

# Achieving Adequacy: Tax Options for New York in the Wake of the *CFE* Case

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# **ACHIEVING ADEQUACY: TAX OPTIONS FOR NEW YORK**

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*Achieving Adequacy* is intended to provide a useful resource for understanding the impact of recent school finance legislation on the state's tax and education system. The study examines options available to New York policy makers as they seek to adequately fund elementary and secondary education and other public services.

The Institute on Taxation and Economic Policy (ITEP) is a non-profit tax policy research group focused on fairness and adequacy in federal, state and local taxes. Founded in 1980, ITEP has conducted analyses of tax systems in almost every state. ITEP's work is funded by the Annie E. Casey Foundation, the Nathan Cummings Foundation, the Ford Foundation, the Joyce Foundation, the Tides Foundation, the Wellspring Foundation, the Rockefeller Foundation, and the Winthrop Rockefeller Foundation, among others.

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All conclusions or interpretations in this report are those of the authors.

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# EXECUTIVE SUMMARY

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New York policymakers face a unique opportunity to reshape the state's tax system and its school funding system. After nearly a decade of litigation, the New York State Court of Appeals found, in its June 2003 *Campaign for Fiscal Equity (CFE) v. State of New York* decision, that the current school funding system violates the state constitution's guarantee of a "sound basic education" to New York City students. The *CFE* decision signals conclusively to New York lawmakers that they must devote substantial new resources to funding education in order to repair the constitutional violations found by the court. And there is now general agreement that a statewide policy response to the *CFE* decision will be necessary.

Adequately funding education for students throughout New York State has been projected to cost up to \$8.5 billion annually. And New York continues to struggle with projected budget shortfalls as it seeks to adequately fund other public services. The state's already-strapped tax system may simply be insufficient to meet these needs—raising several questions:

- What tax policy changes could be enacted to help adequately fund services in New York?
- What will be the implications for tax fairness and adequacy of potential tax reforms?
- How will these changes in tax and spending policy affect the state's economy?

The main finding of this report is that the New York tax system fails to achieve basic goals of a sound tax system—including equity, adequacy, and economic development goals—but that the tax system can be reformed in ways that simultaneously achieve all of these goals. In other words, while the immediate goal of New York policymakers is achieving revenue adequacy, making the tax system fairer and more conducive to economic development can be achieved at the same time.

New York's personal income tax is the only major progressive revenue source used by the state. For this reason, the income tax can play an important role in reducing the unfairness of the tax system. Yet New York's income tax has been sharply reduced by a variety of changes. Repealing poorly targeted tax breaks and making the tax more progressive could be an important step in restoring fiscal adequacy.

The New York corporate income tax is in decline. A host of tax breaks created by the legislature—and a variety of other tax loopholes created by the corpora-

tions themselves—have steadily reduced the yield of the tax. Rather than creating the "business-friendly" climate leaders claim to want, these tax breaks have made New York's tax system less transparent and less fair. Closing these loopholes and seeking disclosure of corporate tax breaks could help restore the tax.

New York's sales tax applies a high tax rate to a narrow set of transactions, exempting many sales from tax. This makes the sales tax a less reliable—and less fair—revenue source in the long run. Broadening the tax base to include more goods and services can help reduce pressure on New York lawmakers.

New York's property tax is regressive and poorly administered—and the state spends billions annually on the poorly targeted "STAR" tax exemption. Reforming or repealing STAR and improving tax administration could help make the property tax a less painful, more reliable revenue source for New York.

New York could also harness a variety of less conventional revenue sources in response to its current fiscal shortfall, including the estate tax, gambling revenues and a stock transfer tax. But each of these options can only provide a small part of the solution to New York's fiscal shortfall—and gambling revenues present a host of troubling questions.

The structural flaws in each of New York's taxes presents a challenge to lawmakers—but also provides a unique opportunity to achieve tax adequacy and fairness. This report estimates the impact of 26 specific options for tax reform. The study estimates each option's impact on state and local revenues in 2006. The offsetting impact of these options on federal taxes are projected as well—an important consideration in assessing the impact of tax changes.

All of these reforms could help make the New York tax system more equitable and sustainable—but what about the impact on the state's economy? ITEP's analysis shows that when the impact of tax increases and spending increases are considered together, these changes would, on balance, have a stimulative effect on the state economy.

The *CFE* case represents a wake-up call to New York policy makers seeking to adequately fund education across the state while avoiding future school funding litigation—but also provides an opportunity for lawmakers to craft tax reform solutions that will ensure the long-term solvency of New York state and its local governments as they seek to fund a variety of important services.

# SUMMARY OF FINDINGS

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The purpose of this study is to help policy makers and the public to understand the current debate over tax policy and school funding in New York. The study has three broad goals:

- First, the report provides a detailed **menu of revenue-raising options** that could be used to adequately fund public services in New York.
- Second, the report looks at the **tax fairness impact** of various tax reform options on New York taxpayers at different income levels.
- Third, the report analyzes the **impact on economic development** of these tax options.

This introductory chapter provides a “road map” for the study, describing the contents of each chapter.

## Basic Tax and Education Policy Concepts

This report deals with two public policy areas—state tax policy and education finance. **Chapter One** provides a brief introduction to important principles of tax and education policy used in the study. Tax policy principles covered in this chapter include fairness, base-broadening, adequacy, exportability, neutrality and economic development. The chapter also explores the principles of adequacy and equity as they affect education funding, and provides a basic introduction to tax incidence analysis.

## About the CFE Case

New York is no stranger to fiscal crises. But the New York Court of Appeals’ June 2003 ruling that the current education system does not provide students with a “sound basic education” heralded the beginning of a new and important era in the state’s tax reform saga. **Chapter Two** provides a detailed analysis of the CFE case and its explanation of what a “sound basic education” means in New York.

Chapter Two also looks at estimates of the policy changes that will be required in order to improve New York education, reviews estimates of the cost of implementing these changes, and surveys the experience of several other states that have attempted court-ordered school funding reform, with the goal of gleaning lessons that might help achieve adequacy in New York.

## The Current New York Tax System

**Chapter Three** provides a summary of the current tax structure. The chapter shows that the New

York tax system is *regressive*. That is, it requires low-income taxpayers to pay more of their incomes in taxes than the very wealthy. This is primarily due to the state’s heavy reliance on sales and excise taxes.

Chapter Three also demonstrates that while New York relies more heavily on local tax revenues than most states, taxing districts outside of New York City rely on a relatively undiversified tax base.

New York’s reputation as a “high tax” state is blunted somewhat when the interaction between federal and state taxes is taken into account. Chapter Three explains how this interaction works, and discusses impending threats to this important mechanism for tax exporting.

## Personal Income Taxes

The personal income tax plays a pivotal role in the New York tax system. The tax helps to offset the regressive impact of New York’s consumption and property taxes. Yet income tax cuts enacted in the past quarter century have dramatically reduced the fairness of the tax—and have made the New York tax system more regressive overall. Moreover, the tax base contains loopholes that further reduce the overall progressivity of the tax, while limiting the state’s ability to fund education. **Chapter Four** describes the factors limiting the yield and progressivity of the New York income tax and discusses options for tax relief to offset the impact of income tax hikes on low- and middle-income New Yorkers.

## Corporate Income Taxes

New York’s corporate income tax base is being eroded—partially due to poorly targeted tax breaks enacted by New York lawmakers, but partially due to creative accounting by corporations seeking to minimize their tax liability. **Chapter Five** assesses the most harmful corporate tax loopholes used in New York and suggests alternatives for broadening the tax base. The chapter also discusses the importance of corporate tax disclosure as a means of diagnosing the health of the tax in the future.

## Sales and Excise Taxes

New York relies less on sales and excise taxes than most other states. The state’s consumption tax as a share of income was just 36th highest nationally in 2002. Yet, as **Chapter Six** shows, this low-yield tax is

the result of a comparatively high tax rate and a comparatively narrow tax base. The state allows a host of sales tax exemptions that discriminate in favor of some taxpayers and against others—in ways that reduce the overall fairness of the tax system.

Closing these loopholes would broaden the base of the sales tax, increasing its perceived fairness—but would also make the tax system more regressive. For this reason, Chapter Six also discusses options for low-income sales tax relief.

## Property Taxes

Like most states, New York relies on locally levied property taxes as a primary mechanism for funding elementary and secondary education. As shown in **Chapter Seven**, New York has the 10th highest property taxes in the United States, almost 25 percent above the national average. But the state's ongoing fiscal difficulties mean that efforts to reduce the burden of property taxes should focus on targeted, cost-effective measures.

Chapter Seven describes several tax reforms that could help achieve this, including the creation of a statewide property tax and the enhancement of an existing low-income “circuit breaker” tax credit.

The chapter also discusses weaknesses in the main tax relief mechanism used by the state, the STAR homestead exemption. STAR is poorly targeted and expensive—and restricts the state's ability to provide targeted tax relief to those homeowners and renters for whom the New York tax system is most burdensome.

## Other Revenue Sources

The lion's share of any new tax revenues are likely to come from the major tax sources already levied by New York. But several lesser revenue sources could be harnessed to help fund education. **Chapter Eight** looks at several minor revenue sources, including the estate tax, gambling revenues, and a stock transfer tax, and assesses the virtues and shortcomings of each as revenue-raising solutions for New York.

## Tax Reform Options

How would the revenue-raising strategies outlined in this report affect tax adequacy and tax fairness? **Chapter Nine** describes 26 tax changes that can be used as “building blocks” for revenue raising. Distributional and revenue analyses are provided.

Because none of these building blocks will be suffi-

cient to fund adequacy on its own, the chapter also presents four packages of tax reform options that could be adequate to fund New York education.

## Economic Impact of a Sound Basic Education

One reason that lawmakers frequently give for resolving fiscal crises through spending cuts rather than tax hikes is the alleged negative impact of tax increases on state economies. But the sheer scale of the state's current fiscal shortfall means that policy makers may find tax hikes unavoidable. **Chapter Ten** shows that a balanced analysis of the impact of tax hikes—that is, one that takes into account the positive impact of public spending alongside the negative impact of tax hikes—reveals that adequately funding education in New York State can have a positive impact on the state's economy, and that these tax and spending changes must be properly structured to maximize the positive impact on economic growth in New York. The analysis shows that funding education through an income tax hike would have the most positive impact on the state's economy.

The chapter also discusses the broader literature on the economic development impact of tax increases, and finds little empirical evidence that taxes have a negative impact on economic development.

## Building Support for Tax Reform

Implementing wholesale tax reform is rarely easy. **Chapter Eleven** describes strategies for informing the public about available tax reform options, and the impact of these options on tax fairness and adequacy.

The chapter discusses two sources of information that a growing number of state governments now regularly provide: tax incidence analyses and a tax expenditure report. New York is among the dozens of states that currently do not produce a regular tax incidence report. Like many states, New York does publish a tax expenditure report that lists many of the special tax breaks carved out of the state tax code—but the state's report could do more to help lawmakers evaluate the usefulness of these tax breaks.

The chapter discusses the importance of public opinion of tax policy options—and shows that public evaluations of these options depend critically on showing the linkage between taxes and spending. In evaluating public opinion on tax issues, lawmakers should critically evaluate the wording of polls to see whether the questions asked make this linkage clear.

## CHAPTER ONE

# BASIC PRINCIPLES OF TAX AND EDUCATION POLICY

This report deals with complicated issues of education finance and tax policy. In discussing these issues, the report will frequently touch on certain fundamental concepts and principles. This chapter provides a brief introduction to these concepts. The goal of the chapter is to familiarize the reader sufficiently with these principles to be able to evaluate the basic policy choices facing New York.

### Principles of Tax Policy

There is a widely agreed-upon set of principles according to which tax systems are judged. These tax policy principles include:

- Tax fairness;
- Broadening the tax base;
- Adequacy;
- Exportability;
- Neutrality; and
- Economic development consequences.

**Tax fairness** can be thought of in two important ways: *vertical equity* and *horizontal equity*.

Vertical equity means the way a tax system treats people at different income levels. Three terms are typically used in discussing vertical equity:

- *Regressive* tax systems require low- and middle-income families to pay a higher percentage of their income in taxes than do upper-income families. New York sales and excise taxes are especially regressive; New York property taxes are also somewhat regressive.
- Proportional or *flat* tax systems take the same share of income from all taxpayers. A flat-rate income tax is one example of a proportional tax.

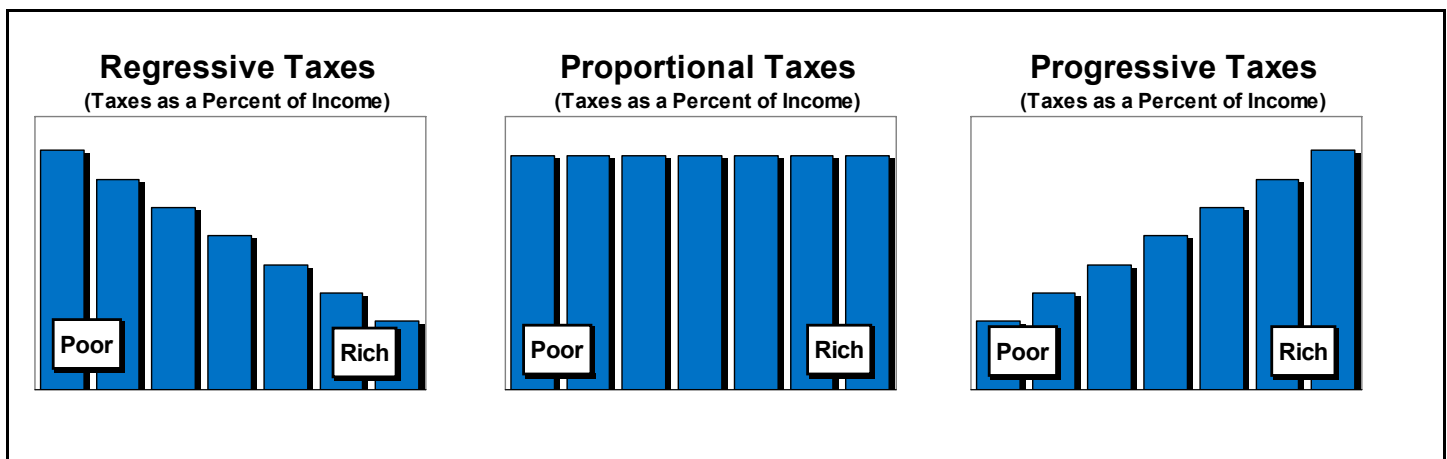
- *Progressive* tax systems require upper-income families to pay a larger share of their incomes in taxes than those with lower incomes.

Historically, there has been widespread acceptance of the notion that, at a minimum, tax systems should not be regressive. That is, poorer families should not contribute a larger share of their incomes in taxes than do the wealthiest families.

The New York tax system is regressive. As shown in Chapter Three, low- and middle-income New York families pay more of their income in state and local New York taxes than do upper-income families.

A second measure of tax fairness is how a tax system treats taxpayers who are fundamentally similar in terms of their ability to pay. When economists discuss the horizontal equity of a tax system, this is what they are referring to—the extent to which the tax system provides preferential treatment to some taxpayers over other, very similar taxpayers.

The New York tax system is riddled with tax loopholes that violate this second conception of tax fairness. Personal income tax breaks for pensions and annuities, property tax exemptions that provide bigger benefits to residents of wealthier school districts, corporate tax breaks for manufacturing companies and sales tax exemptions for services all serve to create inequities between otherwise identical taxpayers. Targeted tax loopholes of this sort reduce the yield of a each penny of a sales tax and each mill of a property tax—and also violate the public’s sense of basic tax fairness. For this reason, **broadening the tax base** by eliminating special tax breaks is doubly beneficial: it reinforces public perceptions of tax fairness, and it increases the long-term viability of the New York tax





system. The dual fiscal constraints of a continuing economic slowdown and budget shortfalls should motivate lawmakers to take a hard look at base-broadening strategies.

At the end of the day, the main criterion by which lawmakers will judge their tax system is **adequacy**. That is, the tax system must yield enough revenue to pay for the public services that lawmakers and their constituents demand. But it is important to remember that adequacy has both a short-run and a long-run dimension. A forward-thinking tax reform agenda will ensure that state revenues are sufficient to pay for public services in the upcoming fiscal year, and will also reduce the likelihood of fiscal crises recurring in the future. This means increasing taxes that tend to grow with the economy (such as personal income taxes) and avoiding taxes that tend to grow more slowly than the economy, such as cigarette and sales taxes. Where possible, this also means reforming slow-growing taxes to increase their growth rate.

An **exportable** tax is one that is partially paid by non-residents. Such taxes have an important place in the American federal system since the public services provided by the 50 states and their local governments are, in varying degrees, enjoyed by individuals and businesses from other states—including tourists and commuters as well as businesses that hire a state's high school and college graduates and those that deliver goods and services to a state's residents using the publicly-funded infrastructure. This is why state tax systems in the American federal system are and should be designed in part to make those other beneficiaries of a state's public services and public infrastructure pay a fair share of the state's taxes. Because of New York's unique geography, in which many of its largest metropolitan area's most prosperous suburbs are located in other states, and because of its role as one of the world's financial, cultural and diplomatic capitals, non-resident businesses and individuals depend on the reliability of our basic public services. Taxing these non-residents has traditionally been and will continue to be important in designing New York's state-local tax system.

There are broadly three ways in which taxes can be exported: directly, by having non-residents pay the tax (sales taxes paid by tourists and commuters, for example); indirectly, by levying taxes on businesses which are then passed on partially to non-residents; and through interaction with the federal income tax. By taking these factors into consideration, policy makers have the power to adjust the percentage of

## Important Tax Policy Principles

☞ **Fairness:** Does the New York tax system treat people at different income levels, and people at the same income level, fairly?

☞ **Base-Broadening:** Does each tax apply to as much of the potential tax base as possible, or does the tax allow targeted tax breaks that reduce the yield of each tax?

☞ **Adequacy:** Does the tax system raise enough money, in the short run and the long run, to finance the public services demanded by state taxpayers?

☞ **Exportability:** Individuals and companies based in other states benefit from New York public services. Do they pay their fair share?

☞ **Neutrality:** Does the tax system interfere with the investment and spending decisions of New York businesses and individuals?

☞ **Economic Development Consequences:** How does a tax—or a proposed tax change—affect the business climate, and the quality of life, in a state?

any revenue increase that will end up being “exported” in one of these three ways.

The interaction with the federal income tax is perhaps the most important of these. Taxpayers who itemize their deductions on their federal income tax returns are allowed to deduct the state and local income and property taxes<sup>1</sup> that they paid during the year. Because these deductions reduce federal income tax liability, part of the state and local income and property taxes initially paid by New York itemizers is actually paid by the federal government. The portion of taxes exported in this way depends on one's federal income tax bracket. For taxpayers with federal taxable incomes above \$319,000 in 2004, the benefit of federal deductibility is 35 percent.

This means that the real burden of state and local taxes for itemizers (particularly for wealthier taxpayers

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<sup>1</sup> Federal legislation passed in 2004 allows taxpayers, on their 2004 and 2005 federal tax returns only, to deduct their state and local sales tax payments if they do not take a deduction for state and local income taxes paid. While this provision may help a very small number of New Yorkers with low incomes and high property taxes, it was designed primarily as a benefit for taxpayers in states without income taxes, and sunsets after 2005.

who are the most likely to itemize their deductions on their federal returns and who are in the highest federal tax brackets) is never as large as their state tax pay-

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*The “federal offset” makes progressive state income tax increases an especially good deal for New York residents.*

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ments would indicate. This also means that when a state raises income or property taxes to pay for some needed public services, a substantial portion of the revenue involved will not be coming from local taxpayers at all—but will be coming from the federal government. If, on the other hand, sales taxes, fees or excise taxes are raised to pay for those services, virtually none of the additional taxes paid by local residents will be offset by federal tax savings. This makes state income tax increases—and progressive state income tax hikes in particular—an especially good deal for New York residents.

The principle of **neutrality** (sometimes called “efficiency”) tells us that a state’s tax system should stay out of the way of economic decisions. If people make their investment or spending decisions based on the tax code rather than basing them on what makes economic sense on its own, that’s a violation of the neutrality principle. For example, the big tax breaks that the Reagan administration provided for commercial real estate in the early 1980s led to far too much office construction and the phenomenon of “see-through office buildings” that nobody wanted to rent. These wasteful investments came, of course, at the expense of more productive investments. When lawmakers use tax incentives to encourage certain economic activities at the expense of others, they prevent the free market from speaking for itself.

Policy makers are frequently concerned about the negative **economic development consequences** of tax changes. In particular, lawmakers (and analysts with an anti-tax agenda) frequently make dire predictions about the negative impact of tax increases on a state’s economy without factoring in the offsetting positive impact of the new public spending that results from these tax increases. It is important to assess these two changes—tax hikes and spending hikes—side by side to get a true picture of how the fiscal policy changes would affect New York’s economic climate. Chapter Ten of this study measures the long-term impact of the

spending and tax changes on economic growth and employment in the state.

## Education Policy Principles

Since 1973, when the United States Supreme Court ruled that the financing of public education did not involve fundamental rights under the U.S. Constitution, the principal battleground for challenges to the various state education funding systems has been in state courts. As a result, technical and legal terms tend to dominate discussions of how best to fund schools. This section provides an overview of two of the most important terms used in these battles—equity and adequacy.

**Equity** is what people have in mind when they evaluate whether a state’s education system is fair to all of its students. Measuring the equity of a school funding system means measuring the treatment of any particular student compared to any other student. This can mean looking at the treatment of students in different school districts, or the treatment of students with different needs who live within the same school district. Definitions of equity also differ on a more fundamental level: what ought to be equalized? And what does “equal” mean? Over the years, courts have analyzed equity in terms of, among other things:

- equal access to education;
- equality of educational outcomes; and
- equal dollars per pupil.

**Adequacy** means providing sufficient public funding to allow all children to attain a certain basic level of education. While equity compares the amount of spending in a specific school district compared to other school districts, adequacy measures whether the amount of spending in any given district measures up to some particular standard for the quality of education across the state. For example, if state and local spending on New York public education were allocated between school districts in a way that did not provide enough money to pay for each district’s needs, but provided a similar amount of education resources to children across the state, it could be said that the New York education system was equitable but not adequate. If, on the other hand, New York provided large amounts of education spending for poor school districts, but provided even more for wealthy districts, the state’s school funding system would be adequate but not necessarily equitable.

Both of these terms are notoriously hard to define: state constitutions (including New York’s) usually

provide only vague wording describing the required quality of schools. As a result, the burden of interpreting these vague mandates for public education usually falls on state courts and on legislatures. As described in Chapter Two, New York courts have rejected the idea that the state’s constitution requires achieving equity between poor and wealthy districts—but the June 2003 decision of the state’s highest court in *CFE v. State* held that New York students do have a right to the opportunity for a “sound basic education”—and takes important steps toward defining specifically what adequacy requires in New York State.

## Understanding Tax Incidence Analysis

In evaluating the impact of any proposed tax change (and in evaluating current taxes), it is important to distinguish between the amount of revenue raised and the amount that is actually paid by New Yorkers. Throughout this report, we analyze the fairness of options for tax reform by measuring the amount of tax paid by various New York income groups as a share of that group’s total income. We measure taxes this way because this approach makes the critical distinction

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*Tax incidence analysis allows us to make the important distinction between the taxes collected by New York and the taxes actually paid by New York residents.*

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between the taxes raised by New York and the taxes paid by New Yorkers. These estimates, known as tax incidence analyses, are produced using the ITEP Tax Model. Our analyses usually divide the New York population into quintiles (groups of 20 percent), and further subdivide the wealthiest quintile into three subgroups. This is done because the wealthiest quintile received more than half of all New York income in 2004—and because income is distributed unequally within the top quintile. The following table shows the distribution of New York income in 2004.

- The poorest quintile of New Yorkers, with an average income of \$9,400, earned just 2.9 percent of all income in the state in 2004.
- The wealthiest one percent, with an average income of \$1,547,100 represented 23.5 percent of all income in the state.

## The Distribution of Income in New York All Families & Individuals in 2004

Income Group	Income Range	Average Income	Share of Income	
<b>Lowest 20%</b>	Less than \$15,000	\$9,400	2.9%	
<b>Second 20%</b>	\$15,000 to \$28,000	\$21,600	6.6%	
<b>Middle 20%</b>	\$28,000 to \$46,000	\$36,400	11.0%	
<b>Fourth 20%</b>	\$46,000 to \$76,000	\$58,900	17.8%	
<b>Top 20%</b>	<b>Next 15%</b>	\$76,000 to \$158,000	\$103,900	23.9%
	<b>Next 4%</b>	\$158,000 to \$590,000	\$237,900	14.5%
	<b>Top 1%</b>	\$590,000 or more	\$1,547,100	23.5%

## Conclusion

This chapter has described a few of the most important terms that will be useful in understanding the CFE case, and in understanding potential tax reform solutions to the state’s constitutional crisis. Of course, policymakers may seek to address the education funding concerns outlined by the court without repairing the tax policy concerns that are described in this report. But by tackling these problems simultaneously, lawmakers can help avoid a recurrence of this court-induced reform. The remainder of this report will focus on tax reform options that could help New York lawmakers to achieve meaningful reform in both of these important policy areas.

## CHAPTER TWO

# WHY SCHOOL FUNDING REFORM IS NECESSARY

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The June 2003 *Campaign for Fiscal Equity* (CFE) decision is the latest volley in a nationwide battle to establish the opportunity for a quality education as a fundamental right under state constitutions. The CFE decision states clearly that New York State is not meeting its constitutional obligation to provide an adequate education for New York’s school children—and places school funding reform squarely on the agenda of state lawmakers. This chapter provides an overview of this important court decision, reviews the current status of the attempts to implement the decision and to improve New York State’s education system in response to this decision, and surveys the experience of other states that have sought school finance reform.

### Is Education a Fundamental Right?

In the past quarter century, education advocates have sought to spell out what rights to a basic education—if any—are guaranteed by the various state constitutions. After a 1973 U.S. Supreme Court decision ruled that the Equal Protection Clause of the Fourteenth Amendment does not require equal funding of poor and wealthy school districts, advocates in many states sought to locate these guarantees in their own constitutions.<sup>2</sup> New York was among these states.

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***The New York State Constitution has been interpreted to guarantee a “sound basic education” to all New York school children—and a series of court decisions have found that the state has not met this requirement.***

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The New York Constitution requires the state legislature to provide New York school children with a public education. Article XI, §1 requires that “the legislature shall provide for the maintenance and support of a system of free common schools, wherein all the children of this state may be educated.”

But this provision, known as the “Education Article” of the New York Constitution, tells us nothing about the quality or duration of the education that the

state must provide. (Almost every other state also has an Education Clause that describes the state’s duty to provide education—and most of these constitutions describe education in similarly general terms.)

In 1982, the state Court of Appeals took a first step toward interpreting the New York Education Clause. The Court found in its *Levittown v. Nyquist* decision that Article XI requires the state to “ensure the availability of a sound basic education to all its children”—leaving unanswered the question of what a “sound basic education” means.<sup>3</sup> But the Court also ruled that neither the Education Clause nor any other provision of the New York Constitution required reforming school funding to achieve greater equity between poor and wealthy districts, closing the door to an equity-based avenue to school finance litigation in New York.

