DISCUSSION DRAFT

Local Income Tax for School Finance in New York State: A Primer

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Introduction

Education financing has been at the center of policy discussions not only in New York State but throughout the nation. In New York, schools are financed from a combination of sources. According to the State Education Department[1], in 2003-04, 49 percent of funding for public education came from local revenue sources, 44 percent came from State aid and grants, and 7 percent came from the federal government. Within the local revenue category, property taxes comprised nearly 90 percent of the total.

New York State's tax burden is competitive with other states when comparing state imposed taxes only. In fiscal year 2005, New York ranked 27th with a burden of $68.03 per $1,000 of personal income. The national average was $66.83. However, the story is completely different when local taxes are added into the mix. In fiscal year 2002, the latest year available for these statistics, New York had the highest state and local tax burden in the country at $130.79 per $1,000 of personal income. This compares unfavorably to the national average of $103.98. The real property tax is one of the main reasons for this result as evidenced in a recent report from the Office of the State Comptroller where they found that in 2002, local property taxes per $1,000 of personal income in New York were 28 percent above the national average[2].

Soaring real property tax burdens, not only in New York but throughout the country, have exerted pressure on school finances and local school districts have been forced to consider alternative revenue sources. In several other states, there has been a shift away from further increases in the property tax toward local personal income taxes. Such movement creates a variety of issues including changes in the distribution of the tax burden and competitive motivation between local jurisdictions. This paper explores these and other issues from a potential imposition of local income taxes for financing public schools.

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[1] New York State Education Department, State Aid to Schools: A Primer, December 2005.
[2] Office of the New York State Comptroller, Property Taxes in New York State, April 2006.

Background

New York's Current System of School Finance

New York State has approximately 700 individual school districts, of which the 5 districts in the largest cities (New York City, Buffalo, Rochester, Syracuse, and Yonkers), are colloquially known as the Big Five. In all districts, except the Big Five, school boards prepare annual budget proposals in the spring of each year and those budgets must be approved by voter referendum in mid-May. Capital improvement projects and new purchases for transportation that are financed off-budget through borrowing are voted on as separate initiatives apart from the operating budget. The Big Five districts have their spending plans incorporated as part of the municipal budget with no direct vote by city residents.

As described in the introduction, New York State schools are financed primarily by the real property tax. In 1998, the State assumed a portion of the local property tax burden through the STAR (School Tax Relief) program. STAR provides exemption amounts from the school property tax, based on age, from the full value of the taxpayer's home. The State then reimburses localities for the revenue loss created by the STAR exemption. In New York City, residents also receive a refundable STAR tax credit when they file their personal income tax return. Beginning in the fall of 2006, homeowners will receive a local property tax rebate directly from New York State. Rebate amounts vary across school districts based on the school tax rate. In future years, homeowners will receive either a rebate check or a refundable credit on their income tax return.

School districts may also generate local revenues if their county shares some of the local sales tax. Local sales tax rates are imposed at between 3 percent and 5.5 percent. This is in addition to the State sales tax rate of 4 percent, and the MTA tax rate of 0.25 percent for jurisdiction located in the downstate MTA region. In addition, some small city school districts impose a consumer utility tax with rates that cannot exceed 3 percent.

New York City imposes its own set of taxes including a personal income tax levied on residents, business taxes on unincorporated businesses, corporations, banks, insurance companies and utilities, plus other miscellaneous taxes. The city of Yonkers also imposes a personal income tax surcharge on residents, and nonresidents who work in Yonkers. These local income taxes will be discussed later in this report.

Most school districts in New York State are fiscally independent jurisdictions. That is, they decide their own budgets and levy their own taxes, typically real property taxes, to raise most of the necessary local share of revenues. However, New York State's Big Five school districts are fiscally dependent. This means that these school systems do not levy taxes, but instead are dependent upon citywide taxes for local financial support. State aid for education are assigned to the city treasury, not that of the school district.

In addition to the STAR program, New York State provides significant support to education through grants and aid. Most of this funding comes from State tax and fee receipts located in the General Fund, but a portion also comes from Special Revenue Funds, notably net revenues from the lottery which are earmarked for education finance. State aid for education is distributed in various ways. The vast majority of general support for public schools is provided through formula-based aids. The largest of these is *Flex Aid* which encompasses what was previously known as operating aid and several other formula-based aids. Funds are largely distributed based upon district wealth per pupil, subject to per pupil minimum aid amounts.[3]

Education Finance Litigation

The New York State Constitution, Article XI states that "The legislature shall provide for the maintenance and support of a system of free common schools, wherein all the children of this state may be educated." In the 1990's, a group known as the Campaign for Fiscal Equity (CFE) sued the State of New York in that the level of education funding provided to New York City schools did not offer students the opportunity for a sound basic education. The Court of Appeals found for the plaintiffs and set a deadline of July 30, 2004 for the Governor and the Legislature to agree on a budgetary remedy.

