

Tax Revenue Options

A Working Paper
Prepared as Support for
“Can New York Get an A
in School Finance Reform?”
A Report by
the Citizens Budget
Commission
November 2004



FOREWORD

Founded in 1932, the Citizens Budget Commission (CBC) is a nonprofit, nonpartisan civic organization devoted to influencing constructive change in the finances and services of New York State and New York City governments.

This Working Paper was prepared under the auspices of CBC's Education Finance Committee, which we co-chair. The other members of the Committee are: Paul R. Alter, Richard H. Bagger, Stephen Berger, Deborah A. Buresh, Lawrence B. Bittenwieser, Evan A. Davis, Stephen F. DeGroat, Kenneth D. Gibbs, Bud H. Gibbs, H. Dale Hemmerdinger, Bill Lambert, James L. Lipscomb, Stanley Litow, Robinson Markel, Joel H. Moser, David I. Moskowitz, Lester Pollack, Hector P. Prud'homme, Alfredo S. Quintero, Edward L. Sadowsky, William G. Salter, and Howard Wilson.

The CBC created this ad hoc Committee in the wake of the 2003 New York State Court of Appeals decision in the Campaign for Fiscal equity case. Initially, we believed that the scope of the Committee's work would be confined to helping public officials identify the most economically effective sources of revenue to fund the Court's decision. However, as the Committee explored the issues, and as the Governor and State Legislature failed to reach an agreement on the amount required, we broadened the scope of our work. The Committee recognized that in order for the goal of the Court's ruling to be achieved - for student's to obtain a sound basic education - changes were needed beyond the allocation of more money.

The Committee prepared its final report, *Can New York Get An "A" In School Finance Reform*, with two goals in mind. The first is to provide the responsible public officials – judges, legislators and others – with sound advice on how to craft a remedy that will be effective and efficient. But the CBC also recognizes that shaping policy affecting so many lives, and costing so many billions of dollars, should involve an informed citizenry who support the eventual outcome. Accordingly, the CBC seeks also to use the Committee's final report, and a companion conference scheduled for December 2-3, 2004, to stimulate informed debate about the options available to New Yorkers for providing their children a sound basic education.

In order to prepare the final report, the Committee met nine times between January and November of 2004. Its meetings were focused on research conducted by the staff and expert consultants. This background research has been organized into six working papers, of which this is one. This working paper was prepared by Marcia Van Wagner, Deputy Research Director at the Citizens Budget Commission, and Dwight Denison, Associate Professor at New York University's Robert F. Wagner Graduate School of Public Service, with additional assistance from Jo Brill, CBC Director of State Studies, and Selma Mustovic, CBC Research Associate. All six working papers and the final report are available at the Commission's website, www.cbcny.org.

The research was made possible by generous support from the Andrew W. Mellon Foundation and by designated contributions from CBC Trustees.

Paul E. Francis
Eugene J. Keilin

INTRODUCTION

This paper reviews the tax revenue options considered by the Citizens Budget Commission (CBC) in its analysis of how New York State can best pay for court-ordered sound basic education initiatives.

When faced with the need to raise revenues, policymakers have many choices. New taxes can be implemented, rates on existing taxes can be raised, and the base to which existing taxes are applied can be broadened to include previously exempt items.

Some of these options are better than others. Raising a tax that falls heavily on the poor has negative social impacts, for example. Taxing highly mobile resources, such as labor, can impede a region's competitiveness. Some taxes could require onerous increases in rates to yield necessary revenue. Imposing taxes on a narrow base can lead to inequities among taxpayers whose income or activities are otherwise similar.

For these reasons, revenue options should be evaluated relative to basic principles of public finance. These principles pertain to a tax's adequacy (does it raise enough revenue?), whether it treats similar taxpayers similarly, whether it is likely to distort economic decisions, and whether it is based on ability to pay.¹

In addition to these criteria, when a tax is a local or state tax its competitive impacts should be considered. Tax rates or practices that are out of line with competitor regions can make sustained economic growth more difficult to achieve.

The Commission considered broadening the base of two taxes, sales and corporate income; raising rates on two existing statewide taxes, personal income and sales; and instituting a new statewide property tax. These options are discussed below.

Section One of the paper considers base broadening. This discussion is separated into two sections: consideration of increasing revenue on remote and internet sales, and consideration of increasing revenue by taxing more services. The discussion of taxing services includes taxation of retail services and taxation of professional services. The discussion of base broadening then turns to corporate income tax reform.

Section Two of the paper assesses the options of raising the rates on the personal income tax (PIT) and the sales tax. The section also discusses the possibility of implementing a statewide property tax.

Section Three analyses the impact on the resources of 11 school districts of increases in statewide taxes, coupled with increased education aid distributed in line with proposals by the Campaign for Fiscal Equity. Because the amount of revenue required to satisfy the court-ordered

¹ Other public finance taxation principles that CBC did not consider at length are a tax's volatility and its ease of administration.

sound basic education policy is unknown as of this writing, the impacts of broad-based tax revenue measures are evaluated at the high end of the range of proposed additional spending.

BROADENING THE BASES OF THE SALES AND CORPORATE INCOME TAXES

Public finance experts have long held that taxes are best structured to apply to a broad base at low rates, because those taxes are least likely to cause distortions in economic decision-making and resource allocation. It is generally legally and economically possible for taxes to be applied to a broader base than is the case in practice.

A tax's base may be narrower than the ideal for three reasons. First, most states provide exemptions from taxation to an array of activities. In New York State, for example, the Department of Taxation and Finance publishes a 172-page report on exemptions and other tax preferences.² These often narrow exemptions frequently have political rather than economic origins.

Second, a tax's base can be narrowed because of difficulties in collection of the tax. The sales tax is particularly prone to evasion, because it is collected at the point of sale by private parties for whom acting as tax collector can be an inconvenience. The sales tax is difficult to collect on out-of-state purchases by the state residents for this reason.

Third, a state's tax laws may allow alert taxpayers to shift income to avoid the tax. Corporate income tax laws have come under scrutiny in recent years as such practices have become more costly to state and federal governments.

The Commission considered broadening the base of the sales and corporate income taxes and concluded that more revenue could be raised from these taxes by taking steps that many other states have already taken to improve enforcement and close loopholes. The conclusions are:

- The State should embrace the national Streamlined Sales Tax Project to ensure that taxes on internet and remote sales can be collected in the future. When fully implemented, this initiative could yield from \$40 million to \$590 million per year in increased state sales tax collections.
- The State should broaden the base of the sales tax to include many retail services that are not subject to tax. This could yield \$950 million in additional revenues.
- The State should apply the sales tax to professional services when they are sold to consumers (not businesses). This could yield \$175 million to \$595 million per year.
- The State should reform its corporate income tax laws to capture income on which corporations are now able to avoid paying taxes, for additional annual revenue of \$320 million to \$435 million.

² State of New York Department of Taxation and Finance, *2004-2005 Tax Expenditure Report*, February 10, 2004, <<http://www.budget.state.ny.us/pubs/supporting/TaxExpendReport0405.pdf>>, accessed October 20, 2004.

Sales tax base broadening

The sales tax is a consumption tax that is imposed on the purchase price of a sale transaction between two parties. In New York State, the sales tax rate is 4 percent. The State allows localities to impose an additional tax of up to 4.25 percent.³ Coupled with the sales tax, which applies to transactions within the state, is the use tax, which applies to out-of-state purchases of goods and services for use within the state. New York residents are obliged by law to remit use tax to New York State and their local jurisdiction on purchases they make elsewhere, although few do. The use tax rate is identical to the sales tax rate.

Taxation of internet and remote sales. Remote sales are transactions between residents and vendors outside of the state and are therefore subject to the use tax. Remote sales can be facilitated through catalog, telephone and mail-order companies, and the internet. Remote sales pose a particular problem for states because states have no authority to require vendors in other states to collect and remit the tax, unless the vendor has a significant physical presence in the state (the legal term for this presence is nexus). In contrast, in New York the tax on intrastate sale transactions are collected by the vendor and remitted to the State on a quarterly basis. The growing use of the internet has refocused attention on the issue of remote sales, but they have posed a problem for state tax collections for decades.

Two types of remote sales are most relevant to understanding the impact of remote sales on tax revenues. The first is the vendor-to-consumer sale or retail sale. Most of these transactions are taxable under the use tax, yet many residents do not know that a tax should be paid on such transactions. Until recently, residents were supposed to file a separate form to report and pay tax on remote sales, but now the tax can be reported on the New York State income tax form. As tax compliance on remote sales is difficult to enforce, the growth in remote vendor-to-consumer sales represents a significant loss in tax revenues. The second type of transaction is the business-to-business sale. Some business-to-business transactions are exempt from the use tax, and to the extent that internet and other remote sales are business-to-business sales that would otherwise be exempt, the state is not losing tax revenues from such transactions.

The taxation of remote sales is consistent with widely accepted public finance principles such as broadening the tax base to increase stability. Taxation of remote sales also promotes taxpayer confidence that everyone is paying a fair share. Often in-state vendors complain that remote vendors have a price advantage, because the use tax is so easily avoided.