Since the 1982 decision made it clear that the courts did not require school funding to be *equitable*, education advocates next sought to convince the courts that New York had failed to achieve the constitution’s guarantee of an *adequate* education.

### The CFE Decision: A Decade of Litigation

The litigation culminating in the June 2003 decision began in 1993, when a nonprofit coalition called the Campaign for Fiscal Equity (CFE) and more than a dozen community school boards filed a lawsuit arguing that the state had not met its constitutional duty to provide an adequate education to children in New York City. Representatives of the state government sought to dismiss the case, and successfully argued that the community schools—and the City of New York, which had filed a companion case—were not eligible to file such a suit.

But in June of 1995, the state Court of Appeals ruled that Campaign for Fiscal Equity could proceed with its challenge of the State’s school finance system on the grounds that it denies students in New York City the opportunity to a “sound basic education.”<sup>4</sup> In other words, the court admitted that adequacy was a legitimate basis for a constitutional complaint, and allowed CFE the chance to prove that New York State

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<sup>3</sup>*Board of Education, Levittown Union Free School Dist. v. Nyquist*, 57 NY2d 27 (1982)

<sup>4</sup>*Campaign for Fiscal Equity, Inc. v. State of New York*, 86 NY2d 307 (1995)

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<sup>2</sup>*San Antonio Ind. School Dist. v. Rodriguez*, 411 US 1 (1973)

is not adequately funding schools. The case was remitted to a trial court to evaluate CFE's claims.

In 1999, a trial court heard arguments from CFE and other organizations in a case that sought to answer several fundamental questions:

- What precisely is a “sound basic education?”
- Are students in New York City receiving the opportunity for a sound basic education?
- If not, does the fault lie with a lack of adequate resources?

In January of 2001, the State Supreme Court ruled that students in New York were not receiving the opportunity for a sound basic education, and that the school finance system was largely to blame for these inadequacies. As a result, the Court found the State's system for funding public education unconstitutional. The State of New York immediately appealed the trial court's decision, and in June of 2002 an appellate court overturned much of the January 2001 decision.

In June of 2003, the Court of Appeals (the state's highest court) reversed the intermediate court's decision and reinstated the original ruling—that the state's system of funding New York City schools was unconstitutional. The Court found that “whether measured by the outputs or the inputs, New York City schoolchildren are not receiving the constitutionally-mandated opportunity for a sound basic education.”

The Court of Appeals also used the evidence gathered by the trial court to clarify its ruling that the Education Clause required the state to provide all students the opportunity for a “sound basic education.” The Court ruled that a sound basic education requires providing New York school children a “meaningful high school education, one which prepares them to function productively as civic participants.”

### The Court's Remedy: Achieving Adequacy

Faced with a choice between providing no guidelines to the legislature on how to reform education finance and providing a detailed blueprint for reform, the Court chose a middle ground, requiring the State to take three concrete steps toward reform:

- The state must **determine the cost of providing a sound basic education** in New York City.
- The state must **ensure that each school has the resources necessary** to provide the opportunity for a sound basic education.
- The state must **create a system of accountability** to ensure that these new state resources are being used effectively to fund education.

Though the *CFE* decision pertains to New York City school children, the decision will likely have implications for all of New York's school children. For the first time, state policymakers have guidelines against which to judge the adequacy of elementary and secondary education. And the availability of this yardstick will likely prompt them to apply the *CFE* requirements on a statewide basis, which is, in fact, the position that has been agreed upon by the governor and the legislative leaders.

The *CFE* remedy required the State to act quickly—and state policymakers failed to do so. In fact, the July 30, 2004 deadline set by the Court of Appeals passed without any legislative action. The case is now back in the hands of the courts for further action.

Shortly after the state missed this deadline, supreme court Justice Leland Degrasse appointed a panel of three distinguished lawyers to serve as referees to “hear and report with recommendations” by November 30, 2004 and to specifically:

1. Assess what measures the state has taken to follow the Court of Appeals' directives;
2. Identify areas in which compliance is lacking; and
3. Make recommendations on how to bring the state's school funding system into compliance with the ruling.

After a series of hearings, the judicial referees issued a report making six recommendations:

1. That the New York City school district should be provided with an additional \$5.63 billion per year in operating funds, with this increase being phased-in over a 4-year period;
2. That the state should conduct new “costing out” studies every four years to reexamine and re-determine the costs of providing a “sound basic education” to all students in New York City;
3. That City schools should be provided with \$9.179 billion in additional funding for capital improvements over the next five years;
4. That the state should conduct new facilities studies every five years to determine the additional funding, if any, required in the future to ensure that every New York City student has available facilities sufficient to provide the opportunity for a sound basic education;
5. That the funding studies referred to above should continue into the future until successful reforms to the state's education finance formulas have rendered such studies unnecessary;
6. That certain enhancements, that are essentially agreed upon by the parties, to the existing New York accountability structure be implemented.

It has been estimated that applying the referees' recommendation to all school districts in the state would require approximately \$8.5 billion per year (the \$5.6 billion recommended by the referees for New York City plus \$2.9 billion for other needy school districts around the state).

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*It has been estimated that adequately funding schools statewide would cost about \$8.5 billion per year.*

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The referees did not make a recommendation as to how the responsibility for providing the additional funds should be divided between the state and New York City, suggesting that the state should make that determination on its own. It is not known at this time how the legislature will allocate responsibility between the state and the city. New York City has asked that the state provide all of the additional funds. The state and CFE, on the other hand, have suggested that a portion of this responsibility be carried by the city itself. Under CFE's proposal, this division of responsibility would be determined for all school districts, including New York City, on the basis of a sharing formula that takes into consideration each district's wealth (as measured by both the adjusted gross income of school district residents and the full value of taxable real property in the district) relative to its pupil count adjusted for student need. While it is uncertain how much these funding responsibilities will be divided, it is clear that New York State must find sufficient revenue to substantially increase its state aid to local school districts.

### **How Can New York Achieve Adequacy?**

One important question left unanswered by the court's decision is how New York policymakers must change the education finance system to comply with the decision—and how much these changes will cost. In the wake of the June 2003 Court of Appeals decision, two groups, the New York State Commission on Education Reform and the Sound Basic Education Task Force, organized by the Campaign For Fiscal Equity and the New York State School Boards Association, presented recommendations and costing-out studies to the governor and legislature, and ultimately, when they failed to act, to the State Supreme Court during its compliance proceedings.

### **The Governor's Commission Proposal**

The New York State Commission on Education Reform was established by an Executive Order issued by Governor George E. Pataki. The Commission asked Standard & Poor's School Evaluation Services (S&P-SES) to analyze the issues involved in determining the actual cost of providing a sound basic education. In its report, S&P-SES developed an analytic framework based on the "successful schools" methodology. Actual cost determinations would depend on the specific choices the policymakers might make concerning the extra weightings that should be used for children with special needs, regional cost indices and other such items. For illustrative purposes, S&P-SES showed that using certain variables, the costs for providing the opportunity for a sound basic education for all of New York State's school children would be between \$2.5 billion and \$5.6 billion annually.<sup>5</sup> The Commission has used these variables and these figures in its report. The Commission provided a set of recommendations for the distribution of this additional financing as well as recommendations for ensuring the overall accountability of public education in New York.

The Commission also recommended changing the formulas by which New York distributes state aid to be more sensitive to local cost factors such as wealth, poverty rates and the presence of students with disabilities or limited English proficiency. The Commission also recommended ways for the state to improve capital projects funding, and advised that these changes should be phased-in over five years.

In response to the Commission's findings, Governor Pataki suggested a series of changes to the state's revenue structure, and increases in state, local and federal spending over the next five years that would total \$8 billion.

Under the governor's plan, the additional \$8 billion would be raised over five years using a variety of sources, with the biggest contribution coming from an expansion of video lottery terminals (VLTs). The Governor projects that, once implemented, the expansion of VLTs would bring in an additional \$2 billion annually and would be dedicated solely to providing a sound basic education.<sup>6</sup> The Governor's proposal also includes an additional \$2.5 billion in State aid, an anticipated \$2 billion in additional federal funding and requires New York City to contribute \$1.5 billion.

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<sup>5</sup>Resource Adequacy Study for the New York State Commission on Education Reform, March 2004

<sup>6</sup>State Education Reform Plan, August 12, 2004

The Governor's proposal, however, has flaws. First, in July 2004, the New York Appellate Division ruled that the State's current method of distributing VLT revenue is unconstitutional.<sup>7</sup> The Appellate Division concluded that since VLTs are considered a lottery and the New York constitution requires all net proceeds of lottery revenue to go towards education, the VLT revenue distribution system that includes giving portions of the VLT revenue to horse track interests is unconstitutional. This ruling has been appealed to the Court of Appeals, so any effort to devote additional VLT revenues to education must first cope with this constitutional problem. The use of VLT revenues to fund education is problematic for other reasons, as described in Chapter Eight.

In addition, the Governor's plan includes \$4.5 billion in unsubstantiated aid. The plan projects an additional \$2.5 billion in state aid and an additional \$2 billion being provided by the federal government. However, the Governor does not detail how these revenues will be raised—and the basis for expecting an additional \$2 billion from the federal government is unclear. New York City Mayor Michael R. Bloomberg also claims that he has no source for the proposed \$1.5 billion city share.

#### **Sound Basic Education Task Force Proposal**

A second costing-out proposal was undertaken by two national consulting groups, the American Institute for Research and Management Analysis and Planning, Inc. (AIR/MAP) and endorsed by the Campaign for Fiscal Equity, the plaintiff in the 1993 litigation, and its Sound Basic Education Task Force. The Task Force proposals resemble the Governor and Commission's recommendations in regard to adjusting state aid formulas and implementing better accountability mechanisms. The most significant difference between the two proposals is in the amount needed to provide New York school children with a sound basic education. The AIR/MAP report states that the additional amount needed statewide ranges between \$6.2 billion to \$8.4 billion annually.<sup>8</sup> Taking a figure in the middle of this range, however, and updating it for inflation through 2004-2005, CFE has recommended a total statewide increase of \$8.5 billion. Unlike the Governor's proposal, the Task Force does not suggest a way to raise this additional revenue. Furthermore, the Task

Force proposes \$10 billion in additional funding for capital projects (to be phased in over five years) along with regulative changes whereas the Governor's proposal only suggests regulative changes without any additional funding.

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#### ***Using video lottery terminal (VLT) revenues to fund education may be unconstitutional.***

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Neither of these proposals includes a realistic mechanism for raising the necessary funds—and there remains disagreement on whether achieving adequacy will require additional revenues in the \$2.5 to \$5.6 billion range prescribed by the Governor's Commission or the \$8.5 billion recommended by CFE.

#### **How New York Schools Are Funded**

Why is it so difficult to achieve educational adequacy? The basic problem is that close to half of the revenue currently used to fund schools comes from local governments themselves—and local governments vary tremendously in their ability to finance adequate public services.

In fiscal year 2001-2002, New York state and local governments spent \$35 billion on elementary and secondary education. Of that total state aid to local governments represented just over \$17 billion, or 48.7 percent of all public school funding, and federal aid added another 5 percent. This left local governments to pick up more than 46 percent of the cost of funding elementary and secondary education.

In New York, as in most other states, the primary source of local funding for education is the property tax. One problem with the use of property taxes as a source of school funding nationwide is that property-poor districts are less able to use these revenues to fund schools. The less property wealth in a given district, the less property tax revenue that district can raise in taxes—and the less revenue is available to adequately fund schools. As a result, property-poor districts are usually not able to fund the costs of education as easily as property-wealthy districts.

For example, the Lafayette school district is one of the poorest in the state. For each pupil in the school system, Lafayette has less than \$100,000 of property value that can be taxed to pay for schools. The much wealthier Rye school district has more than \$1.1 million of property value for each student. In 2002, Lafayette real property taxes were 1.81 percent of

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<sup>7</sup>Joseph Dalton et al v. George Pataki, 780 N.Y.S.2d 47 (2004)

<sup>8</sup>The New York Adequacy Study: "Determining the Cost of Providing All Children in New York an Adequate Education", March 2004

property value, while Rye taxed properties at 1.27 percent of value—almost a third less than in Lafayette. But because Rye’s per-pupil tax base is so much larger, the Rye district was able to raise nine times more per pupil than did Lafayette in 2002.

In this example, the vast difference in property wealth between these two districts mean that residents of the low-wealth district are doubly punished, paying property taxes at a much higher rate and receiving much less funding per pupil in return.

In addition to differences in property wealth, differences in the cost of delivering an adequate education can vary among school districts due to “local cost factors”. Local cost factors include the incidence of students in poverty, speaking English as a second language, and/or enrolled in special education programs. The June 2003 *CFE* decision concludes that an increase in these local cost factors will increase the cost of providing a sound basic education.

## The Struggle for Adequacy in Other States

Many states have struggled with court-ordered school finance reform in recent years. While the Court of Appeals’ June 2003 decision is an important step towards achieving educational adequacy, the experience of other states shows that recognizing school funding inadequacies is only the first step in achieving progressive reforms of a state’s education funding and tax systems. This section looks at the recent experiences of three states—Alabama, Kentucky, and Michigan—in combining tax reform with school finance reform, with an eye toward drawing lessons for school finance reform in New York.

In the case of *Harper v. Hunt*, which began in 1990, Alabama’s entire primary and secondary public school system was declared unconstitutional by a lower court because it did not fulfill the constitutional guarantee of an adequate and equitable education.<sup>9</sup>

The lower court’s decision prescribed specific policy changes to remedy these constitutional violations, including performance standards for students and educators, school accountability, staff development, teacher pay, and school capital infrastructure. Annual cost increases for these educational changes were estimated at \$1.7 billion.

Recently, the Alabama Supreme Court upheld the lower court’s finding that the system was unconstitutional, but instructed the lower court to leave deci-

sions about how to achieve adequacy to the legislature and the governor.<sup>10</sup> To date, the legislature has not complied with the court’s mandate—and there is no prospect for revenue-raising reforms in the near future.

In 1989, the Kentucky supreme court found the Kentucky school system unconstitutional in *Rose v. Council For Better Education*. The court described in detail the requirements of an “efficient” education system. The list of these requirements drawn up by the court became the “Rose standards” that has been used in Massachusetts, North Carolina, and a number of other states.

Responding almost immediately to the *Rose* mandate, the Kentucky General Assembly enacted a plan which totally overhauled the system for K-12 education and created a new school funding system that included state-aid adjustments for exceptional and at-risk students as well as transportation costs.<sup>11</sup> It also included funds for special education, preschool programs, technology, professional development, deficient schools and rewarding school improvement.

The main funding sources for the reform plan were a sales tax increase, an increase in the corporate income tax, and loophole-closing personal income tax reforms. Local districts were required to levy a minimum property-tax rate of 30 mills to participate in the state-aid program. Local supplements were also limited, partially equalized, and subject to local voter approval. The new taxes increased funding for schools by 42 percent from 1990 to 1994, and by 1999 the per-pupil spending gap between wealthier and poorer districts had closed from \$1,199 to \$757. During that time, reading scores doubled for Kentucky’s students, and student test performance also improved.

The Kentucky legislature took steps to ensure that the increased state taxes from this plan would not fall primarily on low-income taxpayers by simultaneously enacting a low-income tax credit. The 1990 reforms also strengthened the personal income tax base in a progressive way by eliminating the state’s deduction for federal personal income taxes paid—a rarely used loophole that primarily benefitted the very wealthiest Kentuckians.

Unlike the other states surveyed here, the impetus for school finance reform in Michigan in the early 1990s was not a court mandate, but public dissatisfaction with the state’s high property taxes and

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<sup>10</sup>*Ex parte Governor Fob James*, 2002 WL 11508(Ala.,2002).

<sup>11</sup>*Rose v. Council for Better Education, Inc.*, No. 88-SC-804-TG; Supreme Court of Kentucky, 790 S.W.2d 186 (1989).

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<sup>9</sup>*Alabama Coalition for Equity, Inc. v. Hunt* No. CV-90-883-R (Ala. Cir. Ct. Montgomery County), 6224 So.2d 107 (Ala. 1993).



inequality in school funding between poor and wealthy local districts. In 1993, the state legislature voted to eliminate the local property tax as a source for school funding. In a 1994 election, Michigan voters ratified a “tax swap” that funded local property tax repeal by increasing general sales taxes by two percent and cigarette taxes by 50 cents per pack, with the proceeds devoted to funding schools. The voters also agreed to create a new state-administered property tax. These changes shifted most of the school funding burden from local governments to the state.

The state’s assumption of the school funding burden resulted in funding increases of up to 30 percent for poorer districts, and reductions in revenue to wealthy districts of about 4 percent.

The Michigan tax reforms were also designed to restore balance to the state’s tax system. In 1990, Michigan property taxes were more than thirty percent above the national average, while its sales and excise taxes were more than thirty percent *below* the national average. The 1994 reforms reduced this imbalance substantially: by 2000, Michigan property tax revenues were just seven percent above the national average, and consumption tax revenues were only ten percent below the national average.

While this change restored balance to Michigan’s tax system, it did so by increasing slow-growing cigarette taxes and volatile sales taxes, which generated insufficient revenues to replace the lost property tax receipts. The state responded to these problems two years later, in 1996, by dedicating a portion of personal income tax revenues to schools. But the state’s initial choice of slow-growing, unfair consumption taxes as a revenue source forced lawmakers to return to these issues a second time.

Because this “balancing” process involved increases in regressive sales and cigarette taxes, these changes also made the Michigan tax structure more regressive. Since the 1996 release of ITEP’s study, *Who Pays?*, Michigan has been recognized as one of the “terrible ten” most regressive tax systems in the nation—largely due to the school finance reforms implemented in 1994.<sup>12</sup>

## Conclusion

The June 2003 CFE decision culminated a ten-year judicial odyssey with an emphatic statement that the state’s education system is unconstitutionally in-

adequate. The recommendations of the recent Governor’s Education Commission and CFE’s Sound Basic Education Task Force provide a valuable starting point for thinking about what education policy changes will be required to revitalize the New York education system. However, the question of how educational adequacy can be paid for remains largely unresolved—the Governor’s recommendations provide unfunded or constitutionally suspect revenue sources, and both the CFE and the Special Referees do not recommend any specific approaches to revenue-raising. Later chapters of this report will take a first step toward answering the important question of how tax reform strategies can be used to achieve educational adequacy.

School funding adequacy has been a battleground in dozens of states in recent years—and recognizing educational inadequacy is by no means a guarantee that adequacy will be achieved. The experiences of other states offer valuable insights for state policy makers. Kentucky’s 1990 reforms show that judicial mandates for education funding reform can result in immediate action, with long-run improvements in educational achievements while simultaneously revitalizing the state tax system. Kentucky’s legislature responded to a court mandate within a year, passing a revenue-raising package that increased state revenues through a combination of loophole-closing and rate increases that “spread the pain” between income, sales and property taxes. Kentucky lawmakers also seized the opportunity to enact true tax reform, shoring up the income tax base by eliminating a costly loophole and providing low-income tax relief to help offset the state’s regressive sales tax increases.

The Michigan legislature also managed to push through tax changes to fund educational adequacy. But the state’s use of cigarette and sales tax revenues bodes ill for the long-term viability of education funding in the state—and has made the tax system more inequitable. The Michigan reforms show that school funding based on slow-growth revenue sources may present a short-term respite without providing a long-term solution.

Finally, the example of Alabama shows that judicial mandates are insufficient to ensure educational adequacy. More than a decade after the state’s education system was first found inadequate, no substantial reforms have been enacted—and Alabama’s schools continue to perform poorly. The Alabama experience shows clearly that if judicial mandates are ignored, litigation designed to achieve school funding reform can make matters worse rather than better.

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<sup>12</sup>Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. (1996)

# AN OVERVIEW OF THE NEW YORK TAX SYSTEM

This chapter examines the New York state and local tax structure in comparison to other states and looks at trends in New York tax revenues over the past two decades. It also shows the distribution of state and local tax liability by income levels in 2002 and assesses the distributional impact of tax changes enacted in the 1990s.

## New York Taxes—How High?

Measured as a share of personal income in the state, New York state and local taxes are relatively high. In fiscal year 2002, New York state and local taxes represented 13.1 percent of personal income—highest in the nation and 27 percent above the national average.

Of course, taxes are not the only source of revenue for state and local governments. Nationwide, the states derive almost a third of their own-source revenues from non-tax sources such as user charges and fees for highways, sewers, education, hospitals and parks. When these non-tax revenues are factored in, the overall “burden” of own-source revenues is much lower. This is because New York ranks fourth highest in the nation in the percentage of its own-source general revenues derived from taxes, with almost 75 percent of these revenues coming from taxes. This means that focusing only on tax revenues tends to overstate the cost of New York government compared to other states. When non-tax own-source revenues are included, the apparent cost of funding

government in New York falls from highest in the nation to sixth highest—and this broader measure of “tax burdens” puts New York only sixteen percent above the national average.

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*Most other states rely more heavily on regressive user fees and other non-tax revenues to fund services than does New York. Cross-state comparisons of New York’s “tax burden” should take this into account.*

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Of course, this does not imply that New York should move toward a greater reliance on user fees and other non-tax revenues to fund education. User fees tend to be regressive, requiring low-income taxpayers to pay more of their income in tax. And the underlying principle behind the “user fee” approach to funding government—that public services should be paid for by the individuals and businesses who benefit from these services—is only applicable to a limited set of government services for which the beneficiaries are clearly distinguishable. But it is important to note that

### State and Local Taxes as a % of Own-Source Revenues, 2002

	% of Total	Rank
Connecticut	80.6%	1
Massachusetts	72.8%	9
New Jersey	74.8%	3
New York	74.5%	4
Ohio	69.9%	14
Pennsylvania	67.3%	25
Vermont	70.9%	12
<b>ALL STATES</b>	<b>68.3%</b>	
<b>NY as % of US avg</b>	<b>109%</b>	

SOURCE: Bureau of the Census

### Local Taxes as a % of Total Taxes

	1972	Rank	2002	Rank
Connecticut	49.8%	13	40.3%	21
Massachusetts	51.7%	8	38.0%	29
New Jersey	60.4%	2	47.1%	6
New York	51.5%	10	51.3%	2
Ohio	52.0%	7	44.3%	10
Pennsylvania	38.0%	33	41.2%	20
Vermont	43.6%	21	22.7%	47
<b>ALL STATES</b>	<b>45.4%</b>		<b>40.9%</b>	

SOURCE: Bureau of the Census, Bureau of Economic Analysis

the non-tax revenues relied on by most other states are potentially every bit as burdensome to individuals and businesses as are tax revenues—and that both of these state funding sources should be considered in comparing the cost of government across states.

## A Decentralized Tax System

In recent decades, many states have moved away from local funding of public services and have increased the state’s responsibility for providing these services. As a result, the nationwide share of all state and local taxes levied at the local level has declined from 45 percent to 41 percent in the past thirty years. But this figure has remained stable in New York, making the state one of the most decentralized revenue structures in the nation. In 1972, New York ranked tenth highest nationally in the share of tax revenues derived from local governments. By 2002, the state was second in the nation by this measure. New York is now one of only three states in the nation that actually collect more local tax revenue than state tax revenue. The June 2003 decision represents, in part, an acknowledgment that New York’s historical reliance on local taxes to fund schools has contributed to the state’s inability to adequately fund education.

New York City relies on a diverse mix of own-source revenues, including income, sales and property taxes. By contrast, all other New York local governments are much more limited in their revenue-raising choices. In particular, almost all local governments outside New York City do not rely on local income taxes at all to fund services.

## Limitations of Aggregate Tax Data

The primary problem with the aggregate tax measures presented so far is that they tell us little about whether specific groups of taxpayers experience New York as a low-tax, high-tax, or average tax state. Taxes can affect taxpayers differently depending on their income levels, the composition of their income, their family size, whether they own a home, and many other factors. Most states provide targeted tax breaks aimed at particular income groups—and the impact of

these tax breaks is concealed by focusing on these aggregate tax figures.

Another problem with aggregate measures of taxes is that they include all taxes collected in the state, regardless of whether the residents of the state actually pay those taxes. For example, the New York Department of Taxation and Finance has estimated that residents of other states (and part-year residents) pay as much as 14 percent of all New York personal income taxes. The measures of “tax as a share of personal income” presented in this chapter include all of the taxes paid by non-residents, but do not include the income of these non-residents. For states (like New York) in which non-residents pay an especially large share of the state’s taxes, these aggregate data can make taxes appear much more burdensome than they really are.

Similarly, a significant portion of the taxes paid by businesses to the state of New York are not ultimately paid by New York residents at all, but are “exported” out-of-state and paid by non-residents. Much of the New York business tax ultimately is paid by non-New Yorkers through either higher prices on goods and services exported from New York or lower returns on profit for out-of-state investors in businesses operating in New York. Thus, the business tax component is another reason these aggregate statistics do not tell the whole story.

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*For states (like New York) in which non-residents pay an especially large share of the state’s taxes, aggregate tax comparisons can make taxes overall appear much more burdensome than they actually are.*

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## Sources of Local Tax Revenue, 2002

	Personal Income Tax		Consumption Taxes		Property Taxes		Other Taxes	
	%	Rank	%	Rank	%	Rank	%	Rank
Connecticut	—	13	0.0%	49	98.4%	2	1.6%	49
Maine	—	13	0.2%	47	97.4%	5	2.4%	38
Massachusetts	—	13	1.7%	41	96.1%	8	2.2%	41
New Hampshire	—	13	—	50	98.0%	3	2.0%	44
Rhode Island	—	13	0.3%	46	97.7%	4	2.0%	45
Vermont	—	13	0.7%	43	96.9%	6	2.4%	39
New York City	21%		18%		40%		20%	
Rest of State	0%		23%		76%		2%	
All States	4.6%		16.7%		72.9%		5.8%	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

## Federal Taxes Matter, Too

Cross-state comparisons of taxes are also affected by the ability of state residents to deduct their income and property taxes on their federal tax forms. The more a state relies on federally deductible income and property taxes, the lower the federal taxes paid by its citizens—a factor which simple cross-state comparisons of state and local taxes does not capture. Residents of states relying more

heavily on deductible taxes have lower total taxes—state, local *and federal*—than the residents of states relying more heavily on generally non-deductible taxes (such as the general sales tax).

Federal deductibility is an important mechanism for exporting state taxes to the federal government. In essence, the federal government subsidizes states that rely heavily on deductible taxes. This means that states relying heavily on generally non-deductible taxes or having a low reliance on deductible taxes are missing an opportunity to minimize the amount of state taxes that comes out of the pockets of New York taxpayers.

### **Hidden Federal Tax Hikes on New Yorkers?**

Allowing taxpayers to deduct the state and local taxes that they pay in calculating their federal income tax liability is an essential part of a governmental system in which the federal and state governments have independent sovereign taxing authority. In the American federal system, when people pay state and local taxes, they have less money left over to pay federal taxes. Thus when it comes to the federal individual income tax, which is based on the “ability to pay” principle, taxpayers should be able to deduct their state and local taxes in determining how much of their income is “taxable” by the federal government.

