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Eliminating STAR's Unintended Consequences

John Yinger
The Maxwell School, Syracuse University, joyinger@syr.edu

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It's Elementary

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As discussed in a previous column (June 2005), New York's School Tax Relief Program, STAR, has many unintended consequences. These consequences include higher school tax rates and higher school-district inefficiency. This column presents a simple reform that would minimize these unintended consequences.

The existence of these unintended consequences is now widely acknowledged. A recent report by the New York State Comptroller, for example, argues that

> While STAR indisputably provides property tax relief for those receiving it, its long-term impact may well be an overall increase in State and local taxes… By reducing the local tax share paid for greater school spending, STAR actually provides an incentive to increase school spending.[1]

The link between STAR and the "local share paid for greater school spending" exists because STAR is based on a school district's actual property tax rate. If the school district raises its tax rate, it receives a larger STAR reimbursement. The perverse incentives in STAR can be cut back, therefore, by breaking this link.

The extensions of STAR proposed by Governor Pataki and the New York State Legislature suggest a simple way to break this link and eliminate these unintended consequences. These extensions call for school property tax rebates to be sent directly to homeowners instead of to school districts, as are the basic STAR payments.

As discussed in my January 2006 column, these extensions magnify the price subsidy in the basic STAR program and therefore give voters additional incentive to raise their local property tax rates. This additional incentive could be eliminated by re-designing these rebates so that they are based on **the average school property tax rate in the state** the previous year instead of on a homeowner's actual school tax rate. With this approach, the rebates have no impact on the amount a homeowner must pay for an **increase** in school spending—and therefore do nothing to encourage boosts in school spending and tax rates.[2]

Moreover, this approach could be used to eliminate the price incentives in STAR altogether. Currently, STAR requires a homestead exemption for homeowners and compensates districts for the resulting lost property tax revenue. By changing this exemption/compensation system into rebates given directly to homeowners and basing all rebates on the statewide average tax rate (not the actual rate in the homeowner's district), the link between STAR and the "local share paid for greater school spending" could be completely broken.

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[1] http://www.osc.state.ny.us/localgov/pubs/research/propertytaxes.pdf.

[2] The Governor's version limits rebates to homeowners in school districts that keep their annual school spending increase below a specified cap. As discussed in my previous column, this is an unfair way to minimize STAR's unintended consequences. The approach presented here would be fairer and more effective. As of this writing, it is not clear whether STAR rebates will be implemented and, if they are, whether they will follow the Governor's or the legislature's proposal.

Suppose the state-wide average tax rate is 2 percent of market value. Then a typical district would receive a payment from the state equal to (.02)($30,000) = $600 for each homeowner, regardless of the actual school property tax rate in the district. With the new 30 percent STAR extension, this payment would be (.02)($30,000)(1.3) = $780. The payments would be higher for low-income elderly homeowners, of course, and would be higher in counties where the sales price differential factor boosts the STAR exemption above $30,000 (unless this unfair provision is repealed—as it should be!).

The reform proposed here would eliminate the price subsidy built into STAR but it would not completely eliminate the impact of STAR on local voters. Rebates do give homeowners more disposable income and therefore increase their demand for many things, including education. Nevertheless, many studies find that the impact of a change in disposable income on the demand for education is small, and switching to these rebates would dramatically lower the impact of STAR on school tax rates.

This reform also would add an element of fairness to STAR. Under its current design, STAR provides greater compensation to districts that set higher property tax rates, even if those rates are high because of the districts' wasteful spending practices. If STAR rebates were based on a statewide average school tax rate, homeowners in inefficient districts would receive the same rebates as anyone else.

In addition, this reform could easily be extended to renters, which would also improve STAR's fairness. For example, under the assumption that renters pay 20 percent of the property tax on their apartment buildings in the form of higher rent, an estimate supported by some recent research, STAR rebate checks to renters could be set at (.02)($30,000)(.2) = $120 [or (.02)($30,000)(1.3)(.2) = $156 with the recent extension.]

It is profoundly ironic that the School Tax **Relief** program has resulted in large school tax rate **increases** across New York State. These tax rate increases have offset one-third or more of the initial STAR property tax savings for homeowners and they have raised property taxes by 20 percent or more on commercial and industrial property. These effects arise because STAR lowers the impact of tax increases on local voters. These effects could be eliminated by (1) transforming all STAR subsidies into rebates given directly to homeowners and (2) basing these rebates on the state-wide average school property tax rate, not the actual rate in a homeowner's school district.