Revenue loss. A report by the U.S. General Accounting Office (GAO) estimates that New York State and its local governments lost between \$521 million to \$2,339 million in sales tax revenue as a result of all remote sales in the year 2003. The revenue loss attributed to internet

³ State of New York Department of Taxation and Finance, *New York State Tax Sourcebook*, June 2004. There are currently additional sales tax temporary surcharges of 0.25 percent at the State level, and 0.125 percent for New York City. These surcharges expire in May, 2005. In addition, there is a 0.25 percent surcharge on the sales tax in the Metropolitan Commuter Transportation District (MCTD) to help finance the Metropolitan Transportation Authority.

sales ranges from \$81 million to \$1,155 million.⁴ This is a wide range, because estimates are sensitive to a number of assumptions and there is little data to validate assumptions.⁵ More than half these losses accrue to state government, which in fiscal year 2001-2002 accounted for 52 percent of the sales and use tax collected in New York State.⁶ Applying this share to the GAO loss estimate yields \$270 million to \$1.2 billion in overall remote sales losses, of which \$40 million to \$590 million could be attributed to taxes not paid on internet sales.

Incidence. The incidence of the tax on internet and remote sales falls on those who shop online and otherwise engage in remote transactions. The internet sales require the consumer to have access to a computer and internet, but even those without personal computers generally have public access to computers. Individuals in very low income brackets may lack the access and credit to engage in internet transactions, but other remote sales are less contingent on the availability of computers and a credit card. Therefore, the incidence will not likely be significantly different from the incidence of the sales tax in general. This incidence is discussed in the section of this paper on the sales tax rate option below.

Feasibility. The estimates of lost sales tax revenues due to remote sales are substantial. The problem is not easily addressed, however. The key problem is enforcement and compliance. Compliance will increase if remote vendors participate in the collection of sales and use taxes for other states, but most argue that vendors will not participate until the various sale tax systems are simplified. The Streamlined Sales Tax Project has worked with local governments and the private sector to address this problem by simplifying and modernizing sales and use tax collection and administration.⁷ They argue that seven principles that are necessary to address the challenges of collecting a remote sales tax, and these principles have been accepted by 42 states. (See Appendix A.) New York has not yet joined the Streamlined Sales Tax Project as an implementing member.

Taxation of services. Historically, the sales tax was levied on the sale of tangible goods. As the service sector grew, states expanded the sales tax base to include services. During 2003,

⁴ US General Accounting Office "Sales Taxes- Electronic Commerce Growth Presents Challenges; Revenue Losses are uncertain" June 2000. GAO/GGD/OCE-00-165. Table V.2 p60.

⁵ Estimating the volume of remote sales is challenging as most of the transactions go unreported and estimates necessarily require tenuous assumptions. Several studies have employed consumer survey data to estimate the revenues losses: Donald Bruce and William Fox "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004", Government Financial Officers Association <<http://www.gfoa.org/documents/TNecommerce2004.pdf>> (accessed September 2004); Donald Bruce and William Fox, "E-commerce in the Context of Declining State Sales Tax Bases." *National Tax Journal*, 2000, vol. 53, no 4, Part 4, pp. 1373-90; William Cline and Thomas Neubig, "The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998," Ernst and Young, Economics Consulting and Quantitative Analysis, June 1999.; John Mikesell, "Remote Vendors and American Sales and Use Taxation: The Balance between Fixing the Problem and Fixing the Tax," *National Tax Journal*, December 2000, vol. 53 no. 4, pp. 1273-1285; Keith Snavelly, "State Taxation of Interstate Sales: Enforcement Problems and Prospects." *Public Budgeting and Finance*, 1990, Summer, vol. 10, no. 2, pp. 60-71.

⁶ U.S. Census Bureau, *State and Local Government Finances: 2002 Census of Governments*, <<http://www.census.gov/govs/www/estimate02.html>> (accessed October 21, 2004).

⁷ Streamlined Sales Tax Project, "Executive Summary," April 2004. <<http://www.streamlinedsalestax.org>> accessed September 2004.

services accounted for nearly 60 percent of the gross domestic product.⁸ Moreover, the service sector is more robust during economic downturns. In 2001, for example, when the GDP of the service sector grew 2.4 percent and the goods sector decreased 1.7 percent.⁹

Expanding the sales tax base to additional services has these several advantages:

- generating additional revenues,
- increasing stability of sales tax collections,
- improving the long-term viability of the sales tax,
- simplifying sales tax administration and compliance, and
- fostering consumer fairness by treating goods and services equally.

Taxing services sales: retail vs. business-to-business. Most people experience the sales tax as it applies to retail sales. However, sales also occur in business-to-business transactions. Public finance experts argue that it is not desirable to tax the production inputs to business, because it results in higher production costs that are then incorporated into consumer pricing. The consumer pays the required sales tax on the transaction and a portion of the taxes on production inputs, which have been passed on in the price of the good. This “pyramiding effect” distorts the transparency and alters the incidence of the tax.

Tax pyramiding is illustrated in Table 1. Consider a firm that buys services valued at \$100 and sells them at 200 percent of production costs. If the business-to-business transaction is not subject to the sales tax (assumed here to be 4 percent), then the end consumer will pay total sales tax of \$8. If the business-to-business transaction is taxed at 4 percent then the total sales tax paid by the consumer would be \$12.32. In this scenario the sales tax is shifted to the consumer, and research on the sales tax has shown that the tax is indeed shifted to the consumer in this manner.¹⁰ In the absence of the business-to-business tax, consumers clearly know that the tax paid is \$8. On the other hand, when the business-to-business tax is imposed, the \$4 of indirect sales tax is not transparent to the consumer, the perceived tax burden is underestimated, and an already regressive tax is made more regressive.¹¹

⁸ Bureau of Economic Analysis, National Income and Product Accounts, <<http://www.bea.doc.gov/bea/dn/nipaweb/TableView.asp#Mid>> (accessed October 21, 2004).

⁹ Ibid.

¹⁰ Poterba, James M. (1996) “Retail Price Reactions to Changes in State and Local Sales Taxes” *National Tax Journal*, vol. 49 no.2, pp 165-176.

¹¹ The incidence effects of taxing business-to-business transactions could be minimized if the overall sales tax rate is reduced at the time of the base expansion.

Table 1
Illustration of Tax Pyramiding when Taxing
Business-to-business Transactions

	<u>Exempt</u> <u>Business-to-business</u>	<u>Tax on</u> <u>Business-to-business</u>
Purchased Services	\$100	\$100
Tax on Production Input	0	4
Total Cost of Production	100	104
Retail Price	200	208
Retail Tax	8	8.32
Total Retail Cost	208	216.32
Total Tax Paid	\$ 8	\$12.32

Note: Illustration assumes that all taxes are passed forward to consumer. For simplicity the retail price is set equal to 200 percent of production costs and sales tax rate is 4 percent.

Services like lawn care and carpet cleaning may be purchased by both individuals and businesses. Ideally, individual consumption would be taxed, while the business use would not be taxed. In practice, states have opted for simplicity and therefore dually consumed services are generally either taxed or exempt for both individuals and business.¹² For example, in New York State, landscaping services are taxable for both firms and individuals, while neither is required to pay taxes on carpet cleaning. (See Table 2.)

Sales tax on retail services. The New York State sales tax is similar to other traditional sales tax systems in that it imposes a sales tax on the exchange of tangible goods and exempts some categories of goods like food. Service transactions are generally exempted from the sales tax, but some specific services have been added to the sales tax base. As a result, innovation and new services are not automatically captured in the sales tax base. Table 2 lists 40 basic retail services and identifies whether they are taxed or exempt in New York State.

Incidence. The incidence of the sales tax on services will be similar to the incidence of the sales tax in general.¹³ The overall sales tax is regressive, but the regressivity of the sales tax on services would be no worse than the general incidence. The tax on services consumed in greater proportion by those with more wealth may marginally reduce the regressivity of the sales tax. The regressivity of the tax would increase if fundamental services such as housing are taxed.

¹² The arguments for simplicity are reduced collection costs and easier enforcement.

¹³ Institute on Taxation and Economic Policy, "Should Sales Taxes Apply to Services?" *Policy Brief*, May 2004.

Table 2
New York State Taxation of Household Services

<u>Taxable Services</u>	<u>Tax Exempt Services</u>
Amusement park admission	Barber shops/salons
Auto maintenance – painting	Bowling alleys
Auto repair – labor charge	Cable TV
Auto road service – towing	Carpet/upholstery
Auto rust-proofing	Cultural event admission
Auto washing	Diaper service
Circus or fair admission	Garment alterations – repair
Dating service	Health clubs
Extended service contracts	Commercial horse boarding
Exterminating	Investment counseling
Installation charges	Laundry – dry cleaning
Landscaping/lawn care	Parimutuel racing admission
Marina services	Personal instruction
Parking lots- garages	Private limo service
Pet grooming	Residential electricity
Private club membership	Residential gas
Professional sports admission	Shoe repair
Remodeling – labor	Veterinary services
Self storage	
Swimming pool cleaning	
Tuxedo rental	
TV repair – labor charge	

Source: Michael Mazerov, “Expanding Sales Taxation of Services: Options and Issues,” Center on Budget and Policy Priorities, June 2003.