The Court also impaneled three referees to report back with recommendations on what measure the State should implement. The referees recommended additional annual funds of at least $5.63 billion phased in over four years, and capital improvements of $9.179 billion over a five year period. Extending the court order to provide a sound basic education to all New York State schools would cost considerably more.

Since the order was issued, the State has not implemented its recommendations and CFE brought another suit asking for a court order to force the State to implement the original order. In March 2006, the Appellate Division granted the CFE motion to confirm the referees' report, but stopped short of directing the Governor and the Legislature to adopt a dollar-specific budget.

In light of continuing legal victories by CFE, pressure will continue to be applied on the State budget to provide adequate school funding to New York City schools and to other districts throughout the state. Even if more aid is forthcoming to certain underperforming districts, it is unlikely that it would relieve the building pressure on local property tax burdens in other parts of the state.

[3]See 2005-2006 Description of New York State School Aid Programs (Albany, NY: Division of the Budget). A key determinant of how much Flex Aid a school district receives is its C*ombined Wealth Ratio (CWR)*. The CWR is based upon equal components of district income wealth per pupil, measured by New York Adjusted Gross Income (NYAGI), and real property wealth per pupil.

New York's Rising Real Property Tax Burden

The property tax is the single largest tax imposed in New York by either State or local governments. The tax raised approximately $38 billion in 2005, more than the $34 billion generated by the State's personal income tax and the New York City income tax combined in State fiscal year 2004-05.

In April 2006, the Office of the State Comptroller issued a report documenting the rise in the real property tax burden in New York. The report showed that property taxes had increased by 42 percent statewide since 2000, well above the general growth in inflation for that period. In addition, the report found that the increased burden of the property tax possesses distinct regional variation across the state with the heaviest burden falling on Long Island and in the Mid-Hudson Valley. This corresponds with many of the wealthier suburban school districts found in downstate areas.

Because of the reliability of the property tax as a stable revenue source, its ease of administration, and the growing demand for local government expenditures (especially for education), it is likely that the property tax will continue to grow absent alternative revenue sources.

Existing Local Income Taxes in New York State

In response to the fiscal crisis of the mid-1970's, New York City enacted the first local income tax in New York State in 1975. The City's income tax is imposed on residents and part-year residents of New York City. The City's tax base conforms to the State base, taxable income. The City then imposes its own tax rate schedule. For tax year 2006, the rates range from 2.907 percent to 3.648 percent. Similar to the State income tax, a nonrefundable City household credit is allowed for low and moderate income taxpayers. Also similar to State law, the City allows an earned income credit equal to 5 percent of the federal credit. New York City's tax prior to July 1999 also contained a tax on nonresidents who earned wages or income from self-employment within the City, euphemistically know as the "Commuter Tax". The New York State Legislature repealed the Commuter Tax in 1999.

The only other locality that currently has a local income tax is the city of Yonkers, immediately north of New York City. This tax was enacted in 1985 and is levied as a direct surcharge on the New York State income tax liability of Yonkers residents. The current tax rate equals 10 percent of State liability. Yonkers law still has its nonresident earnings tax, or commuter tax, equal to 0.5 percent of wages and self-employment earnings, after an allowable exclusion of $3,000 which phases out when earnings exceed $30,000.

The New York State Department of Taxation and Finance administers both the New York City income tax and the Yonkers taxes. Taxpayers pay their liability throughout the year via employer withholding or estimated tax payments. Final payments or refunds owed are determined when the tax return is filed the following year. Local taxpayers complete the relevant sections on the State income tax return for these local taxes. The Tax Department conducts audits of local income taxes in conjunction with State tax audits. New York City and the city of Yonkers reimburse the State for the Tax Department's administration of these local taxes.

New York State Legislation

Several bills have been introduced in the New York State Legislature during the 2005-06 session to study education finance reform. A.8091, sponsored by Assemblyman Hooker, would establish the task force on education reform, a panel of 9 members appointed by the Governor and Legislature. The task force would study and recommend to the Legislature the most appropriate means to transition from the property tax to a combination of income and sales taxes.

S.6761/A.10561, sponsored by Senator Larkin and Assemblywoman Gunther, directs the Office of Real Property Services, the state agency charged with local property tax oversight, to assist the Tax Department and the Division of the Budget in studying the fiscal implications of moving education financing from real property taxes to local income taxes.

S.8039/A.11656, sponsored by Senator Little and Assemblywoman Galef, establishes a blue ribbon commission on property tax reform to study and make recommendations on alternatives to the existing system of real property taxation. The commission would be comprised of 13 members appointed by the Governor and the Legislature as well as designees of the Office of Real Property Services and the Department of Taxation and Finance. None of these bills moved out of committee during the legislative session.

A Comparative Perspective

Four states -- Ohio, Iowa, Pennsylvania and Kentucky – currently allow school districts to levy an income tax. The mechanism used and the income subject to tax varies from state to state. It is important to note that while school districts in each of these four states have the authority to levy an income tax, not all actually do so. To provide a comparative perspective, each of the four states taxes, and Multnomah County (Oregon) income taxes, is detailed below.

