

PROPERTY TAX RELIEF: The Case for Circuit Breakers

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Even as the economy begins to recover from the greatest recession since the 1930s, the worst may be yet to come for state and local governments because their fiscal situations typically lag the general economy by two to three years. State budget deficits for FY2010 totaled more than 25 percent of general fund budgets—the largest budget gaps on record.

Making matters worse is the impending “stimulus cliff,” which arises because most of the roughly \$135 billion in federal stimulus aid to state governments and school districts was used to help close state budget gaps in FY2010, leaving a small fraction of the aid for FY2011 (Lav, Johnson, and McNichol 2010). Even before the current recession, states faced substantial structural deficits. The U.S. Government Accountability Office (2007, 1) predicted state and local governments would face

“large and growing fiscal challenges” within a few years time, and continuing through 2050.

These grim forecasts for state and local budgets have led some analysts and policy makers to call for reducing the size of state government, consolidating local governments, restructuring tax systems, and even changing state constitutions. According to Rob Gurwitt (2010, 18) of *Governing* magazine, the “fundamental assumptions about how state government operates need rewiring.”

Given the likelihood of a long-term state and local government fiscal crisis, property tax relief is an important state government function that is now more critical than ever. This article argues that most efforts to provide property tax relief, such as assessment limits and homestead exemptions, are inefficient and create substantial unintended consequences. Circuit breaker programs—a property tax relief mechanism first developed in the 1960s—deserve renewed attention in an era of streamlined state government because they target aid to those who need it most.

Alternative Approaches to Property Tax Relief

The property tax accounts for the largest share of own-source revenues for local governments, and is particularly suitable for funding local services for at least two reasons. First, it is a stable revenue source: property tax revenues do not fall dramatically during recessions as income tax and sales tax collections generally do. Second, property taxes are imposed on an immobile tax base: while people may have the option to buy the same goods in a nearby town with lower sales taxes, or move across state lines for lower incomes taxes, they cannot move their land across city lines to seek lower property taxes.

The property tax is not without problems, however. Chief among them are the disparities in property values across communities, an inexact relationship to taxpayers' ability to pay, and the long-standing unpopularity of the tax. Its revenue importance means that improvement rather than elimination is the best way to address these problems.

Property tax relief can be provided in many ways, some of which are more effective and equitable than others. Wealth disparities among communities make locally funded property tax relief programs inherently problematic. Funding property tax relief at the state level is a better option, since communities with large concentrations of needy taxpayers are unlikely to have the resources to fund local-option tax relief programs. State funding also eliminates inequities in property tax relief among communities.

Assessment caps are used as a property tax relief measure in 20 states, and other states regularly examine proposals to employ such measures. A recent comprehensive study on assessment limits found, however, that "30 years of experience suggests that these limits are among the least effective, least equitable, and least efficient strategies available for providing property tax relief" (Haveman and Sexton 2008, 37). Assessment caps provide the greatest tax reductions to homeowners whose property values have increased the most. Even though such gains in housing wealth are not a liquid asset, tax relief should not be structured to provide the greatest benefit to those with the greatest increase in wealth.

Assessment limits also create horizontal inequities in cases where two homeowners with identical

incomes and homes in the same community face dramatically different property tax bills solely because one owner has lived in the home longer. Fixed-dollar homestead exemptions are better, but still do a poor job of targeting homeowners with the highest property tax burdens, because they provide the same dollar value of property tax relief to all homeowners facing a particular tax rate, regardless of their income.

Residential property tax relief programs across the United States are seldom targeted by income—the best measure of a household's ability to pay taxes. Of the 216 residential property tax relief programs in effect in 2006, only 81 took income into account when setting benefits by using an income ceiling, and only 37 programs set tax relief benefits that varied by income (Significant Features of the Property Tax 2010). Given the fiscal crisis, states should consider replacing untargeted property tax relief with circuit breaker programs that can provide relief to more households in need, without spending more money.

