Local Fiscal Stress
State Austerity Policy & Creative Local Response

Tax Caps in Other States
Lessons for New York

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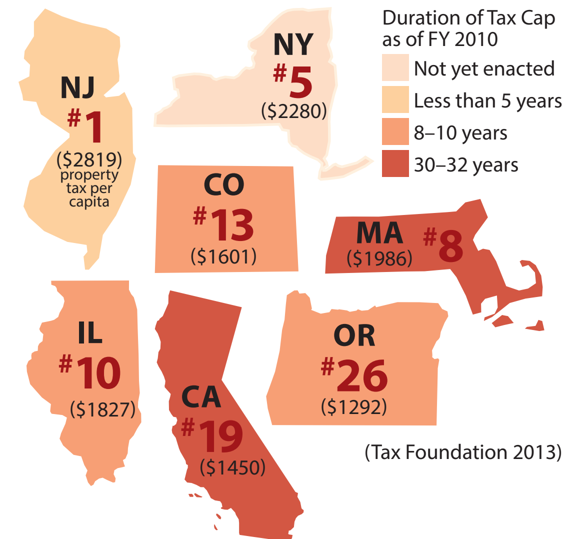
December 2014

Abstract

Local governments in New York are facing increased fiscal stress due to the recently implemented property tax cap. As they struggle to remain solvent in the short term, our research looks towards six other states with more historic tax caps to understand their long-term effects.

In the absence of additional state aid or mandate relief, we find that local governments with property tax caps make more drastic service cuts and increase revenues through overrides and user fees. These sources of revenue are dependent on a community's ability to pay and can amplify existing regional inequalities. This policy brief makes recommendations for state policy changes that can reduce the negative consequences of the tax cap on communities across New York.

Ranking of Selected States by Highest Property Tax per Capita in FY 2010



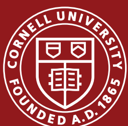
(Tax Foundation 2013)

The NY Property Tax Cap

In 2012 New York joined other states in implementing tax and expenditure limits (TELs) on local governments. The tax cap aims to control the future growth of property taxes across local governments in New York, with the exception of New York City. In essence, the law restricts a local government's tax levy growth to the lesser of 2% or the rate of inflation. The actual formula to calculate the allowable growth is more complex, as the NY State Comptroller has oversight over some adjustments and local governments can make limited exceptions for torts and pensions. Municipalities can exceed their tax cap by overriding the law locally with a 60% supermajority from elected representatives, while school districts can only override with a supermajority of voters.

The law was passed with great fanfare in Albany as a way to provide tax relief to New Yorkers, who paid the 5th highest property taxes per capita out of all 50 states in 2010 (Tax Foundation 2013). Local governments, however, were less enthused as **the law was passed without significant changes to state aid or mandate relief.** A recent survey by Cornell University reports that over 60% of villages and towns and over 80% of cities and counties across New York faced increased fiscal stress due to the tax cap (Homsy et al. 2013). To balance their books, local governments have reported increases in user fees and personnel and services cuts, among other strategies. The long-term impact of the tax cap remains to be seen as the law has only been in effect since 2012. However, the impact of tax caps in other states, as well as quantitative analysis of the NY Property Tax Cap (see *NYS Tax Cap Impact Analysis* companion issue brief), can paint a picture of the economic and social environment in which local governments will operate in the years to come.

> *"Over 60% of villages and towns and over 80% of cities and counties ... faced increased fiscal stress due to the tax cap."*



The Creative Responses to Fiscal Stress Project is directed by Mildred Warner of Cornell University's Department of City and Regional Planning, in collaboration with the Community and Regional Development Institute and with partial funding support from the US Department of Agriculture Hatch and Smith Lever grant programs and NYSUT.
A full copy of the report on which this issue brief is based can be found at www.mildredwarner.org/restructuring/fiscal-stress.

General Effects of Tax and Expenditure Limitations

In this section, we summarize the general effects of TELs based on a review of the results from multi-state, cross-sectional, or comparative studies. Most of these studies focus on the impact of TELs on government size, local fiscal condition, regional equity, public service delivery, and/or economic growth.