Ohio's School District Income Tax

The Ohio school district income tax is an income tax that is designated specifically for the support of Ohio's school districts. The Ohio General Assembly first granted school districts the authority to levy an income tax in 1981. Currently, 153 of the

612 school districts in the state levy the tax. In order to be implemented, the income tax rate must be approved by a vote of the school district residents.

The school district income tax is typically levied, subject to voter approval, on the same income as Ohio's state income tax or on an earned income base. Specifically, income that is taxed includes wages, salaries, tips, interest and dividends, pensions, and capital gains, among other compensation of Ohio residents who live during all or part of a tax year in a school district that levies the tax. In addition, school districts are permitted to levy the tax, subject to voter approval, against an alternative tax base that includes only earned income and self-employment income of the residents of the school district. The tax would exclude all other types of income that would be taxable under existing income tax law, as stated above.

As is the case with the state income tax, part-year residents of a school district which has enacted the tax must pay the school district income tax based upon income received during the resident portion of the taxable year. Similarly, a decedent who, at the time of their death, was domiciled in the school district that levies the tax would have their estate owe tax on the income earned by the estate after the time of death. Unlike Ohio's municipal taxes, corporations and nonresidents are exempt from the school district income tax.

There is no limit on the school district income tax rate. The only requirement is that the rate must be in increments of a quarter (0.25) percent. In 2006, the rate ranges from 0.5 percent to 2 percent.

The Ohio Department of Revenue collects the tax primarily through employer withholding, individual quarterly estimated payments, and annual returns. Employers are required to withhold the tax and submit payments to the state under the same rules and guidelines as they currently use to withhold the state income tax. Local taxpayers subject to the tax are required to file an annual school district income tax return.

If a taxpayer moves from one school district to another, and both districts have enacted a school district income tax, then the individual must file a separate school district income tax return for each district. All told, Ohio school districts raised $170.3 million in fiscal year 2005. Through three quarters of fiscal year 2006, they have raised $151.8 million.

Iowa's Individual Income School District Surtax

In Iowa, as in most states, real property taxes are the primary source of local revenue for school districts. However, school districts may impose an income surtax to fund selected programs. Iowa first authorized the use of the surtax in 1976, and by 2004, some 695,000 taxpayers paid the tax which was imposed in a total of 287 school districts out of approximately 367 total school districts in the state. The rate varies between school districts with the maximum surtax rate capped at 20 percent.[4]

Iowa's individual income school district surtax is imposed on the income tax liability after tax credits on the Iowa Individual Income Tax returns of taxpayers residing within the district on the last day of the tax year. The surtax is not imposed on other income tax returns such as fiduciary or corporation income tax returns.

Iowa's school districts may use the income surtax to fund four areas: instructional support programs, physical plant and equipment levies, asbestos removal, and educational improvement. Income surtaxes are collected by the state through the Iowa Department of Revenue and Finance and held in a special account. In 2004, $69.4 million in revenue was raised with the individual income school district surtax.

Pennsylvania's Earned Income Taxes

Also in Pennsylvania, real property taxes are the major source of local tax revenues for education. Tax rates are imposed on the assessed value of land and buildings owned by individuals and businesses in each school district. However, Pennsylvania holds the distinction of having one of the lowest overall shares of local revenues that are derived from the real property tax. Pennsylvania's real property tax accounts for approximately 86 percent of local tax revenues for education compared to a national average of 96 percent.[5]

The largest non-property tax used to fund Pennsylvania's public schools is the earned income tax (EIT). The power to impose this tax was enacted in 1965 and is levied on the wages, salaries, commissions, net profits, and other compensation of those who reside in the school district. Imposition of the tax does not require explicit voter approval. Income from interest and dividends is not included and school districts are not permitted to tax nonresidents. This tax applies to employed individuals, unincorporated business owners and partnerships and is normally withheld from workers' paychecks.

The majority of Pennsylvania residents pay 1 percent of their earned income to support school and municipal services. Exceptions exist in Philadelphia, Pittsburgh, and Scranton where school rates are higher and in many suburban districts in the Philadelphia area where this tax is not as widely used as in the remainder of the state. The school district and the respective municipalities generally share the revenues evenly.

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[4] Iowa's top statutory tax rates are from 0.36 percent to 8.98 percent. Consequently, the 20 percent surtax would increase these statutory rates to no more than 0.43 percent to 10.78 percent.

[5] These percentages are derived from Table 4: Revenue from Local sources for Public Elementary-Secondary School Systems by State: 2003-04 in Public Education Finances: 2004 (Washington, D.C.: U.S. Census Bureau).

The EIT is collected locally by public or private tax collectors.[6] More than 92 percent of the 500 school districts having the authority to levy an earned income tax did so in 2004. In 2004, the EIT produced $612.5 million or 4.2 percent of total district revenues which is shared between school districts and municipalities as indicated above.

