

Memorandum

To: The Property Tax Cap Reform Commission
From: Courtney Adrian and Dominick Napolitano
Date: May 4, 2015
Re: Adjustments to the Property Tax Cap

Abstract: This paper outlines the origins of the New York State Property Tax Cap and finds that: 1) high school taxes in New York are largely a function of uncontrollable costs like pensions 2) the law contributes to funding disparities between wealthy and poor districts 3) similar laws in other states have resulted in lower property taxes but at the expense of quality instruction 4) provisions surrounding PILOT agreements pose particular problems, and 5) the law is very popular and unlikely to be repealed. In order to address the problems identified here the authors recommend changes to the treatment of Pensions and PILOTS under the cap. They also urge the state to fully fund the Foundation Aid Formula in order to alleviate funding inequities.

Introduction¹

In 2011, the New York State Legislature passed and the Governor signed the law known as the 2 Percent Property Tax Cap. The law applies to both school districts and municipalities, requiring that their annual spending totals within enacted budgets do not exceed an approximately 2 percent increase over the previous year. This memo will focus on the cap as it relates to school districts. The intent of the legislation was to tamp down on what leaders saw as rapidly increasing property taxes, to improve the state's reputation as the highest tax state in the nation, and foster a more business friendly climate. The median homestead property tax bill in New York (\$4,090) was twice the national median (\$2,043) in 2012.²

The phrase "2 percent property tax cap" is a misnomer. In reality each city, town, village, and school district has a new cap calculated for their district each year due to a handful of exclusions to the cap including: 1) capital spending and debt service, 2) pension contribution increases that exceed 2 percent, 3) costs stemming from court settlements, 4) increases in the tax base resulting

¹ Because the tax cap legislation is so recent, much of the research surround its effects has been conducted by think tanks, governmental departments, and districts themselves. None of the sources cited in this brief which relate to the effects of the New York State cap have been peer reviewed for publishing in a scholarly journal.

² New York State Governor's Office. "Reducing Property Taxes for New Yorkers: The New York State Property Tax Cap's Successful First Year." September 27, 2012.

from capital improvements to residential property within a given year, and; 5) unused levy growth carryover from the previous year of up to 1.5 percent.³ The law also states that the cap shall be the lesser of the calculated value or the rate of inflation. In 2014 and 2015 the inflation rate dipped below the 2 percent cap and became the prevailing provision.⁴ It is possible for a school district to have a negative cap or in extreme cases to have a double digit one. School districts may choose to override their cap by obtaining the approval of over 60 percent of all school budget voters.⁵

The primary goal of the legislation was to reduce property tax bills for homes and businesses statewide but a secondary one was to force schools to run more efficiently, trim the fat, share services, and consider consolidation.⁶ This legislation's contribution to "starving the beast" or enacting tax cuts deliberately to force spending reductions was and remains appealing to the Governor and Senate leaders.⁷ Since its enactment, property tax rates have in fact leveled. According to the New York State Comptroller's Report, "Property tax levy growth has slowed over the last several years, from a peak increase of 7.7 percent in local fiscal year ending (FYE) in 2003 to a 2.0 percent aggregate increase in FYE 2013."⁸ However, what is the main topic of debate among the law's supporters and advocates is whether the reductions have come as a result of increased efficiencies or cuts in the quality of education.

School Funding Gap

Governor Cuomo and other state officials are quick to tout New York's standing as the national leader in education spending. They note that between the 1997/1998 and 2012/2013 school years, school district expenditures more than doubled, from \$27.6 billion to \$58.3 billion. Moreover, since the 2005/2006 school year, New York has led the rest of the country in per pupil

³ "The Property Tax Cap: Guidelines for Implementation." New York State Department of Taxation and Finance: October 2011.

⁴ New York State Office of the Comptroller, Division of Local Government and School Accountability. "Property Tax Cap Inflation and Allowable Levy Growth Factors." Retrieved from <http://osc.state.ny.us/localgov/realprop> on 2/21/2015.