TELs are shown to have little effect on overall government size, measured in terms of revenue and spending, although some studies report larger effects than others. For example, using nationwide data of local government finances aggregated to the state level from 1972 to 1992, Shadbegian (1998) showed that TELs had a negative impact on both level and growth of local government. Specifically, property tax limitations increase local governments' dependence on user charges and fees as well as on state aid, which can help offset losses of revenue from property taxes (Mullins and Joyce 1996). Through case studies of California and Massachusetts, Galles and Sexton (1998) show that even though TELs lowered property tax and restrained tax growth, within a decade, real per capita revenue and expenditure exceeded pre-TELs peaks because governments made up the lost revenue through alternative sources.

While TELs may not have a large impact on government size, they have implications for inequality between different localities. Using 25 years of fiscal data from 1972 to 1997 for 31,804 local governments in 787 metropolitan counties in the contiguous 48 states, Mullins (2004) shows that **TELs especially constrain governments and school districts serving lower income and other disadvantaged populations.** He argues that applying a uniform constraining instrument across many jurisdictions with different needs has produced greater regional fiscal disparity as a by-product. The magnitude of impact of property tax caps varies with the types of jurisdictions (Dye and McGuire 1997). **Smaller and less-densely populated communities tend to experience the greatest constraint from property tax limitations** (Merriman 1986; Rown 2000). Regional equity can also be undermined by localities' different abilities to successfully pass overrides or raise other revenues (Lyons and Lav 2007). Greater dependence on state aid means that local fiscal condition often worsens in times of economic downturn when state aid cannot be sustained (Lyons and Lav 2007).

"Applying a uniform constraining instrument across many jurisdictions with different needs produces greater regional fiscal disparity"

According to the Center on Budget and Policy Priorities, **when state aid declines, when override attempts are unsuccessful, and when narrow-based revenues are limited by residents' ability-to-pay, the level and quality of public services are likely to be reduced** (Lyons and Lav 2007). Spending cuts are manifested in public employee layoffs, wage freezes, shutdown of public amenities, elimination of special programs in schools, and stagnation in infrastructure financing (Lyons and Lav 2007; Bell Policy Center 2005). Cowden (1982) shows that California's local governments increasingly contracted out services to the private sector since Proposition 13 took effect.

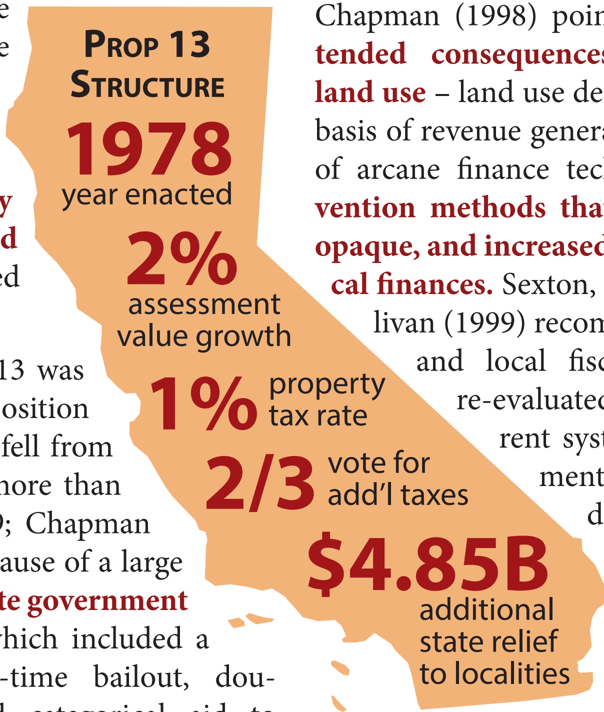
Proponents of TELs argue that reduced government spending is beneficial for economic growth because lower property taxes can contribute to retaining and attracting businesses, but little research has been done on the relationship between TELs and economic growth (Deller and Stallman 2006). McGuire and Reuben (2006) show that TABOR did not have an effect on job growth and income in Colorado beyond the first five years. National studies find greater decentralization in the absence of state mandate relief creates vicious cycles as **local governments under severe fiscal stress shift expenditures to meet mandates at the expense of economic development**, potentially damaging the future prospects of their communities (Warner and Pratt 2005). International comparative studies find that decentralization can undermine long-term economic growth if current expenditure comes at the expense of capital expenditure (Rodríguez-Pose and Ezcurra 2011).