Kentucky's School District Individual License (Wage) Taxes

In Kentucky, local school boards have the authority to levy an occupational license tax for schools on the salaries, wages, commissions, and other compensation of residents of the county who worked, performed or rendered services in the county. In addition, the occupational license tax is also levied on the net profits of all businesses, professions, or occupations from activities conducted in the county. During the 2005-06 school year, only 10 out of the 176 school districts in Kentucky levied the tax.

Before a school district board of education levies an occupational license tax they are required to advertise that such a levy is being proposed and conduct a public hearing for the purpose of hearing comments and complaints regarding the proposed levy and explaining the reasons for such proposal. Explicit voter approval is not required for the tax to be imposed.

There are exemptions to who owe the occupational license tax. Specifically, public service companies that pay an ad valorem tax are exempt in addition to insurance companies, banks, trusts, savings and loans, and income received by active duty Kentucky National Guard members. Nonresidents of the school district imposing the tax are also not obligated to pay.

The occupational license tax is set to a single uniform rate not to exceed one-half of one percent (0.5 percent). The rate continues from year to year until changed. Any county having 300,000 or more inhabitants is authorized to increase the school tax rate to exceed the maximum rate by one-quarter of one percent (0.25 percent). In 2002, Kentucky school districts' received 3.2 percent of their revenue from the occupational license tax compared with 22.9 percent from property tax.

The Multnomah County (Oregon) Personal Income Tax

Multnomah County, Oregon, implemented a temporary three year personal income tax in May 2003 to support eight school districts in the county. This tax allowed school districts to maintain or reduce class size, operate a full-year calendar and maintain or start programs aimed at boosting student achievement.

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[6] The complexity and cost of tax administration of Pennsylvania's myriad local taxes has been broadly criticized as duplicative and wasteful. By some estimates, local governments could save almost $100 million if collection duties were centralized through the State's Department of Revenue. See Mike Wereschagin. "Pa.'s Tax Collection Wastes $100 Million." Pittsburgh-Tribune-Review, Sunday, March 27, 2005.

The tax rate was a 1.25 percent income tax on Multnomah County residents with about 70 percent of the tax revenues going to the schools. The remainder went to county social and correction programs and for tax administration. According to a report on the tax, the eight school districts were projected to receive $91 million in tax revenue in the 2005-06 school year, which is about 13 percent of their budgets. Since county residents failed to renew the tax, the revenues from the tax expired at the end of the 2005-06 school year.

Administrative and Policy Issues

There are various administrative and policy issues that arise when one considers the imposition of a local option income or wage tax (i.e., earned income tax) as new revenue sources for the support of elementary and secondary education. This section of the paper discusses some of the major issues.

The Tax Base

The selection of the tax base for any local tax is a key consideration that drives additional decisions related to tax administration and policy. As evidenced by the experience of other states, local taxes can either be imposed on a broad *income base* akin to that found under the state's personal income tax base (e.g., Ohio, Iowa) or a narrower *earned income base* (e.g., Pennsylvania, Kentucky).

While this decision may be related to administrative considerations, it also has policy implications. Excluding unearned income (e.g., dividends, capital gains) from the tax base means that more of the tax burden would be shouldered by wage earners (typically lower and middle income taxpayers), than those receiving significant unearned income (typically more affluent taxpayers).[7] Moreover, as pensions and income from retirement savings plans, such as 401-K plans or IRAs, are generally not considered income subject to tax under an earned income tax, these types of impositions may impose a higher effective tax burden on younger adults than on more elderly, retired taxpayers.[8]

"Flow-through" entities such as partnerships, S-corporations, and limited liability corporations (LLCs) are an increasingly common form of business ownership, particularly for small businesses. Consequently, often business income is taxed under a personal income tax instead of a traditional corporate income tax. Absent a companion corporate income tax, adoption of a local income tax could result in an additional tax

[7] Unearned income is subject to preferential tax rates under the Federal individual income tax. States typically do not provide such preferences.
[8] Pension and other retirement income is often partially, or in some cases wholly, excluded from many state personal income tax bases.

burden on these forms of businesses. Kentucky's local occupational license tax applies to all business income.[9]

Local or Central Administration

Another key consideration in imposing a local income tax is whether tax administration would be carried out at the local or state levels. As previously noted, independent local administration can be costly and duplicative. In contrast, tax collection by a central state revenue agency can offer administrative economies of scale and enhanced audit capabilities. Moreover, state revenue agencies very often collect any number of taxes, the revenues from which are distributed to multiple local jurisdictions.

In practical terms, an efficient way to collect a local income tax is for the tax to "piggyback" on an existing state personal income tax. In Ohio, for example, state taxpayers who reside in a school district imposing a school district tax file a separate return for that purpose.[10] Tax is calculated as a percentage of School District Taxable Income (SDTI) minus any senior citizen credits. SDTI is derived from Ohio Adjusted Gross Income (AGI) minus allowed exemptions.

