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Citizens Budget Commission
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Good afternoon. I am Elizabeth Lynam, Deputy Research Director at the Citizens Budget Commission. Thank you for the opportunity to testify today. As you know, the Citizens Budget Commission is a nonprofit, nonpartisan watchdog group dedicated to influencing constructive change in the finances and services of the New York City and State governments.

New York residents bear the second highest state and local tax burden in the nation, second only to Wyoming – a state that levies high taxes on the extraction of minerals and no personal or business income taxes. New York collects $150 in state and local taxes for every $1,000 of personal income – 33 percent more than the national average and 26 percent more than all other large and neighboring states that are New York's leading competitors.

Over the past decade, state policy successfully lowered the state tax burden and brought state taxes in line with national averages; however, the same is not true for local taxes. New York's local tax burden is number one in the nation by far. The local tax burden in New York City is more than double the national average and the local burden outside the City is 58 percent above average. Outside New York City, the local tax burden is 32 percent higher than the second highest state.

New York's tax burden is not only high, it is also inequitable. On average, local governments in the United States fund 41 percent of non-federally-funded public services; in New York, local governments fund 55 percent of these services. Funding services – such as education – at the local level creates stark inequities in the quality of public services across the state. Despite high levels of state education aid, students in property-wealthy districts enjoy significantly more resources than students in property-poor districts. In the wealthy district of Scarsdale, the local school tax effort is below $8 for every $1,000 of income and property wealth – 35 percent <u>below</u> the state average – yet per pupil spending in the district is 43 percent <u>higher</u> than the state average. In contrast, in Rochester, the local school tax effort is <u>twice</u> that of Scarsdale, yet Rochester spends <u>29 percent less</u> per pupil than the Westchester suburb.

Raising money for education and other key services with state taxes ensures that residents with higher capacities to pay shoulder a heavier portion of the tax bill. The stark differences between the upstate and downstate economies in New York emphasize the need to fund education at the state level. In the past decade, property values in the suburbs of New York City grew five times faster than in the upstate counties, increasing the local tax base downstate and enabling lower downstate tax efforts. Shifting education funding to the state, either through targeted state aid or local property tax relief, promotes the vital goal of equalizing resources per pupil.

Unfortunately, the State's $5 billion local tax relief program, School Tax Relief (STAR), has not successfully reduced the local tax burden nor advanced equity in the

distribution of local taxes. In fiscal year 2005 STAR payments equaled 6 percent of the statewide property tax levy and 11 percent of the property tax levy upstate. Yet, STAR funds did not actually reduce property taxes by these amounts. In fact, STAR has stimulated local spending growth for schools. A recent study indicates that growth in school spending negates the savings from STAR by one-third on average. Further highlighting this phenomenon, the property tax levy statewide from fiscal year 1995 to 2000 grew 8 percent, yet expanded 48 percent over the next five years – STAR was fully implemented in 2002.

STAR's inducement to increase spending not only negates the intended tax relief, but also increases the tax burden for commercial property owners, who receive no benefit from STAR. As a result, the program in effect created a class system for property, with commercial owners paying higher tax rates. Since the property tax is the single largest tax on business in New York, increasing commercial property taxes detracts from the state's competitiveness. In addition, owners may pass along the increased taxes to their tenants in the form of increased rents. Outside of New York City, renters receive no tax relief from STAR.

In addition to being ineffective in decreasing local taxes, STAR is not targeted to residents with the highest tax burdens. STAR's exemption inflator for property-wealthy counties – and exclusion of renters and commercial property – ensures that more aid arrives where it is least needed. In fiscal year 2005, Westchester County received 3 percent of state education aid yet 10 percent of STAR aid. In fact in 2005, the eight wealthy counties immediately outside New York City received 22 percent of state education aid but 41 of STAR aid.

STAR aid has no rational relationship to the number of pupils or needs in a school district. On average, STAR increased state aid to school districts $713 per pupil or 20 percent. However, Scarsdale received $930 per pupil in STAR aid; this payment increased Scarsdale's total state aid per pupil 84 percent. In contrast, the STAR program increased total state aid per pupil in Utica 13 percent, from $6,200 to over $7,000 per pupil. In Buffalo, Rochester, and Syracuse, STAR increased state aid only 4 percent. If STAR were allocated as school aid, Rochester, Syracuse and Buffalo combined would receive $136 million more aid from the state.

