

The New Jersey Property Tax: Issues and Options

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Introduction

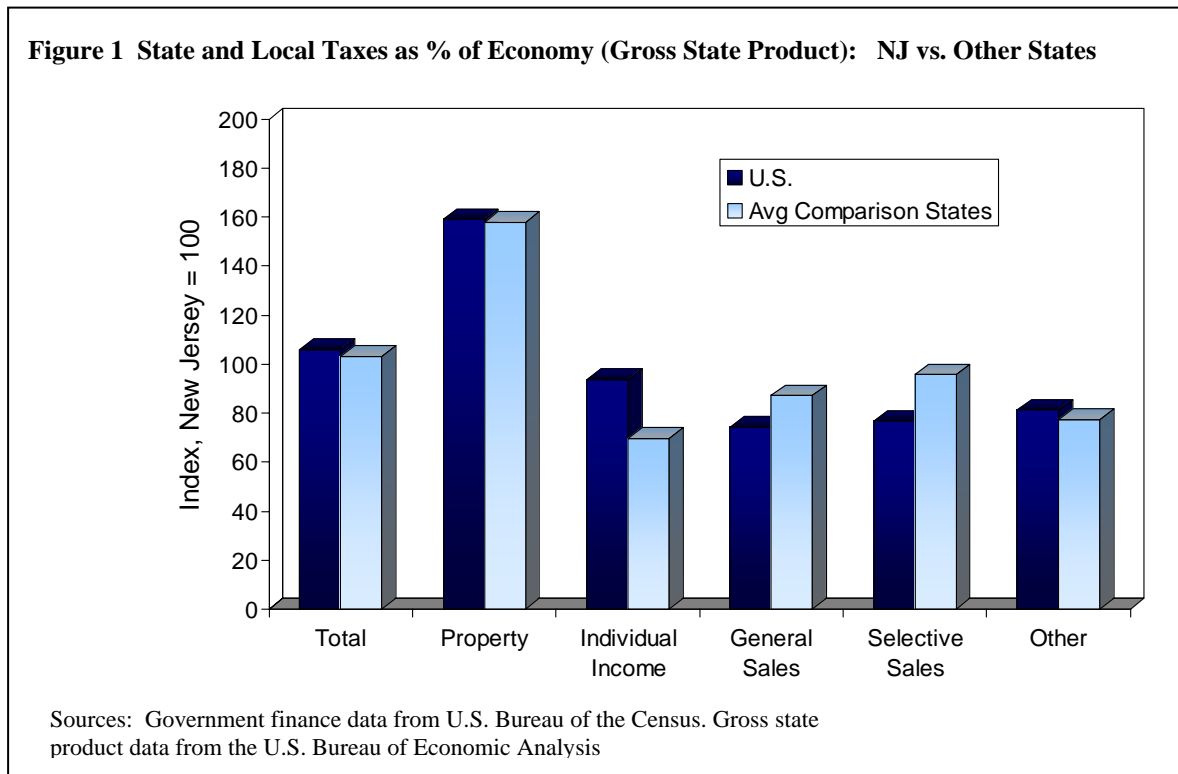
New Jersey property taxes are the highest in the nation. Perhaps as a result, according to public opinion polls a majority of residents support a property tax constitutional convention and would support lowered property taxes even if that requires increases in other taxes.

This brief examines property taxes in New Jersey and potential options for reform. It draws upon a larger report prepared by the authors for the New Jersey Association of Realtors® Government Research Foundation (NJARGRF). Details behind the analysis in this brief are included in the full report.

The New Jersey Property Tax in Comparison with Other States

We begin by examining the New Jersey property tax in relation to the United States as a whole and to seven comparison states: California, Massachusetts, Michigan, New York, Ohio, Pennsylvania, and Virginia. We selected these states in conjunction with NJARGRF to cover a diverse set of economies, tax structures, policy changes, and issues.

Although total taxes are moderately higher in New Jersey than in other states, real property taxes are much higher than the United States average, and far higher than in our comparison states. On average property taxes as a share of gross state product (a broad measure of the state economy) are nearly 60 percent higher in New Jersey than both the U.S. average and the average for our comparison states. By contrast, New Jersey's income, sales, and other taxes are all below the national average and the average of comparison states.



Higher average property taxes are only part of the story. Taxes on residences are particularly high, usually averaging about 25 to 100 percent higher than other states, depending

on the measure chosen. By contrast, taxes on business property are generally lower than in other states.ⁱ Unlike the majority of states, New Jersey does not impose property taxes on tangible personal property, which helps to account for the lower level of business property taxes in New Jersey. (Some non-property business taxes in New Jersey are much higher than in other states, but an analysis of total business taxes is outside the scope of this brief.)

