Property Tax Reform & Land Use

Smart Growth Recommendations from New Jersey Future

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Property tax reforms aimed only at reducing individual homeowners' tax bills will fail to correct one of the most insidious damages inflicted by today's property tax system: competition between municipalities for new nonresidential developments or tax "ratables" that improve the fiscal bottom line but that worsen traffic, suppress much-needed housing opportunities**,** drain older communities of resources and erase open lands.

Prisoner of the Property Tax

It is no secret that runaway property taxes are among the top concerns of New Jerseyans today. In response to some of the highest property taxes in the nation, several citizens' groups are calling for a Constitutional Convention, the goal of which would be to develop an alternative to the current property tax system and institutionalize it by amending the state Constitution. State legislators, in response to voter and media outcry, will meet in special session this summer to consider four issues impacting property taxes: school spending, the cost of public employee pensions and benefits, the consolidation of local governments, and plans for a Constitutional Convention. Their goal is to produce a package of tax reform bills that the full legislature can consider by year's end.

Ever-Climbing Tax Bills

The cry for property tax reform is being provoked by New Jersey's high and rising property tax bills. New Jersey's median real estate tax bill was the highest in the nation as of the 2000 Census, more than one-third higher than second-place Connecticut:

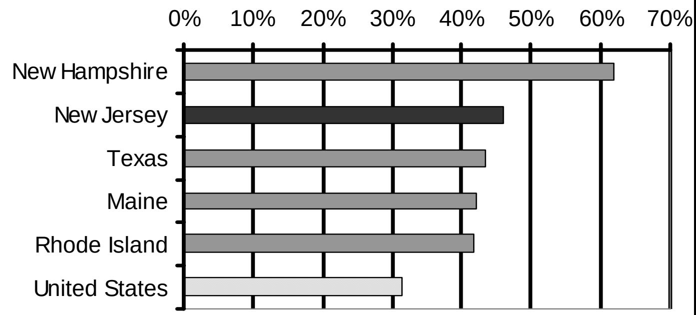
Median Real Estate Taxes (1999)

New Jersey	**4,047**
Connecticut	2,961
New Hampshire	2,946
New York	2,847
Rhode Island	2,507
United States	**1,334**

Data source: 2000 Census

And tax bills have continued to climb: New Jersey property taxes have soared 29 percent over the past four years, according to the Star Ledger. [1] New Jersey's property tax bills are higher than anywhere else, primarily because New Jersey relies more heavily on property taxes

% of Total State & Local Tax Revenue Derived From Property Tax



Data source: U.S. Bureau of the Census, Annual Survey of State & Local Government Finances, 2003-2004

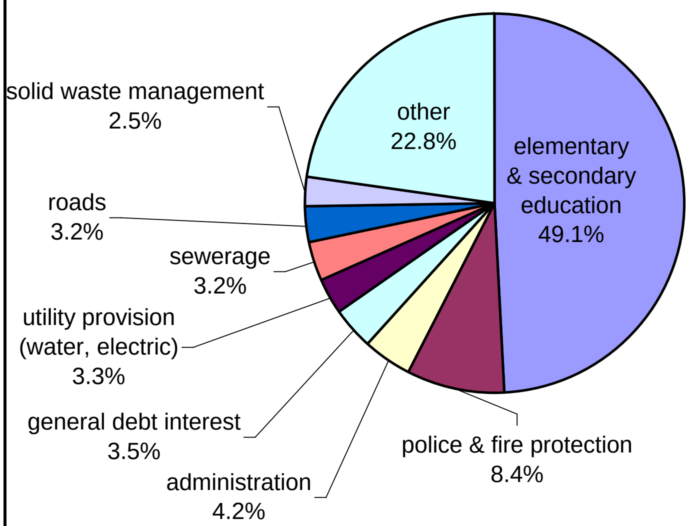
than most other states to pay for government services. In terms of the percent of total state and local tax revenue derived from property taxes in 2004, New Jersey ranks second (46.1 percent) after New Hampshire (61.9 percent), which has no income tax. [2] The 50-state average is 30.4 percent. Among states that collect all three of the major taxes – sales, income, and property – New Jersey is the only one in which property tax revenues exceed sales tax and income tax revenues combined.