Central administration can also broaden the tax base. For example, if a local income tax were to apply to nonresidents, larger jurisdictions might generate a significant share of revenues from persons who work, but do not reside in a jurisdiction (i.e., a "commuter" tax).[11] The taxation of state residents who work, but do not reside, in a particular school district is likely to be a major issue for small cities where nonresidents may hold high paying jobs, but contribute no tax dollars, other than occasional sales taxes, to the local fisc.

Geographic Imposition

The geographic area in which an income tax is imposed has major implications for both taxpayer and student equity. It is important to remember that both of these are likely goals in any school finance reform plan. A local option income tax might be employed to reduce the real property tax burden or to provide additional necessary funds for education.

There are several benefits to imposing an income tax to larger jurisdictions (e.g., counties or states) compared to smaller jurisdictions (e.g., school districts or municipalities). The larger the geographic area in which a tax is imposed, the less likely

[9] Partnerships, LLCs and other "flow-through" entities are taxed at the entity level.
[10] Municipal income taxes are levied in many jurisdictions in Ohio. Tax returns for these taxes are filed directly with the imposing jurisdiction. There is also a companion business income tax.
[11] In New York State, some 14 percent of State personal income tax liability is paid by nonresidents.

taxpayers will “vote with their feet” and move to another tax jurisdiction.[12] It is easier for individuals or families to move to adjacent districts or counties where employment may be continued and closeness to family and friends maintained rather than uprooting to another state just to avoid income taxation.

Local Option Income Taxes

Most local income taxes are accomplished in three general ways. First, elected officials can vote to impose a tax subject to the restrictions contained in existing state enabling legislation. Second, again in keeping with enabling legislation, local elected officials can seek voter approval of their desire for a tax through a referendum. Third, absent enabling legislation, local jurisdictions can appeal to a state legislature for specific or general enabling legislation.

In New York State, only New York City and Yonkers currently impose local income taxes. Both sought and received specific enabling legislation from the State Legislature for these taxes and periodically seek permission to amend the tax rates.[13] However, neither of these taxes is used directly for education purposes. Moreover, unlike all other school districts in New York State, the fiscally-dependent Big Five districts do not have school budget votes. Therefore, there is no precedent for voter ratification of these particular taxes.

In contrast, in Ohio, school boards hoping to impose an income tax must first pass a resolution stating the necessity of imposing the tax. A resolution on the tax is then sent to the county board of elections to be put before voters. The resolution must include the date of the election, the purpose of the tax, the rate and base (i.e., income or earned income only), the effective date and duration of the tax, and any anticipated reduction in real property tax rates.[14] Similarly, the Iowa School district Income tax surcharge is subject to voter approval.

Any optional local income tax in New York State, particularly those at the school district-level, would most likely require voter ratification similar to the Ohio or Iowa models. This is even more likely as recent attempts to impose sub-county or municipal-level taxes, such as real estate transfer taxes, have all included a requirement for a successful voter referendum for the tax to take effect.[15]

The dynamics of a referendum on a local income tax are likely to be very different from that of a school budget vote or school board election. Voter turnout in

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[12] In economic theory, this phenomenon is referred to as the Tiebout Hypothesis, that is, that voters will move to communities that provide the desired mixed of public services at a reasonable “tax cost.”
[13] New York City’s income tax is imposed pursuant to Articles 30 of the New York State Tax Law and. Yonkers income tax surcharge by Article 30-A and the nonresident earnings tax by Article 30-B.
[14] For an explanation of Ohio’s school district income taxes, see Guide to Ohio’s School District Income Tax (Columbus, OH: Ohio Department of Revenue).
[15] See for Ch. 443, L. 2006 (Town of Red Hook); Ch. 262, L. 2005 (Town of Warwick); Ch. 282, L. 2003 (Town of Brookhaven), and Ch. 114, L. 1998 (Peconic Bay Region).

these plebiscites is generally low even though residents are effectively voting on the real property tax levy in that district. A referendum on a new income tax on district residents could generate a far higher voter turnout.

An Additional Tax or Tax Swap?

A local option income tax can either function as an additional revenue source for elementary and secondary education or as a substitute for an existing tax, or portion of the revenues derived there from. Either construct would have a major impact on taxpayer equity vis-à-vis the existing and future tax burden.

A local income tax would affect taxpayer equity with the implications varying by jurisdiction based upon the socio-economics of resident taxpayers. However, there would be clear "winners" and "losers" under any scenario. Taxpayers with high real property wealth (measured by assessed value) and lower income wealth (measured by AGI) would likely benefit from an income tax as their new tax would be based, at least in part, upon their lower income. "House rich" senior citizens would most definitely fall into this group of "winners" (see Example 1). Similarly, farmers would likely benefit under a local income tax. Farm incomes vary greatly and are often negative. Nevertheless, farmers usually have large land holdings on which they must pay real property taxes irrespective of their incomes, although property tax exemptions may help reduce the burden.