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***New York’s tax system is regressive, requiring low-income taxpayers to pay much more of their income in tax than wealthier New Yorkers must pay.***

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Despite the fundamental importance of state and local tax deductibility in a federal system such as ours, there are some immediate threats to this concept. In 1986, when the Congress last undertook a thorough restructuring of the federal tax system, the deductibility of state and local income and property taxes was maintained, but that victory is now being eroded by the evolution of the federal Alternative Minimum Tax (AMT) which was intended to help ensure that wealthy taxpayers can not use excessive deductions and tax loopholes to zero out their tax liability.

The federal AMT acts as a backstop to the regular federal income tax, imposing a lower set of rates on a much broader tax base that excludes many deductions, including the itemized deduction for state and local income and property taxes. But an increasing number of non-wealthy taxpayers are now being affected by

the AMT as the President and Congress have cut the rates of the regular federal income tax relative to the AMT rates, while the AMT exclusion (a sort of standard deduction that is used in calculating AMT liability) has not kept up with inflation. The result is that the AMT, as it is currently structured, serves to undercut the power of the deduction for state and local taxes paid.<sup>13</sup> Unless steps are taken to reform the federal AMT, a growing number of taxpayers will be affected by it. Ideally, the Congress should remove the deduction for state and local taxes from the calculation of the federal AMT since it is not a tax loophole or tax preference that taxpayers use to reduce their federal income tax.

In addition to the real threat to deductibility posed by the evolution of the AMT, some Bush Administration officials have floated the idea of completely eliminating the federal income tax deduction for state and local taxes paid as a way to finance other tax cuts—a move which would cost New York taxpayers billions in additional federal income taxes. Repealing the federal offset—or continuing to allow it to wither away due to the AMT—would amount to a substantial increase in a form of “double taxation” that one would ordinarily expect a pro-Federalism, pro-devolution administration to be opposing rather than supporting.

New York’s business, labor, civic, political, and cultural leaders can work with their counterparts from other states to drop the current treatment of the deduction for state and local taxes under the AMT and to stop efforts to otherwise undercut this important principle of federalism.

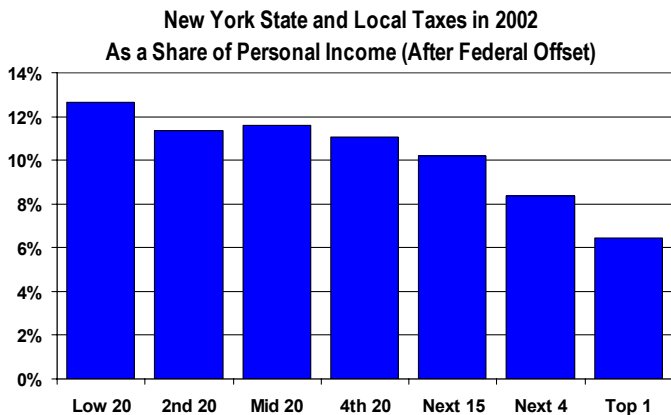
### **The Distribution of New York Taxes**

The distributional chart on the next page takes into account the exporting issues that the aforementioned aggregate data cannot address: the chart estimates the net impact of New York taxes on New York residents at various income levels in 2002. The chart shows that New York’s overall state and local tax system is *regressive*: it requires middle- and lower-income residents to pay a greater share of their in-

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<sup>13</sup> Senator Kay Bailey Hutchinson, Congressional Record, February 27, 2003, Page: S2924, “For those in states with income taxes, their tax deduction benefit has been diminished by the... AMT. People can deduct their state and local income taxes when calculating their regular taxes, but not when determining the AMT. The difference often is the reason people must pay the higher alternative tax. In fact, state and local taxes account for 54 percent of the difference between the AMT and the regular tax calculation. This particularly hurts...AMT payers who are from states with higher income tax rates.”

come in taxes than it does the wealthy. The poorest 20 percent of New York families pay 12.6 percent of their income in state and local taxes, compared to 11.6 percent for middle-income families. The wealthiest one percent of New Yorkers residents paid just 9.1 percent of their income in New York taxes.



When the federal deductibility of income and property taxes is taken into account, New York taxes are even more regressive. After taking account of this “federal offset,” the wealthiest New Yorkers taxpayers pay just 6.5 percent of their income in taxes—about half the tax rate paid by the poorest New Yorkers.

The overall regressivity of the New York tax system is due to several factors:

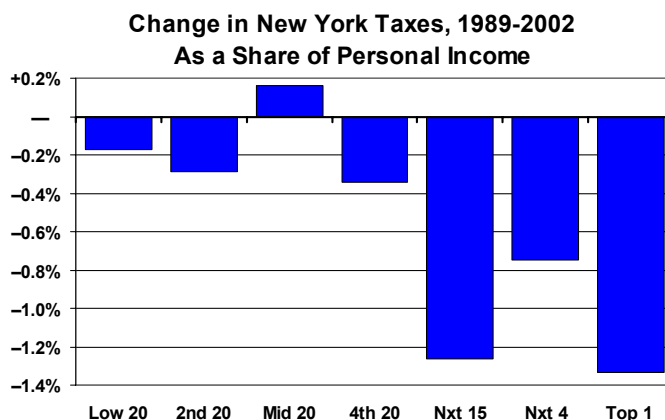
- New York sales and excise taxes are regressive.
- New York property taxes, despite generous credits and exemptions, are also regressive.
- The New York income tax is insufficiently progressive to offset the state’s other regressive taxes.

A regressive tax system is problematic because it places the largest tax burden on those with the least ability to pay. A ten percent tax on middle- or low-income families cuts directly into their standard of living in a significant way. But a similar level of taxation on wealthy families does not as significantly impede their quality of life. This observation is the underpinning of the ability-to-pay principle—the idea that wealthier taxpayers can more easily bear the cost of taxes than can lower-income taxpayers. A progressive tax system takes a larger percentage of the income of the well-off than it does from those with lower incomes, in conformity with the “ability to pay” principle. A regressive tax system—like that of New York—violates this basic principle of tax fairness.

A regressive tax system is also somewhat illogical in that it tries to raise money from the people who have the least of it. The wealthiest one percent of New

Yorkers have more income than the poorest 40 percent combined—so soaking the poor simply doesn’t yield much revenue compared to modest taxes on the wealthiest New Yorkers. Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.

Equally troublesome is that the New York tax system has remained regressive despite an overall decline in taxes. A January 2003 ITEP study found that tax changes in the 1990s had the effect of decreasing more of the tax burden for New York’s wealthiest residents than for the state’s low- and middle-income households.<sup>14</sup> As the following chart shows, almost all New York taxpayers saw, on average, tax cuts during the 1990s. But by far the largest tax cuts were reserved for the very wealthiest New Yorkers.



As will be seen in later chapters, this trend is partially due to cuts in the top marginal income tax rates on the wealthiest New Yorkers. While lower- and middle-income New Yorkers benefitted from these tax cuts as well, the benefits were wiped out by increases in local sales taxes and cigarette taxes.

## Conclusion

The New York tax system is regressive, imposing the highest effective tax rates on those low- and middle-income New Yorkers who can least afford to pay them. The use of an unfair tax system also hinders the state’s effort to adequately fund public services.

The *CFE* decision grants New York policy makers a historic opportunity to ease the tax load on low- and middle-income families, ensure that those with the greatest ability to pay do so and in the process guarantee the funds necessary to provide an adequate education to New York’s school children.

<sup>14</sup>ITEP, *Who Pays? A Distributional Analysis of the State and Local Tax Systems in All Fifty States*. (2003)

## CHAPTER FOUR

# THE NEW YORK PERSONAL INCOME TAX

The personal income tax is the only major progressive tax levied by state and local governments. The New York income tax helps to offset the regressivity of the sales, excise and property taxes that form a majority of New York revenues. But the tax has become sharply less progressive in the past quarter century, and a variety of poorly targeted tax loopholes threaten to reduce the state's ability to fund education and other services. As a result, the state's income tax is no longer sufficient to offset the unfairness of other New York taxes. This chapter looks at options for reforming the New York state income tax.

### New York Personal Income Tax: An Overview

<b>Total Taxpayer Income</b>
<b>Minus</b>
<b>Items Not Included in Federal Adjusted Gross Income</b> (Some Social Security benefits, welfare benefits)
<b>Equals</b>
<b>Income Reported on New York Tax Forms</b>
<b>Minus</b>
<b>New York Adjustments</b> Pensions, Social Security Taxed by Federal Government
<b>Plus</b>
<b>State Additions</b> Federally Tax-Exempt Interest and Dividend Income
<b>Equals</b>
<b>New York Adjusted Gross Income</b>
<b>Minus</b>
<b>Dependent Exemption, Standard/Itemized Deductions</b>
<b>Equals</b>
<b>Taxable Income</b>
<b>Multiplied by</b>
<b>Tax Rates</b>
<b>Equals</b>
<b>Tax Before Credits</b>
<b>Minus</b>
<b>Tax Credits</b> Household, Earned Income, Property Tax Credits
<b>Equals</b>
<b>Net Tax Liability</b>

### How it Works

Like most states, New York's personal income tax is based on federal rules. The starting point for determining New York taxable income is federal adjusted gross income (FAGI). Federal AGI includes most income sources, but excludes most Social Security benefits, welfare benefits, education IRAs and medical savings accounts. New York's use of federal AGI as a starting point means that these federal tax breaks are automatically passed through to the New York tax as well.

In addition to these federal exclusions, New York allows its own "adjustments" to federal AGI. New York AGI differs from federal AGI in two important ways:

- All federally taxable Social Security benefits are exempt in New York.
- All public pension benefits are exempt, and up to \$20,000 of private pension benefits are exempt for New Yorkers over 59 years old.

The state also allows adjustments for federal bond interest and contributions to a College Choice Tuition Savings Program. The chart on the next page compares the cost of these New York adjustments in 2004.

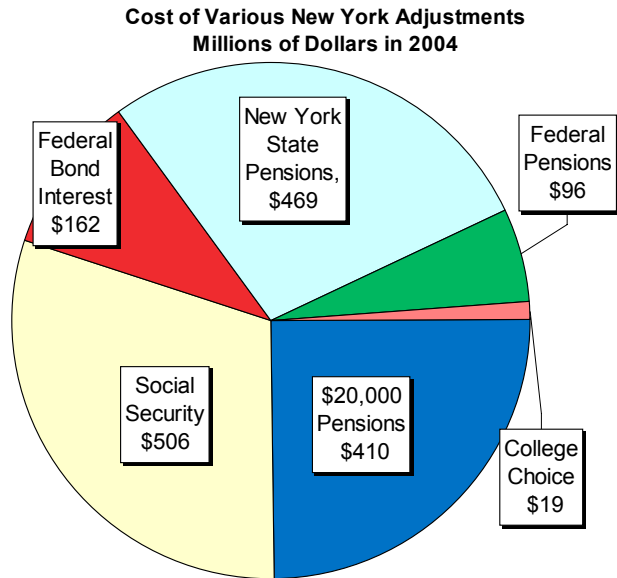
Like the federal government, New York also allows taxpayers to choose between taking a standard deduction, which shelters up to \$14,600 from income for married couples, and itemized deductions, which allow wealthier taxpayers to write off mortgage interest costs, extraordinary medical expenses, real property taxes, and other costs of living. The state also follows federal rules in disallowing part of these itemized deductions for the very wealthiest taxpayers, on the theory that these wealthy New Yorkers have a greater ability to pay than other itemizers.

New York itemized deductions are different from federal itemized deductions, however, in two ways. First, state and local income taxes can be deducted on federal forms, but are not deductible on New York forms. (Most other states take the same approach, diverging from the federal treatment of state and local income taxes.) Second, New York adds a second high-income disallowance for itemized deductions.

New York's tax rate structure is graduated, applying higher marginal rates to higher incomes. The tax has five permanent rates, ranging from 4 percent to 6.85 percent. In 2002, the top rate of 6.85 percent applied to married New Yorkers with taxable income

over \$40,000 (\$20,000 for single taxpayers). For taxpayers with adjusted gross incomes over \$100,000, the benefit of the lower tax rates is gradually phased out, so that taxpayers earning over \$150,000 pay at a flat 6.85 percent rate on all their taxable income. In addition, temporary 2003 legislation creates two higher income tax brackets (7.5 percent and 7.7 percent) that will expire at the end of 2005. The 7.7 percent top rate applies only to New Yorkers earning over \$500,000.

## A Progressive Income Tax

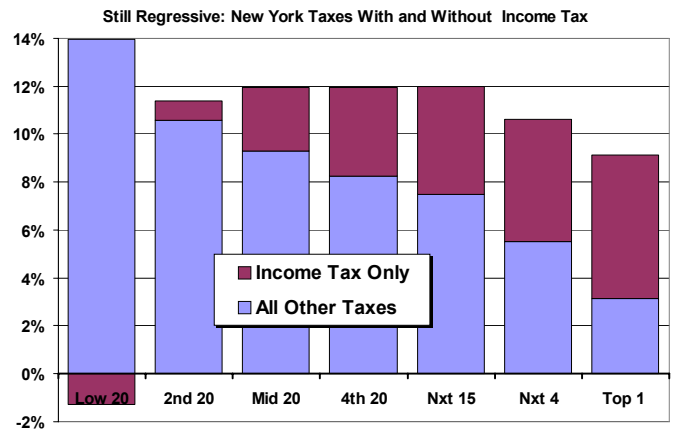


The New York state income tax is progressive. In 2003, low-income taxpayers, on average, received 1.3 percent of their income in refunds. The middle 20 percent of taxpayers paid 2.6 percent of their income in income taxes, and the wealthiest one percent of New Yorkers paid 6.0 percent of their income in New York state personal income taxes.

When the deductibility of state income taxes on federal income tax returns is taken into account, however, the New York income tax is much less progressive—and much less burdensome on the wealthiest taxpayers. In 2003, the effective income tax rate on the wealthiest 1 percent of New Yorker falls from 6.0 to 4.3 percent when federal deductibility is taken into account.

Moreover, the progressive influence of the income tax is not sufficient to offset the regressivity of New York sales and property taxes, as the following chart shows. Only a more progressive income tax—or a dramatically lower reliance on regressive sales and

property tax could allow New York to achieve even a proportional, “flat” tax system overall.



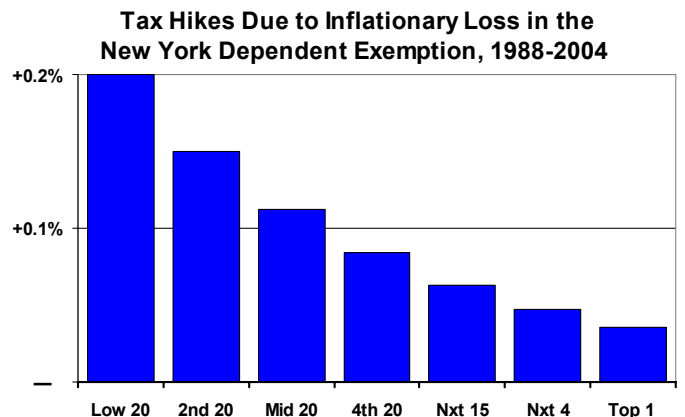
## Factors Limiting Progressivity

While the New York income tax is progressive, several features of the tax structure make it less progressive than it could be. Most notably:

- The state’s personal income tax brackets are not indexed for inflation, which means that each of the higher income tax rates apply to proportionally more New Yorkers each year.
- The top marginal income tax rates have been cut dramatically over the past quarter century—indirectly shifting more of the income tax to low- and middle-income New Yorkers.
- The complete exemption of Social Security benefits only wealthier retirees.
- The state exempts up to \$20,000 of private pension benefits for taxpayers 59 and older, discriminating against elderly wage-earners.

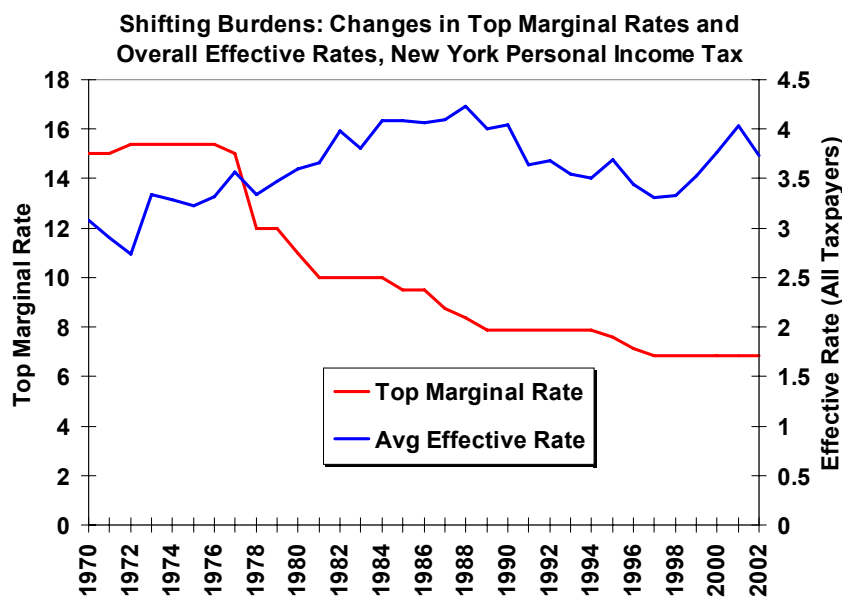
## Indexing for Inflation

New York’s graduated tax rate structure is designed to ease the impact of higher income tax rates on low- and middle-income New Yorkers who have less “ability to



pay,” by allowing them to pay at lower rates. However, the lower tax rates have become less effective over time in sheltering the income of lower-income New Yorkers because the tax brackets are not indexed for inflation. For example, the 4 percent bottom rate applies to the first \$16,000 of taxable income. This amount was last modified in 1997. Between 1997 and 2004, inflation reduced the real value of the bottom bracket to just \$13,600—so each year, more and more low-income taxpayers are paying at rates above the bottom rate. Since the other tax brackets have remained unchanged during this period, inflation has also reduced the value of these intermediate tax brackets over this time. By not updating the tax brackets to take account of this inflationary impact, New York lawmakers have essentially passed a regressive tax hike on low- and middle-income New Yorkers since 1997.

The state’s dependent exemption has been similarly devalued. The exemption was increased to its current level (\$1,000 per child) in 1988. If the exemp-



tion had been indexed for inflation since then, it would be worth almost \$1,600 today—meaning that New York lawmakers have essentially enacted a \$600 cut in the exemption granted to families with children.

**Declining Rates**

Even as effective tax rates have crept upwards, New York lawmakers have enacted a series of cuts in the top marginal rates paid by the wealthiest New Yorkers, falling from over 15 percent in 1973 to 6.85 percent in 2003. One indicator of the impact this inflationary hike has had is the gradual growth in the effective tax rates

on New Yorkers. As the chart on this page shows, the average effective tax rate on New Yorkers has crept upwards even as the top marginal rate has been cut dramatically.

This “tax shift” from lower-income to wealthier New Yorkers has been exacerbated by cuts in the income tax rate that is applied to unearned income. Between 1978 and 1988, New York imposed a higher tax rate on unearned income (including capital gains and dividends) than on earned income. For example, in 1978, the top rates were 12 percent on earned income and 14 percent on unearned income. In 1989, the tax rate on unearned income was lowered to equal the top rate on regular income. Since unearned income is disproportionately realized by wealthier New Yorkers, this change has made the income tax less progressive.

**Social Security Exclusion**

Under federal tax rules, Social Security benefits are exempt for income taxpayers whose “provisional income” is below \$32,000 for married couples (\$25,000 for other taxpayers). Taxpayers with income exceeding these thresholds pay some tax on Social Security benefits.<sup>15</sup> This limited federal tax on Social Security applies to less than 20 percent of elderly New Yorkers. However, New York departs from the federal definition of AGI by allowing taxpayers to subtract any and all Social Security income that is taxable for federal purposes. Both the federal exemption and the New York exemption tend to benefit wealthier elderly taxpayers. The New York-specific exemption, however, is especially regressive—and quite costly.

**Pension & Annuity Exclusion**

New York exempts certain types of pension and annuity income for taxpayers over the age of 59. This exemption applies to the first \$20,000 of eligible pensions and annuities. This tax break is forecast to cost \$410 million in 2004.

This exemption creates two glaring problems of tax equity: first, it provides a special exemption to elderly taxpayers at all income levels. The pension

<sup>15</sup>Provisional income includes most sources, but excludes half of Social Security benefits. For taxpayers with income above these thresholds, but below \$44,000 (\$34,000 for single filers), 50% of Social Security benefits contributing to income above these thresholds are subject to tax. At very high income levels (above \$44,000 for married couples), 85% of benefits are subject to tax.



benefits of the wealthiest executive receive the same favored treatment as do the benefits of the lowest-paid worker. A second inequity in this approach to elderly tax relief is that it provides special treatment for non-working taxpayers, with no comparable exemption for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly New Yorkers who work tend to be poor, this tax preference for unearned income—with no similar tax break for earned income—is hard to justify.

Limiting the pension tax break to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of the New York income tax.

### Low-Income Tax Relief Mechanisms

New York's income tax allows a variety of credits designed to make the income tax more progressive. This section outlines the major tax credits currently available and suggests possible reforms.

Since 1978, New York has allowed a **Household Credit** designed to provide targeted tax relief to low-income families. Single taxpayers earning less than \$5,000 a year receive a \$60 credit, and larger families receive an extra \$15 for each additional family member. The value of the credit decreases gradually for families earning between \$5,000 and \$32,000 (\$28,000 for singles), and is unavailable for taxpayers earning over \$32,000. The relatively low income thresholds keep the cost of this credit low. But this credit is available to fewer and fewer taxpayers each year, since none of the credit's features are indexed for inflation.

The New York **Earned Income Tax Credit** (EITC) is among the most generous in the nation. Low-income working taxpayers can claim a refundable tax credit equal to 30 percent of the federal credit. Because EITC eligibility is determined at the federal level, New York policymakers can ease the administrative burden on state residents by "piggybacking" eligibility for this credit on federal rules. However, one factor that limits both the simplicity and the fairness of the New York EITC is the interaction between the EITC and the household credit. In particular, the state EITC is reduced on a dollar-for-dollar basis by the household credit claimed. Eliminating this interaction would make it easier for New Yorkers to claim the credit and would allow the EITC to fulfill its tax fairness potential.

New York is among more than a dozen states that now allow **dependent care credits** designed to reduce the cost of caregiving for working parents. Like the EITC, New York's dependent care credit is based on federal rules. The New York credit is actually more generous than the federal credit at low income levels, allowing certain taxpayers to claim between 101 percent and 110 percent of the federal credit.

However, the New York credit shares one flaw of the federal credit: its poor targeting. New Yorkers earning over \$65,000 can claim a credit for 20 percent of their dependent care expenses—even though dependent care expenses do not significantly reduce wealthier taxpayers' ability to pay. A few states have restricted eligibility to taxpayers with income below a certain amount. By following this example, New York lawmakers could better target relief to low-income parents and preserve the fairness of the income tax.

### Local Income Taxes

New York is one of about a dozen states that allow certain local governments to levy their own income taxes on top of the state tax. States allowing local-option income taxes usually do it in one of two ways: by granting authority to specific cities or by granting authority to any taxing district at a given level of government (either cities, school districts or counties) in a state. Examples of the latter approach include Maryland, where each county levies a "piggyback" tax that applies to the same tax base as the state tax, and Iowa. New York, by contrast, has given taxing authority only to New York City and Yonkers.

For New York City, state law establishes a separate bracket and rate structure, while for Yonkers the state authorizes the city to impose a tax of up to 19.25% of the amount due the state. For the last several years, Yonkers has set its income tax rate at 5% of the amount due the state. The New York City tax for 2005 (which includes two temporary high-end brackets) has six rates ranging from 2.907 percent (for married couples with taxable income under \$21,600) to 4.45 percent (for income over \$500,000). The Yonkers income tax and large portions of the New York City income tax are subject to reauthorization by the State Legislature for tax years beginning in and after 2006.

One option for New York policymakers seeking to preserve the fiscal autonomy of counties and municipalities is to allow counties outside of New York City the general authority to levy a local-option income tax. These county taxes could, like the New York City tax, be administered and collected by state tax admini-

strators on state tax forms, requiring no new paperwork. An optional statewide local income tax would help achieve tax diversity and adequacy in New York. Given the recent experience of counties such as Erie and Oneida, in which strapped lawmakers have recently sought to balance budgets by increasing the combined state and local sales tax rate as high as 9.75 percent, diversification of the local tax base to include income taxes may be sorely needed.

From 1966 to 1999, New York City also levied a “commuter tax” on New York residents living outside the city (and on residents of other states) that worked in the city. The commuter tax was a flat tax, levied at a 0.45 percent rate for salaries and wages and 0.65 percent for self-employment income. The rationale for the commuter tax, as in other large metropolitan areas nationwide levying such a tax, was that nonresidents working in the city consume city services—and should help pay for the cost of providing these services. The costs imposed by nonresident commuters can be substantial: one recent estimate is that providing services to commuters accounts for between 2.2 and 3.8 percent of the city’s entire budget.<sup>16</sup> In 1999, the state legislature repealed the commuter tax without the assent of New York’s mayor or its city council.

The “commuter tax” repeal reduces New York tax collections by close to \$450 million annually—and creates an incentive for City workers to live in bedroom communities outside the city. Re-enacting the tax would help ensure that the burden of funding New York City government is more equally distributed among those who benefit from city services.

## Exporting State (and Local) Income Taxes

An important—and frequently overlooked—feature of personal income taxes is that part of their cost is ultimately paid by federal taxpayers in other states. New York taxpayers who itemize their federal income tax returns are allowed to deduct their state income taxes on their federal forms. In other words, when New York taxpayers pay their state income taxes, they get part of it back through federal tax cuts.

About 17 percent of the state income taxes paid by New Yorkers are offset by federal tax cuts. For high-income taxpayers, close to 33 percent of their state income taxes are offset in this way.

This write-off tends to benefit higher-income taxpayers (the ones most likely to itemize) and reduces

the progressivity of the New York individual income tax. However, it also benefits the New York economy. The deductibility of state individual income taxes means that some of the state income tax revenues that are used to fund state services actually impose no cost at all on the New York economy.

The deductibility of state income taxes is an especially important consideration when evaluating the impact of potential income tax changes. New York lawmakers seeking to raise income taxes can decide what fraction of a tax hike should be paid by New Yorkers and what portion of the tab should be picked up by the federal government, simply by targeting the tax hike to a particular segment of the population.

State tax increases that target low-income taxpayers (such as reducing the threshold for filing taxes) tend to be paid entirely by state residents, since low-income New Yorkers are unlikely to itemize their federal tax returns. But state tax hikes targeted to wealthier taxpayers will be partially exported to the federal government, because these taxpayers are more likely to itemize their federal tax returns and tend to pay higher marginal federal income tax rates. The more progressive the income tax hike, the greater the percentage of the state tax increase that will be paid in the form of a federal tax subsidy, rather than from the pockets of New Yorkers.

