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New York Governor David Paterson's Tax and Fee Proposals a Mixed Bag

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Meritorious Sales Tax Improvements Accompanied by Many Unjustified New Taxes

Last month, New York Governor David Paterson unveiled a proposal to raise an additional $4 billion through nearly 100 increased taxes and fees, as part of his plan to close New York State's budget gap for fiscal year 2010, which may be as large as $15 billion.

This report looks at several planks of the governor's plan and places them in three categories: proposals that move New York closer to sound tax policy, proposals that worsen tax policy, and some proposals that might be good or bad depending on surrounding circumstances.

The full list of proposed revenue actions, including their anticipated revenue impacts, are found in the Executive Budget's Briefing Book.[1]

Tax Policy Improvements in New York's Sales Tax

Most of the good provisions of Paterson's plan involve broadening the sales tax base. According to a 2004 study by Indiana University Prof. John Mikesell, New York had the country's fourth-narrowest sales tax base in 2003, among the 45 states that levy general sales taxes. Just 30.3% of New Yorkers' personal income ultimately flowed into the sales tax base. The national median among states was much higher, at 43.3%.

An ideal sales tax base should include all consumption exactly once and avoid the taxation of intermediate inputs like business-to-business transactions. Inclusion of business inputs results in double taxation: a purchase is taxed at the intermediate stage and again when it is sold to an end-user.

Exclusion of consumer goods and services increases the rate that must be charged on all other purchases to raise sufficient tax revenue. Such exclusions also create economic distortions, encouraging uneconomic consumption of the exempted goods. And when necessity goods are exempted from the base, sales tax revenues become more volatile, increasing the severity of state budget crises.

New York has many opportunities to improve its sales tax base by eliminating exemptions for consumer goods and services, and it is good to see that Paterson has selected base broadening as a key way to raise revenue. His specific proposals include the following:

Elimination of the sales tax exemption for clothing

Currently, New York State exempts clothing priced under $115 from the sales tax. The elimination of this exemption alone is projected to raise $462 million in FY 2009-10 and $660 million in FY 2010-11.

Expansion of the sales tax to various services

Sales tax would become applicable to personal services including beauty, barbering, manicure, pedicure, massage, and gymnasium services. It would also apply to entertainment admissions including movie theaters and sporting events as well as cable and satellite entertainment services.

Restriction of the sales tax exemption for capital improvements to real estate

As revised, the tax exemption would only apply to costs for new construction, an addition to an existing building, or complete reconstruction. Currently, any capital improvement to a property is exempt from sales tax—including, for example, buying a new oven which you then install in your home. Ideally, all residential construction activity should be taxable, as it is a kind of consumption. However, restriction of the tax exemption would be an improvement from the status quo.

Elimination of the tax cap on gasoline

New York is one of seven states to subject gasoline to all or part of its general sales tax. This is good policy—gasoline use is a kind of consumption, and should be subject to sales tax like other consumption. The gasoline excise tax is *not* a substitute for the general sales tax. Because it is used to fund roads and other programs that benefit drivers as they use fuel, the excise tax is economically akin to a user fee, which should be levied in addition to sales tax.

In 2006, as gas prices rose, New York State capped its 4% general sales tax at 8 cents per gallon of gasoline; any part of the price over $2 per gallon now goes untaxed.[2] While the political rationale for a cap is clear, there is no economic reason why the sales tax should be subject to any cap. Elimination of the cap would improve the sales tax base and increase revenue stability.

Other Meritorious Proposals

Allowing the sale of wine in grocery stores

Currently, New Yorkers may only purchase wine at liquor stores. Furthermore, no family may control more than one off-premise liquor license, and so New York has no liquor store chains. Loosening the restrictions on who may sell wine should increase competition and therefore reduce wine prices for consumers, in addition to generating (in the governor's estimation) $54 million per year in new tax revenue.

No "millionaire's tax" or similar top-rate income tax increase

One notably positive feature of Governor Paterson's plan is what's not in it: any increase in New York State's top marginal income tax rate. While the state's top tax rate is a moderate 6.85%, New York City residents face the highest top rate in the country, 10.498% (6.85% state plus 3.648% city). Increases currently on the table could push that rate to 11.375%, a full point higher than California's 10.3%.[3]

Further increasing New York's top rate would put the state even farther out of step with its competitors, encourage high income people to work less or leave the state, and make state revenues more volatile, as revenues from progressive income taxes are highly sensitive to economic shifts. Governor Paterson's instinct to resist political pressure for an income tax increase is a good one.

