Office of Legislative Services
Background Report

State Options for Replacing Local Property Taxes

OLS Background Report No. __127__

Prepared By:
Revenue, Finance and Appropriations

Date Prepared:
October 2005

New Jersey State Legislature
Office of Legislative Services
State House Annex, P.O. Box 68
Trenton, NJ 08625-0068
http://www.njleg.org

OLS Background Report On State Options for Replacing Local Property Taxes

INTRODUCTION

New Jersey taxpayers face among the highest property tax burdens of any state[1] in the nation. The tax is frequently viewed as an exceptional burden on taxpayers living on modest or fixed incomes, or for communities with low levels of property wealth trying to support local services.

It is often suggested that State taxes replace all or part of the local property tax in order to reduce these burdens. However, reducing such a major tax revenue source would require other major tax policy changes. Policy makers should be aware that replacing local property taxes with State resources could require a potentially significant increase in either sales tax or income tax rates, the State's two major revenue sources. Alternatively, New Jersey could consider the initiation of a statewide property tax to replace some portion of local property taxes, along the lines of what Michigan did in the 1990's, or it could consider the expansion of the sales tax base to include various services not currently subject to that tax. In any case, major property tax reforms will require major tax policy changes and significant sources of replacement revenues.

This background paper is written with the intent of outlining the potential scope of alternative sources of State revenue that might be viable replacements for local property taxes. This report does not advocate any policy change or promote one or another option. The more options that policy makers are aware of, the more informed decisions they will be able to make.

OPTIONS #1 and #2: INCREASING INCOME AND SALES TAX RATES

The State income tax and sales tax currently generate significantly less revenue than local property taxes raise. In FY 2005-06, the income tax is expected to raise $10.28 billion and the sales tax is expected to raise $6.85 billion in State tax revenue. Actual Tax Year 2005 local property tax revenues are not available at this time, but given recent annual growth trends, it can be assumed that total local property tax levies may approach $20.0 billion in 2005 and should exceed that level in TY 2006. Historically, school property taxes account for about 55% of local property taxes, or about $11.0 billion of an estimated $20.0 billion.

---

[1] In 2002, New Jersey ranked #1 with property taxes of $1,908 per capita, nearly twice the national average of $992. New Jersey ranked #3 in property taxes as a percentage of personal income, behind only Maine and New Hampshire. In 2001, the State also ranked #2 in the percent of total state and local revenues derived from property taxes (24.3%), second only to New Hampshire. These figures are the most recently available national comparisons according to U.S. Census Bureau data, as reported by the National Conference of State Legislatures.

Table 1 displays the estimated impact on the income tax and the sales tax if these State tax revenue sources were to replace local property taxes. Replacing the total local property tax with an **increased State income tax** would require that tax to increase by about 195%, which is essentially a *tripling* of income tax rates. Replacing the local school property tax would require an income tax increase of about 107%, or more than a *doubling* of the tax rates. For high-income earners, New Jersey already has among the highest marginal tax rates in the nation. Also shown in Table 1, an **increased State sales tax** would require even greater proportional increases in the current sales tax rate than under the income tax.

Table 1
Estimated Impact of Replacing Local Property Taxes
$ in Billions

	Replace $20 Billion Total Local Property Tax	**Replace $11 Billion Local School Property Tax**
OPTION #1: Increased Income Tax Rates		
Current Revenue (FY06)	$10.28	$10.28
Increase Required	$20.00	$11.00
New Total	$30.28	$21.28
Percent Increase	*195%*	*107%*
Current Rates	From 1.4% to 8.97%	From 1.4% to 8.97%
New Rates *	**From 4.13% to 26.46%**	**From 2.90% to 18.57%**
OPTION #2: Increased Sales Tax Rate		
Current Revenue (FY06)	$6.85	$6.85
Increase Required	$20.00	$11.00
New Total	$26.85	$17.85
Percent Increase	*292%*	*161%*
Current Rates	6 cents per $1.00	6 cents per $1.00
New Rates	**23.5 cents per $1.00**	**15.7 cents per $1.00**

* These new income tax rates assume all marginal rates are increased proportionately. Various other changes to marginal rates are possible.