## Conclusion

New York’s personal income tax plays an important role in reducing the overall unfairness of the state tax structure. But tax cuts in the last two decades have made the income tax much less progressive—and are now insufficient to offset the regressivity of New York state and local sales and property taxes. Reforms that restore the former importance of the income tax, while broadening the income tax base, will likely be an important ingredient in the state’s effort to adequately fund education.

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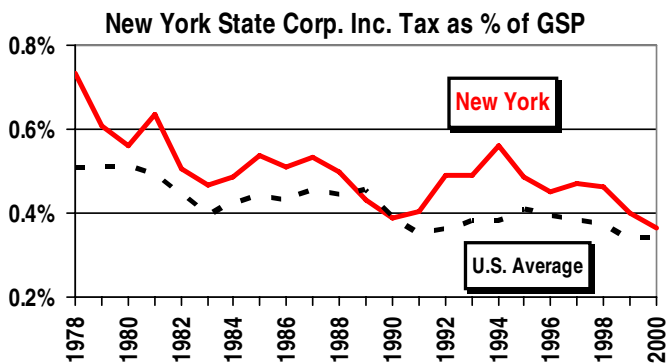
<sup>16</sup>Chernick, Howard and Tkacheva, Olesya. “The Commuter Tax and the Fiscal Cost of Commuters in New York City.” (2001)

# THE NEW YORK CORPORATE INCOME TAX

The corporate income tax is an important tool for state tax progressivity. The corporate tax helps offset the regressivity of the property and sales taxes which make up the bulk of state and local tax revenues. However, in recent years New York state corporate income tax revenues have declined both as a share of total New York revenues and as a share of the state's economy. This decline is troublesome for several reasons: first, it appears to have been at least partially due to corporate tax avoidance strategies rather than the conscious design of New York policymakers. Second, some of the decline is due to tax loopholes granted by New York lawmakers—and there is little evidence that these tax breaks are having a positive impact on the state's economic climate. Third, it means that an increasing proportion of the tax load is borne by individual New York taxpayers. However, New York lawmakers can help revitalize the corporate income tax by eliminating these loopholes and tax avoidance strategies—and can add greater accountability to the tax policy process by allowing more public disclosure of corporate tax breaks.

## A Declining Tax Source

The New York corporate income tax is in decline, both as a share of the state's economy and as a share of total taxes. In the past quarter century, New York state corporate income taxes have fallen by more than half, from 0.73 percent of Gross State Product (GSP) to 0.34 percent of GSP. This mirrors a national trend in corporate taxes, as the following chart shows—but the New York state corporate tax has fallen faster than the national average.



The corporate income tax also represents a smaller piece of the New York tax pie. In 1982, the corporate income tax generated 7.5 percent of all New York tax

revenue. In 2002, the corporate tax represented only 5.7 percent of all New York tax revenue.

## Advantages of the Corporate Income Tax

Unique among the major taxes levied by state governments, the corporate income tax is a progressive tax that is largely exported to residents of other states. Both of these traits—its progressivity and its exportability—are due to the fact that corporate income taxes are generally passed through to owners of corporate stock.

Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy.

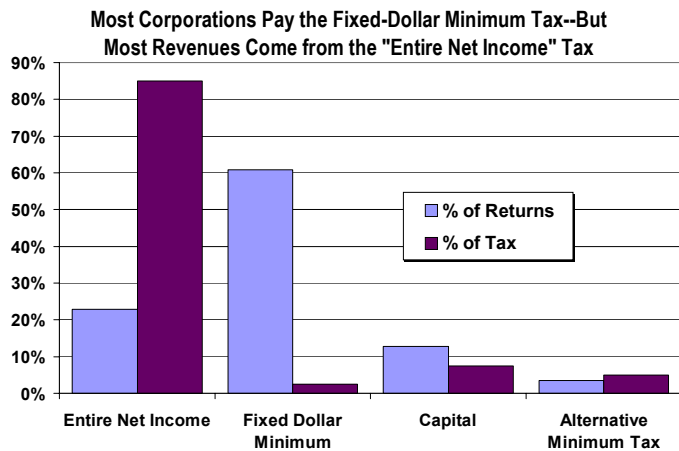
Because most corporations with New York operations have shareholders throughout the nation, the corporate income tax is distributed to other states depending on where a company's shareholders live. The corporate income tax is an important part of the New York tax system because it is the only option available for taxing non-New Yorkers who own stock in companies doing business in New York. These shareholders benefit indirectly from the public services provided to New York corporations—and the corporate income tax is an essential means of ensuring that these out-of-state shareholders share in the cost of providing public services.

## How The Corporate Income Tax Works

Like most states levying a corporate income tax, New York ties its corporate tax base closely to federal income definitions, using federal tax rules as a starting point in determining state taxable income. New York then applies a set of rules that subtract from (and add to) a company's federal taxable income to get New York taxable income.

These rules fall into two broad categories: federally required "housekeeping" rules that limit the amount of a corporation's income each state is allowed to tax, and special targeted state tax breaks that are provided because New York lawmakers want to encourage economic development or other social outcomes. State taxable income is multiplied by a set of tax rates to yield tax before credits. The state allows tax credits for research and other activities which are subtracted to yield net tax liability.

The New York corporate income tax actually involves four separate taxes (businesses are required to calculate liability under each tax and pay the largest). The principal New York corporate tax is a 7.5 percent tax on a slightly modified version of the federal corporate income tax base called the “entire net income” (ENI) base. This tax base accounted for 85 percent of the Article 9-A corporate income taxes paid in fiscal year 2000, but only 23 percent of returns filed.



Corporations doing business in New York are required to calculate their tax under the ENI base and three other bases, and pay whichever method yields the most tax:

- A fixed-dollar minimum tax, ranging from \$250 to \$500 for the largest corporations;
- A “net worth”-based tax;
- An alternative minimum tax, which applies a lower 2 percent rate to a broader measure of profits.

The most important of these four taxes is the ENI tax, which was enacted in 1917 as a three percent tax. The tax rate was gradually increased in subsequent decades, reaching a high of 12 percent in the mid-1970s. Since 1997, the corporate tax rate has been cut dramatically, falling from 9 percent to 7.5 percent.

In theory, the New York corporate income tax is based on corporate profits. Yet the tax base includes many loopholes that allow corporations to pay far less than they would if they were being taxed on actual profits. This means that the effective tax rate on companies doing business in New York (that is, tax collections as a percentage of total corporate profits) is typically much lower than the nominal 7.5 percent rate.

## How States Tax Multi-State Corporations

Many corporations do business in more than one state. Such multi-state corporations typically pay income taxes in more than one state as well. New York faces two important limits as it seeks to tax its share of these companies’ profits:

- First, if a corporation does not conduct at least a minimal amount of business in New York, the state is not allowed to tax the corporation at all. Corporations that have sufficient contact in the state to be taxable are said to have *nexus* with New York.
- Second, each state with which a corporation has nexus must devise rules for dividing the company’s profits into an “in-state” portion and an “out-of-state” portion—and the state can only tax the in-state portion. *Apportionment* is the process by which states achieve this.

These limits exist for a good reason: if every state taxed all of the income of all corporations, businesses could find their profits taxed multiple times. And in fact, when state corporate income taxes were first adopted, there were no agreed-upon rules for dividing corporate profits between states. As a result, some businesses found that nationally, more than 100 percent of their profits were subject to state taxes. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income between states that would result in multi-state businesses’ profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA).

## How Apportionment Works

The UDITPA model legislation prescribed relying equally on three different factors in determining the share of a corporation’s profits that can be taxed by a state. These factors are:

- 1) The percentage of a corporation’s nationwide **property** that is located in a state.
- 2) The percentage of a corporation’s nationwide **sales** made to residents of a state.
- 3) The percentage of a corporation’s nationwide **payroll** paid to residents of a state.

The main rationale for using these three factors to determine taxable income is that companies benefit from public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects each of these benefits.

If every state adopted this standard, as UDITPA was designed to encourage, states could ensure that all corporate income would be taxed exactly once. And most states did initially adopt the UDITPA three-factor approach, assigning each factor an equal weight in determining taxable income. But in the past twenty years, many states (including New York) have chosen to reduce the importance of the property and payroll factors, and increase the importance of the sales factor. New York is one of more than a dozen states that now “double-weight” the sales factor by making a corporation’s in-state sales twice as important as each of the other factors. At the extreme, four states rely entirely on the sales factor (and therefore do not use the property or payroll factors at all) in determining a corporation’s taxable income. This approach is known as the “single sales factor” or SSF. In recent months, lawmakers have seriously considered adopting SSF for New York manufacturers.

### **Pitfalls of the Single Sales Factor**

**S**SF is typically enacted for two reasons. First, it is argued that SSF makes a state a more attractive place for businesses to expand their property and payroll: if the property and payroll factors are ignored in calculating a state’s corporate tax, then a business can hire employees or build a plant in a state without incurring any additional corporate profits tax. Second, SSF is sometimes enacted in response to threats from companies that already have substantial in-state employment and property. For example, Massachusetts adopted SSF in response to threats from the Raytheon corporation that it would reduce its employment in the state unless it was adopted.

But these arguments overlook several disadvantages of heavily weighting the sales factor. First, while some companies will benefit from SSF, **other companies will actually pay more taxes under SSF.** Manufacturing companies that have more of their property and payroll in New York (and sell more of their products to customers in other states) would benefit from SSF, but companies with little in-state employment and property that sell proportionately more of their products in New York would be hurt by SSF. Whether SSF would cut a New York firm’s corporate taxes overall—or hike these taxes—depends on the importance of manufacturing in a state’s economy.

Second, when SSF is enacted in response to the threats of in-state corporations to relocate in other states, there is **no guarantee that these corporations**

**will not “take the money and run.”** For example, after the passage of SSF, Raytheon cut thousands of Massachusetts jobs.

Third, SSF **creates harmful tax avoidance incentives for some businesses.** A company that sells products in an SSF state, but does so only by shipping products into the state (and therefore has no nexus) will not have to pay any income tax to the state. But if such a company makes even a small investment of employees or property in the state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. Thus, SSF gives these companies a clear incentive not to invest in the state. Even worse, SSF gives companies with in-state employees an incentive to move all of their employees out of state to eliminate their nexus with the state—thus zeroing out their tax.

Fourth, by discriminating against some companies and in favor of others, SSF **makes corporate income taxes less fair**—and can result in profitable companies paying no state income tax. For example, under the Illinois SSF rules, a corporation that has all of its employees and property in Illinois, but makes all of its sales to customers in other states, will pay no Illinois tax, no matter how profitable it is. This unfairness reduces public confidence in the tax system.

### **Corporate Tax Loopholes**

**C**orporate tax revenue has declined in many states because of special tax breaks enacted by lawmakers. In addition, many profitable businesses have learned to manipulate tax laws to take advantage of loopholes that lawmakers had no intention of creating. New York has taken steps to close some of these loopholes—but others remain.

Among the most pernicious and frequently exploited of these unintended loopholes is the “**Delaware holding company**” loophole. Corporations operating in multiple states pay New York income taxes only on the share of their profits that are generated in New York. Corporations doing business in New York can therefore reduce their New York income tax by minimizing the amount of New York profit they report. One way they accomplish this is by creating passive investment corporations, or PICs, in states (notably Delaware and Nevada) that do not levy corporate income taxes or do not tax certain types of corporate profits.

Companies then shift their New York profits, on paper, to their subsidiary PICs in, say, Delaware—and reduce the amount of profit that is taxable in New

York. New York is one of 26 states that currently have a statutory mechanism designed to curb the use of the PIC loophole—but is also one of only five states that have taken a narrow approach to closing this loophole. In particular, a May 2003 law disallows certain “related-party” transactions. Four other states take the same approach as New York, explicitly forbidding corporations to deduct payments to PICs from their income. However, there is growing evidence that New York’s PIC legislation may be a temporary solution at best: legislation enacted by Delaware lawmakers in 2004 makes it easier for businesses to circumvent the anti-PIC rules used by New York and other states.

New York’s anti-PIC strategy amounts to closing one loophole at a time—and Delaware’s response to this legislation illustrates that this approach is only effective until corporations are able to find new paths to tax shifting. A more common—and more effective—approach to solving the PIC problem taken by 16 other states is requiring *combined reporting* of income so that the profits from PICs and other subsidiaries are added together for tax purposes. By comparison to the anti-PIC legislation enacted by New York in 2003, combined reporting is a comprehensive solution that eliminates the incentive for multi-state corporations to shift income from higher-tax to lower-tax jurisdictions. Anti-PIC legislation simply closes down one particular avenue for income-shifting while leaving the tax avoidance incentives intact.

Another example of damaging tax avoidance currently used in New York occurs in the division of corporate profits into the categories of **business income** and **nonbusiness income**. The former is income from transactions in the regular course of the business’s trade, and the latter refers to all other income. Generally, for tax purposes, business income is apportioned among the states affected according to a set of apportionment rules. But in more than half the states—including New York—the statutory definition of business income is worded in a way that excludes certain irregular transactions. Businesses in these states can reduce their tax liability by not counting these transactions as part of business income. Many states have closed this loophole by defining business income as all the income that is allowed by recent U.S. Supreme Court standards.<sup>17</sup> New York is among the states that have not taken this step—but could easily

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<sup>17</sup>Michael Mazerov, “Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States,” Center on Budget and Policy Priorities, Washington, DC, Apr. 9, 2002.

shore up the tax base by making a minor wording change in its tax statutes.

One special limitation on the ability of states to tax multi-state corporations is that any given state can only tax companies that have a “physical presence” in the state. Companies that do business in a state without actually having a physical presence there can avoid paying state income tax on income earned in that state. This results in “nowhere income”—income that is not taxed by any state. There is, however, a simple solution to this problem that has been enacted by more than half of the states with corporate income taxes: a “**throwback rule**,” which simply provides that any income of a multi-state corporation that is not taxed in another state will be “thrown back” into the state in which the sales are made to be taxed there. By enacting a throwback rule, New York can help ensure that all income is taxed exactly once at the state level.

The decline of the federal corporate income tax base is well-documented—and New York has taken some steps to avoid it. Federal “stimulus” legislation enacted in 2002, and expanded in 2003, increased the amount of **accelerated depreciation** corporations can write off. In states (such as New York) that base their definitions of taxable corporate profits on federal rules, this federal tax cut means that unless steps are taken to “decouple” from the federal income definitions, state taxes will go down as well. However, legislation passed in 2003 decouples the New York corporate income tax from federal rules, except for some investments in areas of Manhattan. New York’s effort to protect itself from this federally-induced revenue loss follows on the heels of similar responses in dozens of other states—and sets an important precedent as the state seeks to insulate itself from future federally-imposed tax cuts.

## New York Investment Tax Credits

Most of the loopholes described so far are primarily the result of clever accounting by corporations. But lawmakers have also intentionally enacted some tax breaks that further reduce the yield and fairness of the New York corporate income tax.

The New York Investment Tax Credit (ITC) was created in 1969 to encourage companies to invest more in New York State. Under the ITC, when a firm makes a qualifying investment, a certain percentage of the investment is allowed as a dollar-for-dollar reduction in the firm’s tax liability. As initially enacted, the credit offered a 1 percent rebate on any amount invested in plant and equipment in New York state.

The credit has since been expanded, and now allows a five percent credit for investments of less than \$350 million and a four percent credit for investments over \$350 million. The ITC is non-refundable (that is, credits cannot be used to reduce taxes below zero), but unused credits can be carried forward to reduce future taxes for up to 15 years.

The theory behind the ITC is that companies will invest more in plant and equipment if they are rewarded with tax breaks. However, this theory is flawed for two reasons. First, firms tend to make investments when doing so makes good business sense—not because of tax credits. These companies will accept investment tax credits when they are offered, of course—but they’re basically being rewarded for what they would have done anyway.

Second, in the rare cases where business investments are prompted by tax breaks, the investments that result are likely to be bad for the national economy. Tax-driven investments channel resources into areas where they are less productive than they could be—and reduce the efficiency of the economy.

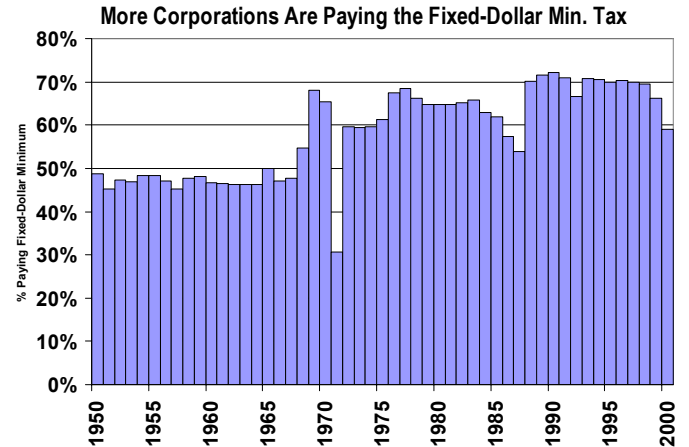
The ITC is also very expensive and targets its benefits to a few of the biggest corporations. In 1985, five companies got over 44 percent of the benefits from the ITC. As a result, at least one of these companies ended up paying only the \$250 minimum tax.

The ITC also has implications for future tax avoidance. Unused tax credits can be carried over to reduce taxes in future years. In any given year, corporations doing business in New York have more than a billion dollars in unused credit carryforwards.

## Strengthening New York’s Minimum Tax

New York is one of about a dozen states that have responded to the growth of corporate tax avoidance by adopting an alternative minimum tax (AMT)—an alternative tax base designed to act as a backstop to prevent corporate tax avoidance in the regular profits-based tax. Unusually, New York actually has two minimum taxes: a fixed-dollar minimum tax and an AMT calculated as a percentage of taxable income. Enacted in 1987, the fixed-dollar minimum tax is \$325 for businesses with annual payrolls under \$1 million, \$425 for firms with payrolls between \$1 million and \$6.25 million, and \$1,500 for firms with payrolls over \$6.25 million. The minimum tax has become increasingly important over the years, as the chart at right shows. In 2001, over 60 percent of corporations filing New York returns paid only the minimum tax. This trend is worrisome because it

suggests that tax loopholes have become increasingly important and because recent cuts in the state’s AMT mean that this important backstop is less effective as a revenue source than it formerly was.



What makes the AMT effective is that it applies a lower rate to a broader, more loophole-free measure of corporate income. But New York lawmakers have gradually eroded this broader income definition by allowing some of the same deductions from AMT income that are allowed from regular income.

Lawmakers have also cut the AMT tax rate dramatically. Between 1998 and 2000, the AMT rate was reduced from 3 percent to 2 percent.

As tax loopholes continue to erode the state’s corporate tax base, strengthening the AMT by increasing the rate and broadening the AMT base will be an important step to help ensure the future vitality of the corporate income tax in New York.

## No-Tax New York Corporations?

The growing use of tax loopholes at the federal level and the decline of the federal AMT has meant that individual Fortune 500 corporations have been able to use federal tax breaks to reduce their corporate tax substantially despite being hugely profitable.

A September 2004 ITEP analysis of 275 of the largest and most profitable corporations in America found that 82 of these corporations—almost a third of the total—managed to pay zero or less in federal corporate income taxes in at least one year between 2001 and 2003.<sup>18</sup> In other words, almost all of these companies actually received net tax rebates from the federal government during this period. Because New

<sup>18</sup>*Corporate Income Taxes in the Bush Years*, Robert S. McIntyre and T.D. Co Nguyen, Citizens for Tax Justice and Institute on Taxation and Economic Policy, September 2004.

York taxable corporate profits are based on federal taxable profits, it is likely that these federal loopholes also reduce the taxes paid by New York corporations.

The CTJ/ITEP analysis was made possible by the fact that publicly held corporations must disclose information about their federal corporate income tax payments to shareholders and the Securities and Exchange Commission (SEC). As a result, we know that some of the top employers in New York have been able to take advantage of loopholes in the federal corporate income tax. For example, the CTJ/ITEP study found that twelve profitable New York-based Fortune 500 companies managed to pay less than zero in federal income taxes in at least one year between 2001 and 2003, and that four of these companies actually paid an effective corporate income tax rate of less than zero overall during the three-year period.

### Profitable New York-Based Fortune 500 Companies Paying Less than Half the 35% Federal Tax Rate

#### Effective Tax Rate:

Company	2003	2002	2001	3-year average
ITT Industries	-23.4%	-27.7%	-14.5%	-22.3%
Time Warner	-3.3%	2.2%	-52.7%	-7.3%
KeySpan	-12.5%	-3.0%	15.8%	-1.6%
JPMorgan Chase	14.6%	-55.6%	17.5%	-1.1%
Verizon	1.8%	-12.1%	28.6%	0.5%
Cendant	6.2%	-4.7%	-0.1%	1.5%
Lehman Brothers	-2.1%	9.9%	2.1%	1.9%
IBM	1.5%	4.7%	0.3%	1.9%
Bank of New York	3.5%	10.3%	-1.6%	3.6%
Dover	1.0%	1.4%	12.8%	4.7%
L-3 Communications	7.4%	5.3%	2.4%	5.6%
Pfizer	-2.8%	27.9%	3.7%	8.2%
Consolidated Edison	-14.0%	7.2%	33.6%	10.8%
Pepsi Bottling	15.1%	3.3%	20.7%	12.2%
Colgate-Palmolive	18.5%	11.8%	5.1%	12.3%
Merrill Lynch	14.2%	17.1%	8.9%	12.9%
American Express	17.3%	21.9%	-10.2%	13.8%
Foot Locker	27.0%	9.4%	4.5%	14.9%
Viacom	18.6%	12.1%	16.5%	16.0%
Metlife	20.3%	38.5%	-2.3%	16.2%
Energy East	2.0%	14.3%	32.9%	17.3%

If these large, profitable corporations were this successful in reducing their tax liability through completely legal tax loopholes on the federal level, it seems plausible that the same corporations may be using these loopholes to reduce their state corporate income taxes as well. Unfortunately, neither the SEC nor most state governments (including New York)

require corporations to release detailed information on the tax loopholes they have claimed.

New York's Department of Taxation and Finance publishes an annual "tax expenditure report" identifying the aggregate cost of some of the tax breaks enjoyed by corporations in New York. But the report tells us nothing about the taxpaying behavior of individual corporations—or about the impact these loopholes are having on the effective tax rate paid by profitable corporations doing business in New York.

As a result, it's not currently possible to determine whether the loopholes described here have spawned an epidemic of state tax avoidance. However, more open disclosure of state corporate tax information could help clarify this issue. As Good Jobs First has documented, nine states now require corporations to disclose some information about the state or local tax breaks they receive. Most recently, in the fall of 2001 North Carolina legislators amended the state's tax-subsidy law to require extensive company-specific reporting of tax credits. These disclosure requirements apply to state tax credits for training, research and development, and machinery and equipment credits. The North Carolina law also requires disclosure, when a company claims development zone credits, of how many of the new jobs created as a result of the tax credit went to residents of the development zone. This sort of disclosure requirement could help New York lawmakers determine the effect of these tax breaks on individual companies' taxpaying behavior.

## Conclusion

The New York corporate income tax is an important source of tax progressivity. In the absence of a healthy corporate income tax, state lawmakers must increase their reliance on other tax sources—including individual income and property taxes. Yet New York lawmakers have taken no actions to prevent this tax shift from corporate taxpayers to individual taxpayers.

At a time when New York policy makers are facing difficult decisions about the appropriate combination of revenue-raising measures to adequately fund education and other important services, shoring up the corporate income tax base by eliminating unintentional loopholes is an obvious (and relatively painless) choice that will be instrumental in ensuring the future vitality of the corporate income tax—and of the state education system.



## CHAPTER SIX

# NEW YORK SALES AND EXCISE TAXES

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Sales and excise taxes, or consumption taxes, are the main reason for the overall unfairness of New York taxes. General sales taxes and specialized excise taxes on items such as alcohol and tobacco hit low- and middle-income taxpayers especially hard. Moreover, each of these taxes face structural limitations that threaten to further reduce the yield and fairness of these taxes over time. This chapter looks at options for increasing the adequacy and fairness of New York sales and excise taxes.

### New York Consumption Taxes: How High?

New York sales and excise taxes are lower than the national average. In fiscal year 2002, New York sales and excise taxes amounted to 3.3 percent of personal income—36th highest in the nation and more than ten percent below the national average. By this measure, New York sales and excise taxes have fallen from 3.9 percent in 1977 to 3.3 percent in 2002. As a result, the state's ranking fell from sixteenth to 36th highest during this period.

However, this result is mostly due to the state's historically low reliance on excise taxes. New York sales taxes were only slightly below the national average in fiscal 2002, while excise taxes in New York were 25 percent lower than the U.S. average.

### The Most Regressive Tax

Consumption taxes are inherently regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. Typically, low-income families spend three-quarters of their income on items subject to sales tax, middle income families spend about half their income on items subject to sales tax, and the wealthiest taxpayers spend less than a sixth of their income on such items. The distributional impact of New York consumption taxes reflects this pattern:

- Sales and excise taxes consume 9.5 percent of the income of the poorest New York taxpayers.
- Middle-income New Yorkers pay 5.7 percent of their income in sales and excise taxes;
- The wealthiest one percent of taxpayers pay 1.2 percent of their income in sales and excise taxes.

Put another way, the New York consumption tax structure is equivalent to an income tax with an 9.5 percent rate for the poor, a 5.7 percent rate for the middle class, and a 1.2 percent rate for the wealthiest New Yorkers. Obviously, no one would intentionally design an income tax that looks like this—yet by relying heavily on consumption taxes, this is the choice New York policy makers have made. The main reason this pattern is tolerated in consumption taxes is that their regressive nature is concealed by an innocuous-looking single rate and that the amount families pay is hidden in many small purchases throughout the year. Property taxes and income taxes are much more noticeable because taxpayers usually receive an annual bill for payment of these taxes.

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*Sales and excise taxes are the main reason for the overall unfairness of New York taxes.*

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### Bang for the Buck?

Another disadvantage of sales taxes is that they are usually not deductible for families who itemize their federal or state income taxes. (For 2004 and 2005 only, federal itemizers can choose to write off sales taxes in lieu of writing off income taxes, but few New Yorkers will find this advantageous.) In contrast, taxpayers who itemize deductions on their federal and state income taxes are allowed to deduct payments for local property taxes. The general non-deductibility of sales taxes means that these taxes offer a poor “bang for the buck” from the perspective of individual taxpayers, who must shoulder the entire cost of the state and local sales taxes they pay.

### A Low-Rate Tax?

The New York general sales tax was introduced in 1965 at a rate of 2 percent. The rate increased to 3 percent in 1969 and 4 percent in 1971. Most recently, the state sales tax rate was temporarily increased from 4 to 4.25 percent.<sup>19</sup> Taken on its own, the state sales tax rate is the lowest in the region.

