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NEW JERSEY
TAX POLICY
COMMISSION

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SUMMARY

**Part I THE REVENUE GAP AND DISTRIBUTION
OF THE TAX BURDEN**

Part II THE PROPERTY TAX

Part III SERVICE LEVELS AND STATE AID

**Part IV TRENDS IN CAPITAL NEEDS AND
DEBIT BURDENS**

**Part V NON-PROPERTY TAXES IN A FAIR AND
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SUMMARY
of the Report of the
NEW JERSEY TAX POLICY COMMITTEE

Submitted to Governor William T. Cahill
pursuant to Executive Order No. 5 of 1970

The report consists of
five separate parts and
a summary volume

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TRENTON, NEW JERSEY

February 23, 1972

NEW JERSEY TAX POLICY COMMITTEE

(appointed by the Governor pursuant to Executive Order No. 5 of 1970)

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VERDELL ROUNDTREE..... *Vice Chairman*
WILLIAM MILLER..... *Chief of Staff*

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The Revenue Gap and Distribution of the Tax Burden

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Chairman, New Jersey Turnpike Authority
Former Governor of New Jersey
JOHN P. LEWIS, *Vice Chairman*, Mercer County
Dean, Woodrow Wilson School of Public &
International Affairs, Princeton University
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International President, United Textile Workers
of America
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ROBERT E. BRUMUND, Gloucester County
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League of Women Voters
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Tax Manager and Asst. Secretary, Grand Union Co.
MARRIOTT G. HAINES, Cumberland County
Assessor, City of Vineland
ROBERT W. KLEINERT, Bergen County
President, New Jersey Bell Telephone Co.
Alternate: ROBERT C. VONSO THEN, Somerset County
General Tax Administrator, New Jersey
Bell Telephone Co.
PHILIP H. MOWERY, Hunterdon County
Realtor and Former Vice President, New Jersey
Farm Bureau

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Attorney and Assemblyman
HENRY C. LANG, *Vice Chairman*, Bergen County
Former President, New Jersey Taxpayers Assn.
Senior Tax Adviser, Standard Oil Company (NJ)
ARCHIBALD S. ALEXANDER, Jr., Mercer County
Essex County Attorney
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Attorney and Former Governor of New Jersey
LAWRENCE L. LASSER, Essex County
Attorney
RONALD OWENS, Essex County
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Attorney

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Attorney and Former Assemblyman
LAWRENCE F. KRAMER, *Vice Chairman*, Passaic County
Former Mayor of Paterson, (resigned October 1971,
upon becoming Commissioner, Department of
Community Affairs)
ROBERT F. GOHEEN, Mercer County
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Alternate: VICTOR FRANK, JR., Bergen County
Executive Assistant to President, CPC
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VERDELL ROUNDTREE, Union County
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Former President, Mutual Benefit Life Insurance Co.
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J. EDWARD CRABIEL, Middlesex County
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President & Chief Executive Officer of Peoples Trust
of New Jersey

Table of Contents

	Page
Letter of Transmittal	iv
The Report in Brief	vi
Chapter I: THE PRESENT TAX STRUCTURE	1
Chapter II: THE PROPERTY TAX	5
Chapter III: STATE AID AND SERVICE LEVELS	9
Transfer of Functions	10
General Purpose Grants	12
State Aid for Schools	15
Chapter IV: FURTHER REFORM OF THE PROPERTY TAX	21
Tax Exempt Property	22
Veterans' Exemption	23
Farmland Assessment	24
Senior Citizens Deductions	24
Property Tax Limits	26
Administration of the Property Tax	27
An Improvement Program	28
Chapter V: THE USE AND COSTS OF PUBLIC CREDIT	30
Debt Limits	32
Revenue Bonds vs. General Obligations	34
Central Municipal Credit Agency	37
Chapter VI: NON-PROPERTY TAXES IN A FAIR AND EQUITABLE TAX SYSTEM	39
A Balanced Tax Structure	39
Business Taxes	40
Taxes on Individuals	45
Reform of Tax Administration	51
Combined Effect of Revenue Recommendations	53
Statement of Senator J. Edward Crabel	55
Statement of Senator James P. Dugan	57

LIST OF TABLES

Table S-1 New Jersey Tax Burden by Income Group	4
Table S-2 Impact of Proposed Municipal Aid Program	13
Table S-3 Comparison of Actual 1971 Urban Aid Grants to 24 Municipalities and Grants under Proposed Revised Municipal Aid Formula	14
Table S-4 Estimated Net Additional Revenue Effects of Proposed Tax Law Changes	53
Table S-5 Comparative Effective Tax Rates by Income Classes Under the Committee's Recommendations and the Present Revenue System	54
Table S-6 Comparative Progressivity Indices of the Present Tax System and the Recommended Tax System	54

Letter Of Transmittal

Trenton, New Jersey
February 23, 1972

Governor William T. Cahill
State House
Trenton, New Jersey

My Dear Governor Cahill:

Your Tax Policy Committee is privileged to submit its Report, in accordance with your Executive Order No. 5 of 1970.

This Report, consisting of five separate volumes and this summary volume, represents the results of the Committee's in depth study of the entire tax structure of the State of New Jersey, including all of its levels of government. We believe it covers every currently significant aspect of the State-local revenue system, and that it provides a blueprint for tax reform in New Jersey which is long overdue. Its recommendations cover the present and foreseeable future fiscal needs of the State and local governments, and will provide for the equitable distribution of the costs of State and local government. The Committee has refrained from any effort to pass judgment on the present or future service needs of State or local governments in the conviction that these are matters of policy determination by the Governor and the Legislature. The Committee has accordingly concerned itself primarily with a restructuring of the revenue system, and submits its recommendations satisfied that their adoption by the Legislature will base public finance in this State on a sound and equitable tax structure.

It is important to emphasize that the recommendations are offered as part of a total system, as a combination of measures to which the Committee members subscribed as a whole. The various recommendations are not offered by the Committee in any sense to offer a selection from which the Legislature is invited to pick

and choose. To the contrary, most of the recommendations are interrelated and interdependent, and would necessarily be supported by various members as separate enactments.

The Committee organized for its work on July 17, 1970 and was then divided into five substantive task forces and a sixth coordinating task force consisting of the chairmen and vice chairmen of the other five. It has devoted a major effort to seeking out the views and interest of the public at large, as an essential background to the consideration of specific tax policy problems. To this end, the several task forces held 25 public hearings throughout the State, and Task Force C, dealing with the property tax, was particularly active in conducting public hearings in various parts of the State selected for the convenience of local taxpayers and public officials. As a result of these hearings, the Committee amassed a rich source of useful data, views and suggestions, and the transcripts and supporting documents are being filed together with this Report.

The Committee's research, under the able direction of its Chief of Staff, was provided by coordinating the departmental resources of the State, with a carefully selected group of consultants, and a small supporting full-time staff maintained in Trenton. As suggested by your Executive Order, the Committee has freely called upon the various State departments for statistical data, analyses, and reports. Wherever required, the work has had the benefit of the most sophisticated computer techniques and data processing. Various members of the Committee have themselves contributed from their own considerable expertise in the fields of business, labor and the professions.

The Committee and its Chief of Staff are very pleased to acknowledge the valuable assistance provided by its consultants, who are acknowledged in the opening of

the Reports to which they contributed, and of the many agencies and individuals who contributed to its deliberations. In particular the Committee was competently assisted by the State Division of Taxation and its Director, Mr. Sidney Glaser, and its Chief of Research, Mr. James A. Arnold, Jr., and by the State Division of Local Finance in providing a variety of special tabulations from its computer output. The Committee also greatly appreciates the benefit of cooperative studies initiated by Mr. Sidney Willis, Chief of the Division of State and Regional Planning, which were financed by Federal grants available to the Division; and the use of meeting facilities provided by Governor Alfred E. Driscoll as Chairman of the New Jersey Turnpike Authority.

The Committee also wishes to note especially the wholehearted support and complete independence which you, as Governor, have provided for it. The Committee

has enjoyed the full cooperation of many of your departments to which it addressed requests for assistance, and the depth and quality of the report reflects the input of many people, too many to acknowledge specifically.

By affixing their signatures to this letter of transmittal, the members have individually indicated their concurrence and approval of the Report as a whole. It should be noted that individual members of the Committee have on some issues strongly disagreed with the consensus eventually reached. Those who have dissenting views on such issues have reserved the right to express their own views thereon. Nonetheless, those signing this Report all agree that, adopted in total the Committee's recommendations will produce a dramatically improved system of taxation for New Jersey.

Respectfully submitted,
New Jersey Tax Policy Committee

Archie S. Alexander

George Baldange

Donald S. Borg

Robert E. Brummund

Richard W. De Krot

R. B. ...

Alfred E. Driscoll

John W. Duckett

James P. Dugan

Walter H. Frank, Jr.

Robert F. ...

F. H. ...

Joseph S. Haines

Richard J. Hughes

James J. ...

Donald Johnson

Ann Klein

Robert ...

Henry C. Lang

John McGovern, Jr.

James S. ...

John P. Lewis

Philip H. Mowery

Konrad ...

Margaret M. ...

Frank J. ...

Frank P. Reiche

Verdell Bountree

Richard ...

Larry ...

Patrick J. Sheehan

W. H. ...

The Report in Brief

The thrust of this Report is to achieve a balanced tax structure for State and local government in New Jersey. The key recommendations are to cut the local property tax by approximately 40%; and to follow the policy that henceforth New Jersey State and local governments will raise not more than one-third of their combined tax revenues from property taxes.

New Jersey's present tax structure is inelastic and regressive. By 1980, if the present system is not changed, State and local governments would have to resort to new taxes or rate increases totaling \$1 billion to \$1.8 billion a year to close recurrent revenue gaps.

The effective rate of tax incidence of the present total State-local tax structure is 19.1 percent for families with under \$3,000 a year in income. For those with over \$25,000 a year, the effective rate of the total structure is 5.4 percent.

The property tax is the chief cause of the major defects in the structure. The tax is by all measures either the highest or near-highest in the nation. It is harshly regressive.

The Committee recommends the following measures to reduce property taxes by an estimated \$863 million a year:

	<i>Amount of Reduction</i>
State financing of local school costs	\$607.9 million (net)
A \$100 million municipal aid program	75.0 million (net)
State assumption of welfare costs	75.0 million
Senior citizens property tax relief	37.8 million
Abolition of veterans' property tax deduction	22.3 million
State assumption of county judicial costs	30.0 million
State payments to municipalities for state-owned property	13.5 million
State assumption of county tax board costs	1.5 million

To insure against future escalation of local property taxes, the Report recommends that local tax rates be

limited by law to not exceeding: \$.50 per hundred of county taxes, exclusive of debt service; \$1.50 per hundred for municipal purposes taxes, exclusive of debt service and reserve for uncollected taxes; and zero for local school taxes, except for debt service and special voted taxes for amounts over the standard state-funded program. These are ceilings to reduce the high present tax rates; most local units will be able to live well below the ceiling rates because of the massive property tax relief program recommended by the Committee.

State funding of substantially the full costs of the public schools is one of the main vehicles for property tax reduction. The other is a new municipal block grant system to take care of the "municipal overburden" of high cost or providing municipal services in an urbanized society. The State would provide sufficient funds for a thorough, efficient standard of education in each local school district. Districts now spending above the standards would be allowed to continue. Local referendum approval would be required for those seeking to increase spending above State support levels (unless the district falls within the exception). A statewide property tax levied at a rate of \$1.00 per hundred of equalized valuation would be used to provide \$553 million (as of 1972) of the funds needed. The remainder of \$852.9 million required would be obtained from non-property taxes, including \$245 million of existing State Aid money.

The following steps would be taken to provide \$926.1 million in non-property tax revenues:

A personal income tax at one-half New York rates	\$550.0 million
Elimination of some sales tax exemptions	237.6 million
Increase corporation tax	90.0 million
Increase business personal property tax rate	27.5 million
Cigarette tax increase	30.0 million
Beer and wine tax increases	10.6 million
Tax on non-commercial banks	2.0 million
Abolition of retail gross receipts, unincorporated business tax	-21.6 million

Consultants and staff for the Report are acknowledged at the foot of the Synopsis of each Part—

William Miller, Staff Director
Lewis B. Thurston III, Administrative Assistant to the Chairman
John Kolesar, Editorial Consultant
Martin T. Dyke, Office Manager

Large cities and urban centers should be allowed to adopt site value taxation by local referendum. Land would be assessed at full value, improvements at 50 percent of value.

The Farmland Assessment Act should be tightened to prevent misuse.

The senior citizens' property tax relief program should be expanded and revised to vary assistance according to income and local tax rates. Elderly tenants should also be provided assistance.

Administration of the property tax should be reformed to eliminate unfair disparities in assessments.

A New Jersey Municipal Credit Corporation should be created to lower local bond interest rates by operating a municipal bond bank, a loan guaranty fund and a debt management advisory service.

Administration of the tax laws should be reformed to make appeals and other procedures less expensive and burdensome for taxpayers.

The committee's recommendations would reform and restructure the State and local tax system of New Jersey to achieve these great benefits:

- Provide massive relief to the property taxpayers of the State.
- Shift the tax burden from property to non-property tax sources.
- Close the projected State revenue gap, and avoid recurring State fiscal crises.
- Eliminate the gross inequities of the present tax system by redistributing the tax burden according to ability to pay.
- Eliminate the inequities of present tax exemptions which make some taxpayers carry a burden that belongs to others.
- Humanize the tax system with a new plan for tax relief for senior citizens, including renters.
- Modernize the financial support of the public schools, to guarantee every child in the State an equal educational start in life.
- Establish permanently fixed ceilings on local tax rates, to guarantee every homeowner that property taxes will be held down in the future as well as the present.
- Provide a fair and equitable tax system, fitted to the needs of effective and efficient State and local governments.
- Provide a balanced tax structure which will generate revenues to match the cost of government, from economic growth rather than from continual new taxes and increases in tax rates.

Chapter I

The Present Tax Structure

Refer to Part I of the Report

The Fiscal Prospect

State Revenue Gap

The Committee's projections of future state revenue and expenditures present the following picture:

	Projected			
	3% inflation		4% inflation	
	1975	1980	1975	1980
Revenues (in millions)	2259.0	3198.4	2366.7	3442.0
Expenditures	2432.3	3868.8	2570.1	4494.7
Revenue Gap	173.3	670.4	203.4	1052.7

These projections were based on the assumption that state school aid would be continued to be funded at the 1971-72 level under the Bateman Formula and that the balance of \$990 million in state bonds authorized in 1968 would be issued and spent on capital improvements.

If, on the other hand, it is assumed that the Bateman Formula is fully funded, the resulting projections are:

	Projected			
	3% inflation		4% inflation	
	1975	1980	1975	1980
Revenues (in millions)	2259.0	3198.4	2366.7	3442.0
Expenditures	2709.9	4168.8	2847.7	4795.0
Revenue Gap	450.9	970.4	481.0	1353.0

The projected revenue gap for New Jersey's State government in 1975, assuming a three per cent inflation rate, is \$173.3 million at present funding levels for school aid and \$450.9 million at full funding of the Bateman school aid formula. In 1980, the gap would widen to \$670.4 million at the lower school aid level and \$970.4 million at the higher level of school aid.

Local Revenue Gap

In theory, the present New Jersey tax system precludes any local revenue gap, so long as property owners continue to pay their local tax bills. The local property tax rate is recomputed each year to provide whatever revenues are required to match budgeted expenditures. Therefore, in order to project future additional burdens on local revenues, it was assumed that average property tax rates would remain constant for the next decade at 1971 levels. Under this assumption, additional revenues can be generated from the property tax only through growth of the tax base.

The projected local revenue gap was calculated by projecting future local expenditures, non-property tax revenues, the remainder required to be raised by property taxes, the growth of the tax base, the yield produced by 1971 rates, and the resulting gap between yield and need.

The following table indicates the statewide totals for a three per cent inflation rate:

	Actual	Projected	
	1969	1975	1980
Expenditures (in millions)	2253.1	3472.8	4716.8
Nonproperty tax revenue	523.1	761.2	1013.4
Property tax need		2711.6	3703.4
Property tax revenue		2568.5	3361.1
Additional need above 1971 rate levels		143.1	342.3

Thus, at a three per cent inflation rate, the projected local revenue gap would be \$143.1 million in 1975 and \$342.3 million in 1980, unless property tax rates are raised from 1971 levels. Similarly, at a four per cent inflation rate, the revenue gaps would

be \$353.6 million in 1975 and \$788.7 million in 1980.

The Combined State-Local Revenue Gap

More than half of the projected state spending would go for aid to local government. This close relationship between state and local finance makes it desirable to consider the state and local revenue gaps together. The minimum combined gap would result from a three per cent per year inflation rate and no increase in school aid formulas.

The minimum combined revenue gap for New Jersey's State and local governments was projected at \$316.4 million in 1975 and \$1,012.7 million in 1980.

A maximum figure was obtained using assumptions of a four per cent inflation rate and full funding of the Bateman Formula. The effect of the additional school aid is to increase state expenditures and decrease local expenditures by identical amounts.

The maximum combined revenue gap for 1980 would be \$1,841.4 million.

These projections give some quantitative idea of the fiscal prospect facing New Jersey:

If present trends continue through this decade, New Jersey's State and local governments will have to raise a \$1 billion to \$1.8 billion a year in new revenues by 1980.

The Basic Cause of the Revenue Gap

The basic cause of the future revenue gap lies in the fact that increased income of New Jersey residents is accompanied by larger increases in government expenditures than in revenues. In economists' terms, the expenditures have greater "income elasticity" than the revenues. Income elasticity is measured as a ratio between the change in expenditure or revenue and the change in personal income of the state's residents. An income elasticity of 1.0 means that an expenditure or revenue source changes at the same rate as income. When income elasticity exceeds 1.0, changes in revenues or expenditures occur at a faster rate than income. When income elasticity is less than 1.0, revenues or expenditures change at a slower rate than personal income.

Estimates of the income elasticity of the State government's expenditures, by department, showed they ranged from a low of .65 for the Department of Defense to a high of 2.23 for the Department of Education. The

income elasticity of total State government expenditures is 1.49. At the same time, elasticity of tax revenues ranged from a low of .35 for cigarette taxes to a high of 1.86 for the emergency transportation tax (a graduated income tax on commuters from New York). The elasticity of the State's entire array of revenue sources is .98. In other words, State revenues have increased about the same rate as personal income while expenditures increased one-and-a-half times as fast as income.

The inelastic quality of New Jersey's State tax structure has caused revenue gaps to open up almost annually. New taxes or rate increases in existing taxes were the only methods open to the governors and legislatures in meeting their constitutional responsibility to draw up balanced State budgets. At the local level, property tax rates were increased each year. In 1971, the State received \$749.4 million in revenues which were produced by tax rate increases or taxes imposed for the first time within the past 10 years. Over the entire decade, new and increased taxes accounted for \$4.1 billion of the \$7.0 billion in revenues collected, 59.5 per cent of the total.

One explanation of the greater elasticity of expenditures lies in government's inherent difficulty in raising productivity. Government services have a high labor component and their rising costs are closely related to wage and salary increases. In private industry it is easier for introduction of labor-saving machinery and improved production methods to reduce the impact of wage and salary increases.

The inelastic nature of New Jersey's state tax system means inevitable recurrent fiscal crises as revenue gaps open up. The expedients of the past can no longer be relied upon to close these gaps. Exploiting the same tax sources cannot cope with the projected growth in expenditures and provide the funds required to reform the tax structure.

Alternatives Considered

A number of different courses might be followed to deal with the fiscal prospect facing New Jersey. Among them are:

(1) *Reduction of expenditures:* Vigorous and drastic efforts to reduce State and local government spending are a first consideration in closing the gap. However, a major recent effort by a special task force of management experts from industry was unable to project savings of even 10 per cent of the State budget. Nevertheless, such efforts should be continued.

(2) *Federal assumption of welfare costs:* It might be reasonable to anticipate a full federal takeover of public assistance costs in the next few years. It is not clear whether such a move would require New Jersey to continue some welfare expenditures to maintain its established standards. Optimistically, federal assumption of welfare costs by 1980 could reduce the projected gap by about \$315 million.

(3) *Federal revenue-sharing:* It is difficult to forecast the impact of federal revenue-sharing proposals, particularly in conjunction with any federal takeover of welfare costs. Under the President's proposal before Congress now, New Jersey would receive \$154 million in the first full year of operation. This would double by 1980 if the State's relative revenue effort, as defined in the proposal, and its proportion of the national population remained unchanged. If both revenue-sharing and federal assumption of welfare costs were to come about, the projected 1980 revenue gap could be reduced by as much as \$615 million.

(4) *Revision of State and local revenue structure:* The projected revenue gaps are so large, even allowing for possible new federal aid, that changes in the revenue structure appear inescapable. In addition, the Committee's recommendations for massive reduction in the property tax and revisions in State aid programs would increase the projected fiscal gaps substantially. If the "mix" of the tax system were changed to rely more heavily on income-elastic taxes, this would minimize the need for raising rates. The total tax burden would be unchanged, but the need for recurrent legislative intervention would be diminished.

The Weight of New Jersey's Tax Burden

Before embarking on any effort to deal with the fiscal prospect ahead, it is important to assess New Jersey's present tax burden. How heavy is it? How is it distributed in relation to personal income?

New Jersey's present tax structure produced \$3.8 billion in 1971. The State collected \$1.6 billion while the local property tax accounted for \$2.2 billion. The sales and use tax accounted for 35 per cent of the State collections. The motor fuels tax and corporation business tax were the second and third most important revenue sources for the State government.

The State government's revenue structure is somewhat similar to that of other states, except that it is well below the national average in its reliance on individual income taxes. New Jersey raised 1.23 per cent of its State revenue from individual income taxes. The national average was 18 per cent. As is well known,

New Jersey leans more heavily on the local property tax than most other states. The property tax produced 54.4 per cent of New Jersey's State-local tax revenues, compared with a national average of 38.7 per cent.

There are a variety of ways to compare the New Jersey tax burden with that of other states. One is to measure the tax load per capita. The combined State-local tax burden per capita in New Jersey in 1970 was \$447.25, placing it 14th on the list of states and 12.4% above the median of \$397.92.

When measured against income, New Jersey's tax burden drops somewhat in comparison with other states. The combined State-local tax burden in 1970 was \$105.76 per \$1,000 of personal income, 34th on the list. In property taxes per \$1,000 income it was 12th. State and local taxes took 10.3 per cent of personal income in New Jersey in 1969, compared with a national average of 11.2 per cent.

The Advisory Commission on Intergovernmental Relations in 1971 produced a more sophisticated method of comparing tax capacity and effort among the states. It developed an average financing system, based on the experience of all the states, and then compared each state's capacity and effort with the average. For 1969, New Jersey was calculated to have a per capita tax capacity of \$410 and raised \$411. It was given an index rating of 100 for its tax effort. In effect, this said New Jersey's tax effort was average.