Definite "losers" would include moderate and high income renters (see Example 2). Even though they may currently, to some extent, pay a portion of their landlords' real property taxes through rent payments, these individuals and families would now face a new explicit tax liability. Another negatively affected group could be taxpayers with low real property wealth but higher incomes.

Resident owners of out-of-district businesses would also have to pay income tax on their net business income under a local income tax if they are members of "flow-through" entities such as LLCs, partnerships and S-corporations. As previously noted, this form of business ownership has become more and more common in recent years. A local income tax typically would probably apply to residents only and depending on how the base was structured, any income of a resident would be subject to tax. This means that business earnings and intangible income (i.e., interest, dividends, and capital gains) would be subject to tax.

An income for real property tax swap raises additional issues. For instance, would real property tax relief associated with the introduction of an income tax be provided to owners of mixed-use (i.e., part-residential) and owners of non-residential real property? The owners of these properties are not necessarily also going to be personal income taxpayers in that district.

Example 1: The Winners - "House Rich" Seniors

Real Property Tax:
The real property tax base of the "Anytown" school district is comprised of 10 residential properties owned by The Smiths and 9 other couples. After applicable exemptions, the taxable value of each home is $200,000. Consequently, the aggregate value of the Anytown real property tax base is $2,000,000.

Resident Personal Income Tax:
The 10 families in the school district are married couples filing jointly, have no dependents, and claim the standard deduction. The Smiths are retired and their $75,000 FAGI is comprised entirely of pensions and unearned income. New York offers a pension of pension exclusion of up to $20,000 ($40,000 marrieds) which results in NYAGI of $35,000. The remaining taxpayers in the school district are not retired and each has $100,000 in wage income.

Tax Increase Scenario:
Anytown needs to raise additional revenue of $10,000 through (A) Real Property Tax or (B) Personal Income Tax.

Outcome:
Because their income is lower than their neighbors – and much of it is not taxable – The Smiths fare significantly better when the tax increase is accomplished through a personal income tax increase. Conversely, their neighbors fare less well. While all taxpayers would face an equal $1,000 tax increase in real property taxes, the Smiths would face a tax increase of only $178 when the personal income tax option is used to raise the additional $10,000 in revenue. Their neighbors, in contrast, would face a tax increase of $1,091 each.

(A) Real Property Tax	The Smiths	Taxpayers #2-10	All Taxpayers, #1-10
Taxable Real Property Values	$200,000	$200,000	$2,000,000
School Tax	$5,000	$5,000	$50,000
Full Value Tax Rate	2.5 %	2.5 %	2.5 %
Share of Real Property Tax Revenue (Percent)	10.0 %	10.0 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	+$1,000	+$1,000	+$10,000

(B) Resident Personal Income Tax*	The Smiths	Taxpayers #2-10	All Taxpayers, #1-10
FAGI	$75,000	$100,000	$975,000
- Pension Exclusion	($40,000)	N/A	N/A
NYAGI	$35,000	$100,000	$935,000
Taxable Income	$20,000	$85,000	$785,000
Tax After credit	$820	$5,029	$46,081
Effective Tax Rate	1.1 %	5.0 %	4.7 %
Share of PIT (Percent)	1.8 %	10.9 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	+$178	+$1,091	+$10,000

*Based upon 2006 New York State Tax Law.

Example 2: The Losers - Moderate and High Income Renters

Real Property Tax:
The real property tax base of the “Anytown” school district is comprised of 9 residential properties. After applicable exemptions, the taxable value of each home is $200,000. Consequently, the aggregate value of the real property tax base is $1,800,000. The Jones rent an apartment and own no real property and therefore do not directly pay any real property tax.

Resident Personal Income Tax:
There are 10 families in the school district. All are married couples filing jointly, have no dependents, and claim the standard deduction. Each family has $100,000 FAGI comprised of wage income.

Tax Increase Scenario:
Anytown needs to raise additional revenue of $10,000 through (A) Real Property Tax or (B) Personal Income Tax.

Outcome:
The Jones do not own their own home the currently pay no real property tax, other than that implicitly in their rent. However, as they have comparable incomes to their neighbors, raising the additional $10,000 in revenue through the personal income tax, instead of the real property tax, increases their tax burden significantly. They would face no direct tax increase under the real property tax, but under the personal income tax they would owe an additional $1,000. Their neighbors would face an equal tax increase.