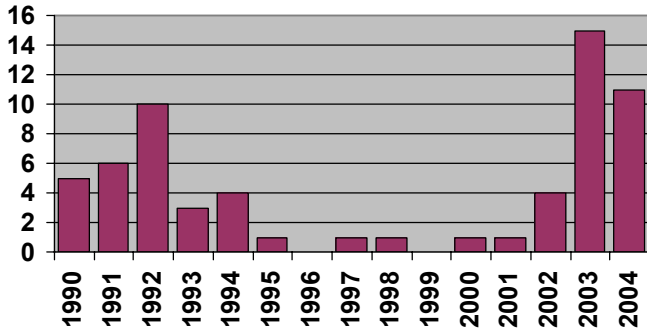
However, New York allows local governments to levy additional sales taxes at much higher rates than

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<sup>19</sup>This temporary tax increase is in effect for two years, from June 1, 2003 to May 31, 2005.

most other states. All local governments are allowed to impose up to 4 percent, and a few have been authorized to impose up to 4.25 percent. This means that the maximum sales tax rate in any New York jurisdiction outside of New York City is 8.25 percent. The New York City general sales tax rate is even higher, at 8.625 percent.

**Counties Increasing Local Sales Taxes, 1990-2004**



In the past two years, more than twenty counties have increased their sales tax. While these tax hikes are less visible than the state tax increases state lawmakers have sought to avoid, they nonetheless make the state’s tax system more regressive.

### A Narrow Tax Base

New York’s sales tax base applies to both tangible personal property (goods such as furniture and books) and certain intangible services. However, state law has carved out a variety of exemptions for goods and services that make the New York sales tax base narrow compared to most other states. The most important reason for this is that New York exempts sales of groceries, and other “necessities” such as prescription and nonprescription drugs and residential utilities, from the state 4.25 percent rate.

The state also allows a wide variety of other sales tax exemptions. These fall into two broad categories: exemptions of goods and exemptions for services.

Sales tax exemptions for goods reduce New York taxes by more than \$8.3 billion annually—almost as much as the state collects in sales taxes each year. In other words, the state sales tax is now almost more loophole than law.

Certain exemptions benefit individual consumers. Residential utilities are exempt, as are sales of prescription drugs. Sales of clothing were exempted by 1998 legislation, although that exemption was suspended in 2003.

Most exemptions were explicitly written into the tax code by legislators. However, another important class of sales tax exemptions can’t be found on the books at all. While the New York sales tax applies to sales of goods unless exempted, sales of services are exempt unless explicitly taxed. This is due to an accident of history: in the early twentieth century (when most state sales tax statutes were written), economic activity in the United States was focused primarily on the production and consumption of tangible goods, and services were much less important. However, since 1950, the importance of services has increased almost continuously.

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*In the past two years, more than twenty counties have increased their sales tax rates.*

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The challenge facing New York—and all other states with outmoded sales tax laws—is to modernize the sales tax base by including at least some sales of personal, professional or business services. However, many states have failed to achieve this. A 1996 study by the Federation of Tax Administrators (FTA) found that of 164 potentially taxable services, less than half were taxed by most states.<sup>20</sup> The FTA study found that New York has done better than many states in adapting its sales tax base, but that the state still taxes just 74 of these 164 services. Notable omissions from the New York base include:

- personal services—laundry, dry cleaning, shoe repair, veterinary services and residential utilities;
- business services—machinery and equipment used in the production process;
- professional services—legal and accounting.

New York lawmakers have broadened the base somewhat. In 1990, for example, the state legislature expanded the tax base to include specific services such as parking, auto leases, janitorial services and detective services. Yet, as the FTA survey shows, many services remain exempt.

### Approaches to Sales Tax Reform

New York relies more heavily on sales taxes than most states, with a relatively high overall rate and

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<sup>20</sup>Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*, Research Report No.147 (Washington, DC: Federation of Tax Administrators), April 1997.

a broad tax base. Yet the state also allows a wide variety of exemptions, many of which may be unwarranted. As New York seeks to raise more revenue for education, which exemptions should be eliminated, and which should be preserved?

Economists generally argue that base-broadening is the best means of ensuring the long-term vitality of a tax. Narrow-based taxes tend to fluctuate more because changes in particular economic sectors can affect the overall yield of the tax, while broader-based taxes are less sensitive to these changes.

To be sure, exemptions can help make sales taxes less regressive, especially when the items exempted are “essentials” such as utilities and prescription drugs. But exemptions are a costly and poorly targeted approach to sales tax relief. For example, exempting groceries from the 4.25 percent state sales tax costs more than \$1.4 billion annually—and the benefits of exempting food go to even the wealthiest taxpayers. A less expensive way to provide targeted tax relief would be a tax credit for low-income taxpayers. Five states currently allow such a credit. The box below shows the details of one such program, the Kansas food sales tax refund. Kansas lawmakers have targeted this rebate to taxpayers over 55 and taxpayers with children under 18. This approach offers several advantages over exemptions: low-income credits can be targeted to New York residents only, and can be designed to apply to whichever income groups are deemed worthy. Chapter Nine of this report shows the impact of enacting such a credit in New York.

The Kansas Food Sales Tax Refund	
Income Level	Refund
\$0 to \$13,150	\$72 per exemption
\$13,151 to \$26,300	\$36 per exemption
\$26,301 or more	no refund

Sales tax exemptions are sometimes simply good economics. There exists broad unanimity among economists that sales tax bases should include services—yet these same economists stress that any base-broadening reform should distinguish between services consumed by individuals and services consumed by businesses. If the goal of a properly designed sales tax is to tax all (and only) retail sales for final consumption, then taxing services consumed by businesses as an intermediate step in the production process is undesirable.

The potential revenue yield of taxing business consumption is tempting—but taxing these services

would distort the economic behavior of businesses. A company that finds itself taxed four times in the process of producing a single good (three times on the purchase of intermediate goods and once on the sale of the final product) will face an incentive to escape taxation by “vertically integrating”—that is, producing intermediate goods itself.

By contrast, a clear-cut case can be made for extending the sales tax base to include personal retail services consumed by individuals.

### Sales Tax Holidays for Clothing

In 1997, New York lawmakers exempted sales of clothing under \$110 from the state sales tax, and allowed an optional local exemption. However, the legislature recently suspended this exemption for one year, allowing in its place a four-week “sales tax holiday.” This is a problematic way of achieving low-income tax relief, for several reasons:

- A four-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other forty-eight weeks of the year. In the long run, sales tax holidays leave a regressive tax system basically unchanged.
- Sales tax exemptions create administrative difficulties for state governments, and for the retailers who must collect the tax. For example, exempting clothing requires a sheaf of regulations to define what is clothing and what is not. A temporary exemption requires retailers and tax administrators to wade through red tape for an exemption that lasts only a few weeks.
- Sales tax holidays are poorly targeted, providing tax breaks to even the wealthiest taxpayers. The benefits of sales tax holidays are not limited to state residents, but also extend to consumers visiting from other states.
- Many low-income taxpayers spend all of their income just getting by—which means that they have less disposable income than wealthier taxpayers. These poor taxpayers may not be able to shift the timing of their consumption to coincide with temporary sales tax holidays. By contrast, wealthier taxpayers are more likely to be able to time their purchases to coincide with the holiday.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are low- and middle-income families. And the heavily-publicized manner in which sales tax holidays are administered means that taxpayers will be very aware of the tax cut

they receive—and will know that state lawmakers are responsible for it.

But in the long run, sales tax holidays are simply too insignificant (and too temporary) to change the regressive nature of a state's tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes. Policymakers seeking to achieve greater tax equity at a minimal cost would do better to shift the overall tax burden to wealthier taxpayers by scaling back sales taxes permanently, or by providing a permanent low-income tax credit.

### Should Internet transactions be taxed?

Another important pitfall facing state and local sales taxes is the importance of Internet-based retail transactions. A growing share of retail purchases are being made on the Internet, and are not being taxed. According to a recent study, the New York state and local revenue loss from “e-commerce” was about \$1.1 billion in 2003 and will reach \$2.4 billion by 2008.<sup>21</sup>

The most appealing solution to the question of the appropriate tax treatment of e-commerce is that it should be treated in exactly the same manner as other retail transactions. That is, retail transactions that are taxable when sold as a “bricks and mortar” transaction should also be taxable when sold via electronic transactions. This is an intuitive notion of tax fairness that most people would agree on.

At present, New York lawmakers have taken all available steps to achieve an equitable approach to taxing Internet transactions. Legislation passed in 2003 makes the state a member of the Streamlined Sales Tax Implementing States.

However, neither this legislation nor any other potential action by the current legislature can reach Internet sales by firms without a physical presence in New York. In 1998, the U.S. Congress created a moratorium prohibiting states from taxing Internet sales by companies that do not have a physical presence in the consumer's home state, effectively limiting states' ability to tax most Internet sales. The moratorium expired in November 2003, but is currently being debated in Congress. Until the issue is decided at the federal level, New York will not be able to take additional steps to tax Internet-based transactions.

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<sup>21</sup>Donald Bruce and William Fox, “State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004.” Center for Business and Economic Research, (Knoxville: Univ. of Tennessee ) July 2004.

### Selective Sales and Excise Taxes

New York relies on a variety of selective sales taxes and excise taxes that apply to sales of particular retail items. In some cases, these taxes are levied instead of the general sales tax: in others, these excise taxes are levied in addition to the sales tax.

New York levies several alcohol taxes, including a beer tax of 11 cents per gallon and a per-gallon tax on sales of wine and other alcoholic beverages.

New York also taxes sales of cigarettes and other tobacco products, including a state cigarette tax of \$1.50 per pack and an additional local New York City tax of \$1.50 per pack.

The state levies a variety of taxes on gasoline. When the gas tax was introduced in 1929, it was levied at 2 cents per gallon. Now, an 8-cent per gallon excise tax is only one of three taxes that affect consumers of gasoline: the state and local sales tax rate of up to 8.75 percent also applies, and a “petroleum business tax” of 14 cents per gallon applies as well.

There have been several important changes to New York excise taxes since the early 1990s.

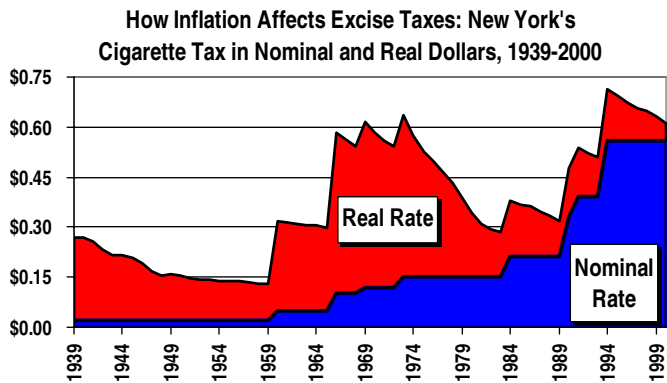
- The state cigarette tax has been increased five times since 1990, rising from 21 cents to \$1.50 per pack.
- New York City increased its local cigarette tax dramatically in July of 2002, from 8 cents per pack to \$1.50 per pack. The total tax on a pack of cigarettes in New York City is now \$3.00.
- The petroleum business tax has increased steadily throughout the past decade.
- The beer excise tax has been gradually lowered from 21 cents to 11 cents per gallon.

Excise taxes are, in general, even more regressive than sales taxes. ITEP's January 2003 *Who Pays* study found that excise taxes consumed 2.7 percent of the incomes of the poorest New Yorkers, 1.1 percent of the incomes of middle-income taxpayers, and 0.1 percent of income for the wealthiest New Yorkers.

### Excise Taxes and Inflation

In recent years, New York lawmakers have increased cigarette taxes at both the state and local levels. Retail sales taxes are levied on an *ad valorem* basis—that is, they are calculated as a percentage of the sales price. This means that when inflation increases the price of goods subject to the tax, sales tax revenues will automatically increase. Unlike sales taxes, the excise taxes described in this section are imposed on a per-unit basis rather than as a percentage of the sales price: for example, the New York state cigarette

tax is a flat \$1.50 cents per pack, no matter how much the pack of cigarettes costs. Excise tax revenue grows (or contracts) only when the volume of the commodity sold grows or contracts, and does not respond to changes in price. In an inflationary environment, this means that states must continually raise the rates of excise taxes in order to keep revenues up with inflation. The chart on this page shows the history of New York lawmakers' unsuccessful attempts to avoid these inflationary losses in cigarette tax revenue. The cigarette tax was enacted in 1939 at 2 cents per pack—or 39 cents per pack in today's dollars. But the real value of the tax gradually declined until it was increased to 5 cents in 1960—after which it again began to lose its value. The state's recently enacted 39 cent-per-pack cigarette tax increase is already having a similar effect: the short-term value of the hike is gradually being offset by an inflationary decline.



## Conclusion

The major source of unfairness in the New York state tax structure is the state's growing reliance on regressive sales and excise taxes as a revenue source. This makes the tax system more regressive, and decreases the long-term adequacy of state revenues by increasing reliance on slow-growth sales and excise taxes. In addition, the state's use of "sin" taxes designed more to discourage consumption than to raise revenues exerts a drag on state revenues.

As the state grapples with ways of achieving adequacy in school funding, it should also keep in mind that taking the "business as usual" approach—funding schools with regressive sales tax hikes—would exacerbate the structural imbalance in the New York tax system.

# NEW YORK PROPERTY TAXES

Like most states, New York relies on local property taxes as its primary funding source for public education. Property taxes are a slow-growing source of revenue—a troubling feature for a revenue stream designed to fund growing educational costs. Even more troubling, the property tax is profoundly unfair, imposing higher burdens on lower- and middle-income taxpayers and placing less wealthy school districts at a competitive disadvantage in funding education. The challenge facing state lawmakers is to find a way to adequately fund education that mitigates these twin sources of unfairness, reducing the burden on low-income New Yorkers and mitigating the gap between low-property-wealth and high-wealth taxing districts. This chapter looks at the impact of New York property taxes on tax fairness and school funding, and evaluates options for property tax reform.

## New York Property Taxes: How High?

New York property taxes are higher than in most other states. In fiscal year 2002, New York property taxes as a share of income were almost 25 percent above the national average—10th highest nationally. However, the state’s property taxes have fallen compared to other states in the past twenty five years: as recently as 1980, New York property taxes were more than fifty percent above the national average.

**New York Property Taxes**

	% of		% of Total	
	Pers. Inc.	Rank	Taxes	Rank
Connecticut	4.1%	7	39.6%	9
Massachusetts	3.5%	17	36.5%	12
New Jersey	4.8%	3	46.3%	2
New York	3.9%	10	30.2%	25
Ohio	3.2%	22	29.4%	29
Pennsylvania	2.9%	29	29.0%	31
Vermont	4.6%	4	41.9%	4
<b>ALL STATES</b>	<b>3.2%</b>		<b>30.9%</b>	
<b>Addendum: New York as a % of National Average</b>				
	124%		98%	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

## Property Taxes are Regressive

New York property taxes are regressive: lower-income taxpayers pay more, as a share of income, than do financially better-off taxpayers. The poorest twenty percent of New Yorkers pay 4.4 percent of their incomes, on average, in property taxes. Middle-income taxpayers pay 3.5 percent of their income in these taxes, and the wealthiest one percent of New Yorkers pay 1.6 percent of their incomes in property taxes.

The main reason why property taxes are regressive is that they are based on home values rather than on income levels. Home values represent a much higher share of income for middle- and lower-income families than for the wealthy. For example, it is common for a middle-income family to own a home valued at two or three times their annual income, but wealthier taxpayers are less likely to own homes worth as much relative to their income levels. As a result, property taxes generally take a larger share of income from middle-income families than from the better-off. And property taxes are insensitive to variations in taxpayers’ income: a taxpayer who suddenly becomes unemployed will find that her property tax bill is unchanged, even though her ability to pay it has fallen. By contrast, income taxes vary with income, so income taxes are more sensitive to taxpayers’ ability to pay.

While the public’s attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home. It is generally assumed that some of the property taxes falling initially on owners of rental real estate are passed through to renters in the form of higher rents. Notably, New York’s largest form of property tax relief, the STAR homestead exemption, only provides relief to homeowners. Because renters tend to be poorer than homeowners, this makes the tax system more regressive.

Property taxes are also paid by businesses. Some of the business property taxes paid in New York are passed through to out-of-state shareholders and owners. Without this business tax, many businesses that use state services would go largely untaxed.

Homeowner property taxes can be partially offset by federal income tax deductions for those itemizing their federal returns. Overall, about 15 percent of these taxes are offset by federal tax cuts in this way.

## How Property Taxes Work

Property taxes are among the most venerable revenue sources used by states. As originally designed, these taxes usually applied to all forms of property wealth, including:

- Real property (land and buildings)
- Personal property (cars, furniture, and other moveable, tangible items)
- Intangible property (paper assets such as stocks and bonds)

In recent decades, most states have moved away from taxing personal and intangible property and now tax only real property. New York taxes some business personal property, but individual New Yorkers generally pay property tax only on their homes.

The amount of property tax paid on any particular home is usually calculated through a multiple-step process. First, county officials assess the taxable value of each property by estimating the amount for which it could be sold—its *market value*. This can be done by direct observation of each individual home, or by observing a smaller sample of homes and using the sample to estimate the value of other similar homes. Second, property is valued for tax purposes—its *assessed value*. The third step is determining the *taxable value* of the property, by subtracting any exempt value from the home. Finally, a millage rate is applied to the property's taxable value. The formula for a given taxing district's millage rate is:

$$(\text{Tax Levy}/\text{Taxable Value}) \times 1000$$

The tax levy represents the amount of revenue being raised. While this procedure works the same way in every New York school district, the rates of at which property is taxed vary widely between districts. In 2001-2002 school year, the median tax rate was 2.3 percent; ranging from 0.38 percent in the East Hampton School District to 2.63 percent in the Levittown School District.

## Property Tax Limits

Since California introduced its "Proposition 13" property tax limits in the late 1970s, almost all states have introduced some form of property tax limit. New York law imposes limits on the overall tax rate that some levels of government can impose on properties. Counties can levy up to 1.5 percent of value, most cities can levy up to 2 percent of value, and New York City can levy up to 2.5 percent (each of

these limits are calculated by taking the tax as a percentage of a five-year average of taxable value)

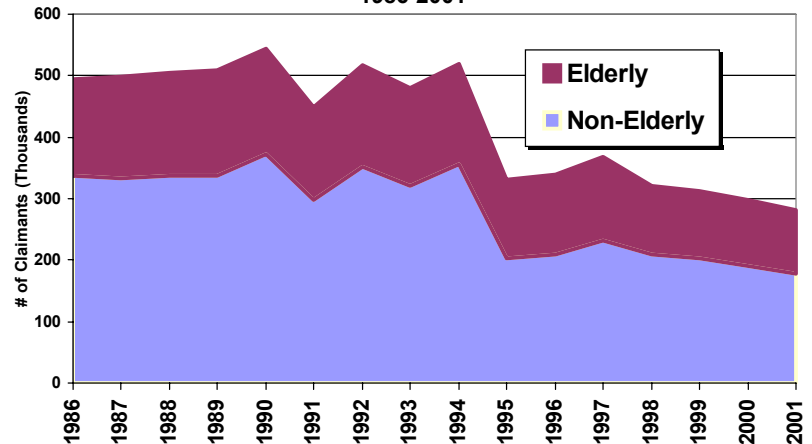
Another common form of property tax limit restricts the annual growth of assessments for any given property. While New York has no statewide limit on assessment growth, New York City and Nassau County each impose this type of limit.

## Property Tax Relief

New York property taxes are high and regressive; any effort to alter the state's use of these taxes for funding public education must address low- and middle-income household property tax relief. This section discusses New York's property tax relief mechanisms.

New York has three state-financed property tax relief mechanisms: a refundable circuit breaker for low-income households and renters, a refundable school property tax credit for farmers, and the School

New Yorkers Claiming the Property Tax "Circuit Breaker"  
1986-2001



Tax Relief (STAR) property tax exemption program.

Since 1978, New York has provided low-income homeowners and renters with a refundable tax credit designed to offset especially high property tax burdens. New York's "circuit breaker" credit is available to homeowners and renters earning less than \$18,000. For homeowners whose property taxes exceed a threshold ranging from 3.5 percent of income to 6.5 percent of income, the circuit breaker credit equals half of the amount by which property taxes exceed this threshold. The credit is capped at \$375 for elderly taxpayers and \$75 for those under 65. The credit is limited to homeowners with home values under \$85,000 and renters with average monthly rent of \$450 or less.

When the circuit breaker was last expanded in 1986, it was among the more generous state property tax relief mechanisms in the nation. But the credit has been left unchanged since then, and as a result the real value of the credit has fallen and the number of state taxpayers claiming the credit has decreased each year. In 1986, almost 500,000 New Yorkers claimed the circuit breaker credit. By 2001, that number had fallen by almost half, to 282,000. This decline is largely attributable to the failure of policymakers to preserve the real value of the credit.

If the main features of this low-income circuit breaker had been adjusted for inflation since 1986, the income threshold would be \$30,521 in 2004; the home value limit would be \$144,128; the average monthly rent would be \$763 and the maximum amount refunded to taxpayers over 65 would be \$636 and \$127 for everyone else.

In general, circuit breakers are an effective means of providing property tax relief. First, circuit breakers address the “insensitivity problem” of property taxes. As already noted, property taxes are insensitive to yearly fluctuations in a taxpayer’s ability to pay, since they are based on property value, not on income. But since circuit breakers allocate their benefits according to the relationship between taxes and income, their benefits are targeted precisely to low-income taxpayers. Second, the better targeting of these credits means that they cost less than “across the board” property tax relief measures—such as homestead exemptions. Third, a substantial portion of “across the board” property tax relief is never received by state residents at all, but is immediately offset by increased federal income taxes for itemizers.

New York also provides a credit against school property taxes to farmers. To be eligible, two-thirds of a taxpayer’s income must come from farming. The credit refunds 100 percent of school property taxes paid on up to 250 acres of agricultural property, and 50 percent of the taxes paid on acreage in excess of 250. The full credit is available to taxpayers with incomes under \$100,000. The credit is gradually phased out for taxpayers with incomes between \$100,000 and \$150,000.

The most expensive form of state-financed property tax relief is the STAR homestead exemption. Enacted in 1997 and phased in over four years, STAR exempts a certain amount of home value from local school property taxable value. Local governments are then reimbursed by the state for the amount the exempted value would have raised for local school districts. Under STAR, all owner-occupied residential

dwelling are eligible for a state-funded “homestead exemption” of at least \$30,000. In counties in which the median home value is greater than the statewide median home value, the value of this exemption is increased. This means that homeowners living in wealthier counties receive bigger homestead exemptions. As a result, a wealthy homeowner living in Westchester County will receive a STAR exemption of \$82,500 while a poor homeowner in a low-wealth county will receive only the basic \$30,000 exemption.

Elderly homeowners with incomes under \$60,000 (adjusted upward to keep pace with inflation after 2002) are eligible for an *enhanced* STAR exemption of \$50,000. Like the basic exemption, the enhanced exemption is increased in counties with home values above the statewide median. In Westchester, the enhanced exemption is currently \$137,590.

In the 2001-2002 school year, STAR exemptions accounted for \$1.875 billion in foregone property tax revenues for school districts outside New York City—slightly more than 15 percent of the \$12.394 billion in property tax revenues actually collected by those districts. New York City received \$112 million in STAR reimbursements—just 2.1 percent of the city property tax revenues allocated to the New York City school system. In recognition of the limited benefits that would accrue to New York City under the STAR property tax exemption, the initial STAR legislation established a special New York City STAR supplement which provides for a state-funded reduction in the New York City resident income tax. This element of the program provided New York City residents with \$520 million in income tax relief in 2001-2002.

STAR has been the centerpiece of legislative efforts to reduce property taxes in recent years. But STAR has significant faults:

- Like most homestead exemptions, STAR is poorly targeted in that it is provided to homeowners at all income levels; the exemption reduces the tax on the wealthiest estate and the smallest row house.
- The STAR exemption goes only to homeowners, even though renters pay property taxes indirectly in the form of higher rents—another flaw shared with other states’ homestead exemptions.
- Unlike the homestead exemptions used by most other states, STAR targets more generous exemptions to taxpayers who live in wealthier counties. As a result, two homeowners with the same income and the same home value can receive dramatically different exemptions simply because they live in different counties.



- The generosity of the STAR exemption to wealthier homeowners means that a substantial portion of the STAR tax relief is offset in the form of higher federal income taxes for New York itemizers.
- The \$60,000 income threshold for the elderly “enhanced” exemption creates a “cliff” effect. Elderly taxpayers with income of slightly less than \$60,000 get benefits that are two-thirds more than taxpayers with only slightly higher incomes.
- In addition, there is no other mechanism for relating elderly homeowners’ property taxes to their income: all elderly homeowners with incomes under \$60,000 receive the same exemption, even if one has income of \$10,000 and the other has income of \$50,000. In other words, the elderly enhanced exemption has very little sensitivity to homeowners’ ability to pay the tax.

### Issues in Assessing Property

One unique problem facing the property tax is that, by comparison to the sales and income tax, the property tax base can be difficult to measure accurately. In theory, the tax base should be equal to the market value of all real estate. But market value changes on an almost daily basis, and even a perfectly informed assessor would find it difficult to update home values in a timely fashion.

In most states, the quality of assessment has historically been poor—and New York is no exception. In 1975, the Court of Appeals ruled that all properties must be assessed at their true market value. After a contentious debate, in 1981 the state legislature authorized assessment at a uniform percentage of market value—but also authorized New York City and Nassau County to assess each of four different classes

of property at different percentages of market value. As a result of this system, one-, two-, and three-family homes in New York City and Nassau County are assessed today at a much lower percentage of market value than are business properties. This approach to property taxation is known as a “split roll”—the tax base is split into a lower-taxed group (usually residential) and a higher-taxed group (usually business). As a result, the tax burden in New York City and Nassau County has shifted away from residential properties and toward business properties.

Other local governments are not authorized to assess various classes of property at different percentages of full value, but local taxing jurisdictions outside of New York City and Nassau County can adopt separate homestead and non-homestead tax rates as a way of providing tax relief for owners of residential properties. Only a small number of school districts currently practice this option.

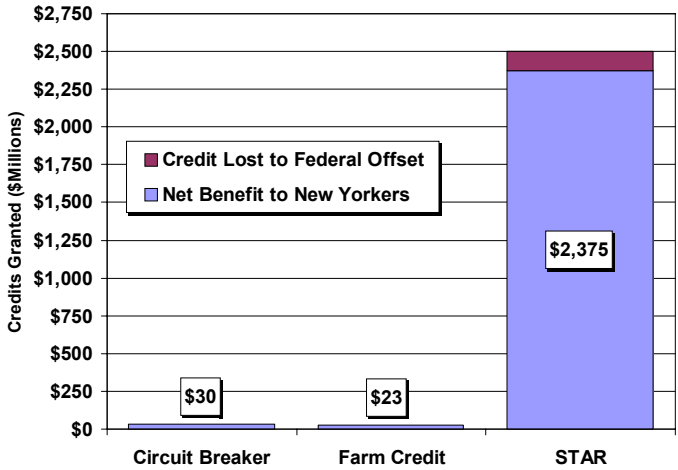
This approach to property tax relief is usually defended as a means of reducing onerous tax burdens on homeowners. And it achieves this purpose—but at a large cost. Like a homestead exemption, a split roll is poorly targeted, allowing tax cuts to the wealthiest homeowners. But because the split roll gives all homeowners the same percentage tax cut, it is much less progressive than a targeted property tax cut like the circuit breaker.