SUMMARY OF GENERAL EFFECTS OF TELs

- TELs hardly affect government size as local governments rely more on alternative sources of revenue
- Alternative revenues reduce negative impacts of TELs but can make budgeting less flexible
- TELs disproportionally affect communities with lower income and smaller populations
- TELs could harm economic growth as cash-strapped municipalities reallocate economic development dollars to keep mandated services alive

California – Proposition 13

Introduced in 1978, California's Proposition 13 was one of the first TELs in the country and was implemented by the public through the state's ballot proposition system. The proposition has been credited with starting the trend of TELs in many other states. Its implementation, however, varies from the NY Property Tax Cap. Instead of limiting the tax levy municipalities can charge, Proposition 13 limits the annual increase in *assessed value* of real property to the lower of 2% or inflation, and fixes the property tax to 1% of assessed value. Property is reassessed when sold, and additional taxes for specific purposes must be approved by 2/3 of voters (Alamo and Whitaker 2012). While Proposition 13 seems stricter than New York's TEL on paper, **the effect of the law has been weakened over time as communities faced financial hardship and more exceptions were added by the state legislature and the public through referenda.** For example, in 1982 the state created a new type of local improvement district specifically exempt from Proposition 13. While voters must approve them locally, these districts have proliferated throughout the state since their inception. Local governments also relied more heavily on state aid and user fees when Prop 13 was implemented (Chapman 1998). Finally, **the state also centralized many welfare and health programs and provided more school aid** to address shortfalls created by the law (Chapman 1998).



The immediate impact of Proposition 13 was substantial. In the first fiscal year after Proposition 13 took effect, county property tax revenue fell from $10.3 billion to $5.04 billion, a decline of more than 51% (Sexton, Sheffrin, and O'Sullivan 1999; Chapman 1998; State Board of Equalization 2012). Because of a large surplus budget and a strong economy, **the state government implemented a $4.85 billion relief plan** which included a one-time bailout, doubled categorical aid to schools, and increased responsibility for certain health and welfare costs which had previous been borne by the counties (Weber 1982). This relief was able to hold local revenue reductions to less than 10% in the first year, when they would have been 28% without the aid, and local services were only reduced moderately (Weber 1982).

> *"While Proposition 13 seems stricter than New York's TEL on paper, the effect of the law has been weakened over time as communities faced financial hardship and more exceptions were added by the state legislature and the public through referenda."*

Summary of CA Prop 13 Effects

- Initial harmful effects of tax cap avoided with substantial increase in state aid and state centralization of services
- New local improvement districts exempt from tax cap proliferated
- Local governments sustain services with special districts, fees, and state aid
- Land use decisions influenced by potential tax revenue growth
- Drastically reduced per pupil funding from taxes for schools

Many researchers have looked into long-term impacts of Proposition 13. Chapman (1998) points out **three unintended consequences: fiscalization of land use** – land use decisions made on the basis of revenue generating ability, growth of arcane finance techniques – **circumvention methods that are complex and opaque, and increased state control of local finances.** Sexton, Sheffrin, and O'Sullivan (1999) recommend that the state and local fiscal relationship be re-evaluated because "the current system of intergovernmental grants and mandates is a convoluted mix of short-term fixes". In terms of public services, **K-12 spending per pupil in California plummeted since 1978** (Lyons and Lav 2007). Some have even traced the root of California's fiscal crisis in 2008 to Proposition 13 (Marois and Nash 2011).

Massachusetts – Proposition 2 ½

Massachusetts' Proposition 2 ½ was implemented in 1980 and served as the inspiration for the NY Property Tax Cap. It limits the annual growth of the tax levy to 2.5% plus physical growth and implements a maximum levy ceiling of 2.5% of total assessed value. **Voters can approve increases above the levy limit with a simple majority**, and the levy ceiling can be exceeded if the increase is for temporary infrastructure debt. The simple majority threshold makes Proposition 2 ½ more lenient than NY's Property Tax Cap. The state also increased aid to schools and municipalities when the proposition was implemented, which staved off the worse effects of the law. However, local governments are now more reliant on state aid and budgets are less stable because of it.