From all of these comparisons, it appears that the total tax burden in New Jersey is not out of line with other states. But its revenue structure is another story. It is less elastic and diversified than in other states. Again, this implies a need for less reliance on the property tax and consideration of more elastic revenue sources. Such a restructuring would not increase or decrease the total tax burden, but it would shift tax burdens among different income classes.

Distribution of the Tax Burden

Thus far, we have considered New Jersey's tax burden in terms of averages or medians. While these have some validity for comparative purposes, they should not be taken as indications that all residents share the burden equally or in proportion to their ability to pay. A more detailed analysis is necessary before the distribution of the tax burden according to income can be determined.

The distribution of the State's population among income classes and the taxes they pay is indicated in Table S-1:

TABLE S-1
NEW JERSEY TAX BURDEN BY INCOME GROUP

Item	INCOME GROUP						
	Under \$3,000	\$3,000-\$5,000	\$5,000-\$7,500	\$7,500-\$10,000	\$10,000-\$15,000	\$15,000-\$25,000	\$25,000 and over
Percentage of consumer units in state	5.5	7.3	17.8	21.0	28.6	16.8	
Mean money income per unit	\$2,136	\$3,852	\$6,437	\$8,737	\$12,098	\$18,352	\$54,300
Percentage of total money income	1.0	2.4	9.9	15.8	29.8	26.5	14.7
Mean property tax bill	\$ 304	\$ 371	\$ 550	\$ 628	\$ 777	\$ 988	\$ 1,500
Estimated % of property taxes paid by group	2.2	3.7	13.6	18.5	31.5	23.3	7.3
Percentage all state-local taxes paid	1.8	3.5	12.8	18.0	31.6	24.8	7.5
% state-local tax paid minus property tax	1.1	3.0	11.3	17.2	32.1	26.8	8.4
Effective property tax rate as % of income	14.2	9.6	8.5	7.2	6.4	5.4	2.9
Effective sales tax rate	1.0	1.4	1.1	1.2	1.2	1.2	.8
Effective rate all state-local taxes	19.1	15.2	13.7	12.1	11.3	9.9	5.4
Effective rate all taxes minus property tax	4.9	5.6	5.1	4.9	4.8	4.5	2.6
Effective rate state-local and federal income tax	22.7	26.3	25.8	24.5	25.9	27.3	30.8
Effective rate state-local and federal income tax minus property tax	8.1	16.3	16.7	16.8	19.0	21.5	27.5

A number of observations may be made on the basis of the table:

—The total State-local tax structure is sharply regressive. It taxes the lowest income class at the highest rate (19.1 per cent) and taxes each higher income group at a lower rate until those in the \$25,000-and-up bracket are taxed at 5.4 per cent of their income.

—When the property tax is removed from the State-local total, the regressiveness is narrowed considerably. All income groups except the highest pay between 4.8 and 5.6 per cent of their income for State-local non-property taxes.

—For all income groups under \$15,000—four-fifths of all consumer units—the State-local tax share is larger than their share of household income. Only the top 20 per cent have a State-local tax share which is smaller than their share of income.

—The top income group fares well by all comparisons. It makes up 3.1 per cent of all households, receives 14.7 of all income and pays the lowest effective State-local tax rates.

—The lowest income group fares the worst on all counts in the State-local picture. With 5.5 per cent of the households, it gets 1.0 per cent of the total income, pays 1.8 per cent of all New Jersey taxes, and pays an effective property tax rate almost five times as high as

the top income group.

—When the federal income tax, with the most progressive rates of all taxes, is added to the State-local tax picture, the effective tax rate becomes roughly proportional for all income classes. (However, it should be noted that if other federal taxes are considered, there is a shift of the burden to lower income groups.) And if the property tax is excluded from the State-local-federal income tax combination, the structure becomes progressive, with rates going up as income goes up.

The Committee concludes:

New Jersey's State and local tax system has two critical deficiencies: its inelastic qualities cause revenues to lag behind expenditure increases, touching off recurrent fiscal crises that demand imposition of new or increased taxes; and

The State and local tax burden bears heaviest on those least able to pay, due primarily to excessive reliance on the property tax and the resulting impact on the housing costs of middle and lower income groups.

In short, New Jersey's State-local tax system is both inefficient and unjust. The correction of these two fundamental defects is the central problem the Committee must resolve in its further recommendations.

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Chapter II

The Property Tax

Refer to Part II of the Report

History and Scope

A law enacted in 1851 gave New Jersey its first truly general property tax. It granted local governments the power to tax all real and personal property (including intangibles) "upon an equal ratio according to actual value."

The State collected no property tax until 1871. Until then, revenue from railroads, banks and insurance companies met all State government needs. Beginning in 1871, the State levied a school tax of two mills on each dollar of assessed valuation. The revenues were reapportioned to local school districts. At various other times it levied property taxes to cover the cost of roads, bridges and tunnels, institutions, and a soldier's bonus. In 1947, the State school tax was repealed, ending the state's use of the property taxes.

In the meantime, there has been movement away from a general property tax for local revenues. In 1945, intangibles were removed from the tax base, starting a series of major legislative events which have narrowed the tax down to a levy on real estate plus certain personal property of telephone companies. A growing list of exemptions and abatements has restricted the tax base further, transferring part of the common burden to owners of the remaining taxable property.

New Jersey's experience points up four developments which should be considered in shaping the future of the property tax:

1. Historically, the tax was designed to support both State and local government; it was originally a light burden, and it was simple in form—so simple that it was assumed anyone could administer it.
2. The first general property tax in the mid-19th century did not anticipate the complexities of ownership and form that property assumes in an industrialized economy.
3. As municipal services grew in scope and cost, the tax came to be a local levy, its burden grew heavier, and it developed by patchwork response to particular evils. But the notion of a simple tax persisted.

The gradual breakdown of the tax as a fair and equitable way of apportioning the costs of government

has been pointed out repeatedly in the past 25 years, prompting adoption of new taxes and changes in the administrative machinery. But excessive local tax rates—which often destroy the very values they seek to tax—remain a central problem in New Jersey government finance.

Trends in the Base and Tax Levy

The property tax has produced a sharply increasing yield, both from annual increases in local rates and from growth in the tax base. The total yield was \$257.6 million in 1945. It rose to \$2.2 billion in 1971. The tax base had expanded to \$60.6 billion by 1971. The statewide effective rate in 1971 was 3.61 per cent of true value.

Projections indicate that with a four per cent per year rate of inflation, the tax base will grow to \$98.1 billion by 1980. If the rate of inflation is three per cent, the base in 1980 is projected at \$93.105 billion. As noted in Chapter I, property tax needs would also grow by 1980—to \$3.7 billion at a three per cent inflation rate and to \$4.33 billion at a four per cent inflation rate. If national fiscal and monetary policies and price-wage controls fail to hold inflation within these limits, the effect on the property tax burden would be greater.

Based on the projections, an unchanged State tax system would require effective property tax rates in 1980 of \$4.42 per hundred (four per cent inflation) or \$3.98 per hundred (three per cent inflation).

The impact on a property owner's tax bill would be much larger than the increase in rates might indicate. Inflation causes property values, and hence assessments, to rise. This moderates the upward spiral of rates. But an individual homeowner is unlikely to see any advantage in an inflationary rise in the value of his house, since it serves only to increase his tax bills. He has little chance to turn the extra value into cash because other similar houses which he can buy have gone up in price.

The Property Tax Burden

There are many ways of describing and comparing New Jersey's property tax burden. The Committee found little comfort in any of them. However, it is

worth noting that it can be misleading to think of a single New Jersey property tax—there are 567 different local property taxes. Also, while most New Jersey municipalities obtain at least three-fourths of their revenue from property taxes, a tenth of them finance their governments with 42 per cent or more non-property revenues. Nevertheless, there is truth in the generalization that the property tax is the mainstay of local government.

The property tax has been rising, a well-known fact in New Jersey's public life. In 1955, the property tax took four per cent of personal income in the State. In 1970 it approached six per cent of personal income. In other words, the tax increased 50 per cent faster than the State's rising personal income.

There is no question that the property tax burden is heavy in most municipalities. Half the municipalities have property tax rates of 3.59 per cent of true value or higher. Of the 567 taxing districts, 185 had true value rates of 4 per cent or more, and 48 had rates of 5 per cent or more. Winfield in Union County had an effective rate of 20.13 per cent in 1971. On the other hand, 64 had rates below 2.50 per cent. Even in municipalities where rates are relatively "low" taxpayers complain about heavy property taxes. Committee studies show that many of these complaints apparently are prompted by sharp increases in a short time, which are difficult to adjust to, even though they occur at levels which other municipalities would consider moderate.

The data refute some common misconceptions:

—Big cities alone do not have the highest tax rates. While five of "the Big Six" cities are in the top five per cent of rates (those over 5.55) they are joined by such places as Shrewsbury Township (Monmouth County), Glen Ridge (Essex), Sussex Boro (Sussex), Chesilhurst (Camden), and Hampton (Hunterdon).

—Industrial ratables do not assure a lower general tax rate, unless they are the right kind and account for more than 40 per cent of the tax base. In the 50 municipalities with highest tax rates, half were well above average in percentage of industrial and commercial ratables. In the 50 municipalities with the lowest tax rates, almost half had far less than the average percentage of industrial ratables.

The Homeowners' Burden

The Committee report has previously discussed some of the interstate comparisons of New Jersey's property tax burden in terms of per capita payments, income and effective rates. As with every method of comparison, there are limitations. Per capita comparisons can be swollen by industrial ratables and not convey the actual burden on homeowners. Income comparisons may be subject to the same flaw. There is, then, some value in

comparing property tax burdens on single-family homes for this is the feature of the property tax which has the greatest impact on the most people.

Data on Federal Housing Administration mortgages in 1968 produce statewide average property taxes on both new and existing single-family homes. The study showed the following ranking of average tax rates for newly mortgaged homes in the states:

New Homes			Existing Homes		
Rank	State	Tax Rate	Rank	State	Tax Rate
1	New Hampshire	2.92	1	Nebraska	2.51
2	NEW JERSEY	2.84	2	Massachusetts	2.76
3	New York	2.59	3	NEW JERSEY	2.59
4	Massachusetts	2.58	4	South Dakota	2.43
5	Nebraska	2.51	5	New York	2.39

When property taxes are related to the family income of people obtaining mortgages on single-family homes, New Jersey ranked sixth in the new homes category—4.33 per cent of family income was taken by the property tax. For existing homes, New Jersey was first—4.58 per cent of income went to property taxes.

And finally, when the average home mortgaged was singled out for attention, New Jersey again topped the list. The average value of homes insured in New Jersey in 1969 was \$20,973 with a property tax bill of \$626 a year—an effective rate of 2.99 per cent. While the average home value in New Jersey was among the highest, it is little comfort to a taxpayer to know that his high tax bill is partly due to the inflated real estate market around him.

The data corroborate the impression held by many a New Jersey homeowner: he is paying the highest property tax bills in the nation.

Who Pays the Property Tax?

On a statewide basis in 1971, residential property owners paid 59.7 per cent of the property tax, 34.9 per cent was paid by industrial, commercial and apartment owners, 1.4 per cent came from farms and 4 per cent from owners of vacant land. From one municipality to another the variations in this pattern were enormous, ranging from Teterboro's 98.2 per cent industrial tax base to Audobon Park's 100 per cent residential tax base.

This report has previously analyzed property tax payments by income class (Chapter I). Property taxes take 3.3 cents from each dollar of those with annual incomes of \$25,000 and up and the rates grow higher with each lower income group until they take 14.6 cents of each dollar of those with incomes under \$3,000. The effect of the property tax is to convert the entire State tax structure into a regressive one. Without the property tax,

New Jersey's tax system would be roughly proportional—that is, it would take about the same amount of money from each dollar income of all economic classes.

The Committee concludes:

New Jersey's property tax is excessive in comparison with other states. It is harshly regressive.

Harmful Side Effects

While the property tax is intended to be no more than a revenue-raising measure, it can have important effects on other major public policies when levied at the burdensome levels which prevail in most of New Jersey.

Environmental Quality

Two relatively recent laws recognize the side effects of the property tax and attempt to use them to bring about beneficial results. One seeks to promote anti-pollution efforts through an exemption or abatement of property taxes on pollution control installations. There have been few instances in which this preferential treatment has been claimed, thus far. The Farmland Assessment Act also was promoted as an ecological measure because it was designed to remove the property tax disincentive to maintain open space. The evidence is inconclusive as to whether it has worked that way.

However, there are undoubtedly some harmful indirect effects of the property tax on the environment. Among them are premature spread of development, as developers seek cheaper land and real estate markets with lower tax burdens, and leap-frog over other more logical sites. The Regional Plan Association, in testimony before the Committee, said:

"... The countryside has measles—houses dotted around, changing it from rural to urban and filling the roads but offering few urban advantages. Local leaders justify 'home rule' in planning and zoning on the basis that local people should have the right to determine what kind of community they want. But debate on most plans or zoning ordinances in New Jersey focuses almost entirely on taxes, not the pattern of the community that will result. . ."

Reduced Property Values

High property taxes can have a depressing effect on the sales value of real estate. Calculations made by the Division of Local Finance showed that rental properties varied in value from one place to another solely because of different property tax levels. For instance, the study concluded that a \$45,000 ratable in a low-tax municipality would be worth only \$32,000 in Newark simply because of the differences in the tax rates of the two communities. The study considered only the economic effect of one variable—the property tax. Other factors undoubtedly influence value. It is conceivable that

because of favorable location, the Newark property has a higher value than one in a low-tax municipality and the effect of the property tax is even larger than indicated.

Housing and Urban Development

In a study for the National Commission on Urban Problems, Dr. Dick Netzer cited a number of ways in which the property tax is harmful to tolerable urban development. Among the effects he cited:

—The tax amounts to a very high consumption tax on housing expenditures and reduces demand. It limits growth of the urban housing stock and limits improvement in the quality of existing housing.

—The deterrent effects are felt more in cities than suburbs, more by tenants than homeowners, and more by the poor than the rich. For upper income groups the outcome may be a marginal encouragement to the trend toward suburban residential locations; for the poor the outcome will be less housing and worse housing.

—Outside the central cities, in metropolitan areas with large numbers of taxing units, there are very large differentials in property tax bases. One consequence is an unacceptably wide variation in the scope and quality of public services from one place to another.

—Wide variation in property tax rates can promote less-than-optimal patterns of location for business establishments. It also leads to emphasis on fiscal criteria in land use planning instead of broader social, economic, and esthetic considerations which should be the basis for planning decisions in urban areas.

A Reduced Role for the Property Tax

Despite the defects of the property tax, the Committee believes it must necessarily be retained as a significant revenue source for local governments.

The independence and vitality of local governments, a political goal of first importance, rests on their ability to finance their own activities. The property tax is the only revenue source which can be tapped in any meaningful way by local governments. Local taxation of income, sales or business tends to shrink the tax base to the long-term harm of the locality. Real property is immobile and disparities must be quite severe before shrinkage of the base sets in.

There are fiscal reasons for keeping the property tax as a source of local revenue. First, it produced \$2.2 billion in 1971 and throwing such a large burden on sales or income taxes, for example, would produce unattractively high rates. In addition, one of its most-criticized aspects—its lack of relationship to ability to pay—can make it a useful component in a properly balanced state tax structure. Some governmental outlays—highway maintenance, education, debt service, em-

ployees' salaries—cannot be easily reduced in a year or two. They require a stable source of revenue for support. During a recession, taxes sensitive to business conditions, such as income and consumption levies, may fail to produce the required income, while the property tax, based on more stable land values, may meet governmental needs more adequately.

Finally, Dr. Netzer has pointed out that without the property tax, housing outlays would be in an unusually favored position compared with other forms of consumption, since few other taxes affect such spending. He suggests there is an argument for keeping the property tax, but at rates which generally apply to other consumer expenditures, say, 5 per cent instead of 15 per cent or more.

However, although there are good reasons for keeping the property tax as a source of local revenue, the Committee believes present levels of the property tax are much too high in New Jersey.

The Committee recommends:

Massive reduction in the burden of the property tax, as a basic policy, accompanied by every possible improvement in the structure of the tax and its administration.

Such a reduction will, in itself, cause property values to increase in many localities and thus help to reduce tax rates throughout the State.

Various plans of achieving property tax reduction are possible—all would require major replacement revenues from the State. The following are some of the ways, and policy considerations involved:

1. The tax rate could be limited by State law to some predetermined level, accompanied by local non-property taxing powers. The Committee strongly recommends against any such proliferation of local taxes.

2. An across-the-board reduction by some arbitrary fraction, say one-half, could be made, recognizing that each municipality would be affected differently depending on its present tax burden. This would disregard the equities of the situation among present high and low tax rate areas.

3. The State could seek an average reduction to the average level of all states, or to some other relationship with the practices of other states. This proposal suggests reducing property taxes to one-third of total State-local taxes, compared with the national average of 39.24 per cent in 1970. (New York and Pennsylvania had percentages of 36.37 and 29.55 respectively.)

4. The State could proceed with whatever reduction results from transferring to the State selected costs of government now borne by the property tax.

The last proposal, chosen by the New Jersey Taxpayers Association in a report it published last year, would have reduced the 1970 property tax total from \$1.9 billion to \$1.1 billion; which was 34 per cent of State-local tax receipts. Coincidentally, this would produce approximately the same remaining property tax levy as is suggested by the third alternative. These approaches are more rational than an arbitrary selection of a fraction to be cut from the present property tax total.

The Committee recommends:

The state should depend on the property tax for only one-third of total state and local taxes in any future year.

Such a massive shift in the tax burden would require replacement taxes at the State level and the invention of ways of returning the revenue to 567 local governments, if the delivery of municipal services is to remain a local responsibility.

Chapter III

State Aid and Service Levels

Refer to Part III of the Report

The Committee has identified five tactics for carrying out the basic strategy of property tax relief:

1. Local government reorganization and management;
2. Regionalization of services;
3. Transfer of municipal or county functions to the State;
4. Strengthening local fiscal capacity;
5. State financial aids to local government.

The first two tactics may be viewed as methods of reducing the over-all cost of government. The last three are methods of shifting costs to non-property tax bases.

Local Government Reorganization and Management

Improvements in local government organization and management have been sought through new charters, administrative reorganization, growing acceptance of executive responsibility and increasing use of trained professionals. In the past, the Faulkner Commission (which developed the Optional Municipal Charter Law) and at present the County and Local Government Study (Musto) Commission have devoted much attention to the possibilities along these lines.

There have been no definitive studies in the United States of the relative efficiency or effectiveness of delivering the services of state and local government at various levels of organization. The Committee, relying on a report by the Rutgers Bureau of Government Research, attempted at least to determine how New Jersey's distribution of responsibilities among state and local governments handled delivery of important services, in comparison with other states. The results, in summary, are:

Education: New Jersey's organization and administration of school expenditures is fairly typical, except that it makes greater use of dependent school districts (Type I districts with no independent revenue-raising powers and oft-times appointed boards).

Highways: Organization and fiscal structure of this function varies considerably from state to state. New Jersey's most distinguishing characteristic is the fact that

only 8.5 per cent of its road mileage is in the state highway system. Like many other states in this region of the country, it divides its local-rural road function between counties and municipalities.

Welfare: New Jersey is one of the minority of 14 states which rely almost exclusively on local units for distribution of welfare funds and services. As a result of this decentralized structure, New Jersey was well above the national average in the percentage of welfare funds spent at the local level, primarily the county.

Hospitals, Health, Sanitation, Sewerage: Use of special districts and authorities has resulted in considerably more regionalization of sewerage service than in many other states. Otherwise New Jersey follows the pattern in most other states.

Police and Fire Protection and Corrections: New Jersey follows the national pattern.

Natural Resources, Parks, Housing and Urban Renewal: The national pattern in these functions is followed by New Jersey.

Based on examination of the practice in other states, there does not appear to be any clearly optimum level of government for administration and delivery of major services of local government which differs from the present pattern in New Jersey, except for welfare and judicial services.

However, steps can be taken to improve efficiency of the present allocation of government services.

The Committee recommends:

1. That the Optional County Charter bill be enacted to enable more efficient forms of county government administration to be adopted.
2. That the County and Municipal Government Study Commission be made a permanent commission.

Regionalization

Based on the work of the County and Municipal Government Study Commission, it appears that regionalization of municipal services can be useful in improving

government services and programs, or in some cases making them possible where they would otherwise not be feasible. However, regionalization may not necessarily reduce tax rates.

Substantial gains have, in fact, been made through regionalization of such specific services as purchasing, police, fire protection, recreation, health, waste disposal and schools, in New Jersey and other states. The economy and efficiency of each such arrangement is determined at the time upon its own facts. There does not appear to be sufficient justification to mandate transfer of any particular service to regional levels of government. If regionalization is to be stimulated, some form of selective inducement seems to be indicated.

The Committee recommends:

As proposed by the County and Municipal Government Study Commission, the State should enact a program of state-sponsored feasibility studies of regionalization or consolidation of specific functions, where such a study is formally requested by at least one municipal chief executive; and for those proposals which are found feasible, financial incentives should be provided, such as transitional State payments to offset temporary financial disadvantage to one of the municipal participants, or a subsidy of administrative costs for an initial period of years, as in Assembly Bill 2450 (1971).

Transfer of Functions

One possible technique of relieving some of the burden on local government finances, which depend so heavily on the property tax, would be assumption of some local functions by State government. This course appears to be especially advantageous where State involvement is already so large as to make local discretion an expensive illusion. The Committee found three such functions: welfare, the judiciary, and county tax administration.

Welfare: New Jersey's welfare programs cost an estimated \$442.6 million in 1971—\$210.9 million in federal funds, \$156.2 million in State funds, \$66.5 million in county funds, and \$8.9 million in municipal funds. The Governor's Task Force on Welfare Management has recommended that the State assume all administrative functions and non-federal costs of public welfare. It justified its recommendation on grounds that it would relieve county and municipal tax burdens, reduce administrative costs, provide more effective administration, coordinate related agencies, and treat recipients more equitably. The 1971 shift in cost to the State was projected at \$75.4 million, with a corresponding reduction in county and municipal taxes. It also estimated

that the President's proposed new welfare program would have gained New Jersey \$28 million in additional aid, which could offset the cost of State assumption.

From a tax policy standpoint, there would be an estimated \$100 million reduction in municipal expenditures and a \$66.5 million reduction in county spending on welfare. Major urban centers would be relieved of the cost of general assistance and all municipalities in a county with high welfare expenditures would receive some relief. Nine counties would receive tax rate reductions of more than 12 points and in Essex County, where welfare costs are the highest, the reduction would be 28 points, the Governor's Task Force estimated.

