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It's Elementary

A Monthly Column by EFAP Director John Yinger

March 2008

Is a Circuit Breaker the Solution for Property Tax Relief in New York?

In the current debate about property tax relief in New York State, several groups have proposed a large expansion of the state's small existing circuit breaker. As I stated in my last column, a circuit breaker might have some of the same unintended consequences as the STAR program. In this column, I explain this point in more detail and examine other features of an expanded circuit-breaker program.

A standard circuit breaker provides an income tax rebate to taxpayers whose property tax payment exceeds a specified share of its income, say b . The rebate is set at a share, say a , of the difference between the property tax payment and b percent of the household's income.¹ For example, a circuit breaker might rebate 50 percent (a) of the difference between a household's property tax payment and 3 ½ percent (b) of its income. This approach is designed to ensure that the burden of the property tax, measured as a share of household income, is kept as low as possible.

As discussed in previous columns, STAR has three major problems. Do these same problems arise with a circuit breaker?

The first major problem with STAR is that it is unfair across taxpayers. Because it is tied to income, a circuit breaker is a much more progressive policy than a homestead exemption, such as STAR. Switching from STAR to a broad-based circuit breaker would therefore boost the progressivity of property taxes in New York. Moreover, renters are eligible for New York's current circuit breaker, which only applies to taxpayers with incomes below \$18,000 (for a single filer). The inclusion of renters in an expanded circuit breaker would also address the major inequity that results from the exclusion of renters from STAR. Finally, a circuit breaker is unlikely to contain anything equivalent to

¹ More formally, for any given household let R be the circuit-breaker rebate, T be the property tax payment, and Y be income. Then the standard circuit-breaker formula is $R = a(T - bY)$. The rebate equals zero when T is less than bY .

STAR's extremely unfair "sales price differential factor," which gives higher exemptions to taxpayers in wealthier counties. A circuit breaker may not be fair in all dimensions; for example, it might reward rich homeowners who buy huge mansions. Nevertheless, replacing STAR with a circuit breaker would greatly improve the fairness of New York's property tax system.

A second major problem with STAR is that it is poorly aligned with the objectives of New York's education finance system. In fact, the school districts that receive the largest financial benefits from STAR are wealthy downstate districts that are not in need of additional state aid, and the districts that receive the smallest financial benefits from STAR are the neediest city districts. A circuit breaker would not solve this problem, because it would not be well integrated into the state's education finance system. Nevertheless, switching from STAR to a circuit breaker would be a step in the right direction, because this change would shift more of the tax relief toward lower-income districts and, if renters were included in the circuit breaker, toward city districts, which tend to have a high concentration of renters.

The third major problem with STAR is that it has severe unintended consequences, and in particular that it strongly encourages local voters to raise their tax rates and hence undermine their own property tax relief. Unfortunately, a circuit breaker would have exactly the same problem. Without STAR or a circuit breaker, local taxpayers must bear the full burden of any increase in local school property taxes. As shown in previous columns STAR lowers the impact of any increase in school taxes because a share of any increase is paid by New York State. This effect is equivalent to a reduction in the price of education and therefore encourages voters to spend more on schools, that is, to raise their property tax rates. With a circuit breaker, New York State would also pick up a share of any increase in local property taxes. In fact, this share is equal to the a parameter in the circuit-breaker formula. Hence a circuit breaker for school property taxes would cut the price of education by a percent. With a set at 50 percent, as in the above example, a circuit breaker would cut the price of education in half. The current small circuit breaker only applies to a few very-low-income voters, so it does not have any impact on voting outcomes, but an expanded circuit breaker for school taxes would probably lower the price of education for most voters and would therefore encourage higher education spending, just like STAR does.

As in the case of STAR, the best way to avoid this problem with a circuit breaker is to put a limit on the school property tax rate that would go into the tax-relief formula. The maximum rate calculating the circuit-breaker rebate could be set, for example, at or near the current state average property tax rate.

So what should New York State do? First, regardless of whether it sticks with STAR or switches to a circuit breaker, New York should impose a maximum on the property tax rate that is used to calculate property tax relief. This is the only way to eliminate the severe unintended consequences that have been caused by STAR and that would be caused by an expanded circuit breaker.

Second, replacing STAR with an expanded circuit breaker would make the state's property tax system fairer and lessen somewhat the current conflict between property tax relief and the state's education finance system. Because this switch would be so progressive, however, and so unfavorable to powerful constituencies in the state, such as the downstate suburbs, I expect that it is unlikely to make it out of the legislature. If STAR is not replaced, an expansion of the current circuit breaker (with a maximum tax rate!) would be a much fairer way to provide additional tax relief than would a further expansion of STAR.

Third, New York should consider the use of a circuit breaker formula to defer property tax payments for homeowners in locations that have experienced rapid increases in property values. A program of this type is currently used in Florida. The main impact of rapid house-price appreciation, of course, is to make homeowners richer. Just as our society does not give special tax treatment to people who win the lottery, it should not forgive taxes for people whose principal asset, their house, has experienced a large increase in value. Nevertheless, rapid increases in house values, and accompanying rapid increases in property taxes, can cause a difficult cash-flow problem for homeowners. These homeowners may be richer, but their wealth is tied up in their house and they may not have access to private financial instruments, such as reverse mortgages, that would allow them to tap into their new wealth. Thus, it makes sense for the state to allow taxpayers with large increases in their property taxes relative to their incomes to defer their property tax increases until their house changes hands. When the house does change hands, the household should pay all deferred property taxes, with interest. This approach, which is equivalent to a state-provided reverse mortgage, solves the household's cash flow problem without any unfair linkage between property tax relief and new-found wealth.