

# The New Jersey Property Tax:

## Issues and Options

Prepared for the  
New Jersey Association  
of REALTORS®

Government Research Foundation

June 7, 2006



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Donald J. Boyd  
Director, Fiscal Studies Program  
The Nelson A. Rockefeller Institute of Government  
Albany, NY 12203-1003  
boydd@direcway.com  
Affiliation given for identification purposes only

William F. Fox  
Professor of Economics and Director  
Center for Business and Economic Research  
The University of Tennessee  
Knoxville, Tennessee 37996  
(865) 974-5441  
billfox@tennessee.edu  
Affiliation given for identification purposes only

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## **About the Authors**

### **DONALD J. BOYD**

Donald J. Boyd is the director of the Fiscal Studies Program at the Rockefeller Institute of Government, the public policy research arm of the State University of New York. The Fiscal Studies Program provides practical independent research about state and local government finances in the 50 states. Don has more than 20 years experience analyzing state and local fiscal issues. His past positions include director of the economic and revenue staff for New York State's budget office, and director of the tax staff for the New York State Assembly Ways and Means Committee. Don holds a Ph.D. in Managerial Economics from Rensselaer Polytechnic Institute in Troy, New York. Boyd also is deputy director of the Center for Policy Research at the University at Albany, where he focuses on research relating to education issues and teacher labor markets.

### **WILLIAM F. FOX**

Bill Fox is the William B. Stokely Distinguished Professor of Business and the Director of the Center for Business and Economic Research at the University of Tennessee. He is past President and recipient of the Steven D. Gold Award from the National Tax Association and former Chairman of the Economics Department at the University of Tennessee. He has held visiting appointments as a Professor at the University of Hawaii and as a scholar at the Federal Reserve Bank of Kansas City.

Fox has served as a consultant in approximately 25 countries and more than 10 U.S. states on a wide range of public policy issues. He has published extensively in academic and nonacademic journals and is a frequent speaker to business, government, and academic audiences around the world.

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## Executive Summary

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.

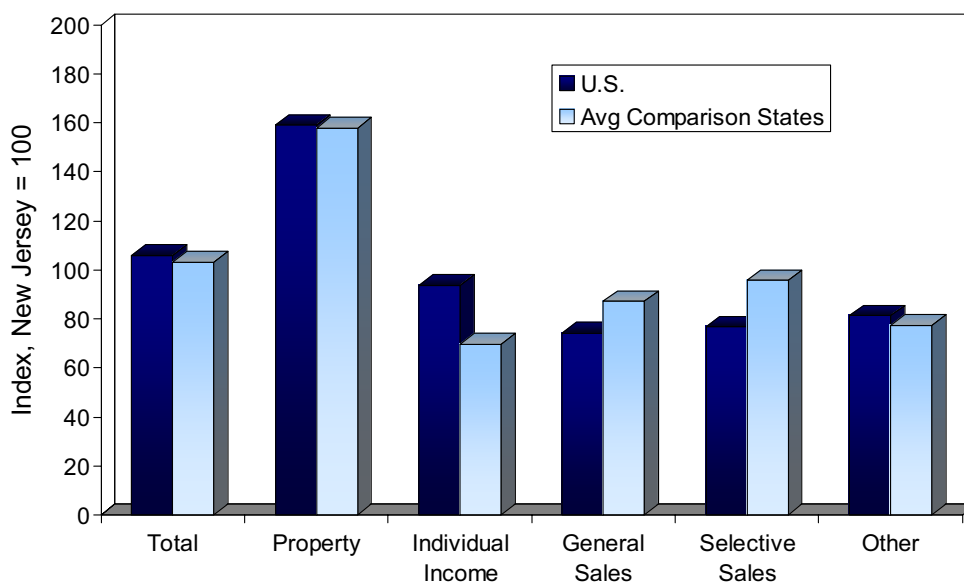
This brief examines property taxes in New Jersey and potential options for reform. It draws upon a larger report prepared by the authors for the New Jersey Association of REALTORS<sup>®</sup> Government Research Foundation (NJARGRF). Details behind the analysis in this brief are included in the full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

**Figure A: State and Local Taxes as Percent of Economy (Gross State Product): NJ vs. Other States**



Sources: Government finance data from U.S. Bureau of the Census. Gross state product data from the U.S. Bureau of Economic Analysis.

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.<sup>i</sup> 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.<sup>ii</sup> 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.

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<sup>i</sup> 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.

<sup>ii</sup> 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.

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.

## **Introduction**

Proposed legislation in New Jersey would put a property tax constitutional convention before the state's voters (A-5269 and potential variants), and elected officials have discussed the possibility of a special session to address property tax issues. Among other things, A-5269 would require the convention to develop revenue-neutral recommendations to:

- eliminate inequities in the current system of property taxation, especially as they affect low and moderate income residents,
- ensure greater uniformity in the application of property taxes,
- reduce property taxes as a share of overall public revenue, and
- provide alternatives that lessen the dependence of local government on property taxes, or provide alternative means, including possible increases in other taxes, of funding local government services.

Possible variants on A-5269 would charge the convention with broader responsibilities, including examination of expenditure issues.

This report is intended to provide the New Jersey Association of REALTORS® Government Research Foundation (NJARGRF) with useful information in advance of a possible convention or special session of the legislature. The first chapter of this report analyzes the existing New Jersey property tax system and compares it with other states. The second chapter identifies and analyzes options for lessening the local property tax burden in New Jersey.

## **Chapter 1:**

### **The New Jersey Property Tax in Comparison with Other States**

This chapter analyzes and describes the New Jersey property tax and how it compares with the United States as a whole and with 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.

The chapter examines:

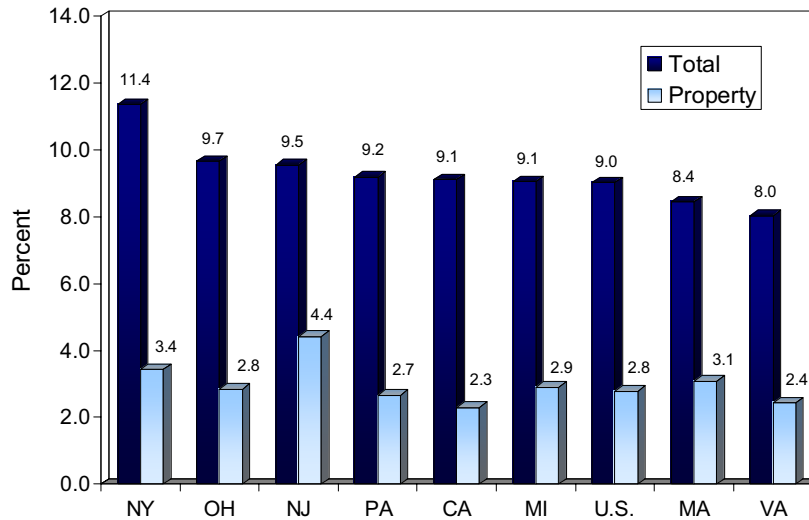
- How the property tax fits into the overall system of financing state and local government
- Trends in the level of taxation and in reliance on different tax sources
- Key features of the property tax
- Issues in how the property tax burden is distributed
- How the property tax is used to fund services and which levels of government are most reliant on the property tax
- Property tax reforms and restructuring

#### ***How the property tax fits into state and local finance***

##### New Jersey's overall level of taxation

As is well known, New Jersey has extremely high property taxes by many measures, and the highest in the nation by some. However, New Jersey's total taxes are only moderately high. Figure 1.1 shows state and local total taxes and property taxes in New Jersey and the comparison states, relative to gross state product. This is a useful measure because it tells us, in a very rough sense, how high New Jersey's taxes are relative to its economic capacity. Another commonly used measure, per-capita taxes, is much less useful, especially because it doesn't take into account the fact that New Jersey is "richer" than many other states and has greater capacity to pay. (Richer states tend to purchase more "government," just as richer people buy more goods and services.)

**Figure 1.1: Total Taxes and Property Taxes Relative to State Economies**



Tables 1.1 and 1.2 show state and local property taxes and total taxes as a percentage of gross state product in New Jersey, indexed to other states, at five year intervals (ending with the latest available fiscal year, 2002). Several tables in this chapter are in pairs and follow the format of these tables, so we will spend time now making sure they are clear. The first table shows New Jersey's taxes as a percentage of gross state product (a broad measure of economic activity) indexed to the 50-state average and indexed to the simple average for the seven comparison states. An index value of 100 would mean that New Jersey's taxes were the same as other states. An index of 150 would mean New Jersey's taxes are 50 percent higher than the other states. Thus, the index of 162.8 for property taxes in 1982 means that New Jersey's property taxes as a percentage of gross state product were 62.8 percent higher than the national average.

The second table in the pair gives the actual values of taxes as a percentage of gross state product, first for New Jersey, then for the 50 states (the United States), then for the average of the comparison states, and finally for the individual comparison states. Thus we see that in 1982 New Jersey's property taxes were 4.36 percent of its gross state product, while property taxes in the 50 states as a whole were 2.68 percent of gross state product. A quick calculation shows that 4.36 is approximately 62.8 percent higher than 2.68, as the index value in the first column of Table 1.1 suggests.

Table 1.2 shows that both property taxes and total taxes have fallen as a share of GSP over the past decade, but they have fallen more slowly than the average of all U.S. states.

Looking at Table 1.1, we see that New Jersey's property taxes have been consistently 40-60 percent above the national average and the comparison states. We also see that New Jersey's total taxes as a percentage of gross state product usually have been less than 10 percent above the nation. These are long-standing patterns. (We also see that while tax levels in most comparison states have been reasonably stable, Michigan's property tax fell substantially after 1992—a story we will turn to later.)

The main conclusions from these tables are that New Jersey's aggregate state and local property taxes are high, but its total taxes are only moderately higher than other states'.

**Table 1.1: State and Local Taxes as a Percent of Gross State Product**

	New Jersey Indexed to:	
	United States	Average of Comparison States
<b>Property Tax</b>		
1982	162.8	140.6
1987	146.0	141.4
1992	153.2	144.6
1997	158.8	154.9
2002	159.0	157.8
<b>Total Tax</b>		
1982	114.2	104.5
1987	108.4	103.2
1992	110.6	106.6
1997	102.2	98.6
2002	105.8	103.1

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Table 1.2: New Jersey Level of Taxation Compared with Other States, Selected Fiscal Years**

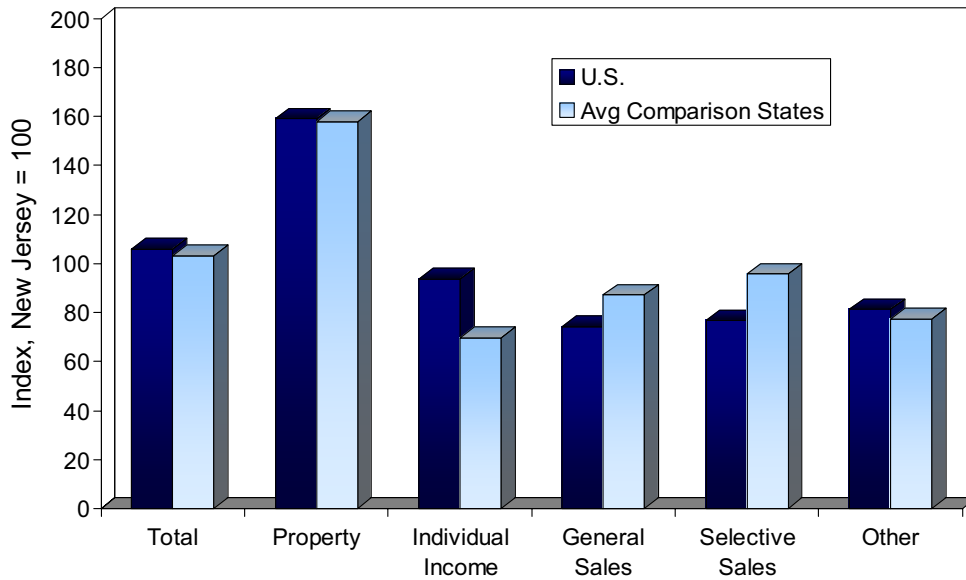
	New Jersey	United States	Average of Comparison States	Comparison States						
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
<b>Property Tax</b>										
1982	4.36	2.68	3.10	2.27	3.83	4.30	3.87	2.62	2.44	2.38
1987	4.06	2.78	2.87	2.33	2.97	3.86	3.62	2.43	2.57	2.31
1992	4.72	3.08	3.26	2.64	3.28	4.44	4.20	2.72	2.83	2.73
1997	4.53	2.86	2.93	2.42	3.14	2.92	3.83	2.74	2.77	2.67
2002	4.42	2.78	2.80	2.29	3.08	2.89	3.43	2.84	2.66	2.43
<b>Total Tax</b>										
1982	9.92	8.69	9.50	8.89	10.17	10.11	12.03	7.80	9.35	8.15
1987	10.05	9.28	9.74	9.30	9.66	10.09	12.54	8.61	9.68	8.33
1992	10.58	9.56	9.92	9.21	9.56	10.39	12.58	9.17	10.18	8.34
1997	9.72	9.51	9.86	9.44	9.63	10.09	11.98	9.52	9.79	8.56
2002	9.54	9.02	9.26	9.11	8.44	9.05	11.36	9.66	9.18	8.03

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

### New Jersey's relative reliance on the property tax

If New Jersey's state and local property taxes are extremely high, but total taxes are closer to the national average, are some taxes relatively low? Yes. Figure 1.2 shows New Jersey state and local taxes in 2002 as a percentage of gross state product, indexed to the national average and to the average for comparison states by tax category. While property taxes were about 59 percent above the national average and 58 percent above the comparison states, all of the other categories were lower than average. The property tax is sometimes referred to as one leg in the three-legged stool of state-local tax structure, with income and sales taxes constituting the other two legs—and in New Jersey, both income and sales taxes are much lower than in other states, as a percentage of gross state product. (Income taxes are about 30 percent below the comparison states and sales taxes are 13 percent below.)