Land Use Implications

Reliance on the property tax not only results in big property tax bills for individual homeowners, it also creates broader incentives that have powerful, distorting effects on land-use decisions. From a fiscal perspective, residential development generally does not "pay for itself" – that is, the cost of the services demanded by residents generally exceeds the tax revenue generated by residential property – whereas nonresidential property generally costs less to service than it generates in revenue. Thus every municipality has an incentive to court nonresidential development – shopping centers, office parks, hotels – while discouraging residential development, thereby keeping costs low relative to revenues. This is the infamous "ratables chase." Further, because public school funding is by far the largest component of local government expenditures *(see pie chart on page 2)*, municipalities endeavor to control costs by excluding

[1] "Trenton puts off property tax reform," *Star-Ledger*, July 11, 2006
[2] New Jersey Future analysis of data from Bureau of the Census, Annual Survey of State and Local Government Finances, 2003-04.

New Jersey Local Government Expenditures, by Function



Data source: U.S. Bureau of the Census, Annual Survey of State & Local Government Finances, 2003-2004

children, [3] favoring senior housing complexes, and resisting the creation of housing that is likely to attract families. Municipalities also favor high-end housing, because expensive homes generate more tax revenue than cheaper ones, and because wealthier residents demand fewer services. Such housing is often encouraged via exclusionary, large-lot zoning, which accelerates the per-capita consumption of open space and limits housing choice for non-wealthy households.

With each town trying to attract retail and office development while squelching many residential projects, the cumulative result is a statewide shortage of housing. Another result is that major commercial projects (e.g. office parks or regional malls) go to the lowest bidder and are not necessarily sited in the optimal location from a regional perspective, with little attention paid to impacts on surrounding municipalities. More insidiously, less fortunate municipalities (and a municipality can become "less fortunate" simply through the aging of its housing stock and infrastructure) risk falling into a downward spiral of disinvestment: a declining tax base causes tax rates to rise, which then chases away prosperous residents and businesses, further depleting the tax base and leaving behind residents most in need of government services, necessitating another round of tax increases, etc.

Municipal "Madness"

All of this happens because municipalities must compete with each other for property tax revenues. In truth, their responses are perfectly rational, given the system within

Sharing Municipal Services

One way to alleviate some of the stark fiscal and social inequities among municipalities would be to share some government services between multiple communities, or consolidate them at the county level, as is done in many other states (Maryland, Virginia, and Delaware are the geographically nearest examples). Counties could be responsible for education, police, and other services now provided at the municipal level, funding these services via an increased reliance on county taxes. This would allow struggling municipalities to be helped by their more prosperous neighbors rather than being condemned to the downward spiral of disinvestment, while at the same time inhibiting wealthy municipalities' ability to wall themselves off from the rest of the region. Sharing services between municipalities in a county could produce the same benefits on a smaller scale.

Sharing services among municipalities, or consolidating them at the county level, may also help reduce the expenses incurred by duplication of services by taking advantages of economies of scale. (Governor Corzine himself recently pointed out that Bergen County's local fire departments together have twice as much fire-fighting equipment as the fire department of NYC, whose population is 10 times that of Bergen County.[4]) The cost savings would be shared by all participating municipalities, reducing the pressure on their individual balance sheets.

School districts may be particularly ripe for consolidation. Consider NJ and its similarly-fragmented neighbor Pennsylvania, which is entirely partitioned into 2,565 municipalities. NJ ranks second among the 50 states (after Alaska) in terms of per-capita government expenditure (state plus local) on elementary and secondary education, while Pennsylvania ranks 14th, with a per-capita expenditure only 70 percent as large as NJ's. [5] One possible explanation for the difference is that the extra expenditure is buying NJ superior school performance; another possibility is that the extra costs are merely waste due to duplication. With more than 2,500 municipalities but only about 500 school districts, Pennsylvania averages about five municipalities per school district; with 566 municipalities but more than 600 school districts, NJ doesn't manage even a one-to-one ratio. Perhaps Pennsylvania's lower per-capita costs derive from economies of scale in the provision of public education, economies that are within NJ's ability to achieve through school district consolidation. The subject merits further investigation.

