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We're discussing property taxes today in the context of the state budget. Therefore, I will begin and end my testimony with a focus on the state's School Tax Relief program, or STAR.

STAR is now the most-extensive, heavily funded program of its type in any state. In 2006-07, STAR cost $3.9 billion – soaking up 12 percent of the state's largest revenue source, the personal income, which provides a dedicated revenue stream in support of the program. This sum has grown to $4.7 billion in the current fiscal year, and is projected to reach over $6 billion in 2010-11, by which point it will soak up 14 percent of income tax revenues. Roughly three-quarters of STAR flows to school districts outside New York City.

But despite the billions already spent on "property tax relief" through this program, public unhappiness over mounting property taxes in New York has persisted and strengthened in the 10 years since STAR was first enacted. STAR has not solved the problem it was meant to address, because it treats the symptom and not the disease. The "relief" STAR provides is temporary, like a large dose of fiscal Novocain. The pain becomes all the greater when the Novocain wears off.

It did not have to be this way. Gov. Pataki's original 1997 STAR proposal included a provision that would have capped the annual growth in school tax levies at 4 percent or the rate of inflation. Exceptions to the growth cap would have been made for increases in enrollment and for the assessed value created by new construction.

At that point, tax levy limits were hardly a novel concept -- even in New York State. Just two years before Gov. Pataki unveiled STAR, Assembly Speaker Silver introduced the "Real Property Tax Limitation Act" (A.6171 of 1995-96), a bill designed to limit all local revenues to the rate of inflation. Exceptions to the cap would have been allowed only in "extraordinary" circumstances, requiring a well-advertised public hearing and vote of the local governing body. The state itself would have been subject to a maintenance-of-effort obligation designed to ensure a steady flow of aid to local governments affected by the limit.

Although the speaker's bill easily passed the Assembly in 1995, Gov. Pataki's proposed cap on tax levies was never seriously considered during the budget process of 1997. Indeed, the original STAR cap provisions never came to an up-and-down vote in either house of the Legislature. They were stripped out of the STAR proposal in budget negotiations before the program was enacted, and Governor Pataki's halfhearted attempts to revive the issue were essentially ignored.

The rest is history. During the years when STAR was being phased in, from 1998 to 2002, homeowners' school tax bills did, in fact, temporarily subside. But the underlying growth rate in school property tax levies accelerated - an effect most fully reflected on the tax bills paid by owners of commercial, industrial property and multi-family residences.

The STAR experience confirms the wisdom of a long-standing axiom in public finance: when you subsidize something, you get more of it. With no tax levy limit in place, spending billions of state tax dollars to dull the pain of high local property taxes simply resulted in higher spending - and ultimately, even higher school property taxes. STAR provided temporary tax stabilization, not permanent tax relief. It was not a tax cut but a "tax shift," as the state comptroller's office noted last year.

By decoupling the added tax "relief" from the tax bill, the new, enhanced "Middle-Class STAR" rebate is likely to produce a smaller bump-up effect. However, it will also weaken the perception among homeowners that you are actually "cutting" their property taxes -- as opposed to cutting them checks. The means-testing of the program has, if anything, made STAR even worse, by introducing new complexity and unintended inequities into determination of who gets the biggest check.

IF STAR ISN'T THE ANSWER, WHAT IS?

STAR had no sooner been fully implemented in 2001-02 than a new real estate boom prompted complaints that rising assessments were pushing school taxes to unaffordable levels, especially for senior citizens. Some taxpayers have become so frustrated that they have begun to advocate the complete elimination of school property taxes. Their frustration is understandable - but their proposed solution would be administratively impractical and economically destructive.

To begin with, the income tax rate necessary to finance elimination of the school property tax on a county-by-county basis would have to be quite high, even in upper income areas of downstate New York. For example, based on 2002 data, I have calculated that in Nassau County, the shift would require an across-the-board income tax surcharge of 76 percent on all income tax filers. The resulting marginal rate of 12 percent would be the highest in the country -- a full 1.5 percentage points higher than the combined rate in New York City. In Suffolk County, the current state income tax rate would have to be doubled -- to 13.7 percent -- in order to replace the homeowners' school property tax.

Westchester, with its larger concentration of wealthy taxpayers, would require a lower surcharge to replace the income tax with a property tax. But less wealthy, less developed counties upstate would need to more than double the current state income tax rate. Such a proposal would also mean a substantial redistribution of the tax burden within the borders of a given county -- assuming, of course, that affluent taxpayers do not shift their primary residences to other states or counties in order to avoid the tax.

