



## Sound Tax Policy Coming to New York (?)

*Fiscal Fact No. 129*

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New York may be making an unconstitutional grab<sup>1</sup> for sales taxes from out-of-state businesses, but it appears that some positive changes to the state's property tax system may be in the offing.

In 2007, the Tax Foundation rated New York's business tax climate as the nation's third worst, with the eighth worst property tax system. New Yorkers pay 13.8 percent of personal income in state and local taxes, the third highest figure in the country. A majority of this is local taxes, of which 75 percent consists of property taxes. Property taxes have also been rising much faster than inflation, an average of 7% per year since 2001.

In this context, last year Governor Eliot Spitzer established the New York State Commission on Property Tax Relief, a bipartisan panel chaired by Nassau County Executive Thomas Suozzi (D). The panel's mandate was to propose solutions to rein in ballooning property taxes while maintaining the state's commitment to public education, which is the primary use of property tax. On Tuesday, the Commission released a [set of recommendations](#).<sup>2</sup>

We've only preliminarily reviewed the Commission's report, but on balance it appears to contain a good set of recommendations. The proposals appear to improve an existing property tax rebate program that rewards school districts for raising taxes; provide a meaningful cap on property tax levies; and increase transparency. Additionally, the tax-limiting proposals are joined with cost-control measures, so that property tax savings can actually accrue to New Yorkers instead of being shifted to increases in other taxes. Governor David Paterson announced this week his support for the tax cap component of the proposal, and we hope to see the other components also gain momentum.

For New Yorkers who think the state's teachers' unions are contributing to the state's fiscal problems, it might be a favorable sign that the head of the largest union calls the report "anti-teacher and anti-education" and says he will lobby legislators to ignore it.<sup>3</sup>

Tuesday's report is preliminary, with a final report expected in December. Key Commission proposals include:

### **1. Reform New York's perverse School Tax Relief program ("STAR")**

Though the media has principally focused on the proposed tax cap, we believe that property tax rebate reforms are the most important part of the commission's recommendations. The STAR program, a statewide program in New York to assist homeowners in paying school taxes, acts in practice as a matching grant for local school tax levies on property. The higher a school district sets its tax rate, the more its taxpayers get back in STAR payments, thus giving districts a good reason to set rates as high as possible. With school taxes making up 61 percent of property taxes (excluding New York City) this is a primary driver of New York's high property taxes.

#### *How STAR works*

Under the STAR program, a homeowner receives a rebate for school taxes on at least the first \$30,000 of home value. The rebate is higher if the taxpayer lives in a county with high average property values or has a household income no higher than \$250,000, and higher still if the taxpayer is a senior citizen (65+) with a narrowly-defined "household income" less than \$70,650. The school district's tax rate is set by voters in the district, but the STAR payment comes from the state's general fund, without any cap set by the state. Unsurprisingly, this leads New York school districts to set very high tax rates, and nine of the ten U.S. counties with the highest average property tax rates are located in New York.

Property values vary widely in New York State, with New York City and its environs generally having much higher median home values than upstate New York. With a larger per capita property tax base, downstate counties tend to have lower property taxes as a percentage of home values, meaning that a \$30,000 tax exemption is less valuable downstate than upstate. As such, the STAR program adjusts the exemption upward in high-value downstate counties; for Westchester County, just north of the Bronx, the 2006 Basic STAR exemption was \$88,830, nearly three times the statewide standard. However, the Basic exemption is not adjusted downward in low-value counties, meaning that the STAR exemption may cover a very large percentage of median home value.

#### *Why STAR Causes Perverse, Reverse Tax Competition:*

Consider Wayne County, located directly east of Rochester, which has the highest property tax rate in the United States, averaging 2.94 percent. The owner of a median-value home in Wayne County (\$99,200) receives at least 30.2 percent of his school taxes (which constitute a majority of property taxes) back in the form of a STAR rebate. If that homeowner has total household income less than \$90,000, that figure rises to 48.4 percent. (Even if his household

income goes as high as \$250,000, he will still get a smaller bonus.) If the homeowner is over 65 with income under \$70,650, he is eligible for "Enhanced STAR" and gets fully 71.6 percent of school taxes back as a rebate. And because New York uses a narrow definition of "income"—federal AGI, which is not fully inclusive of Social Security payments, further adjusted to deduct 401(k) and IRA distributions—many quite wealthy New York seniors still qualify for Enhanced STAR.

**Property Tax Rates and Rebates in Ten Highest Property Tax Counties in Nation**

Top U.S. Counties by Property Tax Rate	Median Home Value 2006	Average Tax Rate	Minimum Share of School Tax Rebated to Median Value Homeowner		
			...With Income < \$90,000		...Senior < \$70,650
Wayne County	\$99,200	2.94%	30.2%	48.4%	71.6%
Niagara County	\$90,700	2.91%	33.1%	52.9%	78.3%
Monroe County	\$120,400	2.83%	24.9%	39.9%	59.0%
Erie County	\$108,900	2.54%	27.5%	44.1%	65.2%
Fort Bend County (TX)	\$161,600	2.53%	n/a	n/a	n/a
Chautauqua County	\$75,300	2.52%	39.8%	63.7%	94.3%
Onondaga County	\$115,900	2.50%	25.9%	41.4%	61.3%
Cayuga County	\$93,200	2.42%	32.2%	51.5%	76.2%
Chemung County	\$76,400	2.41%	39.3%	62.8%	92.9%
Schenectady County	\$145,300	2.39%	20.6%	33.0%	48.9%

Source: U.S. Census Bureau; New York State Commission on Property Tax Relief Preliminary Report of Findings and Recommendations; New York Office of Real Property Services; Tax Foundation calculations

These rebates rise proportionally with school taxes. For every extra dollar that Wayne County assesses that "low-income" senior, he gets an additional 71.6 cents rebated to him, at the expense of taxpayers statewide. STAR places New York taxpayers in a major collective action problem: each district's voters approve a school budget which is in large part billed to taxpayers elsewhere. Indeed, in order to become net recipients of state STAR aid, school districts should raise their property tax rates as high as possible.