The Committee recommends:

The State should take over the full cost and administrative responsibility of county and municipal welfare functions, resulting in a transfer of an estimated \$75.4 million from the property tax burden to the State budget, some of which may be recovered with enactment of pending federal legislation.

Judicial Costs: Like welfare, the judicial system is primarily a state responsibility in New Jersey. The State Constitution establishes a unified court system, with the Chief Justice of the State Supreme Court as its administrative head. The system has often been praised as a model throughout the nation. Perhaps in no other state is the case for matching state financial responsibility with state functional responsibility so clear.

Counties are still responsible for paying part of the costs of the judicial system in the form of budget appropriations for county and superior courts, district courts, judicial and domestic relations courts, jury commissioners, the surrogate, probation departments, and the law library. In addition the offices of the county prosecutor may be considered in part as expense of the judicial system. In 1970 county expenditures on these items excluding the prosecutors' offices totaled \$33,103,484. Off-setting revenues totaled \$10,275,201. The net expense to the State of assuming the cost of these judicial functions and the salaries of county prosecutors and assistants may be estimated at \$30.0 million a year at the 1971 level.

The Committee recommends:

That the State assume the full cost of judicial system operations now borne by county budgets as well as salaries of prosecutors and their assistants, relieving property taxes of an estimated net total of \$30.0 million at the 1971 level.

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State Aid

The State has sought to strengthen local fiscal capability through shared taxes and State aids. The State budget for fiscal year 1972 totaled \$1,784 million, with \$974.7 million or 55 per cent designated as state aid. Included in the term are various revenue-sharing items and some which can be identified as state assumption of service responsibility, rather than state aid.

The present state aid programs provide amounts in the following general categories:

General Purposes	\$ 85,137,000
Education	\$523,423,000
Road Aids	\$ 24,982,000
Health & Welfare	\$316,113,000
Others	\$ 28,066,000
Total	\$974,700,000

Health and Welfare Aids

Only about \$11 million of the \$316 million listed in this category is aid for health services. The remainder is for poverty-related programs. If the state assumed full welfare costs, this category of state aid would be increased by \$75.4 million.

Community health service aid accounts for \$5,362,000. It is distributed according to an equalization formula which operates reasonably well, although there has not been sufficient experience since the program's start in 1966 to make definitive conclusions. There are a few obvious deficiencies in the apportionment formula which should be corrected. These include lack of weighting for poverty population and inadequate equalization.

The Committee recommends:

That the Community Health Services program be continued substantially in its present form, after correction of the technical deficiencies noted in the apportionment formula.

Road Aids

State aid for local roads and highways is distributed under three different programs:

County aid: \$6 million through a formula giving equal weight to road mileage, population and area; \$2 million through a formula giving equal weight to mileage and population; \$1,155,000 divided \$55,000 to each county. No matching funds are required and the money can be used on any county road project approved by the State Department of Transportation.

Municipal aid: A total of \$6.6 million a year. \$4.5 million is apportioned according to mileage and population equally. Minimums are set based on amounts

received from 1936-45. \$2.1 million is distributed under the Herrick Act. Each county gets \$100,000 divided up among municipalities which, in practice, are recommended by the State senator. Municipalities must pay a 10 per cent local share of project costs.

The 1967 program: \$15 million distributed to projects chosen on a priority basis from local plans submitted to the State Transportation Commissioner. Maintenance not eligible. Counties must provide a 50 per cent local share, municipalities 25 per cent.

In 1969, under the three programs, Bergen County received the highest proportion—7.66 per cent. Cape May County got the least portion—3 per cent.

The two older aid programs contain many defects. The formulas are inadequately conceived and so hedged with "grandfather clauses" that they do not come close to meeting today's traffic needs. There is no recognition of higher construction costs in urban areas. As a result, the state's six largest cities get only 2.70 to 5.34 per cent of their total road expenditures from state aid.

The grandfather clauses and equal apportionments distort the formulas even more. In the more rural counties—Cape May, Cumberland, Gloucester, Hunterdon, Salem, Somerset, Sussex and Warren—only 10 municipalities received aid based strictly on the mileage and population standards. The other 153 municipalities all had their aid increased by the minimums and grandfather clauses, in many cases receiving 3 or 4 times their basic formula apportionment. Thus, smaller and more sparsely settled communities get from 20 to 40 per cent of their total road expenditures from state aid. In such urbanized counties as Bergen, Camden, Essex, and Union, only 22 of 148 municipalities benefited from the minimums and grandfather clauses. The rest had to be satisfied with what the basic formula produced.

The Committee recommends:

1. The three present State road aid programs—presently totaling \$30.8 million—should be consolidated. One-half of this aid program should be administered and distributed under the 1967 program authorization. The other half shall be made available in the amount of 60% for counties and 40% for municipalities, to be allocated upon a population-road mileage formula giving twice the weight to population. The Commissioner shall publish and justify his allocations annually.

The DOT shall require all aid funds to be spent on projects which are in accord with a road master plan, with due consideration to environmental and other non-transportation factors.

2. In order to increase the cost efficiency of high-

way construction and maintenance, the Legislature should consider increasing the scope of the state highway system and reducing the local systems, in areas where the lack of a secondary road system is significant.

3. The question of economy and efficiency and community impact in county and municipal organization for road construction, operation and maintenance should be resolved on a case by case approach under the Committee's recommendation relating to regionalization of services.

The DOT shall also be authorized to prepare and publish standards of design, construction, maintenance and costs, for the information of county and municipal officials and the public generally.

General Purpose Grants

A total of \$85.1 million of the fiscal 1972 state budget was designated aid for "general purposes." Of this amount \$50 million met the strict terms of the phrase—\$25 million distributed to municipalities on a per capita basis and \$25 million in "Urban Aid" to 24 qualifying municipalities. The remainder of the general purposes grants represented senior citizens' tax deduction repayments, police and firemen's pension aid, and categorical program aids administered by the Department of Community Affairs.

In addition, the state collected \$276.4 million in taxes for distribution to local governments. These funds came from the financial business tax, personal property tax replacement, railroad tax replacement, public utilities gross receipts and franchise taxes, and insurance taxes.

Urban Aid

Originally, the Urban Aid program affected only the six largest cities in the state. They received \$12 million a year distributed according to a formula using such factors as the local crime and tax rates. Specific programs had to be submitted for use of the money in designated areas. In practice, most of the money went for local government employee salary increases. Strong criticism of the law during its first two years of operation led to its revision in 1971.

The present formula allocates funds to any city over 15,000 population which has at least 350 children 5-17 year old in the Aid to Dependent Child (ADC) program, has at least one unit of publicly financed housing, has an equalized general tax rate above the state average, and has less than the average equalized valuation per capita. Once the eligible list of municipalities has been determined, the money is allocated 60 per cent on the basis of the ADC figure and 40 per cent on a combination of the population, housing, tax burden and tax

resource factors. Detailed expenditure plans are no longer necessary. No restrictions are placed on the use of the funds locally. The distribution of funds was made on October 1, 1971, and payments ranged from a high of \$7,435,889 to Newark down to \$106,842 to Millburn.

The new formula also has its anomalies. The original formula gave an arbitrary weight of 70 per cent to factors representing fiscal burdens and 30 per cent to needs factors. The new formula gives needs factors 60 per cent weighting and fiscal burdens 40 per cent. No rationale has been found for either set of percentages. It is difficult to avoid the conclusion they were chosen to produce a desired set of results within limits of a pre-determined budget allocation.

Why should 350 children between the ages of 5 and 17 on the ADC rolls qualify a municipality for Urban Aid, while 349 qualify it for nothing? Why use ADC enrollment at all? Again, it is difficult to avoid the conclusion that the number of ADC children in a community was selected because someone already counts and reports such children for school aid purposes, so the administrative chore is reduced, and the figure was selected to produce a pre-determined result.

The use of tax rates may not be desirable as a measure of need for funds, since the more prolific the spending, the higher the level of state aid. The use of the general tax rate—which includes county and school district taxes—also seems somewhat misplaced in a municipal aid program.

The formula provides more aid to municipalities with higher proportions of residential and apartment property. While there is no doubt New Jersey faces a housing shortage, it is questionable whether one specific program goal of state government should be made a condition for municipal block grants. A better principle might be that specific program goals should be sought through specific aid programs, while the basic municipal block grant program should be based upon a broad evaluation of municipal needs and resources.

A Proposed Block Grant Program: Drawing upon experience with current and past Urban Aid grant programs, it is possible to suggest a more adequate program based on a fundamental premise: a municipal block grant program should attempt to provide all municipalities with a minimum level of resources which can be allocated among functions and services as the people of a community and their elected representatives determine. If a community wishes deluxe services, it can charge itself a deluxe tax rate to acquire them.

Upon this basic guarantee of resources, a superstructure of specific aid programs could be erected to achieve state goals, such as a particular level of housing, health

services, police protection, street maintenance etc. The basic program would have no strings attached except those needed to insure honest administration. The superstructure programs should have numerous strings attached to measure results through performance standards.

Specifically, the proposed Municipal Aid Program would insure that there is a direct and constant relationship between the local *municipal purposes tax rate* in a community and the amount of tax plus aid dollars for expenditure. Expressed as a formula, the relationship is:

$$\text{Municipal Aid Grant} = \frac{(\text{Pm Vpcs} - \text{Vm})}{(\text{Pm Vpcs})} (\text{Tm})$$

Pm=the population of the municipality, according to the 1970 census or the estimate as of the previous July 1 by the Office of Business Economics in the Department of Labor and Industry.

Vpcs=the average statewide equalized tax valuation per capita.

Vm=the equalized valuation of the municipality, as reported by the director of the Division of Taxation October 1 the previous year, as corrected on appeal.

Tm=the local municipal purposes tax levy for the previous year, plus the Urban Aid or Municipal Aid Grant received in that year.

For municipalities with above-average ratables, multiplying the per capita statewide average of ratables (Vpcs) times local population (Pm) and then subtracting the amount of local ratables (Vm) would produce a negative number. They would receive no aid. For a municipality with below-average ratables, a decimal fraction between 0 and 1 would be produced. That fraction would then be applied to the previous year's total of municipal purposes taxes and aid to derive the new grant amount.

In effect, the state would provide from its resources a sum of money to guarantee to each municipality a property tax base equal to the statewide average property tax base per capita.

One substantial limitation of the basic formula is recommended: no municipal aid grant should exceed one half the sum of the previous year's local municipal purpose levy and Urban Aid or Municipal Aid received in that year.

Impact of the Proposed Program

As an example, the proposed formula was applied to Newark and to Commercial Township, Cumberland County. Newark, with a population of 382,417 and ratables totaling \$1,546,489,712 is below the state aver-

TABLE S-2
STATE OF NEW JERSEY
IMPACT OF PROPOSED MUNICIPAL AID PROGRAM

County	Total Number of Municipalities	Number of Recipient Municipalities	Basic Formula		Basic Formula With: 50%-of-Tax-Levy Ceiling	
			Estimated 1971 Cost	Number of Municipalities Affected	Estimated 1971 Cost	Number of Municipalities Affected
Atlantic	23	15	\$ 2,879,549	2	\$ 2,866,195	
Bergen	70	7	743,877	0	743,877	
Burlington	40	26	1,701,480	3	1,644,575	
Camden	37	32	9,032,664	7	8,008,164	
Cape May	16	3	46,159	1	42,518	
Cumberland	14	11	1,302,096	4	1,283,251	
Essex	22	7	30,393,307	0	30,393,307	
Gloucester	24	15	1,284,762	3	1,265,494	
Hudson	12	8	26,488,961	3	25,406,212	
Hunterdon	26	8	115,130	0	115,130	
Mercer	13	6	7,329,047	1	6,397,535	
Middlesex	25	11	3,253,197	0	3,253,197	
Monmouth	53	25	2,911,023	1	2,896,882	
Morris	39	9	196,231	1	196,031	
Ocean	33	10	855,008	1	843,276	
Passaic	16	6	7,912,856	0	7,912,856	
Salem	15	11	371,683	3	334,104	
Somerset	21	7	390,933	0	390,933	
Sussex	24	5	167,718	0	167,718	
Union	21	7	4,089,729	1	4,063,062	
Warren	23	7	505,323	0	505,323	
Total	567	236	101,970,733	31	98,729,640	

age in per capita ratables. Thus a fraction of almost one-half is multiplied times its 1970 municipal purposes tax levy of \$43,417,480 and its 1970 Urban Aid Grant of \$4,964,103. It is eligible for total aid of \$23,019,572. Similarly, the formula produces a grant of \$18,389 for Commercial Township with its population of 3,667 and its \$11,044,789 in ratables. However, its municipal purposes levy in 1970 was only \$30,166 and it would be entitled to no more than half that amount—\$15,083.

All told, 236 of the state's 567 municipalities would be eligible for Municipal Aid Grants totaling \$101,970,733 under the basic formula. The remaining 341 municipalities would receive nothing, since their property tax resources are above average. But the 50 per cent ceiling would reduce grants to 31 of the 236 municipalities, lowering the statewide total to \$98,729,640.

It is significant that 85 per cent of the aid funds would

go to the 24 municipalities which received Urban Aid last year (see Table S-3). Increases would range from 50 per cent to 900 per cent over the 1971 grants. In addition, 152 municipalities would receive grants for the first time. The proposal provides vastly increased amounts of money for the older, larger, higher cost municipalities over any program of the past. On a county basis, here is a breakdown of Municipal Aid grants at 1971 levels:

Grant Conditions: The Committee considered the question of attaching strings to Municipal Grant aid. Since the formula bases the size of the grant partially on the previous year's municipal purposes tax levy, there is an apparent possibility for a governing body to attempt to gain additional aid by varying the size of the local budget. The proposition was tested and it was found that a municipality could get more state aid by

TABLE S-3
State of New Jersey
COMPARISON OF ACTUAL 1971 URBAN AID GRANTS
TO 24 MUNICIPALITIES AND GRANTS UNDER PROPOSED
REVISED MUNICIPAL AID FORMULA

Municipality	1971 Urban Aid Grant	Proposed Revised Municipal Aid Formula
Newark	\$ 7,435,889	\$23,019,572
Jersey City	3,861,861	17,039,222*
Camden	2,230,650	5,705,190*
Trenton	1,925,785	6,168,957*
Paterson	1,768,299	6,377,147
East Orange	934,376	3,864,546
Elizabeth	890,336*	2,470,362
Hoboken	711,104	2,320,872*
Union City	662,999	2,927,605*
Atlantic City	610,291	1,649,392
Passaic	403,005	1,438,995
Orange	379,313	1,440,918
Plainfield	304,559	1,122,995
New Brunswick	290,771	1,221,125
Long Branch	275,965	664,286
Irvington	256,802	1,623,714
Vineland	254,580	509,249
Bridgeton	242,283	366,622
Perth Amboy	240,099	1,029,200
Asbury Park	227,124	485,111
Lakewood	175,686	410,849
Neptune Township	158,806	314,825
Bayonne	118,433	1,201,740
Millville	106,842	335,561
Total	\$24,465,858	\$83,708,055

* Adjusted Grants less than Basic Grant because 1970 Local Municipal Purposes Tax Levy plus Urban Aid less than twice Formula Grant. Grant reduced to one-half 1970 levy plus Urban Aid.

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raising its budget, but only at a greater increase in cost to itself. The potential for manipulation is minimal, particularly if the first funds are applied to property tax reduction. Accordingly, the Committee proposes that the first-year grants be mandated for property tax reduction.

Another possible difficulty to be avoided is payment of block grants to municipalities already receiving disproportionate non-property tax revenues from shared state revenues, particularly public utilities franchise and gross receipts taxes. These taxes go to those municipalities where public property is located, with some getting up to 75 per cent of their total municipal purpose revenue from these sources alone. Such municipalities have relatively low tax burdens and may need no additional state aid. The operation of the formula together with the Committee's proposal to capitalize the utility revenues for the apportionment of county taxes will substantially avoid this problem.

Perhaps the most significant control the Committee proposes is a system of annual reporting on the use of the grant, an annual post-audit of such expenditures on a work-performance basis, and the delegation of power to the Department of Community Affairs to reduce or withhold the block grant from any municipality which is found clearly to be operating wasteful programs with inefficient management, inadequate administrative organization, unsound personnel practices, or inefficient delivery of services. This control contemplates development of a strong performance audit function at the state level which will be able to evaluate programs both as to service need and performance, including unit costs.

The Committee recommends:

1. A Municipal Aid Program, as described in this Report, to provide block grants to each municipality sufficient to guarantee it the equivalent of a property tax base equal to the State average per capita tax base. The program would distribute about \$100 million a year.
2. Replacement of the present \$25 million Urban Aid program with the broader, more adequate Municipal Aid Program, reducing the State's net annual cost to \$75 million.
3. Restrictions on Municipal Aid grants to insure that a) the first year's grants must be used for property tax reduction; b) no grant shall exceed 50 per cent of a municipality's previous year's municipal purposes tax levy plus its Urban Aid or Municipal Aid grant; c) grant expenditures will be subject to performance post-audit by state management examiners, with appropriate sanctions for improper or wasteful use of funds.

State Aid for Schools

New Jersey had 1,482,469 pupils in public schools Sept. 30, 1970. They attended schools in 578 school districts; 201 are single-municipality districts providing elementary and secondary education; 315 are single-municipality districts with only elementary education; 62 are regional districts of varying kinds.

On a statewide basis, school spending totaled \$1.73 billion in 1970-71, with \$453 million, or 26.1 per cent, coming from state aid. In the early 1960s, state aid accounted for 22 to 23 per cent of expenditures. This jumped to 28.6 per cent in 1966-67, following enactment of the state sales tax. The aid proportion has been dropping since. Since 1966, each annual increase in school expenditures has exceeded \$100 million. In only one of those years did state aid cover more than 35 per cent of the increase—in the 1966-67 year additional state aid covered 97 per cent of the increase. Thus, it is apparent that local taxes bear the brunt of public school finance in New Jersey. The state ranked 42nd in percentage of public school finances provided from state revenues in 1970-71.

Local school taxes rose from \$410 million in 1960 to \$1,288 billion in 1971. The average full value school tax rate rose from \$1.42 per hundred to \$2.12 in that same period. School taxes were 49.2 per cent of local tax bills in 1960, on average, and by 1971 took 58 per cent of local tax bills. In 1970, average current expense per pupil was \$800.56.

With the heavy dependence on local property taxes to support schools, local variations were very wide. Essex County municipalities had the highest average local school tax—\$2.64 per hundred. Cape May County districts had an average school tax rate of only \$.93 per hundred. Cape May municipalities spent only 35.5 per cent of their taxes on schools, while Hunterdon County municipalities spent 73.9 per cent on schools. Cape May had \$87,230 in property valuations for each pupil, while Salem County had only \$20,206 in valuations per pupil. Although both spent approximately the same amount per pupil, municipalities in Salem had to levy a school tax that averaged twice as high as those in Cape May. Disparities among individual school districts were even wider.

New Jersey ranked 8th in the nation in total public school enrollment but was tied for 47th in the number of school-age children per 100 adults aged 21-64 in 1969.

New Jersey ranked fourth in personal income received (\$22,470) by residents per child in 1969.

It ranked 15th in average number of pupils per teacher (21.21 in 1969, compared with a national

average of 22.7). It ranked 8th in estimated salary of all teachers in public schools in 1970-71. Only New York and Alaska had higher expenditures per pupil in 1970-71.

Current expense costs per pupil among districts ranged from a high of \$10,477.30 to a low of \$484.40. Excluding the 20 per cent at each extreme, the range in current expense per pupil was from \$962.59 down to \$660.76. The highest costs per pupil occurred in the small number of districts which operate only high schools while the lowest costs occurred in districts which operate only elementary schools.

Equality: Equality of educational opportunity has long been one of the basic values of democracy. Since 1875 the State Constitution has contained the following mandate:

"The Legislature shall provide for the maintenance and support of a thorough and efficient system of free public schools for the instruction of all the children in the State between the ages of five and eighteen years."

There are substantial differences of opinion as to what constitutes equality of educational opportunity. Among standards discussed are equal expenditures per pupil, equal taxable valuations per pupil, a specified limit to variations among districts, specified minimum attainments such as ability to read by age 9, allocation of resources in accordance with ability to pay, and development of the full potentialities of all pupils. Some have challenged the idea that expenditures per pupil are a measure of educational quality. But one authority has responded, "If money is inadequate to improve education, the residents of poor districts should at least have an equal opportunity to be disappointed by its failure."

All the disparities in school financing cannot be explained by differences in fiscal capacity. For instance, 136 New Jersey school districts had taxable valuations in the average range of \$30,000 to \$40,000 per pupil. Yet they supported educational spending programs ranging from \$600 per pupil to \$1,600 per pupil.

Thus, equal fiscal capacity does not necessarily mean equal educational opportunity.

Local control of public schools has a long tradition and remains the basis for delivery of educational services in all states except Hawaii. The theory has been that local control of schools and local financing are inseparable. But such authorities as Dr. James B. Conant and the late Dr. James E. Allen Jr. have argued that control of the vital aspects of schools can be maintained at the local level even if financing comes from the State. In fact, local control may be of little value under present circumstances in many districts, where there is too little in the way of fiscal resources to do more than select one of a number of bad choices.

Recently, a number of State and federal courts have been filed in New Jersey and elsewhere challenging present school financing schemes as a violation of the Equal Protection clause of the United States Constitution or the education clause of the State Constitution. Several of these cases have resulted in orders to abandon unequal financing methods. The recent New Jersey Superior Court decision in the case of *Robinson et al. v. Cahill et al.* produced a similar order.

State Aid: The modern period of state aid for schools in New Jersey began in 1954 with enactment of the first fully funded equalization program, proposed in the 7th Report of the Commission on State Tax Policy. The present state aid system includes aid in 25 categories, totaling \$485 million in the 1972 fiscal year.

The present equalization aid formula produces \$245 million in aid for 596 districts, including 18 county vocational districts. The aid is computed on a variety of factors, including minimum aid for those districts with large local fiscal resources, equalization aid based on ratables, "Bateman Formula" aid based on equalization and performance incentives, "save harmless" grants, \$27 per pupil for the "Big Six" cities, and \$25 per pupil for all districts. The Bateman formula aid (named after the State Senator who headed the commission which proposed the formula) has been only partially funded. If it were to be fully funded by the 1973-74 school year, it would require \$356 million a year in additional aid over present levels, according to estimates by the New Jersey Education Association. Thus, State revenues would have to be increased \$119 million each year for three years. If full funding were achieved over a five-year period, annual increases of \$87 million a year would be needed. The state would then reach the goal proposed in the formula: financing 40 per cent of the projected \$2.53 billion school expenditure bill.