The tax savings for local property tax payers would vary widely, depending on the value of property and the local property tax rates. The 2004 average property tax payment in New Jersey was about $5,500, but easily varied from a couple of thousand dollars to well over $10,000 for many homeowners. Also, about one-quarter of local property taxes are paid by non-residential properties, which would likewise gain a significant tax benefit if local property taxes were eliminated. The State Constitution would have to be amended to allow separate tax treatment of different types of property such as residential vs. non-residential.

The tax increases offsetting the property tax savings would also be significant. Analyzing the impact of the sales tax rate increases is problematic, because taxpayer's sales tax liabilities are not tracked, and they can also vary significantly from year-to-year based on the type of purchases made, such as for automobiles or expensive electronics. The potential impact of an income tax increase can be analyzed more effectively. **Table 2** displays the estimated effect of increased marginal tax rates on Joint Filers for the income tax increases displayed in Table 1. **Table 3** displays the effect on Single Filers. Overall, about four in five State homeowners, those with incomes below $100,000 annually, would see property tax reductions greater than their income tax increases. Many of the remaining higher-income homeowners would see income tax increases exceed their property tax savings. Income taxpayers who do not pay property taxes would face income tax increases without a property tax savings. These examples do not include the impact of any potential change in existing State direct property tax relief programs or rebates.

Table 2
Estimated Impact of Replacing Local Property Taxes With an Increased Income Tax -- Joint Filers

Income Level	Current Total Income Tax Liability *	Revised New Total Liability	
		After Replacing Total Property Tax	After Replacing School Property Tax
$50,000	$718	$2,118	$1,486
$100,000	$2,474	$7,298	$5,121
$150,000	$5,236	$15,446	$10,839
$200,000	$8,379	$24,718	$17,345

* Assumes personal exemptions for taxpayer, spouse, and two dependent children. Excludes the impact of the current property tax deduction in order to isolate the effect of increased marginal tax rates. Current liabilities would be less than shown based on the value of current property tax deductions and the applicable marginal rate.

Table 3
Estimated Impact of Replacing Local Property Taxes With an Increased Income Tax -- Single Filers

Income Level	Current Total Income Tax Liability *	Revised New Total Liability	
		After Replacing Total Property Tax	After Replacing School Property Tax
$50,000	$1,215	$3,584	$2,515
$100,000	$4,180	$12,331	$8,653
$150,000	$7,365	$21,727	$15,246
$200,000	$10,550	$31,123	$21,839

* Assumes a personal exemption for the taxpayer. Excludes the impact of the current property tax deduction in order to isolate the effect of increased marginal tax rates. Current liabilities would be less than shown based on the value of current property tax deductions and the applicable marginal rate.

The statewide aggregate estimates for these options would be far from precise. Actual income tax or sales tax rate changes required to replace local property taxes would vary from year to year. The aggregate data are also a mixture of State fiscal year and local and individual tax year figures, further complicating the precision of the estimates. Moreover, the estimates for the taxpayer examples make necessary simplifying assumptions. To isolate the impact of increased marginal tax rates the impact of the existing property tax deduction is excluded. The actual impact would be more complex than is shown, given the interaction between the current property tax deduction and the resulting reduction in the value of the deduction following an elimination or partial elimination of local property taxes. The actual impact would have two offsetting effects: 1) the inclusion of the existing property tax deduction would lower the current tax liability and increase the net tax increase under the revised new liabilities; and 2) the fiscal savings from the elimination or reduction of the property tax deduction would allow for a slightly lower percentage increase in marginal tax rates than the 195% and 107% estimates used in this analysis.