The Case for the Property Tax Circuit Breaker

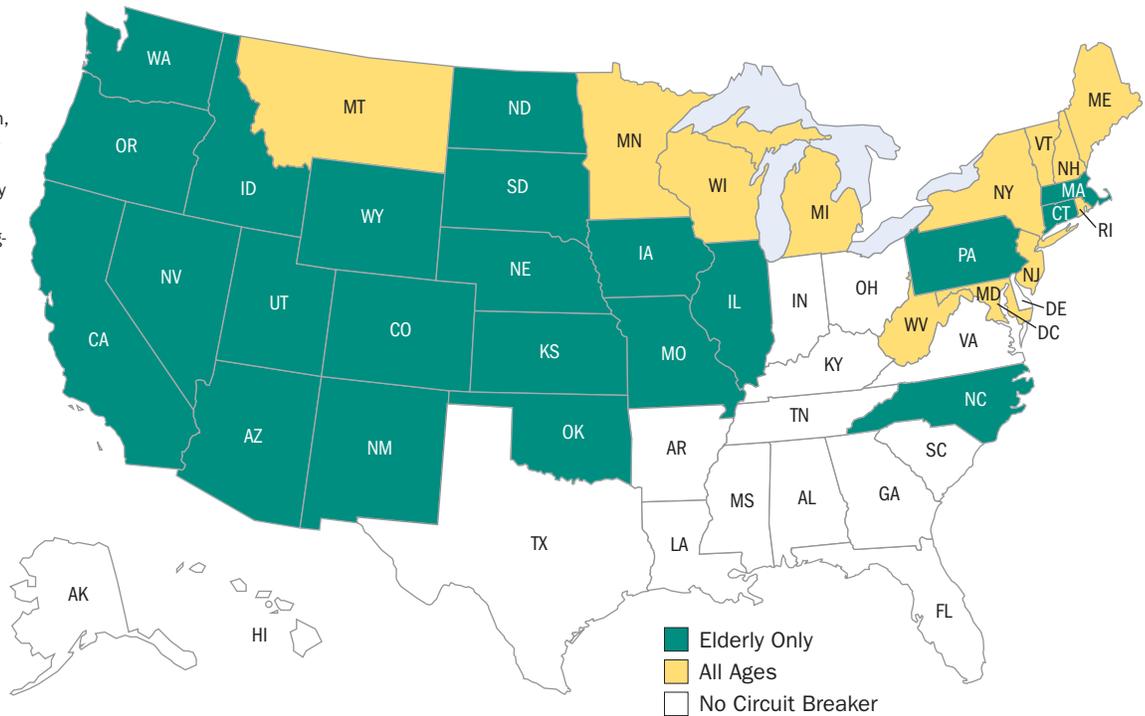
When applied to property tax relief, the term *circuit breaker* is used to describe programs that provide benefits directly to taxpayers, with benefits increasing as claimants' incomes decline. As an electrical circuit breaker stops the flow of electrical current to protect a circuit from overload, a property tax circuit breaker is a policy mechanism designed to stop property taxes from exceeding a claimant's ability to pay, protecting the taxpayer from property tax overload.

A clear definition is critical since most states with true circuit breaker programs do not use that term to describe them. For example, Maine calls its circuit breaker program the Maine Property Tax and Rent Refund Program. Meanwhile, some states use the term to refer to property tax relief programs in which relief does not vary with income. In Indiana, a program is called a circuit breaker even though the program ties relief to property value, not to income.

Over the last 40 years, two-thirds of the states and the District of Columbia have adopted state-funded circuit breaker programs (see figure 1). Each of these programs satisfies the circuit breaker definition above. However, the design of these programs, and consequently their effectiveness, varies

FIGURE 1
States with State-funded Circuit Breaker Programs, 2009

Note: Providing benefits for all ages does not always mean providing the same benefits. Six of the thirteen states (including Washington, DC) shown as providing benefits for all ages provided enhanced benefits for elderly claimants. The program in Kansas is available to younger residents with a dependent child under eighteen. Funding for California's circuit breaker program was suspended in 2008 due to budget constraints.



considerably. Properly designed circuit breakers can target property tax relief more precisely and with less expense than broad-based mechanisms such as homestead exemptions and assessment caps.

Recommendations for a Circuit Breaker Program

We offer seven recommendations designed to obtain maximum benefit when creating or reforming a circuit breaker program. The New York case study presents the efforts of one state trying to reform its circuit breaker program (see box 1).

Provide property tax relief to owners and renters of all ages. Currently, more than two-thirds of state circuit breakers do not cover non-elderly households, and a quarter of programs do not cover renters. Restricting eligibility to seniors is based on the false assumption that age is a good proxy for property tax burden. In fact, while the elderly have higher property tax burdens on average, Census data show elderly and nonelderly homeowners both devote about 35 percent of their incomes to all home ownership costs combined (Bowman et al. 2009, 11).

Furthermore, circuit breakers eliminate the need to use age as a rough proxy for property tax burdens since they target relief based on each household's income and property tax liability. States should also provide circuit breaker benefits for renters, because they pay property taxes indirectly as part of their rent and they generally have lower incomes than homeowners. States that cover renters typically estimate renter property tax payments by specifying a percentage of rent equivalent to property taxes, most commonly 20 percent.