### Conclusion

Property taxes are inequitable in two important ways. First, these taxes hit low- and middle-income taxpayers most heavily. Second, the gap between low-wealth and high-wealth school districts allows wealthier districts to collect more tax revenue for schools at a lower tax rate—and poor districts must levy a higher tax rate to raise the same amount of money for schools.

New York lawmakers have taken steps to address each of these problems—but the state’s property tax relief mechanisms leave much to be desired. The STAR homestead exemption is expensive and poorly targeted, giving tax cuts to the wealthiest homeowners and no tax relief at all to low-income renters. Meanwhile, the state’s main targeted property tax credit, the “circuit breaker,” has been allowed to lose its value in recent years. Tax relief could be better targeted to those that need it the most by reforming (or repealing) STAR and expanding the circuit breaker.

**Comparing the Cost of Three Property Tax Relief Mechanisms**



## CHAPTER EIGHT

# OTHER IMPORTANT REVENUE SOURCES

This study has focused on the major taxes currently levied by New York State, including personal income, corporate income, consumption and property taxes. But state policymakers are also likely to look at a variety of less important revenue sources to help meet the state's funding needs. This chapter discusses these options, with an eye toward evaluating their usefulness in restoring fiscal adequacy to New York.

### Estate and Inheritance Taxes

Like most states, New York levies an inheritance tax that is closely linked to the federal estate tax. The federal estate tax has historically allowed a dollar-for-dollar tax credit against inheritance taxes levied by states, up to a certain maximum amount. Most states—including New York—have defined their estate taxes to be exactly equal to the amount of this credit, so that the New York estate tax will add exactly nothing to the total amount of estate taxes paid by New York decedents. This “pickup tax” amounts to a transfer of estate tax revenues from the federal government to the states, rather than a state tax hike.

Federal tax cuts enacted in 2001, however, are scheduled to repeal the estate tax over ten years—and, more critically for New York, phases out the federal credit allowed for state estate taxes between 2002 and 2005. The federal credit is scheduled to fall by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and will cease to exist in 2005. However, the New York estate tax is linked to the federal tax in effect before 2002, which means that unless state lawmakers take additional action, the state's estate tax will not be repealed.

While the estate tax represents less than 2 percent of New York taxes, it plays an important role in the state's tax structure. Like personal and corporate income taxes, the estate tax helps to offset the regressivity of the other taxes levied by New York. Any effort to reduce or repeal the estate tax will shift state and local taxes from wealthy decedents to living workers and consumers—and from wealthier taxpayers to the low- and middle-income New Yorkers who are hit hardest by the current tax system.

### State-Sponsored Gambling

Lotteries, and gambling revenues more generally, have been a popular revenue-raising choice for lawmakers in recent years. Lotteries are operated by non-profit agencies of the state government. No tax

applies to lottery revenues; the government's revenue stream is derived from the amount wagered on tickets. However, substantial expenses are required to operate a lottery—such as prizes, marketing, administration, and auditing—and the net revenue received by states averages only 35 percent of the gross revenue. In fiscal year 2003, New York's state lottery brought in about \$1.8 billion after these operating expenses in 2003.<sup>22</sup> New York also collects various taxes and fees associated with horse race gambling, which amounted to \$38 million in 2003.<sup>23</sup>

As the scale of New York's fiscal crisis has widened, some policymakers have suggested expanding the state's reliance on various gambling revenues, including “video lottery terminals,” as a way of shoring up the state's tax system. Despite providing New York with needed revenue, state-sponsored gambling presents an array of negative issues. In particular:

- State-sponsored gambling is a regressive revenue source. Low-income and poorly-educated taxpayers are far more likely to participate in lotteries and other forms of gambling than are wealthier, better-educated taxpayers.
- The revenue gains from gambling may be illusory. Instead of increasing state revenues, gambling may simply shift money from one tax to another with no net gain to New York. When consumers spend more money on gambling activities, they will spend less money on other items, such as travel, recreation and basic needs. If these purchases are subject to sales tax, increasing gambling revenue will mean a decrease in state sales tax revenue.
- Like other “sin” taxes, gambling is not a truly voluntary tax. Compulsive gambling has been recognized as an addictive disease. Relying on compulsive gamblers to fund public services amounts to taking advantage of these gamblers' addictions. And because state gambling administrators tend to downplay the poor odds of winning, gamblers are usually given incomplete information about these odds—which means that gamblers are being tricked into these “voluntary” spending decisions.

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<sup>22</sup>Comprehensive Annual Report For Fiscal Year Ended March 31, 2002.

<sup>23</sup>Annual Statistical Report, January 2004

- Compulsive gambling introduces a variety of social costs, including increased crime rates, decreased private savings, and job losses. These social costs can reduce the quality of life for children living in families headed by gamblers, and can result in higher social welfare spending by state governments in the long run.

Perhaps the most problematic shortcoming of this revenue-raising solution is that the yield of gambling revenues seems likely to decline over time. As more and more states increase their reliance on gambling revenues, the attractiveness of traveling to New York to gamble will decline, and New Yorkers seeking to gamble may well do so in neighboring states that formerly did not allow gambling. In the long run, an increasing percentage of state gambling revenue will be paid by state residents rather than tourists.

### **Intangible Personal Property Tax**

In the early twentieth century, many states levied property taxes not just on real property and tangible personal property but on intangible personal property such as stocks and bonds. Most states now exempt stocks and bonds, focusing instead on more easily taxed items such as homes and cars. However, in Florida, property taxes include intangible personal property. Florida imposes a \$1 per \$1000 value on intangible personal property with the first \$250,000 of taxable assets exempt for individual filers, \$500,000 for joint filers and \$250,000 for corporations. The high exemptions are designed to ensure that the administrative burden of paying these taxes is minimized for low- and middle-income taxpayers whose intangible wealth is quite low. Even with this large exemption, Florida's intangible property tax raises close to \$500 million annually.

The main argument for levying a tax on intangible personal property in addition to real property is that wealth is wealth regardless of its form. A New Yorker who keeps her wealth in real property (for example, a home) should not be taxed more heavily than someone who chooses to keep her wealth in stocks and other forms of investment income. Adding intangible property to New York's tax base could help restore fairness and adequacy to the state's tax system.

### **Stock Transfer Tax**

In 1905, New York lawmakers enacted a "stock transfer tax." The tax applied to stock transactions taking place on Wall Street. Starting in 1966, revenues from the tax were given to New York City. Although the tax

still legally exists (and is technically collected) today, it has essentially been repealed since 1981: while Wall Street brokers still collect the tax on each sale of stock and pay it to the state, the tax is immediately rebated back to these brokers in its entirety. At the time of repeal, the tax rate varied depending on the price of the stock being traded, ranging from a low of 1.25 cents per share (for shares worth under \$5) to 5 cents per share for stocks valued over \$20 per share. The tax on any transaction was capped at \$350.

Re-introducing the stock transfer tax (by eliminating some fraction of the rebate that is currently granted) could help New York City (or New York State) deal with its current fiscal crisis. In 2003, New York collected—and immediately rebated—\$9.5 billion in stock transfer tax revenues.<sup>24</sup> Because the existing rebate mechanism means the tax is still collected, the administrative burden of re-enacting the stock transfer tax would be minimal.

One frequently cited reason for repealing the tax was that the high rate and unique nature of the tax might encourage Wall Street traders to relocate outside the state to avoid it. However, reimposing the tax at a much lower rate could help New York to meet the state's funding needs with a minimal impact on Wall Street. Because a stock transfer tax would be paid by shareholders, the tax would be quite progressive (since stock shares are held disproportionately by wealthier taxpayers) and would be partially exported to residents of other states (since many shareholders trading in New York live in other states). Even at rates just one-tenth of the former 5 cent top rate, such a tax could raise close to a billion dollars annually to help fund education in New York.

### **Conclusion**

This chapter has surveyed several revenue sources that could be used in combination with increases in major New York taxes to help fund education. These include revenue sources that New York currently levies and those they could consider. None of these sources can independently resolve the state's ongoing fiscal shortfalls—but each could contribute to funding adequacy in New York.

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<sup>24</sup>New York City Independent Budget Office (2004), *Budget Options for New York City*, p.19.

# OPTIONS FOR ACHIEVING ADEQUACY

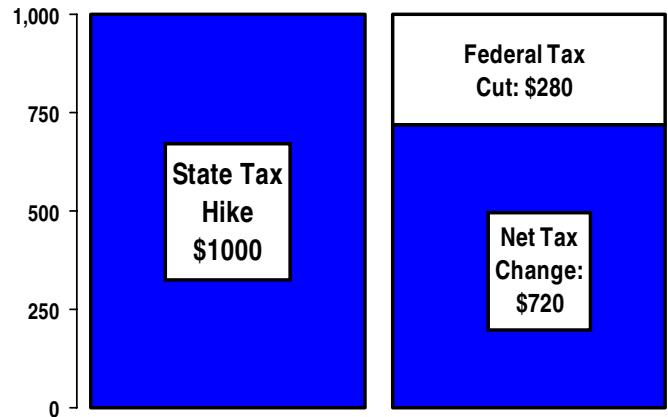
As New York lawmakers struggle to raise revenue for education and other public services, they face an important choice between three tax strategies: **broadening the base** of New York taxes to include currently exempt items (for example, by expanding the income tax to include all pension income, including more services in the sales tax base, or eliminating corporate income tax loopholes), **increasing the rates** of these taxes, or looking to entirely **new revenue sources** that the state does not currently use. Base-broadening is the best place to start in achieving structural tax reform—but loophole-closing will be insufficient to meet the state's revenue raising needs, so lawmakers may also be forced to increase tax rates or introduce new taxes. This chapter describes various options that could help to resolve New York's fiscal shortfall.

Most of the proposals described here would increase New York taxes, but the chapter also includes several revenue-reducing options that could be adopted in conjunction with revenue-raising reforms to mitigate the impact on low- and middle-income taxpayers. **In each case, this chapter estimates the annual revenue impact of the proposals if enacted in calendar year 2006.**

For each option described in this chapter, the accompanying bar charts show the impact of these options on each New York income group, expressed as a share of that group's income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent portion of each bar shows the amount of state tax change that is offset immediately by federal tax changes. For New Yorkers who itemize deductions on their federal tax returns, changes in state income and property taxes can produce offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by New Yorkers, including federal state taxes, as the following example shows.

Suppose an itemizing New York taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 increase in New York income taxes. The value of his or her federal itemized deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer's income will be subject to federal tax after the New York tax cut. Since this last increment of

## How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens: An Example



income is taxed at 28 percent, this person's federal tax liability decreases by \$280. So the *total* tax hike for this itemizing New York taxpayer from a \$1,000 increase in state tax liability is actually \$720, not \$1,000. Our distributional analysis of this proposal (the second column in the chart above) shows that taxpayers do not pay the full \$1,000 tax hike, since \$280 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overstate the tax increase on New Yorkers.

State and local property taxes are also deductible on federal tax returns, so a similar percentage of property tax increases on New York taxpayers who itemize will be offset by federal tax cuts.

If, on the other hand, the same itemizing New York taxpayer was subject to a \$1,000 sales tax hike, federal taxes would not change, because sales taxes generally cannot be deducted.<sup>25</sup> This means that the whole \$1,000 tax hike would be paid by the taxpayer. In this example, the choice between sales and income taxes does not affect state revenues—the state receives an extra \$1,000 with either approach—but the New York taxpayer fares much worse under the sales tax than under the income tax.

<sup>25</sup>Due to a temporary tax break enacted by Congress in 2004, federal itemizers can choose between writing off sales taxes and income taxes in 2004 and 2005—but for almost all New York residents, deducting income taxes will always be a better option.

This “federal offset” is most important to wealthier taxpayers, who are more likely to itemize federal returns and pay at higher marginal rates. Low-income New Yorkers, who tend not to itemize their federal returns, are unaffected by this federal interaction.

## Building Blocks for Tax Reform

This section shows the impact of a variety of tax changes that could be implemented to raise (or reduce) New York tax revenues. Since none of these options are individually sufficient to meet the state’s spending needs, the following section combines these “building blocks” into larger packages of revenue-raising plans that could raise the \$8.5 billion that may be needed to adequately fund services.

### A. State Personal Income Tax Rate Changes

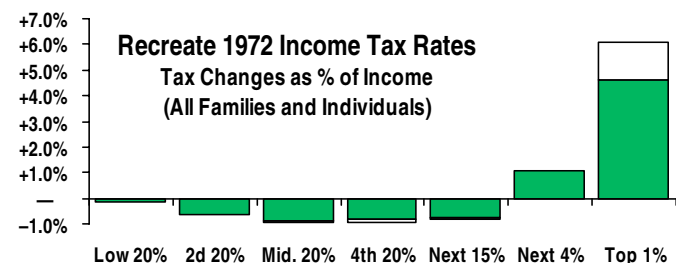
#### 1. Recreate 1972 Income Tax Rates

##### Principal Features

- Increases New York taxes by \$6.7 billion.
- Decreases federal taxes by \$2 billion.
- Tax cut for 95 percent of taxpayers, on average.

##### Discussion

New York’s state income tax brackets and rates are less progressive than they have been in the past. This option undoes the income tax rate cuts enacted over the past thirty years, reimposing the tax rate structure as it existed in 1972. The 1972 income tax rates ranged from 2 percent to 15 percent. The 1972 tax brackets are indexed for inflation, so the 15 percent top marginal rate would apply to taxable income over \$236,000 in 2006. This option would raise \$6.7 billion in New York tax revenues, of which \$2 billion, or 29 percent of the state tax hike, would be offset by lower federal income tax payments for New York itemizers.



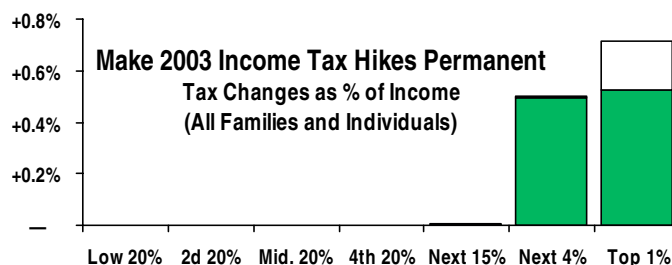
#### 2. Make 2003 Temporary Income Tax Rate Hikes Permanent

##### Principal Features

- Increases New York taxes by \$1.5 billion.
- Decreases federal taxes by \$285 million.

##### Discussion

In 2003, New York lawmakers enacted a temporary income tax surtax on the wealthiest taxpayers, with new top tax rates of 7.5 percent (on taxable income above \$150,000 for married couples and \$100,000 for single taxpayers) and 7.7 percent (above \$500,000 of taxable income for all families) for tax year 2003. The higher tax rates are currently scheduled to gradually decrease in 2004 and 2005, and will sunset at the end of 2005. This option would make the top rates—as they were imposed in 2003, with a top rate of 7.7 percent—a permanent part of the state income tax. Nineteen percent of the state tax hike from this option would be offset by lower federal income taxes for New York itemizers.



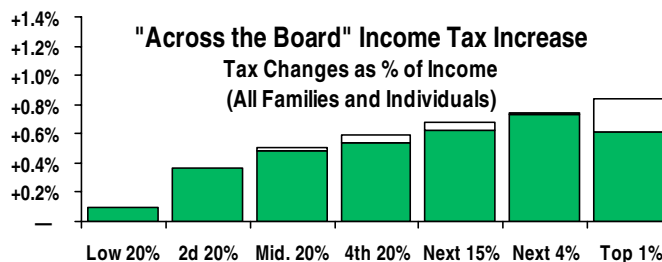
#### 3. “Across the Board” Income Tax Increase

##### Principal Features

- Increases New York taxes by \$4.2 billion.
- Decreases federal taxes by \$500 million.

##### Discussion

This option increases the importance of the personal income tax in New York’s tax system, but does not make the tax more progressive. The option



would increase all of the income tax rates by 10 percent, resulting in a tax hike for those currently paying state income taxes. Because the poorest New Yorkers generally pay no income tax, this option would not impact low-income New Yorkers substantially. 12 percent of the state tax hike from this option would be offset by lower federal taxes for itemizers.

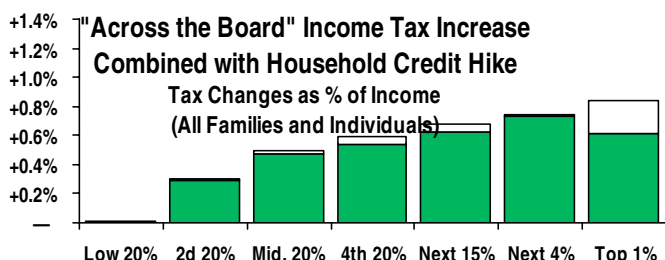
#### 4. “Across the Board” Income Tax Increase Combined with Household Credit Hike

##### Principal Features

- Increases all New York income tax rates.
- Increases the household credit by \$50.
- Increases New York taxes by \$4.15 billion.
- Reduces federal taxes by \$500 million.

##### Discussion

This option is more progressive than the “across the board” income tax hike in option 3 because part of the tax hikes on low-income taxpayers are offset by an expansion of the household credit. This change combines a 10 percent income tax hike with a \$50 increase in the maximum household credit (for all those currently eligible for the credit). 12 percent of this state tax hike would be paid for directly by the federal government in the form of federal income tax cuts for New York itemizers.



#### 5. Tax Unearned Income at a Higher Rate

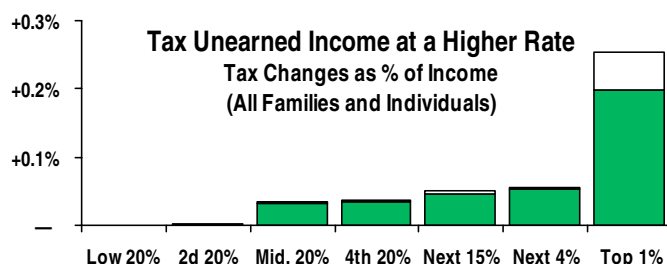
##### Principal Features

- Applies a higher tax rate to unearned income such as capital gains and dividends.
- Increases New York taxes by \$600 million.
- Reduces federal taxes paid by \$98 million.

##### Discussion

Until 1988, New York taxed earned and unearned income under separate rate schedule, with a lower top rate on earned income (12 percent) than on unearned income such as capital gains and dividends (14 percent). This option re-imposes a higher income

tax rate schedule on capital gains and dividends. These income sources are taxed at a rate 1 percentage point higher than other income sources, so income that would be taxed at 6.85 percent under the regular income tax would instead be taxed at 7.85 percent under this option. Because wealthier New Yorkers receive most dividends and capital gains, this is a very progressive tax increase. A substantial portion of this tax hike never comes out of the pockets of New York taxpayers, but is paid by the federal government in the form of lower federal tax liability for New Yorkers.



## B. Income Tax Base Broadening Options

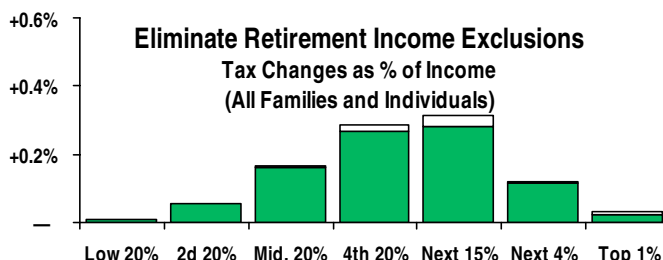
#### 6. Eliminate Retirement Income Exclusions

##### Principal Features

- Conforms the New York tax treatment of pensions and Social Security benefits to federal rules.
- Simplifies the New York tax system by eliminating two special tax preferences.
- Increases New York tax revenues by \$1.1 billion.
- Decreases federal taxes by \$86 million.

##### Discussion

This option simplifies the New York income tax by conforming to the federal income tax treatment of Social Security and pension income. New York currently exempts all Social Security income and the first \$20,000 of pension benefits. Federal income tax rules exempt all Social Security benefits for taxpayers with income below \$32,000 for married couples, and



subject less than twenty percent of elderly New Yorkers to tax on their Social Security benefits, as discussed in Chapter Four. Tying New York income tax rules to federal rules in this manner also makes the New York income tax simpler and easier to understand. Eight percent of the state tax hike from this option would be offset by federal tax cuts for New York itemizers.

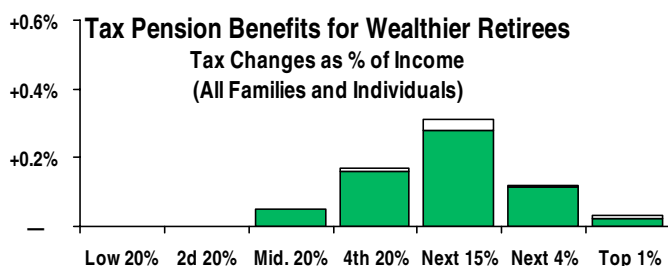
## 7. Tax Pensions for Wealthier Retirees

### Principal Features

- Adds an income limit to the current income tax exclusion for pension benefits
- Progressive tax change.
- Increases New York tax revenues by \$870 million.

### Discussion

This option disallows the pension exemption only for New Yorkers earning over \$50,000 a year. Because income taxes can be written off on federal income tax forms by itemizers, part of this hike would be offset by federal tax cuts.



## C. Better Targeting of Income Tax Credits

## 8. Limit Dependent Care Credit to Low-and Middle-Income Parents

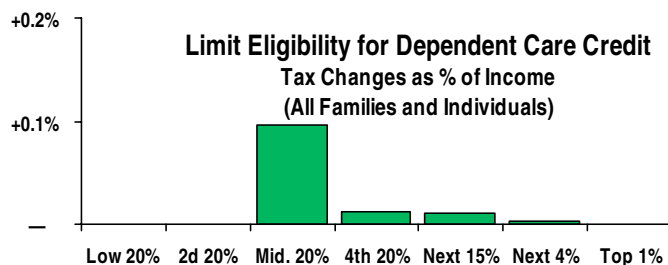
### Principal Features

- Caps eligibility for child care credit at \$40,000
- Progressive tax change.
- Increases New York tax revenues by \$90 million.

### Discussion

The New York dependent care credit is based on federal eligibility rules—which means that taxpayers at all income levels can claim the credit. Some states allowing similar credits have imposed income limits on eligibility—which better targets the credit to the low- and middle-income families who need the credit most. Because income taxes can be written off on

federal income tax forms by itemizers, a small part of this hike would be offset by federal tax cuts.



## D. New York City Income Tax Options

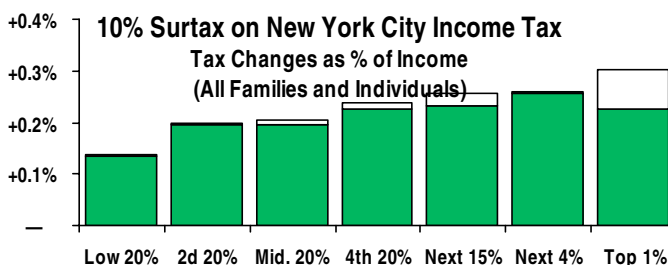
## 9. Temporary City Income Tax Surcharge

### Principal Features

- Imposes a surcharge on the City income tax.
- Progressive tax change.
- Increases New York tax revenues by \$630 million.

### Discussion

This option would impose a 10 percent surcharge on the New York City income tax. It is assumed that the 14 percent surcharge will remain part of the city income tax in 2006, but that the currently-imposed temporary top rates will expire. Because the local income tax is progressive, the surtax would be progressive too. Because local income taxes can be written off on federal income tax forms by itemizers, part of this hike would be offset by federal tax cuts.



## 10. Re-Enact New York City "Commuter Tax"

### Principal Features

- Imposes flat-rate 0.45 percent tax on New York City commuters.
- Slightly progressive tax change.
- Some of tax is paid by non-New Yorkers.
- Increases New York tax revenues by \$500 million.

## Discussion

This option recreates the flat 0.45 percent wage tax that was imposed on New York City workers living outside the city (or outside the state) from 1966 to 1999. The commuter tax ensures that workers living outside the city who commute to the city to work contribute their fair share to the cost of providing public services. Because the commuter tax was levied at a flat rate, this option is only slightly progressive. Because local income taxes can be written off on federal income tax forms by itemizers, part of this tax hike would be offset by federal tax cuts.

## 11. New Progressive Commuter Tax

### Principal Features

- New, graduated version of commuter tax.
  - Progressive tax change.
  - Increases New York tax revenues by \$1 billion.

### Discussion

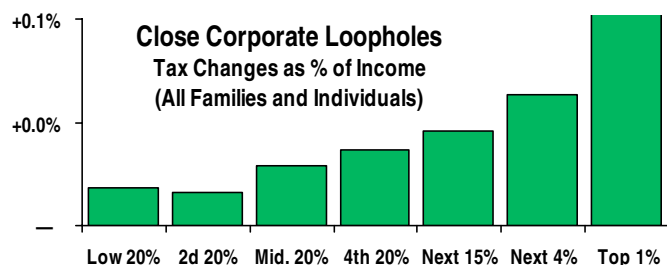
This option re-enacts the wage tax that was imposed on New York City workers living outside the city (or outside the state) from 1966 to 1999, but replaces the prior flat rate with a graduated-rate tax similar to the rate structure imposed under the city income tax (with rates substantially lower than the city rates). The commuter tax ensures that workers living outside the city who commute to the city contribute their fair share to the cost of providing services. Because local income taxes can be written off on federal income tax forms by itemizers, part of this tax hike would be offset by federal tax cuts.

## E. Corporate Tax Reform Options

## 12. Close Corporate Loopholes

### Principal Features

- Broadens the base of the corporate tax.
- Progressive tax change.
- Most of tax is exported to non-New Yorkers.



- Increases New York tax revenues by up to \$1 billion.

### Discussion

This option shores up the corporate tax base by strengthening the minimum tax, enacting combined reporting and a “throwback rule.” Because most of the corporate tax is exported to non-residents, the impact of this option on New Yorkers is minimal.

## F. Sales and Transaction Tax Options

## 13. Re-enact Stock Transfer Tax At Lower Rate

### Principal Features

- Re-enacts stock transfer tax with a rate schedule one-tenth of the rates used in 1981 (when the tax was repealed).
  - Progressive tax change.
  - Much of tax is exported to non-New Yorkers.
  - Increases New York tax revenues by \$800 million.

### Discussion

This option re-creates the New York stock transfer tax, which was repealed in 1981, at a lower set of rates capped at 0.5 cents per share for the highest-valued stocks. (The original tax was levied at a rate up to ten times higher.) Because shares of stock are held disproportionately by wealthier taxpayers, this would be a progressive tax change—and because many shareholders live in other states, part of this tax hike would be exported to shareholders around the nation.