(A) Real Property Tax	The Jones	Taxpayers #2-10	All Taxpayers, #1-10
Taxable Real Property Values	N/A	$200,000	$1,800,000
School Tax	N/A	$5,000	$45,000
Full Value Tax Rate	N/A	2.5 %	2.5 %
Share of Real Property Tax Revenue (Percent)	N/A	11.1 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	N/A	+$1,110	+$10,000
(B) Resident Personal Income Tax*	The Jones	Taxpayers #2-10	All Taxpayers, #1-10
FAGI	$100,000	$100,000	$1,000,000
NYAGI	$100,000	$100,000	$1,000,000
Taxable Income	$83,000	$83,000	$830,000
Tax After credit	$4,232	$4,232	$42,320
Effective Tax Rate	4.2 %	4.2 %	4.2 %
Share of PIT (Percent)	10.0 %	10.0 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	+$1,000	+$1,000	+$10,000

*Based upon 2006 New York State Tax Law.

Example 3: The Winners – Vacation Homeowners

Real Property Tax:
The real property tax base of the "Anytown" school district is comprised of 10 residential properties owned by The James and 9 other couples. The James home is a vacation home. The others are the families' primary residences. After applicable exemptions, the taxable value of each home is $200,000. Consequently, the aggregate value of the real property tax base is $2,000,000.

Resident Personal Income Tax:
The 10 families in the school district are married couples filing jointly, have no dependents, and claim the standard deduction. Each family has $100,000 in wage income.

Tax Increase Scenario:
Anytown needs to raise additional revenue of $10,000 through (A) Real Property Tax or (B) Personal Income Tax.

Outcome:
The James fare significantly better when the tax increase is accomplished through a personal income tax increase, as it applies only to school district residents. The James do not face a tax increase while the district residents with similar incomes must pay a tax increase of +$1,111 each.

(A) Real Property Tax	The James	Taxpayers #2-10	All Taxpayers, #1-10
Taxable Real Property Values	$200,000	$200,000	$2,000,000
School Tax	$5,000	$5,000	$50,000
Full Value Tax Rate	2.5 %	2.5 %	2.5 %
Share of Real Property Tax Revenue (Percent)	10.0 %	10.0 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	+$1,000	+$1,000	+$10,000

(B) Resident Personal Income Tax*	The James	Taxpayers #2-10	All Taxpayers, #1-10
FAGI	$100,000	$100,000	$1,000,000
NYAGI	$100,000	$100,000	$1,000,000
Taxable Income	$83,000	$83,000	$830,000
Tax After credit	$4,232	$4,232	$42,320
Effective Tax Rate	4.2 %	4.2 %	4.2 %
Share of PIT (Percent)	N/A	11.1 %	100.0 %
Share of $10,000 Tax Increase (Dollars)	N/A	+$1,111	+$10,000

*Based upon 2006 New York State Tax Law.

Likewise, should relief be extended to the owners of residential real property that is not their primary residence? If so, it is likely that part of the existing real property tax burden would be shifted from these individuals – who may be nonresidents - to school district residents (see Example 3). In each state there are areas with high proportions of vacation homes whose owners pay real property taxes to support local schools, but who are not entitled to vote on school budget referenda.

A tax swap of a local income tax for real property taxes would also affect business owners earning income from "flow-through" entities. The owners of these businesses may, or may not, benefit from the real property tax relief included in a swap if they do not own the favored type of real property within the school district. Moreover, if blanket real property tax relief were offered, a "big box" retailer paying the state corporate income tax (rather than the personal income tax) might receive a real property tax reduction, but would pay no local income tax.

Generally speaking, a local income tax – either an additional tax or as part of a tax swap – would become a more important part of the local revenue stream over time. This is because income taxes are generally more elastic than real property taxes.[16] This means that many of the foregoing taxpayer equity impacts would similarly be exacerbated over time and that the income tax would become an ever larger share of the local revenues.

However, income taxes tend to be more volatile than real property taxes. This is because certain components of the income base, most notably capital gains, vary considerably from year-to-year as the economy moves through phases of the business cycle. Property taxes tend to be more stable and predictable as the tax base does not vary greatly over time.

School District Spending Limits

Efforts to reform and expand the existing STAR program have often included limits on spending by school districts. Critics have argued that because of the absence of any spending restraints, the original STAR program encouraged school districts to increase spending above the level they would have done so without the program.

Most recently, the 2006-2007 Executive Budget proposed that only homeowners in school districts that restrained spending would benefit from STAR Plus rebates of $400. In order for homeowners to qualify, their respective school districts would have to

[16] The concept of "tax elasticity" refers to the relative change in revenue from a particular tax caused by a 1 percent change in income. Because of "multiplier effects," a 1 percent change in income results in more than commensurate increase in income tax revenues. As a result, income taxes are considered "elastic." In contrast, real property taxes are relatively "inelastic" as assessed values often increase slower than income. See Cordes, J. J. "Revenue Elasticity (Tax Elasticity)" in J.J. Cordes, R.D. Ebel and J.G. Gravelle, Eds. The Encyclopedia of Taxation and Tax Policy (Washington, D.C.: Urban Institute Press), p. 312.

cap spending increases at the lesser of 4 percent or 120 of the increase in the Consumer Price Index (CPI).[17]

Absent spending restraints, school districts adopting a local income tax could also use the infusion of additional revenue to spend more, rather than use funds prudently. One potential way to at least partially offset this effect would be to condition the ability to enact a local income tax upon "swapping" these revenues for a proportional decrease in real property tax rates. As previously noted, in Ohio, local income tax referenda may, but are not required to, explicitly be used to reduce real property tax rates.

