticeable difference in resources available for groceries or other household expenses. An employee earning $75,000 would pay $1,500 more in Social Security tax.

A New York family with two children eligible for the federal child tax credit would lose $1,000 a year from the scheduled reduction in the credit (from $1,000 to $500 per child). Since 2009, the child tax credit has been refundable – meaning that families with low incomes can receive the full value of the credit even if it surpasses the income tax they would otherwise pay. Under the fiscal cliff, refundability will be lost for most families, eliminating an important source of support for many low-income New Yorkers.

The Tax Policy Center, a project of the Urban Institute and Brookings Institution, provides a tax calculator allowing comparison of various scenarios for individual taxpayers based on current law and changes associated with the fiscal cliff.

Consider, for example, an individual worker who lives in Onondaga County, is unmarried and has no dependents, and has adjusted gross income equal to average annual wage for Central New York of $44,070. Assuming the worker owns a home, has no mortgage and pays average Onondaga County property taxes as calculated by the Tax Foundation, his or her federal tax (including income tax and payroll taxes) under 2012 law would be an estimated $10,487. Under the scheduled 2013 law, it would be $11,815 – an increase of $1,328 or 12.7 percent.

Or, consider a Nassau County couple who make combined earnings of $250,000. Assuming one child in college with typical tuition and fees, average Nassau County property taxes, and typical levels of charitable donations, the couple would pay an estimated $66,892 in combined federal income tax and payroll taxes. Under the scheduled 2013 law, that total would be $78,924, for an increase of $12,032 or 18 percent.

Impact of Sequestration on New York

New York spent $40.3 billion in federal funds on health care, education, transportation, and other programs in State Fiscal Year (SFY) 2011-12. Automatic cuts in federal programs that are scheduled as part of the fiscal cliff would reduce federal support for the State budget by more than $600 million in the coming year, with additional cuts directly hitting local governments and individuals across the State.

The federal Office of Management and Budget estimated in September that BCA sequestration would drive reductions in non-defense discretionary appropriations of 8.2 percent, and in non-defense direct spending of 7.6 percent, from levels otherwise scheduled. The BCA also imposed annual caps on federal discretionary spending over a ten-year period.

Federal Funds Information for the States (FFIS), a joint program of the National Governors Association and the National Conference of State Legislatures, estimates that 18 percent of federal grant dollars flowing to states – or $7.5 billion in the federal fiscal year ending September 30, 2013 – would be subject to the cuts described above. The Division of the Budget has estimated that if federal sequestration is implemented as provided by the BCA, New York State and local governments could lose approximately $5.0 billion in federal funding over nine years, starting in SFY 2013.[4]

FFIS identifies $609 million of such cuts in aid to New York State for 2013. As shown in Table 2 on the last page of this report, the State would lose more than $210 million in federal funding for education, well over $100 million for health and human services and a similar amount for housing programs.

The outline of cuts made under sequestration has important implications for states. While these

[4] New York State Division of the Budget, *Midyear Update to the Financial Plan for Fiscal Year 2012-13,* November 2012, p. 13.

cuts would be harmful to New York's residents, they largely exempt Medicaid, the largest stream of federal assistance to the Empire State. Half of all federal spending cuts required by BCA apply to defense programs; New York's share of federal defense spending is among the lowest of the states. FFIS also estimates that scheduled reductions in National Institutes of Health programs would cut such funding for New York by $153 million in 2013.

Certain Alternative Solutions May Pose Risks for New York

As elected officials and policy advocates promote potential solutions to avoid the fiscal cliff, some proposals currently under discussion could have significant negative impacts on New York.

Discussion of potential tax reforms that would increase federal revenues has included proposals to eliminate or reduce the federal tax exemption for interest on bonds issued by state and local governments. New York State, its public authorities, and local government entities in the State collectively represent one of the largest groups of municipal bond issuers in the nation. In 2011, New York issuers ranked first nationally for long-term bond sales, with a total of $39.3 billion.

Municipal bonds provide funds for essential capital infrastructure such as school buildings, roads, bridges, hospitals, environmental projects, and other facilities. Reduction or elimination of the federal tax exemption for such purposes would result in higher debt service costs at a time when both the State and many of its government units face significant budgetary pressures.

Any change in the tax-exempt status of municipal bonds could force the State, municipalities, school districts, and public authorities to make a choice between passing on higher costs to taxpayers, or reducing capital investments for essential infrastructure.

New York State and New York City impose taxes on both personal income and business income, and the City of Yonkers imposes a personal income tax. A portion of the higher borrowing costs for these entities may be offset by additional revenues from taxes that would be due on interest earned on municipal bonds that was formerly tax-exempt. It is unclear, however, whether the tax revenue impact would completely offset the higher borrowing costs.

Another option under consideration in Washington is capping federal itemized deductions at a certain level, such as $35,000. In many states, such a limit would allow middle-class taxpayers to retain the full value of deductions they currently claim. In New York, a combination of higher average incomes and living costs – including comparatively high State and local taxes – would make such a cap on deductions more costly to taxpayers than in most other states.

New York's Balance of Payments

As a comparatively wealthy state, New York contributes a disproportionate share of all federal tax revenue. While the State receives relatively large proportions of certain federal spending programs – particularly Medicaid – its share of federal military spending and procurement is relatively low.

On balance, as former U.S. Senator Daniel Patrick Moynihan and subsequent analyses showed in a series of reports, the Empire State sends significantly more dollars to Washington in tax payments than it receives in federal expenditures. Moynihan's final report on the subject was issued in 2000.[5] The Northeast-Midwest Institute analyzed 2005 data and concluded that New York received 82 cents of federal expenditures for every dollar paid in

[5] Taubman Center for State and Local Government, Harvard University John F. Kennedy School of Government, *The Federal Budget and the States: Fiscal Year 1999*, Cambridge MA; December 2000.

federal taxes.[6] A separate analysis by the Tax Foundation, also based on 2005 data, concluded that New York received 79 cents in federal expenditures for every dollar of taxes paid to Washington.[7] The majority of states – 32, as of 2005 – receive more in federal spending than their taxpayers send to Washington, according to the Tax Foundation.