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[3] For an example, see Mansnerus, Laura, "Great Haven for Families, but Don't Bring Children," *New York Times*, August 13, 2003.
[4] Howlett, Deborah, "Corzine lays out agenda on property tax reform", *Star-Ledger*, July 12, 2006
[5] New Jersey Future analysis of data from Bureau of the Census, Annual Survey of State and Local Government Finances, 2003-04.

which they must operate. But is it the property tax *per se* that causes the warped land-use incentives, or is it the way property taxes are collected and used? To answer this question, it is illustrative to consider two hypothetical alternatives to New Jersey's present system of taxation.

A Statewide Property Tax: First, consider the land-use implications if NJ were to abolish municipal and county property taxes and instead adopt a statewide property tax, the revenues from which would then be distributed among the 566 municipalities and 21 counties to pay for local services, including schools. (The formula for redistributing property tax revenues would presumably depend on the size and needs of a municipality's population.) With property tax revenues now accruing directly to the state, nonresidential development would confer no particular tax advantage on local jurisdictions. Municipalities would suddenly become indifferent to hosting new malls or office parks; if anything, they may actually resist such developments because of the non-monetary costs (traffic, aesthetic considerations) they impose. With local fiscal calculations no longer distorting the market, major commercial projects would be more likely to locate where they would make the most sense from a regional perspective.

With the state covering additional costs generated by new residents, municipalities would no longer have a fiscal incentive to exclude certain segments of the population, whether it be lower-income households or families with school-age children. This would dampen the impulse toward large-lot zoning and diminish the general resistance to residential developments of all kinds. And with the state serving as a safety net to bridge the fiscal gap for municipalities with declining tax bases, the downward spiral of disinvestment could be averted.

Are Towns Spending Beyond Their Means?

New Jersey's local governments are saddled with more of the burden of raising money for schools than towns in most other states. New Jersey ranks near the top (third after Nevada and Rhode Island) in terms of the percent of school funds generated from local sources, as of 2005. [6]

Or are they? NJ is actually near the middle of the pack, *not* at the bottom, in terms of state school aid per pupil [7] – at \$5,191, NJ ranks 22nd. NJ has a higher cost of living than many other states, so a dollar-amount comparison leaves NJ's state government looking slightly more generous than it might otherwise, but school aid in NJ is still higher than in some other relatively high-cost states, such as Maryland and Pennsylvania, and is considerably higher than in Rhode Island (\$3,702) or Nevada (\$2,571), the two states with higher local-government percentage contributions. In terms of dollar amounts, NJ's state government does not appear conspicuously tight-fisted in funding education.

How, then, are NJ's municipalities and school districts having to pony up such a large percentage of school expenditures? Because per-pupil spending is high overall – third-highest in the nation, after NY (\$12,059) and Connecticut (\$11,773).[8] So while state government's contribution to education is average in absolute terms, in percentage terms it's very low, because NJ simply spends a lot more than most other states. Local government makes up the difference.

In reality, local governments may be doing more than simply making up the difference. In some instances they may be adding substantially to that difference, choosing to spend money on school amenities simply because they can afford to. Additional, discretionary expenditures may genuinely result in superior school quality and performance, in which case local taxpayers may feel the expenditures are justified, but it is an open and subjective question as to how much any particular school district *should* be spending on a per-pupil basis. (The question is further complicated by the issue of duplicative costs among numerous, fragmented municipalities, as discussed in "Sharing Municipal Services" on page 2.) For that matter, the same holds true for non-school services like police and fire protection, street cleaning, or trash removal – additional expenditures may result in a higher quality of life, but how high *should* they be? And are New Jerseyans willing to give up some of these "discretionary" local expenditures, and with them the additional quality of life that they buy, in exchange for reduced property tax bills?