Unfortunately, Democratic legislators are apparently revisiting the idea of raising the top tax rate on very high-income people.[4] Paterson, though he has not included any income tax rate increases in his proposal package, did leave the door open to a Millionaires' Tax in the event that the deficit worsens further. Mayor Mike Bloomberg is right when he says that would be a bad idea.

Bloomberg said Thursday, "Raising taxes on those with the flexibility to move their businesses—as was done in previous crises—will lead to an exodus that will hurt us for decades and have devastating consequences for the entire state."[5] Oddly, Bloomberg's own administration has floated the idea of an income tax increase at the city level, even though he has made the key argument against such a move.

Bad Proposals Target Specific Products with High Tax Rates

Many of the negative components of the Paterson plan fall into two categories: provisions that make the tax code more complicated, and provisions that single out disfavored goods or activities for punishment. Paterson would impose new, special taxes on sugary drinks, beer, wine, cigars, luxury cars, yachts, furs and airplanes.

"Obesity tax" on sugary drinks

Paterson is proposing an 18% tax on soft drinks containing sugar, which would raise $404 million in its first year and over $500 million in its second. The tax is supposedly intended to offset government costs related to obesity, and would therefore be a Pigovian tax—one that is levied to offset social costs imposed by the taxed activity.[6] However, like my colleague Gerald Prante, I am not holding my breath for a demonstration that the tax will be set at the economically optimal level, instead of serving as a punitive tax on a specific product.[7]

Two major defects of the proposal stand out. First, people who are not obese will often pay the tax, and many of the obese will avoid it. Secondly, it will be levied ad valorem (as a percentage of price), not as a specific excise (on a per-unit basis).

As Katherine Mangu-Ward at *Reason* points out, not all soda drinkers are obese and not all obesity is caused by soda.[8] If the tax is imposed on soda, why not ice cream?

Furthermore, Pigovian taxes should be specific excise taxes: a pack of premium cigarettes imposes the same health costs as a pack of bargain cigarettes, and so each is taxed the same amount. Do premium Jones Sodas cause more obesity than discount store brands with the same calorie content? Presumably not, and so there is no Pigovian rationale for a higher per-bottle tax on more expensive soda.

We can say one positive thing about this proposal: Paterson admits that what he wants is a tax, instead of claiming he's proposing a soda "user fee" as Florida's governor Charlie Crist did with cigarettes.[9]

"Luxury tax" on items including furs and boats

Paterson would impose an additional 5% tax on cars priced over $60,000, boats over $200,000, jewelry and furs over $20,000 and non-commercial aircraft over $500,000. That's on top of the 4% statewide sales tax and local sales taxes that are also generally in the 4% range.

Generally, luxury taxes are gimmicks that raise little tax revenue (projected at $15 million for FY 2010-11) while appealing to class warfare sentiment. A 10% federal luxury excise tax imposed in 1990 devastated the yacht industry, and employees thereof. Because yacht sales fell sharply after imposition of the tax, revenues were far below projections. Ultimately, Congress responded by repealing the tax.

The lesson of the yacht luxury tax is instructive: narrow-based taxes are more likely to have distortionary effects than broad-based ones, as it is relatively easy for consumers to substitute an untaxed purchase for a taxed one (e.g., by taking fancy vacations instead of buying a yacht, or by purchasing a used yacht made before imposition of the tax.) By contrast, income and general sales taxes must generally be avoided by earning or consuming less, which are more difficult steps to take.

Higher taxes on beer, wine and cigars

Beer and wine tax rates would both more than double, while cigar taxes would rise by about 50%. Additionally, cigar taxation would shift from an ad valorem basis (tax as a percentage of price) to a specific excise basis (tax as a fixed amount per unit). While the move to specific excise taxation for cigars is a good one, raising these taxes to close the state's budget gap is not justified. It is an attempt to balance the budget using a tax on a disfavored minority instead of a broad-based tax that spreads costs more fairly.

New sales tax holiday

Paterson would replace the all-year clothing exemption with two annual holidays offering tax-free clothing priced under $500. Sales tax holidays are our least favorite tax trend here at the Tax Foundation, one that we have written about extensively. As I said just last month:

Sales tax holidays make the tax code more complicated, distort economic decision-making, don't appear to foster economic activity, and are a gimmicky distraction from real tax relief.[10]

If Paterson is unconvinced that sales tax holidays are useless, he need look no further than a study from his state's own Department of Taxation and Finance.[11] Conducted after New York's 1997 clothing sales tax holiday, the study found that nearly all of the increased sales activity during the holiday was offset by reduced activity before and after. For the quarter in which the holiday fell, clothing sales rose just 2.9% from a year earlier, which the Department attributed to normal economic growth.