Even full funding of Bateman formula aid will not end disparities in educational resources. The minimums and flat rate grants lessen equal educational opportunity in a fiscal sense. The formula contains factors which encourage disparity in per pupil expenditures. Wealthy tax districts will still enjoy lower tax rates for a given expenditure program. The court order in *Robinson v. Cahill*, unless reversed on appeal, would end use of the minimum aid factors.

The search for the "perfect" state aid program which will equalize educational opportunity on the basis of equality of local fiscal capacity is destined to remain a will-o-the-wisp, so long as spending programs are permitted to vary among districts according to the initiative and willingness of people to tax themselves for public education. Nor would it be possible to achieve substantial equality of local tax rates for schools, even with a

fixed level of school district spending programs, unless the state aid formula reduced all local rates to the rate of the near-wealthiest district, imposing a financial burden on the state which would be imprudent if not impossible. In comparison with such a state aid program, full state financing is a much more attractive alternative.

State Financing would provide a number of important advantages:

—It would eliminate the wasteful competition in educational programs and tax rates which now exists among local districts.

—It would reduce municipal "ratables zoning," with important benefits for the social, esthetic and environmental health of local communities. Now, as costs of school needs are felt locally, municipalities attempt to zone out people and children and to zone in industry. They may not attract the industry, but they succeed in keeping out the people.

—Support for State housing policies would probably increase as zoning deterrents relaxed.

—Schools could be supported by balanced use of property and non-property taxes. A uniform statewide property tax at a modest level could be substituted for the present existing local tax rates, without trying to shift the entire burden of school costs to non-property taxes.

—Tax havens could be eliminated. The present disparity creates unearned tax shelters for avoidance of equal contributions to the state responsibility for education.

—Expenditures of adequate funds by school districts to provide an equalized educational program can be assured. The legislature would have both the opportunity and the responsibility to decide how much per pupil is to be supported and can thus encourage districts with inadequate programs. Such a role would fulfill literally the education clause of the State Constitution.

—It can remove a deterrent to school district reorganization, which often founders because of the unwillingness of a wealthy district to take up the burdens of a poorer district.

—Of greatest importance, state financing would provide for equal educational opportunity within the meaning of the recent judicial decisions.

Full Funding of Local Schools by the State: The Committee is unanimous in the belief that the time has come for substantially full funding of the public elementary and secondary school system by the State government. This was also the conclusion reached by the

Fleischmann Commission in New York State recently. It is the most promising way of satisfying the equal taxation and education requirements of recent judicial decisions while retaining local administration of schools.

The Committee recommends:

That the State assume responsibility for all of the operating costs of a standard quality education.

Educational Program: Wide disparities in spending per pupil now exist, due to such factors as differences in regional costs of living, differing education problems, and varying education standards among districts. In response to these diverse influences, actual expenditures per pupil are heavily affected by underlying differences in taxable valuations per pupil. A State funding program must be flexible enough to recognize inherent differences among districts and yet be expressed in terms of a uniform quality of education which eliminates the effects of taxable wealth as a factor in educational quality.

The Committee recommends:

The Commissioner of Education shall annually determine and promulgate a current expense cost per pupil sufficient to support a uniform high quality standard of elementary and secondary education, provided that he shall not for any year promulgate a cost per pupil which is greater than 120 per cent of the weighted average expenditure by the school districts during the next preceding school year.

Each district shall be entitled to an annual distribution of the amount of the promulgated cost per pupil multiplied by its number of weighted pupils, determined in accordance with the Bateman Act. The distribution to the school districts shall take into account inherent regional cost differences so that the amount provided for each school district will be sufficient to permit the district to achieve for its pupils the quality of education intended by the promulgated standard.

Variations from the Standard Quality Program: The Committee has been deeply concerned with the extent to which any school district should be allowed to vary the quality of its education program above or below the promulgated standard. There are those who feel strongly that every child, no matter where he lives, should receive the same quality educational program. This is a literal application of the equality standard and would produce the same result as a single state school district. Others feel equally strongly that the State should encourage "lighthouse districts" which can eventually bring to all pupils the benefits of innovation and ad-

vancement in the art of teaching and learning. Whichever is the more valid approach, the Committee believes that it is neither necessary nor desirable now to try to force a reduction of expenditures in those districts which have been spending above-average amounts per pupil. On the other hand, it is feasible and desirable to encourage, and possibly compel, those districts which now have inadequate and under-funded education programs to take advantage of state support to raise the quality of their education programs.

The Committee recommends:

(a) Any district which has been spending less than the amount certified for the district shall be encouraged by the Commissioner prudently to increase its expenditures to the amount certified, provided that no district may increase its current expenditures per pupil for any year by more than 20 per cent over the prior year's expenditures unless it shall first receive the approval of the Commissioner, except that any district shall be entitled to increase its per pupil expenditures to the standard quality state program over a period of five years with or without approval.

(b) No district may spend more per pupil than the State quality program provides unless the question is first approved by the voters of the district at a referendum, provided that any district which was spending more per weighted pupil than the state-supported program prior to its adoption may continue to spend that amount per pupil without a referendum.

Equalization of Leeway Ability: Although it is necessary to allow school districts, with the approval of their voters, to exceed the per pupil expenditures certified by the Commissioner of Education, it is also logically necessary to prevent this process from re-establishing educational inequality. The Committee, after considering several alternatives, finds that state cost-sharing can equalize tax burdens of financing local leeway expenditures. Under an optimum cost-sharing approach, the state would provide a district of average wealth with half the cost of its local leeway expenditures. For districts of greater or less wealth, the state percentage would vary inversely with the district's wealth per pupil, as in the following formula:

$$\text{State share of local leeway expenditure} = 1 - \frac{(.5 \times \text{Local Equalized Valuation Per Pupil} \times 100)}{\text{State Avg. Equalized Val. Per Pupil}}$$

This formula would provide absolute equality of tax rate among districts for any leeway expenditure for all school districts up to \$62,316 per weighted pupil or \$77,895 per unweighted pupil (double the state average), as of 1971. Above the limits, there would be no State sharing. But there are only a handful of such dis-

tricts, they have very few pupils and they would be able to finance leeway expenditures with a lower tax rate per dollar than districts below the limit. The Committee believes they would have no effect on educational equality.

The Committee recommends:

The State shall equalize the ability of all districts to provide local leeway expenditures, subject to the approval of the voters of the district, by State sharing of the cost of such expenditures on the basis of a payment of 50 per cent of the cost exceeding the standard State quality program, for a district of average wealth per pupil (using a weighted average), with proportionately more of a state share for districts of less than average wealth, and a lesser state share tapering to zero for districts with more than twice the average wealth. To control the scope of the State's commitment, the state should not share in any cost per pupil exceeding 133 per cent of the current State-certified program for the district.

Other School Aid Programs: Building aid, atypical student aid and other categories of existing state aid programs would not be affected by the proposed State funding of operating costs. Such programs, including transportation, would be aided and financed as under present law.

The Committee recommends:

The proposed full funding of operating expenses shall replace existing formula aid only. All other existing programs should be retained as presently authorized.

Collective Bargaining: With the State paying substantially all the costs of local education, there is a new State responsibility for the manner in which such costs are determined. At the outset the problems might not be severe, but it would be unrealistic to assume that the Legislature would be satisfied very long with the responsibility of making annual appropriations for full school costs if those costs were largely the result of 578 different collective bargaining efforts by the school districts.

The Committee recommends:

Establishment of a regional collective bargaining system for teachers' salaries and fringe benefits. A regional representative of the State, after consultation with local school boards, would be authorized to bargain collectively for the school districts in relation to salaries and fringe benefits of teachers and

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administrators, with power to recognize historical, cost of living and other inherent differences among districts and regions. The result of the collective bargaining shall be binding on the school districts.

Retained Local Control: The Committee agrees with Dr. Conant and Dr. Allen that local control over public schools is both desirable and feasible together with State funding.

The Committee recommends:

Each local board of education shall continue to be responsible for:

- (a) educational programs;
- (b) staffing ratios;
- (c) appointment of personnel;
- (d) selection and implementation of auxiliary services;
- (e) conditions of work, and work assignments;
- (f) administration and management of the school system.

Source of State Funds: Total school costs now run about \$1.9 billion a year. Local property taxes accounted for more than \$1.2 billion of this amount. It would take extreme increases in other taxes to replace this entire property tax burden. For example, full replacement of the 1971 amount would require an added 10 per cent sales tax or more than the yield of an individual income tax at full New York State rates.

However, a property tax levied at a uniform rate statewide could still produce the benefits of full state funding and reduce the amounts needed from non-property taxes to manageable proportions.

Property taxes at four different statewide rates illustrate the possibilities:

A. If the rate were set at the 1970 median (\$2.13), total collections would be \$73 million more than was collected by the municipalities. But 284 districts would have their taxes decrease by varying amounts, while 283 districts would have increases.

B. At a \$2.00 rate (the present average), state collections would equal present local school taxes. But 227 districts would have rate increases and 340 would have reductions.

C. At a \$1.50 rate, 467 districts would enjoy substantial tax reductions, while 100 would have increases. The State would need \$277.3 million in replacement revenue from non-property tax sources.

D. At a \$1.00 rate, 519 districts would have tax reductions totaling \$564.3 million, while only 48 districts (largely tax havens) would have increases totaling

\$9,036,585. The State would need \$555,258,654 in replacement revenue.

A statewide property tax at a \$1.00 rate would provide a stable base for financing school operating costs, avoiding some of the consequences of wider annual swings in revenues from less stable tax sources. Such a rate would permit a reduced level of personal income taxation, giving New Jersey a balanced, moderate tax structure that does not lean too heavily on any one revenue source and compares favorably with rates in all neighboring states for all major tax sources. In addition, a \$1.00 statewide property tax would reach the ratables of those tax havens which represent such a serious competitive threat to their neighboring municipalities.

The Committee recommends:

State funding of local schools should be financed by a tax of \$1.00 per hundred of equalized property value in each municipality, replacing the present local school tax, and by non-property taxes to make up the balance. Districts which chose to spend more than the standard State program would finance the leeway amount, less State aid, by a special property tax authorized by the voters.

Cost of the Program

The cost of the program has been estimated as follows for the first year, assuming it were adopted for the 1972-73 school year:

Basic quality program	\$1,496,179,429.
unused potential ^x	127,570,089.
Net	1,368,609,340.
State share of leeway ^y	37,294,781.
	1,405,904,121.
Property Tax	552,992,026.
	852,912,095.
Present formula 71-72	245,013,900.
New Money Needed	\$ 607,898,195.

^xabout 40% of the districts.

^yabout 60% of the districts.

The above estimate is based upon the following basic 1971-72 data:

Current expenditures to be financed	\$1,495,972,769.
Weighted pupils	1,774,815.1
Average expenditure	\$842.89
State average equalized valuation per weighted pupil	\$31,158

Educational Quality: Full state financing also carries

with it greater state responsibility to assure good quality education in all districts. A performance standard for testing the success of the districts—perhaps on an individual pupil basis—would be desirable. Such accountability is not yet easy to obtain because results are not clearly measurable. There are indications, however, that rapid progress in the art is being made.

The Committee recommends:

The Commissioner of Education should be required to develop and publish a periodic evaluation of the effectiveness of the State's public school system, with a view to achieving the best possible performance of all the public schools and of the system as a whole.

The Commissioner of Education be given a man-

date to develop and administer, subject to the approval of the State Board of Education, appropriate remedies to be employed where a district fails continually to show sufficient educational progress and to report publicly his recommendations and actions under this procedure.

Whenever an increase in the per pupil expenditures of a district would exceed the State supported program beyond a reasonable local leeway, the State Board of Education, upon recommendation of the Commissioner, may limit any increase in the district's per pupil expenditure if the district is already spending more than one-third above the amount determined and certified by the Commissioner for the district or such increase would cause its expenditures to exceed such amount by more than one-third.

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Chapter IV

Further Reform of the Property Tax

Refer to Part II of the Report

Even at the reduced levels recommended by the Committee, improvements in the structure and administration of property tax must be made to end remaining injustices and inefficiencies.

A number of adjustments in the tax base, existing and proposed, were considered by the Committee. Most were aimed at alleviating some of the harmful side effects of the tax or at using such side effects to achieve some benevolent purpose. New adjustments proposed included classification of property and site value taxation. Existing adjustments in the base which were evaluated include tax-exempt property, veterans' exemptions, farmland assessments, housing abatements, and senior citizens exemptions.

Classification of Property

Classification of different types of property for different property tax treatment has been tried historically in an effort to shift burdens from one class of taxpayers to another. Minnesota has had the most highly developed classification system since 1913. It has long been a source of controversy. Those with experience in administering Minnesota's law strongly oppose classification. One deputy commissioner of taxation advised concisely, "Don't do it." The former commissioner of taxation said the classification system cannot work equitably and leads to changes in the law inspired by politics, not economics. In 1970, voters in Massachusetts defeated a property tax classification proposal.

The Committee recommends:

No program should be considered which would resort to classification of real estate or shrink the tax base further or distort its use to distribute the local tax burden. Massive over-all reduction in the property tax burden, as recommended by the Committee, will provide basic correction of the causes of the pressure for further exemptions or subsidies.

Site Value Taxation

A more fundamental type of classification is implied proposals for site value taxation—partially or totally

exempting improvements from property taxes. Such proposals would shift much, if not all of the tax to land. This approach is similar to Henry George's idea of taxing land only. Dr. Netzer evaluated the proposal for the Committee, basing his work on a study made in three New Jersey municipalities. He considered four social goals: the need to encourage new private investment in the older cities; the desire to expand the housing supply; preserving open space; and easing the economic position of older citizens with low or modest incomes.

He concluded that proposals to exempt all improvements or 50 per cent of the value of improvements appear, on balance, to offer significant advantages and few disadvantages when compared with the present property tax system in achieving the four stated goals. However, he cautioned that the study dealt with averages for each class of property and that individual properties might be affected quite differently. If a rapid change were made to site value taxation, there would be very extreme individual windfall gains and losses. Dr. Netzer suggested even a mild reform plan should be adopted only after close examination of the effects on individual properties within specific municipalities.

The Committee was most impressed with the possibility of encouraging new private investment in older cities through use of site value taxation. Coupled with other recommendations in this Report, as well as growing national aids to urban centers, tax deterrents to private investment in cities could be reduced appreciably.

However, site value taxation, by shifting taxes to land, would run counter to other policies which seek to preserve open space, such as the Farmland Assessment Act. Some recent reports on use of site value taxation elsewhere have not been encouraging. Therefore, site value taxation must be considered only as one additional approach to the stubborn and difficult problems of urban centers. It is not acceptable for general application at this time.

The Committee recommends:

1. That principal urban centers be given the option of using a system of site value taxation, under

which land is assessed at its full value and improvements at half of their value.

2. A principal urbanized center shall be defined as a municipality with 100,000 population or more, or a central city of at least 50,000 population of a standard metropolitan statistical area, as defined by the U.S. Census Bureau.

3. The system may be adopted only after winning a majority of votes cast in a municipal referendum.

4. A five-year transitional period shall be provided for installation of the system.

5. Once adopted, site value taxation may not be abandoned except upon another referendum. A five-year transitional period shall be provided for return to the regular tax base.

6. The regular tax base be used for purposes of county and state apportionment of taxes.

Tax Exempt Property

Tax exemptions for governmental property and private charitable, religious and educational property cause problems in all states to varying degrees, depending on terms of their laws and their property tax levels. There have been many criticisms of present exemption systems by federal, state and private commissions. Terms such as "property tax philanthropy," "blind subsidy" and "compulsory contributions" are often used.

Exemptions for private institutions have been criticized by the Advisory Commission on Intergovernmental Relations on three grounds:

1. State-granted exemptions spread the costs among taxpayers in one locality, not to a statewide tax base. The impact is unequal and sometimes a community bears costs of an institution which serves a much wider area.

2. Legislatures may feel unduly benevolent when they can make generous contributions to worthy private causes without any obvious cost to the state.

3. The legislatures are actually imposing forced contributions on local taxpayers without their consent and outside of local budgetary processes.

The Commission suggested that outright grants instead of exemptions would avoid the inequities and replace hidden subsidies. They would also offer the opportunity to judge whether the service performed is worth the continuing grant, a test rarely used when exemptions are considered. In any case, there is a need for full compilation and dissemination of statistical data in an area where costs are shifted automatically and ordinary budget scrutiny is not available.

There is a consensus that at least the following criteria should be applied in considering exemptions:

1. The property tax loss should be clearly identified and be considered a cost of government.

2. Exemptions should have clearly defined objectives and benefit the community.

3. No exemption should be granted if it benefits the group at the expense of another equally disadvantaged group.

4. No exemption should be granted if it costs more than an alternative public program.

5. No exemption should be granted if the objective could be achieved more efficiently and equitably through a direct subsidy.

Tax exemptions are a sizable problem in New Jersey. In 1971, exemptions removed \$11.9 billion worth of property from local tax rolls, about 20 per cent of all land and improvement values in the state. About 15 per cent of the state's land area was exempt.

The ownership and value of the exempt properties was:

Municipal government	\$4.29	billion
County government	\$.87	billion
State government	\$1.2	billion
Federal government	\$1.8	billion
State, interstate authorities	\$.65	billion
Charitable, non-profit groups	\$.86	billion
Fraternal organizations	\$.026	billion
Religious organizations	\$1.7	billion
Other	\$.5	billion

In terms of acreage, Hunterdon County had the lowest percentage of exempt land—4.45 per cent. On the other hand, one-fourth of all land in Hudson and Burlington was exempt. In terms of property values, the range of exemptions ran from a low of 9.72 per cent of Cape May County's total valuations to a high of 44 per cent of Burlington's. Within municipalities the range was even larger. State-owned property accounted for at least 1 per cent of the values in 125 of the 567 municipalities, reaching a high of 55 per cent of the gross valuations in Chesterfield Township (Burlington County).

It is obvious from these disparities that unsuspected and inequitable burdens are being borne by communities, often with little relationship to the benefits received. Granting that the purpose of tax exemption is to support some public benefit, there remains the question of how the costs are to be distributed.

No purpose would be served by taxing municipal property for municipal purposes, school property for school purposes, or county property for county purposes. In each case the addition to the tax base would be canceled by adding the tax bill to budgeted expenditures. No redistribution would result.

State-owned and privately owned exempt property are another matter. If they were subject to property taxation, revenues to pay the tax bills would have to come from non-property tax sources. There would be a shift

of the tax burden from property to other private or public sources.

It should be noted that certain exemptions cannot be changed without amending the State Constitution, which provides:

“ . . . Exemptions from taxation may be altered or repealed, except those exempting real and personal property used exclusively for religious, educational, charitable or cemetery purposes, as defined by law, and owned by any corporation or association organized and conducted exclusively for one or more such purposes and not operating for profit.”

Over the years, a number of expedients have been developed in an attempt to cope with problems arising from exemption of public property. Such expedients include payments in lieu of taxes by the state, counties, authorities, and commissions, usually where the land or amount of ratables exceed some specified minimum or serve some special purpose. In the 1970 fiscal year, the state distributed \$155,777 to municipalities through various payments in lieu of taxes, obviously far short of any solution to such a widespread problem.

The Committee recommends:

1. Municipal property owned by the taxing district should be exempt, except when leased for commercial purposes.

2. County-owned property—other than parks, roads and bridges—should be taxable by the municipality in which it is situated for municipal purposes only, and should not be used in County tax apportionment. This will redistribute the cost of serving such property from the municipal tax base to the county-wide tax base.

3. Public school property should continue to be exempt from taxation by the school district and also by the municipality, where it is owned by and located within a school district which is co-terminous with a single municipality; public school property of a regional school district should be taxable by the municipality in which it is situated, for municipal purposes only, and should not be used in County tax apportionment.

4. State-owned property other than roads, bridges, parks, recreation areas, riparian rights, watersheds, reservoirs, wilderness areas and open space, should be subject to State payments in lieu of taxes for county and municipal purposes only at the various local tax rates. This will redistribute the cost of serving such property from the municipal property tax base to State-wide non-property taxes. It is estimated that \$13.5 million will thus be shifted annually.

5. Exemptions for religious, charitable, educational and cemetery uses, as protected by the Constitution, should be retained, but all other property tax exemptions should be submitted by the Legislature to a statewide referendum to determine whether they should be continued.

6. Part II of the report also includes specific recommendations for the continued exemption or taxation of property of public authorities, treating them generally in a manner parallel to the above recommendations relating to state, county, municipal and school district property.

Veterans' Exemptions

The State Constitution grants qualified New Jersey war veterans a \$50-a-year deduction from their property tax bills. In 1971, the deductions totaled \$22.3 million. They amounted to 1.7 per cent of the gross tax levied on real estate, requiring sizable offsetting increases in local tax rates.

The original purpose of the exemptions was to recognize the service of veterans to their nation and state and to make readjustment easier. However, the deduction produces a shift in the tax burden from those who can claim the exemption to those who cannot—among them other less affluent veterans and the parents and children of veterans.

The Advisory Commission on Intergovernmental Relations has pointed out:

“Property tax exemption is the wrong way to finance veterans' continuing bonus and disability payments. This method, to be sure, is merely an expansion of traditional procedure and, politically, is a rather painless way of making big annual expenditures since it can be done without budgeting and without accounting . . .

If these benefits to veterans are socially desirable they should not be contingent on property ownership . . .”

The Committee recommends:

The State Constitution should be amended to repeal the veterans property tax deduction.

Farmland Assessment

The Farmland Assessment Act of 1964 provides preferential assessment of “land . . . actively devoted to agricultural or horticultural use” at its value for use rather than its value on the real estate market. Two other key provisions of the act are:

1. Preferential assessment is granted only to land of not less than five acres, in a single ownership, from which gross sales of products or payments received under a government program must average \$500 a year for the two preceding years or there must be clear evidence that it will do so within a reasonable time.

2. When the use changes to non-agricultural or non-horticultural use, there is a roll-back tax due equal to the difference between the amount paid and what would have been paid under normal assessing for the year of change and the two preceding years.

In 1971, preferential assessments under the act totaled \$7.4 million or .34 per cent of valuations in the state.

The primary intention of the act was to help preserve agriculture in a rapidly urbanizing state, and thus help preserve one kind of open space. Whether the act has actually served these purposes is not clear from the evidence so far. Between 1964 and 1969, farm acreage in the state shrunk by 10 per cent and the number of farms declined 20 per cent. A survey in 1967 by the Department of Agricultural Economics and Marketing at Rutgers—The State University found a majority of the farmers surveyed said the act had no influence on their decisions on whether to sell their land. On the other hand, 40 per cent reported the act had been a positive influence in enabling them to continue to farm.

While it is clear that for the most part the act has been used by those for whom it was intended—farmers—the Committee has heard complaints about corporations buying large farm holdings near developing areas and qualifying for preferential assessment through production of \$500 in hay crops etc. It is questionable whether any public policy justifies shifting tax burdens from land speculators, casual farmers, or even gentlemen farmers to others in the community.