One consequence of New Jersey's very high residential property taxes is that the initial incidence of New Jersey's total taxes falls more heavily on lower-income families than is true for taxes in most other states. By one ranking, New Jersey's taxes on poor families are the seventh-highest of any state.ⁱⁱ It is difficult to know whether this conclusion holds up after considering behavioral responses to taxation. Heavy reliance on property taxes also raises other issues. While the property tax has many benefits, it does have the disadvantage that it can be very difficult to administer uniformly within a state.

Local governments levy almost all property taxes, both in New Jersey and in most other states. Virtually all of New Jersey's higher property taxes result from higher *local* property taxes. That does not mean that high property taxes result primarily from local policy choices—quite the contrary, state governments generally define the taxes that local governments are allowed to levy and the limits on those levies, and they generally determine which services will be financed by state government and which by local government.

Although New Jersey's higher property taxes often are attributed to its heavy reliance on local government to finance education, this is only part of the picture. New Jersey's school district property taxes as a percentage of gross state product were 78 percent higher than the United States average in 2002, but county and municipal taxes were also high, at 54 percent above the United States average. School districts account for a slight majority of New Jersey's "excess" property taxes relative to the nation (as a percentage of gross state product), but counties and municipalities are a close second.

Finally, although New Jersey's local property taxes are high, total local revenue in New Jersey is actually lower than in other states, primarily reflecting lower nontax revenue, lower state aid, lower federal aid, the absence of any local sales taxes, and other taxes that are lower than average. Local governments in New Jersey are much more constrained in their revenue-raising ability than local governments in many other states.

Many states have reduced or constrained growth in property taxes. The property tax limitation and reform movement began with California's Proposition 13 in 1979, followed shortly thereafter by Proposition 2-1/2 in Massachusetts. Voters in Michigan passed a resolution in 1995 that reduced local property taxes for education and raised the state sales tax rate from 4 to 6 percent. This change effectively cut the property tax contribution to education finance in half and caused overall property taxes to fall significantly. By contrast, New Hampshire adopted a statewide property tax to help fund schools following a 1997 state Supreme Court decision. New Hampshire's state property tax was only 0.1 percent of state and local tax revenue in 1999 but it rose sharply to 27.9 percent of total tax revenue in 2000. Vermont also adopted a statewide property tax in response to litigation ruling its system of financing schools unconstitutional. But the pressure in most states has been for lower property taxes. In 2004, Pennsylvania adopted Act 72, the "Homeowner Tax Relief Act." Participating school districts will qualify for a state property tax reduction allocation funded by gambling revenue if they either adopt an additional earned income and net profits tax or personal income tax or propose a property tax relief question at an upcoming municipal election. The state expects that gambling will eventually generate \$1 billion each year that can be used for local property tax relief.

Recent rapid rises in property values throughout much of the country and concomitant property tax increases seem likely to keep the pressure on additional states to reduce property taxes.

Revenue Options: Alternatives for Financing Property Tax Relief

Three major options for lowering reliance on the property tax are considered in the report: reduce the size of government, raise non-property taxes, and finance more of government with user fees. Of course, some combination of these options could be adopted. The options are evaluated in terms of four major goals for a good tax system: fairness, administration and compliance, revenue performance, and economic efficiency. Further, the options are considered in the context of replacing \$3.45 billion of property tax revenue in 2005. A property tax reduction of this magnitude would lower by one-half the extent to which New Jersey's property tax exceeds the national average (as a share of gross state product).

Reduce the Size of Government

The desirability of cutting property taxes and not replacing the revenues is a good option if New Jersey's state and local governments are regarded as too large, but presumably not if the government is seen as the right size. The report does not seek to answer the question of whether New Jersey's government is too large, but does provide a comparison with other states. The story regarding the relative size of New Jersey state and local governments is mixed, but does not evidence that its revenues are large relative to many other states. The combined New Jersey tax burden is 10.4 percent of personal income, which is at the national average and in the middle of the comparison states. Further, New Jersey's own-source revenues, which include tax revenues, charges, fees, and miscellaneous revenues, are well under the national average and second lowest among the comparison states as a percent of personal income.

A \$3.45 billion property tax reduction would lower total state and local government *tax* revenues by 9 percent, which would place New Jersey taxes nearly one percent of personal income below the national average. It would also lower the share of total state and local taxes provided by the property tax from 46.3 percent to 41.3 percent. Still, New Jersey's reliance on the property tax would be much above the average state's.

Reducing the property tax without replacing the revenue would require that a similar cut be made in government expenditures. The report considers the alternative of lowering state and local government employment. New Jersey employs 5.66 percent of its population in the state and local government sector, which is larger than the national average of 5.42 percent. New Jersey could reach the national average in state and local employment by eliminating 21,039 positions, but this would lower costs by only about 30 percent of the \$3.45 billion. A total of 70,300 slots must be eliminated to cut government by \$3.45 billion, which would represent 14 percent of New Jersey state and local government. Then, the difficult decision would need to be made regarding which employees to remove. New Jersey's employment share is highest in elementary and secondary education employees and the data do not indicate that employment is unusually high in areas that are often thought of as bureaucracy, so there are not obvious choices for where to make large employment cuts.