## 14. Eliminate Sales Tax Exemptions (Services)

### Principal Features

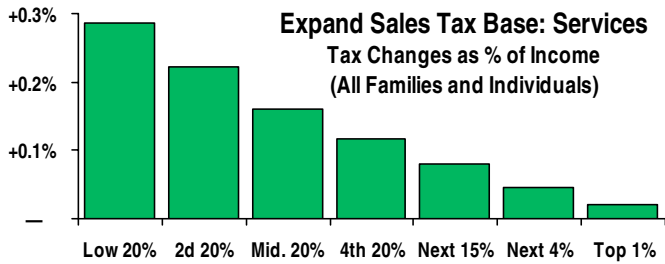
- Includes certain personal services in the state sales tax base.
  - Regressive tax change.
  - Increases New York tax revenues by \$620 million.
  - Federal taxes are not affected by this change.

### Discussion

This option expands the state sales tax base by taxing various personal services, including cable TV, laundry and shoe repair, and interstate telephone service. The option would raise \$620 million for New York in 2006. Although adding services to the sales tax base makes the sales tax less regressive, the impact of this tax option is nonetheless clearly regressive compared to income- or property-tax based options. By broadening the tax base, this option treats different consumers more equally—and arguably makes it easier for lawmakers to avoid increasing the sales tax



rate. Because sales taxes are generally not deductible on federal income tax forms, little or none of this tax hike would be offset by federal tax cuts.



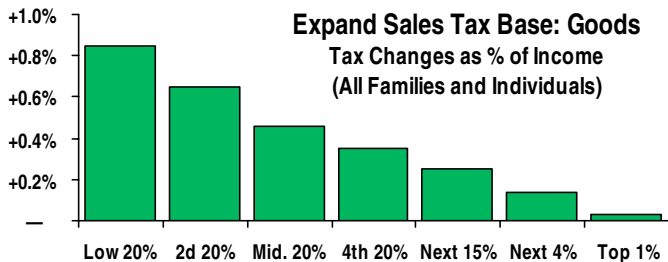
## 15. Eliminate Sales Tax Exemptions (Goods)

### Principal Features

- Eliminates exemptions for tangible property.
- Increase horizontal equity by broadening tax base.
- Regressive tax increase.
- Increases New York tax revenues by \$1.77 billion.
- Federal taxes are not affected by this change.

### Discussion

This option augments the state sales tax base by eliminating exemptions for various goods, including groceries, newspapers and periodicals, and college textbooks. This is a regressive sales tax change—but one that would yield \$1.77 billion in 2006. By broadening the tax base, this option helps to achieve horizontal equity, ensuring that the tax system won't discriminate against taxpayers based on which items they purchase—and arguably makes it easier for lawmakers to avoid increasing the sales tax rate. On the other hand, taxing "necessities" such as groceries will make the sales tax more regressive, worsening the vertical equity of the New York tax system. Because sales taxes are generally not deductible on federal income tax forms, little or none of this tax hike would be offset by federal tax cuts.



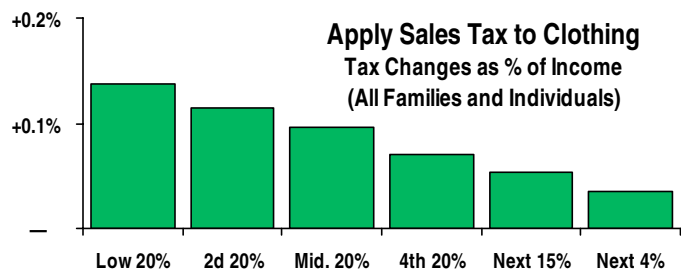
## 16. Limit Sales Tax Exemption for Clothing

### Principal Features

- Limits current sales tax exemption for sales of clothing under \$110 to two weeks per year.
- Increases New York revenues by \$520 million.

### Discussion

New York allows a state sales tax exemption for purchases of individual items worth less than \$110. (Legislation passed in 2003 temporarily suspended the exemption, but allowed a two-week sales tax holiday from the state sales tax.) The largest tax cut from this exemption, as a share of income, goes to low-income New Yorkers. This option would repeal the exemption and instead allow a two-week sales tax holiday from both state and local taxes.



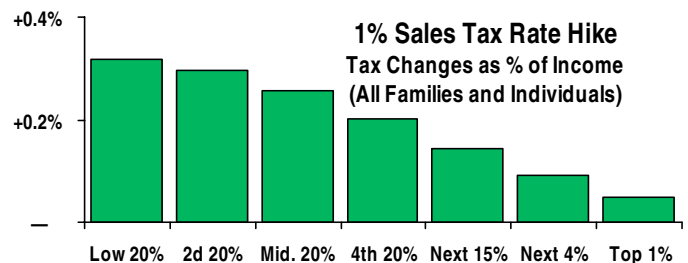
## 17. Sales Tax Rate Hike

### Principal Features

- Raises state sales tax rate by 0.5 percent.
- Regressive tax increase.
- Increases New York tax revenues by \$1.2 billion.
- Federal taxes are not affected by this change.

### Discussion

The general sales tax is the most regressive major tax levied by the state—and New York already has a relatively high state sales tax rate when local taxes are taken into account. This option would increase the state sales tax rate by 0.5 cents, raising \$1.2 billion. (2003 legislation enacted a temporary 0.25 cent sales tax increase, which is currently scheduled to sunset in



May of 2005.) Increasing the sales tax rate without broadening the tax base to include currently exempt services exacerbates the current discrimination between the low-income taxpayers who tend to consume goods and the upper-income taxpayers who are more likely to consume untaxed services. Because sales taxes are generally not deductible on federal income tax forms, little or none of this tax hike would be offset by federal tax cuts.

## 18. Expand Sales Tax Base to Include Groceries, Offer Refundable Sales Tax Credit

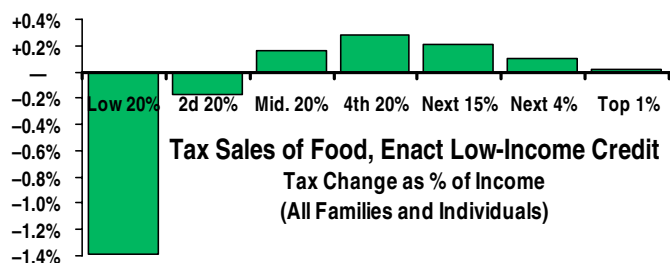
### Principal Features

- Broadens tax base by taxing groceries at the regular sales tax rate.
- Uses some revenues from this base expansion to fund a refundable tax credit designed to offset taxes on groceries; net state tax increase of \$590 million.
- Makes sales tax less regressive.
- No impact on federal income taxes.

### Discussion

This option broadens the New York state sales tax base by taxing groceries at the regular statewide rate. The sales tax hike on lower-income taxpayers is offset by a grocery tax credit designed to make the sales tax less regressive. As a result, this option would reduce taxes on low-income New Yorkers while raising \$590 million in state tax revenue. The main disadvantage of this option is the difficulty of administering a tax credit of such a large scale—and the fact that unlike the current food tax exemption, a food tax credit would only be available to those who apply for it.

Because sales taxes are generally not deductible on federal tax forms, this option does not affect federal taxes paid by New Yorkers.



## 19. Statewide Property Tax

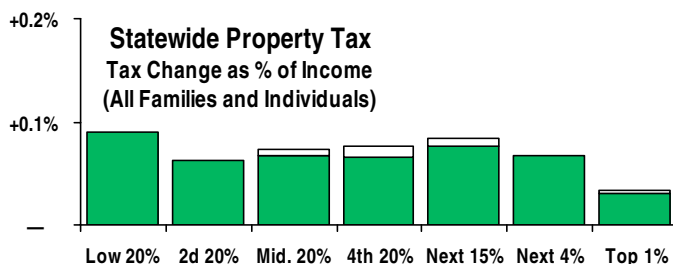
### Principal Features

- Imposes a statewide property tax.
- Regressive tax increase.
- Increases New York tax revenues by \$500 million.
- Federal taxes decrease by \$35 million.

### Discussion

This option creates a statewide property tax. This tax change would alleviate one source of tax inequity by requiring the same amount of property tax effort from the poorest and wealthiest districts. However, increasing reliance on property taxes would also make the New York tax system more regressive—and would do nothing to resolve the inequities in the current STAR exemption.

Because property taxes are deductible on federal income tax forms, some of the added property tax would be offset by federal tax cuts.



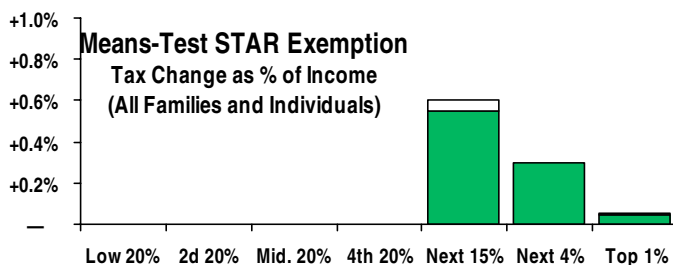
## 20. Means-Test STAR Exemption

### Principal Features

- Limits eligibility for STAR exemption to homeowners earning less than \$125,000.
- Progressive tax increase.
- Increases New York tax revenues by \$1.3 billion.
- Federal taxes decrease by \$92 million.

### Discussion

Most homestead exemptions are available to taxpayers at all income levels. But a few states now impose income limits on these exemption. This option disallows the STAR exemption for New Yorkers earning over \$125,000. Because property taxes are



deductible on federal income tax forms—and because this property tax hike would be paid almost entirely by New Yorkers who itemize and pay at higher federal income tax rates—more than 25 percent of this state tax hike would be offset by federal tax cuts.

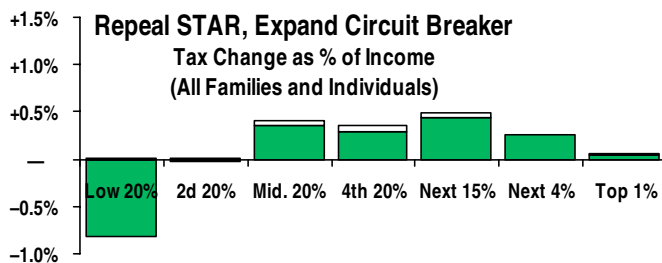
## 21. Repeal STAR, Expand Circuit Breaker

### Principal Features

- Repeals STAR homestead exemption
- Expands eligibility for circuit breaker.
- Increases New York tax revenues by \$1.6 billion.
- Federal taxes decrease by \$227 million.

### Discussion

This option repeals the STAR homestead exemption, and expands the “circuit breaker” tax credit to include more middle-income New Yorkers as well as non-elderly homeowners and renters. Because property taxes are deductible on federal income tax forms, some of this state tax hike would be offset by federal tax cuts.



## 22. Cigarette Tax Increase

### Principal Features

- Raise cigarette tax by \$0.50 per pack to \$2.00.
- Regressive tax increase.
- Increases New York tax revenues by \$250 million.
- Federal taxes are not affected by this change.

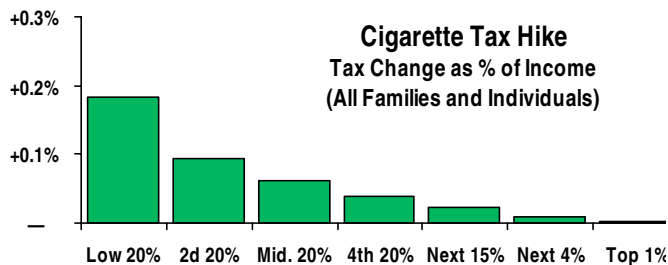
### Discussion

This option increases the state cigarette tax from \$1.50 to \$2.00 per pack. Because cigarette taxes are highly regressive, this tax hike would impact low-income taxpayers most heavily. Some argue, however, that increases in cigarette taxes may discourage smoking—although there is some evidence that high cigarette tax rates simply encourage tax evasion.

Because the behavioral effect of such a tax hike is uncertain, the actual yield of a 50-cent hike could be substantially less than the \$250 million projected here.

Cigarette taxes are a poor long-term choice for revenue raising, since they are calculated based on the volume of sales rather than as a percentage of the sales price. This means that revenues will only grow when the rate increases or when consumption grows. The recent decline in cigarette consumption means this tax is likely to decline over time.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax would be offset by federal tax cuts.



## 23. Increase Gasoline Excise Tax

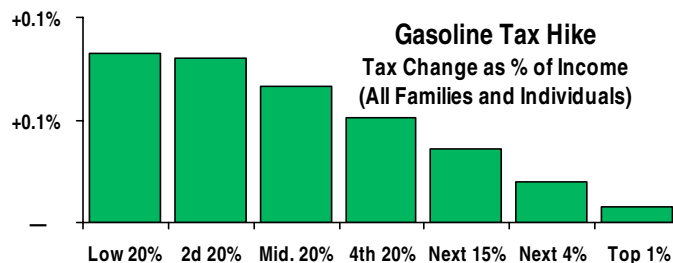
### Principal Features

- Impose 5 cents per gallon tax hike on gasoline.
- Regressive tax increase.
- Increases New York taxes by \$300 million.
- Federal taxes are not affected by this change.

### Discussion

This option would levy an additional five cents per gallon excise tax on motor fuels, with the revenues devoted to state general revenue funds. While this option is less regressive than the cigarette tax hike modeled above, this excise tax hike still hits low-and middle-income taxpayers most heavily. The “per-unit” nature of this tax means that the yield is likely to decline over time.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax would be offset by federal tax cuts.



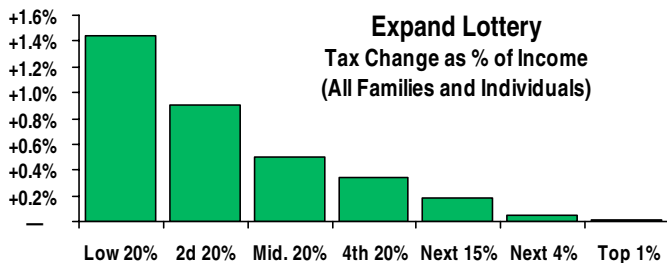
## 24. Expand New York Lottery

### Principal Features

- Increases New York revenues by up to \$2 billion.
- Federal taxes are not affected by this change.

### Discussion

Lotteries are an increasingly popular revenue-raising choice for states, and New York was one of the first states to rely heavily on this revenue source. However, a lottery is also among the most regressive revenue-raising options available to lawmakers. One recent proposal would expand the state’s reliance on “video lottery terminals” (VLTs) to fund education. Such a change could yield up to \$2 billion annually for education—although the state’s current collections from VLTs have been well below initial forecasts, and the future yield of New York VLTs could be reduced substantially if neighboring states increase their reliance on this revenue source.



## Tax Relief Options

Many of the options described in this chapter would increase taxes on low-income New Yorkers. Some options would even make the state tax system more regressive. Recognizing that lawmakers may wish to shelter low-income taxpayers from some of the additional burdens imposed through these tax increases, this section looks at several approaches to targeted low-income tax relief that could be used in conjunction with the revenue-raising options described above. Options are presented for each of the three major taxes levied in New York—personal income, property and sales taxes.

## 25. Expand the Earned Income Tax Credit

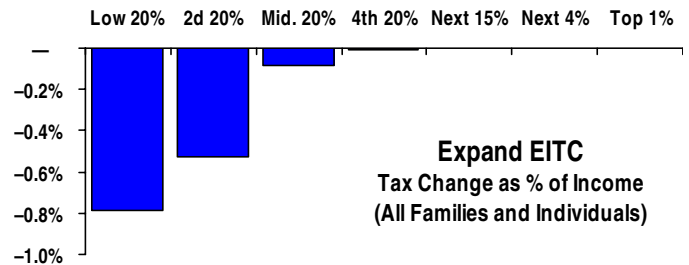
### Principal Features

- A refundable EITC based on the federal credit.
- Targeted to lower-income working families.

- Reduces New York tax revenues by \$450 million.

### Discussion

New York’s Earned Income Tax Credit (EITC) is one of the most generous in the nation—but is insufficient to offset the regressivity of other New York taxes. This option expands the state EITC to 50 percent of the federal credit, and eliminates the interaction between the EITC and the Household Credit.



## 26. Enact a \$150 Sales Tax Rebate

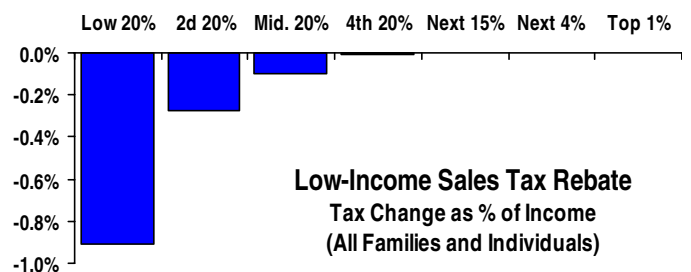
### Principal Features

- \$150 per-exemption refundable tax rebate.
- Restricted to taxpayers earning less than \$30,000 annually.
- Targeted to lower-income working families.
- Reduces New York tax revenues by \$390 million.

### Discussion

This option partially offsets the regressivity of the New York sales tax by allowing a sales tax credit for taxpayers earning less than \$50,000.

Because eligibility is limited to low-income taxpayers, the sales tax credit is a less expensive way of reducing sales taxes than an exemption. However, sales tax credits must be applied for, while sales tax exemptions are automatically granted to all eligible consumers. Low-income taxpayers who are not aware of a sales tax credit will not receive its benefits.



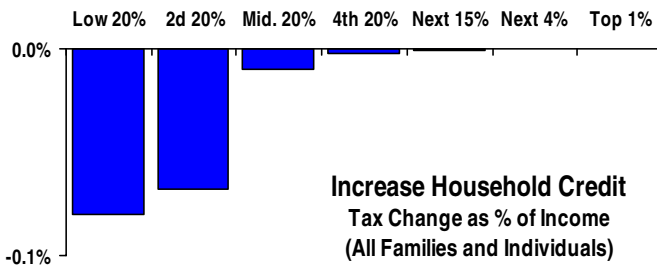
## 27. Increase Household Credit

### Principal Features

- Increases the household credit by \$50 for each family and \$25 for each exemption.
- Reduces New York tax revenues by \$55 million.

### Discussion

The New York personal exemption credit offers valuable tax relief to low- and middle-income New Yorkers. However, the credit's value has declined substantially since the credit was last adjusted in 1987. This option increases the credit by \$50 for each eligible taxpayer, plus \$25 for each exemption in the family. Because the credit is available only to lower-income New Yorkers, this tax break targets relief to the low-income New Yorkers who need it most—and results in virtually no offsetting federal tax increase.



## Putting It All Together:

As the charts at the beginning of this chapter make clear, none of the “building blocks” described so far can generate a sufficient amount of revenue to meet the *CFE* funding requirements. This section presents a variety of ways in which revenue-raising and tax-relief options could be combined to yield close to the \$8.5 billion that may be needed to comply with the *CFE* requirements. The combinations presented here are chosen to represent the variety of options available to lawmakers and should not be understood as recommendations for tax reform.

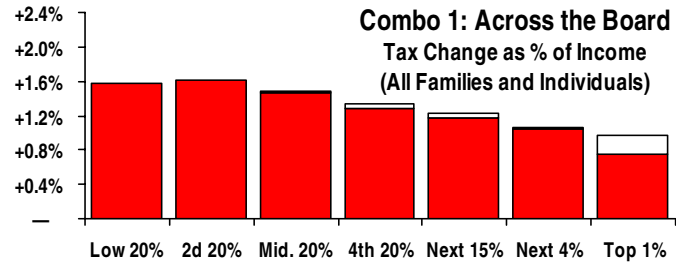
### Combination 1: Sales Tax Expansion and “Across the Board” Income Tax Hike

#### Principal Features

- Increases sales tax rate by 1 percent on all goods and expands the sales tax base.
- Increases all personal income tax rates.
- Increases New York revenues by \$8.4 billion.
- Decreases federal taxes paid by \$500 million.

### Discussion

This option takes the simplest possible approach to revenue-raising—it increases both of the major state revenue sources relied upon by New York. This plan broadens the sales tax base and increases the statewide rate by 1 percent, and increases personal income tax rates by 10 percent across the board. Even though this plan relies on the personal income tax for about half of its revenue, the net effect is slightly regressive—because the plan does not make the personal income tax more progressive.



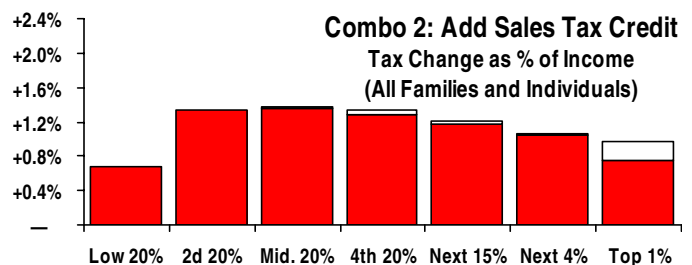
### Combination 2: Add Low-Income Relief

#### Principal Features

- Adds a Sales Tax Credit to Combination 1.
- Increases New York revenues by \$8 billion.
- Decreases federal taxes paid by \$500 million.

### Discussion

This option adds one feature to the regressive Combination 1: a \$390 million refundable sales tax credit. This addition makes this option slightly less regressive. Because the low-income beneficiaries of the sales tax credit do not itemize federal tax returns, this option results in the same federal tax change as Combination 1—yielding a greater “bang for the buck” than the first option.



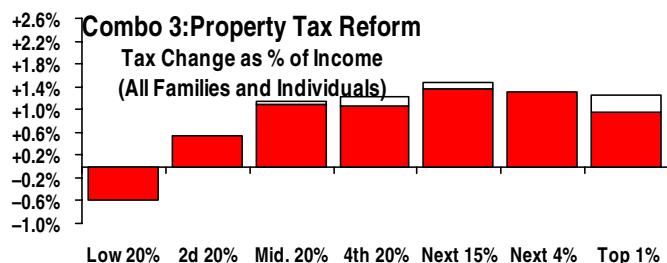
## Combination 3: Property Tax Reform

### Principal Features

- Repeals STAR.
- Expands circuit breaker tax credit
- Enacts statewide property tax.
- “Across the board” personal income tax increase, plus corporate loophole closing.
- Increases New York revenues by \$8.5 billion.
- Decreases federal taxes paid by \$900 million.

### Discussion

This option focuses on progressive property tax reform, replacing the expensive STAR exemption with a targeted circuit breaker credit and imposing a new state-wide property tax. The option also includes the an “across the board” income tax increase and closes a variety of corporate tax loopholes. A substantial portion of this added state revenue is offset by federal tax cuts for itemizers. Because most of this plan’s revenue comes from the progressive income tax, and because the repeal of STAR makes the New York property tax much less regressive, this plan is mostly progressive overall.



## Combination 4: Progressive Tax Reform

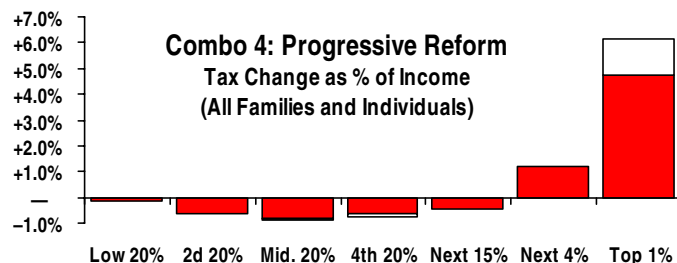
### Principal Features

- Relies on progressive revenue sources.
- Increases New York revenues by \$8.5 billion.
- Decreases federal taxes paid by \$2 billion.

### Discussion

This option relies only on changes in the personal and corporate income taxes to raise \$8.6 billion. The option uses the 1972 income tax rates described in Option 1, and also broadens the income tax base to include retirement income for wealthier New Yorkers (leaving the retirement income of those earning less than \$50,000 a year exempt, as in Option Seven). The option also closes a variety of corporate tax loopholes. Because these taxes are federally deductible, much of the income tax increase on wealthier

New Yorkers would be offset by federal income tax cuts for New York itemizers.



### Conclusion

New York lawmakers can choose from a wide variety of tax options to achieve educational adequacy, including options that reform the tax structure and options that simply raise rates. Any revenue-raising package that fully funds education in New York will require some combination of these options, rather than relying only on one tax source.

This report does not recommend any particular option or combination of options—rather, the tax changes modeled here should be understood as representative of the range of options available to New York lawmakers.

The chart on the next page evaluates each of the options presented in this chapter in terms of the basic tax principles described in Chapter One.

## New York Tax Reform Options and Principles of Taxation

	Does Each Proposal Achieve...				
	Vertical Equity	Base- Broadening	Adequacy	Export- ability	Neutrality
<b>Revenue Raising Options</b>					
Recreate 1972 Income Tax Rates	✓		✓	✓	✓
Make 2003 Temporary Rate Hikes Permanent	✓		✓	✓	✓
"Across the Board" Income Tax Increase	✓		✓	✓	✓
"Across the Board" Tax Hike, Credit Hike	✓		✓	✓	✓
Tax Unearned Income at a Higher Rate	✓		✓	✓	
Eliminate Retirement Income Exclusions	✓		✓	✓	✓
Limit Dependent Care Credit Eligibility	✓	✓	✓	✓	✓
Temporary City Income Tax Surcharge	✓	✓	✓	✓	✓
Re-Enact New York City "Commuter Tax"	✓	✓	✓	✓	
New Progressive Commuter Tax	✓	✓	✓	✓	
Reinstate 0.5 Percent Stock Transfer Tax	✓	✓	✓	✓	
Close Corporate Loopholes	✓	✓	✓	✓	✓
Eliminate Sales Tax Exemptions (Services)		✓	✓		✓
Eliminate Sales Tax Exemptions (Goods)		✓	✓		✓
Sales Tax Rate Hike			✓		
Expand Sales Tax Base, Sales Tax Credit		✓	✓		✓
Statewide Property Tax			✓	✓	
Means-Tested STAR Exemption	✓	✓	✓	✓	
Repeal STAR, Expand Circuit Breaker	✓	✓	✓	✓	✓
Cigarette Tax Increase					
Increase Gasoline Excise Tax					
Expand New York Lottery					

## THE ECONOMIC IMPACT OF ACHIEVING ADEQUACY

Most policymakers would prefer to see New York State's schools receive adequate funding—yet some may fear that the revenue options described in earlier chapters of this report might hurt the state's economy. In evaluating these fears, it is important to remember that public spending offers economic benefits that must be measured against the social costs of tax increases—and that the economic benefits of public spending are especially pronounced when spending is focused on education. This chapter presents data showing that on balance, an infusion of new state spending funded by tax increases will result in a stronger New York state economy. The chapter also discusses the economic literature on the impact of taxes on economic development, and looks at efforts by New York to promote economic growth through the tax code.