The Committee concludes that it is necessary and desirable to tighten up provisions of the act in light of seven years' experience.

The Committee recommends:

1. That to qualify for farmland assessment, the owner must receive at least 25 per cent of his gross income from farm operations, and the farm must yield at least \$500 a year plus an average of \$25 an acre for each acre over five acres.

2. The rollback should be extended by Constitutional amendment to the year of change of use plus four preceding years, by adding one year each year for the first two years after the amendment. Assessors should be required to carry qualified farmland on the tax rolls at both full market value and the qualified farm value.

3. New regulations of the Director of Taxation should be promptly implemented and firmly enforced. To determine the owner's income qualification, the gross income of the owner and spouse living together, and the consolidated income of corporate owners and of holders of a majority of stock of the corporation should be used.

Housing Abatements

Three types of laws provide property tax abatements to encourage construction of housing for low and moderate-income families:

1. *Public housing* authorities pay 10 per cent of the rent rolls to the municipalities in which they are located in lieu of taxes.

2. *Middle-income* developments, usually funded under federal programs, can receive special tax treatment under two enabling acts. Limited-divided housing corporations may pay 15 per cent of rent to the city in lieu of taxes. Urban renewal corporations may also pay 15 per cent of rents but for a shorter term, under the Fox-Lance formula.

3. *New Jersey Housing Finance Agency* projects for moderate-income families are eligible for payments in lieu of taxes of 20 per cent of rent or less, either under provisions of the law creating the HFA or the Fox-Lance formula. In practice, most HFA developments are expected to receive abatement of taxes to the 15-per-cent-of-rent level.

These programs are aimed at stabilizing and subsidizing housing costs of the low and moderate-income families who live in the apartments constructed. As such, they produce revenues which fall short of the public costs generated and represent a shift of costs to other property owners in the municipality. They further housing policies at the expense of tax policies. Two questions arise:

A. Is it appropriate to shift the cost of housing tax abatements to municipal taxpayers, or would it be appropriate for the State to reimburse the municipalities for the costs they incur in excess of the payments they receive from the housing developments?

B. Will massive general property tax reductions together with tax shelters granted in federal housing legislation cause the existing tax abatement programs to become outmoded?

The Committee recommends:

Property tax abatements are more closely related to housing policy than tax policy, and their implications should await the report of the Governor's Task Force on Housing; but each such program should be recognized as a form of shrinkage of the property tax base which requires the most careful selection and evaluation.

Senior Citizens' Deductions

Even a generally tolerable property tax level can produce hardship for individual taxpayers or groups of taxpayers. Senior citizens make up one group which

often presents special property tax problems, for two reasons:

1. They have usually experienced a drastic reduction in income after retirement and are especially susceptible to the effects of inflation.

2. The tax rate represents a levy on unrealized capital gain, because the appreciated market value of their homes bought over a lifetime cannot be used to pay taxes so long as they live in them.

New Jersey recognizes the housing problems of the elderly through special provisions of the State Constitution and Law. Resident property owners over 65 with incomes of \$5,000 or less are given a \$160-a-year deduction from their property tax bills (less if the bill does not total \$160). Half the cost of the program is borne by the municipalities, and thus is paid for by local property owners, including the senior citizens themselves. The other half of the cost is borne by the State, and thus falls on non-property taxes.

The senior citizens deduction scheme is deficient in a number of ways. The deduction is considerably less than the maximum assistance provided in such states as Wisconsin, Kansas, Minnesota, California and Vermont, where credits as high as \$475 are afforded. The New Jersey deduction does not vary with income or the local property tax level and provides no relief to elderly renters, who may be in the greatest need of assistance.

The lack of variation with income is inequitable. A claimant gets a \$160 deduction whether he has \$1,000 in income or \$5,000. If his income is \$5,001, he gets nothing. A sliding scale for eligibility would eliminate the arbitrariness of the cutoff point. Operating like a negative, progressive tax, it would allow greater benefits for those at the lowest income levels without increasing the total cost. It would also permit benefits to be spread over a greater range of incomes, a step which can also be accomplished by broadening the definition of income. The present definition is broad, but it excludes social security benefits. The result is that a person with \$6,000 income but no social security benefits gets no senior citizens' deduction, while a person with \$4,500 income and \$1,500 in social security benefits gets the deduction. If the reason for setting an income eligibility requirement is to define the taxpaying capacity of the claimant, the source of the income should be immaterial.

After studying various income adjustments, the Committee concludes that a simple concept will accomplish what is required: each elderly taxpayer should be responsible for property tax payments up to 7 per cent of his income. The tax abatement should then cover the remainder of his bill, up to a specified maximum.

The 7 per cent income factor is based on the fact that

20 to 25 per cent of family income is spent on housing and 20 to 25 per cent of housing costs (in rental units) is attributable to the property tax. Thus, 25 per cent of 25 per cent approximates the general level of income taken for taxes.

A general ceiling of \$500 should be applied to the amount of taxes which will be abated, for fiscal reasons and to limit assistance to reasonably standard housing accommodations. The \$500 ceiling is based on the median value of dwellings in New Jersey in 1970—about \$22,000. The Committee's tax reform program would reduce the statewide general tax level to about \$2.00 per hundred, producing a tax bill of \$440 a year when applied to the median house. Because of wide variations in local rates, the ceiling should be adjustable upward or downward. This can be done by applying a percentage based on the difference between the local tax rate and the median effective tax rate in the State. This would minimize the present unequal treatment of senior citizens living in different municipalities with different tax rates. The rate adjustment factor would be determined by the following formula:

$$\frac{\text{Equalized tax rate of Municipality}}{\text{Median effective tax rate of State}} \times \$500$$

A minimum rate adjustment factor of .6 and a maximum of 1.4 should be set. Thus the ceiling could vary between \$300 and \$700, depending on the local tax rate. The claimant's 7 per cent income factor would be subtracted from this amount to determine his benefit. The result is a deduction which varies with income and with the relative tax burden in the municipality. The arbitrary cut-off is eliminated.

The present senior citizens' deduction provides no relief to those who, by choice or force of circumstances, rent their housing. They are discriminated against, even though a sizable proportion of their rents is used to pay property taxes. This defect could be cured by treating 25 per cent of rent payments as property tax payments. Thus, a senior citizen paying \$150 a month rent could treat \$450 a year as the amount of taxes paid. Relief could be provided under the same income and rate factor adjustments applying to elderly homeowners.

The cost of the present deduction is estimated at \$24.4 million a year, half borne by the State, half borne by local taxes. The Committee staff estimates the total cost of the new deduction system we have described would be \$50.5 million a year. Present deductions are administered by local assessors. In those states which have income taxes and provide property tax relief to senior citizens, the deduction has been administered by the State as a credit against the income tax. If the credit exceeds the income tax due, the claimant receives a rebate. This eases the job of obtaining proof of income,

removes the administrative burden from local government and shifts the full cost to statewide revenue sources.

The Committee recommends:

A Senior Citizens Property Tax Relief program with the following provisions:

1. Delete the present \$5,000 eligibility cutoff and replace it with a formula which will allow some benefits for those with incomes of up to \$7,100 a year.
2. Allow each senior citizen a property tax credit or rebate equal to the amount of property tax paid or \$500, whichever is less, minus 7 per cent of the senior citizen's gross income, including the income of the property owner's spouse living in the same dwelling.
3. Restore income from whatever source derived to the definition of included income.
4. Adjust the \$500 ceiling upward or downward as the equalized tax rate in the claimant's municipality varies from the median tax rate in the state, within a range of \$300 to \$700.
5. Include renters in the property tax relief program by considering 25 per cent of rent paid as property tax.
6. The State should administer the program and bear its full cost.

Property Tax Limits

Assuming a tax reform program which reduces property taxes sharply, there remains the problem of preventing an erosion of the benefits through future escalation of rates. Property tax limits in one form or another have been devised for this purpose and used in 43 of the 50 states. New Jersey is one of the seven states, all in the Northeast, with no limits whatever.

Limits adopted by states in the latter 19th century were aimed primarily at trying to reduce excessive spending and borrowing. Later, limits were adopted as a response to the property tax delinquencies of the 1930s and an effort by state governments to shift from over-use of the property tax to sales and income taxes. A study of those states with limits indicates clearly that property tax limits are not effective in curtailing over-all government spending. But they have been successful in diverting pressure for increased revenues to non-property sources. Such a de-emphasis of the property tax is needed in New Jersey and is a key policy recommendation of this Committee.

The Committee believes specific limits should be set for each level of government using the property tax—

the county, municipality and school district. In such limits, it is necessary to take into account the programs recommended by the Committee which would affect local property tax levels. The major items which would be removed from the property tax by the Committee's recommendations are:

	<u>1971 Estimate</u>
Welfare Costs	\$ 75 million
Senior Citizens' Deductions	\$ 12.2 million
Veterans' Deductions	\$ 22.3 million
County costs of judiciary (net)	\$ 30.0 million
County tax board costs	\$ 1.5 million
<u>Additional Aid Programs</u>	
State payments on tax-exempt property	\$ 13.5 million
Municipal block grant (net)	\$ 75 million
State school financing and aid (net)	\$607.9 million
Reductions in property tax	\$837.4 million
Additional senior citizens relief	25.6 million
Net total	<u>\$863.0 million</u>

Present county tax rates, on a true value basis, range from a low of \$.39 per hundred in Morris County to a high of \$1.22 per hundred in Hudson County. With the relief recommended by the Committee, the county rate ceiling need not be higher than \$.50 per hundred, which is below the 1970 rates in 16 of the 21 counties.

The chief difficulty in establishing a limit for municipal purpose taxes is to find one which will be low enough to be meaningful for most municipalities (where the statewide average rate is \$.79 per hundred) and at the same time will be high enough for the "Big Six" cities (where present municipal purpose rates range up to \$2.89 per hundred). With the tax relief recommended by the Committee, any of these cities could operate under a \$1.50 per hundred limit.

With the proposed new State financing for schools recommended by the Committee, the simplest way to state a limit for school districts is: no local tax levy unless it is voted at a referendum, except to maintain expenditure programs at the level prior to the start of State funding, including capital outlays, debt service and operating expenses.

The Committee also considered delegation of non-property taxing power to local governments as a method of protecting the integrity of the property tax limits. But such a step has serious disadvantages. In the most urbanized state in the nation, with resulting competitive pressures on municipalities and a mobile population, optional use of non-property taxing powers can do great harm to municipal tax bases.

The Committee recommends:

1. Adoption of property tax rate limits, based on equalized taxable valuations calculated over a three-year average, as follows:

County purposes—\$.50 per hundred exclusive of debt service.

Municipal purposes—\$1.50 per hundred exclusive of debt service and reserve for uncollected taxes.

School purposes—as voted only, except for debt service and the tax rate equivalent required to finance per pupil amounts over the certified State standard.

2. In order to provide some flexibility, the stated limits for county and municipal purposes may be exceeded by vote of the people at a referendum, provided no annual increase exceed 10 per cent of the preceding year's effective tax rate.

3. Non-Property taxing power should not be delegated to counties or municipalities.

Administration of the Property Tax

New Jersey has long been in the forefront of efforts to improve the administration of the property tax. Simple equity requires that inequality in assessments be eliminated as far as is feasible, whether at the present high levels of property taxation in New Jersey or at some future reduced level.

The Sixth Report of the Commission on State Tax Policy in 1953 touched off a number of steps aimed generally at eliminating inequalities in assessments by strengthening the office of the assessor and improving assessing techniques. In 1954 a new system of comparing the aggregate true market values of property among municipalities was developed as a basis for distributing State school aid. Comparisons of sales prices to assessed values were made for each property transfer in the State. A table of equalized valuations listing an average ratio of sales price to assessed value is published for each municipality each year. Similar ratios are used by counties to equalize the apportionment of county taxes among municipalities.

One valuable by-product of these continuous sales ratio studies is a vast amount of valuable information, which the State Division of Taxation has made available to the Committee.

The sales ratio data has been effectively used in the process of inter-district equalization for apportioning State aid to schools, apportioning county taxes and measuring local debt limitations.

However, intra-district equalization is even more important in a fair distribution of the tax burden. It is the process of making sure that neighbors and property owners within a municipality with like properties are treated alike on their tax bills. The basic skill of the assessor and his continuous attention to the factors which affect valuation are crucial to achieving equality of treatment.

Committee studies of inequality within districts explored three areas:

1. Disparities in assessments of individual properties of the same class.
2. Disparities in assessment of different classes of property.
3. Whether assessments were regressive (at higher percentages of value for lower-value properties), proportional (at the same percentage for all properties), or progressive (at higher percentages for higher-value properties).

An indicator of disparities among individual property assessments is the "coefficient of variation," a measure of the average deviation from true market values. A coefficient of 20, for instance, indicates the average assessment is 20 per cent off the mark. In a municipality using a 50 per cent assessment ratio a coefficient of 20 would lead one to expect assessments running at 40 to 60 per cent of true value. A coefficient of 100, on the other hand would mean assessments scattered from near 0 to over 100 per cent of true value. The coefficient expresses the average error. Thus a coefficient of 20 means many errors larger than 20 per cent. A coefficient of less than 20 indicates a relatively good assessment roll and 10 per cent is considered about the best that can be achieved consistently. A coefficient of 30 or more indicates some deficiency in the valuation process.

In checking all 73,050 usable sales which occurred from 1966 to 1970, Committee studies found the following average statewide deviations:

Average Statewide Coefficients of Variation 1966-70

Property Class	Average Coefficients of Variation			
	1967	1968	1969	1970
Vacant land	47.8	45.3	49.0	46.8
Residential	22.7	21.3	24.0	25.5
Farm	29.4	26.7	43.1	45.2
Commercial, Industrial, Apartment	32.0	32.1	32.7	31.8

In no category was there a majority of taxing districts within the desirable range of coefficients under 20. The lowest coefficient found was 2.8 per cent, very good indeed. The highest was 160, which means that the average error was 1.6 times the average assessment ratio for that municipal property class. In the vacant land category, less than one-tenth of the taxing districts fell within the range under 20 per cent average error.

The Committee concludes that the assessment process must be strengthened to reduce variations in individual assessments present in most municipalities.

Another tabulation compared assessments to see if there was any discrimination among the four classes of property. Vacant land was found frequently under-assessed in comparison with residential property. There appeared to be a more-than-accidental pattern of discrimination against commercial and industrial property.

This report has previously dealt with the regressivity of the property tax which stems from the fact that lower and moderate-income people spend a larger proportion of their income on housing than do higher-income groups. Even a property tax which is administered with a perfectly even hand is subject to this kind of regression. But if assessments decline as a percentage of true value as the value of property increases, another, compounding form of regressivity is introduced. A coefficient of regressivity can be calculated for each municipality and each class of property, through the use of computers. A coefficient of 1.0 means that assessments are at approximately equal percentages of true value for all properties, regardless of their total value. Coefficients under 1.0 mean that assessment percentages decline as the sales price goes up and are regressive. Coefficients over 1.0 mean that assessments increase in percentage of true value as the price goes up and are progressive. A coefficient between .9 and 1.1 was considered an indication of relatively equal treatment for properties in all price ranges. A tabulation of the data for 1970 showed:

<u>Property class</u>	<u>REGRESSIVITY</u>		
	<u>COEFFICIENT COUNT</u>		
	Number of municipalities with coefficients of:		
	Less than .9	.9 to 1.1	More than 1.1
Vacant land	140	16	31
Residential	319	102	45
Farm	3	2	0
Commercial, Industrial Apartments	60	22	17

The tabulation shows assessments are regressive in most municipalities: higher-valued property is assessed at lower percentages of true value. This was especially true of vacant land, where three-fourths of the municipalities displayed regressive assessment patterns. Residential property assessments were classified 68 per cent regressive and industrial, commercial and apartment properties 61 per cent regressive.

The committee concludes that regressivity of assessments is so widespread and of such proportions that the assessment process must be strengthened to correct this unfair distribution of the tax burden.

An Improvement Program

New Jersey now has a disorganized assessment system depending upon 900 different local assessors who are only loosely responsible to county boards of taxation. They are subject to supervision by the State Director of Taxation, but his authority is meant to be exercised only in extreme cases. The total spent on this structure by county and municipal governments has been estimated at \$23.2 million a year. It all comes out of the property tax.

Major strides in professionalization of assessing have been made in recent years. They have resulted in better training and more security for assessors. But the office is still open to considerable political pressure and there are too many part-time assessors. Some cannot cope with complicated problems of assessing larger and high-cost structures.

The Committee recommends:

1. The Director of Taxation be empowered, after public hearing upon adequate notice, to prepare a map of assessment districts covering the State. Each district should be of sufficient area, roll composition, and administrative requirements, to justify the employment of at least one full-time professionally qualified assessor. No district should include property situated in more than one county, nor should any district boundary divide a municipality.

2. Within 2 years after the July 1 following the enactment of appropriate legislation, all valuations and assessment lists for property tax purposes should be prepared by the assessor of the district.

3. Each district should be headed by a single assessor to be appointed by the Director of Taxation from a list of certified assessors. An assessor shall be professionally qualified prior to his appointment. He should pass a certification examination authorized by Chapter 44, Laws of 1967, and be entitled to protected tenure of office.

4. Each office of district assessor should employ full-time, certified assistants to perform the various assessing duties in the district. Positions should be classified and salaries uniformly prescribed.

5. The Director of the State Division of Taxation should be required to promulgate rules and regulations to:

- a. Mandate uniform guidelines for assessing administration, including granting of exemptions;
- b. Mandate use of the State Appraisal Manual;
- c. Establish a uniform base year for purposes of revaluation;

- d. Establish standards for revaluations and revaluation firms;
- e. Establish depreciation and compliance guidelines;
- f. Provide specific definitions of "maintenance" vs. "improvement" of real property and establish necessary guidelines for assessing improvements;
- g. Define various items of personal property to avoid duplicate assessment of such items as real property.

6. The Director of the State Division of Taxation should be required to provide technical assistance to assessors, when requested, for assessing specialized classes of property.

7. New Jersey should enact a statute, similar to one in effect in New York State, making mobile homes taxable as real estate.

8. In establishing sales ratios, the Director should supplement sales data with appraisals of properties where sales are sparse or unrepresentative.

9. Appeals

- a. Status of the county boards of taxation should be changed from an administrative-appeals body to an appeals body solely, with the State sharing all or part of the costs. Qualifications should be established for appointment of members to county boards of taxation.

- b. The State should enact a statute establishing a simplified appeals procedure in which established assessment ratios may be used as conclusive evidence. A proven deviation of 10% or more from the county ratio should be substantial evidence of an incorrect assessment.
- c. County tax board appeal petitions, rules and procedures should be standardized throughout the State.
- d. Proceedings of the county tax boards should be recorded and should be available to any party to such proceedings.
- e. County tax boards should be required to set forth findings of fact and conclusions to support their determinations.
- f. The Division of Tax Appeals in the Department of the Treasury should be replaced by a full-time tax court, an inferior court system within the judicial branch of government, such court to continue the use of informal procedures.
- g. Direct appeal to the tax court should be permitted, at the election of either party, where the value of property subject to the appeal exceeds \$100,000.
- h. Decisions of the tax court (or Division of Tax Appeals, if retained) should be published to assist in the achievement of uniformity and consistency.

Chapter V

Use and Costs of Public Credit

Refer to Part 4 of the Report

Trends in Capital Needs and Debt Burdens

Most taxes paid by the people of New Jersey are used for daily operating expenses of government. But another important channel for use of government revenues is the payment of principal and interest on money borrowed by governments, primarily to finance capital needs. Payment of principal and interest (together known as debt service) accounted for expenditure of 7.22 per cent of New Jersey's State and local government revenues in 1968-69. Thus, the use of borrowed funds and the costs of borrowing can be significant in the fiscal system.

The total outstanding debt of New Jersey's State and local governments rose from \$2.28 billion in 1957 to \$4.45 billion in 1968-69. This increase of 95.9 per cent was less than corresponding increases in personal income and revenues collected by the State and local governments. In comparison with other states, New Jersey's increase in outstanding debt has been even more moderate (62 per cent per capita for New Jersey, against 97 per cent for all states). Thus, New Jersey's growing use of borrowed funds compares favorably with national averages in recent years.

New Jersey's most dramatic increase in the use of borrowed funds has been the direct debt of the State government, which rose from \$0.3 billion in 1965 to \$1.5 billion in 1970 (including both outstanding debt and authorized but unissued debt). This is an increase of 368 per cent. In the same period, authorized debt of State agencies (largely autonomous authorities and Rutgers University) went up 108 per cent to \$1.6 billion and authorized debt of local governments and local authorities went up 66.1 per cent to \$3.75 billion.

The cost of borrowing by government shows up in annual budgets as debt service payments. These payments increased in New Jersey from \$152 million in 1957 to \$327 million in 1968-69, a rise paralleling the increase in outstanding debt. However, the figure for 1968-69 is probably understated by as much as \$30 million due to an unusually large amount of short-term debt. High interest rates in 1969 caused many State and local government agencies to borrow on a short-term

basis. Since short-term borrowing carries lower interest rates and postpones payment of principal, debt service payments are held down temporarily. Once the short-term loans are converted to long-term borrowing, as they must be, annual debt service payments would increase.

While New Jersey's governments have moderately increased their use of borrowed funds in recent years, requirements for additional debt service will have significant budgetary impact in coming years. One major cause of this impact is a large amount of debt which has been authorized in the past but unissued. At the end of fiscal 1970, authorized but unissued debt totaled \$2.2 billion, a 529 per cent increase from 1965. If all of this debt were issued within the next four years under usual terms, the added debt service would total about \$170 million a year by 1976.

The credit needs of State and local governments over the next 10 years will reflect at least three broad policy influences:

1. Growing social consciousness of need to improve public institutions of all kinds—educational, charitable, penal, health and welfare, transportation.
2. Determination to allocate an increased share of the resources of government and consumers to improving the quality of the environment.
3. Accumulated demand for these and other purposes during recent periods of high interest rates.

The capital needs of State government were reviewed in 1968 by a Governor's commission and the top priority needs were totaled at \$1.95 billion. A major part of that commission's recommendations have been covered by authorized State bond issues and are not dealt with in this report.

The social capital needs of New Jersey's 21 counties and 567 municipalities will rise from the current level of \$431 million a year to nearly three quarters of a billion annually by 1981, an increase of about 69 per cent. The increase will be larger in suburban counties, while the major urban counties will have a slower rate of growth in capital spending.

The counties and municipalities will spend a cumula-

tive total of more than \$3.5 billion for environmental capital needs in the next decade. Nearly 60 per cent of this represents the cost of regional sewerage facilities. The remaining 40 per cent will be spent for development of regional systems for solid waste disposal, required by State master plans and programs. Local governments will be responsible for raising about 60 per cent of the cost of these environmental protection needs, with most of the local share coming from operating revenues, special assessments and federal and state aids.