Raise Other Taxes

Replacing property tax revenues with other taxes is a second alternative considered here. Income, property and sales taxes dominate New Jersey revenues, just as in other states, which means the income and sales taxes are probably the most likely options for replacing property tax revenues. Property taxes could be lowered either by allowing local governments to use sales or income taxes at their own discretion to replace their property taxes or by enacting higher sales or income taxes across the state (either through a required local tax or higher state tax rates). A mechanism for transferring the revenues to local government would be necessary if the state collected the additional revenues for the purpose of property tax reductions. Selective sales taxes, such as on alcohol and tobacco products, are another option to generate additional revenue.

New Jersey's sales and income tax bases tend to be narrow compared with many states so relatively large rate increases would be necessary to replace the revenues. The sales tax would need to be raised from 6.0 percent to about 9.0 percent to replace \$3.45 billion in revenues. This would place New Jersey's sales tax rate second highest to the combined average state and local rate in Tennessee (which does not have a broad-based income tax). Greater reliance on the sales tax would probably increase the volatility of the overall tax structure, but would not significantly alter the underlying growth of tax revenues. A higher sales tax would be regressive, at least when measured against current income. Higher sales taxes could also create some perverse incentives, such as increasing the motivation to purchase taxable goods and services remotely.

Alternatively, New Jersey could impose the sales tax on a series of currently untaxed services, a step that many states have found politically difficult to do. A number of states have broadened the base to services, but generally those that raise relatively small amounts of revenue. Professional services, such as medical, legal and accounting services, and construction services would probably need to be taxed if significant revenue is to be generated through taxation of services. Taxation of many services increases the extent of taxation on business-to-business transactions, which can cause tax cascading and increase the cost of doing business in New Jersey.

Higher income taxes are another possible alternative. The income tax structure currently ranges from 1.4 percent on incomes below \$20,000 to 8.97 percent on incomes above \$500,000. The degree of progressiveness is high among U.S. states, and the average effective rate is only 2.05 percent as a percent of total personal income. The average *effective* rate would need to rise by 0.9 percent to generate \$3.45 billion, and given the relatively narrow tax base, the average *actual* tax rate would need to increase 1.4 percent. But, this could be accomplished with a wide range of different rate increases. For example, the revenue could be generated with rates ranging from 2.8 percent to 10.37 percent if an across the board increase in income taxes was enacted. New Jersey would have the highest marginal income tax rate in the country with such an increase and the highest rate would be more than 2.5 percent above any neighboring state. Differentials of this magnitude can be difficult to levy in today's mobile economy. Ultimately, the decision on which rates to increase would determine the progressiveness and other effects of the reform.

The combination of alcohol and tobacco taxes collected \$865 million in 2004, evidencing it would be very difficult for New Jersey to significantly reduce the property tax using these sources. Increases in selective sales taxes are probably best used as one component of an overall package to lower property tax burdens rather than the major part of the reform.

Higher User Fees

User fees are the third alternative considered here. User fees refer to prices charged for services provided through the public sector. User fees can only be imposed when people can be excluded from consuming the service, which means they cannot be used for services such as police protection and environmental protection. Key advantages of user fees are that they are paid by those who consume the services, and if set properly the fees provide the necessary funding to finance the costs of any service increases. Disadvantages include that it might be *undesirable* to exclude people from consuming some services, such as education.

New Jersey state and local governments raise only 14.7 percent of their revenues with user fees, compared with a national average of 19.1 percent. New Jersey could replace about \$2 billion of property taxes if it imposed user fees at the national average. Unfortunately, it is difficult to see areas where additional user fees could be imposed since the major areas where New Jersey is particularly light are tuition and hospital charges, which may be quite difficult to raise significantly.

Notes

ⁱ Based on analysis of information in the following reports: Center for Public Finance Research, *50-State Property Tax Comparison Study, Payable Year 2004*, Minnesota Taxpayers Association, January 2005.; Cline, Robert, Thomas Neubig, Andrew Phillips, and William F. Fox (2005). “Total State and Local business Taxes: Nationally 1980-2004 and by State 2000-2004.” *State Tax Notes*, May 9: 423-437.; District of Columbia Chief Financial Officer, *Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison, 2003*, August 2004.; Ernst & Young LLP, Robert Cline, Tom Neubig, and Andrew Phillips with William Fox, for Council on State Taxation, *Total State and Local Business Taxes*, April 2005. See full report for details.

ⁱⁱ McIntyre, Robert S., Robert Denk, Norton Francis, Matthew Gardner, Will Gomaa, Fiona Hsu, and Richard Sims, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, 2nd Ed. Institute on Taxation and Economic Policy, January 2003.