**Figure 1.2: State and Local Tax Sources as a Percentage of GSP, New Jersey Relative to Other States, 2002**



Tables 1.3 and 1.4 show these data for individual states. The top panel of each table shows each individual tax category as a percentage of gross state product. The lower panel shows each tax category as a percentage of total taxes. Let's focus on Table 1.4, with the actual percentages. It shows that New Jersey counts on the property tax for 46 percent of its revenue, compared with only about 30 percent in the U.S. as a whole and in the average of the comparison states. New Jersey's reliance on the sales tax is far lower than in the U.S. as a whole, but only a bit less than in the comparison states. New York, Massachusetts, and Ohio stand out for their high reliance on the income tax.

Finally, Figures 1.3 and 1.4 show the composition of New Jersey's state tax structure and local tax structure, respectively, relative to other states. It is clear that it is New Jersey's extraordinary reliance on local property taxes that sets it apart from other states.

**Table 1.3: Indexed New Jersey Reliance on Tax Sources, 2002**

	New Jersey Indexed to:	
	United States	Average of Comparison States
<b>Tax per \$100 of gross state product</b>		
Total Taxes	105.8	103.1
Property Tax	159.0	157.8
Individual Income Tax	93.6	69.7
General Sales Tax	74.3	87.1
Selective Sales Taxes	76.8	95.7
Other taxes	81.3	77.4
<b>Tax as share of total taxes</b>		
Total Taxes	100.0	100.0
Property Tax	150.3	152.7
Individual Income Tax	88.5	68.0
General Sales Tax	70.3	84.8
Selective Sales Taxes	72.6	91.4
Other taxes	76.8	75.2

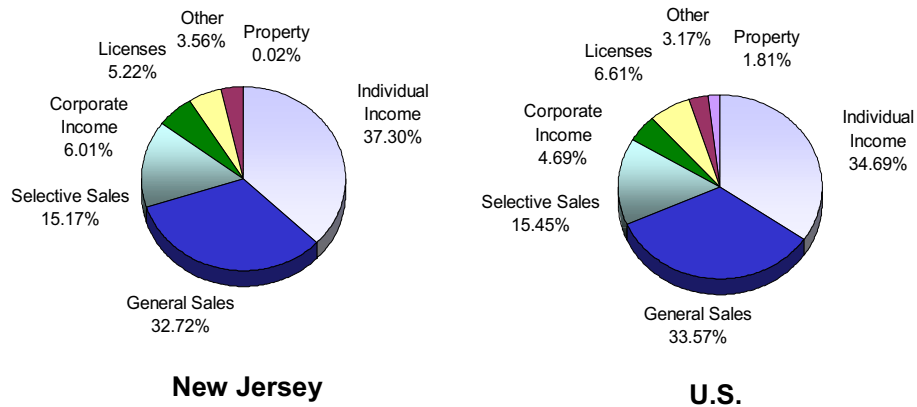
Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Table 1.4: New Jersey Combined State-Local Reliance on Different Taxes, Compared with Other States, 2002**

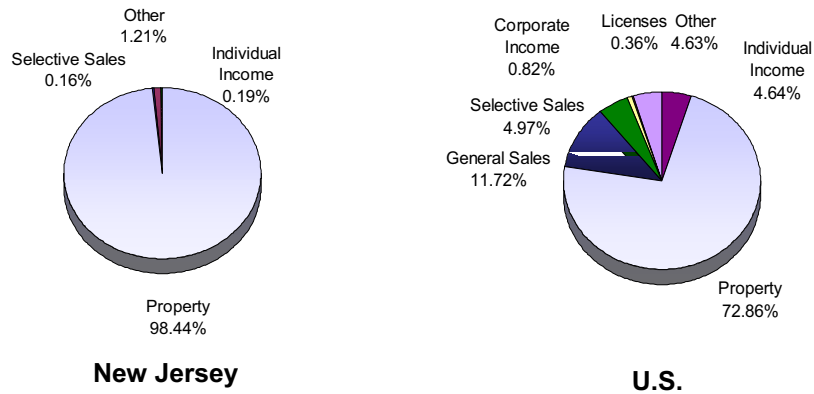
	New Jersey	United States	Average of Comparison States	Comparison States						
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
<b>Tax per \$100 of gross state product</b>										
Total Taxes	9.54	9.02	9.26	9.11	8.44	9.05	11.36	9.66	9.18	8.03
Property Tax	4.42	2.78	2.80	2.29	3.08	2.89	3.43	2.84	2.66	2.43
Individual Income Tax	1.89	2.02	2.72	2.50	2.80	1.95	3.86	3.15	2.32	2.43
General Sales Tax	1.65	2.22	1.90	2.37	1.31	2.30	2.13	2.05	1.83	1.30
Selective Sales Taxes	0.77	1.01	0.81	0.78	0.59	0.72	0.75	0.82	0.92	1.07
Other taxes	0.80	0.99	1.04	1.18	0.67	1.19	1.20	0.79	1.44	0.79
<b>Tax as share of total taxes</b>										
Total Taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Property Tax	46.3	30.8	30.4	25.1	36.5	32.0	30.2	29.4	29.0	30.3
Individual Income Tax	19.8	22.4	29.2	27.4	33.1	21.5	34.0	32.6	25.3	30.3
General Sales Tax	17.3	24.6	20.4	26.0	15.5	25.4	18.7	21.3	19.9	16.2
Selective Sales Taxes	8.1	11.2	8.9	8.5	7.0	8.0	6.6	8.5	10.1	13.4
Other taxes	8.4	10.9	11.2	12.9	7.9	13.1	10.5	8.2	15.7	9.8

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Figure 1.3: State Taxes as a Percentage of Total State Taxes, 2002**



**Figure 1.4: Local Taxes as a Percentage of Total Local Taxes, 2002**



***Key features of property tax systems***

State property tax systems can vary in important details. Two features of New Jersey’s property tax system, aside from the high level of taxation, are particularly notable. First, unlike the majority of states, New Jersey does not generally tax personal property. As noted below, this may be the main reason that New Jersey’s property taxes on business property tend to be lower than those in other states. Although most states still tax this property, the trend has been toward less taxation of tangible business property.

Second, New Jersey has an almost bewildering array of homeowner property tax relief programs. These programs have been modified in many different ways in recent years. The key elements at present are:

- FAIR Rebate Program—rebate available for eligible homeowners and renters, based upon income, age, and filing status. A combination of the prior homestead rebate and NJ SAVER (School Assessment Valuation Exemption Relief) rebate programs.

- Senior/disabled property tax freeze program, also known as the property tax reimbursement
- Other—New Jersey also has a special program for disabled veterans or their surviving spouses, and a \$250 home property tax deduction for senior citizens, the disabled, or their surviving spouses

Table 1.5 summarizes key features of the property tax systems in New Jersey and the comparison states.

**Table 1.5: Key Features of State Property Tax System**

	New Jersey	California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
<b># of local assessing units (a)</b>	567	58	351	1,526	1,198	88	67	226
<b>Administration</b>			Administered by city and town assessors					County supervisors or city councils set tax rates; school districts do not
<b># of independent school districts receiving property tax revenue (b)</b>	547	1,025	-	576	683	667	501	-
<b># of other local governments receiving property tax revenue (b)</b>	411	2,044	386	1,711	2,484	1,543	2,350	209
<b>Do tax rates or assessed-value ratios vary by class of property? (c)</b>	No	No	No	No	Allowed in some cases	No	No	No
<b>Tangible personal property (d)</b>	No (not generally taxable)	Yes	Yes	Yes	No	No	No	Yes, but local-option exemptions
<b>Intangibles (d)</b>	No	No	No	No	No	Yes, when held by dealers	Yes, specified intangibles are taxable	No
<b>Homeowner exemptions and credits (e)</b>	FAIR rebate, based on income, age, property value	Constitution provides \$7,000 reduction in taxable value for qualifying owner-occupied home; senior citizen and disabled tax deferral	No general homestead exemption. Aged, blind, and disabled general relief. Cities and towns may allow principal-residence exemption, generally up to 20%.	Homesteads exempt from school property tax levies for operating purposes	State "STAR" property tax relief program allows \$30k assessed value reduction for school property taxes; local option to tax homesteads at lower rates; up to 50% senior citizen exemption at local option	Local option for exemption up to 50% of median assessed value of residential properties	Local option senior citizen exemption and deferral, income limited	
<b>Income-limited circuit breaker programs (e)</b>	Aged and disabled, \$100k income limit, \$790 max benefit	Aged, blind or disabled, \$37k income limit, \$600 max benefit; renter program also available	Aged, \$63k joint income limit, \$790 max benefit; renter program also available	All ages; \$83k income limit, \$1,200 max benefit; renter program also available	Aged have \$29k income limit, \$375 max ben, lower limits and benefits for non-aged; renter program also available	Aged and disabled, \$24k income limit, assessed value savings up to \$5k	Aged, disabled, surviving spouses, \$15k income limit, \$500 max benefit; renter program also available	
<b>Limits, caps, and freezes (e)</b>	Aged long-term residents potentially eligible to have taxes frozen at base, year level, generally 2001	Proposition 13: 1% of market value cap; individual assessments cannot increase annually by more than lesser of inflation rate or 2%	Proposition 2-1/2: in general local tax districts cannot levy taxes in excess of 2.5% of taxable value, nor increase taxes by more than 2.5% annually, with some exceptions	Individual property values cannot increase by more than 5% annually; total property taxes cannot increase by more than the inflation rate, with some exceptions	Constitutional tax limits for counties, cities, and villages based on full value of properties	Local tax districts cannot collect taxes in excess of 1% of property value without voter approval; most have obtained approval to exceed this limit.	Increase in school taxes limited to growth in statewide average wages; for districts that opt in, also limits on tax as % of taxable value, varying by type of local government	

Sources: Individual state web pages; unpublished comparison reports; and:  
a) International Association of Assessing Officers, Property Tax Policies and Administrative Practices in Canada and the United States, 2000, as reported in Table 3 of Rafoof, 2002  
b) Authors' analysis of government finance data from Census Bureau  
c) Commerce Clearing House, State Tax Guide, 2001, International Association of Assessing Officers, and NCSL, as reported in Appendix B of Rafoof, 2002  
d) Commerce Clearing House, State Tax Guide, 2001, as reported in Appendix A of Rafoof, 2002  
e) Based primarily on Baer, 2003

## *The distribution of property taxes*

Although New Jersey property taxes are high, they are not uniformly high. Several studies have shown that taxes on residential property are high, but taxes on business property are more in line with other states.

Tables 1.6 and 1.7 show several measures of effective tax rates on residential and business property in New Jersey and the comparison states—Table 1.6 shows New Jersey rates indexed to rates elsewhere, and Table 1.7 gives the actual rates. The first block of each table provides information on effective tax rates on residential properties. Rows 1-4 (with the “CPFR” source note) generally show taxes on a property of equal value in the largest urban area in each state, based on an annual study by the Center for Public Finance Research of the Minnesota Taxpayers Association. Row 5 (with the “DCCFO” source note) shows taxes in the largest city in a given state on a residence valued like one typically owned by a family with median income in that city. By any of these measures residential property taxes are far higher in New Jersey than in the U.S. on average, and usually considerably greater than in the comparison states.

The second block of numbers in each table shows two different measures of taxes on business property. Rows 6-8 (with the CPFR source note) present effective tax rates calculated in the same way as the CPFR residential tax rates. Row 9 (with the “E&Y/COST” source note) is from a recent study by the Council On State Taxation and shows estimates of the taxes on business property as percentage of private gross state product. But both measures lead to similar conclusions—taxes on business property generally are lower in New Jersey than in other states. While we do not have definitive data to explain why business property taxes are relatively low in New Jersey, as the section on features of the property tax system points out, New Jersey generally does not impose property taxes on inventories and other tangible personal property but many other states do, and this could be part of the explanation. (Note that some other business taxes are higher in New Jersey than elsewhere, however. An analysis of total business tax burden is outside the scope of this chapter.)

**Table 1.6: Indexed New Jersey Property Tax Burdens by Type of Property**

Row #		New Jersey Indexed to:	
		United States	Average of Comparison States
<i>NOTE: Data source given in parentheses</i>			
<b>Property tax as % of property value</b>			
<u>Residential property</u>			
1	Urban Homestead median value (CPFR)	162.5	156.1
2	Urban Homestead \$150k (CPFR)	140.6	142.5
3	Urban Apartment \$600k (CPFR)	121.1	99.0
4	Rural Homestead \$150k (CPFR)	169.6	126.1
5	Residence, largest city (DCCFO)	197.3	196.4
<u>Business property</u>			
6	Urban Commercial \$1 million (CPFR)	94.9	80.0
7	Urban Industrial \$1 million (CPFR)	71.2	65.1
8	Urban Industrial \$25 million (CPFR)	70.8	64.9
<b>Property tax as % of private gross state product</b>			
9	Business property (E&Y/COST)	97.2	102.0

Sources: (See reference section for full citation.)