Before declaring that state government needs to pay more for schools or local services, it may be necessary to look at exactly what local government dollars are being spent on. Shifting some of the tax burden onto other, statewide taxes will accomplish nothing if municipalities and school districts choose to regard the increased revenue stream from the state not as a replacement for locally raised funds but as an enhancement to their total budgets. It seems reasonable to ask whether municipalities or school districts might be spending too much, however "too much" may be defined.

[6] New Jersey Policy Perspective, *New Jersey Snapshots 2006*
[7] Ibid.
[8] Ibid.

A Local Income Tax: In contrast, consider the likely results if local services continue to be funded from local revenues, but municipalities raised money via a local income tax (on residents and businesses) rather than a local property tax. Under this scenario, with each municipality still on its own to raise as much money as it can, the competition among municipalities to lure high-income residents (who yield more tax revenues) would become even more intense than it is now, making large-lot zoning more commonplace. Municipalities would still have an incentive to exclude children in an attempt to suppress costs (and thence the tax rate), resulting in limited housing choices for families with children. The ratables chase would continue, as it would still be true that commercial properties generate revenue (via taxes on their income) without adding to educational costs, the biggest component of municipal budgets. And the cycle of disinvestment would still loom for municipalities less equipped to play the game of attracting commercial properties or wealthy residents.

Curbing Competition

Retaining the property tax but collecting it at the state level would substantially mitigate competition among municipalities and would thereby address all of the warped land-use incentives mentioned above, while switching to a local income tax would do nothing to remedy the present problems and in fact would make some of them worse (see table below). It appears that the negative land-use side effects of New Jersey's over-dependence on the property tax may actually be more properly attributed to the unhealthy inter-municipal competition that arises from our over-dependence on municipal government for funding local services.

Which land use side effects are improved by which tax solution?

Land-use side effect	statewide property tax	local income tax
Ratables chase	YES	NO
Housing shortage	YES	NO
Zoning out children	YES	NO
Large-lot / exclusionary zoning	YES	NO
Location of regionally significant projects	YES	NO
Cycle of disinvestment	YES	NO

To end the distorting influence of the property tax system on our landscape and our future quality of life, the movement for property tax reform must embrace proposals that curb inter-municipal competition. One such solution is shared municipal services (see "Sharing Municipal Services" on page 2). Increasing state aid to municipalities – particularly for education – is another. This option would require shifting some of the tax burden to one of the statewide taxes (income or sales or a newly-created statewide property tax), and it raises the question of how to guarantee that municipalities (and school districts!), with new money coming in from the state, would then lower their local tax rates by a corresponding amount (see "Are Towns Spending Beyond Their Means?" on page 3). But it would level the playing field, distributing the costs of public education more evenly over the entire base of taxpayers statewide.

Another option is regional tax-base sharing, as is presently practiced in the Meadowlands. Tax sharing involves pooling the revenues generated by taxes on property across an entire region (e.g., a county) and distributing those revenues among all municipalities in the region, whose residents, incidentally, all share in the intangible costs of large-scale developments. Tax sharing ensures that the fiscal benefits of development accrue to the entire region and not solely to the host municipality, i.e. that the benefits are regionalized along with the costs. Under such a setup, no municipality has a fiscal incentive to individually solicit development that will not benefit the larger region. And because they will all share in both the revenues and the costs regardless of where in the region development occurs, municipalities don't have to compete; in fact, they collectively have an incentive to seek regionally optimal sites for those developments that are desirable, sites that maximize the regional benefits of the development while minimizing the regional costs (including intangible costs).

Recommendations for Effective Property Tax Reform

Wherever the debate over property tax reform plays out, whether in the legislature or in a Constitutional Convention, that debate needs to address the land-use side effects of the current property tax system and acknowledge that part of the problem is an over-reliance on local government for funding public services, especially schools. Particular attention should be paid to solutions that minimize municipal competition for tax revenues, since that competition is the direct cause of many unwanted land-use effects. Such solutions include:

- Shared services
- Tax-base sharing
- Increased state aid to municipalities, particularly for education

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