Competitiveness. All states tax some retail services. Of the 40 items listed in Table 2, New York taxes 22. This is slightly more than New Jersey, which collects taxes on 17 services, and slightly less than Connecticut, which taxes 25 services. To the extent that business-to-business transactions are excluded from the base, then New York State’s competitive position will not be affected. Expanding the sales tax base will also remove tax distortions creating economic bias toward consumption of services.

Table 3
Selected Tax Exempt Services and Potential State Sales Tax Revenue
New York, 2004

Service	Revenue Potential (millions)
Capital improvements	\$509
Interstate and international telephone	327
Cable TV Service	141
Eyeglasses, hearing aids and prosthetic aids	74
Newspapers and periodicals	72
Commercial horse boarding and training	72
Laundering, tailoring, shoe repair and similar service	68
Certain admission charges*	58
Telecommunications and internet	54
Internet access service	44
College textbooks	27
Veterinarian services	25
Mandatory gratuity charges	18
Dues for fraternal services	12
Internet data centers	10
Coin operated car wash services	2
Commercial buses	2
Certain coin-operated charges	2
Total	\$1,517

Source: *Annual Report on New York State Tax Expenditures* New York State Department of Taxation and Finance, February 2004. <<http://www.budget.state.ny.us/pubs/supporting/supporting.html>> (accessed March 2004).

*Includes charges of ten cents or less, and admission charges to: race tracks, boxing or wrestling matches, live circus performances, dramatic or musical arts performances, motion picture theaters, and sporting facilities where the patron is a participant such as bowling alleys, health and fitness centers, and swimming pools.

Revenue potential. Table 3 shows the tax revenue foregone by New York State due to its exemptions of selected retail services. If these services were subject to taxation, the State could collect an additional \$1.5 billion annually. However, telephone, cable television, and internet services are subject to other taxes or exempted by federal law. Taxing the remaining services on this list would yield about \$950 million annually.

Sales tax on professional services. Professional services, such as those provided by lawyers, accountants, and consultants, are excluded from the sales tax in New York State. Nationally, about 82 percent of professional service transactions are business-to-business transactions.¹⁴

While taxing professional service transactions could generate significant revenues, additional economic and administrative issues are important to consider. As already shown, taxing business-to-business transactions results in tax pyramiding and excess costs to consumers. Two additional factors should be considered in the context of taxing business-to-business professional services:

- Taxing business-to-business transactions creates inequities in business competition. This inequity can be seen through an elaboration on the scenario in Table 1. If two firms are competing for consumers, and one firm has the internal capacity to provide the service, but the other firm contracts the service to an external vendor, then the tax on business-to-business transactions will put the firm who out-sources at a competitive disadvantage. Since smaller firms tend to use outsourcing to a greater degree, taxing business-to-business transactions will favor larger organizations.
- There are challenges in administering a sales tax on professional services. The first challenge is assigning the transaction to a taxing jurisdiction. For example, when a law firm in New York City provides legal services to a firm in Los Angeles, has the transaction occurred in New York or Los Angeles? Is the nexus of the transaction the point where the service is produced, or the location of the firm who received it? According to the principles of the Streamlined Sales Tax Project, “the uniform rules will be destination/delivery based and uniform for tangible personal property, digital property, and services. Special sourcing rules will be developed for unique industries.”¹⁵ Unless professional services are deemed unique, the destination principle dictates that the location of the receiving firm determines the taxing jurisdiction. Thus, New York State would not tax the Los Angeles firm when it purchases services from New York firms, although New York firms purchasing services from outside the state would be taxed. Nevertheless, collection of remote sales tax is difficult, because the courts have ruled that a state cannot require an out-of-state vendor to collect and remit a sales tax unless the vendor has a substantial physical presence in the state.

The complexity of the economic and administrative issues of a tax on professional services has generally deterred states from taxing such services. Only Hawaii, New Mexico, and South Dakota impose a sales tax on professional services.¹⁶ In the 2004 fiscal year, Governor

¹⁴ Calculated from Brian C. Moyer, Mark A. Planting, Paul V. Kern, and Abigail M. Kish, “Improved Annual Industry Accounts for 1998–2003: Integrated Annual Input-Output Accounts and Gross-Domestic-Product-by-Industry Accounts,” *Survey of Current Business*, Bureau of Economic Analysis, June 2004, Table I, p 33.

<http://www.bea.doc.gov/bea/ARTICLES/2004/06June/0604GDP_Industry.pdf> (accessed October 18, 2004).

¹⁵ Streamlined Sales Tax Project --Executive Summary –April 2004.

¹⁶ Federation of Tax Administrators “Sales Taxation of Services” April 1997. Research Report No. 147, p. 11.

Tom Vilsack of Iowa proposed sales tax reforms that included broadening the base to some professional services, but the proposal was not passed.¹⁷

By imposing a sales tax on only those professional services consumed by individuals, most of the disadvantages can be abated. Administration will be a bit more complex, but can be accomplished through exemption certificates like those issued to not-for-profit organizations. Remote sales are to become less of an issue, because household consumption of professional services is likely to occur within the state.

Incidence. As noted above, the incidence of a sales tax on services will be similar to the incidence of the sales tax in general.¹⁸ The overall sales tax is regressive, but the regressivity of a sales tax on professional services should be no worse than the general incidence. Professional services are consumed to a greater degree by those in the higher income brackets, which diminishes the overall regressivity of the sales tax.

Competitiveness. A sales tax on household consumption of professional services is likely to have minimal impact on the competitive position of New York State. However, taxation of business-to-business consumption of professional services would have greater consequences since very few states currently tax professional services. The sales tax would increase production costs and therefore place New York professional service providers at a relative disadvantage to other states. Smaller and start-up businesses use professional services disproportionately; therefore, a tax on business-to-business transactions could also impede economic development in the state.

Revenue potential. The revenue from a sales tax on professional services would be about \$2.6 billion, if a 4 percent tax were imposed on both business-to-business and business-to-consumer transactions; however, this is not the best option. The volume of sales of professional services to consumers is difficult to know, but available data indicate that revenues from these would range from \$175 million to \$595 million annually.¹⁹

Corporate income tax base broadening. New York State businesses pay numerous taxes including corporate income taxes, utility taxes, sales taxes and property taxes. The tax structure includes many exemptions and rules that some argue should be changed to eliminate inequities in the treatment of similar taxpayers, and to overcome “loopholes” that some companies use to avoid paying taxes. In particular, the corporate income tax could be reformed to yield more revenue while conforming to the practices of many other states.

In 2003, corporations paid \$2.3 billion in New York State corporate income tax revenues.²⁰ These taxes comprised about 5 percent of all State tax revenues.²¹

¹⁷ *State Tax Notes*, May 24, 2004, p. 577.

¹⁸ Institute on Taxation and Economic Policy. “Should Sales Taxes Apply to Services?” *Policy Brief*, May 2004.

¹⁹ This estimate is derived from applying the national share of household purchases of business and professional services (from Moyer, et al., Table I, op. cit.) to New York State Gross State Product, Bureau of Economic Analysis, <<http://www.bea.doc.gov/bea/regional/gsp.htm>> (accessed October 18, 2004.)

²⁰ State of New York, Department of Taxation and Finance, *Fiscal Year Tax Collections: 2002-2003*, Table 2, http://www.tax.state.ny.us/pdf/stats/Stat_FY/2002_03_Annual_Statistical_Report_of_NY_State_Tax_Collections_Tables.xls.

Corporate income tax laws vary widely among states. The taxable base may include net income, gross receipts, capital stock, or other forms of income and assets. Rules governing how income is allocated across taxing jurisdictions can also vary considerably. Aggressive tax management leads many corporations to take advantage of differences in tax laws and shift liability to states where taxes are low or nonexistent. Critics of the structure of corporate income tax in the U.S. argue that increased sophistication in tax avoidance strategies has led to considerable erosion in the corporate tax base and corporate income tax payments in recent decades. The average effective corporate income tax rate levied by states declined from 5.3 percent in 1979 to 3.8 percent in 1998.²²

While corporations find myriad ways to reduce their tax liabilities, three features of many state tax laws have allowed what critics argue is unnecessary erosion of the corporate tax base.²³

1. A conflict between federal law and the income apportionment rules applied by many states allows corporations to avoid taxes because a corporation must, by federal law, have a “nexus” in a state where it does business before the state can tax the profits associated with that business. So, for example, a state in which a corporation has no physical presence, yet sells goods or services, is barred from taxing the profits associated with those sales. Thus, a corporation may have profits not subject to any state’s corporate income taxes. This phenomenon is known as “nowhere” income.
2. Corporations create subsidiaries in states with no tax, and use them to funnel income from states with taxes that allow deductions for payments to subsidiaries. These entities are known as “passive investment companies” or “PICs”. The best-known case is the creation of a trademark for the Toys R Us mascot “Geoffrey the Giraffe” in Delaware to receive deductible royalty payments from New York and other states with no mechanism to recapture these revenues.
3. Corporations have become more creative and aggressive in defining income as “non-business” income, which by federal law cannot be taxed. Certain types of extraordinary income and investment income which could be interpreted as business income is sheltered from taxation.