Potential Increased Revenue Volatility: It should also be noted that any change from the current property tax system to one financed by increased sales or income taxes would increase the level of uncertainty in annual budgeting. Revenue levels would be more uncertain and unanticipated large annual surpluses and shortfalls would occur. The property tax is a relatively "stable" revenue source, in that local property tax rates are levied in order to raise a prescribed amount of revenue each year. Property tax revenue amounts are relatively dependable, while the local tax rates are volatile, changing from year to year. Under the income tax or the sales tax, the rates would be dependable, since they are written into law, but the revenue amounts would be volatile. For example, the stock market crash and national recession in 2000 and 2001 precipitated a revenue shortfall in the income tax of about $2.0 billion below the Governor's original estimates for FY 2002 (off by more than 20%). If the income tax were to collect three times the amount of revenue it currently does in order to replace property taxes, a similar revenue shortfall to that seen in FY 2002 could quickly reach $6.0 billion, escalating the State's fiscal troubles. Greater dependance on historically volatile revenue sources will, logically, result in more volatile annual budgeting.

OPTIONS #3 AND #4: A STATEWIDE PROPERTY TAX OR EXPANDING THE SALES TAX BASE

Increasing State income tax or sales tax rates need not be the only options for raising State revenue to replace local property tax revenues. Two other potentially significant revenue sources at the State level could include the enactment of a statewide property tax or an expansion of the sales tax base to include many services not currently subject to the tax.

OPTION #3: Statewide Property Tax. According to the National Conference of State Legislatures, 15 states have a statewide property tax. Michigan's 1994 property tax reform plan, known as "Proposal A", has garnered much national attention. Proposal A replaced local property taxes as a funding source for local school district spending with a series of increases in other taxes. Among many changes, the state sales tax went up by 50% (from 4 cents to 6 cents per dollar), the cigarette tax increased by 200% (from 25 cents to 75 cents per pack), and **a statewide property tax was introduced, although at a substantially lower level than the previous local school property tax rates.** All in all, the Michigan Department of Treasury[2] states that a typical Michigan homeowner saved about $2,000 in property taxes in 2002, from projected future levels if local property rates in the mid-1990's had continued. While property taxes had consumed 4.6% of state personal income in fiscal year 1993, by fiscal year 2000 they comprised only 3.27% of state personal income, falling from above average to average levels nationally.

A statewide property tax could be included as part of a New Jersey reform proposal. According to 2004 data from the New Jersey Department of Community Affairs, the average local property tax rate statewide was $3.02 per $100 of value. Policy makers could choose to implement a statewide property tax at some rate less than the current average, and potentially raise billions of dollars. However, this option would shift some of the property tax burden to municipalities that currently have low local property tax rates.

---

[2] *School Finance Reform in Michigan -- Proposal A: Retrospective*, Michigan Department of the Treasury, 2002. http://www.michigan.gov/documents/propa_3172_7.pdf

OPTION #4: Expanded Sales Tax Base. Over time the United States has increasingly shifted away from being goods-based economy toward being service-based economy. According to a report by the Center on Budget and Policy Priorities[3] (CBPP), household spending on durable and non-durable goods declined from 39% of consumption in 1970 to 33% of consumption in 2001. Meanwhile, the consumption of services increased from 31% to 44% during the same period. However, most state sales taxes are based primarily on revenue from tangible goods, so that over time, the sales tax is based on a smaller and smaller proportion of a state's economic activity. The CBPP study attempted to estimate the revenue potential of expanding states' sales tax bases to a variety of services (excluding housing, health care, education, transit, banking, insurance, legal and funeral services). For New Jersey, the study indicated that sales tax revenues could increase by as much as 45% over current revenues. Of course, the actual revenue amount raised would depend on which categories of services were and were not included in the sales tax.

CONCLUSION

In New Jersey, relief from the burden of high local property taxation has long been discussed by taxpayers and policy makers alike. Since local property taxes account for such a significant source of revenue, any major reform would require significant sources of alternative revenues. This background paper has outlined a number of alternative State revenue sources that may have the potential to raise enough funds to replace some portion of the local property tax. However, policy makers will face important and difficult choices in determining an effective alternative to the current funding system.

Prepared by:
Martin Poethke
Office of Legislative Services

[3] US Department of Commerce data, as reported in *Expanding the Sales Taxation of Services: Options and Issues*, 2003, Michael Mazerov, Center on Budget and Policy Priorities.