Based on present debt plus the need for permanent financing of debt authorized but unissued, it may be projected that New Jersey taxpayers will be called upon to support \$500 million a year in new debt obligations over the next few years. In addition, public authority debt to be incurred for environmental quality improvements, roads and other revenue-producing projects will make larger demands upon the people. Past experience indicates that a growing population and rising income levels may be able to absorb these new burdens without undue sacrifice. Nevertheless, the nature and volume of present and future use of credit by New Jersey governments underscores the importance of sound borrowing practices, effective controls and competent debt management.

Borrowing vs. Pay-As-You-Go

The question of whether it is better to pay for capital improvements from borrowed funds or from current budget appropriations is a recurring one. New Jersey law encourages some pay-as-you-go efforts by:

1. Requiring a five per cent down payment (with a few exceptions) for all capital improvements to be bonded, and
2. Providing for creation of municipal capital improvement funds in which a municipality may accumulate money to be used for future capital expenditures.

Local governments, both in New Jersey and the rest of the nation, make greater use of borrowed funds than do the state governments. For instance, in 1968-69 the states paid for only 38.3 per cent of their capital outlay costs through use of long-term debt. The national average for local governments was 68.2 per cent. In New Jersey long-term debt financed 40.1 per cent of the state's capital expenditures in the 1965-69 period, compared with a 60.2 per cent debt ratio for local governments.

In recent years, there has been an apparent shift away from pay-as-you-go financing by New Jersey's local governments. In the 1965-66 period local governments financed 51.7 per cent of their capital ex-

penditures from long-term debt. By the 1968-69 period long-term debt paid for 65.5 per cent of capital outlays. Current expense pressures are undoubtedly a factor in this trend.

Policy Considerations

Overall considerations coupled with taxpayer resistance tend to set upper limits upon the amount of private income that can be diverted to State and local treasuries through use of taxes and service charges. Therefore, consideration must be given to the impact which the setting aside of current income for pay-as-you-go capital outlays will have upon the amounts available for current services. Obviously, if heavy resort to pay-as-you-go capital financing is likely to reduce amounts for current services, the relative benefits of each course must be carefully weighed.

Where debt is used to finance capital expenditures, there can be considerable cost in the planning and issuance of the debt. Among such costs are preparation of the debt plan, development of materials for use in marketing the bonds, financial consultant fees, legal fees, advertising and printing costs, bond rating fees, paying or fiscal agency fees, maintenance of records and reporting upon debt, and services of investment bankers in the sale and distribution of the credit instruments.

The greatest cost of borrowing falls under the general heading of "interest," a term which includes the pure cost of the use of money, the element of risk arising from inflationary decreases in the value of money repaid to bond purchasers, the element of risk that the bond debt will not be repaid, and the cost of issuing the debt instruments. In economic terms, most of these costs are deemed to be no more than the future worth of a dollar in hand.

The argument is frequently made—and not entirely without foundation—that borrowed money is likely to be spent under fewer restrictions than is current revenue. This argument is reinforced by observation of the well-established safeguards surrounding the preparation and administration of current operating expense budgets and the only recent beginning of comparable protections in respect to capital outlays, especially when financed from bond proceeds.

Even though many borrowing proposals are defeated at referenda each year, most public officials would prefer to raise capital funds through borrowing than confronting voters with stiff increases in current taxes or charges to finance additional facilities on a pay-as-you-go basis. The "fly now, pay later" syndrome is not restricted to airlines.

A frequently cited argument for borrowing is that it

distributes the cost of a facility over its useful life, treating present and future users more equitably. Pay-as-you-go financing tends to concentrate the burden upon a current generation of taxpayers. However, this argument bypasses the question of cost-effectiveness. It also suggests the use of service charges as an alternative.

Economic Considerations

Interest costs, construction cost indexes and inflationary decreases in the value of the dollar are important factors in an economic evaluation of borrowing vs. pay-as-you-go policies.

Much of the savings in interest costs gained by pay-as-you-go policies can be lost if construction costs rise during a period of delay while a government accumulates a down payment from current revenues. When both interest rates and construction costs rise rapidly, as in the latter 1960s, delay can be even more harmful to pay-as-you-go accumulation of capital funds. In addition, inflation reduces the future value of the money repaid to bond investors, substantially reducing the economic cost to the borrower.

Impact of Federal Taxes

Because both taxes and service charges are used to finance capital projects—whether through borrowing or pay-as-you-go—the federal income tax can have a varying impact for different taxpayers. For instance, when a project is financed by service charges, individuals gain no federal tax advantage because the charges are not deductible in calculating their tax liability. On the other hand, where the service charge is paid by a business, it becomes part of expense and reduces federal taxes. Projects financed by State or local taxes produce some federal tax reduction for individuals and businesses.

The question of whether to finance revenue-supported capital projects by borrowing or pay-as-you-go produces a complex set of advantages and disadvantages for various taxpayers. Debt financing reduces the immediate financial demands on a resident and permits him to make personal use of the money. Ultimately, of course, the requirement for payment of interest will cancel this advantage. For the individual, the trade-off may hinge on whether he moves from the jurisdiction early in the life of the facility, taking with him the cash saved through borrowing or leaving behind his share of the equity in a revenue-financed community facility.

When projects are financed with taxes instead of revenues, the impact of federal taxes produces a clear financial advantage for individuals residing in municipalities which use pay-as-you-go capital financing. The taxpayer in the municipality using debt financing has

more immediate cash on hand, because of lower taxes, but his future liability for debt service. Smaller federal tax reductions leave him at a net disadvantage. Again, he can move and leave the future liability behind.

Summary of Advantages and Disadvantages

Pay-as-you-go financing can have substantial advantages over debt financing, but these advantages are closely related to economic conditions at the time capital outlays are required. In a period of rising prices, high tax rates and a heavy backlog of capital needs, greater weight must be given to the advantages of borrowing. Financing with borrowed funds tends to minimize the effects of inflation, reduce the impact of the capital outlay on current tax levies, and spread the cost over the useful life of the outlay so as to require those who enjoy its use to share in the financial burden.

The Committee recommends:

1. The present requirement for a 5 per cent down payment for debt financing by local governments be retained; but
2. Local governments should be encouraged to increase the down payment to 10 per cent whenever feasible, without making this a mandatory requirement.

Debt Limits

Limitations on the amount or authorization of state and local debt are widely used among the states. A referendum is a common requirement for authorization of state debt. New Jersey is one of such states. Its State debt is not subject to limit, so long as the debt is authorized at a referendum. It may incur debt for any public purpose and on any terms acceptable to the financial market. However, 34 states impose constitutional restrictions on local government debt and 14 (including New Jersey) establish such limitations by law.

The debt limits in New Jersey, with some of the complex variations omitted, are:

Municipal	3.5 per cent
School	varying percentages depending upon grades covered, e.g. K-12—4%; regional high school—3.0%
County	2.0 per cent

The percentage limits are based on debt-to-property-valuation ratios, and are expressed in terms of "net debt," omitting such things as self-liquidating debt, bond anticipation notes, sinking fund assets, regional school district debt and autonomous authority debt,

among others. School debt may exceed the prescribed limit if there is unused municipal debt capacity.

The debt limits are not inflexible. The laws provide a variety of procedures for borrowing beyond the limits. Depending on the type of school district involved, debt limits may be exceeded with the approval of the voters, the local governing body, the Commissioner of Education, and the Local Finance Board in the Department of Community Affairs. Usually, at least two of these approvals are required. Counties and municipalities may exceed their debt limits under eight different types of situations. The most important of these exceptions is an "extension of credit" authorized by the Local Finance Board where that Board is satisfied that statutory standards are being met and the debt will not harm the local unit's financial capacity. This procedure, in effect, imposes an administrative debt limit with each determination by the board. The extension of credit is intended and operated as a constructive influence on municipal finance. However, it presents a needless source of market confusion or uncertainty in the process and resulting label on the bond issue. These shortcomings can be corrected.

The great majority of counties, municipalities and school districts have operated well within the debt limits. At the end of 1970, this was the debt position of the 21 counties and 567 municipalities:

Net debt percentage of debt limit	Number of governments
0	92
0-49.9	355
50.0-99.9	79
100-199.9	44
200-299.9	10
300-349.9	6
Not reported	2

The debt position of 551 school districts (Union County figures not included) on June 30, 1970, is summarized in the following chart:

	Type I and II Districts	Regional and other districts	Total
Total number	495	56	551
Number under limit	385	41	425
Number over limit	110	16	126
Number with excess debt fully absorbed by municipal borrowing power	67	Not applicable	
Number where excess debt and municipal debt exceeds municipal debt limit	60	Not applicable	

Thus, only 60 of the 567 municipalities have exceeded their debt limits and in 35 of these the excess is entirely to school debt. Although 110 Type I and

Type II school districts have exceeded their debt limits, in 67 of them unused municipal borrowing capacity absorbed the entire excess, as permitted by State law.

In spite of the relatively small number of municipalities and school districts exceeding debt limitations, some authorities believe the debt limits have harmful, unintentional side effects. Among them are:

1. They depress local and State-local spending and may result in lower public service levels. They also have a quantitatively greater effect on metropolitan area local governments, the areas with perhaps the greatest needs for public services.

2. When pressure on municipal credit rises, the limits are bypassed by issuance of revenue bonds and creation of public authorities and special districts, whose debt is not counted against present statutory limits. Such debt usually encounters higher interest rates.

These criticisms have often prompted suggestions for easing or abolishing statutory debt limits, substituting purely administrative limits. While these proposals can find support in experience and economic analysis, the Committee believes such a step is likely to be misunderstood and its benefits would be outweighed by the concern it might cause taxpayers and bond investors. For the great majority of school districts and local governments, the limits have been high enough to have no harmful effects.

Debt to Property Ratio

Debt limits have also been criticized for their reliance on taxable valuations as the measure of local debt-paying capability. The Advisory Commission on Intergovernmental Relations has recommended shifting away from property valuations as the basis of local debt limits. The 1968 Pennsylvania Constitution established tax receipts over a period of years as the base for local debt limits. On the other hand, the most recent Model Bond Law of the National Municipal League continues with the use of assessed valuations. The proposals for a new debt limit basis are grounded in the decreasing reliance on the property tax in generating local revenues. Similarly, the massive reduction in the property tax burden recommended by this committee requires revision in the measure of debt limitation.

A fundamental question involved is: What are debt limits supposed to limit? The standard answer is that they are intended to establish the degree to which a government agency may pledge anticipated future revenues through their capitalization in the present. But the debt limits are applied to bond issue principal amounts, not the amount of future debt service required. Depending on the terms of bond issues and the interest rates at the time of issuance, debt service payments can

vary widely for issues of various principal amounts. Therefore, if debt limits are intended to place a ceiling upon the commitment of future revenues to present capital outlays, the debt limit should be based on aggregate amounts of future debt service that can be due at any given time.

The Committee recommends:

1. That all county, municipal, school and local or regional public authority bond issues be reviewed and approved by the Division of Local Finance, without carrying damaging connotations of extension of debt limits.
2. That the debt guideline be based on a ratio of the projected debt service of the issuer to the equalized valuation of its taxable property, and that any issue which falls within the guideline shall be deemed approved by the Division of Local Finance.
3. That the guidelines be fixed at approximately twice the present net debt percentages, to allow for the inclusion of projected interest payments in the measure of debt burden.

Limitations on Temporary Borrowing

New Jersey's counties and municipalities are permitted limited use of short-term borrowing for three purposes: 1) notes anticipating revenue from taxes or utilities; 2) emergency notes, and 3) notes issued in anticipation of issuance of long-term bonds. Neither revenue notes nor emergency borrowing have presented any substantial policy issues. Bond anticipation notes, however, have become a source of concern.

Short-term debt of New Jersey's State and local governments increased from \$128.1 million in 1962 to \$592.1 million in 1968-69. This increase of 360 per cent compared with a 161 per cent increase for the rest of the nation. Clearly, New Jersey's governments have been using temporary debt at a significantly higher rate than governments in other states in recent years.

The function of bond anticipation notes is to give local governments the option of issuing debt in advance of capital requirement or of accruing the obligations in anticipation of issuing long-term debt. Under existing practice, however, some of the safeguards built around the local debt process are being weakened. For instance, state law limits the maximum term of indebtedness to the period of probable usefulness of the capital facility. Under existing practice a public structure can be designed, constructed and available for use within two years, while present legislation permits use of short-term financing for up to five years. This practice could prove to be unsound, because it permits a period of debt fi-

ancing over a period of time beyond that stipulated by law.

Heavy resort to short-term financing permits present officeholders to authorize and complete projects without avoiding public political accounting for the debt service they have incurred. Short-term financing can be costly, too, if it involves a wrong guess about the trend of the bond market.

The Committee recommends:

1. Major capital financing should be transferred promptly to the permanent capital markets, and should not be permitted to preempt a significant portion of short-term funds available.
2. A local government issuer should be required to appropriate a full year's interest on each bond anticipation note upon or before its issuance.
3. A local government should be required to appropriate and pay off each year a fractional portion of each bond anticipation note equal to 1 divided by the number of years of probable usefulness of the capital facility involved.
4. A local government issuer, including authorities, should have no power to borrow any portion of required amortization or interest, except interest during construction required by a public authority.
5. The period of probable usefulness under the statute should begin to run no later than one year after the capital improvement being financed becomes operational and is first used.

Revenue Bonds vs. General Obligations

Direct debt of New Jersey local governments must be issued as general obligations, i.e., full faith and credit debt with an unlimited pledge of ad valorem taxation supporting the debt. Only local authorities may issue debt backed solely by project revenues. This raises two broad issues:

1. Should municipalities be allowed to issue pure revenue bonds?
2. Are public authorities over-used because of their revenue bond capability or otherwise?

The evidence suggests strongly that New Jersey local governments are increasingly relying on self-supporting debt in recent years. Between 1965 and 1969, self-liquidating debt in New Jersey increased from \$430.7 million to \$658.1, a rise of 52.8 per cent. At the same time, tax-supported debt increased from \$1.56 billion to \$2.1 billion, or 34.7 per cent.

Evaluation of the Options

In most situations the general obligation pledge is the

best security that can be offered by a local government borrower, and therefore the one that commands the best interest rates in the bond market. However, there are exceptions. In the Great Depression, some revenue bonds, especially water revenue debt, fared better than general obligation bonds. The threat of turning off water service resulted in current payment of water bills while real property taxes remained delinquent. As local governments expand their tax and revenue base, bondholders tend to rely less on the property tax pledge. And the bond rating agencies sometimes give well-supported revenue bonds ratings which are equal to or better than those accorded to general obligation bonds. In the case of non-revenue-producing activities like education, protection of life and property, public health and welfare, the general obligation pledge is obviously the best way to secure long-term debt. But in the case of governmental enterprise operations, the importance of the general obligation pledge may be significantly reduced.

Marketing considerations can be important. Small amounts of revenue-supported debt may fail to attract competition at a bond sale and might better be combined with general obligation debt. But where large amounts of revenue financed debt are involved, it might be better to offer both kinds of bonds in order to attract investors interested in each kind of debt. Large, older cities may find more interest in their revenue bonds, because of the hesitance of investors to purchase bonds backed by overburdened local tax base. But revenue debt can result in higher costs for interest, legal fees, financial consultant fees, etc. and should be used only where there is a net advantage.

An alternative is possible: issuance of bonds secured by a dual pledge of revenues and full faith and credit of the issuer. In some cases such bonds have won better investment reception than general obligations. Such bonds, however, are counted against statutory debt limits and can have adverse effects on future general obligations of a local government.

Public Authorities

There has been a growing use of public authorities of all kinds. It is not apparent that the cause of this trend has been avoidance of debt limits or the general obligation requirement for direct county and municipal debt. There are some disadvantages to the use of authorities. In New Jersey, until the enactment of Chapter 288, Laws of 1969, there was no state supervision of authorities. The 1969 law gave the Division of Local Finance supervision over accounting, auditing, and financial administration practices of county and municipal authorities. The authorities are semi-independent, have full revenue borrowing powers limited only by what the

market will take, and are not restricted in the ways they can market bonds. The borrowing costs of the authorities have not been reported, but it may be assumed from experience elsewhere that their interest costs are substantially greater than general obligations of the municipalities in which they operate.

The Committee recommends:

1. Continuation of the requirement that counties and municipalities pledge their full faith and credit to bonds issued for revenue-producing projects, but that the law be amended to permit the local government to pledge project revenues as further security for the bonds.

2. That the use of authorities for specific inter-municipal purposes be continued, but their financing should be subject to approval by the Division of Local Finance.

3. Authority obligations be offered at public sale under regulations similar to those applicable to bonds of municipalities.

4. The use of intra-municipal authorities be prohibited without approval of the Division of Local Finance, upon a showing that the financing of the proposed authority can and will:

- a. be by revenue bonds only, without municipal guarantee;
- b. use bonds offered at public sale upon competitive bids;
- c. will not impair the credit of the creating municipality.

The Market for Municipals

The municipal bond market—a term which includes the market for state, county, municipal, school and public authority obligations—is a market for financial specialists. It operates under practices established by custom and usage and distributes securities within a relatively narrow group of purchasers. Commercial banks hold almost half of the municipal bonds issued. Individuals hold more than a third, but a large part of their purchases are also made through commercial banks. Insurance companies make up the third largest group of holders.

Private rating services are important factors in the market. The principal services are Moody's and Standard & Poor's. Moody's highest rating is Aaa and Standard & Poor's AAA. Moody's has eight ratings: A is considered higher medium grade, Baa lower medium grade, Ba bonds with some speculative characteristics, C the lowest grade. In the Standard & Poor's system there are seven grades: A for upper medium grade, BBB

medium grade, BB lower medium grade, B low grade, and D for defaulted bonds. The higher the grade rating, the lower the interest rate.

New Jersey Bond Ratings

New Jersey has a sophisticated set of statutory and administrative controls on public borrowing, primarily regulating counties, municipalities and school districts. Counties and municipalities are subject to the Local Bond Law, which sets debt limits, fixes the maximum maturity of a bond issue to the period of probable usefulness of the facility financed, regulates the form of obligations and their sale, and sets up various other protections for the marketability of New Jersey bonds. Administration is placed in the hands of the Division of Local Finance and the Local Finance Board in the Department of Community Affairs. The Local Budget Law and Local Fiscal Affairs Law also regulate financial procedures of county and municipal governments.

School bonds are authorized and regulated under an entirely different statutory system, the Education Law, which is much less detailed than the Local Bond Law in its terms.

The security behind county, municipal and school district bonds is primarily the taxing power of the issuing body. However, school bonds have four additional elements of security:

1. A municipality must pay over to type II school districts (generally those with separately elected school boards) the amount of taxes required for school purposes, even if the municipality has not actually collected the taxes and has to borrow the money.

2. The State Treasurer is required to establish a school aid capital reserve fund for each district and use this fund to pay debt service on a district's bonds whenever it is unable to meet payments on bonds.

3. The Fund for Support of Free Public Schools, created by the State Constitution, is dedicated to preventing defaults on school bonds. The fund, consisting of receipts from sale of state riparian lands, has assets of about \$30 million.

4. A little-known provision of the School Law which makes obligations of a Type II district a lien upon all real estate in the district, including the personal estates of all of its inhabitants.

It is notable that there have been no defaults on the securities of any New Jersey county, municipality, school district or authority since the Great Depression of the 1930s. Even then, only 2 per cent of New Jersey issues were involved in defaults. Since that time, the local bond and fiscal affairs laws have been improved and new administrative practices instituted.

Despite this seemingly impressive array of protective devices, New Jersey municipal securities are not accorded especially high ratings. General obligations of the state government are given the highest rating, Aaa. But no school or municipal bond in New Jersey is rated higher than Aa. Forty-one New Jersey bonds are rated Baa, a rating which denotes some speculative characteristics. None are so rated in New York, Connecticut, Massachusetts, New Hampshire, Maryland, Ohio, Delaware, Illinois or Michigan, among other states. There are no ratings below A in Connecticut or Delaware and only 5 per cent of Massachusetts bonds get such ratings. Over the past six years, 64 per cent of the half billion dollars in New Jersey school bonds sold were rated under an A. In the 1969-70 fiscal year, when New Jersey's school bonds represented 5.3 per cent of the nation's sales, they accounted for 38 per cent of all Baa ratings.

These ratings were made in spite of the special remedies for assuring payment of school debt. In a February 18, 1971, Wall Street Journal article about Chapter 177 Additional State School Aid bonds, a Standard & Poor's analyst was quoted as saying, "We still haven't decided how much weight to assign the State's backing."

Nevertheless, bank examiners are required to use national ratings in judging bank investments, and New Jersey cannot avoid use of the ratings. In addition, recent trends toward consolidation of New Jersey commercial banks—the major purchasers of New Jersey local bonds—can be expected to increase the need for bonds with national ratings that make them marketable in the national market.

Savings Through Improved Ratings

In 1971 an amendment to Chapter 177 Additional State School Aid Bonds won the City of Newark an Aa rating for an \$18.7 million bond issue which had originally been accorded a Baa-1/BBB rating. The estimated improvement in the interest rate was from an original 6¾ per cent to an actual 5¼ per cent, a saving of \$3.6 million on the entire issue. The State Treasurer estimated savings on future Chapter 177 bond sales would total \$35 million.

The Division of Local Finance reported that an effort to convince the investment community of the merits of New Jersey bonds was able to raise the ratings of 30 local governments and to retain better ratings for 7 others. The resulting savings have been estimated at \$4 million. Other studies have corroborated this effect of improved bond ratings.

The Committee concludes that tax savings to local governments from improved bond ratings would justify

major new state facilities and programs to improve bond ratings.

The role of the State in supervising municipal finance is well-established in New Jersey. A debt management advisory service can readily be developed as part of a municipal credit agency, in cooperation with the existing authority and facilities of the Department of Community Affairs. An adequate appropriation and skilled personnel will be required. The cost might well be recovered out of the fees and earnings of the agency. Once established, it could provide important help to local governments in preparing bond issues to lower interest costs.

A Central Municipal Credit Agency

Three basic methods of reducing interest costs on local borrowing appear to be available:

1. Issuance and sale of all municipal bonds through a state agency, such as the one used by North Carolina.
2. A loan guarantee fund, which, in effect, sets up an insurance fund to guarantee repayment of principal and interest.
3. A state municipal bond bank, such as Vermont's, which supports local bonds with a moral, but not legally binding, commitment to repay holders of defaulted local bonds.

The chief advantage of the North Carolina system is that it puts a qualified state agency in a position to serve as financial advisor to the municipalities seeking to borrow funds. The Committee believes expansion of New Jersey's present debt management advisory services would be in better accord with the traditions and capabilities of local governments in this state.