Several states have revised tax laws to recapture corporate tax payments. New York State has not yet acted to change its corporate tax laws in this fashion. Reforming the State’s corporate tax structure could level the playing field for all businesses in the state while recapturing revenue for public purposes.

The State of New Jersey recently passed a corporate tax reform package that some consider a model for how reform could work in New York. The New Jersey reforms include the following elements:²⁴

²¹ State of New York, Department of Taxation and Finance, *New York State Tax Sourcebook*, Table 3.

²² Steven Maguire, Congressional Research Service, “Average Effective Corporate Tax Rates,” *State Tax Notes*, September 4, 2000.

²³ Michael Mazerov, “Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States,” Center on Budget and Policy Priorities: Washington, D.C., May 23, 2003.

²⁴ This description of the New Jersey reforms relies heavily on Mary E. Forsberg, “A Question of Balance: Taxing Business in the 21st Century,” New Jersey Policy Perspective white paper, Feb. 3, 2003,

- Disallowing royalty, dividend and interest payments to related entities. This limits the ability of corporations to take advantage of PICs.
- Requiring corporations to report transactions among related companies at the request of the director of the State Division of Taxation. This is a weak version of consolidated reporting, which combines the income of all of a company's subsidiaries for apportionment purposes.
- Changing the definition of nexus from one that requires physical presence to one requiring economic presence.
- Establishing a "throwback" rule. "Throwback" (also "throw-out") rules enable states to capture revenues by disregarding the "nowhere" income in apportioning liability. For example, when a state uses sales in an apportionment formula, it assigns liability by computing the share of sales in that state relative to sales in other states. With a throwback rule, the portion of sales in other states to which the corporation owes no tax is eliminated from the denominator, thus raising the corporation's liability in the remaining states. In New Jersey, any additional liability arising from this method is capped.
- Reforming the minimum tax. The alternative minimum tax was increased and supplemented by an alternative minimum assessment, computed on the basis of either gross receipts or gross profits. Corporations must pay the greater of the two.

Revenue potential. Accurate estimates of the impact of corporate income tax reforms are difficult. Corporate tax returns, which would provide the basis for microsimulations, are not available to the public. Furthermore, the State's tax expenditure report fails to provide estimates for many corporate exemptions. However, while estimates of the revenue impacts of corporate tax reform can vary widely, available information suggests that a few changes in New York's corporate income tax law could yield from \$320 million to \$435 million annually.

The experience from other states suggests that mandating combined reporting increases corporate income tax revenues 12 to 13 percent. While 18 states require combined reporting, there have been no recent conversions except for Vermont; combined reporting will take effect there in 2006.²⁵ There is therefore no recent evidence of the impact on state revenues of switching to combined reporting. However, since 2003 combined reporting bills have been introduced in seven states in addition to Vermont,²⁶ and in at least three cases one can review official estimates of the fiscal impact of combined reporting. These estimates are in a narrow range of 12 to 13 percent.²⁷

<<http://www.taxanalysts.com/www/taxpolicyreadings.nsf/WebReadings/A5E1A17F1141B79385256E1400794694?OpenDocument>> accessed August 16, 2004.

²⁵ HB 784 of 2004.

²⁶ Arkansas (HB 1105, 2004); Connecticut (Bill 6802, 2003); Iowa (HSB 724, 2004); Maryland (SB 727, 2004); Massachusetts (HB 3825, 2003); Missouri (HB 1, 2003); Wisconsin (Amendment to SB 197, 2003).

²⁷ State of Wisconsin, Legislative Fiscal Bureau, Joint Committee on Finance *Paper #112: Corporate Income and Franchise Tax – Combined Reporting*, June 1999. *Report of the Maryland Board of Revenue Estimates on Estimated Maryland Revenues*, December 17, 2003 and Maryland General Assembly Department of Legislative Services, "Fiscal and Policy Note, Senate Bill 727", 2004 Session. *Iowa Budget Report: Fiscal Year 2005*, <http://dom.state.ia.us/state/budget_proposals/files/FY05/FY05_Iowa_Budget_Report.pdf>.

Given the present level of corporate income taxes in New York, adopting mandatory combined reporting²⁸ would generate about \$220 million additional corporate income tax revenues.²⁹ More stringent application of regulations to prevent firms from inappropriately classifying investment income as non-business income would yield from \$85 million to \$130 million.³⁰ Raising the alternative minimum tax as a general measure would limit the ability of corporations to avoid taxation. This could be accomplished by increasing the current rate to 3.25 percent, where it stood in 1998, or by eliminating the ability of corporations to take tax credits against the minimum tax. Depending on the approach, these measures would yield from \$17 million to \$85 million.

Other measures could be taken that would strengthen the corporate income tax. Among these are implementation of a “throwback” rule. Information adequate to develop estimates about additional revenues stemming from this change is not available.

Incidence. Analyzing the incidence of corporate taxes is complicated, because the burden of the taxes can be shifted in many ways. With respect to the corporate income tax, corporate ownership is geographically diffuse and demographically diverse since stocks are held by both individuals and institutions, including pension funds. Taxes can be shifted to customers through higher prices or to employees through lower wages. If little of the tax is shifted, the tax must be paid by the owners or shareholders, but ultimately may fall on the factors or inputs that are least mobile.

Even after taking into account the ability of corporations to shift the tax burden to others, including labor, the corporate income tax is, on balance, progressive.³¹ Those in the top 5 percent of the income distribution in New York pay a larger portion of their income in corporate taxes than other groups.

Competitiveness. Of the 50 states, 45 impose a corporate income tax. New York State’s corporate income tax ranks twelfth in taxes per \$1,000 of personal income.³² Among New York’s competitors – the other nine of the ten largest states in the nation and two geographic neighbors – Illinois, California and New Jersey exceed New York in corporate income taxes per \$1,000 of personal income. Comparisons of corporate tax burdens based on personal income are not ideal, since personal income does not include corporate profits. States with a concentration of highly profitable firms will appear to have higher corporate taxes measured as a percent of personal income than others. Financial activities, which are disproportionately concentrated in New York, accounted for 43.9 percent of corporate profits nationally in 2003 but only 6 percent

²⁸ Current state law makes provision for combined reporting, but it is not mandatory unless a particular firm is required to file combined reports by the Tax Commissioner.

²⁹ Combined reporting would be restricted to firms filing under the state’s Article 9-A corporate franchise laws. Separate tax structures apply to banks, insurance companies, and others for whom this provision is less relevant.

³⁰ The high end estimate would result if firms filing under the alternate minimum tax basis divided income between business and investment income similarly to those filing on an entire net income (ENI) basis. The low end of the estimate assumes that division changes to one midway between the current division and that for ENI filers.

³¹ Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, January 2003, <<http://www.itepnet.org/whopays.htm>>, accessed March, 2004.

³² *New York State Tax Sourcebook*, op. cit., Tables 9 and 12.

of employment.³³ While personal income does reflect the high wages paid to financial sector workers, it is an imperfect proxy for corporate income and thus this measure likely overstates the actual burden to corporations.

The top marginal income tax rate on corporations in New York is 7.50 percent, tied with Connecticut for 23rd place. New York's top rate is less than that of Pennsylvania, Massachusetts, New Jersey, California, and Ohio.³⁴ It is important to note, however, that New York City imposes an additional corporate income tax of 8.85 percent.

The fact that neighboring competitor states have higher corporate income taxes suggests that there may be room to remove tax loopholes and increase State tax revenues without appreciably changing the choices of businesses to locate or expand here. Of the states with corporate income taxes, 25 have throwback rules, including competitor states California, Illinois and Texas. About one-third of the states, including California and Illinois, use combined reporting to prevent a wide variety of tax avoidance strategies; others, including Connecticut, New Jersey, and Ohio, use narrower rules to prevent income shifting.³⁵ Table 4 shows New York's competitor states and whether they had corporate income taxes, throwback rules, and policies to prevent income shifting through combined reporting or other mechanisms in place from 1995 to 2000. The table does not reflect the passage of New Jersey's corporate income tax reform measures in 2003.

³³ Bureau of Economic Analysis, <<http://www.bea.doc.gov/bea/newsrelarchive/2004/gdp204p.xls>>, accessed September 27, 2004.

³⁴ *New York State Tax Sourcebook*, op. cit. Table 18.

³⁵ Mazerov, op. cit.

Table 4
State Policies to Eliminate "Nowhere" Income and Reduce Income Shifting
New York and Competitor States, 2000

State	Had Corporate Income Tax	Had "Throwback Rule" in Effect	Had Policy to Nullify Income Shifting
New York	yes		
California	yes	yes	yes
Connecticut	yes		
Georgia	yes		
Florida	yes		
Illinois	yes	yes	yes
Massachusetts	yes		
Michigan	*		
New Jersey	yes	**	**
Ohio	yes		yes
Pennsylvania	yes		
Texas	yes	yes	

* Michigan replaced seven business taxes, including the corporate income tax, with a "single business tax" -- a modified value added tax -- in 1976.

**New Jersey enacted legislation addressing both issues in 2003.

Source: Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," Center on Budget and Policy Priorities, Washington, D.C., May 23, 2003.