Proposition 2 ½ was also adopted at an opportune time, when Massachusetts was experiencing rapid economic growth now known as the "Massachusetts Miracle." **K-12 enrollment was also dropping, which meant that schools could afford to operate under a smaller budget** (Oliff and Lav 2010). The proposition itself does not require the state to offset local tax losses, but after heated debate with local governments, the legislature increased state aid by $265 million in the first fiscal year (Bradbury and Ladd 1982). Unlike California, there was very little state surplus at the time (Bradbury and Ladd 1982). But like California, Massachusetts' localities made up for the loss of property tax revenue through other revenue sources; real revenue per capita from these sources rose 73.7% from 1982 to 1990 (Galles and Sexton 1998).

Prop 2 ½ Structure

1980 year enacted

50% override vote

2.5% annual levy growth & levy ceiling

$265M additional state aid

Since the passage of Proposition 2 ½, override votes have been on the rise. Voter surveys show that by the 1990s, most people either regretted the severity of the TEL or felt that its mission had been accomplished (Cutler, Elmendorf, and Zeckhauser 1999). In empirical research on override activities, override attempts are usually termed "successful" if they are approved by voters and put into action. Using panel data from 1987 to 2009 for all 351 Massachusetts towns, Wallin and Zabel (2011, 392) find that "richer towns tend to have more successful override votes and tend to be in better fiscal condition than poorer towns … but an increase in [average real per capita] income does not directly impact override behavior or local fiscal conditions.

> *"Voter surveys show that by the 1990s, most people either regretted the severity of the TEL or felt that its mission had been accomplished."*

Summary of MA Prop 2 ½ Effects

- Initial harmful effects of tax cap reduced by increase in state aid and economic boom
- Local governments rely more on user fees, overrides, and state aid to fund expenditures
- Overrides have allowed wealthier communities to tax themselves more and maintain or improve services
- Communities with higher school taxes are more desirable

On the other hand, using regression models on 3,370 override proposals for all 351 Massachusetts towns from 1990 to 2007, Roscoe (2014, 145) finds that **"overrides were more successful in communities that had higher levels of education, lower levels of affluence, and smaller nonwhite populations… [and] in towns with lower existing tax rates"**, but the impact of income is much smaller than education level and non-significant for some subsets of jurisdictions. Oliff and Lav (2010) find that from 1983 to 2004, **communities with higher per capita income had higher rates of override approvals** as well as higher total dollar amounts in these approved overrides. They also argue that **Proposition 2 ½ is arbitrary, static, and insensitive to changing local needs**, and that it does not reflect the true costs of services. Expenditure increases are attributed to rising health costs for public employees and rising special education costs, which are beyond the control of local governments and school districts (Oliff and Lav 2010). Bradbury, Mayer, and Case (2001) find that Prop 2 ½ results in housing price appreciation in neighborhoods that are willing and able to raise school spending, which could unintentionally limit student mobility.

Oregon – Ballot Measure 5 and 47/50

Oregon's citizen-initiated Ballot Measure 5 led to the 1990 constitutional amendment that fixes the property tax rate to 1.5%. The follow-up Measure 47 in 1996 and Measure 50 in 1997 cap the annual growth of assessed value to 3%, which made Measure 5 more binding. By 2006, the two measures had reduced local revenues by $41 billion, and because Oregon has no sales tax, the lost revenue was made up mostly through the use of more volatile income tax and state aid (Henkels 2010). In 1980, 62.6% of all property tax was distributed to school districts; now the state government is responsible for 70% of school funding (Linhares 2011). Even though state funding is equalized across districts, spending per pupil dropped and extracurricular programs were cut (Linhares 2011). At the time of passage, **Measure 5 included a five-year phase in period which reduced immediate impact on local budgets** and provided the time needed to switch to alternative revenues. **It also mandated that the state government compensate K-12 school districts for all lost revenues** (Linhares 2011).

