

# THE ECONOMIC IMPACT OF ACHIEVING ADEQUACY

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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

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<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.