RAISING RATES ON EXISTING BROAD-BASED TAXES

Often the simplest means to increase revenues is to raise existing tax rates. It requires uncomplicated legislation and adds little to administrative costs.

The Commission considered increases in personal income tax (PIT) rates and sales tax rates. In addition, the possibility of a statewide property tax was considered. These options were evaluated on the basis of adequacy, incidence, and competitiveness.

Competitiveness. New York's voters have expressed a preference for a rich array of services. By itself, this preference would result in high taxes relative to other states. However, taxes in New York are also disproportionately high because New Yorkers spend more for given services than is the case elsewhere. For example, Medicaid spending is more than double the national average per beneficiary.³⁶

These high costs are not fully reflected in comparisons of state taxes, because the State of New York shifts many of its expenses to the local level. Table 5 shows the overall tax burden in New York compared to the United States average. While many State taxes fall below the median

³⁶ Citizens Budget Commission, *Confronting the Tradeoffs in Medicaid Cost Containment*, February 25, 2004, <<http://www.cbcny.org/publications.html>>.

in a 50-state comparison, the combined state and local tax burden places New York at the top. For the taxes under consideration, New York is ranked 26th in general sales tax and 1st in personal income tax.

Table 5
State and Local Tax Revenues per \$1,000 of Personal Income, 1999-2000

<u>Tax Revenues</u>	<u>State & Local Taxes</u>			<u>State Only Taxes</u>		
	<u>U.S.</u>	<u>50-State</u>		<u>U.S.</u>	<u>50-State</u>	
	<u>Average</u>	<u>New York</u>	<u>Rank</u>	<u>Average</u>	<u>New York</u>	<u>Rank</u>
Total Tax	\$112	\$141	1	\$69	\$68	29
Property Tax	32	41	9	1	0	NA
Total Gen Sales Tax	28	27	26	22	14	43
Total Select Sales Tax	12	10	41	10	8	45
Motor Vehicle License	2	1	44	2	1	50
Individual Income Tax	27	46	1	25	38	6
Corp Net Income Tax	5	10	3	4	4	18
Other Taxes	6	6	27	4	3	38

Sources: Revenue data from U.S. Census Bureau, State and Local Government Finances by Level of Government and by State, 1999-2000, <<http://www.census.gov/govs/www/estimate00.html>> (November 5, 2003); Personal Income data from U.S. Department of Commerce, Bureau of Economic Analysis, "Regional Data," *Survey of Current Business*, March 2003, D-66, <<http://www.bea.doc.gov/bea/ARTICLES/2003/03March/D-Pages/0303DpgJ.pdf>> (November 5, 2003).

Another way to assess competitiveness is to compare tax rates, although differences among states in the base to which rates are applied makes this comparison of limited usefulness. Among the forty-one states that impose an income tax, New York ranks 18th in the magnitude of its top income tax rate, which is 6.85 percent.³⁷ However, of the large industrial states, only Ohio, Minnesota and California have a higher top tax bracket, and neighboring states New Jersey, Massachusetts, and Connecticut have lower tax rates. (See Table 6.) Furthermore, New York City and Yonkers impose a local income tax that increases considerably the top bracket for residents of those cities. While some other states allow income taxes to be levied locally, it is unusual.

³⁷ This rate disregards the current personal income tax surcharge, which brings the top rate to 7.75 percent for married taxpayers filing jointly with adjusted gross income over \$500,000. This surcharge is scheduled to expire in 2006.

Table 6
State Personal Income Tax Rates for Top Brackets
as of January 1, 2002

Rank	State	Rate (percent)	Rank	State	Rate (percent)
1	Montana	11 %		Louisiana	6 %
2	Rhode Island	9.65		Missouri	6
3	Vermont	9.5	28	Delaware	5.95
4	California	9.3	29	Virginia	5.75
5	Oregon	9	30	North Dakota	5.54
6	Iowa	8.98	31	Massachusetts	5.3
7	Maine	8.5	32	Arizona	5.04
8	Hawaii	8.25	33	Alabama	5
	North Carolina	8.25		Mississippi	5
10	New Mexico	8.2	35	Maryland	4.75
11	Minnesota	7.85	36	Colorado	4.63
12	Idaho	7.8	37	Connecticut	4.5
13	Ohio	7.5	38	Michigan	4.1
14	Arkansas	7	39	Indiana	3.4
	Oklahoma	7	40	Illinois	3
	South Carolina	7	41	Pennsylvania	2.8
	Utah	7	42	Alaska	none
18	New York	6.85		Florida	none
19	Wisconsin	6.75		Nevada	none
20	Nebraska	6.68		New Hampshire	none
21	West Virginia	6.5		South Dakota	none
22	Kansas	6.45		Tennessee	none
23	New Jersey	6.37		Texas	none
24	Georgia	6		Washington	none
	Kentucky	6		Wyoming	none

Source: New York State Tax Sourcebook, March 2003.

Of the 45 states that impose a sales tax, New York ranks near the bottom in its statewide tax rate. Only two states with sales taxes – South Dakota and Wyoming – have a lower state tax rate. (See Table 7.) Again, the taxing authority of localities varies from state to state. New York allows its localities to impose an additional sales tax, which is not true of all other states. Local taxing authority in New York is necessary because localities are expected to bear a greater share of costs for education and health expenses than is the case elsewhere.

The competitiveness of the property tax can be evaluated only on a community-by-community basis, because in most cases property taxes are levied at the local and not the state level. In New York, the property tax is exclusively a local revenue source, levied and collected by local governments. Rates therefore vary widely, making comparisons of rates among states uninformative.

Table 7
State Sales Tax Rates
as of January 1, 2002

Rank	State	Rate (percent)	Rank	State	Rate (percent)
1	Mississippi	7 %	19	New Mexico	5 %
	Rhode Island	7		North Dakota	5
3	Minnesota	6.5		Ohio	5
	Nevada	6.5		South Carolina	5
	Washington	6.5		Vermont	5
6	Illinois	6.25		Wisconsin	5
	Texas	6.25	32	Kansas	4.9
8	California	6	33	Utah	4.75
	Connecticut	6	34	North Carolina	4.5
	Florida	6		Oklahoma	4.5
	Kentucky	6	36	Missouri	4.225
	Michigan	6	37	Alabama	4
	New Jersey	6		Georgia	4
	Pennsylvania	6		Hawaii	4
	Tennessee	6		Louisiana	4
	West Virginia	6		New York	4
17	Arizona	5.6		South Dakota	4
18	Arkansas	5.125		Wyoming	4
19	Idaho	5	44	Virginia	3.5
	Indiana	5	45	Colorado	2.9
	Iowa	5	46	Alaska	none
	Maine	5		Delaware	none
	Maryland	5		Montana	none
	Massachusetts	5		New Hampshire	none
	Nebraska	5		Oregon	none

Source: New York State Tax Sourcebook, March 2003.

Revenue potential. Both sales and personal income taxes have the capacity to raise a large amount of revenue. In state fiscal year 2003-2004, the sales tax raised \$9.7 billion, or 23 percent of total State tax revenue. The personal income tax raised \$24.1 billion, or 58 percent of total tax revenue. For each \$1 billion of additional revenue, the effective personal income tax rate (taxes collected divided by total adjusted gross income) must rise 0.2 percentage points. To raise \$1 billion, the state sales tax must increase 0.5 percentage points.³⁸

³⁸ The Commission considered the tax options discretely. If the sales tax base were broadened through taxation of services and better enforcement of remote and internet sales tax collections, the rate increase required to raise \$1 billion would be less than 0.5 percentage points.

In 2000, New York local governments collected a total of \$25.2 billion in property taxes with an average tax rate on full market value of 2.76 percent.³⁹ Raising \$1 billion in revenue would require a statewide property tax rate of 0.11 percent of market value.

Incidence. New York State's personal income tax is progressive. As income increases, the applicable marginal tax rate increases. Nominally, the top tax bracket applies to income over \$40,000 (for married taxpayers filing joint returns). Arguably, the absence of additional marginal rates above this level suggests that the progressivity of the tax is limited. However, New York's income tax has an unusual feature that increases the tax's progressivity. Most progressive income taxes are structured so that even the wealthiest taxpayers benefit from having paid lower rates on portions of their income. In these circumstances, the effective tax rate – the ratio of the amount paid relative to the total taxable income – is lower than the top marginal tax rate. In New York, the State recaptures that benefit by phasing it out for the top rate payers. For adjusted gross income of \$150,000 and more, taxpayers pay a flat rate of 6.85 percent on all their taxable income.⁴⁰

Sales taxes tend to be regressive. Lower-income households spend a larger proportion of income than do higher income households, who are able to save or invest a larger portion of income. In New York State some goods, such as groceries, rent, and other items deemed necessities, are exempt from sales tax to ease the burden on lower-income households.

Assessing the incidence of the property tax is complicated. Broadly speaking, it is a tax on wealth and would, therefore, be progressive. Because it is a tax on an illiquid asset, however, it is not based on ability to pay. Furthermore, commercial property owners are sometimes able to shift the cost of the tax to customers and tenants, and owners of residential rental property are able to shift some costs to tenants.