If the add-on income tax was imposed on a statewide basis, excluding only New York City, it appears a top rate of roughly 10 to 11 percent would be necessary, depending on whether the tax also applied to out-of-state workers employed largely in New York City.

The most important question is this: how would the state's economy be affected by a law that eliminated school taxes for one class of property owners while significantly increasing the income tax for all households -- including the many business owners also covered by the tax? Assuming New York City is excluded from any such change, raising the income tax back to double-digit levels in the rest of the Empire State would dramatically reduce the incentive to work, save and invest in New York compared to other states with lower marginal rates. The negative consequences of a higher income tax rate are likely to easily outweigh any benefits realized from lowering or even eliminating the property tax for homeowners.

Proposals to shift a large part of the school tax base to the income tax also ignore the substantial volatility of the income tax base. Between fiscal years 2001 and 2003, New York State's income tax collections dropped by 14 percent, with virtually all of the decrease concentrated among high-income taxpayers. The property tax, by contrast, is a far more stable and reliable revenue source.

TREATING THE ILLNESS

The real root cause of the problem -- the source of high property taxes -- is the high cost of local government and school districts in New York, which is the primary element in the "perfect storm of unaffordability" described by Gov. Spitzer. Calming that storm requires a concerted effort to attack the factors that drive costs, such as state mandates. But at the end of the day, experience indicates that significantly higher state aid will not produce lower property taxes -- unless local governments and school districts feel some real pressure to restrain their overall costs.

For your consideration today, the example I'd like to point to is Massachusetts. Throughout the 1970s, the Bay State perennially rivaled New York in rankings of combined state and local tax burdens relative to income. As late as 1980, New York and Massachusetts were Numbers 1 and 2 on this list, respectively.

New York has continued to rank in the top three throughout the past 25 years. But as of the latest Tax Foundation rankings, Massachusetts had tumbled to 28th place, well-below average. In fact, it's been more than 25years since Massachusetts was even in the top 10. No one calls its "Tax-a-chusetts" anymore.

What happened in the meantime? The answer: Proposition 2 1/2. Passed by the voters of Massachusetts in 1980, Prop. 2 1/2 limits annual increase in any municipality's tax levies to 2 1/2 percent, and also limits total property taxes to 2 1/2 percent of market value.

Opponents predicted it would starve local governments, especially schools. But there is no evidence of this. In fact, per-pupil expenditures by Massachusetts public schools increased faster than the national average and faster than per-pupil expenditures in New York during the first 23 years after Prop. 2 1/2 was enacted. To a degree that surprised both sides in the original Prop 2 1/2 debate, voters in many municipalities took advantage of the loophole allowing overrides of the limit for specific spending purposes. And over time, the Commonwealth assumed a much larger share of local school expenditures. But the Massachusetts income tax rate did not go up. In fact, at 5.3 percent, it is now lower than it was for most of the 1980s and early 90s.

New York should revisit the kind of tax cap proposed by Gov. Pataki as part of the STAR program -- limiting annual tax levy hikes to 4 percent or inflation -- allowing overrides and making exceptions for growth in enrollment and the size of the property-tax base.

The greatest virtue of the cap is improved accountability – because it would force the Governor and the Legislature to directly confront the financial consequences of the mandates the state imposes on school districts.

During the few times when the possibility of a cap has been publicly raised in New York, the main objection has been that it is somehow undemocratic in that it would supposedly rob local governments or school districts of discretion in raising revenue. But the Massachusetts experience indicates this is a red herring. Given a chance to override limits, voters frequently do just that. Yet over time, the overall tax burden in that once heavily taxed state has fallen dramatically, compared to national and New York trends.

In closing, I would suggest that the governor's Executive Budget include these provisions:

1. Immediately cap school property tax levies in the manner I described above, adding a wide range of mandate-relief provisions such as those included in Assembly bill 8775, also known as the Property Taxpayers Protection Act.
2. Repeal the STAR rebate, redirecting a portion of the $1 billion spent on rebates this year to an enhanced real property tax circuit-breaker, administered through the income tax and targeted narrowly at those homeowners who truly (and often temporarily) cannot afford to pay their property tax bills. The bulk of the money now spent on rebates should be used to finance broad-based state tax relief.