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It's Elementary

A Monthly Column by EFAP Director John Yinger
October 2012

Holding Tax Shares Constant Is a Bad Idea: What the Homestead Tax Option in New York Can Teach Us about Romney's Income Tax Proposal

The Republican presidential candidate, Mitt Romney, has proposed a tax system in which the share of taxes paid by the top 1 percent of taxpayers remains constant. In an interview on "Face the Nation" on June 17, 2012, Mr. Romney said that "one of the absolute requirements of any tax reform that I have in mind is that people who are at the high end, whether you call them the 1 percent or 2 percent or half a percent, that people at the high end will still pay the same share of the tax burden they're paying now."¹

New York State has some experience with this type of program design through its "Homestead Tax Option" for the property tax (HO for short). This column describes the provisions that hold tax shares constant with the HO, discusses the experience with these provisions in cities that have adopted the HO, and explains why the use of this approach in the federal income tax would be a major disaster.

As discussed in my July 2012 column, the HO is a complicated possibility that allows a city to apply a different property tax rate to residential and nonresidential property.² This option is attached to revaluation of the city's taxable property. A revaluation often leads to a situation in which the effective property tax rate (that is, taxes as a share of true market value) on residential property goes up and the effective property tax rate on commercial and industrial property goes down. Some cities delay reassessing their property, even when their assessments are out-of-date, because this type of shift is unfair and unpopular. As a result, they may retain a system with poor assessments that unfairly impose higher property taxes on some homeowners than on others whose houses have the same value. The HO is designed to encourage revaluation, along with its improvement in equity across homeowners, while preventing the unfair and unpopular shift in the tax burden from nonresidential to residential property.

More specifically, the HO defines homestead property as single-family houses and apartment buildings with only a few units, and allows a city to adjust the homestead and non-homestead property tax rates so that each type of property pays the same share of property taxes that it did before revaluation. This is a perfectly reasonable starting point. The problem is that in

¹ The transcript for this interview is posted on the internet at: http://www.cbsnews.com/2102-3460_162-57454827.html?tag=contentMain;contentBody. Mr. Romney has made similar comments in other interviews.

² The full details of the HO can be found in the pamphlet, "The Homestead Option Tax," published by the New York State Department of Taxation and Finance, Office of Real Property Tax Services in January 2011 and available at: <http://www.tax.ny.gov/pdf/publications/orpts/homestead.pdf>. Many of these details are not considered here, such as provisions that allow a jurisdiction to phase out the HO. The quotation in the text is from this pamphlet. The pamphlet says that the HO is used by "12 cities, 17 towns, four villages and 43 school districts."

later years, the HO keeps the focus on tax shares instead of focusing on tax rates. To be specific, the HO requires a city to adjust its effective tax rates for the two types of properties based on property tax shares. These requirements are not binding for small changes in the homestead or non-homestead tax bases, but they can have a major impact if long-term changes in these tax bases are large.³

Because of these requirements, the effective tax rates for homestead and non-homestead property depend on long-term property value trends. If the value of a city's commercial and industrial property goes down without a large decline in city population (and hence in the value of homestead property), then this provision requires an increase in the effective property tax rate on business property. In contrast, rapid population decline in a city may have a relatively large impact on the homestead portion of the tax base and lead to an increase in the effective tax rate on homestead property. These types of changes in the property tax rate have nothing to do with the problems caused by poor assessment and I do not know of any policy justification for them.

In the case of Buffalo, NY, for example, the ratio of the non-homestead property tax rate to the homestead tax rate was 1.82 in 1995, about a decade after the implementation of the HO. This ratio went up to 2.82 in 1999, and then declined to 1.65 in 2011.⁴ This experience obviously introduces considerable uncertainty into the future path of property tax rates on commercial and industrial property. This uncertainty will make it difficult for businesses to plan their construction projects and may, indeed, discourage some of them from considering new projects at all. Moreover these changes in relative tax rates are unrelated to any fairness principles.

Now let us turn to the Romney Rule for the federal income tax. Any tax plan that holds the tax share of the top 1 percent constant requires the tax rate paid by the top 1 percent to decline as their income grows relative to the bottom 99 percent.⁵ From 1953 to 1981, the income of the top 1 percent earned about 10 percent of all income.⁶ This income share increased rapidly until it reached a peak of about 24 percent in 2007. The latest income share, for 2010, is 20 percent. The following table shows the relationship between the income share of the top 1 percent and the tax rate that is required to hold the tax share of the top 1 percent constant.

³ My July column did not provide the details of these adjustments. I plan to provide a more complete explanation in a future column.