CPFR: Center for Public Finance Research, Minnesota Taxpayers Association

DCCFO: District of Columbia Chief Financial Officer, Nationwide Comparison

E&Y/COST: Ernst & Young LLP, for Council on State Taxation

**Table 1.7: New Jersey Effective Property Tax Rates Compared with Other States**

Row #	New Jersey	United States	Average of Comparison States	Comparison States							
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia	
<i>NOTE: Data source given in parentheses</i>											
<b>Property tax as % of property value</b>											
<u>Residential property</u>											
1	Urban Homestead median value (CPFR)	2.33	1.43	1.49	1.23	0.62	3.20	0.78	1.19	2.19	1.24
2	Urban Homestead \$150k (CPFR)	2.00	1.42	1.40	1.19	0.18	3.20	0.61	1.19	2.19	1.24
3	Urban Apartment \$600k (CPFR)	2.22	1.83	2.24	1.25	1.04	4.07	4.38	1.38	2.09	1.49
4	Rural Homestead \$150k (CPFR)	2.21	1.30	1.75	0.96	1.42	1.84	3.34	1.32	2.42	0.96
5	Residence, largest city (DCCFO)	2.96	1.50	1.51	1.08	1.33	1.82	1.12	1.45	2.64	1.11
<u>Business property</u>											
6	Urban Commercial \$1 million (CPFR)	1.94	2.05	2.43	1.25	3.01	4.02	3.92	1.48	1.83	1.49
7	Urban Industrial \$1 million (CPFR)	1.17	1.64	1.79	1.00	1.65	3.28	2.35	1.86	1.10	1.28
8	Urban Industrial \$25 million (CPFR)	1.17	1.65	1.79	1.00	1.65	3.28	2.35	1.90	1.10	1.28
<b>Property tax as % of private gross state product</b>											
9	Business property (E&Y/COST)	1.69	1.73	1.65	1.22	1.75	1.91	2.19	1.71	1.42	1.37

Sources: (See reference section for full citation.)  
 CPFR: Center for Public Finance Research, Minnesota Taxpayers Association  
 DCCFO: District of Columbia Chief Financial Officer, Nationwide Comparison  
 E&Y/COST: Ernst & Young LLP, for Council on State Taxation

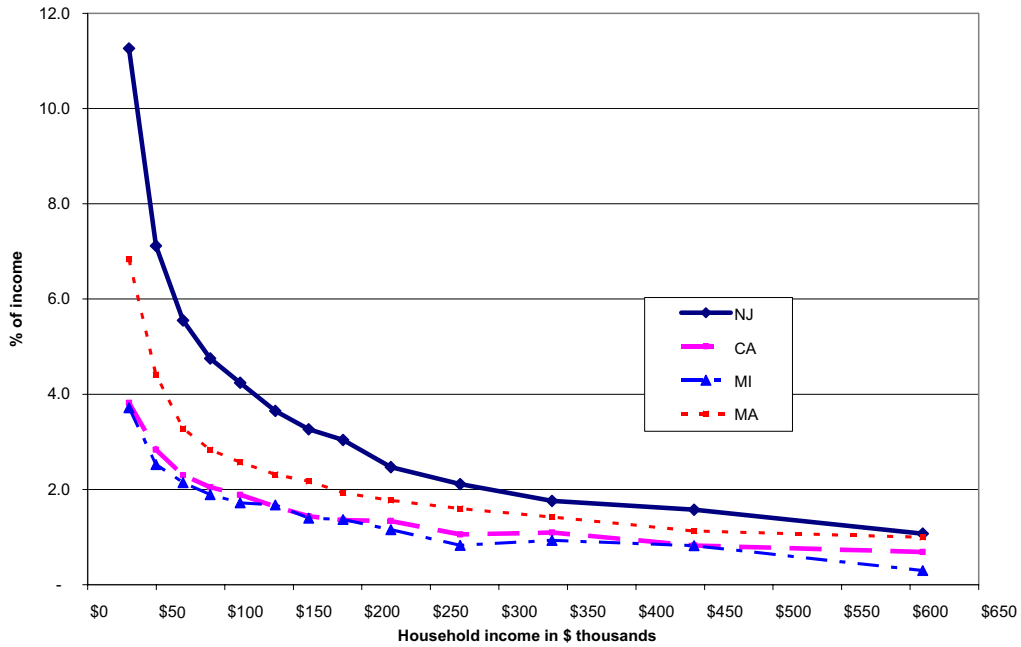
The high level of residential property taxation has clear implications for the distribution of taxes across income ranges. Although people with higher incomes tend to have more expensive houses than people with lower incomes, the amount spent on houses as a percentage of current income tends to fall as income rises. As a result, direct property tax payments tend to fall as a percentage of current income as income rises—put differently, the direct impact of property taxes is regressive, and the New Jersey “premium” versus other states is likely to fall more heavily on homeowners with lower current income than those on higher current income.<sup>3</sup>

Figure 1.5 shows homeowner property taxes as a percentage of household income in New Jersey and three of the comparison states, California, Michigan, and New York based on the public use microdata sample (PUMS) from the 2000 Census. (These three states fairly represent the pattern in other comparison states. Other comparison states are excluded so that the figure does not become cluttered and hard to interpret.)

Clearly the direct impact of homeowner property taxes relative to current income is regressive in New Jersey and the other states—taxes as a percentage of income fall as current income raises. However, because property taxes are so much higher in New Jersey than elsewhere, the impact is much greater in New Jersey—the New Jersey line is higher than the other lines at all income levels, especially lower-income levels. This is one of the main reasons that New Jersey was found to have the seventh highest taxes on poor families of any state in a 2003 report by the Institute for Taxation and Economic Policy. (Washington and Florida, which do not have income taxes and rely heavily on sales taxes, were first and second.)

<sup>3</sup> Economists have studied the incidence of property taxes extensively. When all property taxes are considered, not just homeowner taxes, the property tax in aggregate is generally considered to be progressive relative to lifetime or permanent income. The main reason for this is that the national-average tax is considered a tax on capital, the ownership of which tends to rise as a share of income as income rises. This is known as the “new view” of property tax incidence. This is particularly true when we compare capital to permanent or lifetime income, rather than current income in a single year. The incidence is far less clear, however, when we consider just homeowner property taxes and when we consider the differential between a high-tax location such as New Jersey and other locations. Here the incidence of the “extra” tax is more likely to be regressive.

**Figure 1.5: Effective Homeowner Property Tax Rates by Income Level, Selected States**



Source: Authors' analysis of Census 2000 Public Use Microdata, 1% Sample.

New Jersey's property taxes also vary significantly geographically. It is not easy to compare taxes to the overall economy at the substate level, but we can look at how taxes vary relative to property value. Table 1.8 shows the median effective tax rate of the townships in each county. In general, taxes tend to be highest relative to property value in southwestern counties—taxes are highest by far in Camden County, and second highest in neighboring Gloucester. Taxes are lowest in the seaside counties of Cape May and Ocean County. Three of the five-highest-tax jurisdictions relative to property value are in Camden, and three of the five lowest-tax jurisdictions are in Cape May.

**Table 1.8: Effective Tax Rates by County**

<b>County</b>	<b>Median Effective Tax Rate</b>	<b>County Median Minus Statewide Median</b>	<b>County Median Indexed to Statewide Median</b>
Atlantic	2.50	0.20	108.7
Bergen	2.04	(0.26)	88.7
Burlington	2.61	0.31	113.5
Camden	3.49	1.19	151.7
Cape May	1.37	(0.93)	59.6
Cumberland	2.68	0.38	116.5
Essex	2.45	0.15	106.5
Gloucester	3.05	0.75	132.6
Hudson	2.53	0.23	110.0
Hunterdon	2.03	(0.27)	88.3
Mercer	2.56	0.26	111.3
Middlesex	2.36	0.06	102.6
Monmouth	2.07	(0.23)	90.0
Morris	1.99	(0.31)	86.5
Ocean	1.86	(0.44)	80.9
Passaic	2.69	0.39	117.0
Salem	2.84	0.54	123.5
Somerset	1.89	(0.41)	82.2
Sussex	2.42	0.12	105.2
Union	2.37	0.07	103.0
Warren	2.35	0.05	102.2
<b>Statewide</b>	<b>2.30</b>	<b>-</b>	<b>100.0</b>

Source: Authors' analysis of data from the New Jersey Division of Taxation.

Communities with lower incomes have a very slight tendency to have higher than average property taxes as a percentage of property value, but the relationship is rather weak. However, as Table 1.9 shows, the very highest tax jurisdictions do have incomes that are well below average, and the very lowest tax jurisdictions do have above-average incomes.

**Table 1.9: Highest and Lowest Effective Tax Rates, 2004**

<b>Municipality</b>	<b>County</b>	<b>Effective Tax Rate as % of Property Value</b>	<b>Per capita income, 2000 Census</b>
Winfield Township	Union	12.60	21,565
Tavistock Borough	Camden	8.42	14,600
Audubon Park Borough	Camden	5.15	16,926
Woodlynne Borough	Camden	5.08	14,757
East Orange City	Essex	4.87	16,488
<b>Statewide</b>		<b>2.30</b>	<b>27,006</b>
Deal Borough	Monmouth	0.74	38,510
Mantoloking Borough	Ocean	0.62	114,017
Cape May Point Borough	Cape May	0.62	52,689
Stone Harbor Borough	Cape May	0.58	46,427
Avalon Borough	Cape May	0.57	50,016

Sources: Authors' analysis of property tax data from the New Jersey Division of Taxation, and income data from the 2002 Census of Population.

***Which governments are “responsible” for NJ’s high property taxes?***

In the vast majority of states, property taxes are almost exclusively the province of local governments, and that is true in New Jersey and in the comparison states. Tables 1.10 and 1.11 show

property taxes as a percentage of gross state product by level of government.<sup>4</sup> State and local property taxes in New Jersey are higher than in other states “because” local property taxes are higher—about 65 percent higher than both the United States average and the average for the comparison states. Although public discussion of New Jersey’s property taxes often focuses on the extent to which school taxes are high, the tables show that county and municipal taxes are high, too, albeit to a lesser extent—county and municipal taxes as a percentage of gross state product are 36 percent above the comparison-state average, while school district taxes are 110 percent above the average.<sup>5</sup> Among the comparison states, only Michigan has a significant statewide property tax.

Table 1.12 shows how much each level of government contributes to New Jersey’s “excess property taxes” (the extent by which they exceed national and comparison-state averages). Here we see that New Jersey state and local government property taxes as a percentage of gross state product exceed the national average by 1.641 percentage points. Local taxes are 1.736 percentage points higher than in other states, while state property taxes (virtually nonexistent) are slightly lower. Counties and municipalities account for 0.805 percentage points of the local difference, while school districts account for the other 0.931 percentage points. Put differently, counties and municipalities account for almost as much of New Jersey’s “excess” property taxes as do school districts.

**Table 1.10: Indexed New Jersey Reliance on the Property Tax**

	New Jersey Indexed to:	
	United States	Average of Comparison States
State & local governments combined	159.0	157.8
State government	0.9	0.9
Local governments	164.6	163.8
County and municipal governments	154.0	136.0
School districts	177.9	210.4

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

<sup>4</sup> School district property taxes are zero in both Massachusetts and Virginia because school districts in these states do not levy property taxes directly. Instead, overlying local governments levy taxes and provide payments to school districts—in the Census Bureau’s terminology, districts receive “parent government contributions.” Although these contributions are for school purposes the revenue is not raised by school districts, and they can be derived from property taxes and other revenue sources. There is no easy way to disentangle these contributions and attribute their associated property tax revenue to school districts, so this table is less straightforward than we would like.

<sup>5</sup> The school districts in this analysis are limited to those classified by the Census Bureau as fiscally independent. The Bureau classifies some large school districts as dependent that are treated as independent in other data sources. To see whether this influenced the conclusion, we also constructed an alternative measure of school property taxes that assumed elementary and secondary education spending in fiscally dependent school districts is financed from property taxes, up to the amount of property taxes raised by the parent government. While this increased the amount of property taxes assumed to finance elementary and secondary education in New Jersey, it also increased the school property tax amount in other states, and did not change the fundamental conclusion that non-school property taxes are much higher in New Jersey than elsewhere and contribute to New Jersey’s high property taxes.

**Table 1.11: New Jersey Property Taxes Compared with Other States, by Level of Government**

	New Jersey	United States	Average of Comparison States	Comparison States						
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
State & local governments combined	4.423	2.783	2.804	2.287	3.082	2.892	3.428	2.842	2.662	2.434
State government	0.001	0.097	0.105	0.148	0.001	0.558	-	0.005	0.012	0.008
Local governments	4.422	2.686	2.699	2.139	3.081	2.333	3.428	2.837	2.649	2.426
County and municipal governments	2.295	1.490	1.688	1.120	3.081	1.310	2.175	0.925	0.778	2.426
School districts	2.127	1.196	1.011	1.019	-	1.023	1.253	1.912	1.871	-

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Table 1.12: Differences by Level of Government**

	New Jersey Minus:		Property taxes as % of GSP		
	United States	Average of Comparison States	New Jersey	United States	Average of Comparison States
State & local governments combined	1.641	1.619	4.423	2.783	2.804
State government	(0.096)	(0.104)	0.001	0.097	0.105
Local governments	1.736	1.723	4.422	2.686	2.699
County and municipal governments	0.805	0.607	2.295	1.490	1.688
School districts	0.931	1.116	2.127	1.196	1.011

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

Why are school district and other local governments' property taxes higher than the national average and the comparison state average? Do these local governments provide services that are delivered by state governments in other states? Do they receive less state aid than their counterparts in other states? Do they rely on property taxes while other local governments rely on other taxes and nontax revenue? Finally, do they simply spend more than other governments?

Tables 1.13 and 1.14 provide insight into these questions. The top part of each table shows the share of state-local spending that is paid for directly by the state government in New Jersey and in other states. It provides an indication of the extent to which service delivery is centralized at the state level rather than at the local level (it also reflects how the mix of services provided by governments varies across states). Table 1.14 shows that about 43.4 percent of all state-local spending in New Jersey is paid for directly by state government—not much different from the U.S. average of 43 percent or the comparison-state average of 42.2 percent. This suggests that New Jersey state government is providing at least as much in the way of direct services as other states.

The second part of Table 1.14 is more telling. It shows, for local governments in each state, the percentage of revenue that is derived from state aid. Here we see that New Jersey county and municipal governments count on state aid for 26.8 percent of their budgets. This is not much different from the 25.3 percent national average, but a fair amount less than the 32.3 percent average for the comparison states, and overall it is a mixed picture. Things are more clear-cut with school districts—New Jersey districts receive only 43.5 percent of their revenue from the state government, compared with 48.7 percent for the U.S. as a whole and 47.1 percent for the comparison states. School districts in New Jersey rely on local taxes to a greater extent than do their counterparts in other states.

**Table 1.13: Indexed New Jersey Spending Distribution and State Aid**

	New Jersey Indexed to:	
	United States	Average of Comparison States
<b>Extent to which spending is centralized at state level</b>		
State spending as % of state-local spending	101.0	102.8
<b>State aid as % of local revenue</b>		
County and municipal governments	105.9	83.1
School districts	89.4	92.4

Sources: Government finance data for 2002 from U.S. Bureau of the Census used for state-local spending, and for county and municipal governments. State aid as percentage of school district revenue from National Center for Education Statistics, Common Core of Data, National Public Education Financial Survey Table 2, 2002–03.

**Table 1.14: New Jersey State-Local Division of Responsibility Compared with Other States**

	New Jersey	United States	Average of Comparison States	Comparison States						
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
<b>Extent to which spending is centralized at state level</b>										
State spending as % of state-local spending	43.4	43.0	42.2	35.5	52.4	40.8	35.7	40.7	46.9	43.7
<b>State aid as % of local revenue</b>										
County and municipal governments	26.8	25.3	32.3	34.7	36.3	35.2	31.3	26.2	27.9	34.2
School districts	43.5	48.7	47.1	58.9	40.9	63.3	45.6	44.8	36.6	39.6

Sources: Government finance data for 2002 from U.S. Bureau of the Census used for state-local spending, and for county and municipal governments. State aid as percentage of school district revenue from National Center for Education Statistics, Common Core of Data, National Public Education Financial Survey Table 2, 2002–03.