⁵ McMahon, E.J. "New York State's Property Tax Cap," The Empire Center, November 30, 2011.

⁶ New York State Governor's Office. "Reducing Property Taxes for New Yorkers: The New York State Property Tax Cap's Successful First Year." September 27, 2012.

⁷ Reisman, Nick. "Skelos: Don't Tinker with Tax Cap." State of Politics (Time Warner Cable News), 1/12/2015.

⁸ This statistic includes school districts and local governments. Office of the State Comptroller. "2014 Annual Report on Local Governments." Retrieved from <http://www.osc.state.ny.us/localgov/datanstat/annreport/> on 2/21/2015.

spending.⁹ Looking more carefully at recent trends, however, reveals a dramatic slowing of growth in education spending that some argue may lead to diluted program quality and jeopardize the well-earned reputation of New York's schools.

In the first school year impacted by the tax cap, 2012/2013, we see that spending remained virtually unchanged from the previous year (see Appendix A). This slowdown stands in stark contrast with preceding school years, going back to 1993/1994, which, despite multiple recessions, experienced consistent year-over-year growth. Holding the tax levy relatively steady and reining in government spending will be taken in some circles as evidence of the property tax cap's success. But when we consider that education costs do not hold steady, and in fact grow at a higher than 2 percent rate, a dramatic and increasing funding gap is revealed. Appendix B shows this trend clearly. The culprits here, according to Deborah Cunningham of the New York State Association of School Business Officials, are skyrocketing pension costs and the rising costs of debt maintenance.¹⁰ Others have cited an increase in costs associated with healthcare, special education, transportation, and building maintenance.¹¹

It is important to note that the tax cap policy does provide a full exemption for debt service associated with capital projects, as well as a partial exemption for pension costs, which means school districts are not as constrained in their tax rate decision-making as Ms. Cunningham indicates. Nonetheless, there may be a possible crowd-out effect in which un-exempted pension increases are taking up a disproportionate share of the 2 percent levy increase, leaving less room for appropriate funding for programs.

The Impact of Spending Limit Laws in other States

Most other states in the nation impose some tax expenditure limit (TEL) like the property tax cap on its local governments.¹² Whether or not these limits are effective at actually lowering taxes largely depends on the specific provisions of the limit, but supermajority voting requirements

⁹ New York State Policy Office, Education Team, and the Division of the Budget. "The State of New York's Failing Schools: 2015 Report," p. 4.

¹⁰ Cunningham, Deborah H. "NY Property Tax Implications for School Districts," New York State Association of School Business Officials, December 17, 2014, p. 3.

¹¹ New York State's School Board Association. "Excelsior! Key Drivers Behind New York's 'Ever Upward' Property Tax Burden." April 2008.

¹² National Conference of State Legislatures. "State Tax and Expenditure Limits." Retrieved from <http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx> on 2/22/2015.

have been shown to result in spending reductions of two percent on average.¹³ Other researchers claim that, “A TEL is unlikely by itself to reverse the underlying conditions that yield expanding government.”¹⁴ In other words, it is impossible to actually “starve the beast”. In reality, you can only starve students. The property tax cap has only been effective in the state for three fiscal years and the long term effects of the cap on spending cannot yet be observed, although short term statistics show that it has slowed. For instance from FY 2014-15 to FY 2013-14 the average allotment for school district spending has actually been a decrease (not an increase) of 0.03 percent.¹⁵

The evidence on whether or not TELs harm educational outcomes is clearly yes. According to research conducted after passage of Proposition 13 in California, Proposition 2½ in Massachusetts, and TELs passed in measures in 47 other states, “I find that limitations are associated with larger student-teacher ratios and lower cost-of-living adjusted starting teacher salaries, all else equal... I find that limitations are associated with lower student performance on mathematics, science, social studies and reading examinations, all else equal.”¹⁶ Other researchers note, “A growing body of research is producing a consistent conclusion; imposition of tax and expenditure limits results in long-run reductions in the performance of public school students.”¹⁷ To summarize: in other states, the spending reductions have not resulted in increased efficiencies, but rather reduced services.