*How to Fix STAR*

The commission does not make a specific proposal on overhauling STAR, but principles it lays out include:

- Continuing to limit the STAR exemption to primary residences, but expanding it to include renters as well as owners
- Phasing out the benefit for high-income taxpayers and high-value properties

- Making benefits income-based, with a broad definition of income
- Ensuring that STAR does not fully offset any taxpayer's school tax liability or exceed a maximum limit

The purpose of local aid is to ensure that municipalities with relatively low property tax bases per capita can afford to provide essential services, including education, without taxing their populations out of their homes. STAR turns this objective on its head, by giving extra money to municipalities with larger tax bases, and by financially rewarding those school districts that raise their property taxes. Additionally, STAR is problematic because it excludes rental and non-residential property, and complicates the property tax system. As such, from our perspective, the best solution would be to replace STAR with a local aid formula entirely independent of property tax receipts.

However, even if the STAR program is maintained, it could be made significantly less harmful by implementing the commission's recommendations, if such reforms (1) reduce the number of taxpayers receiving STAR benefits, (2) reduce the magnitude of the property tax subsidy, and (3) make the tax treatment of property more neutral by including renters. STAR reform is an ideal area for bipartisan cooperation: liberals should want to fix the program because it is in many ways regressive,<sup>4</sup> and conservatives should want to fix it because it encourages growth of government and wasteful spending at the local level.

## **2. Limit the annual rise in a municipality's total property tax levy to 4 percent or 120 percent of CPI, whichever is less**

The limit would apply to all property (including non-residential), and increases below the cap in one year could be "banked" for use in later years. Additionally, voters could approve a larger increase with a 55 percent or 60 percent supermajority vote, with the required margin depending on annual changes to state aid.

For note, currently, *all* New York school budgets are already subject to annual voter referenda. Voters can hold down their local property taxes by rejecting school budgets and insisting on lower spending. However, even though New Yorkers report high dissatisfaction with their property tax burden, over 90% of school budgets have been approved since 1998.

The commission suggests that (1) putting the tax levy itself instead of the school budget before voters will make the tax question more transparent and voters more likely to insist on slower revenue growth, and (2) limiting referenda to years when the budget growth is particularly large will focus voters on the importance of restraining tax revenues. This is plausible, based on Massachusetts' experience with a system very similar to the one proposed in New York. Since the inception of Massachusetts' override process in 1980, only 39 percent of tax overrides have been approved.

On Thursday, Gov. David Paterson announced his support for the tax cap proposal (slightly modified to maintain the annual requirement for voter approval) and asked the legislature to implement it as soon as possible. At the Tax Foundation, we are generally lukewarm on

property tax limitation measures like this one; we believe they often lead municipalities to blame the cap for slower growth of services, and therefore demand increased state aid, leading to rises in other taxes. However, this could be a favorable reform if coupled with meaningful spending control measures described below.

### **3. Take steps to control growth of education spending**

New York primary and secondary education spending grew an average of 7.9 percent over the last six years, well above the 5.0 percent national average. Any reform that reduces property taxes but does not address the growth of spending will simply necessitate the increase of some other tax to fund education. Expense control measures are likely to be the most politically difficult part of any property tax reform plan, but they are essential to its long-term success.

Measures proposed by the commission to control expenses include (1) improving municipalities' collective bargaining positions with teachers' unions by repealing a law that grants teachers annual pay raises even if they do not approve a new contract, (2) obligating school district employees to contribute toward the cost of health insurance, (3) requiring cost-benefit analysis for new education mandates at the state level, and (4) repealing a law that requires school districts to use many contracts within each school construction project, artificially increasing construction costs.

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### **Notes**

1. See Joseph Henchman, "Amazon Files Suit Against New York Tax on Out-of-State Businesses," Tax Foundation Tax Policy Blog, May 2, 2008, <http://www.taxfoundation.org/blog/show/23179.html>.

2. *A Preliminary Report of Findings and Recommendations to Governor David A. Paterson*, available at [http://www.cptr.state.ny.us/reports/CPTRPreliminaryReport\\_20080603.pdf](http://www.cptr.state.ny.us/reports/CPTRPreliminaryReport_20080603.pdf).

3. Nicholas Confessore, "Panel Urges 4% Tax Cap on Property in New York," *New York Times*, June 3, 2008, available at [http://www.nytimes.com/2008/06/03/nyregion/03taxes.html?\\_r=1](http://www.nytimes.com/2008/06/03/nyregion/03taxes.html?_r=1).

4. Looking only at the set of homeowners in any one county, the system appears progressive, providing a larger percentage benefit to the owners of less valuable homes. However, several features of the program are regressive. New Yorkers who pay school taxes indirectly through rent tend to be less wealthy than homeowners, but receive no break under STAR, as renter-occupied property is excluded from the program. The program also provides the largest tax exemptions in wealthy suburban counties downstate; the amount of home value exempted from tax in tony Westchester is three times higher than in any upstate county. Finally, as the

STAR program grows, the exemptions and rebates must be funded by new revenue from other taxes. Most recently, this took the form of a \$1.25 jump in the highly regressive cigarette tax.

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