All three taxes are paid in part by residents of other states. Since this analysis focuses on the incidence for New York State residents, it is relevant to account for this tax "exporting." Table 8 shows tax exports. For both the personal income tax and the property tax, about 13 percent of total tax payments are exported. About 5 percent of the sales tax is exported. Additional information on these estimates can be found in Appendix B.

³⁹ U.S. Bureau of the Census, *Census of Governments*, <<http://www.census.gov/govs/estimate/00sl33ny.html>>.

⁴⁰ The State's temporary personal income tax surcharge makes the tax even more progressive by establishing two additional brackets, one applicable to taxpayers with adjusted gross income of \$150,000 and the other to taxpayers with adjusted gross income in excess of \$500,000. These brackets are based on married taxpayers filing joint returns.

Table 8
Tax Payments and Taxes Exported
New York State, 2000
(dollars in thousands)

	<u>PIT</u>	<u>Sales</u>	<u>Property</u>
Total tax payments	\$24,663,112	\$8,563,323	\$15,846,743
New York residents	\$21,491,115	\$8,113,593	\$13,787,999
<i>share</i>	87.1%	94.7%	87.0%
Nonresidents	\$3,171,997	\$449,730	\$2,058,744
<i>share</i>	12.9%	5.3%	13.0%

Notes: PIT resident tax payments include part-year residents.

Sources: See Appendix B.

It is possible to construct an index of progressivity based on data from the State Division of Taxation and Finance and the Institute on Taxation and Economic Policy (ITEP). To construct the index, taxes paid per dollar of income was calculated for each income bracket. For each income bracket, this amount was divided by the taxes paid per dollar of income among the lowest income bracket. Thus, the index for the lowest bracket equals 1. For other brackets, if taxes paid per dollar of income is higher than for the lowest bracket, the index is greater than 1 and the tax is progressive. If taxes paid per dollar of income is less than the lowest bracket, then the index is less than 1 and the tax is regressive. On average, the progressivity index for the New York State personal income tax is 3.16, the index for the sales tax is 0.58, and the index for the property tax is 0.79.⁴¹ (See Table 9.)

Feasibility. Raising personal income and sales tax rates is politically unpopular, but is administratively simple. These rates have been changed many times in New York State and the mechanisms for making the necessary changes in withholding tables and retailer's remittances are in place. A statewide property tax poses more obstacles to implementation. Because the tax has up to now been the purview of local governments, instituting a statewide tax may be unwelcome by counties and municipalities, and assessment practices would be difficult to coordinate.

⁴¹ For the personal income tax, this is an imperfect measure because adjusted gross income is not perfectly correlated with household income. In any given year some wealthy taxpayers may show low adjusted gross income, while lower-income households may enjoy windfalls that temporarily push them into higher brackets.

Table 9
Progressivity Index for Personal Income, Sales, and Property Taxes

<u>Income Level</u>	<u>Tax per Income</u>			<u>Progressivity Index</u>		
	<u>PIT</u>	<u>Sales</u>	<u>Property</u>	<u>PIT</u>	<u>Sales</u>	<u>Property</u>
Less than 9,999	0.02	0.05	0.04	1.00	1.00	1.00
10,000 - 19,999	0.03	0.05	0.03	1.19	0.96	0.83
20,000 - 34,999	0.04	0.04	0.03	1.90	0.86	0.74
35,000 - 49,999	0.05	0.04	0.03	2.57	0.70	0.83
50,000 - 74,999	0.06	0.03	0.03	2.95	0.64	0.86
75,000 - 99,999	0.07	0.02	0.03	3.33	0.48	0.91
100,000 - 199,999	0.08	0.02	0.03	3.90	0.44	0.86
200,000 - 499,999	0.09	0.02	0.03	4.33	0.34	0.74
500,000 - 999,999	0.10	0.02	0.03	4.52	0.34	0.74
1,000,000 or more	0.10	0.01	0.01	4.57	0.18	0.37
Average	0.07	0.05	0.03	3.16	0.58	0.79

Sources: CBC staff calculations for sales and property taxes based on New York State tax data from the New York State Department of Taxation and Finance using spending distributions calculated by Institute on Taxation and Economic Policy data. PIT calculations based on tax tables from New York State Department of Taxation and Finance. See Appendix B for more details.

Note: Taxes per income calculated for raising \$11 billion in revenue; sensitivity analysis shows little effect on index for different levels of revenue.

The Impact of School Finance Changes on Communities

Using State revenue sources to finance increased State spending on education redistributes resources from wealthy communities to communities with greater educational challenges. Since the incidence of the statewide revenue sources under consideration vary, however, it is likely that this redistribution among communities will depend on which revenue source is used.

The Commission analyzed the impacts of using broad-based State taxes to pay for additional education spending using 11 representative school districts. These communities include large and small cities, wealthy and poor suburbs, and a rural area. Selected characteristics of these school districts are shown in Table 10.

Table 10
Selected Characteristics of 11 New York School Districts

School District	Population	Number of Households	Median Household Income	Personal Income Tax Liability of Median Household	Tax as percent of Income
New York City	8,008,278	3,021,588	\$38,293	\$1,111	2.90%
"Big 4" Cities					
Buffalo	292,648	122,720	24,175	497	2.05%
Rochester	219,766	88,997	27,001	607	2.25%
Syracuse	147,393	59,517	25,092	577	2.30%
Yonkers	196,086	74,351	44,046	1,399	3.18%
Other Upstate Urban					
Binghamton	48,119	21,389	25,967	612	2.36%
Utica	60,692	25,123	24,767	520	2.10%
Upstate Rural					
Massena	17,509	7,235	33,996	963	2.83%
Wealthy Suburban					
Great Neck	43,426	16,223	84,434	3,870	4.58%
Scarsdale	18,507	5,881	188,419	11,413	6.06%
Poor Suburban					
Roosevelt	17,286	4,524	57,109	2,189	3.83%

Sources: CBC staff calculations from New York State Education Department, Office of Management Services, Fiscal Analysis and Research Unit, *School District Profiles*; NYS Dept. of Taxation and Finance, *Analysis of Personal Income Tax Returns*; U.S. Bureau of the Census, 2000 Census.

The districts comprise a wide range of both population, from 17,286 in Roosevelt to over 8 million in New York City, and median income, from just over \$24,000 in Buffalo to more than \$188,000 in Scarsdale.

The net impacts of state-financed education initiatives vary depending on two factors: first, a district's economic resources, which will be the source of additional tax revenues; second, how much new aid a district gets from the new State education policy. Residents of districts with little or no new educational needs will be liable for more tax payments, while their schools will receive little or no aid.

Tables 11 to 13 show analyses of the net gains and losses by district under two scenarios: one in which the State finances all but \$2.7 billion in additional education aid from sources other than broad-based taxes, and the other in which all \$7.4 billion of additional aid is derived from one of the three broad-based taxes considered in this paper.⁴²

⁴² The other sources of funding include educational efficiencies, gambling revenues, and tax base broadening. See CBC's report, *Can New York State Get an 'A' in Education Finance Reform?* November, 2004.

Table 11 shows the net gains and losses by district under a scenario in which the State funds \$2.7 billion of new education aid with one of three statewide taxes: the personal income tax, the sales tax, and a statewide property tax. The first column of the table shows the distribution of the \$2.7 billion in aid, which is based on the share of additional aid for districts calculated by the Campaign for Fiscal Equity. The second through fourth columns show the amount of additional revenues that would be raised in each district under each of the three alternative revenue scenarios.⁴³ The remaining columns show the net gain or loss of resources to the district. Table 12 shows the same information as Table 11, but for an additional \$7.4 billion in education aid.

Wealthy suburban districts will lose resources because they have no need for additional aid funds, while taxes on residents of those districts rise substantially. Yonkers loses resources because higher taxes outweigh additional aid. Yonkers currently receives high levels of aid as a result of court-ordered desegregation. The remaining districts gain resources under each scenario.

Table 13 translates the information from Tables 11 and 12 to a per pupil basis. If education aid increases by \$2.7 billion, the net gain in resources per pupil in New York City is roughly \$730 to \$830, while the net loss in Scarsdale ranges from about \$2,000 to \$4,300. If aid increases by \$7.4 billion, the net loss per pupil in Scarsdale grows to between \$5,600 and \$11,700 and the net gain in New York City ranges from about \$2,000 to \$2,300.

⁴³ The methodology for estimating the impacts of the revenue scenarios is contained in the relevant portions of Appendix B.