Funding Equity, Efficiency, and Behavior Distortion Concerns in New York Under the Cap

Whether or not New Yorkers will see long term savings or reductions in education quality caused by the cap will take time, but the effects of this program on funding equity between wealthy and poor districts can already be observed today. The most glaring problem with the cap is one of equity. A percentage cap on spending from year to year exacerbates funding inequities

¹³ The Tax Policy Center (Urban Institute and Brookings Institution). “State and Local Tax Policy: What Are Tax and Expenditure Limits?” from *The Tax Policy Briefing Book*. 8/20/2009.

¹⁴ Zycher, Benjamin. “State and Local Spending: Do Tax and Expenditure Limits Work?” American Enterprise Institute, May 2013. http://www.aei.org/wp-content/uploads/2013/05/-state-and-local-spending-do-tax-and-expenditure-limits-work_152855963641.pdf

¹⁵ Press & Sun-Bulletin, a Gannett Company. “NY’s Property Tax Cap Works; Don’t Undo It.” 2/28/2015. <http://www.pressconnects.com/story/opinion/editorial/2015/02/27/nys-property-tax-cap-works-undo/24131015/>

¹⁶ Figlio, David. “Did the ‘Tax Revolt’ Reduce School Performance?” *Journal of Public Economics* 65 (1997): 245-269.

¹⁷ Downes, Thomas A. and David N. Figlio, “Do Tax and Expenditure Limits Provide a Free Lunch? Evidence on the link Between Limits and Public Sector Service Quality,” *National Tax Journal*, March 1999.

between districts which rely primarily on the property tax as a revenue source (wealthy districts which have large property tax bases) and those who operate mostly on state aid (poor districts which have small property tax bases). A 2 percent increase on a school currently taking in \$10 million in property tax revenues results in a much higher increase than a school who only takes in \$5 million. In the following year, the 2 percent increase will be applied to a base that has increased by \$200,000 for the wealthy school where it will be applied to an increase of \$100,000 for the poor school. This ability for a school to provide own-source revenue will persist and become exponentially worse over time. If state-aid does not make up the difference, then the poor school will have less funding in the future. This phenomenon can be seen in Appendix C, where the schools in the highest decile receive the largest increases under the cap.

The State sets a per-pupil expense requirement for each district, requires that each school fund itself at least at the Expected Minimum Contribution, and then funds the remainder from State Aid. Wealth differentials between districts are somewhat compensated for in the school aid formula which incorporates the amount of property wealth in a district when the Expected Minimum Contribution is calculated. Districts with less property wealth are expected to cover less of their costs. However, the 2 percent tax cap is not addressed by any part of the foundation aid formula, so wealthy school districts who raise above the Expected Minimum have the 2 percent cap applied to all of their property tax revenues, not just their Expected Minimum.

Additionally, in this scenario poor districts are the ones forced by a bigger funding squeeze to find greater efficiencies and consolidate or share services— while the wealthy ones are not forced to change their behaviors by the cap, which isn't as binding for them. This effect is on top of many other facets of the property tax cap which allow it to favor wealthy districts. Wealthier jurisdictions override at a higher rate than poorer ones.¹⁸ This exacerbates the exponentially increasing difference in ability to collect revenue over time described above.

An unpublished study by Sipple shows that the tax cap tends to result not in greater efficiency, as hoped, but rather in the cutting of educational services.¹⁹ One of his surveys, reproduced in

¹⁸ Yinger, John. "Four Flaws in New York State's Property Taxes and How to Fix Them: Levy Limits." June 2012. Accessed from http://cpr.maxwell.syr.edu/efap/about_efap/ie/June12.pdf

¹⁹ Sipple, John. "Trading Financial Insolvency for Educational Insolvency: A Hypothesis." December 2014. <http://s3.amazonaws.com/mildredwarner.org/attachments/000/000/505/original/99700cfc12b64b6ad9edfcec4fd31c3e>

Appendix D, shows that the number of schools which have considered increased efficiency prospects such as consolidation is about 45% for high need school districts. The number of high need districts which have considered budget solutions which lead to education insolvency such as personnel cuts and reduced services are 90% and 55% respectively. In other words, schools aren't taking the efficiency bait that the Governor and Senate think they are.