⁴ Data on homestead and non-homestead property tax rates is difficult to come by. These figures come from Kent Gardner, "Non-Homestead Tax Rates and City Competitiveness," Center for Governmental Research Inc., available at: <http://www.policyarchive.org/handle/10207/bitstreams/10959.pdf> and Minnesota Taxpayers' Association, "50-State Property Tax Comparison Study," various years, available at <http://www.lincolnst.edu/subcenters/significant-features-property-tax/resources.aspx> .

⁵ The algebra behind this assertion can be found in the appendix to this column.

⁶ This figure and the following ones are documented in Emmanuel Saez, "Striking it Richer: The Evolution of Top Incomes in the United States" (Updated with 2009 and 2010 estimates), which is available at: <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2010.pdf>

Changes in the Tax Rate on the Top 1% that Are Required to Keep
Their Tax Share Constant

If the Income Share of the Top 1% Is:	Then the Required Change in the Tax Rate of the Top 1% Is:	And the New Rate for the Top 1% Is:
15.0%	41.7%	34.0%
16.0%	31.3%	31.5%
17.0%	22.1%	29.3%
18.0%	13.9%	27.3%
19.0%	6.6%	25.6%
20.0%	0.0%	24.0%
21.0%	-6.0%	22.6%
22.0%	-11.4%	21.3%
23.0%	-16.3%	20.1%
24.0%	-20.8%	19.0%
25.0%	-25.0%	18.0%

Note: These calculations hold total taxes and the income of the bottom 99% constant (or, equivalently, they hold the tax rate on the bottom 99% constant), they assume a starting income share of 20% for the top 1% (which was the share in 2010), and they assume a tax rate for the top 1% of 24% (the rate in 2009).

This table indicates that an increase in this income share from its current (2010) value of 20 percent back to 24 percent would require a 21 percent cut in the average tax rate of the top 1 percent. The average tax rate of the top 1 percent was 24 percent in 2009, so this change in the income share would cut the tax rate of the top 1 percent down to 18 percent.⁷ In contrast, if the income share of the top 1 percent dropped to 15 percent, their average tax rate would have to increase by about 42 percent.

Because the income share of the top 1 percent is difficult to predict, these results imply that the implementation of the Romney Rule would lead to enormous tax uncertainty for the nation's wealthiest taxpayers. In doing their long-term tax planning, they would have to guess what their rate was going to be in the years ahead. As in the case of the Homestead Option, this type of uncertainty is not a desirable feature of a tax system.

Although the change in the income share of the top 1 percent is uncertain, the most likely outcome over the next few years is that this share will increase. Recent evidence indicates, for example, that "the top 1% captured 93% of the income gains in the first year of recovery... It is likely that this uneven recovery has continued in 2011 as the stock market has continued to recover."⁸ This suggests that the income share of the top 1 percent is likely to keep rising for the

⁷ The average tax rate for the top 1 percent of taxpayers can be found at: <http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Tax-Rate-and-Income-Percentile>

⁸ See the paper by Saez cited in Note 3.

next several years as the economy grows. If so, the implementation of the Romney Rule would lead to a steadily declining tax rate for the wealthiest Americans, and to steadily declining fairness—at least by most people’s standards—in the federal income tax.

In short, the Romney Rule is a bad idea and it should be rejected regardless of whether or not Mr. Romney becomes President.

Appendix: The Algebra of the Romney Rule

Let t stand for an average income tax rate and Y for the total income earned by a given group. Let a subscript “1” indicate the top 1 percent the income distribution and a subscript “99” indicate the bottom 99 percent. The Romney Rule holds the share of taxes paid by the top 1 percent to a given fixed value, say s . In symbols, the Romney Rule is:

$$\frac{t_1 Y_1}{t_1 Y_1 + t_{99} Y_{99}} = s$$

This equation can be solved for the tax rate on the top 1 percent, namely, t_1 , that is required for the Romney Rule to hold. The result:

$$t_1 = t_{99} \left(\frac{s}{1-s} \right) \left(\frac{Y_{99}}{Y_1} \right)$$

This equation shows that the required tax rate on the top 1 percent declines whenever the income of the top 1 percent, Y_1 , grows relative to the income of the bottom 99 percent, Y_{99} .

Finally, the income of the top 1 percent can be expressed as a share, say r , of total income in the economy:

$$\frac{Y_1}{Y_1 + Y_{99}} = r$$

This definition implies that $(Y_{99}/Y_1) = (1 - r)/r$. Substituting this expression into the above result yields another form of the Romney Rule:

$$t_1 = t_{99} \left(\frac{s}{1-s} \right) \left(\frac{1-r}{r} \right)$$

This form of the Romney rule was used to generate the results in Table 1. Because $t_{99}s/(1-s) = Ts/Y_{99}$, where T is total tax revenue, holding t_{99} constant is equivalent to holding T/Y_{99} constant.