Applying sales tax before coupon discounts, regardless of the coupon's issuer

Like many states, New York currently uses a differential rule for the tax treatment of coupons: coupons issued by a manufacturer are applied after calculation of tax, while those issued by a retailer are applied before calculation of tax. Under Paterson's proposal, all coupons would now be applied after calculation of tax. The order matters because the tax is higher if it's calculated before the coupon.[12]

From a perspective of simplicity and neutrality, the best policy is to treat all coupons in the same way as simple discounts, where a retailer reduces the price of an item. That is, take the discount off, then apply tax to the price as discounted. Paterson's reform moves in the opposite direction, applying tax to the pre-discount price for all coupon purchases. One likely result will be to encourage retailers to offer discounts in forms other than coupons, to gain more favorable tax treatment; it could also make retailers less likely to offer discounts in general.

Governor Paterson's coupon reform is projected to raise only $3 million per year, not much consolation for moving New York farther away from sound tax policy and from other states' treatment of coupons.

Good or Bad? It Depends

There are a few other tax changes which Paterson proposes that might or might not be good ideas, depending on the specific circumstances.

Higher fees for various government services

Tuition would rise by $620 per year at SUNY schools and $600 at CUNY schools. Paterson would also establish new or higher fees for services and activities including:

- Motor vehicle license issuance
- Motor vehicle registration
- Purchasing auto insurance
- Transporting seed
- Selling seed
- Selling cigarettes
- Operating a food business
- Operating a security guard training school
- Operating a clinical laboratory
- Operating a nuclear power plant
- Taking the civil service exam
- Marine fishing
- Trout and salmon fishing
- Obtaining a certificate of need for a medical facility
- Asbestos certification, licensing and project notification
- Boiler inspection
- Transferring real property
- State park admission and activities
- Entering a horse in a pari-mutuel race
- Registering in professions including:
    - Physicians
    - Barbers
    - Notaries public
    - Cosmetologists
    - Real estate agents
    - Tax preparers
- Filing your taxes on paper
- Paying your taxes by installment
- Writing a bad check to the state department of taxation

As I said last year in my discussion of proposed tax and fee increases in New York City,[13] a fee increase is appropriate if it is needed to keep up with the cost of the service provided for the fee, but not if it is diverted to provide general revenue. Figuring out whether the fee increase matches the cost increase requires detailed spending information we don't have. However, it seems unlikely that New York State has persisted in charging below-cost fees for a broad swath of services that it provides.

Higher fines for various kinds of malfeasance

Paterson would raise fines for certain traffic violations, falsifying vehicle inspections and maintenance, operating a crane without a certificate of compliance, and violating food safety regulations. He would also increase fees related to driver license suspension and allow automated speed enforcement cameras.

As with fees, the question of what fines are appropriate is empirical: a fine should be set to bring the individual cost of a behavior in line with its social cost. Insufficient fines are economically inefficient, and so are excessive fines. If Paterson's proposals will bring fines closer into line with the economically ideal amounts, they are a good thing.

New taxes on hospital gross receipts, hospital services and health insurance premiums

Paterson proposes a variety of new taxes and charges on insurance and health care. The government's interaction with health care providers is a morass of subsidies, payments, taxes and implicit taxes. As such, it is not very useful to consider the tax proposals in a vacuum, separate from other issues like reductions in Medicaid reimbursement rates (which Paterson is also proposing). Because the tax issues here are inextricably linked to non-tax ones, it may be that there is more than one "right" answer on tax policy here.

Expansion of government-run gambling

Paterson would take several steps to expand government-run gambling operations in the state, including:

- Allowing Quick Draw (Keno) and Video Lottery Terminals (essentially, slot machines) to run 24 hours a day.
- Building a new VLT parlor at Belmont Park on Long Island.
- Allowing the New York Lottery to join more multistate games in addition to Mega Millions.

As my colleagues Gerald Prante and Alicia Hansen laid out in a commentary last year, expanded government gambling has pros and cons.[14] Government-run gambling is subject to a very high implicit tax rate, and it is often presented to the public as an alternative to taxation when it is in fact a hidden and regressive tax. On the other hand, widely available, government-run gambling provides more freedom of choice than prohibition, even if the government restricts choices and extracts monopoly rents.

Notes

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