Finally, there are concerns that certain provisions of the funding cap may cause behavior distortions that impact economic decision-making. Tax cap regulations currently require jurisdictions to subtract new PILOT agreement payments from their tax cap calculation. This has put some school districts in the unenviable position of having to decide whether to pursue an override to order to collect PILOT payments not grandfathered into the levy, and face the financial penalties that go with defying the cap, or forgo revenue that they otherwise would have expected to collect. Fear of this kind of bind has prompted concerns that the property tax cap might inhibit economic development by discouraging use of PILOT agreements. We saw this happen last year when school board members in New Paltz went on record to oppose use of a PILOT agreement to encourage construction of dormitory housing because of concerns over property tax cap rules.²⁰

Political Environment

Before launching into our recommendations we pause to evaluate the political landscape. The property tax cap is time-limited, with a 2016 sunset. Its enactment was tied to an agreement on rent control that expires this year; presumably, reauthorization of the property tax cap will be considered when the future of the rent control agreement will be debated in June 2015. Governor Cuomo reportedly is not explicitly seeking to permanently enact the cap, leading to speculation that his efforts will focus on extension.

Governor Cuomo has a history of employing funding carrots (or sticks, depending on your perspective) to ensure compliance with his policy agenda,²¹ and his strategy with the property tax cap illustrates this propensity. His administration has offered a "property tax freeze credit" that reimburses property tax increases for those who qualify for the STAR exemption, but only

²⁰ Townshend, Mike. "New Paltz School Board to Support Town in Park Point Suit." *New Paltz Times*, 7/10/2014.

²¹ For a good example, see Bakeman, Jessica. "Cuomo Dangles School Aid for Education Reforms," *Capital New York*, 1/22/2015.

for homeowners residing in jurisdictions that comply with the property tax cap.²² His methods appear to be working: of 673 school districts subject to the property tax cap, only 19 overrode the cap in the 2013/2014 school year, down from 44 the previous school year.²³

New York State United Teachers challenged the legality of the tax cap on school districts, and in 2014 a New York State Supreme Court justice firmly rejected their suit.²⁴ The union has vowed to continue its fight, despite widespread public support. A poll conducted earlier this year showed that 70% of New Yorkers support the cap, including strong majorities among both Democrats and Republicans.²⁵ Both the property cap's popularity and Governor Cuomo's indicate that the cap is here to stay. Such is the prevailing opinion that even education advocates deeply concerned over threats to education funding posed by the cap have taken to limiting their policy recommendations to amending rather than repealing it.²⁶

Because rising pension costs pose a possible threat to the viability of the property tax cap, we now briefly address the issue of pension reform. Under Governor Cuomo's watch, a series of pension reforms were enacted in 2013. These reforms included raising the retirement age and requiring employees to contribute a greater percentage of their salary toward retirement. In his 2015 State of the Union address, Governor Cuomo alluded to a possible new round of pension reform when he stated "Albany has been too concerned with protecting the pension rights of teachers and not enough with the future of students." Even if the governor succeeds in further reform, the short- and medium-term budgetary impact may be minimal since the New York State constitution prevents alterations to pension agreements with current employees.

Recommendations

Given Governor Cuomo's strong advocacy for the property tax cap, and, more importantly, the policy's wild popularity among the public, the most productive question to ask, at the moment, is

²² Retrieved from http://www.tax.ny.gov/pit/property/property_tax_freeze.htm on 3/21/2015.

²³ Spector, John. "Few NY School Districts Tempt Property Tax Cap." The Journal News, A Gannett Company, 2/11/2015.