Avoid low income ceilings and restrictions on maximum benefits. Many circuit breakers fail to provide meaningful tax relief because they have low income ceilings that exclude middle-income households, or low limits on maximum benefits that result in inadequate relief. For example, Oklahoma's circuit breaker program restricts eligibility to claimants with incomes below \$12,000 and caps relief at \$200. In 2008, almost three-quarters of state circuit breaker programs had income ceilings below the national median household income of \$50,223. In the current fiscal crisis, states should take care to set appropriate limits to restrain the

BOX 1**New York's Effort to Provide Targeted Property Tax Relief**

Policy makers in New York state are considering adopting a new, expanded circuit breaker program to provide more targeted property tax relief because the existing circuit breaker program does not provide adequate assistance. It currently excludes households with incomes above \$18,000, and provides an average annual benefit of only \$109 per claimant (Bowman et al. 2009).

The state's primary means of providing direct property tax relief to households is the School Tax Relief program (STAR), which has three components. Basic STAR is available to all taxpayers on their primary residence, and exempts the first \$30,000 in property value from school district taxes, with adjustments for municipalities where assessed values diverge from market values and for downstate counties with high real estate prices. Enhanced STAR exempts a higher value, and is available only to homeowners over age 65 with limited incomes. Middle Class STAR provided a rebate check that depended on households' income and their other STAR benefits, but was repealed in 2009 for 2009–2010 and subsequent fiscal years.

STAR is an expensive program—the three property tax components cost about \$3.9 billion in 2008–2009. However, because benefits are spread so widely, many homeowners still face excessive property tax burdens. According to the 2006 American Community Survey, even after accounting for reductions under the Basic and Enhanced STAR programs, 20.1 percent of New York homeowners paid more than 10 percent of their income in property taxes, while 52.6 percent paid less than 5 percent. By providing such generous relief to the second group, the state is not able to provide enough for the first. Also, by providing larger exemptions for counties with high house prices, STAR largely subsidizes households in property-wealthy communities, which makes the state's property tax system more regressive (Duncombe and Yinger 2001).

To provide more targeted relief, several proposals have been introduced to establish a new circuit breaker program. During the 2005–2006 legislative session, Assemblywoman Sandy Galef and Senator Betty Little sponsored a plan with many desirable features: a multiple-threshold formula to make the distribution of tax relief more progressive; an income ceiling high enough to include all middle-income households; and a copayment requirement to discourage excessive spending by local governments. The cost would

have been limited by making homeowners choose either circuit breaker benefits or Middle Class STAR.

The Omnibus Consortium put forward a proposal similar to the Galef–Little plan, but with two improvements. First, it includes renters. Second, it uses a graduated structure for the income brackets, so that a small income increase that moves a claimant from one bracket to the next does not result in a much larger decrease in circuit breaker benefits.

The consortium's proposal was introduced in spring 2009 by Senator Liz Krueger and Assemblyman Steve Englebright; it is cosponsored by Galef, Little, and many other legislators. Once fully implemented this plan is estimated to cost \$2.3 billion annually, which is 65 percent less than the cost of the 2008–2009 STAR property tax programs, even though the new plan would provide much more generous relief to households facing the largest property tax burdens.

Plans to pay for the circuit breaker have been clouded by the state's repeal of the Middle Class STAR rebates in response to the 2009–2010 budget deficit. Governor David Paterson has also proposed a circuit breaker plan, which would tie circuit breaker benefits to a spending cap for state government. Annual spending growth would be restricted to inflation growth. When revenues exceed this limit, the surplus would be returned to homeowners via a circuit breaker. While this plan may seem attractive, it would accentuate budget cycles and result in unpredictable year-to-year fluctuations in tax relief for homeowners.

Given the state's fiscal crisis, creating a new circuit breaker program now seems more difficult than when the Galef–Little bill was being actively debated in the 2006–2008 period. Still, it is a positive sign that many legislators and the governor are all advancing targeted and cost-effective circuit breaker proposals, and have repealed the expensive and untargeted Middle Class STAR program.



Ron Deutsch (left) and John Whiteley at a June 2009 meeting of the Omnibus Consortium.

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cost of circuit breaker programs without rendering these programs ineffective.

Use a multiple-threshold circuit breaker formula. States use three basic types of circuit breaker formulas: threshold, sliding-scale, and quasi circuit breakers. Threshold circuit breakers are the only type that bases tax relief directly on property tax burdens—that is, the percentage of income spent on property taxes. Using multiple thresholds will result in a more progressive distribution of benefits.