Table 11
Net Impact on District Resources of \$2.7 Billion Education Aid Financed with Higher Statewide Taxes
(dollars in thousands)

DISTRICT	New Aid	Additional Taxes Paid			Net Gain/(Loss)		
		PIT	Sales Tax	Property Tax	PIT	Sales Tax	Sales Tax
NEW YORK CITY	\$1,673,016	\$890,062	\$886,678	\$787,463	\$782,954	\$786,337	\$885,553
"Big 4" Cities							
BUFFALO	59,244	13,325	21,946	14,027	45,920	37,298	45,217
ROCHESTER	57,626	12,069	16,322	13,110	45,557	41,303	44,516
SYRACUSE	31,714	7,661	12,960	9,151	24,052	18,754	22,562
YONKERS	8,135	22,398	14,464	20,797	(14,263)	(6,329)	(12,662)
Other Upstate Urban							
BINGHAMTON	8,363	2,776	5,007	2,765	5,587	3,356	5,598
UTICA	14,059	2,919	5,270	2,908	11,140	8,789	11,152
Upstate Rural							
MASSENA	2,846	993	2,338	1,648	1,853	508	1,199
Wealthy Suburban							
GREAT NECK	0	16,854	12,884	19,560	(16,854)	(12,884)	(19,560)
SCARSDALE	0	19,017	12,281	9,098	(19,017)	(12,281)	(9,098)
Poor Suburban							
ROOSEVELT	5,760	1,286	983	1,502	4,474	4,777	4,258

Sources: American Institutes for Research and Management Analysis and Planning, Inc., *The New York Adequacy Study: Determining the Cost of Providing All Children in New York an Adequate Education*, Table: Actual Spending and Projections of "Adequacy" costs for 517 Districts Not Spending at "Adequate" Levels, March 2004, <http://www.cfequity.org/Costing%20Out%20_District-by-District.pdf> (October 24, 2004); NYS Education Department, *School District Profiles*, op. cit.; NYS Dept of Taxation and Finance, 3/98 = 2/00 Statistical Tables; NYC & Co., *New York City Statistics*, <<http://www.nycvisit.com/content/index.cfm?pagePkey=57>> (October 24, 2004).

Table 12
Net Impact on District Resources of \$7.4 Billion Education Aid Financed with Higher Statewide Taxes
(dollars in thousands)

DISTRICT	New Aid	Additional Taxes Paid			Net Gain/(Loss)		
		PIT	Sales Tax	Property Tax	PIT	Sales Tax	Property Tax
NEW YORK CITY	\$4,585,302	\$2,439,429	\$2,430,155	\$2,158,232	\$2,145,873	\$2,155,147	\$2,427,071
"Big 4" Cities							
BUFFALO	162,373	36,519	60,148	38,444	125,854	102,225	123,929
ROCHESTER	157,937	33,078	44,736	35,931	124,859	113,202	122,007
SYRACUSE	86,919	20,998	35,520	25,082	65,921	51,399	61,837
YONKERS	22,297	61,387	39,642	57,000	(39,090)	(17,346)	(34,703)
Other Upstate Urban							
BINGHAMTON	22,920	7,609	13,722	7,578	15,312	9,198	15,342
UTICA	38,533	8,000	14,444	7,969	30,533	24,089	30,564
Upstate Rural							
MASSENA	7,801	2,721	6,408	4,515	5,080	1,393	3,285
Wealthy Suburban							
GREAT NECK	0	46,192	35,312	53,609	(46,192)	(35,312)	(53,609)
SCARSDALE	0	52,121	33,658	24,934	(52,121)	(33,658)	(24,934)
Poor Suburban							
ROOSEVELT	15,787	3,525	2,695	4,117	12,262	13,092	11,671

Sources: See Table 11.

Table 13
Net Impact Per Pupil of Increased State-Financed Education Aid and Higher Statewide Taxes

DISTRICT	Pupils	Net Gain/(Loss) per Pupil					
		Additional \$2.7 Billion in Education Funding			Additional \$7.4 Billion in Education Funding		
		PIT	Sales	Property	PIT	Sales	Property
NEW YORK CITY	1,068,630	\$733	\$736	\$829	\$2,008	\$2,017	\$2,271
"Big 4" Cities							
BUFFALO	46,545	987	801	971	2,704	2,196	2,663
ROCHESTER	40,077	1,137	1,031	1,111	3,115	2,825	3,044
SYRACUSE	24,637	976	761	916	2,676	2,086	2,510
YONKERS	25,091	(568)	(252)	(505)	(1,558)	(691)	(1,383)
Other Upstate Urban							
BINGHAMTON	6,447	867	521	868	2,375	1,427	2,380
UTICA	8,918	1,249	986	1,250	3,424	2,701	3,427
Upstate Rural							
MASSENA	2,854	649	178	420	1,780	488	1,151
Wealthy Suburban							
GREAT NECK	6,100	(2,763)	(2,112)	(3,207)	(7,573)	(5,789)	(8,788)
SCARSDALE	4,448	(4,275)	(2,761)	(2,045)	(11,718)	(7,567)	(5,606)
Poor Suburban							
ROOSEVELT	3,437	1,302	1,390	1,239	3,568	3,809	3,396

Sources: See Table 11.

APPENDIX A

Key Features of the Streamlined Sales Tax System⁴⁴

Uniform definitions within tax laws.

Legislatures still choose what is taxable or exempt in their state. However, participating states will agree to use the common definitions for key items in the tax base and will not deviate from these definitions. As states move from their current definitions to the Project's definitions, a certain amount of impact on state revenues is inevitable. However, it is the intent of the Project to provide states with the ability to mirror closely their existing tax bases through common definitions.

Rate simplification.

States will be allowed one state rate and a second state rate in limited circumstances (food and drugs). Each local jurisdiction will be allowed one local rate. A state or local government may not choose to tax telecommunications services, for example, at one rate and all other items of tangible personal property or taxable services at another rate. State and local governments will accept responsibility for notice of rate and boundary changes at restricted times. States will provide an on-line rate/jurisdiction database to simplify rate determinations.

State level tax administration of all state and local sales and use taxes.

Businesses will no longer file tax returns with each local government within which they conduct business in a state. Each state will provide a central point of administration for all state and local sales and use taxes and the distribution of the local taxes to the local governments. A state and its local governments will use common tax bases.

Uniform sourcing rules.

The states will have uniform and simple rules for how they will source transactions to state and local governments. The uniform rules will be destination/delivery based and uniform for tangible personal property, digital property, and services. Special sourcing rules will be developed for unique industries.

Simplified exemption administration for use- and entity-based exemptions.

Sellers are relieved of the "good faith" requirements that exist in current law and will not be liable for uncollected tax. Purchasers will be responsible for paying the tax, interest and penalties for claiming incorrect exemptions. States will have a uniform exemption certificate in paper and electronic form.

⁴⁴ Streamlined Sales Tax Project *Executive Summary*, April 2004.

Uniform audit procedures.

Sellers who participate in one of the certified Streamlined Sales Tax System technology models will either not be audited or will have limited scope audits, depending on the technology model used. The states may conduct joint audits of large multi-state businesses.

State funding of the system.

To reduce the financial burdens on sellers, states will assume responsibility for funding some of the technology models. The states are also participating in a joint business – government study of the costs of collection on sellers.

APPENDIX B

Revenue Estimates Methods

Personal income tax (PIT)

Data on the New York State personal income tax was obtained from the New York State Department of Taxation and Finance.⁴⁵ Fiscal year 2000 was the most recent data available at the time. The broad based tax revenue estimates are derived by applying a proportional increase to the tax rates. A proportional rate increase assumes that deductions and tax credits are held at the same level as the base year and that the relative progressivity of the bracket tax rates is maintained. The appropriate proportion is calculated by taking the additional tax revenues needed divided by the total tax collections. The estimated additional tax collections are found by multiplying the base tax collections by the proportional increase.

The exported personal income taxes are tax liabilities paid directly by non-New York State residents. In fiscal year 2000 the taxes paid by non-residents was 12.9 percent of the total New York State personal income tax collections. The exported portion of the PIT is assumed to remain the same for the additional tax collections.

The progressivity of the PIT was calculated from the detailed tables on liability by income bracket provided by the New York State Department of Taxation and Finance. That data provides aggregate adjusted gross income (AGI) and associated liability for each tax bracket. The liability for each bracket is divided by AGI to derive the relative burden for households in each tax bracket, assuming that tax returns provide a reasonable proxy for households.

The PIT collections by district were derived from the New York State data available for the county level. The State PIT collections from a county were multiplied by the ratio of district aggregate income to county aggregate income to estimate the district portion of the county income taxes in 2000.⁴⁶ The additional PIT collections from a district were estimated by applying the proportional rate increase to the PIT collections in 2000.

Sales tax

Total taxable sales were \$206.9 billion from April 1999 to March 2000.⁴⁷ A rate of 3.6 percent on this base would generate an additional \$7.4 billion in sales tax revenue.⁴⁸ This would raise the current state rate of 4 percent to 7.5 percent. Local rates would be in addition to this rate, so the combined state and New York City tax would be 11.6 percent.

⁴⁵ New York State Department of Taxation and Finance, *Analysis of Personal Income Tax Returns*, <http://www.tax.state.ny.us/Statistics/Personal_Income_Tax_Statistical_Reports.htm>.

⁴⁶ Calculations from data provided by New York State Education Department, Office of Management Services, Fiscal Analysis and Research Unit, *School District Fiscal Profiles*, <http://www.oms.nysed.gov/faru/Profiles/profiles_cover.htm>.

⁴⁷ New York State-Department of Taxation and Finance, *Sales Tax Statistical Reports*, <http://www.tax.state.ny.us/Statistics/Sales_Tax_Statistical_Reports.htm>.

⁴⁸ A tax increase would likely decrease the volume of sales on goods with elastic demand, resulting in lower tax collections than indicated. As our purpose is to provide rough revenue estimates there was no effort to incorporate the price effect of the new tax on the sales base.