²⁴ McMahon, E.J. "A Big Court Win for NY's Tax Cap," The Empire Center, September 25, 2014.

²⁵ Sienna College Research Institute. "Heading into Fifth State of the State, Cuomo Ratings Up." January 20, 2015.

²⁶ In a panel discussion on "Effects of the Tax Cap" hosted by Cornell University on 12/9/2014, panelist Deborah Cunningham of the NY State Association of School Business Officials noted that she and her colleagues had conceded that "the state had the right to pursue educational improvements and tax relief and could pursue both policy goals simultaneously" and their recommendations reflect "the reality that [property tax caps] are here to stay." Panel recording retrieved from <http://www.mildredwarner.org/restructuring/fiscal-stress>.

not whether the cap should exist, but rather what kind of reform to the cap should happen. We recommend that local obligations for the main uncontrollable cost drivers also have a cap applied to them. The remainder of the increase on these items would be paid for by the state. We call this policy the cost valve. This policy would be in addition to the current property tax cap. We also recommend that the state make legally binding its obligation to make up differences in funding caused by disparities in property tax bases with state aid – something it already does through its funding formula. Finally, technical changes are needed to improve the exclusions for PILOTS and carryover currently incorporated in the tax cap calculations.

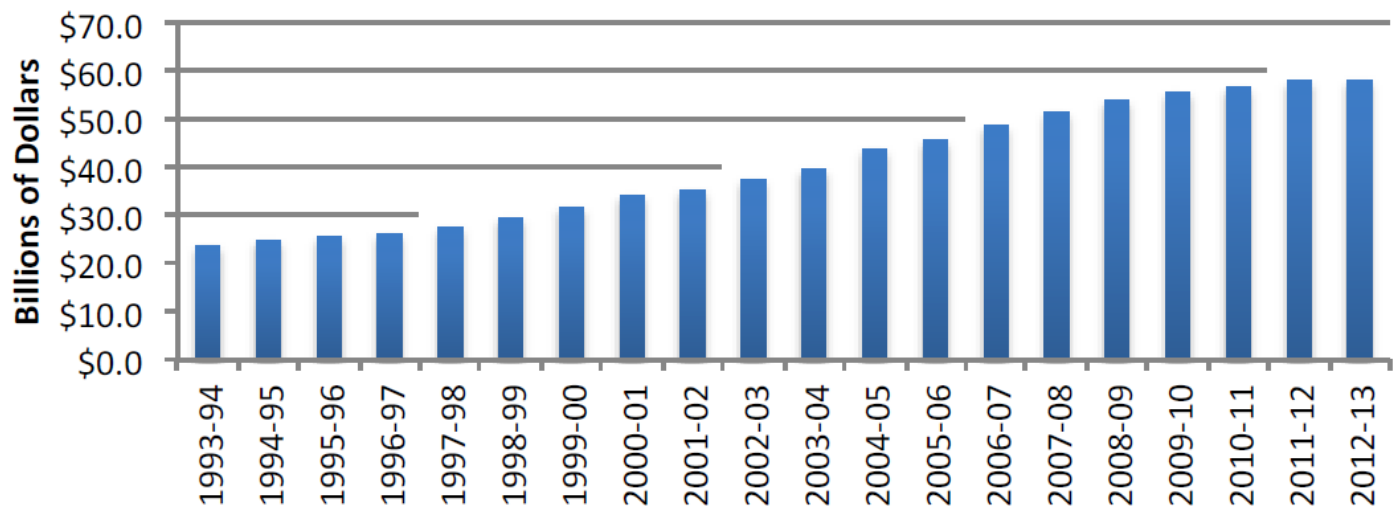
- **The Cost Valve.**²⁷ This proposal would allow portions of education cost drivers which are not controlled by the district to be paid for by the state. Specifically, increases in pension and healthcare costs over 2 percent will be paid for by the State of New York and will not go towards the cap. This is similar to the state's current reimbursement structure for county Medicaid costs. This is logical because it solves the principal agent problem whereby pension benefits and healthcare benefits are decided at the state level but paid for by districts. This solution achieves the dual and opposing goals of tamping down property taxes by leaving the cap in place and by allowing schools to keep pace with the increased cost of doing business each year and improving the educational outcomes of children.
- **Fill the Gap Between Wealthy and Poor Districts.** The state should fully fund the state aid formula in order to correct for growing funding inequities between wealthy and poor districts. While this solution does not address the inequality caused by the cap directly, fully funding a highly equitable formula will fill a large part of the gap while continuing to allow the cap to do its primary job: keeping property taxes low. Promoting state funding over local funding also encourages the use of the Personal Income Tax over the Property Tax which has a more progressive structure.
- **Technical Change to New PILOT Payments.** In order to prevent behavior distortions that inhibit economic development, and provide school districts with increased flexibility to adequately fund their schools, include new PILOT agreement payments in the tax base growth factor. This is a valuation in the changes to taxable property that can be added to