### *Revenue sources of local governments*

Unlike many other states, in New Jersey local governments rely almost exclusively on the property tax, and in the case of school districts, the property tax is the only local revenue source available. In this respect New Jersey is dramatically out of line with the financing systems of other states.

Tables 1.15 and 1.16 and Figure 1.6 show how remarkably different New Jersey’s revenue structure is from other states. Each table begins, in the top row with “general revenue”—a broad concept of local government revenue that includes revenue from own sources (property taxes, other taxes, plus fees and charges), plus revenue from other governments. The index values in Table 1.15 show us that this broad measure of revenue is actually much lower in New Jersey than elsewhere—12 percent lower than the U.S. average and 14 percent lower than the comparison states.

The next two rows show revenue from other governments and again, New Jersey is much lower than elsewhere—revenue from both federal and state governments is lower. The next row shows own-source revenue—general revenue, excluding revenue from other governments. New Jersey local governments’ revenue from their own sources is about the same as the U.S. average (index of 97.6, close to 100) and the average in the comparison states (index of 101.3).

Own-source revenue consists of nontax revenue plus tax revenue. New Jersey local governments’ nontax revenue is about 42 percent lower than the U.S. average and a third lower than the comparison states. This may be because local governments in New Jersey have less statutory authority to raise revenue from fees and charges.

Tax revenue, by contrast, is about 20 percent higher than in other states, and this is due exclusively to New Jersey's single-minded reliance on property taxes. New Jersey local governments have no authority to impose sales taxes, and almost no ability to raise revenue from other taxes, either.

**Table 1.15: Indexed New Jersey Local Government Revenue Source, 2002**

	New Jersey Indexed to:	
	United States	Average of Comparison States
<b>General revenue</b>	88.1	86.2
Federal intergovernmental revenue	45.9	43.8
State intergovernmental revenue	77.1	69.1
<b>Own-source revenue</b>	97.6	101.3
Nontax revenue	58.1	66.6
Taxes	121.9	119.5
Property taxes	164.6	163.8
Individual income taxes	4.9	2.5
General sales taxes	-	-
Selective sales taxes	3.9	5.2
Other taxes	25.4	20.6

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Table 1.16: New Jersey Local Government Revenue Compared with Other States**

	New Jersey	United States	Average of Comparison States	Comparison States						
				California	Massachusetts	Michigan	New York	Ohio	Pennsylvania	Virginia
<b>General revenue</b>	8.742	9.927	10.144	12.084	7.389	10.078	13.422	10.757	9.392	7.883
Federal intergovernmental revenue	0.197	0.428	0.449	0.560	0.394	0.384	0.510	0.410	0.571	0.311
State intergovernmental revenue	2.734	3.544	3.956	5.417	2.833	4.964	4.710	3.905	3.180	2.683
<b>Own-source revenue</b>	5.811	5.955	5.739	6.107	4.163	4.730	8.203	6.442	5.641	4.889
Nontax revenue	1.319	2.269	1.981	2.881	0.957	2.137	2.373	2.161	1.862	1.498
Taxes	4.492	3.686	3.758	3.226	3.206	2.592	5.829	4.282	3.779	3.391
Property taxes	4.422	2.686	2.699	2.139	3.081	2.333	3.428	2.837	2.649	2.426
Individual income taxes	0.008	0.171	0.333	-	-	0.140	0.592	0.923	0.677	0.000
General sales taxes	-	0.432	0.323	0.565	-	-	1.025	0.346	0.041	0.286
Selective sales taxes	0.007	0.183	0.138	0.256	0.054	0.050	0.172	0.038	0.042	0.353
Other taxes	0.054	0.214	0.264	0.266	0.071	0.070	0.612	0.137	0.369	0.326

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

**Figure 1.6: Local Revenue as a Percent of Gross State Product, 2002**

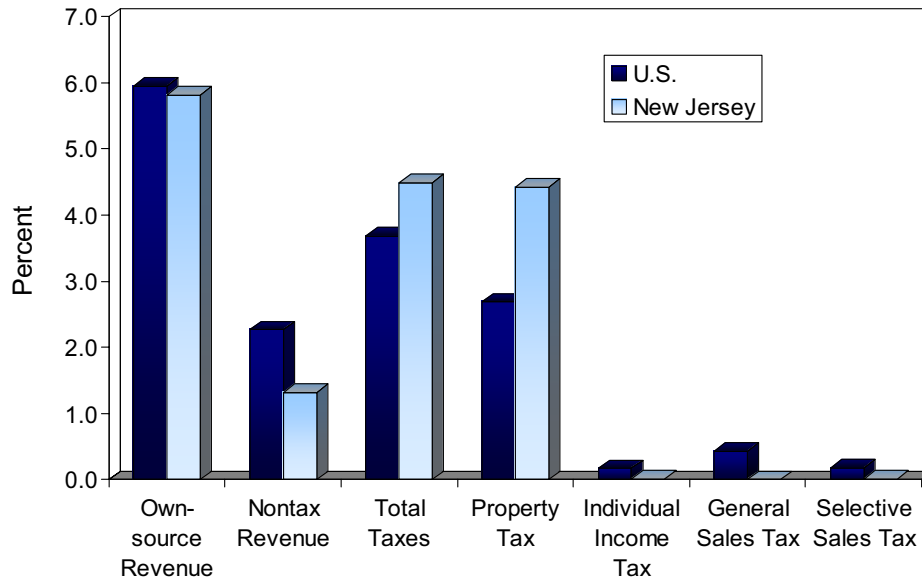


Table 1.17 recasts these numbers showing the difference between New Jersey and other states (rather than indexes) so we can see the relative importance of different revenue sources. Relative to the nation as a whole, New Jersey local government’s “shortfall” in nontax revenue is largest, at 0.950 percentage points of gross state product. It would make sense to explore in detail the nontax sources of revenue that local governments raise in other states that are not raised in New Jersey. The next largest differences are in state aid, which is 0.810 percentage points below the United States average, followed by sales tax and then other taxes.

**Table 1.17: New Jersey Local Government Revenue Compared with Other States**

	New Jersey Minus:		Local revenue as % of GSP		
	United States	Average of Comparison States	New Jersey	United States	Average of Comparison States
<b>General revenue</b>	(1.186)	(1.402)	8.742	9.927	10.144
Federal intergovernmental revenue	(0.232)	(0.252)	0.197	0.428	0.449
State intergovernmental revenue	(0.810)	(1.222)	2.734	3.544	3.956
<b>Own-source revenue</b>	(0.144)	0.072	5.811	5.955	5.739
Nontax revenue	(0.950)	(0.662)	1.319	2.269	1.981
<b>Taxes</b>	0.806	0.734	4.492	3.686	3.758
Property taxes	1.736	1.723	4.422	2.686	2.699
Individual income taxes	(0.163)	(0.325)	0.008	0.171	0.333
General sales taxes	(0.432)	(0.323)	-	0.432	0.323
Selective sales taxes	(0.176)	(0.131)	0.007	0.183	0.138
Other taxes	(0.160)	(0.210)	0.054	0.214	0.264

Sources: Government finance data - U.S. Bureau of the Census;  
Gross state product data - U.S. Bureau of Economic Analysis.

## *Property tax reforms and restructuring*

Many states have reformed or restructured their property tax systems in recent years, and others currently are considering reforms. Worthy of first mention is the property tax limitation movement, which had its modern start in Proposition 13, passed in California in 1979. Proposition 13 limited assessed value increases to no more than 2 percent per year until a property is sold, after which assessed value reverts to market value. Massachusetts' Proposition 2-1/2 also limits both the level of taxation and growth in taxation, with opportunities for voters to override these limits, as is the case with limits in many states. Most states limit property taxes or local government spending in some fashion—the only exceptions are Hawaii, Maine, New Hampshire and Vermont.

More-recent limitations include the Taxpayer Bill Of Rights (TABOR) in Colorado and voter measures in Oregon, both of which are quite comprehensive and constraining. Some tax and expenditure limits are linked to inflation plus population growth as is the case with Colorado's TABOR. A criticism of such constraints is that they preclude growth in real spending and reduce the size of government relative to the economy and thus limit the quality of service delivery. Colorado's limit has been particularly perverse in its limitations during the recent state fiscal crisis from 2001 to 2003. Of course, limits on growth are exactly what is intended.

Property tax bases in New Jersey and elsewhere vary enormously across districts reflecting variation in wealth and income. High reliance on property taxes can lead to large disparities in education spending per pupil unless state aid formulas redistribute spending dramatically. One of the most common reasons for property tax reform in recent years has been to reduce reliance on local property taxes for education, with the intent of reducing disparities in education spending across districts or at least raising the level of spending in the poorest or lowest spending districts. Often states have made these changes in response to litigation similar to the Abbott case in New Jersey, or in response to the threat of litigation.

Michigan and New Hampshire have both reduced local property taxes for education in recent years. 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, as Table 1.2 at the start of this chapter showed. New Hampshire, on the other hand, ultimately 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.

Ohio faced considerable pressure to reform its tax structure after a 1997 state supreme court ruling that declared the state's education finance system unconstitutional due in part to "over reliance" on local property taxes. Ohio then went through several rounds of increased state funding for schools followed by court findings that the financing system was still unconstitutional. Subsequent attempts at mediation between the plaintiffs and the state failed and the court again found the system unconstitutional in late 2002. The legislature rejected the governor's proposed tax increase for education in 2003 and education finance reform efforts essentially ended. The 2005-06 budget recently signed by Governor Taft enacted significant tax changes, phasing the personal income tax down by 21 percent, phasing out the tangible personal property on machinery and equipment, and phasing in a new commercial activities tax.

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.

Virginia adopted the Personal Property Tax Relief Act in 1998, which now provides approximately a 70 percent reduction in personal property tax on qualifying vehicles, relative to prior law. More recently the focus in Virginia has shifted to homeowner property tax relief. Governor Timothy Kaine, during his 2005 election campaign, proposed a constitutional amendment to allow local governments to exempt 20 percent of a home's value from property taxes. Former Governor Kilgore had proposed a mandatory cap on assessed-value increases of owner-occupied houses while he was still in office.

### ***Recap: New Jersey Property Tax in Comparison to Other States***

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 selected comparison states of California, Massachusetts, Michigan, New York, Ohio, Pennsylvania, and Virginia. 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 tend to be lower than in other 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. 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 chapter.)

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. 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.

Property taxes in New Jersey and in most other states are levied almost exclusively by local governments. 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, that 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, 54 percent higher than 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 other states.

Many states have reduced or constrained growth in property taxes in recent years. 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.

## **Chapter 2: Revenue Options: Alternatives for Financing Property Tax Relief**

Chapter 1 of this report identifies the very heavy reliance that New Jersey places on the property tax. This chapter identifies options for financing property tax reductions and the advantages and disadvantages of these options.

### ***Criteria for Evaluating Policy Options***

A series of criteria have been developed over the years for evaluating revenue options. The criteria are briefly described in this section and are used to evaluate the revenue options given in the following sections. These criteria include:

- Fairness
- Administration and compliance efficiency
- Revenue adequacy, stability and elasticity
- Economic efficiency

#### **Fairness**

Analysts normally use two concepts to evaluate tax fairness, vertical equity and horizontal equity. Vertical equity refers to the relative tax burden of households with different levels of household income. Taxes are generally described as progressive, proportional, or regressive based on whether the tax burden rises as a percent of income, stays constant as a percent of income, or falls as a percent of income as household income rises.

Horizontal equity refers to the relative tax burden paid by households with the same income. Most analysts describe taxes as horizontally equitable if households with the same income pay substantially the same taxes. Broad tax bases are most likely to be horizontally equitable, and narrow tax bases and tax structures with many exemptions are most likely to be inequitable.

Horizontal and vertical equity can be examined in terms of individual taxes, such as the property or personal income tax, or they can be studied in terms of the overall tax system. Most analysts believe that it is most important for the entire tax structure to have the desired equity, and that less attention should be attached to the fairness of individual taxes.

#### **Low Administration and Compliance Costs**

Businesses and individuals face compliance costs in filing tax returns, remitting taxes, maintaining records and meeting other requirements of complying with the tax structure. These costs may be implicit, as when individuals spend their otherwise free time tracking their earnings and deductions and filling out their income tax returns. These costs may be explicit, as when individuals hire a tax preparation service, or when businesses hire tax accountants. Administrative costs are the expenditures borne by state and local governments in collecting taxes, including auditing, receiving and processing returns, collecting remittances, and so forth.

Tax complexity, which often arises because of special provisions in the tax system, is an important source of high compliance costs. Simplicity, uniformity and transparency normally lead to low compliance costs and can promote government accountability.

## Revenue Adequacy, Stability and Elasticity

Three aspects of tax revenues should be considered. First, tax revenues must be adequate to meet the current financial needs of state and local governments that are based on the demand for services. It is important to remember that adequacy means that revenues should neither be too high nor too low.

Second, revenues should grow at the appropriate pace, which analysts often summarize with the revenue elasticity. Specifically, elasticity refers to the growth rate of revenues relative to growth in the economy.<sup>6</sup> The revenue elasticity is generally calculated as the percent change in tax revenues divided by the percent change in personal income (a measure of overall economic activity) for some specific time period. For example, if personal income increased by 5 percent between one year and the next, and tax revenue increased by 6 percent, then the elasticity for this time period would be 1.20 (i.e., 6 percent divided by 5 percent). Taxes are generally described as elastic (a coefficient greater than one) meaning revenues grow faster than the economy; inelastic (a coefficient lower than one) meaning revenues grow more slowly than the economy; or unit elastic (a coefficient equal to one) meaning revenues grow at the same rate as the economy. An elasticity of about 1, indicating revenue growth equal to economic growth, is probably appropriate over the long term, though it could be lower or higher if government is initially too small or too large for citizens' tastes.