Threshold formulas provide a benefit for the portion of a claimant's property tax bill that exceeds set percentages of income. For example, the Massachusetts circuit breaker, which is limited to taxpayers over age 65, uses a 10 percent single-threshold formula. The taxpayer is responsible for the entire tax bill up to 10 percent of household income, while the circuit breaker benefit offsets the tax bill above this threshold, up to a maximum benefit of \$960.

Multiple-threshold formulas set multiple threshold percentages that increase from the lowest income bracket to the highest, with these thresholds usually applied incrementally like a graduated income tax. Maryland uses four threshold percentages: the circuit breaker benefit offsets any property tax liability above 0 percent of income for the first \$8,000 of income, above 4 percent for the next \$4,000 of income, above 6.5 percent for the next \$4,000 of income, and above 9 percent for income of \$16,001–\$60,000.

Sliding-scale formulas reduce property taxes by a set percentage for each income bracket, with lower relief percentages for higher income brackets. All claimants in a given income bracket receive the same percentage of relief regardless of their property tax bill.

Quasi circuit breakers use multiple income brackets to target benefits to low-income households; benefits are determined without reference to a claimant's property tax bill, except that they cannot exceed the actual property tax paid. A few states use hybrid circuit breakers that employ elements of all three types of formulas.

Ensure reliable state funding. Even generous circuit breakers can become ineffective without reliable state funding. Circuit breaker benefits should be treated as an entitlement, rather than relying on budget appropriations that can result in pro-rated benefits (as in Iowa), unpredictable annual changes in formulas (as in New Jersey), or elimination of benefits in some years (as in California). Unpredictable fluctuations in circuit breaker benefits are difficult for taxpayers to manage and can have potentially dire consequences on household budgets.

Given the disparities in property wealth across municipalities, it is important for circuit breakers to be funded by the state, rather than at the option of local governments. Because of differences in program design and participation levels, the costs to state governments of existing circuit breaker programs vary considerably, ranging from .004 percent to 6.3 percent of property tax collections among 14 states where program cost data are readily available (Bowman et al. 2009, 20).

Use copayment requirements with threshold circuit breakers. States that use threshold formulas should relieve only a portion of property taxes exceeding the threshold. The remaining difference between the taxes exceeding the threshold and the circuit breaker benefit may be considered a copayment. Copayment requirements are important for avoiding inefficient increases in local spending. If a circuit breaker shields taxpayers from 100 percent of any property tax increase, they have no incentive to scrutinize increased local spending since they will benefit from better public services without any increase to their tax bill.

Deliver circuit breaker benefits in a timely and visible way. States use three methods of distributing circuit breaker benefits: rebate checks, income tax credits, and property tax credits or exemptions. A property tax credit reduces the tax bill based on a property's full assessed value, while a property tax exemption reduces a property's assessed value.

Providing benefits through a property tax credit or exemption has two key advantages over rebate checks or income tax credits. First, taxpayers receive an immediate reduction in their property tax bills instead of facing a delay between the date they pay their property taxes and the date their circuit breaker application can be processed. Second, taxpayers observe the benefit as property tax relief instead of mistaking an income tax credit for income tax relief. Since renters do not pay property taxes directly, their circuit breaker benefits can be dispersed through a rebate check.

Use a public outreach campaign. Low participation is a common problem among existing circuit breaker programs. Taxpayers will not apply for benefits if they are not aware of the program, or if they do not believe they qualify for benefits. To increase awareness and participation, states may promote programs through print advertising, broadcast media, and/or speaking tours. The Internet is a particularly useful and low-cost tool for circulating up-to-date program details including deadlines, contact information, printable claim forms, or online applications. Some states are able to enlist the help of nonprofit organizations in promoting participation if the group views the circuit breaker program as supporting its mission. For example, the Gerontology Institute at the University of Massachusetts promotes that state's program as part of its efforts on behalf of the elderly.

Conclusion

The current fiscal crisis may usher in a new era for state governments under intense pressure to redesign programs to "do more with less." Property tax relief is a core function of state governments, and it can be made more fair and cost-effective by using a circuit breaker program. This policy tool is designed to stop the property tax from exceeding a taxpayer's ability to pay by targeting tax relief to those who need it most.

A majority of the states currently employ circuit breakers, but most programs fall short of ideal leaving ample room for improvement. New York's poorly targeted property tax relief system, for example, could be replaced with an expanded circuit breaker that provides more help to taxpayers overburdened by the property tax, but costs less than the current program. Circuit breaker programs can also help strengthen the property tax itself as a mainstay of local government finance. **L**

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