²⁷ This suggestion was initially proposed by the School Board Association in 2008.

the cap. A similar correction was successfully made Massachusetts' property tax cap after the passage of Proposition 2 ½ in 1980 to remove tensions between economic development and education funding.

Appendix A

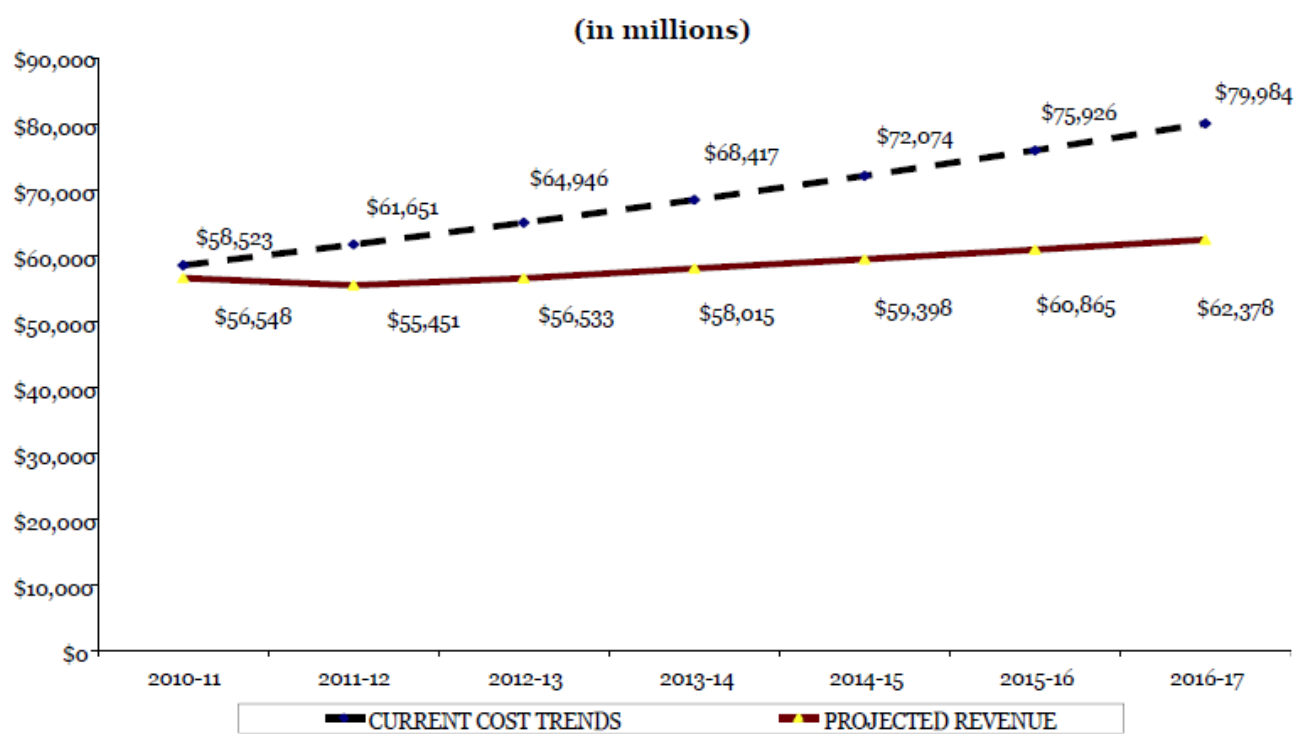