Federal and State Tax Implications

State and local income taxes and real property taxes are deductible under the federal individual income tax. Real property taxes are also deductible under the personal income taxes of many states, including New York State. Consequently, for the group of taxpayers who itemize deductions, the impact of any local real property tax increase can be partially offset against the state and federal income tax, while a local income tax increase can only be offset against federal income tax.[18]

At the same time, as federal taxpayers reap an increased state and local tax itemized deduction, this may trigger the application of the federal Alternative Minimum Tax (AMT). The AMT applies imposes higher marginal tax rates on many middle and higher income taxpayers who claim a large amount of itemized deductions and/or exemptions.

Regional Impacts

A local option income tax could have regional impacts. Such is the case in Ohio where most jurisdictions adopting the school district income tax are located in the more agrarian areas of the state.[19] Income taxes generate relatively small amounts in these districts as farming activities generate relatively low, if any, positive incomes. The more urban areas of the state, with higher concentrations of middle and upper income individuals, would be less likely to adopt a local income tax.

New York is not unlike Ohio in that large geographic portions of the state are agrarian in nature. Accordingly, it is possible that similar regional dynamics could occur with a local option income tax for education in New York State.

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[17] Exceptions were allowed for districts with enrollment increases and capital expenses previously approved by voters. The actual rebate program passed by the Legislature did not contain a spending cap.
[18] In tax year 2004, approximately 23 percent of full year resident New York State taxpayers claimed itemized deductions under the state personal income tax. In contrast, for tax year 2003, approximately 38 percent claimed itemized deductions for federal individual income tax purposes.
[19] Phone interview with Mike Sobul, Ohio Department of Revenue, April 6, 2006.

Jurisdictional & Administrative Complexity

There are approximately 700 school districts in New York State. Adoption of a local income tax by a large number of these jurisdictions, many of them very small in size, would create a tax administration challenge. This is particularly true if the taxes were wholly administered locally, as is the case in Pennsylvania.

The challenge of administration would be less daunting if the tax base was linked to the state personal income tax and administered in tandem with the state's tax. A separate form might be required, as in Ohio and Iowa, but theoretically a simple surcharge on state tax liability could be collected using only a single line on the state's existing personal income tax returns (i.e., New York State forms IT-150 and IT-201). This would likely require a single surcharge rate to be used by localities if they opted for the income tax. If localities were allowed to impose their own surcharge rates, then new forms would be required to accommodate the hundreds of school districts.

Taxation of residents of other states, and residents of other New York State jurisdictions, would be even more complicated. Residents of other states file the current IT-203, nonresident income tax return. A straight surcharge on state tax liability would mean the simple addition of another line, again assuming a single local rate statewide.

Taxation of New York State residents living outside, but working inside, a school district imposing an income tax would be another matter. Allocation rules would have to be developed for such a tax, as well as a means to avoid double-taxation. These requirements make this type of tax (i.e., a nonresident income tax) far more difficult to administer.

Audit & Compliance

Any local option income tax that is centrally administered in tandem with a state personal income tax would benefit from existing audit and compliance activities of a state revenue department. Similarity of tax bases would mean that audits could be conducted jointly, as is current practice in New York with the New York City and Yonkers taxes. Moreover, this task would also be simplified if the tax were only imposed on residents of a school district. Calculation of different tax bases and the imposition of the tax on nonresidents would complicate any audit and compliance activities.

Either an income tax or wage tax would require the cooperation of employers to remit withholding payments on a regular basis along with existing state income tax payments. This would pose an additional administrative burden on employers, but not an overly onerous burden as many may already be required to withhold both New York State and New York City or Yonkers taxes.

Any locally administered income tax – and one that is also imposed on nonresidents – would be far more difficult and costly to administer. Local tax collection as found in the Pennsylvania model would be far less efficient than a centrally administered tax.

From the taxpayer's perspective, real property tax burdens may be considered onerous due to their high visibility. Homeowners typically pay their school tax once a year in September. Alternatively, they may pay monthly into an escrow account handled by their mortgage lender. Income taxes are much less visible especially if it is being paid weekly or bi-weekly through employer withholding.

Revenue Distribution

A local income tax imposed across numerous school districts would create additional distribution issues for the state revenue agency. In New York, the Tax Department currently collects and distributes both income and sales and use tax revenues for the both the State and local jurisdictions. Currently, there are 110 local jurisdictions that receive distributions of local sales tax revenues. Moreover, the Department collects and distributes local income tax revenues to New York City and to the city of Yonkers. Local option income taxes would significantly increase the administrative aspects of distributing revenue to these districts.