Conclusion

The changes in federal tax and spending policies that make up the fiscal cliff would reduce the federal budget deficit in 2013 by more than 40 percent, or an estimated $451 billion. The Congressional Budget Office and other nonpartisan experts agree that failure to limit the deficit would weaken the economy over time.

The BCA sequestrations are one result of Congressional action in response to the debt ceiling crisis of mid-2011 when the U.S. Treasury had reached its statutory debt limit. Although BCA averted a U.S. government default, the nation's credit rating was downgraded from AAA (the highest level) to AA+, the first downgrade in U.S. history. The threat of a repeat of the debt ceiling impasse of 2011 has already produced warnings from the major rating agencies. For example, Fitch Ratings recently warned that "failure to avoid the fiscal cliff and raise the debt ceiling in a timely manner as well as securing agreement on credible debt reduction would likely result in a rating downgrade in 2013." The perception that the U.S. government has difficulty working cooperatively only adds to the uncertainty surrounding these issues.

Experts also agree that the fiscal cliff represents an immediate threat to the economy, which continues to recover slowly from the effects of the Great Recession. In New York and some other states, the impact of Superstorm Sandy has hit many communities and thousands of individuals especially hard. Allowing the fiscal cliff's tax and spending policies to take effect and remain in place for a full year would risk shocking the economy with more austerity than it could bear without falling into recession.

The Congressional Budget Office estimates that the changes that make up the fiscal cliff would reduce the nation's real Gross Domestic Product by 0.5 percent between the fourth quarter of 2012 and the fourth quarter of 2013.[8] If that were to occur, the impact in New York would likely include the loss of hundreds of millions of dollars in State tax revenue, further complicating an already difficult fiscal picture. Any outcome of negotiations related to the fiscal cliff that imposes disproportionate costs on the Empire State would worsen a longstanding imbalance of payments between New York and the federal government.

Clearly, neither allowing the tax increases and spending cuts which constitute the fiscal cliff to occur as scheduled, nor allowing large federal deficits to continue indefinitely, would represent an acceptable outcome for New Yorkers. A balanced approach that addresses long-term deficits, without imposing immediate economic damage, is essential.

[6] "Flow of Federal Funds to States," Northeast-Midwest Institute, Washington DC.

[7] Tax Foundation, "Federal Taxes Paid vs. Federal Spending Received by State, 1981-2005," October 19, 2007.

[8] Congressional Budget Office, "Economic Effects of Policies Contributing to Fiscal Tightening in 2013," November 8, 2012.

Table 2: FFIS Estimates of Impact of Sequestration on New York State

(in thousands of dollars)

Issue Area	Program	Selected Aid Programs	
		FFY 2012 Enacted	Change FY 2013 to FY 2012
Education			
	Compensatory Education (Title I) - Local Education Agencies	1,131,874	-86,455
	Special Education Basic State Grant	758,003	-57,898
	State Grants for Improving Teacher Quality	195,518	-14,934
	College Work-Study	91,503	-6,989
	Other Education	2,670,681	-44,035
	Education Total		***-210,311***
Health and Human Services			
	Head Start	495,550	-37,851
	Low Income Home Energy Assistance	375,510	-28,682
	Ryan White - HIV/AIDS Part B	164,499	-12,565
	Ryan White - HIV/AIDS Part A	126,787	-9,684
	Substance Abuse Prevent. & Treatment Block Grant	114,637	-8,756
	Social Services Block Grant	106,103	-8,523
	Child Care & Development Block Grant	101,521	-7,754
	Other Health and Human Services	36,013,906	-22,942
	Heath and Human Services Total		***-136,758***
Housing			
	Public Housing Operating Fund	899,066	-68,672
	Public Housing Capital Fund	311,462	-23,790
	Community Development Block Grant - Entitlement (Locals)	241,022	-18,410
	Other Housing	229,167	-17,504
	Housing Total		***-128,376***
Agriculture			
	WIC - Supplemental Feeding Program	429,492	-32,805
	Other Agriculture	6,854,040	-2,076
	Agriculture Total		***-34,881***
Labor			
	Unemployment Insurance State Administration Base Allocation	210,856	-16,106
	Workforce Investment Act - Dislocated Workers	53,041	-4,051
	Other Labor	167,570	-12,799
	Labor Total		***-32,956***
Transportation			
	Federal Transit Administration - Capital Investment Grants (New Starts)	389,990	-29,788
	Other Transportation	3,274,555	0
	Transportation Total		***-29,788***
Environment			
	EPA - Clean Water Grants	157,577	-12,036
	EPA - Drinking Water Grants	58,193	-4,445
	EPA - State and Local Air Quality Management	15,771	-1,205
	Other Environment	24,136	-1,844
	Environment Total		***-19,529***
Other Issue Areas			
	Homeland Security	79,718	-6,028
	Justice	77,040	-5,875
	Interior	23,110	-1,223
	Energy	15,943	-1,218
	Arts and Humanities	13,616	-1,040
	Commerce	6,155	-470
	Other Agriculture	120,895	-151
	Appalachian Regional Commission	9,682	-69
	Other Issue Areas Total		***-16,073***
New York State FFIS Estimate TOTAL			**-608,672**

Note: The FFY 2012 Enacted column includes programs that are covered under sequestration, as well as programs that are not. Some figures reflect net totals.

Source: Federal Funds Information for the States