New York State School District Spending



SOURCE: NYSED, Analysis of School Finances, 2014 and School District Fiscal Profiles 2012-13.

Appendix B

Impact of Caps on Local and State Revenues for New York School Districts



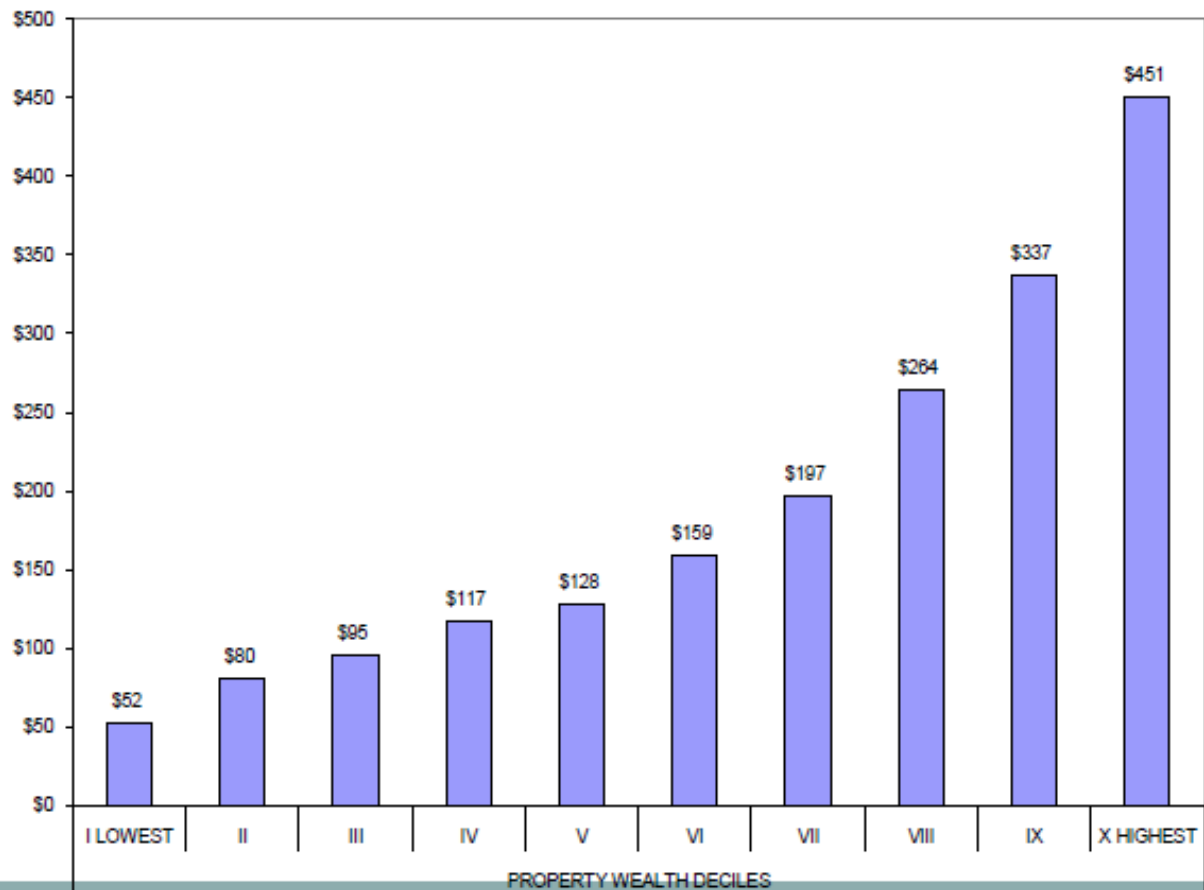
**SOURCE: NY State Board of Regents Item,
“Development of 2012-13 Regents State Aid Proposal”**

