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It's Elementary

A Monthly Column by EFAP Director John Yinger
July 2012

Four Flaws in New York State's Property Taxes and How to Fix Them: The Homestead Option

This is the third of four columns on property taxes in New York State. This column explores the Homestead Option, which is another major structural flaw in the state's property taxes.¹

The Homestead Option is a classification law, which is defined as a law that allows a jurisdiction to charge different effective property tax rates for different types of property. In most cases, classification leads to a higher effective property tax rate on business property than on residential property.

Classification laws have pros and cons. On the plus side, classification with a higher tax rate on business property can shift some of the property tax burden in a low-income city onto nonresidents, many of whom benefit from city services. For example, some city businesses are owned by people who live in the suburbs but work in the city. In addition, some city businesses are owned by shareholders who live around the country. A higher tax rate on business property will shift some of the tax burden off of city residents and onto these relatively high-income nonresidents. The incidence of the property tax is difficult to determine, and some of the taxes on business property might be shifted to consumers or workers. Thus, property tax classification with a higher tax rate on business property would undoubtedly lead to an increase in tax exporting, but the extent of this increase is not known.

Another advantage of classification is that it can ease the unfair impact of a reassessment on residential property. In the case of Boston, for example, decades of poor assessments resulted in a much higher effective property tax rate on business than on residential property. Without classification, a major revaluation that took place in the early 1980s would therefore have resulted in a large increase in residential property tax rates. This increase would have been arbitrary and unfair to homeowners.² Classification, in the form of a higher mill rate for business

¹ The rules for the Homestead Option can be found at: <http://www.tax.ny.gov/pdf/publications/orpts/homestead.pdf> .

² One could argue that this shift is not unfair to long-term homeowners, who have benefited from low assessments for many years. In their case, re-assessment can be thought of as a repayment of an implicit loan from the city. But recent homebuyers had no benefit from the low residential assessments, and, indeed, may have paid a premium for their homes because the taxes were so low; re-assessment imposes arbitrary and unfair tax increase in these buyers.

than for residential property, allowed Boston to eliminate variation in assessment/sales ratios within a class of property through revaluation, while preserving the relatively low effective tax rate for residential property.³ In New York State the Homestead Option makes it possible to avoid comparable unfair increases in taxes on homeowners associated with re-assessment, although these increases are not likely to be as large as they were in Boston.

The big disadvantage of classification is that it generally is set up with a higher tax on business property—and may therefore discourage economic development. The best available evidence indicates that a city’s business property tax rate has an extremely small impact on economic development, but the effect is not zero.⁴

In New York, assessing units that complete a state-approved revaluation are allowed to implement the Homestead Option, which is a type of classification. More specifically, the homestead option allows the unit to preserve the levy shares that existed before revaluation. If business property provided 50 percent of the levy before revaluation, then passing the Homestead Option would keep business property’s share at 50 percent, even if business property only made up 40 percent of the post-revaluation assessments. The only way to accomplish this outcome is to set a higher post-revaluation nominal tax rate—and hence a higher effective property tax rate—on business property than on residential property. (Assessing units have some leeway to vary from the pre-revaluation business share, but these provisions are rarely used and are not central to the points in this column, so they are not considered here.)

The problem is that this arrangement focuses on levy shares instead of effective property tax rates. In most parts of New York, the value of business property has not been growing as fast as the value of residential property. As a result, the only way to keep the business share fixed, at 50 percent in my example, is to gradually raise the effective property tax rate. So what we have witnessed in jurisdictions with the Homestead Option is steadily rising effective property tax rates on business property.

Because classification has pros and cons, it might make sense under some circumstances to balance them by selecting an effective property tax rate that is somewhat higher than the residential property tax rate. But it makes no sense at all to say that the net benefits from classification are rising over time so the gap between the business and residential rates should rise as well. And it certainly makes no sense to implement a policy in which this rate gap is likely to go up continually and without limit. But that is exactly the impact of New York’s bizarre Homestead Option.

Moreover, businesses may not respond very much to differences in relatively unchanging effective property tax rates across communities, but they are likely to respond to a situation in which the effective tax rate is almost certain to increase steadily—at an unknown pace.

³ For further discussion of the Boston case, see J. Yinger, H.S. Bloom, A. Boersch-Supan, and H.F. Ladd, *Property Taxes and House Values*, New York: Academic Press, 1988.

⁴ For a detailed estimate of this effect in New York State, see W. Wong, “Taxes and State and Local Economic Development: The Homestead Tax Option in New York,” unpublished Ph.D. dissertation, Syracuse University, 1998. (Available through the Syracuse University library.)

Businesses like predictability, so it might be hard to attract business to locations in which the effective property tax rate on business property is following an uncertain upward path.

As of January 2001, 12 cities, 17 towns, 4 villages, and 42 school districts were using the Homestead Option. To aid these jurisdictions—and all others that consider classification in the future—the Homestead Option should be changed so that it focuses on effective tax rates, not levy shares. Jurisdictions that revalue should be allowed—but not required!—to set differences in effective tax rates for business and residential property, up to the difference that existed before revaluation.

Correction: My June 2012 column inadvertently left out the word “percent” in describing recent experience with overrides. Here is the corrected sentence:

In May 2012, about 7 percent of New York’s school districts presented budgets that required an override, and about 60 **percent** of these budgets passed.