

# Education Finance and Accountability Program (EFAP)

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## *It's Elementary*

A Monthly Column by EFAP Director John Yinger

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### **The Unintended Consequences of Property Tax Relief**

High local property taxes are a source of frustration for voters in many states. Moreover, the combination of high school property taxes and wide variation in district wealth per pupil is a major source of existing disparities in educational funding. Not surprisingly, therefore, many elected officials have supported property tax relief, not only as a way to gain political favor for cutting taxes but also as a way to add balance to the state's revenue system and to reform educational finance. The trouble is that property tax relief programs often have significant unintended consequences.

New York State provides an ideal case study. In 1997, New York passed the School Tax Relief Program, STAR, which became fully effective in 2001. STAR exempts from school property taxes a certain amount of a house's value. The basic STAR exemption, \$30,000, is available to all homeowners, whereas an enhanced STAR exemption, \$50,000, is available only for elderly homeowners with annual incomes below \$60,000. Consider a house worth \$100,000 in a school district with a 1.5 percent property tax rate. Without STAR, a

nonelderly owner of this house pays a property tax of  $(.015) \times (\$100,000) = \$1,500$ , but with STAR, this owner's tax drops to  $(.015) \times (\$100,000 - \$30,000) = \$1,050$ , a reduction of \$450, or 30 percent.

STAR has two other key provisions: renters receive no exemption, and STAR exemptions are adjusted upward by a "sales price differential factor" in counties with a median house sales price above the state average.

New York State funds STAR; that is, each school district is compensated by the state for the revenue it loses because of the STAR exemptions. Thus, STAR acts as a type of state aid. Because of their high renter populations, all the large cities in New York except Yonkers receive relatively little benefit from STAR. In contrast, the wealthy suburbs of New York City receive relatively large benefits because of their high homeownership rates and their high house values. In 2001-2002, the STAR program provided property tax relief per pupil ranging from \$320 in New York City and \$564 in the upstate big cities to \$1,395 in the wealthy downstate suburbs.

The most serious problem with STAR is that rental and sales-price provisions result in an unfair distribution of tax relief. Despite the funding needs of the large cities, which are highlighted by the CFE case (discussed in several previous columns), STAR distributes roughly \$3 billion dollars in a manner that is heavily skewed toward low-need districts.

STAR also has had some fairly dramatic unintended consequences, namely, that it has led to increased spending and increased property tax rates in school districts throughout the state. The rate increases offset some of the original STAR tax savings for homeowners, and they boost the tax burden on commercial and industrial property. The higher spending has boosted educational performance, but because STAR ignores student needs, and rewards wealthy counties, it has not led to more equity in educational spending or outcomes.

The mechanism behind these changes is straightforward. By exempting a share of residential property from taxation, STAR lowers the "price" a voter must pay for any increase in educational services. If a voter has a house valued at \$90,000, then exempting \$30,000 or one-third of that value from taxation is equivalent to cutting the voter's "price" by one-third. Just as people buy more coffee when the price of coffee falls, voters vote for more educational services when the price of these services falls. According to estimates by my EFAP colleague William Duncombe, Professor Tae Ho Eom of Rutgers University, and me, a 1 percent drop in the price of educational services through STAR leads to about a 0.2 percent

increase voters' the demand for student performance, which is purchased through higher taxes. When the price is cut by one-third, as in the above example, performance goes up by  $(33)(.2) = 6.6$  percent. In 2002, STAR cut the price in the average district by 32 percent, with considerably higher cuts in some districts.

Overall, therefore, STAR is distributed in a profoundly unfair manner and, ironically, it has led to a substantial increase in property tax rates in New York State. Although STAR does provide some net property tax relief to homeowners, the \$3 billion that is spent on STAR every year would do more to promote equity in the state's education finance system, while lowering the burden of school property taxes, if it were shifted into a comprehensive revision of the state's educational aid programs.

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