Tax revenue elasticities for New Jersey state and local governments and the average U.S. state and local government are reported in Table 2.1 for the years 1993 to 2002 and for 1993 to 2004. Data for 1993 and 2002 are drawn from the same source, making them more comparable, but the elasticities are probably understated because of the very weak revenue collections in the last year, 2002. Data for 2004 are pieced together from various sources, so they are less comparable, but are probably a better indicator of the long run performance of New Jersey taxes. For the shorter time period, New Jersey's overall tax revenue elasticity was 0.77, indicating that tax revenues grew less than eight-tenths as fast as the economy over the nine year time period. The low overall tax elasticity was the result of weak growth in selective sales taxes, such as taxes on gasoline, tobacco and alcohol products, and low property tax elasticity. The sales tax elasticity was a little over 1, meaning revenues grew slightly faster than income, and the income tax elasticity was slightly under 1. The income tax elasticity is probably much higher for most time periods and is normally greater than the sales tax elasticity.<sup>7</sup> The property tax elasticity was 0.8, about the same as total tax revenues. New Jersey's overall elasticity was lower than the U.S. average, though its sales tax elasticity was higher.

Tax revenues have increased significantly since 2002 as evidenced by the elasticities for 1993 to 2004. Estimated New Jersey elasticities through 2004 are likely a better indicator of the long-term revenue elasticities. All of the major taxes (property, income, and sales) grew at about the same rate as the economy and the overall tax system grew a little slower than the economy (likely because of the selective sales taxes).

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<sup>6</sup> Elasticity normally is used to describe the relative growth of revenues net of any policy changes (such as rate or base changes) and buoyancy describes the relative growth of revenues including the effects of policy changes. No distinction is made between buoyancy and elasticity in this report.

<sup>7</sup> The sales tax elasticity is generally under 1 for U.S. states, but a more carefully developed econometric analysis of elasticities over more than 30 years found New Jersey's sales tax elasticity to exceed 1. The income tax elasticity is much greater than 1 for all states, including New Jersey. See Bruce, Fox and Tuttle (2005).

**Table 2.1: State and Local Tax Revenue Elasticities, 1993-2002 and 1993-2004**

<b>Tax Source</b>	<b>New Jersey, 1993 to 2002</b>	<b>U.S. Average, New Jersey, 1993 1993 to 2002</b>	<b>U.S. Average, New Jersey, 1993 to 2004</b>
Property Tax	0.81	0.80	1.00
Sales Tax	1.08	0.99	1.06
Income Tax	0.98	1.04	1.04
Total Taxes	0.77	0.88	0.96

Source: U.S. Bureau of the Census and authors' calculations.

Third, revenues should be stable across the business cycle. Tax revenue growth rates can be very volatile across the business cycle as many states learned between 2000 and 2003. Purchasing patterns for durable goods and housing make the sales tax volatile and the timing and earning of non-labor income make the personal income tax cyclical. But, public service demands are relatively stable, or even rise in slow economic environments. Thus, state and local governments seeking to maintain service levels over the business cycle would want to lean towards tax systems that are relatively stable, though the volatility of essentially all taxes makes this a difficult objective to achieve.

### Economic Neutrality

Economists generally argue that taxes should be designed to impose the smallest possible effects on the behavior of people or businesses. A tax system with low effects on behavior is referred to as neutral or efficient. Taxes alter behavior when they change firms' location decisions, reduce the amount that people work, or modify the amount or location of purchases. Many tax distortions arise because of people and businesses seeking to exploit differences in tax structures across state and local governments, but the taxes can also change behavior within a state. Businesses moving to low tax jurisdictions is an example of exploiting differences between governments, and people choosing to work less is an example of changing behavior in a state.

### *Revenue Options*

Three general options exist for financing a reduction in New Jersey's property tax:

- Reduce the size of government
- Raise other taxes
- Finance more government with user fees

The following sections address each of these options in detail, with the intent of showing the strengths and weaknesses of each option. Most of the discussion focuses on tax options, but no attempt is made to select a preferred alternative since this is ultimately a policy decision that needs to be made by the people of New Jersey through the state's legislature and governor. Of course, the various options that are discussed below could be combined in a single reform plan, but this possibility is not directly addressed here. For example, Texas Governor Perry proposed a property tax relief plan that included greater reliance on a variety of taxes including raising the sales tax rate by 0.7 percent, raising the cigarette tax by \$1 and closing some corporate tax loopholes.

The alternatives considered here are placed in the context of property tax relief, but this requires an answer to the question of how large the property tax reduction should be, at least for purposes of the analysis. We do not seek to directly answer this policy issue for New Jersey; instead we assume a level of property tax reform for analytical purposes. We also consider options for replacing the revenue.

A stylized reduction in the property tax is adopted for this report based on the extent to which New Jersey's reliance on the property tax exceeds the U.S. Specifically, New Jersey's property tax currently represents 4.25 percent of GSP compared with 2.68 percent for the U.S. We assume that the property tax is reduced by one-half of the extent to which New Jersey's burden exceeds the national average. Thus, we assume that the property tax is lowered by 0.78 percent of GSP, which translates into approximately \$3.45 billion in 2005.<sup>8</sup> The corresponding change for 2002 was \$2.98 billion, which represented 18.6 percent of property tax revenue in that year, and would represent a similar reduction in the average property tax bill if applied equally to all property.

An important issue is whether tax relief would be provided through direct property tax reductions (such as through a lower tax rate) or through some form of property tax rebate. The former lowers the role of property taxes in the New Jersey tax system by reducing tax rates faced by business owners, homeowners and renters. This will change the growth rate of the overall tax structure, alter fairness according to which tax replaces the revenue, have little implication for administration and compliance (since the property tax must be collected anyway) and reduce the economic distortions from the property tax, but raise distortions arising from other taxes. These effects are described in the tax replacement section below.

A property tax rebate operates more like an expenditure of government revenue than a tax reduction. The effects probably are not the same as those arising from a proportionate reduction in the property tax because there likely would be a ceiling on the maximum amount of the rebate, and the rebate would not apply to all property (such as only to owner occupied housing). This means that the tax imposed on decisions at the margin (for example, whether to buy a more expensive house) would not be changed for people at the cap. In all likelihood, with a rebate revenues net of the rebate would grow faster than with a proportionate decrease in property tax revenues, more of the benefits would be targeted to homeowners (and particularly middle income homeowners because of the ceiling on the rebate), some additional administrative costs could be necessary depending on the structure of the rebates, and the rebate would not reduce the economic distortions of taxation as much as a tax reduction (because some decisions are not changed at the margin).

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<sup>8</sup> This assumes a 5.5 percent GSP growth rate in 2005.

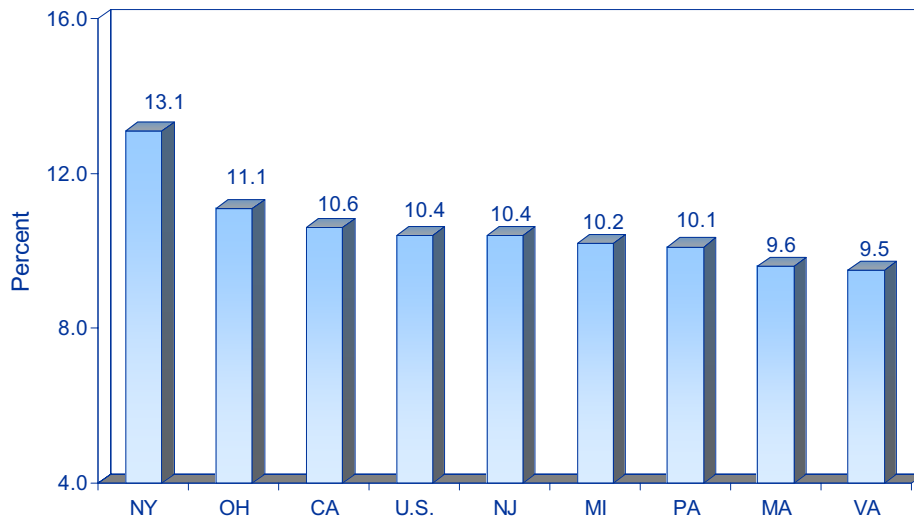
## ***Reduce the size of government***

This section examines the effects of reducing both taxes and government spending by \$3.45 billion.

### **Cutting Taxes by \$3.45 billion**

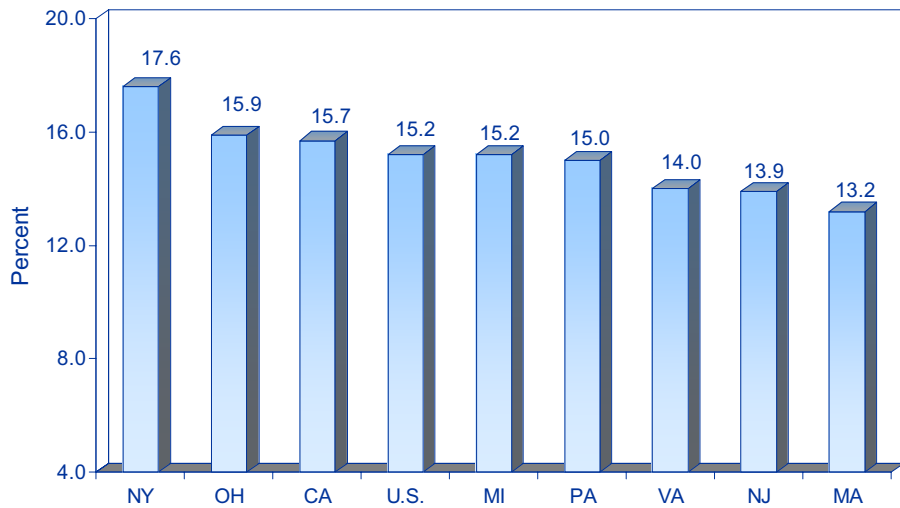
*Is New Jersey Government Too Large?* An obvious option is to lower the size of government by an amount equal to the property tax reduction. This option should be pursued if there is agreement that New Jersey state or local government or both are too large. There is no simple answer to whether government is too large, but comparison with other states is one way to judge the size of government. Government must be scaled to the states' economies to make such comparisons meaningful. Gross State Product (GSP) and personal income are two possible options for comparison. GSP is a broad measure of production in New Jersey, and personal income is a broad measure of incomes received by New Jersey residents. Neither measure includes revaluation of assets (such as capital gains from housing or stock price increases). The data provide a mixed story regarding whether New Jersey's state and local governments are large. Relative to personal income, New Jersey's state and local *tax* collections are at the national average, 10.4 percent, and are approximately in the middle of the comparison states (see Figure 2.1). New Jersey's state and local *own source* revenues<sup>9</sup> are well below the national average and second lowest among the comparison states (see Figure 2.2) as a percent of personal income. As shown in Chapter 1, New Jersey's taxes appear higher relative to Gross State Product (see Figure 1.1 above). Thus, comparisons based on the two data series point in somewhat different directions regarding the size of government relative to other states.

**Figure 2.1: State and Local Total Tax Collections as a Percent of Personal Income, 2002**



<sup>9</sup> Own source revenues include tax revenues, charges, fees, and miscellaneous revenues.

**Figure 2.2: State and Local Total Own-Source Revenue as a Percent of Personal Income, 2002**



*Effects of the Tax Cut on the Revenue Structure.* A property tax cut of \$3.45 billion in 2005 would represent at least 9 percent of tax revenue.<sup>10</sup> A revenue reduction of this magnitude would place New Jersey's state and local taxes below the national average by either measure. Of course, spending cuts of \$3.45 billion would also be necessary to keep state and local budgets balanced.

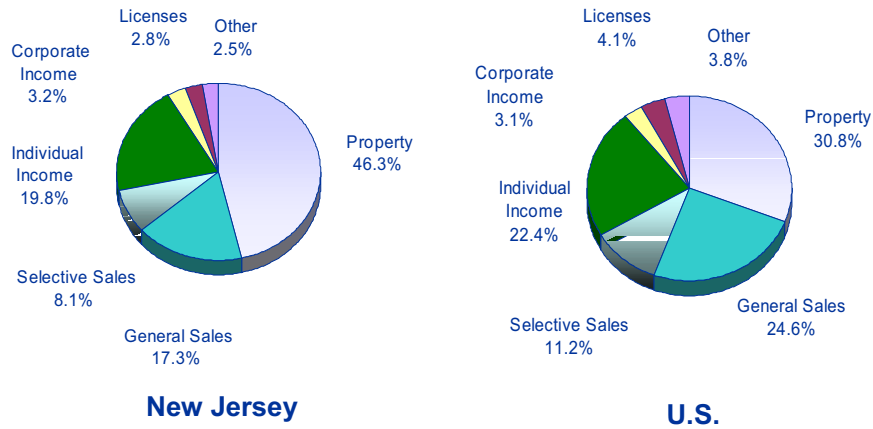
As described in Chapter 1 and as seen below, New Jersey relies very heavily on the property tax compared with other states and uses essentially all other tax sources less intensely than the U.S. average. The existing state and local tax structure for New Jersey and the U.S. is given in Figure 2.3. Reducing the property tax without replacing the revenue alters the tax structure by lowering the property tax's share of financing from 46.4 percent to 41.3 percent (see Figure 2.4),<sup>11</sup> while all other taxes rise as a share of total taxes.<sup>12</sup> New Jersey would still have very strong reliance on the property tax relative to the U.S. average and would remain light in taxation of other sources.

<sup>10</sup> Based on a corresponding (\$2.98 billion) property tax reduction in 2002.

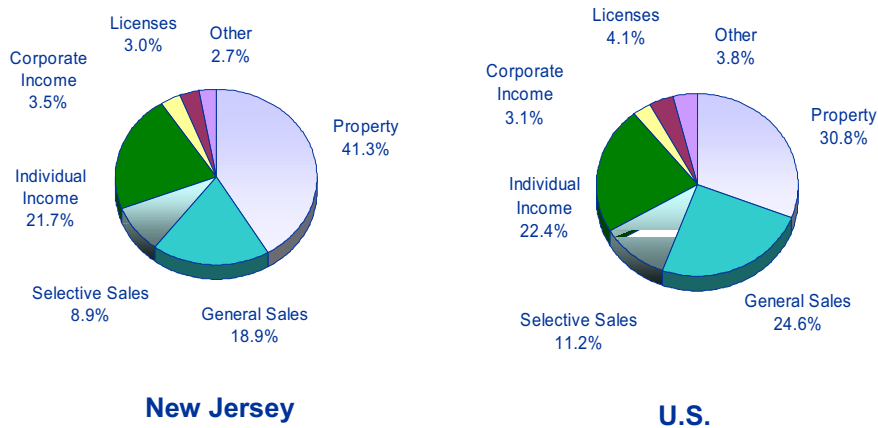
<sup>11</sup> Arithmetically, reducing property taxes without replacing the revenues changes the distribution of New Jersey taxes because of the lower property taxes and because of lower total taxes. Another tax or revenue source replaces the property tax in the alternatives described below.

