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:

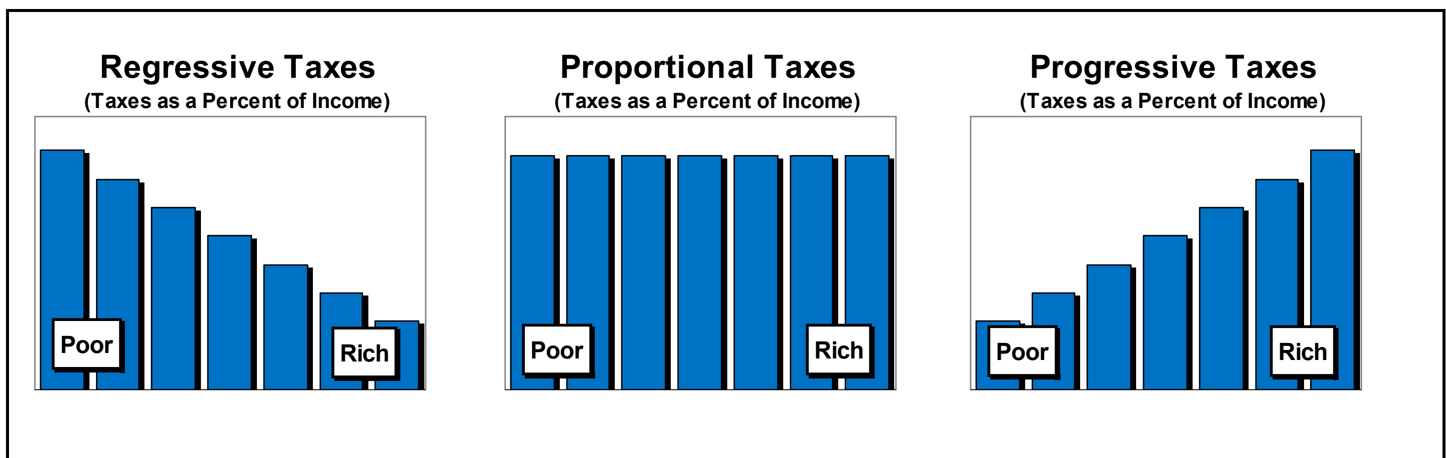
- *Regressive* tax systems require low- and middle-income families to pay a higher percentage of their income in taxes than do upper-income families. New York sales and excise taxes are especially regressive; New York property taxes are also somewhat regressive.
- Proportional or *flat* tax systems take 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 any revenue increase that will end up being "exported" in one of these three ways.

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?

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[1] 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

[1] 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 payments 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 "federal offset" makes progressive state income tax increases 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 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.

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.

- 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
	Lowest 20%	Less than $15,000	$9,400	2.9%
	Second 20%	$15,000 to $28,000	$21,600	6.6%
	Middle 20%	$28,000 to $46,000	$36,400	11.0%
	Fourth 20%	$46,000 to $76,000	$58,900	17.8%
Top 20%	Next 15%	$76,000 to $158,000	$103,900	23.9%
	Next 4%	$158,000 to $590,000	$237,900	14.5%
	Top 1%	$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.