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It's Elementary

A Monthly Column by EFAP Director John Yinger
May 2012

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

The property tax is the foundation of New York's local revenue system. It is the main source of revenue for public schools in New York and for many other local services, such as police and fire. It provides a relatively fair and stable tax base. It is fair because market value of property is a good indication of the owner's ability to pay and because market value usually can be estimated with reasonable accuracy even when it is not observed in a given year. It is stable because real estate values generally do not exhibit sharp change from one year to the next.

Of course, property tax rates may be too high. The property tax is only one component of the overall state and local public finance system in New York State, and it might be true that the State relies too heavily on the property tax relative to other broad-based taxes, such as the income and sales tax. It also might be too high because local governments provide too many public services. But those are questions for another column. My starting point for this column (and the three that follow) is that the property tax is, and should continue to be, a major component of New York States revenue system.

Since we are going to rely heavily on the property tax, we should make sure that it is designed in a fair and effective manner. This is not the case in New York State. So this column and the three that follow discuss four major structural problems with the property tax in New York State—and how to fix them.

The column this month is about New York's School Tax Relief Program, or STAR for short. I have written about STAR in previous columns. This column provides an updated perspective on the program.

STAR provides exemption from a portion of school taxes for all homeowners in New York.¹ The state then compensates school districts for the revenue they lose because of this exemption. There is nothing wrong with property tax exemptions, per se. Indeed, these exemptions can make the tax fairer, by most people's standards, because they lessen the tax burden the most on the on homeowners with the least valuable housing. However, the STAR exemptions have three major flaws.

The first flaw is that the design of these exemptions gives school districts an incentive to raise their tax rates. With a \$120,000 average house value, for example, a \$30,000 STAR exemption implies that $30/120 = 1/4^{\text{th}}$ of any tax increase will be picked up by the state. If the price of coffee drops by $1/4$, people will drink more coffee, and if the price of education drops by $1/4$, voters will spend more on education.

Several scholars have found that this incentive has had a real effect, which varies across districts.² Estimates by my colleagues William Duncombe, Tae Ho Eom, and me, for example, indicate that STAR has led to an increase in school spending in individual school districts between 1 and 7 percent and to an increase in property tax rates between 2 and 18 percent.

These tax rate increases not only offset a large portion of the initial tax savings for households, they also constitute a large tax increase for businesses, who do not receive STAR exemptions. STAR was introduced by Governor George Pataki. I find it ironic that by failing to recognize the incentives built into his own plan, this supposedly pro-business governor is responsible for such a large increase in property taxes on business property.

¹ The STAR exemptions were supplemented with income tax rebates for a few years, but those rebates were eliminated in 2009.

² See J. E. Rockoff, "Local Response to Fiscal Incentives in Heterogeneous Communities," *Journal of Urban Economics* 68 (2) (September 2010), pp.138-147 and W. Duncombe, T. H. Eom, and J. Yinger, "The Unintended Consequences of Property Tax Relief: New York State's STAR Program," Paper presented at the annual conference of the Association of Policy Analysis and Management, November 2011.

This flaw could easily be removed by basing state compensation on the state average school property tax rate—not the rate selected by an individual district. This change would eliminate a district’s incentive to spend more because STAR compensation would not increase when a district raised its own tax rate.

STAR also has two provisions that make it very unfair. The first provision is that it does not provide any compensation to renters. As a result, the STAR compensation from the state is much higher in rich districts than in poor districts. Downstate small cities, for example, receive STAR compensation of over \$2,000 per pupil, for example, compared to only about \$400 per pupil for the upstate Big Three cities.

STAR is part of the state’s education finance system. It would be perceived as wildly unfair to have a state education aid program that provided funds based on homeownership, and STAR should be held to the same standard. The state should extend STAR to renters. This extension could be implemented in the form of a rebate for renters on New York State income taxes.

Another provision of STAR makes it even more unfair, namely the Sales Price Differential Factor. This provision, which costs state taxpayers \$1 billion, increases the exemption in counties with above-average home sales prices. As a result, the 2010 exemption in Westchester County was \$99,111, whereas the exemption in most of the upstate counties was \$30,000. Proponents of STAR have tried to argue that this is just a correction for the cost of living, but the truth is that tax systems do not—and should not—account for variation in the cost of living across locations. Markets already pay higher wages in locations with higher costs of living, and it makes no sense for governments to subsidize people for living in high-cost locations. In short, the Sales Price Differential Factor is profoundly unfair and should be removed from STAR.

Overall, STAR makes the property tax fairer within a school district because it provides the most relief to homeowners with the least valuable houses. As currently designed, however, STAR gives local voters an incentive to boost property tax rates and it gives unfair preference to school districts with a relatively high concentration of homeowners or with relatively high property values. These are serious problems but they could easily be corrected. Reforms to STAR should be on the agenda of New York State’s policy makers.