Illinois – Property Tax Extension Limitation Law

Illinois' Property Tax Extension Limitation Law (PTELL) limits the annual growth of property tax to the lower of 5% or inflation for non-home rule taxing districts. It went into effect in 1991 in the five collar counties of Chicago which had high growth rate of property taxes and high concentration of anti-tax legislators (Dye 1997). As of 2012, out of the 102 counties in Illinois, 33 have approved the PTELL referendum in addition to Cook County and the five collar counties, while 9 counties have rejected it, and the remaining 65 have held no such referendum ("History of PTELL" 2012). Unlike school districts which get 1/3 of their revenue from the state, municipalities do not receive increased state aid possibly because they have a wider range of revenue options, and counties may freely choose to enter or rescind a PTELL through referenda (Illinois Department of Revenue 2012). Dye and McGuire (1997) studied the effect of PTELL using non-capped jurisdictions as controls and found that **the cap effectively restrained the growth of property tax in all jurisdictions except fire districts, and it restrained school district operating expenditures**. In a follow-up study five years later, Dye (2001) confirmed his earlier findings and noted a **low success rate of override referenda**. According to a 2012 report by the State Budget Crisis Task Force, the state government has had to devote much funding and resources to school districts in PTELL counties, and budget deficits have led to devolution of responsibilities down to the municipal governments; neither state government nor local governments are in the position to help each other (*Report of the State Budget Crisis Task Force* 2014).

Colorado – TABOR

Colorado's Taxpayer Bill of Rights (TABOR) is a 1992 constitutional amendment that places restrictions on both revenue and spending, with tax increases possible only through biennial votes. This measure limits revenue growth to inflation and population growth, and any revenue surplus needs to be returned to taxpayers. **TABOR is one of the strictest TELs in the nation** as it applies to both state and local governments. Brown (2006) finds that **TABOR has created fiscal stress in municipalities, resulting in 356 elections for exemptions** to spend beyond TABOR limitations, of which 325 were approved by voters. A tenth-year evaluation of TABOR by Bell Policy Center (2003) reports that at the state level, education and public health have disproportionate spending cuts, which has led to increased use of private charity funds and financial write-offs. Many mental health programs have been dismantled in rural counties, which have the highest suicide rate; while funding for programs in rural community colleges was eliminated in 2004 due to budget constraints (Bell Policy Center 2003).

SUMMARY OF EFFECTS ON OTHER STATES

Oregon – Ballot Measure 5 and 47/50

- Schools now primarily funded by state
- Municipalities rely more on volatile income tax and state aid

Colorado – TABOR

- Budgeting is inflexible as taxpayers have to approve almost all tax increases
- Majority of tax increases are approved
- Disproportionate spending cuts in education and public health

Illinois – PTELL

- Optional tax cap approved by voters in only 33 out of 102 counties
- State devotes more resources to schools in counties with PTELL

New Jersey (p. 6)

- More exemptions were added to law

New Jersey

In 2007 New Jersey enacted a 4% cap on annual growth of property tax revenue that can be overridden by a supermajority. It was modified in 2011 to a 2% limit with a simple majority override. **The more stringent limit was negotiated with a greater range of exceptions, including debt payments, rising health benefit and pension costs, unforeseen emergencies, and rising K-12 enrollment** (Reitmeyer 2010). Because this cap was quite recent, research on its impact is not very comprehensive. Thaiprasert, Faulk, and Hicks (2011) predicted the economic impact of the cap on economic activity in New Jersey using a regional computable general equilibrium model (CGE) and projected the effect of the cap will cause a 1.5% increase in total production, a 1.6% increase in employment, and average increase of $1,129 in household income.

RECOMMENDATIONS FOR NEW YORK

Changes to Property Tax Cap

- Allow simple majority overrides for fairer votes
- Incorporate additional exceptions for disaster relief and capital outlay so localities can prepare for the future

Changes to State Policy

- State should increase and target its aid to municipalities and schools to stave off the worse effects of the cap
- State should lower local tax burden by lifting mandates and centralizing fiscal responsibility for services

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