### Education: The Other Side of the Coin

Public investments in education produce economic benefits, public and private, in the near term and in the long run. In the near term, individuals working in the education sector receive private benefits in the form of higher earnings and expanded job-related benefits. The public benefits of education spending include higher tax revenues and improved social outcomes. For example, spending on early childhood education produces improved grade retention, lower placement in special education, and better social adjustment.<sup>26</sup>

An educated citizenry also contributes to growth in the long run by attracting “good jobs” to the state. A well-educated workforce can raise the productivity of an economy by allowing innovations to be implemented more quickly, encouraging the location of companies with the higher-skilled jobs that are a crucial ingredient in long-term growth. A better educated workforce will help New York to compete for these higher-skilled jobs.

### How Spending Affects the Economy

An increase in public education spending means the creation of new teaching jobs, hiring other school personnel, and increased school-related pur-

chases in local economies. These new jobs and additional purchases stimulate the economy directly. This stimulus is then multiplied as the new wages and spending flow into local businesses, allowing them to grow and generating additional positive effects beyond the initial public spending.

While most public spending will have some positive impact on a state's economy, education spending is especially well targeted to achieve economic development, for two reasons. First, an effective education system is one of the most important factors in determining the quality of life in a state. A quality education system makes a state more attractive for individuals and businesses. Second, almost all public spending on education goes to in-state activities, including salaries for teachers living in-state and construction of schools.

The source of the revenue that supports this new education spending also has economic implications. Taken on their own, taxes tend to have a negative impact on the economy. Different taxes affect different sectors of the economy. An individual income tax initially affects individual wage-earners, lowering the returns from working and reducing disposable income. A sales tax falls on the consumers of retail goods, raising the price of consumer items and lowering retail sales. Corporate income taxes fall initially on businesses, lowering the returns to investment and reducing the income of business owners. Property taxes, which fall on homeowners, landlords, renters and businesses, increase the cost of home-ownership, increase property-related business costs and reduce the returns to investment.

Another important factor related to the source of revenue is the fact that federal tax law treats various state taxes differently. The federal tax code allows state income and property taxes as itemized deductions before federal tax liability is calculated, while sales and excise taxes are generally not deductible. As a result, there is an implicit federal subsidy for these deductible taxes. Consequently, raising a given amount of revenue from a income or property tax will leave more money in the hands of New York residents than would the same amount of revenue raised from a generally non-deductible sales tax.

For New York, the federal subsidy for property tax increases would most likely be about eleven

<sup>26</sup>Steven Barnett, “Long-Term Effects of Early Childhood Programs on Cognitive and School Outcomes,” *The Future of Children*, Vol. 5, No. 3 Winter 1995.



<b>Table 1. Economic Indicators For New York's Economy</b>					
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
Total Employment (Thous)	10,220	10,455	10,488	10,407	10,412
Gross State Product (\$M)	743,873	798,382	826,488	na	na
Personal Income (\$M)	619,659	663,005	678,874	680,182	696,531
na = not available					
Source: Bureau of Economic Analysis					

percent. This means that eleven cents of every dollar of additional revenue would come from the federal government. The federal subsidy for revenue raised through the state income tax would typically be about seventeen percent, but could be higher if more progressive income tax hikes were enacted.

In contrast, revenue raised by increasing general sales or excise taxes would come with little or no federal subsidy. For this reason, this option should be expected to reduce economic activity more than the property or income tax options.

To estimate the economic impact that additional education spending and various revenue options will have on the state's economy, this report uses an economic model that is specifically designed to reflect New York's particular economic and demographic structure. The model is a general equilibrium model, developed for ITEP by Regional Economic Models, Inc. It takes into consideration the linkages between the various industries within the state, between industries and the workforce, and between the state and national economies. The model allows fiscal policies with opposing tendencies, such as tax and spending increases, to be analyzed simultaneously, so that the net impact of these opposing policies can be observed.

Three standard indicators for tracking the impact of fiscal policies on the economy are employment, gross state product, and personal income. Table 1 shows New York's recent economic performance according to these indicators. These figures are the baseline against which the impact of spending and tax options are measured in this chapter.

Table 2 shows how the baseline would be affected by increased education spending and three alternative ways of funding that spending. The gross effects of the spending and each revenue alternative are shown, as well as the net effect of various combina-

tions of spending and revenue sources.

The top portion of Table 2 shows that \$6 billion of new spending on primary and secondary education in New York would, taken on its own, increase total employment in the state by 1.26

percent. Gross state product and personal income would increase by 1.1 percent and 0.78 percent.

The lower portion of Table 2 shows that \$8 billion of new education spending would, taken on its own, increase employment by 1.67 percent. Gross state product and personal income would increase by 1.47 percent and 1.05 percent.

Of course, this new spending must be paid for—and tax hikes, taken on their own, will depress economic growth. The table shows the negative impact that various tax hikes, taken on their own, have on the economy. This impact can be seen to grow with the regressivity of the tax. The personal income tax, being the most progressive and therefore having the largest federal subsidy, has the smallest negative impact on the economy. The income tax increase required to fund an additional \$6 billion in education spending would, taken on its own, reduce employment by 0.78 percent. Using property taxes to raise the same amount of revenue would reduce employment by 0.87 percent, and the sales tax increase required to fund the same level of spending would reduce employment by 0.94 percent.

The net effects are shown on the right side of the table. Funding \$6 billion of new education spending with the income tax has a net effect of increasing employment and gross state product by 0.48 percent and increases personal income by 0.27 percent. In contrast, funding the additional spending by raising the sales tax reduces the net economic benefit by about one third. In each case, however, the net impact of raising \$6 billion in new

<b>Table 2. Impact of Education Spending with Various Revenue Sources</b>							
	Gross Effects (percent change)				Net Effects (percent change)		
	Education Spending	Personal Income Tax	Property Tax	General Sales Tax	Personal Income Tax	Property Tax	General Sales Tax
<b>Impact of \$6 Billion</b>							
Total Employment	+1.26	-0.78	-0.87	-0.94	+0.48	+0.38	+0.32
Gross State Product	+1.10	-0.67	-0.75	-0.80	+0.44	+0.35	+0.30
Personal Income	+0.78	-0.52	-0.58	-0.62	+0.27	+0.20	+0.16
<b>Impact of \$8 Billion</b>							
Total Employment	+1.67	-1.04	-1.17	-1.25	+0.64	+0.51	+0.43
Gross State Product	+1.47	-0.89	-1.00	-1.07	+0.58	+0.47	+0.40
Personal Income	+1.05	-0.69	-0.78	-0.83	+0.36	+0.27	+0.21

tax revenues and devoting this revenue to education on the New York economy is clearly positive.

The results for an \$8 billion increase in education spending show the same pattern: the spending provides economic benefits, the taxes to fund the spending reduce these benefits, and the net effects are greatest when the spending is funded with the most progressive tax. Overall, increasing the additional spending by one third, from \$6 billion to \$8 billion, increases the net benefits by one third. Again, the overall economic impact of achieving adequacy under each scenario is positive.

## Taxes and Economic Development

The results in the previous section show that when the positive impact of public spending is measured alongside the negative impact of tax increases, the net effect of a policy shift involving simultaneous changes in these variables are likely to be positive. So why do some policymakers remain leery of the impact of taxes on the economy?

One problem is the prevalence of the pseudo-economic argument that tax increases always hurt a state's economy—and that tax cuts always help. Economic analyses that support this result generally omit the positive impact of public spending and simply measure the negative impact of a tax increase that removes taxpayer income from circulation—basically assuming that the revenue from tax increases is thrown down a hole rather than being used to fund public services. In other words, economic analyses that purport to show that tax increases hurt state economies generally achieve this result through poor research designs.

A recent survey of the literature on economic development by economist Robert Lynch suggests that the quality of research design has a lot to do with the divergence between studies claiming that taxes hurt state economies and studies that are unable to find such a linkage:

Most of the studies that suggest taxes have a small negative effect on economic activity do so only when public spending is held constant as taxes increase—a circumstance that is highly uncommon in the real world.<sup>27</sup>

Studies that look only at the impact of tax cuts, without factoring in the impact of associated cuts in

public services, are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that's unrealistic—but that's the implication of studies that don't factor in the impact of cuts in services.

## New York's "Empire Zones"

Most policymakers recognize the linkage between taxes and spending that this chapter has highlighted—and yet state lawmakers continue to offer expensive, poorly administered tax breaks in the name of economic development. One notorious set of tax breaks ostensibly designed to encourage economic development is the Empire Zone program. Created in 1986, this tax abatement program was designed to help encourage businesses to locate in economically depressed areas. Under the program, the state designated certain areas with high poverty or unemployment rates as "Empire Zones." Businesses that increase their employment within these Zones are eligible for various tax breaks, including sales tax exemptions, wage tax credits, and property tax breaks.

The Empire Zone program is estimated to cost \$291 million in fiscal year 2004. But there is growing evidence that the job creation goals of the credit are being met—if at all—at a very high price. By one recent estimate, every job created by the Empire Zone program in 2003 cost the state more than \$40,000. There is also evidence that the program's administrators are not systematically requiring proof that the credit is being used to create jobs at all.

## Conclusion

Few New Yorkers look forward to the tax increases that may be necessary to fund educational adequacy. Yet, as this chapter has shown, education spending creates jobs which stimulate economic activity and multiply as the income and additional spending from these jobs reverberates through the economy. A true accounting of the costs and benefits associated with achieving educational adequacy (and tax adequacy) shows that on balance, tax and spending reform can have a salutary impact on the New York state economy.

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<sup>27</sup>*Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*. Economic Policy Institute, 2004.

# BUILDING SUPPORT FOR TAX REFORM

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This report has shown that lawmakers seeking to adequately fund education and other services have available an array of progressive structural tax reforms that will meet the state’s short-term needs and help ensure the long-term vitality of the tax system. In short, a variety of good options are available: but how can policymakers build public support for the difficult decisions that await them? This chapter explores tools and strategies for educating the public, the media and state policymakers on the real impact of tax reform.

### The Importance of Tax Incidence Analysis

The primary goal of policymakers seeking to fund education and other services is achieving adequacy—that is, raising sufficient revenues to pay for needed services. But tax equity is an equally important goal. This report has presented a series of “tax incidence analyses”—estimates of how the New York tax system affects taxpayers at different income levels, and how proposed changes would affect tax fairness. These thumbnail sketches of the tax equity impact of tax reforms are an essential dimension on which to evaluate these reforms. However, like most states, New York does not regularly use such analyses to help lawmakers evaluate their tax system. Only three states—Maine, Minnesota, and Texas—have legal requirements mandating the regular use of tax incidence analyses.

This means that New York policy-makers are evaluating tax changes without knowing how their constituents are affected by these changes. This increases the likelihood that lawmakers will be persuaded by false claims about the fairness of various proposals—and also makes it less likely that tax equity will be a factor in tax policy decisions.

Six states—Alabama, Colorado, Minnesota, Missouri, Texas and Washington—have incidence models for all major state and local taxes. Five other states—Delaware, Maine, Michigan, Nebraska and New Hampshire—are currently developing such models. Another 23 states are able to estimate tax incidence for income tax options only.

By following in the footsteps of these states and introducing a regularly-used tax incidence model, New York can increase public understanding of tax policy issues—an important goal as the state struggles to fund education. But until a regular tax incidence

analysis capability is introduced, policymakers and the public will have no easily available basis for evaluating the fairness of important tax policy decisions.

### Tax Expenditure Reports

Lawmakers seeking to raise revenues without hiking rates will be intensely interested in expanding the base of various taxes by eliminating tax loopholes. But this exercise can only be achieved effectively if lawmakers have available a “laundry list” of the many tax loopholes currently embedded in the code. In states that currently publish them, tax expenditure reports supply lawmakers—as well as advocates and the general public—with such a list. New York, like dozens of other states, now publishes an annual Tax Expenditure Report detailing all of the enacted tax breaks in the sales tax, personal income tax and corporate taxes. The report includes basic information on the history of each tax break and estimates the annual cost of continuing to provide these breaks. However, the report could be made more useful in several ways:

- For some tax breaks, the original intention of lawmakers is all but forgotten. A good tax expenditure report should describe the rationale for creating (and continuing) each of the tax breaks that reduce New York revenues.
- These reports should also assess whether each tax break is effective in achieving the public policy goals they are designed for—and whether these goals might be better achieved through other means.
- In any state that bases its income tax rules on federal law, certain tax breaks will be inherited automatically from the federal government. It is important to include these breaks in the list of state tax expenditure—since New York has the option of decoupling from most of these federally-imposed tax cuts.
- As shown in Chapter Six, the growing importance of untaxed personal services is the greatest threat to the future of the New York sales tax. But because the sales tax statutes exempt services unless specifically taxed, untaxed services are generally not viewed as New York tax expenditures. Other states with similar sales tax statutes now recognize the

importance of taxing services and include tax expenditure estimates for specific services in their annual reports. New York should do the same.

report is already a useful laundry list of potential base-broadening tax reforms, the report could be made even more useful by providing a more complete list of tax expenditures and providing basic evaluations of the effectiveness of each tax break.

## **The Role of Public Opinion**

A crucial step in the process of state tax reform is explaining to voters why reforms are necessary. Lawmakers should present potential tax increases to voters in a way that makes clear both the costs and the benefits of enacting these changes.

Poll results show that survey respondents are more likely to support tax increases when they are tied to particular purposes. A March 2004 Zogby poll found that when respondents are explicitly asked to support or reject a state tax increase designed to provide state aid to schools in response to a court decision requiring adequate school funding, almost two-thirds of respondents supported such a hike—with only thirty percent opposing the plan. In other words, New Yorker voters supported tax hikes for education by more than a two to one margin.

Of course, when survey respondents are asked whether they support tax increases in general, they are far more likely to reject them outright. For this reason, it is essential to “connect the dots” by reinforcing the perceived linkage between the taxes that must be raised to adequately fund services and the additional public spending that will result from these tax hikes.

## **Conclusion**

A prompt solution to New York’s school finance woes can only be found if policymakers are willing to explain the available options to the public in an effort to build public support for potential unpopular tax reform ideas. Polling data suggests that New Yorkers are opposed to tax increases in general, but that residents are much more likely to support tax increases when it is clear that any additional revenues will be targeted to achieving educational adequacy. Voter education is critical to building support for a package of spending and tax increases that will achieving adequacy in funding education and other critical public services.

It is also essential to increase the quality of the information available to lawmakers, the media and the public about the impact of various tax reform options on the public. Regular public disclosure of the tax incidence impact of the current tax system—and of proposals for change—will help achieve greater voter education. And while the state’s tax expenditure

## CHAPTER TWELVE

# CONCLUSION

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The decade-long saga of the *Campaign for Fiscal Equity* case has concluded with a clear statement that policy makers must retool the state's school finance system to adequately fund education in New York City. There is a growing consensus that the state's response to the *CFE* decision must achieve adequacy not just for New York City, but for students everywhere in New York State—and that adequacy should be a goal for all of the public services provided by the state of New York.

The *CFE* decision tells us not only that New York does not currently provide an adequate education for its children, but that this educational failure can be linked to shortcomings in the state and local tax structure. By combining true tax reform with the effort to raise sufficient funds for education, New York can help ensure the long term viability of the state's fiscal structure—and avoid crises of school funding adequacy in the future.

Fortunately, this study's detailed analysis of the New York tax system has shown that sensible tax reform options are available to policymakers—and that revenue-raising tax reform can be achieved through reforms that also make the tax system fairer and that make New York a more attractive place for businesses and individuals. In other words, the goals of tax adequacy, equity and economic development do not necessarily conflict with each other.

This study has argued that achieving adequate public revenues will require a transformation of the state's fiscal structure. The study has identified a variety of tax reforms that could be enacted as a means of enabling educational adequacy, including base-broadening, rate increases, introducing entirely new revenue sources—and reintroducing old ones.

This study does not recommend any particular revenue-raising solution to the state's current fiscal crisis. The study does provide detailed analyses of many options which could be part of the state's approach to funding public services, including:

- **Repealing personal income tax loopholes.** Personal income tax breaks for pension and Social Security benefits reduce the yield—and the perceived fairness—of the income tax. Making the income tax base broader will help fund education and other essential government services in the long run. (Chapter Four)

- **Restoring the progressivity of the personal income tax.** In the past quarter century, the top income tax rates have been reduced dramatically—making the New York tax system much less fair overall. Restoring the higher top marginal tax rates formerly used would help raise needed revenues and would restore the former progressivity of the income tax. (Chapter Four)
- **Restoring the New York City commuter tax.** Before being repealed in 1999, this tax helped ensure that non-residents working in New York City paid their fair share to support the provision of public services. Re-enacting the tax would be an important step towards adequately funding city schools—and, if the new tax includes a graduated rate structure, would represent a step towards tax fairness in New York. (Chapter Four)
- **Eliminating corporate income tax loopholes.** The New York corporate income tax is under siege. A host of creative accounting loopholes have reduced the yield of the corporate tax in recent years—but loophole-closing measures could be enacted to restore the tax. (Chapter Five)
- **Strengthening the corporate minimum tax.** New York has taken the first step toward eliminating the specter of “zero-tax corporations” by enacting a corporate minimum tax—but tax changes enacted in the past decade have weakened the minimum tax dramatically. Broadening the tax base and increasing the rate will be essential to ensuring that all companies doing business in New York pay their fair share. (Chapter Five)
- **Broadening the sales tax base to include more goods and/or services.** Like most states, New York excludes many personal and professional services from its sales tax base. These services are a growing part of the economy—which means that the long-term vitality of the sales tax depends on including these services in the tax base. The state could also eliminate expensive, poorly targeted exemptions for various goods such as groceries, clothing and utilities. While these changes might increase the perceived fairness of the sales tax, the net impact of this change would still be regressive—so any further sales tax expansion would exacer-

bate the current regressivity of the New York tax structure. (Chapter Six)

- **Increasing excise taxes on cigarettes, gasoline or alcohol.** These options have recently become increasingly popular in other states—but are naturally declining revenue sources and will be insufficient to fund education in the long run. These options are also quite regressive. (Chapter Six)
- **Retooling the New York property tax.** Even after the full implementation of the STAR property tax exemptions, New York’s property tax remains especially burdensome for low- and middle-income taxpayers—and the unequal distribution of property wealth between districts makes it much harder for low-wealth districts to fund services using the property tax. Options for improving the fairness of the property tax include means-testing the STAR exemption to make it available only to those for whom property taxes represent a heavy burden, repealing STAR in favor of a more targeted approach to property tax relief, and a statewide property tax. (Chapter Seven)
- **Offsetting regressive tax hikes with low-income protection.** An increasing number of states now routinely consider introducing and expanding low-income credits to accompany any major regressive tax hike. These credits include the Earned Income Tax Credit, sales tax credits, and property tax “circuit breakers.” New York could expand its EITC and circuit breaker provisions, or enact a sales tax credit, to mitigate the impact of regressive tax hikes on low-income New Yorkers—at a minimal cost to the state. (Chapters Four, Six, and Seven)
- **Preserving the estate tax.** Estate and inheritance taxes are one of the few truly progressive revenue sources available to New York policymakers. Recent legislation repealing the federal tax will add pressure on New York lawmakers to follow suit. Because the New York estate tax is “decoupled” from the federal tax, this important source of tax fairness will continue to be levied in New York unless lawmakers take active steps to repeal it. (Chapter Eight)
- **Taxing intangible property.** Most states have moved away from taxing all forms of real and personal property in recent decades—but a modest tax on intangible wealth such as stocks and bonds could help restore adequacy and

fairness to the New York tax system. (Chapter Eight)

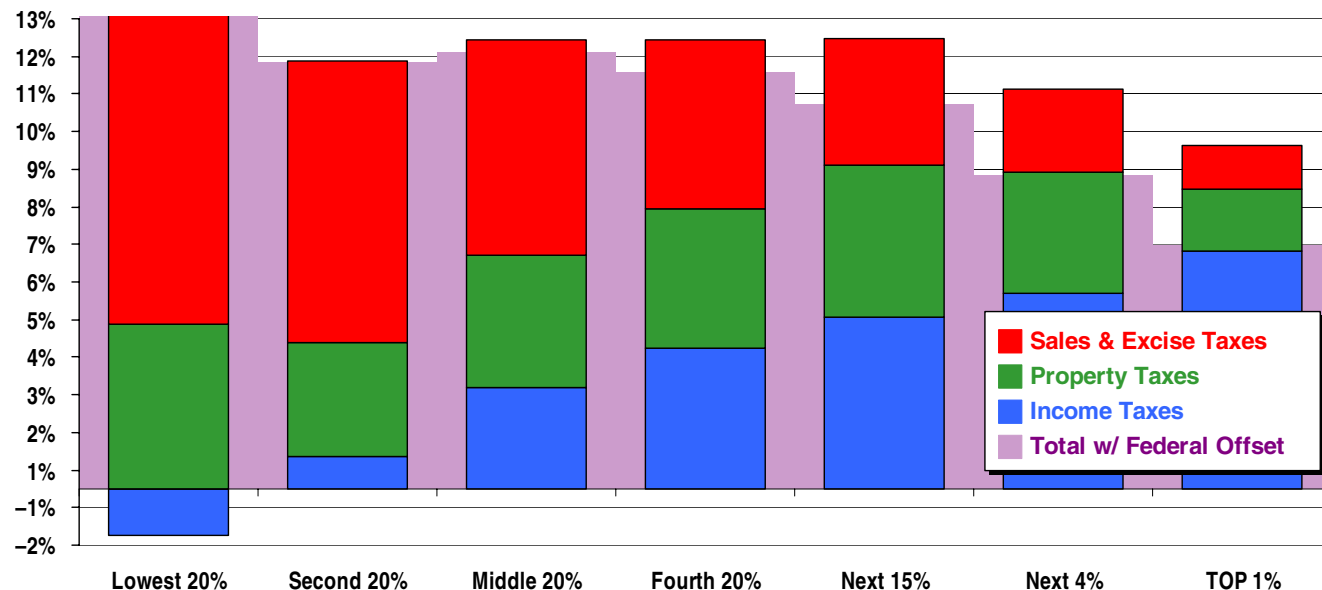
- **Re-introducing the stock transfer tax.** Before being repealed in 1981, the stock transfer tax offered advantages that are rare among taxes levied at the state level: its progressivity and its exportability meant that it added to the fairness of the New York tax system at a minimal cost to in-state residents. Re-enacting the tax, even at a much lower rate than the former 5-cent-per-share tax, could help diversify and solidify the New York tax system. (Chapter Eight)
- **Increasing the use of gambling revenues.** New York was among the first states in the nation to use revenue from state lotteries and other gambling sources to help fund public services. As more states have introduced lotteries, the promise of gambling revenues as a long-term funding source has faded. The potential revenues from this approach are uncertain in the short run, and likely to decline in the long run—and gambling revenues are among the most regressive revenue-raising options available. (Chapter Eight)

The study also suggests that providing more detailed information on the impact of the current New York tax system (and of the impact of proposed reforms) could help pave the way for successful tax reform. In particular, increased disclosure of corporate tax liability information (Chapter Five), a regularly tax incidence report and a more detailed tax expenditure report (Chapter Eleven) would help the public, the media and lawmakers to understand why base-broadening and reducing regressivity are both important goals of structural tax reform.

None of these options would be easy to enact: as we have seen, public skepticism toward tax increases is a substantial hurdle to overcome—and some policymakers remain leery of the potential economic impact of major tax changes. But, as this report has shown, structural tax reform is a goal worth achieving for New York policymakers not just because loophole-closing tax reforms will ensure the short-term and long-run adequacy of the fiscal system, but also because educational adequacy can have a positive impact on the state’s economy as well. New York policymakers face formidable political hurdles as they seek to achieve adequacy in compliance with the state constitution—but the economic and fiscal rewards for surpassing these hurdles will be enjoyed for decades to come.

## New York State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than \$15,000	\$15,000 – \$27,000	\$27,000 – \$44,000	\$44,000 – \$74,000	\$74,000 – \$160,000	\$160,000 – \$634,000	\$634,000 or more
Average Income in Group	\$8,700	\$20,700	\$34,900	\$56,800	\$101,700	\$250,200	\$1,663,000
<b>Sales &amp; Excise Taxes</b>	<b>9.5%</b>	<b>7.5%</b>	<b>5.7%</b>	<b>4.5%</b>	<b>3.4%</b>	<b>2.2%</b>	<b>1.2%</b>
General Sales—Individuals	3.9%	3.6%	2.9%	2.5%	1.9%	1.3%	0.7%
Other Sales & Excise—Ind.	2.7%	1.6%	1.1%	0.7%	0.5%	0.3%	0.1%
Sales & Excise on Business	2.9%	2.3%	1.7%	1.3%	0.9%	0.6%	0.4%
<b>Property Taxes</b>	<b>4.4%</b>	<b>3.0%</b>	<b>3.5%</b>	<b>3.7%</b>	<b>4.1%</b>	<b>3.2%</b>	<b>1.6%</b>
Property Taxes on Families	3.9%	2.7%	3.1%	3.2%	3.5%	2.7%	0.7%
Other Property Taxes	0.5%	0.4%	0.4%	0.5%	0.5%	0.6%	0.9%
<b>Income Taxes</b>	<b>-1.2%</b>	<b>0.8%</b>	<b>2.7%</b>	<b>3.7%</b>	<b>4.6%</b>	<b>5.2%</b>	<b>6.3%</b>
Personal Income Tax	-1.3%	0.8%	2.6%	3.7%	4.5%	5.1%	6.0%
Corporate Income Tax	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.3%
<b>TOTAL TAXES</b>	<b>12.7%</b>	<b>11.4%</b>	<b>11.9%</b>	<b>11.9%</b>	<b>12.0%</b>	<b>10.6%</b>	<b>9.1%</b>
Federal Deduction Offset	-0.0%	-0.1%	-0.3%	-0.8%	-1.8%	-2.3%	-2.7%
<b>TOTAL AFTER OFFSET</b>	<b>12.6%</b>	<b>11.3%</b>	<b>11.6%</b>	<b>11.1%</b>	<b>10.2%</b>	<b>8.4%</b>	<b>6.5%</b>

Note: Table shows 2002 tax law at 2000 income levels.

## APPENDIX B: ITEP TAX MODEL METHODOLOGY

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The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of the ITEP model:

**The Personal Income Tax Model** analyzes the revenue and incidence of current federal and state personal income taxes and potential changes in:

- rates—including special rates on capital gains,
- inclusion of various types of income,
- inclusion of all federal and state adjustments,
- exemption amounts and phase-out methods,
- standard deduction amounts and phase-outs,
- itemized deductions and phase-outs, and
- credits, such as earned-income and child-care.

**The Consumption Tax Model** analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline

excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes.

**The Property Tax Model** analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

**The Corporate Income Tax Model** analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

**Local taxes:** The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

### Addendum: Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

#### *Micro-Data Sets:*

IRS 1988 Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax Files 1990-99; Current Population Survey: 1988-2003; Consumer Expenditure Survey, 1988-90 and later; U.S. Census, 1990 and 2000.

#### *Partial List of Aggregated Data Sources:*

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey; Census of Population Housing; etc.

*A more detailed description of the ITEP Microsimulation Tax Model is on the ITEP website at [www.itepnet.org](http://www.itepnet.org).*