<sup>12</sup> Revenue from all taxes except the property tax is assumed to remain constant, but the amount of total tax revenues (which is the denominator in the percent calculations) is reduced by an amount comparable to \$3.45 billion in 2005. Arithmetically, this increases the share of the other taxes.

**Figure 2.3: Taxes as a Percent of Total State and Local Taxes, 2002**



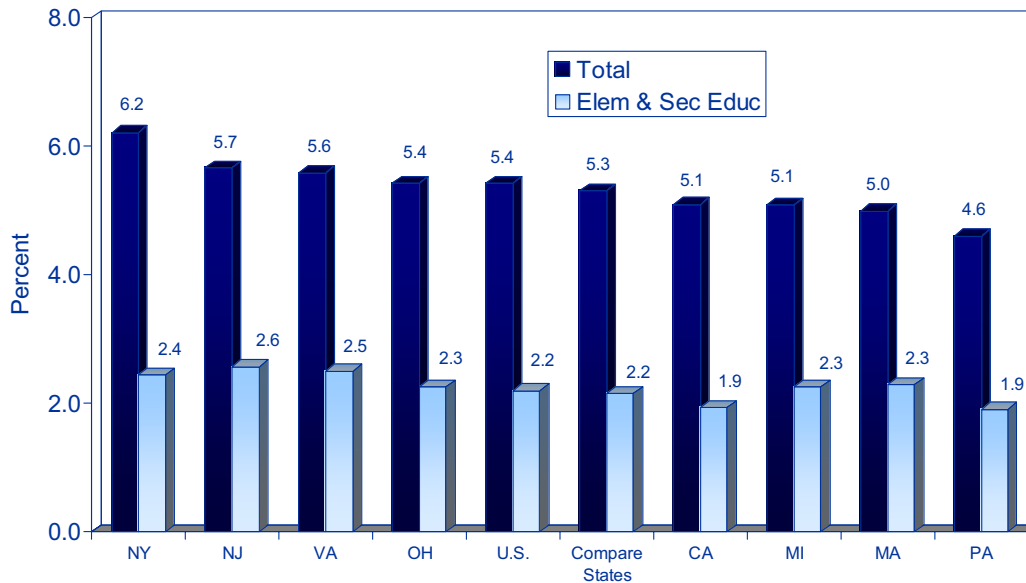
**Figure 2.4: State and Local Taxes as a Percent of Total State Taxes, 2002  
[NJ property tax reduced by one-half of additional U.S. property tax]**



**Cutting New Jersey State and Local Government Employment**

The property tax reduction could be used to lower staff in New Jersey state and local governments. Employment by New Jersey state and local governments is somewhat above the national average and second highest among the comparison states. The average state employs 5.42 percent of its population in the state and local government sectors while New Jersey employs 5.66 percent of its population (see Figure 2.5). New Jersey state and local government is very high relative to the U.S. average in the percent of population working in elementary and secondary instructional employment and is about the same *on average* in other sectors though there is some variation. New Jersey is high in the percent working in police and judicial systems (though low in corrections), highways, public welfare, solid waste management and sewerage, transit and libraries. New Jersey is low in employment in higher education, hospitals and health services, and utility services such as water, electric and gas supply. Some of these differences arise because of choice in the degree to which services, such as hospitals and utilities, are delivered in the public or private sectors. Others may reflect the highly urban nature of the New Jersey economy.

**Figure 2.5: State and Local Government FTE Employment as a Percent of the Population**



One option for reducing the size of New Jersey’s state and local government would be to lower state and local employment by the amount that New Jersey exceeds the national average relative to the population. Cutting state and local government employment by 0.24 percent of the population represents 21,039 positions. Specific areas to cut would need to be identified through some type of management analysis since the data do not provide obvious evidence of bloated bureaucracy, since New Jersey is high in sectors such as instructional education positions. The average New Jersey state and local government wage was \$51,209 in 2003, meaning state and local government wage expenditures would be reduced by \$1.077 billion through the employment cut. In addition, the state would garner savings in fringe benefit costs. The wage component by itself is only 30 percent of the \$3.45 billion property tax reduction baseline that was described above. A total of 70,300 positions—about 14 percent—would need to be eliminated to cut wage costs by the entire property tax decrease. A cut of this magnitude would place New Jersey’s public sector employment at 4.86 percent of population, or .056 percentage points below the national average.

The unemployment rate could rise in the short run if state and local government employment is reduced, but the private sector economy is very adaptable and people with good skills will generally find alternatives quickly. Further, the effects could be diminished if the layoffs were to occur over a period of time, rather than being implemented in a brief window. New Jersey’s 4.0 percent June 2005 unemployment rate would have been just below 4.2 percent if one third of the employees (7,000) were laid off from state and local employment and did not find another job right away.

### ***Replace Property Tax with Other Taxes***

Property tax reduction could be financed with greater reliance on other taxes. Property, income and sales taxes dominate state and local taxes, raising a combined 78.4 percent of taxes in the average state. Thus, sales and income taxes are the major options for replacing property tax revenues and this section examines greater reliance on these taxes. A brief discussion of higher selective sales tax rates is also provided. New Jersey could replace local property taxes with a state property tax, as states such as

New Hampshire and Vermont have done. This option is not considered here since it would not reduce the overall New Jersey property tax burden.

New Jersey appears to have very narrow sales and income tax bases by comparison with many other states, meaning there is a tendency for New Jersey's tax rates to be high relative to the revenue raised. Thus, increasing reliance on either the sales or income tax by raising the tax rates will tend to make New Jersey's statutory tax rates very high compared with many other states. This is a particularly troublesome problem since high tax rates can be important causes of distortions in the behavior of people and businesses, such as changing business locations, causing people to work less or causing people to shop online more. This suggests that base broadening is an option that should also be considered.

Financing property tax reductions with higher state taxes requires a formula to transfer the revenues from the state to the local level. Formula design is not normally a technical problem but can be politically contentious. The formula could be structured to replace the property tax reductions in each jurisdiction, but this will re-enforce any inequities that already exist in the property tax/education finance structure and would shift revenue from income-rich jurisdictions to property-rich jurisdictions. Also, a formula that would replace property tax reductions today may not be effective in replacing the revenues lost over time. A formula that includes hold harmless provisions to prevent the loss of revenues in the short term could be combined with provisions that transfer revenue based on other criteria in the longer term.

#### Replace Property Tax Revenues with Sales Tax Revenues

*Higher Sales Tax Rate.* New Jersey could replace the property tax with higher sales taxes. Michigan used this strategy in 1995 when it raised its sales tax rate from 4 percent to 6 percent to finance lower property tax rates. New Jersey's 6.0 percent sales tax rate would need to be increased by about 3 percentage points to finance the property tax relief – a nearly 50 percent increase.<sup>13</sup> The 9 percent rate would put New Jersey in second place behind Tennessee for the highest combined state and local sales tax rate. New Jersey's 6 percent state sales tax rate is already higher than the median state's 5 percent rate.<sup>14</sup> Thirty four states have local sales tax rates and the median state and local rate is about 6.5 percent, meaning New Jersey's rate is currently below the median state and local tax rate.<sup>15</sup>

The overall tax structure would look more similar to the U.S. average if the sales tax option were adopted, though the property tax reliance would still be high compared with the average of other states (see Figure 2.6). What is different is that the sales tax would become an above average source of revenue. All other taxes would still raise a lower share in New Jersey.

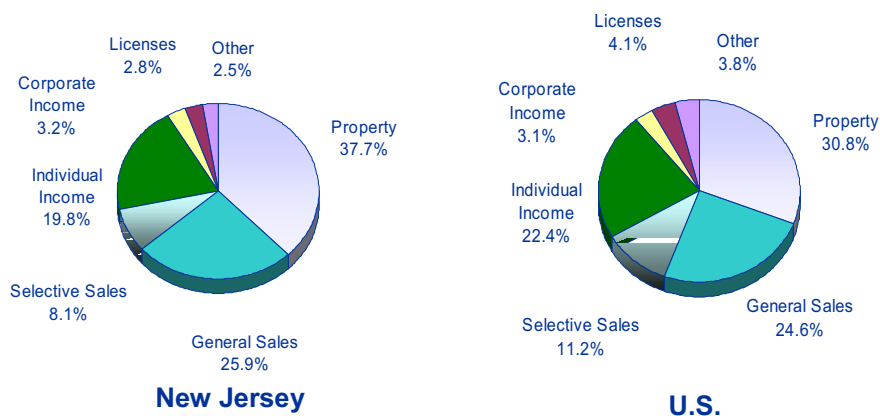
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<sup>13</sup> A 3.0 percent sales tax rate increase in 2002 would have generated about \$2.98 billion, corresponding to \$3.45 billion in 2005.

<sup>14</sup> Twenty of the 45 sales taxing states have a rate that is at least 6.0 percent.

<sup>15</sup> See the State Sales Tax Clearinghouse at <http://www.taxch.com/STRates.stm>.

**Figure 2.6: State and Local Taxes as a Percent of Total State Taxes, 2002**  
**[NJ property tax reduced by one-half of additional U.S. property tax, added to sales tax]**



Overall, the sales tax is generally seen as regressive when measured against current income, but is closer to proportional when compared with lifetime income (see Fox, 2003). As noted above, equity of the property tax is often described in similar terms, so there may not be significant changes in the overall degree of fairness. Though trading the sales tax for the property tax may not have significant effects on the relative tax burdens of broad groups of people and businesses, it will have effects on specific individuals or firms. People who purchase significant amounts of taxable goods, such as jewelry, automobiles and so forth will see their tax burden rise and those who spend more of their income on housing will see a tax reduction.

A higher sales tax rate would alter the economic incentives arising from the tax structure. The purchase of sales taxable items would be discouraged while incentives to purchase residential housing and other forms of property would rise. Higher sales tax rates also encourage more online purchases because of the difficulty in collecting the use tax. Bruce and Fox (2004) estimate that in 2003 New Jersey lost between 2.8 and 4.4 percent of total state tax revenues because of uncollected use tax on online sales.

The proportion of taxes paid by businesses in New Jersey is somewhat under the U.S. average. Cline et al (2005) conclude that New Jersey is tied for 34<sup>th</sup> in the percentage of private sector GSP paid in state and local taxes on business. Businesses pay a significant share of both property tax and sales tax revenues<sup>16</sup> so a shift to sales taxes may not radically alter the relative taxation of business activity if the property tax reduction applies to both business and residential property. Still, greater sales tax might shift the tax burden from highly capital-intensive firms to less capital-intensive firms. Increased reliance on the sales taxes would raise the business share of taxes if the property tax reduction were limited to owner occupied housing.

The sales and property taxes appear to have similar long-term revenue elasticities. Sales taxes are generally more volatile<sup>17</sup> than the relatively stable property tax, so this reform would add volatility to the overall New Jersey tax system.

*Sales Tax Additional Services.* Bruce and Fox (2000) found New Jersey's sales tax base to be the third narrowest among the states, only exceeding Rhode Island and Massachusetts. Mid-Atlantic and New England states generally have narrow sales tax bases relative to the rest of the U.S. New Jersey, as with

<sup>16</sup> Analysts generally presume that about 40 percent of sales taxes are collected on business to business transactions.

<sup>17</sup> See Bruce, Fox and Tuttle (2005).

most states, exempts food, prescription drugs, and many other items. New Jersey's exemption for clothing is relatively uncommon across the U.S. As noted above, the narrow base requires higher rates to generate a given amount of revenue, and higher rates increase the perverse effects on behavior.

States differ significantly in their taxation of services, with some, such as Hawaii, New Mexico and South Dakota, taxing almost all services and others, such as Colorado and Illinois, taxing very few services. These differences generally arise more from history of the tax's adoption in the specific state than from significant changes in the base once the tax has been adopted. Hawaii and New Mexico, the states taxing the most services, started their sales taxes with the very broad base, so there was no need for these states to expand the base.

Table 2.2 lists the extent to which the comparison states and New Jersey tax services. The table shows the number of each service taxed by each state and the total number of services in the category. Hawaii taxes 160 of the services and New Mexico taxes 156 of the services. Despite its generally narrow sales tax base, New Jersey taxes 55 of 168 services identified by FTA and is essentially at the top of the comparison group. Among the comparison group, only Ohio taxes noticeably more services. The main difference is that Ohio taxes more personal and computer services. Barber and beautician, diaper, carpet cleaning, garment repair, gift-wrapping, laundry, and tuxedo rental services are taxed in Ohio but not in New Jersey. Ohio also taxes Internet service providers, computer information services, data processing services, and mainframe computer access, none of which are taxable in New Jersey.

States often consider broadening the base, and particularly to services, as a means of increasing sales tax revenue without raising the sales tax rate. The Federation of Tax Administrators (FTA) recently conducted a survey of the states to determine the extent of sales taxation of services.<sup>18</sup> A basic conclusion of the report is that only minor changes in taxation of services have taken place over the past decade, with the exception of Nebraska. A longer-term study would reach similar conclusions, with Texas being one of the few other states that have made significant expansions of the base. Florida and Massachusetts enacted relatively broad taxation of services 15 to 20 years ago, but both later repealed the legislation. The Massachusetts' legislation never went into force as the state realized that the chosen structure would have discouraged business activity relative to other states. The Florida legislation was repealed after six months because it was politically unpopular and imposed high compliance burdens.

New Jersey could begin taxing the additional services taxed by Ohio, similar to the proposal considered by the legislature during June. However, taxation of these services will provide relatively little revenue and would not be close to replacing \$3.45 billion in property tax revenues. Taxing the several dozen services included in the June legislation would only have raised an estimated \$175 million. Consumption of some services, such as health care, is growing very rapidly and extension of the base to these services could add elasticity to the system. But many services that states have considered will not increase the elasticity to a noticeable extent, so they neither offer much revenue nor do they increase the tax system's potential for revenue growth.

