

# 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.