A precedent for a loan guarantee fund is contained in a bill sponsored by Senator Proxmire and Representative Patman. It set up an insurance fund modeled on the Federal Deposit Insurance Corporation. Another precedent is the recently formed American Municipal Bond Insurance Corporation (AMBIC), a private enterprise, which insures principal and interest payments on local bond issues. The insurance costs 1.5 per cent of the combined principal and interest payments on the bond issue. In December, Washington Township (Bergen County) purchased the insurance for a \$3,450,000 bond issue. The bonds were given an AA rating instead of the BAA they would have earned without the insurance. The interest saving over the life of the bond issue was estimated at \$138,285, compared with a premium cost of \$40,231.

The actual risk of loss to investors in New Jersey local government bonds is almost non-existent. The controls on local finance which exist in state law, restraints placed on any municipality threatened with going into

default, and especially safeguards for school bonds, all enhance the quality of New Jersey local bonds.

The Committee concludes that New Jersey already has many of the elements of a municipal bond guarantee system. But its local governments do not seem to be receiving the lowered interest costs that such a system would warrant. A fresh organization of the bond guarantee resources is needed to emphasize to the investment community the high quality of the security provided.

Use of State Agencies

Issuance of bonds by state agencies to finance local public improvements dates back at least to 1947, when the Pennsylvania State Public School Building Authority was formed to build schools and rent them to local districts. The state bonds were repaid from the revenues received from the rents. Somewhat similar agencies were created later in Georgia, Maine and Virginia. Several Canadian provinces have set up central financing authorities for local improvements of various kinds.

The Vermont Municipal Bond Bank was created in 1969 and is the only existing state agency with broad powers to purchase bonds of local governments. The only formal guarantees behind the bonds of that bank are the receipts from the local governments in payment for debt service on their bonds owned by the bank. The only issue sold by the bank so far was well-received by the market.

Policy Questions in Creation of a Bond Bank

A bond bank like the one in Vermont has a number of advantages. It improves access of smaller municipalities to credit markets on more favorable terms and overcomes limitations on their ability to plan and market debt. Many of the unit costs involved in selling bonds are reduced as the size of the issue gets larger. There is a better secondary market for state agency bonds and diversifying the economic base behind the bonds would also have beneficial effects on interest rates. The major possible disadvantage is that the state's Aaa credit rating might be impaired.

The "make-up provision" of a bond bank law determines the ability of its debt to win an Aa rating. There are various examples of such provisions, which stop short of pledging the state's credit behind the bonds. The Vermont law is one. New Jersey's Housing Finance Agency Law is another. The Housing Finance Agency law states that "there shall be annually appropriated" any sums required to maintain a specified minimum capital reserve. It is recognized that no one can compel the legislature to appropriate the sums indicated, but it is also recognized that no legislature would feel free to disregard the obligation, since it would harm the

credit of the state. It is apparent that the financial community views the clause as a moral obligation of the state, since the HFA bonds are rated Aa, just below the rating according to New Jersey's state bonds.

The Committee concludes that there are advantages and disadvantages to all the approaches toward improving the marketability of New Jersey local government debt. At various times, any one of the approaches might be better than the others. Thus, the most effective course would be a combination of the three approaches—a centralized debt management advisory service, a guarantee fund, and a bond bank.

A New Jersey Municipal Credit Agency

The benefits of all three approaches could be obtained through legislation creating a public corporation with a distinguished board of directors and business-like management. The corporation would be headed by a qualified executive and organized into three divisions: a bond bank, a guarantee fund and a debt management service.

The bond bank division would be structured along the lines detailed in Senate Bill No. 858 (1970). It would be authorized to hold county, municipal and school district bonds. No more than 10 per cent of its portfolio could consist of the obligations of any one issuer, and not more than 25% of any one issue of the bond bank may be for one local issue. The law should contain a make-up provision of the type used in the New Jersey Housing Finance Agency law.

The guarantee fund would be established by the state, with initial capital coming from transfer of the balance in the Fund for Support of Free Public Schools and the school building aid capital reserve funds earmarked to continue support of school borrowing. In addition a state appropriation of a capital reserve for guarantee of municipal bonds would provide coverage for 12.5 times its amount in bonds, if there were no make-up provision, and substantially more if there were such a provision. The reserve fund would grow with earnings, assuming no defaults.

An optional guarantee could also be provided. The Fund would, upon request and with suitable supervision of the local borrowing, guarantee prompt repayment of principal and interest on any bond issue. The issuer would pay a premium for such insurance. Given the record of New Jersey local bonds since the 1930s, the AMBIC premium charge of 1½ per cent of debt service would be adequate. If the bond bank wished to dispose of any of its holdings in the secondary market, it could

make them more marketable by adding the guarantee of the fund.

Municipalities with high credit ratings might not use either the guarantee fund or the bond bank, but these facilities, as well as the debt management service, would be open to all local governments.

The agency would realize two types of earnings: a return on investment of its assets, and premium income. The investment earnings might be set aside in reserve to limit recourse to the make-up provision. The premium income could be held in another reserve to strengthen the guarantee fund. When premium earnings plus capital reserve reach a total double the amount required to cover the maximum debt service in any future year on bonds guaranteed, the surplus could be distributed as a dividend to the customers of the fund, in proportion to the premiums they have paid in.

The fund would guarantee to the holder of any bonds issued and guaranteed under the act that principal and interest will be paid promptly when due. If a paying agent does not have funds on hand five days before the due date, he would be authorized to notify the fund, which should then immediately deposit the required amount with the agent.

The fund would be limited to guarantee of some stated multiple of its capital reserve. This would enable the legislature, through its control over appropriations to the reserve, to control the total amount of the state's moral obligation.

The proposed agency would have a number of advantages. The bond bank would serve those municipalities with inadequate access to the bond market. The guarantee fund would provide improved credit ratings, particularly for larger municipalities with Baa ratings which have used the maximum permitted by the bond bank. The risk of adverse effect on the state's credit rating arising from use of the bond bank alone will be lessened, if not avoided entirely. Coupled with strengthening of state administrative supervision of local borrowing practices, the program should result in major savings in interest costs for local governments. The price of these advantages is obviously greater interdependence of local units in financing and greater state participation in the local borrowing process.

The Committee recommends:

Creation of a New Jersey Municipal Credit Corporation to operate a municipal bond bank, a municipal bond guarantee fund, and a local debt management advisory service.

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Chapter VI

Non-Property Taxes In a Fair and Equitable Tax System

Refer to Part V of the Report

A: A BALANCED TAX STRUCTURE

In previous chapters, the Committee's Report has presented these needs and goals of tax reform:

1. To close the revenue gap with income-elastic sources that produce revenue growth at about the same rate as expenditures grow.
2. To eliminate the unjust regressivity of the present tax structure.
3. A massive shift in the tax burden from the property tax to other revenue sources, through full state funding of a standard public school education program, a block grant program for municipalities, and transfer of other government costs to non-property tax sources.
4. Elimination of inequities in the property tax which exist in the senior citizens' deduction, veterans' deduction, farmland assessments and tax-exempt property.
5. To provide about \$850 million in non-property revenues from sources which enhance elasticity and progressivity of the tax structure, maintain favorable competitive conditions for economic development, and achieve a balanced structure with the flexibility to meet present and future needs.

In seeking a balanced tax structure, it is important to consider comparative burdens among states. The policies of the states interact: they are competitive and compared; they offer alternative sites for economic development and places to live and work; they are near each other and influence their own progress as well as their neighbors' by their tax policies.

We have seen before that New Jersey's tax structure varies greatly from the norm in most other states. It makes almost no use of personal income taxes. It makes subordinate use of the property tax. These two facts account for much of the regressive, inelastic nature of the present tax structure. The system is unbalanced.

A study by the University of Kentucky in 1969 illustrated what New Jersey's tax structure means to a family of four at various income levels. In a comparison of tax burden in relation to income for all states, the study found that for families with income under \$5,000 New Jersey's tax impact was the highest of all. Only

at the \$25,000 income level did New Jersey's tax impact come down to the average for all states. At the \$50,000 level, New Jersey's tax impact dropped slightly below average. Property taxes on housing account for the greater part of this regressivity.

Studies of comparative business taxes among the states indicate that the tax burden can be relatively light in some places in New Jersey, and heavy in others, depending on the level of local property taxation. For industries with high profit rates, New Jersey's relatively low corporate income tax can offset the property tax.

The Advisory Commission on Intergovernmental Relations has developed a tax effort index to show how much of its taxing capacity a state is using, in comparison with the average state. The index indicates New Jersey's business taxes are at 85 per cent of average effort, non-farm residential property taxes are at 176 per cent of average effort, other personal taxes are 68 per cent of average effort. Total personal taxes in New Jersey were rated at 102 per cent of average effort.

Income Elasticity: New Jersey's non-property tax sources have a combined income elasticity of .98, an indication that revenues from these sources grow at about the same rate as personal income of the state's residents. At the same time, state expenditures have had an elasticity of 1.50. They have grown at a rate of 50 per cent faster than the growth in revenues. If the revenue system is to be flexible enough to meet the needs of state and local government without resort to constant increases in tax rates, the elasticity of the revenue system must be increased to approximately 1.50.

Progressivity: A tax is considered progressive when the rate increases as income increases. As we have seen, New Jersey's tax structure works just the opposite: as income goes up, the rate goes down. Implicit in the use of an income measure of ability to pay is the assumption that the larger the income, the smaller the sacrifice each added dollar of taxes represents.

In analyzing New Jersey's tax structure, progressivity indices were calculated for various taxes. An index of 1.0 represents a tax which has an equal rate for all in-

come groups, an index below 1.0 indicates a regressive tax and an index above 1.0 a progressive tax.

The property tax has an index of .55, sharply regressive. The most progressive index rating goes to the inheritance tax—2.16. Other taxes with regressive indices are taxes on public utilities, motor fuels, motor vehicle fees, insurance taxes and tobacco taxes. Those with progressive indices are taxes on corporation business, retail sales, alcoholic beverages, and spectator admissions. The total system has an index of .68, indicating its regressivity. Removing the property tax raises the index to .86.

In order to improve the progressivity of the tax structure it would be necessary to shift from property taxation to progressive non-property sources or to make rate structures of present non-property taxes more progressive.

Equity: There are no universally accepted standards for measuring the equity of a tax system. Given the approach to income elasticity and progressivity adopted by the Committee, equity would demand a balanced use of three major measures of tax contribution—accumulated wealth (property), spending, and current income. In addition, stability of yield is an absolute requirement for state and local governments, since they cannot engage in deficit financing as the federal government can. An approach to achieving greater balance, elasticity, stability, and progressivity in New Jersey's tax structure would include an equal use of property, sales and income taxes, so that one-third of the \$3.8 billion of taxes collected in 1971 would be from property taxation and the remainder from income and sales taxes.

The Committee recommends:

As a present goal, at least until the effects of the proposed restructuring of the tax system, together with possible federal takeover of welfare or revenue-sharing, are achieved and stabilized, that the State shift to a state-local revenue system using one-third property taxes, one-third income taxes and one-third sales taxes.

Replacement revenues for the property tax should be sought from income-elastic sources with progressive rate structures, to overcome the deficiencies of the present tax structure; and

Specific tax sources should be selected, following these principles, and with due regard to comparative tax burdens, from both business and personal levies.

B: BUSINESS TAXES

Corporation Business Tax

New Jersey's corporation business tax has two parts—a franchise tax levied at the rate of two mills per

dollar of net worth and an income tax levied at 11 per cent of corporate net income. In 1970 the net worth tax produced \$52 million and the net income tax \$112 million. The net worth tax is a longstanding revenue measure for the state. The net income tax is a relative newcomer, adopted in 1958.

Rates: Many states in recent years have increasingly relied on income taxes on corporations, undoubtedly responding to criticisms that the older franchise taxes were unfair to businesses which were losing money. In addition, franchise taxes were first imposed in the days when the corporate method of doing business was a privilege granted by acts passed by the State Legislature, a theory which no longer holds true, since corporations are chartered under general laws without the trappings of privilege. This has led to suggestions that New Jersey drop its net worth tax and convert its Corporate Business Tax into one based wholly on net income.

However, reliance on the corporate net income tax would confront the state with some fiscal dangers. In years of economic decline, corporate net income can suffer sharp drops, reducing state revenue and possibly even forcing emergency actions to comply with constitutional mandates for a balanced budget. The net worth tax has elements of stability which are desirable to counteract some of the ups and downs of the economy.

The net worth tax has other merits. It is based on one measure of ability to pay—the amount of property owned, the net worth of assets used in a business. In view of recommendations elsewhere in this report to reduce real estate taxes (including those on business) and to exempt purchases of machinery used in manufacturing from the sales tax, the net worth tax is justifiable as a reasonable way to take some account of business property in a balanced tax structure. Moreover, if the net worth tax were to be replaced by a net income tax, some industries would receive windfall shifts in tax burden while others would suffer sharp increases. Since business has learned to live with the present corporate tax structure, such sudden lurches in the tax burden should be endured only when sound reason makes them necessary. No such reasons have been found by the Committee. However, the net income tax is a more sensitive measure of corporate ability to pay and any additional revenue sought from taxes on corporate businesses should come from the net income tax.

New Jersey's business tax climate compares favorably with other states. Most states are rapidly increasing corporation taxes, under pressure of revenue needs. The New York State corporate net income tax rate has gone to 9 per cent for 1972, Ohio's to 8 per cent, Connecti-

cut's to 8 per cent and Pennsylvania's is to be pegged at 11 per cent beginning July 1, 1972. In the light of these factors, New Jersey's corporate net income tax can be increased to 7.25 per cent. Because the net worth tax equates to a 1.8 per cent income tax in terms of revenue raised, New Jersey's rate would approximate a 9 per cent net income tax. In view of the state's need for revenue and business tax reductions anticipated from other recommendations of this Committee, such an increase is necessary and justified.

The Committee recommends:

That the corporation business tax continue to be a two-pronged levy. The net worth tax rate should remain at the present 2 mills per dollar. The net income tax rate should be raised to 7.25 per cent, increasing State revenue by \$90 million a year.

A Second-tier Direct Net Income Tax: Many out-of-state corporations engaged in interstate commerce are beyond the reach of New Jersey's franchise tax. This limitation on the tax results from decisions of the U.S. Supreme Court, which have restricted the power of the states to levy franchise taxes for the privilege of doing an exclusively interstate business within a state. However, a number of states have developed as an addition to their corporate franchise taxes an income tax levied not on the privilege of doing business within their states but on income derived from sources within the state. Called "second-tier" income taxes, they often are identical in major respects to the states' corporate franchise taxes, using the same rates and the same division of income methods used in determining franchise taxes. They also have an added advantage over corporate income taxes—they can include in the measure of tax liability interest and other income from securities issued by the U.S. government and its instrumentalities. Such interest and income cannot be taxed under state corporate income taxes.

The "second-tier" income taxes have been ruled constitutional by the U.S. Supreme Court. Congress (in P.L. 86-272) has sought to narrow the reach of second-tier state income taxes, but it is clear that a considerable area of activities of exclusively interstate businesses now untaxed under franchise levies are within the reach of a second-tier net income tax. Thus, an out-of-state corporation maintaining only a sales office in New Jersey would presumably be taxable under a direct net income tax, whereas it would not ordinarily be taxable under a franchise tax for the privilege of doing business within the state. On equitable grounds, interstate businesses deriving income from New Jersey should make some contribution to the costs of maintaining government operations and services within the state.

The Committee recommends:

The adoption of a second-tier net income tax as part of the corporation business tax, to be applied to corporations deriving income from within New Jersey and which are not subject to the franchise tax. Lack of useful data makes a specific revenue anticipation from this tax inadvisable, but experience in other states suggests possible revenue of \$2 to \$4 million.

Notice of Business Activities: New Jersey law requires out-of-state corporations to obtain certificates of authority from the Secretary of State before doing business in the state. Corporations which fail to qualify are subject to small fines and denial of the use of the state courts. Similar laws are in force in all other states. Some impose fines and personal liability on corporate officers and agents, but these provisions are rarely enforced. The denial of use of the courts has also been ineffective, since a corporation can qualify by obtaining a certificate of authority when and if it desires resort to the courts.

Such a loophole in the law could seriously affect enforcement of the recommended second-tier net income tax. To safeguard state revenues and reduce unfair tax-free competition, a more effective means for discovering out-of-state corporations which may be taxable must be devised. Such a means would be a statute requiring every out-of-state corporation carrying on specified activities or maintaining specified types of property within the state to file a Notice of Business Activities with the Director of Taxation, unless exempt. Exemptions would be granted to those corporations which have obtained Certificates of Authority or filed returns under the corporation business tax or second-tier net income tax. The sanction for failure to file a timely notice of business activity should be denial of access to the state and federal courts in New Jersey, upon a finding that the corporation was required to file a return under one of the corporate taxes. There should be no automatic, statutory escape clause from the sanction, and regular, systematic enforcement by the Tax Division will be required.

The Committee recommends:

That a Notice of Business Activities be required of all out-of-state corporations which do not file returns under the corporation business tax or the proposed second-tier corporate net income tax and are subject to such taxes. Coupled with appropriate sanctions and enforcement, the notice requirement will close an inequity in present corporation tax laws.

Modifications in Measuring Net Worth

The Committee has considered several proposed modifications in the method of calculating net worth for payment of the franchise tax. It has concluded that many

of the proposals, such as eliminating long-term debt as a deduction, while having some merit, would cause inadvisable shifts in tax burdens among industries or would require administrative procedures which are not feasible. A few proposed changes, such as including leased real estate and tangible personal property in the determination of the property factor of the apportionment formula, should be adopted. There is also a need to determine the allocation of net worth in specialized industries, such as trucking, airlines, radio, television and investment companies. Such a review should be conducted by the Tax Study Committee which is recommended in this report.

Unincorporated Business Taxes

In 1966, New Jersey enacted an excise tax of .25 per cent on the gross receipts of individuals and other unincorporated entities engaged in business. The law exempts businesses with yearly gross receipts of less than \$5,000, as well as corporations subject to the corporation business tax and the financial business tax. The revenue is distributed to municipalities as a portion of the replacement for business personalty revenues removed from the local tax base. This tax produced \$14,861,494 in 1968, the first year of operation, and in 1971 produced \$17,098,182.

The tax has several fundamental defects. It is imposed regardless of whether a business is making a profit or losing money. It has no relationship to the value of the property used in the business. It unfairly imposes heavier burdens on businesses whose ratio of net profit to gross receipts is low.

The tax was enacted as a temporary expedient, to replace local revenues lost from reductions in the business personal property tax. The far-reaching tax reforms recommended in this report will improve the local revenue picture in a fundamental way, making it unnecessary to retain an unfair, temporary expedient. The Committee sees no justification for continuing to use gross receipts as a measure of unincorporated business taxes.

However, a tax on unincorporated businesses using net income as the measure would not suffer from the basic defects of the gross receipts tax. Devising the specific provisions of such a tax is fraught with many technical difficulties. A detailed study of an unincorporated business net income tax is required before a recommendation can be made to the legislature.

The Committee recommends:

Repeal of the gross receipts tax on unincorporated businesses, and consideration of a net income tax on these businesses by the proposed tax study group in

order to develop a concrete proposal for submission at a later session of the legislature.

Retail Gross Receipts Tax

The Retail Gross Receipts Tax was also enacted in 1966 for distribution to municipalities as replacement for lost revenues from the business personal property tax. In 1971, revenue from the tax was \$4,582,210.

The tax is levied at 1/20 of 1% on gross receipts of all retail stores which have sales of more than \$150,000 a year. The tax is directed at one class of taxpayers and is inherently unfair. The justification for it is eliminated by the comprehensive revenue proposals in this report.

The Committee recommends:

The retail gross receipts tax should be abolished.

Business Personal Property Tax

The business personal property tax is levied upon the tangible personal property used in business by individuals, partnerships, corporations and other establishments engaged in trade. Property is valued at 50 per cent of original cost and a statewide rate of \$1.30 per hundred of equalized value is applied. The State Treasurer collects the tax and receipts are a portion of an annual \$106,835,188 distributed to municipalities under the Business Personalty Replacement Act of 1966. The tax produced \$50,978,295 in 1971.

While the personalty tax has little philosophical appeal, an increase in its rate would offset revenue lost from the recommended exemption of production machinery from the sales tax. The personalty tax does not cause all of the harmful economic effects which arise from imposing the sales tax on new machinery, since it defers tax payments until production benefits from machinery are an actuality. Along with property tax relief for business contained in other recommendations in this report, the Committee believes increasing the personal property tax rate a reasonable step.

The Committee recommends:

The business personal property tax rate should be raised to \$2.00 per hundred, producing an estimated revenue increase of \$27.5 million a year. The tax base should remain 50% of original cost.

Taxes on Banks and Other Lending Institutions

Ever since the United States Supreme Court decision in the celebrated case of McCulloch v. Maryland a century and a half ago, the states have been restricted in their ability to tax banks. The decision held that national banks were immune from state taxation in the absence of federal consent. Federal law since has al-

lowed some taxation of national banks, but not to the extent of other businesses. For competitive reasons, the states have also had to exercise similar restraint in taxation of state-chartered banks and other financial businesses.

Since 1864, Congress has permitted states to impose real property taxes on banks plus one of four other taxes—on bank shares, on stock dividends, on net income, or a franchise or excise tax measured by net income. In 1969 Congress widened the range of taxes which states might impose on national banks on an interim basis and scheduled an end to the long standing immunities of national banks. The act was originally planned to be effective January 1, 1972. However, there is a probability that some restrictions recommended by the Federal Reserve Board may be written into the permanent law and, in the meantime, the interim provisions are extended until January 1, 1974.

The New Jersey bank stock tax, enacted in 1914, is the major tax imposed on banks in this state. They are also subject to the real property tax, the sales and use tax and miscellaneous levies. But there is no tax on banks corresponding to the corporate net income tax. The value of a bank's stock is determined by its capital, surpluses and undivided profits, and a deduction is allowed for the assessed value of real estate. The rate was .75 per cent until 1970, when it was doubled to 1.5 per cent. The tax yielded \$7,843,000 in 1971.

The financial business tax, enacted in 1946, taxes industrial banks, personal finance and small loan companies, sales finance and mortgage finance businesses, dealers in commercial paper, and others in competition with national banks for moneyed capital. Designed as a counterpart to the bank stock tax, it is levied at a 1.5 per cent rate on net worth. It yielded \$2,452,000 in 1970.

Mutual savings banks, savings and loan associations, and building and loan associations are not covered by either the bank stock tax or the financial business tax. Nor does the corporation business tax apply to them. Such banks have argued for favored treatment on grounds that they are mutual associations serving the home mortgage market for the great mass of ordinary citizenry.

The present interim federal law would allow New Jersey to impose on national banks whose principal offices are within the state any tax (other than on intangibles) which is also levied on state chartered banks. Thus, New Jersey for the first time could impose a combined net income and net worth tax on both national and state banks.