The recently-implemented "Middle-Class STAR Rebate" program takes a small step in the right direction. The rebate better targets relief to lower-income households, yet because it is based on the STAR exemption, the rebate embodies the same equity flaws as the original STAR program. Consequently, the maximum amount of the rebate for non-seniors varies from $250 in Buffalo to $327 in Saratoga Springs to $809 in Scarsdale. Limiting the rebate to households with less than $250,000 in annual income was an important first step, but the state needs to go further to direct the most tax relief to the most in need.

The Citizens Budget Commission is currently studying options to lower the local tax burden and improve equity in local taxes. Tomorrow, the CBC will release a background paper entitled, "Local Taxes in New York: Easing the Burden," and host a half-day conference at the Rockefeller Institute to discuss the options in the paper. These options include measures to 1) reduce the tax burden to more competitive levels and 2) distribute the tax burden more equitably.

One option to both reduce the tax burden and improve equity is a state takeover of local Medicaid costs and more aggressive Medicaid cost containment. County governments shoulder a significant portion of Medicaid funding yet have no control over the policy. The current local funding levels are unusually high and especially burdensome in economically-challenged communities with high shares of Medicaid-eligible residents and low levels of taxable resources. While the recently phased-in local Medicaid growth cap is a step in the right direction, the cap does not address existing inequities; for poorer counties with high shares of Medicaid recipients, even a 3 percent annual growth rate is too high. A state takeover of all non-federal Medicaid costs would provide incentive for the State to pursue cost reduction strategies and apportion funding of the program more equitably. A first step before a full state takeover could be the enactment of a zero percent growth cap for local Medicaid expenditures. As an alternative, the State could assume expenditures of all counties outside New York City first, with a plan to takeover the City's expenses when the state's finances improve.

Another option to reduce the local tax burden is to reform the Taylor Law to ensure that local governments have the tools to manage their labor costs effectively. Currently, state law does not specify time limits on negotiations or require that a new contract be in place before the expiration of an old contract. As a result, many localities and unions operate without a contract and often find themselves almost immediately back at the negotiating table once a new contract is settled. Such practice is a drain on employee morale and leads to large retroactive settlements. In addition, state law should clearly define the criteria utilized by arbitrators. In particular, arbitrators should have a clear understanding of "ability to pay" and place more weight on the fiscal impacts of labor settlements. Lastly, labor negotiations might move toward a "last-best" model in which unions and management submit a final offer and the arbitrator chooses between the two. This model provides incentive for both parties to submit reasonable offers and to minimize differences between the two submissions.

A third option to reduce the local tax burden is to convert the state pension benefit system from a defined benefit system to a defined contribution system, as is common practice in the private sector. Absent this shift, New York would benefit from the creation of a new "tier" for newly hired workers that included larger employee contributions to the fund and higher age requirements for retirement. Low municipal wages once justified generous pension benefits, but as local government wages have outpaced the private sector, these benefits have not been scaled back.

In addition to pursuing these strategies to reduce New York's high taxes, the State should also pursue strategies to establish a more equitable tax system. One attractive option is to convert the Middle-Class STAR rebate into a circuit breaker program. Over time, any new funding for the STAR program could be redirected into expanding the circuit breaker. This program would base tax relief on an individual's property tax burden and income, not on county wealth as is the case for STAR. The State could also incorporate renters into the new and improved circuit breaker program. Landlords pass on a portion of their property taxes through increased

rents, yet currently renters outside of New York City receive no benefit from the state's largest property tax relief program.

To ensure effective tax relief, the circuit breaker should be administered as a refundable personal income tax credit, to avoid the rebate being taxed as personal income. The program should provide enhanced relief to lower income levels and the maximum benefit should be capped, to ensure that localities do not pass their entire tax burden to the state.

Another option to promote equitable funding of local services is strict adherence to the new foundation-based school aid formulas. Strict application of these formulas will shift assistance to more needy districts and narrow the gaps in local school tax efforts among wealthy and poor districts. Unfortunately, last-minute political compromises weakened the initially proposed reform in two ways. First, local districts were allowed to calculate their local share of funding using their historic local sharing aid ratio rather than applying the median tax rate to their taxable resources, as originally proposed. Second, the enacted foundation aid included $329 million for 304 wealthy districts that should not have been eligible for increased education aid. These base grants and enhancements for the wealthiest districts work against equity, exacerbating a pattern of inequitable per pupil spending. The new foundation approach makes significant progress in raising spending among poorer districts but leaves much unachieved in promoting greater equity and better targeted use of state aid.

Thank you for your time. I am happy to answer any questions.