

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.

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.

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
ALL STATES	68.3%	
NY as % of US avg	109%	

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
ALL STATES	45.4%		40.9%	

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.

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.

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.

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.

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.¹³ 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.

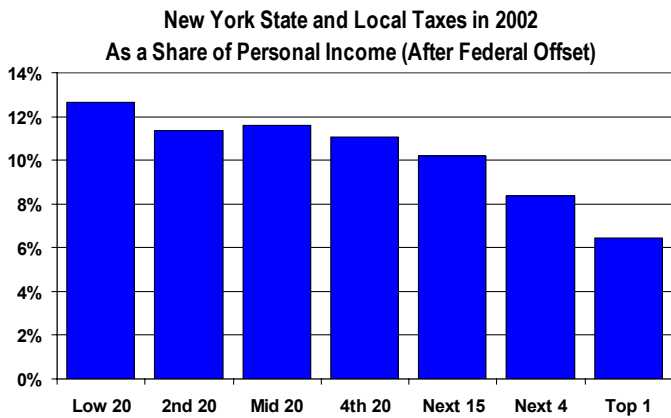
New York’s business, labor, civic, political, and cultural leaders can work with their counterparts from other states to drop the current treatment of the deduction for state and local taxes under the AMT and to stop efforts to otherwise undercut this important principle of federalism.

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-

¹³ 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:

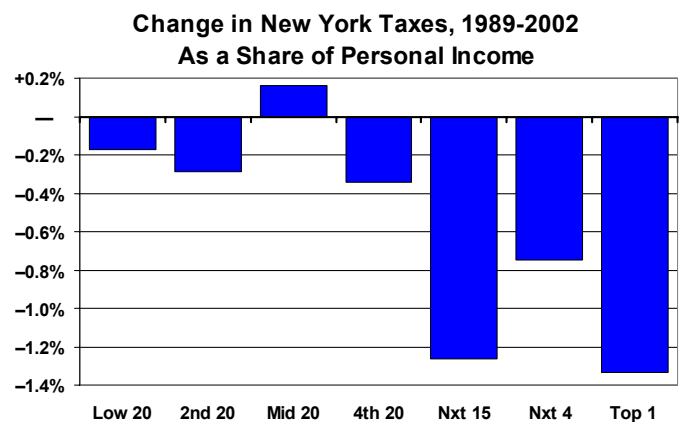
- New York sales and excise taxes are regressive.
- New York property taxes, despite generous credits and exemptions, are also regressive.
- The New York income tax is insufficiently progressive to offset the state’s other regressive taxes.

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.¹⁴ 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.

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