The estimated sales tax payments paid by New York State residents utilizes the research of The Institute on Taxation and Economic Policy as follows. The aggregate sales tax for a given income level “L” is estimated with the following model :

- Estimated Sales Tax $T_L = NYAGI_L \times \text{Beta}_L$

Where $NYAGI_L$ is the aggregate New York adjusted gross income for income level “L”, and Beta_L is the imputed portion of household income spent on New York sales taxes (varies by income level) derived from the ITEP estimates for New York State.⁴⁹ Imputed spending was calculated based on the information provided by ITEP on the household burden of the sales tax by income bracket.

The ITEP study employs a sophisticated data set where the Consumer Expenditure Survey data is matched to households to estimate total resident consumption and the share of consumption for non-durable goods, food, shelter, clothing, and transportation. The appropriate sales tax is applied to the consumption estimates. The incidence is determined by comparing consumption to income.⁵⁰

A portion of the sales tax in New York State is paid directly by nonresidents. The magnitude and portion of the sales tax that is exported to nonresidents is estimated with the following formulas:

- Exported Sales Tax = Actual NYS Sales Tax Collections – S Estimated Sales Tax_L (Summation across each income level)
- Exported Proportion = Exported Sales Tax / Actual NYS Sales Tax Collections

Nearly all of the exported sales transactions are expected to be in New York City. For simplicity, the exported portion of the sales tax is attributed entirely to the sales in New York City. The exported amount of sales calculated in this way is roughly consistent with estimates from the visitor spending statistics reported by NYC & Company⁵¹.

The sales tax collections by district were derived from the New York State data available on the county level. The total sales tax collections for the county were multiplied by the ratio of district aggregate income to county aggregate income to estimate the district portion of the

⁴⁹ Institute on Taxation and Economic Policy’s “Who Pays? A Distributional Analysis of the Tax Systems in All 50 States”, 2nd Edition. January 2003. <<http://www.itepnet.org/whopays.htm>>

⁵⁰ For further discussion of the ITEP methodology see The Institute on Taxation & Economic Policy, “Appendix V: Methodology” and “Description of the ITEP Model” <www.ctj.org/itep/model.htm>

⁵¹ NYC & Co statistics show that \$15.6 billion was spent by tourists in NYC in the year 1999. The 4% sales tax rate applied to this amount yields \$624 million in sales tax revenues, compared to \$450 million estimated by CBC. However, some of the goods and services purchased by tourists are exempt from the sales tax. If about three-quarters of the purchases by tourists are taxable at 4%, then the exported amount of sales tax under both methods of estimates are roughly consistent. The amount of tourist spending exempt from sales tax is unknown, but this adjustment does not appear unreasonable.

<<http://www.nycvisit.com/content/index.cfm?pagePkey=57>>

county sales taxes.⁵² The new additional sales tax collections by district were found by applying the rate increase to the district base collections.

State property tax

There is currently not a statewide property tax in New York. The market value of the taxable property in the state, \$911.9 billion, was obtained from New York State Office of Real Property Services.⁵³ Given the \$911.9 billion property tax base, the state would have to levy an effective rate of 0.81 percent tax per dollar of market value to raise \$7.4 billion dollars.

Because there is not a statewide property tax in New York, there is no data to directly estimate the incidence of the property tax by income level. Therefore, the incidence analysis employs the local property tax incidence estimates developed by the Institute on Taxation and Economic Policy (ITEP).⁵⁴

The aggregate property tax for a given income level “L” is estimated with the following model:

- Estimated Property Tax_L = NYAGI_L x Beta_L

Where NYAGI_L is the aggregate New York adjusted gross income for income level “L”, and Beta_L is the imputed portion of household income spent on New York local property taxes (varies by income level) derived from the ITEP estimates for New York State. ITEP estimates are based on local property tax collections and therefore a state imposed property tax would not necessarily exhibit the same incidence.

A portion of the property in New York State is owned directly by nonresidents, or is passed on to non-resident consumers and shareholders. The magnitude and portion of the property tax that is exported to non-residents is estimated with the following formulas:

- Exported Property Tax = Actual NYS Property Tax Collections – S Estimated Property Tax_L (Summation across each income level)
- Exported Proportion = Exported Property Tax / Actual NYS Property Tax Collections

For the analysis of property tax revenues by district, the local property tax collections were derived by applying the 0.81 percent effective rate to the school district’s total market value of taxable property obtained from the New York State Office of Real Property services.

The ITEP study matches Census data with data drawn from property tax deductions on individual tax returns. This data can capture the effects of tax credits and circuit breakers that are

⁵² Calculations from data provided by New York State Education Department, Office of Management Services, Fiscal Analysis and Research Unit, School District Fiscal Profiles, op. cit.

⁵³ New York State Office of Real Property Services <<http://www.orps.state.ny.us/MuniPro/>>

⁵⁴ “Who Pays? A Distribution Analysis of the Tax Systems in All 50 States”, 2nd Edition. January 2003.

intended to reduce the regressivity of the property tax. ITEP makes a series of assumptions in developing their estimates:⁵⁵

- Direct payments of income, sales, and property taxes are borne by the payer.
- Tax on rental units is split 50 percent between household and landlords.
- Tax on Corporations is considered a “capital tax” and allocated between residents and nonresidents on the basis of the state’s share of national capital income with an adjustment for residents owning in-state taxable capital.
- Since New York State has a corporate tax higher than the median tax rate for the states, a portion of the capital taxes is shifted to consumers or wage earners as appropriate to the commercial activity.

Professional services tax

The revenue estimates for a sales tax on professional services consumed by households use two methods. These estimates provide the \$175.05 million to \$596 million range.

Method 1. New York gross state product (GSP) from legal services and other business expenses (accounting, engineering, architecture, consulting, etc.) is \$46,287 million in 2001.⁵⁶ The GSP takes into account the intermediate production of these services in terms of business-to-business transactions. However, GSP includes more than private consumption; it also includes investments in fixed assets, government consumption, and adjustments for import and exports. Data is not available to isolate private consumption of the New York GSP directly, so the national input-output data for gross domestic product is used to calculate a proxy. The private consumption of GDP for professional⁵⁷ services is 41 percent.⁵⁸ Another adjustment is necessary, because the GDP data includes consumption by nonprofit organizations as private consumption. The portion of GDP that is attributed to nonprofit spending is reported in Table 1.9 of the New Nonprofit Almanac and Desk Reference.⁵⁹ The current operating expenditures in the nonprofit sector are reported as a percentage of services to be 21.5 percent. Since nonprofit organizations are exempt from the sales tax, the base is reduced by 21.5 percent. As shown below, the adjusted GSP is multiplied by a sales tax rate of 4 percent to get the estimate of \$595.9 million.

⁵⁵ The Institute on Taxation and Economic Policy, “Appendix V: Methodology” p 5. and “Description of the ITEP Model” <www.ctj.org/itep/model.htm>

⁵⁶ <<http://www.bea.doc.gov/>>

⁵⁷ The industry categories for GDP and GSP are slightly different, but the professional and business services includes services similar to the legal and other business services in the GSP data.

⁵⁸ Survey of Current Business, June 2004. Table I. <<http://www.bea.doc.gov/bea/pub/0604cont.htm>>

⁵⁹ Independent Sector, (2002) "The New Nonprofit Almanac and Desk Reference" Jossey-Bass: San Francisco, CA. Table 1.9, p 28.

GSP for legal and other professional services	Portion of private consumption	Adjustment for Nonprofit organizations	Estimated Tax Base*	Estimated Tax revenue
\$46,287	0.41	0.785	\$14,897.47	\$595.90

Dollar amounts in millions.
*multiplication product of first three columns.

Method 2. The second method is similar to the method 1 except that gross receipts are used to estimate the tax base rather than GSP. Gross receipts for legal and professional services are not available, except for the year 1997. In 1997 the ratio of receipts from services to GSP from services is 1.56. The ratio of 1.56 is applied to the GSP from legal and other professional services for the year 2001, providing an estimate of \$72,400 million in gross receipts from professional services in New York. Similar adjustments to those in method 1 are needed to isolate the receipts paid by households. The portion these services consumed by households and nonprofit organizations is .077 of the total receipts based on national GDP data for personal consumption expenditures for professional services relative to total industry output.⁶⁰ This share is adjusted for nonprofit organizations as in method 1.

Gross Receipts for professional services	Portion of private consumption	Adjustment for Nonprofit organizations	Estimated Tax Base*	Estimated Tax revenue
\$72,400	0.077	0.785	\$4,376.20	\$175.05

Dollar amounts in millions.
*multiplication product of first three columns.

The point estimate using the gross receipts approach is substantially lower than the GSP approach. Both methods are vulnerable to assumptions about the applicability of GDP percentages in adjusting New York data to estimate the tax base. If all the assumptions were valid, then the two estimates would be expected to be approximately the same. As they are different, one or more of the underlying assumptions are suspect and therefore the two estimates provide only an approximate range for the potential tax revenues.

⁶⁰ Survey of Current Business, June 2004. Table H. <<http://www.bea.doc.gov/bea/pub/0604cont.htm>>