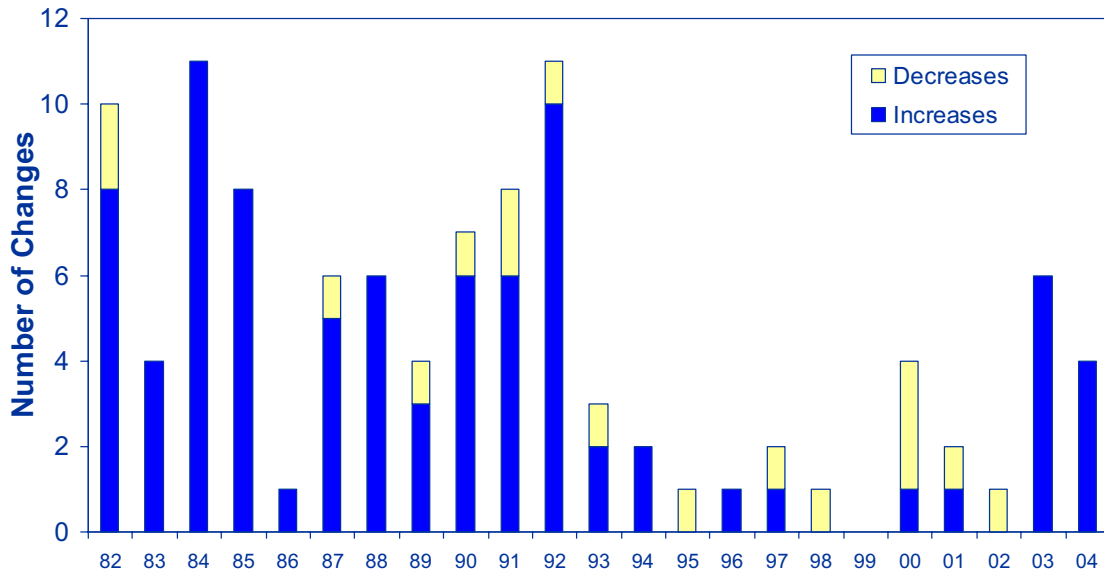
Professional services, such as medical, legal and accounting services, and construction services, offer the greatest revenue potential, but *no* state has been successful at adding these services to its base. Further, taxation of many professional services would significantly expand the taxation of business-to-business transactions, which economists generally regard as bad tax policy. The state could also look to taxing more consumer goods, such as clothing. New Jersey could also consider raising the favored sales tax rates in the urban enterprise zones to the standard 6.0 percent rate.

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<sup>18</sup> <http://www.taxadmin.org/fta/pub/services/services.html>.

States generally have found it easier to generate additional revenue with a higher sales tax rate than with sizeable broadening of the base to services, despite the frequent discussions about base broadening in legislative assemblies. Nonetheless, states were more reticent about raising sales tax rates during the recent downturn than in previous years (see Figure 2.7).

**Figure 2.7: Number of Sales Tax Rate Changes**



**Table 2.2: Number of Services Taxable, 2004**

State	Utility	Personal Services	Business Services	Computer	Amusement	Professional Services	Repair	Other	Total
CA	4	2	7	2	1	0	3	4	23
MA	9	1	4	0	1	0	2	2	19
MI	12	2	7	1	1	0	1	2	26
NJ	10	2	10	0	6	0	14	13	55
NY	4	4	13	1	5	0	14	15	56
OH	8	12	14	5	3	0	12	14	68
PA	9	6	16	1	1	0	14	8	55
VA	1	3	4	0	1	0	4	5	18
<b>Total Services</b>	<b>16</b>	<b>20</b>	<b>34</b>	<b>8</b>	<b>15</b>	<b>9</b>	<b>19</b>	<b>47</b>	<b>168</b>

Source: Federation of Tax Administrators.

Decisions on whether to tax services should not be determined simply on the revenue potential but should be made on a service-by-service basis, using the criteria of revenue (adequacy, stability etc.), fairness, economic efficiency and administration and compliance. Economists generally argue against taxing services that are mostly used by businesses because such taxes are likely to create significant changes in business behavior. For example, firms are encouraged to vertically integrate (such as by hiring accountants and lawyers as firm employees) rather than purchasing services from providers (such as accounting or legal firms). Also, taxes on business services “cascade” and increase the costs of doing business in New Jersey. Taxing services that are easy to deliver across state boundaries can be problematic because of the difficulty in collecting use taxes and the competitive disadvantage that can be created for New Jersey firms. Administrative difficulties exist for taxing services that are often provided

through small firms using cash payments, such as lawn care. On the other hand, some services such as cable television are easier to tax but have proven politically difficult in some states.

The fairness implications of taxing services are difficult to discern. Consumption of almost every good or service, is regressive, meaning that high income people spend a lower percentage of their income on these items than do middle or low income households. Only a few exceptions exist, including country club memberships, private schools, and life insurance. Thus, choosing a particular set of items to tax cannot eliminate the regressivity of sales taxes. Further, taxes can be easily imposed on health care services, but many question the fairness of taxing services such as cancer treatments. On the other hand, taxation of some discretionary health services (such as some plastic surgery) might seem fair, but it is hard to know which services are voluntary.

### Replace Property Tax Revenues with Income Tax Revenues

New Jersey could replace property tax revenue with income tax revenue. New Jersey income tax rates currently range from 1.4 percent on taxable incomes below \$20,000 to 8.97 percent on taxable incomes above \$500,000. The average effective rate was 2.05 percent in 2002 (personal income tax revenue divided by total personal income), a relatively low effective rate given that the marginal tax rates are high. As noted above, New Jersey tends to have high rates for the amount of revenue that is generated. Vermont and California are the only states with a higher state tax rate on the upper bracket, except for Iowa and Oregon that have essentially the same rate at 8.98 and 9.0 percent (and New York's top rate is higher when the New York City income tax is taken into account).

New Jersey's income tax rates are more progressive than in many other states. One measure of the rate progressivity is the ratio of the highest marginal tax rate to the lowest marginal tax rate. In New Jersey's case this is 8.97 percent divided by 1.4 percent. Based on this comparison, New Jersey is exceeded by only about five states. The result is that a considerable share of total taxable income is taxed at relatively low rates.

The *effective* tax rate would have to be raised by 0.9 percentage points of personal income to replace the property tax revenue – amounting to about a 43 percent increase in average tax. Given the narrowness of the New Jersey income tax base compared with personal income, the effective tax rate on *taxable* income would need to increase by about 1.4 percent to generate the required revenue. Higher tax rates across the board could also result in greater tax avoidance and evasion in New Jersey and require an even greater rate increase—above 1.4 percent—to replace the property tax. The rate increase could be achieved in many different ways. An across the board increase of 1.4 percent could be enacted for all taxpayers, meaning that rates would range from 2.8 percent on incomes below \$20,000 to 10.37 percent on incomes above \$500,000. The across the board approach would yield a dramatically higher percentage increase in tax for lower income taxpayers than for upper income taxpayers – e.g., a 100 percent increase for someone in the lowest tax bracket (ignoring credits and other features outside tax brackets), but approximately a 25 percent increase for someone with \$500,000 income (see Table 2.3). The revenue could also be raised with rates that are more or less progressive than the existing tax structure. Given the high degree of progressiveness of New Jersey's existing rates, greater progressivity would be a questionable strategy.

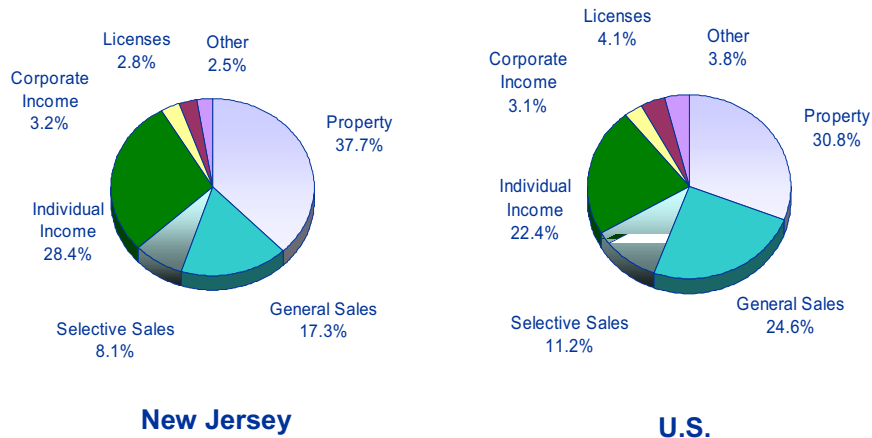
**Table 2.3: Current and Estimated Tax Liability, 1.4 Percent Rate Increase**

Taxable Income	Current Tax Liability	Liability with 1.4% Across the Board	
		Increase	Percent Tax Liability Increase
20,000	280	560	100.00%
40,000	630	1190	88.89%
75,000	1,470	2520	71.43%
100,000	2,750	4150	50.91%
200,000	8,698	11498	32.19%
500,000	27,808	34808	25.17%

Source: Authors' calculations.

The income tax option would have similar effects on the tax structure as the sales tax option, except it would be the income tax rather than the sales tax that would rise above the U.S. average (see Figure 2.8). An income tax increase would almost surely result in a more elastic tax system than the current New Jersey structure, though the decision of how to implement the income tax increase would influence the elasticity.<sup>19</sup> For example, a lower maximum threshold (the income at which the highest tax rate becomes effective) would make the structure more elastic. Care must be taken to ensure that the overall tax structure does not become too elastic because government could then quickly become far larger relative to the economy than citizens' current tastes require.

**Figure 2.8: State and Local Taxes as a Percent of Total State Taxes, 2002**  
**[NJ property tax reduced by one-half of additional U.S. property tax, added to income tax]**



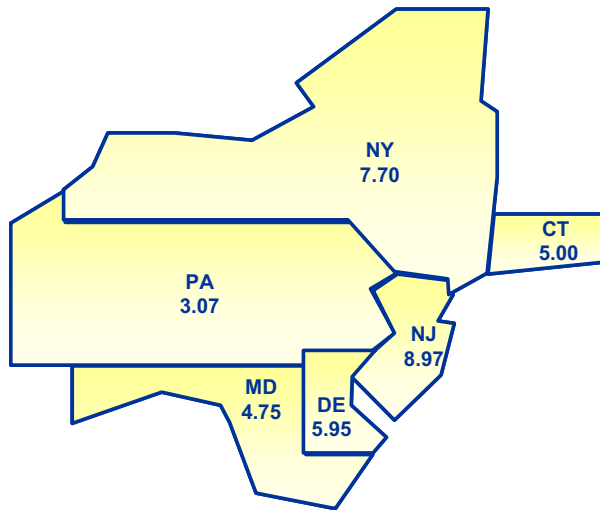
The income tax can be used more easily to achieve New Jersey's fairness goals than either the sales or property tax, since the income tax is levied directly on income. Fairness goals are more difficult to achieve with taxes like the sales tax because it is only indirectly imposed on people. Thus, New Jersey could choose to make the overall tax system more or less progressive than the current structure, depending on the tastes for tax fairness. Little change in administration and compliance costs should be expected since the tax is already collected.

<sup>19</sup> The 1993 to 2004 income tax elasticity in Table 2.1 is higher than the property tax elasticity. Further, Bruce, Fox and Tuttle (2005) find a much higher income tax elasticity over a longer time period.

People’s responses to high income tax rates are a reason for concern. An increasingly mobile society makes high income tax rates increasingly difficult to impose in any single state. Higher income people are best able to avoid New Jersey’s tax by relocating their taxable presence, particularly for non-labor income such as interest, dividends, and stock options. Some people also have the option to choose other states for their residence if they work near the New Jersey border. People are more likely to move or change their taxable residence to avoid the income tax as rates rise, and particularly as tax rate differences increase. A 10.37 percent maximum New Jersey rate would be the highest of any state and the only state rate above 10 percent.<sup>20</sup> The New Jersey rate would be even higher compared with the maximum 7.7 percent state rate in New York, 5.0 percent in Connecticut, and 5.95 percent in Delaware (see Figure 2.9). Of course, the highest rate would only be applied to a small number of taxpayers, but these are likely to be the most mobile taxpayers.

Means of expanding income tax revenue without increasing the highest marginal rate should be considered. For example, the exclusion for pension income could be eliminated, at least for upper income households (as was considered by the legislature this year). Flattening out the income tax rates by increasing rates at the bottom is another option. Of course, this raises taxes relative to current liabilities much more on lower income households than on upper income households, but all would contribute more income taxes. Studies of the effects that specific proposals have on households need to consider both property tax savings and income tax increases.

**Figure 2.9: States’ Highest Individual Income Tax Rates, Tax Year 2005**



### Selective Sales Tax Rate Increases

Selective sales taxes are those taxes imposed on specific products, such as tobacco, alcohol, and motor fuel. Increases in selective sales tax rates, and particularly for cigarettes, have been a common means across the country of generating additional revenue in recent years. For example, thirty-six states have raised their cigarette tax rates a total of at least 53 times since 2000.<sup>21</sup> New Jersey changed its rate three times during this window to reach \$2.40 per pack, second highest in the country after Rhode Island (\$2.46). New Jersey’s alcohol tax rates are not as high relative to the nation, though the pattern varies by product (see Table 2.4). Total revenue from taxes on alcohol and tobacco were about \$865 million in 2004 meaning that it is inconceivable that selective sales taxes can be used to provide significant property

<sup>20</sup> State income tax rates have been steadily falling. Fifteen states had top rates above 10 percent in the mid-1980s.

<sup>21</sup> See [http://www.taxadmin.org/fta/rate/cig\\_inc02.html](http://www.taxadmin.org/fta/rate/cig_inc02.html).

tax relief. Higher motor fuel taxes are not considered as an alternative here, since the revenue is normally used for road construction and repair.

Selective sales taxes generally have very low elasticities because the rates are imposed per unit of consumption (such as per pack of cigarettes or per gallon of beer) rather than on value. As a result, revenues grow only with consumption and not with increases in the price of the product. Replacing the property tax, which has an elasticity of about 1.0, with very inelastic alcohol or tobacco taxes could result in too little revenue growth over time. This concern may be less important if the property tax relief is given through rebates that are a fixed or relatively fixed amount per household.