<http://www.regents.nysed.gov/meetings/2011Meetings/October2011/1011sad1.pdf>

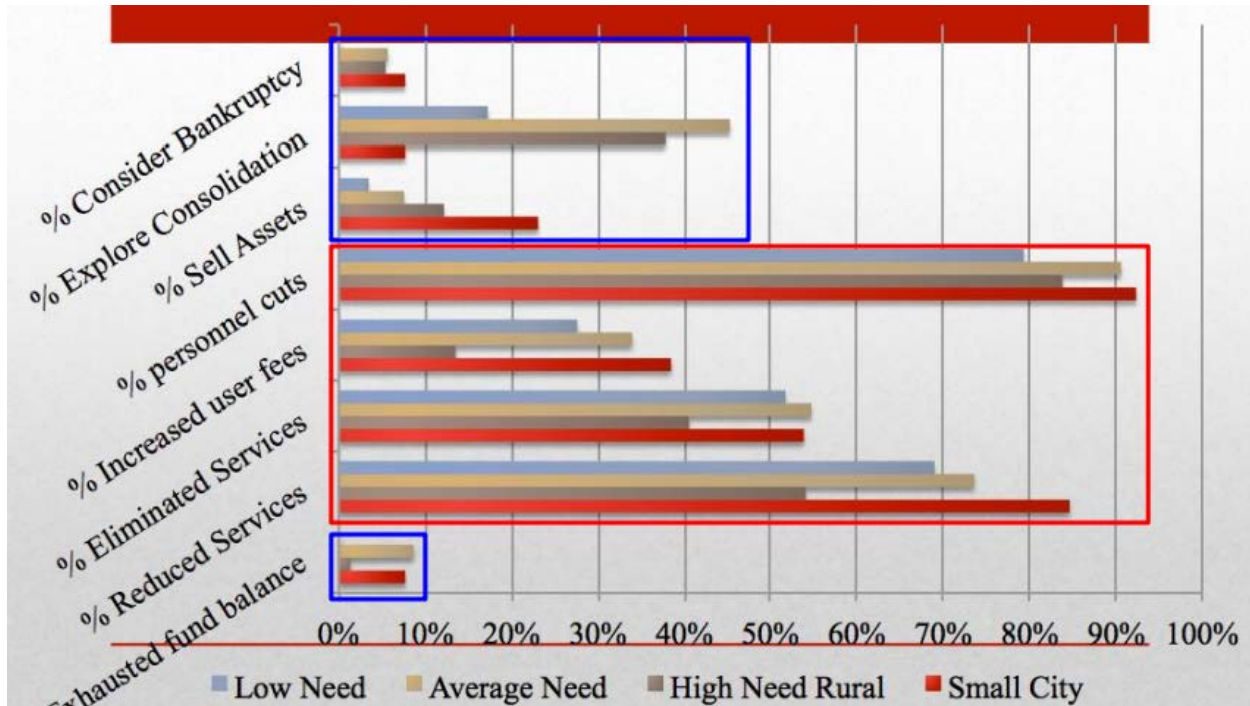
Appendix C

The Impact of the Tax Cap Varies Dramatically with District Wealth

2% LEVY INCREASE PER PUPIL (BASED ON 2009-10)



Appendix D



SOURCE: "Trading Financial Insolvency for Educational Insolvency: A Hypothesis"

John W. Sipple, PhD, Associate Professor, Cornell University

December 2014

<http://s3.amazonaws.com/mildredwarner.org/attachments/000/000/505/original/99700cfc12b64b6ad9edfcec4fd31c3e>