Selective sales taxes can create large decreases in consumption of the products. While distorting people’s decisions to buy products is often undesirable, reductions in consumption are sometimes the intent for taxes on tobacco or alcohol products. Of course, less tax revenue is generated if consumption is lowered. High tax rates can also encourage remote or out of state purchasing, which also lowers New Jersey sales. The latter is an undesirable shift in behavior from New Jersey’s since it lowers tax revenues without reducing consumption of tobacco or alcohol products. Tobacco and liquor taxes are regressive, at least against current income.

**Table 2.4: Tax Rates on Alcohol Products (\$ per gallon)**

<u>Product</u>	<u>U.S. Median Tax Rate</u>	<u>New Jersey Tax Rate</u>
Beer	0.188	0.12
Liquor	3.75	4.40
Wine	0.69	0.70

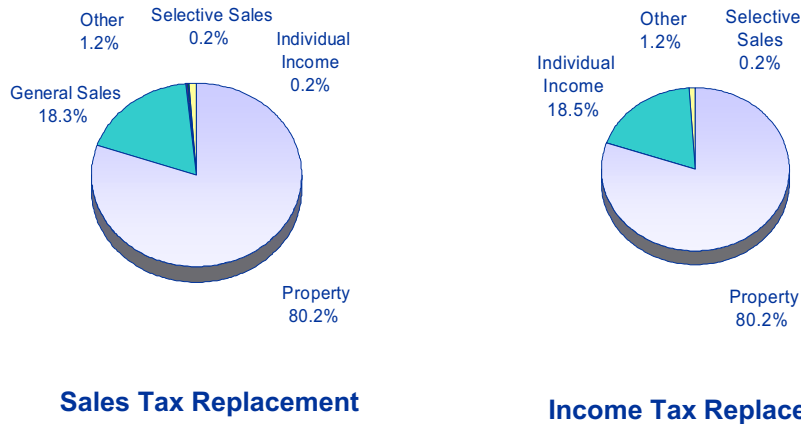
Source: [http://www.taxadmin.org/fta/rate/tax\\_stru.html](http://www.taxadmin.org/fta/rate/tax_stru.html).

### State versus Local Tax Increases

*Should State or Local Taxes Replace the Property Tax?* The discussion above was primarily focused on replacing the property tax revenue with higher state level taxes, but the same taxes could be imposed at the local level. As described above, Pennsylvania is currently encouraging local governments to shift more education finance to a local income rather than property tax basis. Two key advantages could result from replacing local property tax revenue with a *local* income or sales tax rather than with a *state* tax. First, local tax systems would be more balanced since they currently collect more than 98 percent of their revenue from the property tax (see Figure 1.4). Balance can be an important characteristic to achieving the desired growth and stability in tax revenues since tax structures can be likened to an investment portfolio. Greater balance tends to reduce the volatility in the structure and still result in better growth.

Figure 2.10 illustrates the local revenue distribution with both a local sales and a local income tax replacing \$3.45 billion of property tax revenue. The appearance of both is very similar since each is assumed to generate \$3.45 billion, and New Jersey raises only a small amount of revenue from the income tax today (approximately \$30 million from municipal income taxes) and none from local sales taxes. Using either a local sales or a local income tax would add balance to the system, though New Jersey local governments would still use relatively more property tax finance than the average state.

**Figure 2.10: New Jersey Local Tax Scenarios as a Percent of Total Local Taxes, 2002**



Second, reliance on local tax sources would allow local governments to retain flexibility and local choice in their funding and service delivery decisions, since one local tax would be replaced with another. Greater use of a state tax would require local governments to rely on more state transfers, though a rebate system or a one time change in education transfers from the state may have little influence on how decisions on local spending are made at the margin. A significant increase in the state role in education funding (and local funding generally) may be of concern for the state legislature as well, since it would make the state more responsible for financing local spending and would alter the balance of state versus local taxes.

A number of other factors enter into the decision of whether to use state versus local taxes. Any additional administration and compliance costs could be limited if the New Jersey Division of Taxation collected local income or sales taxes on behalf of local governments. This could reduce the number of returns that businesses must file and preclude the large diseconomies of scale that could result from income or sales tax collection by small governments. Even with state collection of the tax, it is more difficult to collect taxes on behalf of the many local governments than for one state because of the need to determine the situs of which local government should receive the revenue. New Jersey is currently an associate member of the Streamlined Sales Tax Project (SSTP) and is expected to come into compliance with the SSTP on October 1<sup>st</sup>. The SSTP requires that all tax revenue be attributed on a destination basis across local governments. Attributing local revenues on a destination basis is somewhat more complex than taxing local transactions at the point of sale. Still, collection on a destination basis is good tax policy and decisions by the SSTP, such as collecting on a zip plus four basis, will make administration and compliance much more manageable.

*Local Tax Revenue and Tax Rates.* State and local sales tax bases are likely to be very similar, so approximately the same total state and local sales tax rate would be necessary to replace the property tax reduction regardless of which level imposes the tax. Thus, an average 3.0 percent local sales tax rate would be necessary. About 10 states have local rates that average at least 2 percent across the entire state.

If a local surtax were levied on the New Jersey state income tax, it would require the same 1.4 percentage point across the board income tax increase (a 43 percent increase) that would be needed for a state increase. However, local average income tax rates might need to be higher than the state replacement rate because local income taxes are often levied only on wages, and not on total income. An average local rate of about 1.65 percent would be necessary to replace \$3.45 billion of property tax revenue if all wage

and salary income could be taxed. However, the average rate would probably need to be at least 1.7 percent to allow for some evasion and avoidance behavior.

While the local income tax might be 1.4 percent on average, actual rates in any locality would differ significantly depending on the local government's current use of the property tax and the income tax base in the jurisdiction. Some places would need much higher income tax rates than others to replace their lost property tax revenue. Specifically, income tax rates would need to be higher in places that tend not to be the situs of work. Similarly local sales tax rates would need to be higher in jurisdictions that have relatively little taxable sales.

Data are available to compare the effects of local income tax rate increases across counties with the property tax reduction, but similar data are not available for the sales tax. For this analysis, an 18.6 percent reduction in the property tax is assumed and the reduction is assumed to be in proportion to a county's share of the statewide property tax base. This is similar to a fixed decrease in the effective tax rate across all of New Jersey. Table 2.5 illustrates the effects in 2002 of local income taxes imposed at flat rates across New Jersey, using both a surtax on the New Jersey personal income tax and a wage tax. The property tax reductions vary from \$462.0 million in Bergen County to \$15.9 million in Salem County. The total revenue could be replaced with either a flat rate surtax or local income tax across all of New Jersey, but the distribution of a fixed rate local income tax would not allow all counties to replace the lost revenue. Twelve counties would not have sufficient revenue with the surtax and 11 counties would not have sufficient revenue with the wage tax. Essex County would receive a significant increase in revenue, particularly with the wage tax, indicating it has relatively more income tax base than property tax base.<sup>22</sup> Essex County is the situs of greater earnings than of New Jersey taxable income (one of five counties for which this is true). Ocean County, on the other hand, would experience a large decrease in revenues, indicating it has relatively more property tax base than it has income tax base. This is evident because Ocean County has 6.9 percent of the state's total property tax base but only 4.4 percent of New Jersey's total taxable income base. Salem County would obtain more revenue with a wage tax, though less with a surtax on the state tax. Bergen County would obtain less revenue with either income tax structure.

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<sup>22</sup> Note that the wage tax base is attributed to the place of earnings and not to the place of residence.

**Table 2.5: 2002 Revenue Effects of Income Tax Scenarios (\$ Thousands)**

County	Extent to which income tax revenue increase exceeds (or falls short of) property tax reduction		
	Property Tax Reduction	Net Change with Income	Net Change with
		Tax Surtax (1.41 percent rate)	Wage Tax (1.65 percent rate)
Atlantic	\$110,920	(\$51,696)	(\$26,071)
Bergen	\$461,963	(\$30,412)	(\$87,846)
Burlington	\$127,920	\$11,523	\$8,561
Camden	\$112,494	\$18,390	\$22,594
Cape May	\$90,202	(\$66,606)	(\$69,815)
Cumberland	\$23,659	\$2,212	\$10,326
Essex	\$130,158	\$128,082	\$174,525
Gloucester	\$71,529	(\$2,846)	(\$16,516)
Hudson	\$117,327	\$17,506	\$94,909
Hunterdon	\$74,917	(\$12,648)	(\$35,002)
Mercer	\$120,847	\$17,253	\$46,749
Middlesex	\$223,815	\$17,917	\$120,575
Monmouth	\$264,994	\$17,979	(\$85,843)
Morris	\$279,945	(\$15,764)	(\$11,366)
Ocean	\$205,820	(\$72,235)	(\$126,481)
Passaic	\$117,335	\$5,255	\$3,279
Salem	\$15,875	(\$1,551)	\$63
Somerset	\$203,262	(\$27,363)	(\$40,081)
Sussex	\$54,209	(\$4,709)	(\$31,733)
Union	\$134,113	\$56,377	\$62,111
Warren	\$37,288	(\$6,662)	(\$12,939)
<b>Total</b>	<b>\$2,978,594</b>	<b>\$ -</b>	<b>\$ -</b>

Source: New Jersey Department of Revenue and authors' calculations.

Counties or other local governments could be allowed to impose local option income tax rates as necessary to raise the required revenue, as opposed to using an average tax imposed across the state (as was assumed in the previous paragraph). Effective property tax rates already differ significantly across counties as illustrated in Table 2.6, so this general practice would not be new. Average county property tax rates vary about 2.5 fold, from 3.49 percent of property value in Camden to 1.37 percent in Cape May. Revenue neutral income tax rates would need to vary much more, ranging from 0.71 percentage points of taxable income in Essex County to 5.41 percentage points in Cape May County. The wider disparity of rates arises both because of the very low effective property tax rate in Cape May County and the very large income tax base in Essex County. The revenue neutral wage tax rate would range from 0.7 percent of wages in Essex County to 7.28 percent in Cape May County.

**Table 2.6: Revenue Neutral Income Tax Rates**

<b>County</b>	<b>Median Effective Property Tax Rates</b>	<b>Revenue Neutral Surtax Rates</b>	<b>Revenue Neutral Wage Tax Rates</b>
Atlantic	2.50	2.65	2.15
Bergen	2.04	1.51	2.03
Burlington	2.61	1.30	1.54
Camden	3.49	1.22	1.37
Cape May	1.37	5.41	7.28
Cumberland	2.68	1.29	1.15
Essex	2.45	0.71	0.70
Gloucester	3.05	1.47	2.14
Hudson	2.53	1.23	0.91
Hunterdon	2.03	1.70	3.09
Mercer	2.56	1.24	1.19
Middlesex	2.36	1.31	1.07
Monmouth	2.07	1.32	2.43
Morris	1.99	1.50	1.72
Ocean	1.86	2.18	4.27
Passaic	2.69	1.35	1.60
Salem	2.84	1.57	1.64
Somerset	1.89	1.63	2.05
Sussex	2.42	1.55	3.97
Union	2.37	1.00	1.12
Warren	2.35	1.72	2.52
Total	2.30	1.41	1.65

Source: New Jersey Department of Revenue and authors' calculations.

The specific effects of these options on individual counties would depend on how the overall reform is structured. For example, Essex County would raise more revenue with an income tax than with the property tax (using the average rate approach in Table 2.5). Essex County citizens could offset the additional revenue with a lower property tax rate (assuming this is allowed), or with higher services, or some combination of the two. A county that raised less income tax revenue than property tax revenue might choose to raise its income tax rate, or cut services, or both. If, on the other hand, a local income tax is imposed with the revenue redistributed back to counties according to the size of their property tax reduction (which is what might occur if a state income tax increase were enacted), then the revenue effects would be neutral across counties.

### ***Replace Property Tax with User Charges***

Property tax revenues could be replaced with user fees. User fees refer to prices for consumption of services, and in most cases, prices that are sufficient to finance the costs of delivering the service. The user fee is essentially a price much like those set in the private sector. The fee must be distinguished from other charges that are not linked to consumption of a service, such as many wheel (or automobile) charges.

User fees work best for services where consumers can be excluded from consuming the service, such as when drivers must pay a toll to access a road. Economists also prefer user fees in cases where accessing the service diminishes other peoples' ability to use the same services. This occurs with roads because usage of the road creates congestion for other users. On the other hand, provision of defense or clean air to one group of people also results in defense or clean air for others, with essentially no diminution for the original users. User fees are frequently imposed for utility services (payment for water or solid waste services), hospital services, parking, road usage through tolls, park entry fees, tuition and elementary school fees such as for meals.

User fees offer several important advantages. First, they are fair in a dimension that was not described above. User fees can result in benefit equity, meaning that the beneficiary of services pays for the service provision. Second, only those who value the service buy the service. This prevents the adverse distortions in behavior that arise from taxes. Third, if the user fees are set correctly (or changed as needed), the revenues should grow fast enough to finance delivery of the service.

Not surprisingly, there are also disadvantages of user fees. First, they do not work well for many services, such as many components of K-12 education, many roads, environmental protection, and police protection, because of the difficulty or undesirability of excluding people from consuming the service. This means that many services must be financed with taxes and not with user fees. Second, there may be perceptions of inequity because some individuals will not have access to certain services. One response has been to subsidize the delivery of services, at least for some people. Higher education tuition and school lunches are examples. Subsidies are not always the best approach but they can increase access. Finally, in some cases user fees can entail significant administration and compliance costs, such as can occur with some toll roads.

The advantages of user fees are sufficiently strong so that state and local governments should use them whenever possible. On average, state and local governments raise about 19.1 percent of their general revenue with charges (not all of which may fit the description of user fees provided above). New Jersey generates only 14.7 percent of its general revenue from charges, suggesting that New Jersey may have considerable capacity to impose user fees more intensely. It is true that New Jersey could replace over \$2 billion of property tax revenue if it had the same propensity to impose user fees as the average state (either based on a share of GSP or a share of total revenues).

The difficult task is identifying areas where user fees can be levied more frequently or heavily. New Jersey raises less revenue as a share of GSP from tuition, hospital charges, parks, sewerage, and “other” charges. Tuition and hospital charges account for most of New Jersey’s lower collection of user fees. The likelihood is that universities and hospitals are less likely to be in the public sector in New Jersey than in the average state, and this results in lesser collection of user fees but also lower public sector costs. Thus, there are no obvious choices for where user fees could be imposed more intensively, so user fees may offer relatively little room for new revenues.

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