There are many difficulties yet to be resolved before

definitive action can be recommended. National banks with headquarters outside of New Jersey are still beyond the reach of state taxation under the interim federal legislation. The competitive position of New Jersey banks vis-a-vis banks in New York and Pennsylvania operating within New Jersey is a substantial problem. If the permanent Congressional legislation takes effect, the out-of-state banks would also lose much of their tax immunity, changing the competitive balance. The measure of bank income raises problems also. Bank income for federal tax purposes is substantially lower, in relation to economic income, than that of other businesses. A net income tax on banks modeled after the federal levy might not have the same revenue impact as the net income tax on other corporations.

A review of the state tax structure as applied to lending institutions is very much in order, but thoroughgoing changes must wait until Congress resolves the uncertainties in the federal legislation. In the meantime, the Committee sees no justification for the current complete bank tax immunity granted to savings banks, savings and loan associations, and building and loan associations. As an interim measure, the most appropriate step would be to close this gap in the tax laws with enactment of a tax on these institutions measured by a 5 per cent rate on net income. Because of the previously mentioned favorable treatment given bank net income, it is likely that the tax will not result in a burden equal to those imposed by the bank stock tax and the financial business tax. In part, this is a tentative acceptance of the contention by savings banks, savings and loan associations, and building and loan associations that they are entitled to preferential treatment. The premise ought to be re-examined at a later date.

The Committee recommends:

That a study of the taxation of banks and lending institutions be undertaken, for completion and presentation to the Legislature after Congress acts on permanent provisions of law affecting national banks. In the meantime, a 5 per cent tax measured by net income should be imposed on lending institutions not covered by the bank stock tax, the financial business tax and the corporation business tax.

Taxation of Insurance Companies

Like most states, New Jersey generally imposes a tax of 2 per cent on premiums of insurance companies and exempts them from general corporation and franchise taxes paid by other businesses. Premiums which qualify for special treatment under the federal income tax law are exempted.

The rates apply to New Jersey companies and out-of-

state companies alike, but are limited to one-eighth of a company's total taxable premiums received both within and outside of the State. New Jersey companies are allowed an offset for premium taxes paid to the city and county where they are located (reduced by \$200,000 for companies with capital and surplus of \$15 million or more).

The evidence indicates that the premium tax represents a higher percentage of insurance companies' net income, using the same base as for federal tax purposes, than do the state's taxes on other kinds of businesses. Thus, a net income tax applied to insurance companies at the same percentages used in other business taxes would produce less revenue than the premium tax.

This does not seem unfair, however. The relative amount by which insurance companies have been more heavily taxed than other businesses has narrowed in recent years. The premium tax remained static while other business tax rates rose. The situation is similar in other states. A higher-than-usual franchise tax is also justified by special treatment granted to the insurance industry—exemption from the anti-trust laws and special State supervision and assistance. Insurance premiums are also exempted from the sales tax.

New Jersey insurance companies suffer some competitive disadvantages because about half the states openly discriminate in favor of their own companies, either with reduced taxes or complete exemptions. In addition, nearly all states have retaliatory taxes by which they raise tax rates on any company from a state which has higher rates. Discriminatory and retaliatory taxes were outlawed a long time ago for other businesses, but federal legislation permits them in the insurance business. If New Jersey raised its premium tax, retaliation from other states might cost some New Jersey companies as much as \$10 for each dollar of added revenue here. The effect is to limit business activity within New Jersey and preclude any increased taxation of insurance companies. Since these oddities have been fostered by federal legislation, the state's Congressional delegation should be urged to initiate corrective legislation.

The New Jersey tax has three inequities:

a. Non-insured employee health and welfare benefit plans evade the premium tax. But the employer becomes an insurer covering the risks of other persons and should be subject to the same taxes and supervision as an insurance company.

b. A new type of group insurance policy has been designed to evade taxes. Under this subterfuge, the insurance company collects a premium of only 5 to 10 per cent of normal. The difference is deposited in a

special bank account in the employer's name and no claims are paid from it. Even under present law a change could be made that the tax should be paid on the full premium amount, not just the 5-10 per cent labeled "premiums."

c. Business firms purchase group, property and liability insurance from out-of-state insurance firms not admitted to do business in New Jersey. If the transaction takes place outside the state, the premium is not taxed. The policy can then be ceded to and serviced by another out-of-state insurance company admitted to do business in New Jersey. There seems to be no legal means at present to tax this second insurance company, either.

The Committee recommends:

That the State enact a new tax on the use of insurance to cover risks within New Jersey. The tax would be patterned after the use tax which complements the retail sales tax. The definition of insurance would be broadened to include all employee protection plans, whether handled by an insurance company or an employer. Such a law would close these three inequities in the present premium tax.

Insurance companies should be subject to the requirement for filing a notice of business activity, as recommended earlier by the Committee.

The surplus line tax of 3 per cent can be changed to 5 per cent without competitive jeopardy or retaliation from other states. The Committee sees little equity in maintaining the one-eighth limitation on the total of premiums subject to the tax.

An on-going study group should be established to review the complex issue of insurance taxation in order to assist New Jersey's representatives in Congress to abolish discriminatory and retaliatory insurance taxes.

Public Utility Taxes

New Jersey levies three taxes on public utilities:

a. A franchise tax of 5% on gross receipts of companies, other than railroads, grossing \$50,000 or more annually and 2% on those grossing less. The tax is assessed by the state and distributed to municipalities where the utilities are located. Revenue totaled \$64,390,423 in 1971.

b. A 7.5% tax on gross receipts of utilities. These revenues, which were \$88,545,143 in 1971, are distributed to municipalities on the basis of the amount of utility property within their borders as are the franchise tax revenues.

c. A surtax on the other two taxes, which produced \$20,442,352 for state use in 1971.

Telephone and telegraph companies do not pay gross receipts taxes. They are subject, instead, to the local

property tax. In 1971, local revenues from these taxes totaled \$49,783,000.

The Committee recommends no change in these taxes, nor does it recommend any increase in rates, due to the regressive nature of public utility taxes. Balancing of the entire tax structure is needed to overcome the dominant effects of such regressive taxes.

Railroad Property Tax

Since 1966 New Jersey has levied a state tax on certain types of railroad property, replacing the former local tax on Class II railroad property. The state pays aid to the municipalities which formerly levied the Class II tax. In 1970, \$11,015,238 was paid in replacement aid. The law has operated equitably, in place of the unfair methods which once existed, and no changes are recommended.

Value-Added Taxation

Value-added taxation is widely used in Europe and in the past, in Michigan. In recent years there has been heightened interest in such taxes at the state and federal level, though none is in effect now. Generally, value-added taxation is levied on a very broad base—the entire output of a state or nation. In practice, the tax is imposed on business firms by taxing the difference between their receipts and the payments they make for materials, services and capital equipment.

Depending on treatment of payments for input, particularly investment expenditures, a value-added tax may take on theoretical similarities to a business net income tax or a consumer sales tax. However, the tax is neutral in its impact on corporate and non-corporate businesses, efficient and inefficient producers, labor-intensive and capital-intensive industries, and integrated and non-integrated firms. Because of the broad tax base, a low tax rate produces a large amount of revenue.

However, there are some disadvantages to a value-added tax. As a national tax it is likely to be passed completely to consumers in the form of price increases, and thus has considerable regressivity. As a state tax on the other hand it is difficult to shift on to consumers in other states in the price of New Jersey goods shipped out of State. Rather, New Jersey concerns would simply move to other states to escape this burden. A value-added tax is difficult to make non-regressive through related exemptions. While it is a highly elastic tax, as is an income tax, it is not as progressive as an income tax. Within the framework of our existing federal and State laws a state imposed tax on value added is objectionably deficient when compared to the sales tax for example. Sales tax payments may be deducted from

income for federal personal income tax purposes, but cost increases due to value-added taxes cannot be deducted under present federal regulations.

The Committee believes that a value-added tax must be viewed in context with the entire tax structure, and not as if it were the only tax to be imposed. A properly balanced structure of other taxes on business and individuals, as recommended in this report, can achieve most of the advantages of a value-added tax without its corresponding disadvantages.

The Committee recommends:

Against adoption of a value-added tax for New Jersey.

C: TAXES ON INDIVIDUALS

Death Taxes

Death taxes fall into two major classes—estate taxes and inheritance taxes. Estate taxes, used by the federal government and eight states, levy a progressive tax on the value of an entire estate, regardless of the identity of the beneficiaries. The tax has the advantage of simplicity, efficiency and comprehensibility. Inheritance taxes, used by 38 states and the District of Columbia, use separate rate schedules for different classes of beneficiaries. Transfers to spouses, children and other close relatives are taxed at lower rates than transfers to distant relatives or non-relatives. Simplicity is sacrificed to lessen the burden on the immediate family.

New Jersey's transfer inheritance tax, one of the heaviest such taxes in the nation, is weighted in favor of Class A beneficiaries—fathers, mothers, husbands, wives, children, etc. (Class B consists of charities, hospitals, educational institutions, etc.; Class C are collateral relatives, brothers, sisters, or their spouses; Class D covers other transfers.) In 1970 transfers to the immediate families of decedents accounted for 64.9 per cent of the total transferred but only 35.3 per cent of taxes. Transfers to collateral relatives and non-relatives accounted for 19.3 per cent of the estates but 52 per cent of the taxes. The Committee believes great emphasis should be placed on protecting the immediate family of decedents, particularly widows where the primary family wage-earner has died prematurely. Achieving the simplicity of an estate tax would involve a much heavier tax burden on widows and other close relatives of decedents. The only circumstance justifying adoption of an estate tax would be passage of federal legislation significantly increasing the federal credit for moneys collected under a State estate tax. In such a case, a New Jersey estate tax would capture the federal credit without an added burden on immediate families of decedents.

The Committee recommends:

Retention of the inheritance tax at its present rates.

New Jersey's first death tax was enacted in 1914. It specified an exemption of \$5,000 for each beneficiary in Class A, close relatives of the decedent. Fifty-seven years later the exemption remains at \$5,000. Inflation alone justifies increasing this exemption.

The Committee recommends:

Increasing the present \$5,000 exemption on transfers to close relatives (Class A beneficiaries) to \$20,000; and providing that gifts more than three years prior to death may not be deemed to have been made in contemplation of death.

The transfer occurring at the death of one of the tenants under a joint tenancy has always been deemed subject to inheritance taxation, subject to proof of the ownership by surviving joint tenants. However, when the real property is held by a husband and wife as tenants by the entirety, the property has always been exempt from tax, whether it is held for residential or investment purposes. This special treatment is accorded because of the fear that a death tax on the family home could force the surviving spouse to sell the home to pay the tax. The principle is valid when applied to the home. But it has allowed the tax-free transfer of large holdings of investment and business properties which do not merit special treatment. It has been suggested that taxing such transfers when the homestead is not involved would produce as much as \$2.2 million in added revenues. In any case, equity supports a change in the law.

The Committee recommends:

Elimination of the inheritance tax exemption on non-homestead property held as joint tenancies of the entirety.

When life insurance proceeds are payable to the estate of the insured or to his executor, administrator or trustee under a trust created by a will, they are taxable in New Jersey. But when life insurance proceeds are payable to the trustee of a trust created during the lifetime of the insured and then over to a beneficiary under the terms of such a trust, or to a designated beneficiary under the policy, they are not taxable. Therefore, most life insurance proceeds escape taxation in New Jersey.

The preferential treatment of life insurance proceeds is based upon the conclusion that life insurance is purchased for purposes of protection, rather than investment. But insurance policies have a cash surrender or loan value, and in this respect resemble other taxable assets. The Committee believes that a dollar exemption can be used to give recognition to the role of insurance

in providing a basic sum to ward off unforeseen misfortune. Beyond this exemption life insurance proceeds should be treated as any other asset for inheritance tax purposes.

The Committee recommends:

That life insurance proceeds be included in the inheritance tax base to the extent they exceed:

1. \$50,000 paid directly to the decedent's spouse, plus
2. An additional \$10,000 paid to the spouse for each surviving minor child of the decedent who lives with his or her surviving spouse.
3. \$10,000 for each Class A beneficiary other than the decedent's surviving spouse.

That the distinction between life insurance proceeds payable to testamentary trusts (taxable) and those payable to inter-vivos trustees (not taxable) be eliminated. The distinction has no economic or other basis.

That benefits from pension, stock bonus and profit-sharing plans be taxed only to the extent of the decedent's contributions, instead of being fully taxed as they are now. This is a more equitable approach.

Transfers to charitable organizations were exempt in New Jersey until 1922, when a 5 per cent levy on all such transfers of \$500 or more was enacted. Exceptions were enacted in ensuing years until 1962, when the complete exemption was restored.

The Committee recognizes the social contributions of these benevolent organizations. But when bequests to widows and children are taxed, it seems only fair that a modest tax be placed on transfers to charitable organizations. However, such a tax should not be imposed on testamentary transfers to non-profit educational organizations. Most states exempt transfers to out-of-state charities only if the charity is exempt in its home state. Bequests to New Jersey educational institutions from other states might suffer, and these institutions depend heavily on such contributions. Other types of charitable organizations, such as hospitals or churches, receive relatively few bequests from out-of-state decedents and would suffer little or no diminution of contributions.

The Committee recommends:

That the flat 5 per cent inheritance tax on charitable bequests over \$5,000 be restored, with an exemption for non-profit educational institutions.

The Sales and Use Tax

New Jersey's sales and use tax, enacted only five years ago, is the State government's chief revenue

source, accounting for 40 per cent of its budgeted revenue. This level of revenue is obtained in spite of the fact that New Jersey's sales tax imposes a relatively low per family tax burden in comparison with other states. This is a direct outgrowth of an extensive list of exemptions.

The tax has often been criticized as regressive, but it need not be. Zero regressivity may not be attainable but it is a goal worth pursuing through use of a rational system of exemptions. The tax is income-elastic and broad-based. Use of the tax, and modifications, should be viewed in the perspective of the total tax structure, including enactment of a graduated income tax. The Committee concludes that continuation of the sales and use tax is an acceptable and essential part of such a balanced tax structure, both to preserve a major source of State revenue and to insure a broad and equitable tax base.

The present 5 per cent sales tax rate is generally in line with rates in nearby states. However, its wide range of exemptions has the effect of narrowing the tax base and making it less elastic. In 1970, the rate was raised from 3 to 5 per cent to obtain needed revenue for the State government. Revenue from the sales tax can also be increased by narrowing the range of exemptions, and where this can be done while making the tax more progressive, elastic and broader-based, it is a preferable course.

The Advisory Commission on Intergovernmental Relations has observed that a sales tax should cover most personal services as well as retail sale of tangible goods. Exemptions which make the tax more regressive narrow the tax base, requiring higher rates to raise a given amount of revenue. This unjustly increases the burden on those items covered by the tax. Exemptions should be granted only when they serve one or more of the following purposes:

1. They decrease regressivity;
2. Remove inequities;
3. Prevent harm to the economy;
4. Remove conflicts with other public policies; and
5. Remove administrative impracticalities.

Several existing exemptions in the New Jersey sales and use tax law serve none of these purposes.

The existing exemption for clothing purchases was inserted for the laudable intention of making the tax more progressive. But recent evidence indicates that it has the opposite effect; it is regressive. Of the 45 states which levy a sales tax, only 5 continue to exempt

clothing. To insure that elimination of the exemption would have minimum impact on low-income families, a rebate or credit system can be devised. Such a system would return about \$10 million to low-income families, tending to make the entire sales tax burden more progressive. The combination of the credit-rebate system and elimination of the clothing exemption would increase sales tax revenues \$70 million a year.

The Committee recommends:

That the sales tax exemption for clothing be replaced by an income tax credit or rebate to each family having a total income of \$1,300 or less per person.

A second major exemption which narrows New Jersey's sales tax base without making the tax more progressive, equitable, elastic or practical is personal and professional services. Spending on services is increasing faster than spending on tangible goods. Removing them from the tax base causes revenues to lag behind growth of the economy and growth of government costs. The exemption also produces such inequities as a sizable tax on a washing machine used for home laundering and an exemption for laundering sent out to a commercial establishment. However, the Committee believes that one area of professional services should continue to be exempt—medical services. To impose a tax on these services would cause unpredictably severe and unavoidable personal hardships. For similar reasons, the sales tax exemption for prescription drugs and medicines should be continued.

The Committee recommends:

That the sales tax exemption for personal and professional services should be eliminated, except for professional medical and health services. The tax on services should include those used in construction, maintenance and repair of real property. It also should extend to legal, accounting, engineering and architectural services, title searches, etc.

The tax should be applied to all services except medical and health services and the personal services of beauty, barber, shoe repair shops and employment agencies.

It is estimated that elimination of the exemption of purchases of services would add \$154.0 million to State revenue, as indicated in the following table:

Estimated Revenue from Proposed Sales Tax on Services

<u>Service</u>	<u>Estimated Revenue</u>
Laundry and Dry Cleaning	\$ 12.8 million
Business, Management Consulting	9.0
Statistical and Computer	2.3
Public Relations	.2
Interior Decorators	.2
Practice of Law	15.6
Practice of Architecture, Engineering	12.0
Practice of Accounting	10.0
Construction	91.9
TOTAL	\$154.0 million

The Committee has considered a number of other present exemptions in the law and concluded that they should be removed. In summary, these exemptions and the reasons for eliminating them are:

On-premises consumption of alcoholic beverages: As the Twelfth Report of the State Tax Policy Commission pointed out, there is no good reason to exempt a \$20 bar check while a \$2 meal served in the same room is taxed.

Magazines, periodicals: This exemption does nothing to make the sales tax progressive or equitable. No compelling reasons of public policy require it.

Casual sales of aircraft and boats: The basic intent of this exemption recognizes administrative difficulties in collecting a tax on such sales. However, casual sales of aircraft and boats or vessels documented under U.S. Bureau of Customs statutes can be collected without administrative impracticalities. They should be.

Certain coin-machine sales: Sales of other articles do not exempt the first 10¢ of value. The exemption of articles sold from vending machines should be removed in the interest of equity as well as for administrative simplicity.

Films, records, and tapes used in theater, radio and television productions: To continue this exemption would serve no valid purpose and would be inconsistent with taxation of professional services.

Sales covered by local sales tax ordinances: This exemption benefits only one municipality and is totally inequitable. Other recommendations in this report will benefit the municipality along with others in like circumstances and remove the last shred of plausibility for this exemption.

The Committee has concluded that a number of exemptions should be continued for good reason. In addition to the aforementioned exemptions of expenditures on medical services and prescription drugs and medicines, they are:

Food; food products; beverages; food sold in school cafeterias; utility bills; motor fuels; property for use in research or development; wrapping paper, wrapping twine, bags, cartons; farm production items; products used by morticians; chemicals and catalysts; school textbooks; renting, leasing, licensing or interchanging of trucks, tractors, trailers or semi-trailers; cigarettes; the Bible; the United States flag; locomotives, railroad cars and rolling stock; buses.

One exemption previously removed should be restored—the exemption for sales of machinery used in production of goods. The Committee received credible evidence that taxation of production machinery sales will cause great long-term harm to growth of the State's industrial base. Ultimately the harm will be felt in loss of employment and reduction of the tax base. Restoration of this exemption would reduce sales tax revenue by \$25 million a year, but this amount would be offset by the recommended increase in the tax rate on business personal property.

Summary of recommendations:

1. The Committee recommends repeal of sales and use tax exemptions for the following items, with the estimated increase in State revenue for each:

	In Millions
On-premises consumption of alcoholic beverages	\$ 6.0
Clothing and footwear	80.0
Services	154.0
Magazines and periodicals	0.6
Casual sales of aircraft and boats	.75
Coin-machines sales under \$.10	1.0
Films, records, tapes in theater, radio and television productions	1.2
Sales under local sales tax law	4.0
Building materials taxable but not taxed	25.0
Total exemptions removed	\$272.55

2. In conjunction with repeal of the clothing exemption, an income tax credit or rebate should be paid to each family having a total income of \$1,300 or less per person. Cost: \$10 million.

3. The exemption of sales of machinery, apparatus and equipment used in manufacturing tangible goods should be restored, to prevent harm to the State's economy. Cost: \$25 million.

The net total additional sales and use tax revenue resulting from the recommendations would be \$237.55 million. In the 1971-72 fiscal year,

revenues would have been raised from the presently budgeted \$563 million to \$800.55 million.

The Personal Income Tax

The defects of New Jersey's tax structure have been documented. It is regressive, inelastic, self-defeating. It oppresses the poor, causes educational inequality, distorts physical development, tears at the social fabric. All of this without being either efficient or equitable.

In previous parts of this Report, the Committee has charted a basic restructuring of the tax system. It has proposed moving New Jersey away from its traditional over-reliance on the local property tax, the central fact of fiscal life in the state-local tax system.

There can be no doubt now that using the property tax as the primary source of government revenue—\$2.2 billion of the \$3.85 billion raised in 1971—has done great harm to basic values—home ownership, economic development, simple justice to the poor, the elderly and to groups of the so-called affluent chosen by the most off-handed processes. To wander into such a distorted, inequitable circumstance is shameful. To continue it willfully and knowingly would be unpardonable.

There is only one tax which will produce both the revenue and equity needed to restore balance to New Jersey's tax structure—a graduated personal income tax. Without it, there cannot be enough revenue to lighten the property tax. Without it, no patching and bending of the other taxes will produce an equitable whole. Without it, the State and local governments are foredoomed to annual raising of rates and reductions of service. There can be no tax reform for New Jersey without a graduated personal income tax.

Design of a State Income Tax

In considering the outlines of a personal income tax, the Committee considered several basic issues:

1. Competitive effects on the economy.
2. Relationship to the federal income tax.
3. Taxation of non-residents.
4. Rates and deductions.

The Committee is mindful of the fact that New Jersey's economic development has benefited somewhat because business firms have located within the State in preference to neighboring states with income taxes. However, New Jersey need not impose an income tax at rates as high as those in New York State now. Pennsylvania has recently adopted an income tax, also. Thus, whatever advantage New Jersey had before need not be given up entirely. Possibly even more important, the kind of tax reforms made possible through use of a personal income tax can make New Jersey substantially more attractive for rational economic growth.

Any state personal income tax must be affected by its relationship with the federal income tax. Alaska, Nebraska and Vermont have adopted income taxes which "piggy-back" on the federal tax, simply imposing taxes at a percentage of an individual's federal income tax liability. Such a tax has been suggested to the Committee, largely on grounds of simplicity. But most of the simplicity which is apparent from a distance disappears on close view. And what simplicity is gained involves some considerable losses in other ways.

"Piggy-back" income taxes, for instance, supposedly permit simplified tax forms. But not so for out-of-state residents, who must allocate income on state tax returns but not the federal return. The federal income tax cannot reach interest income from state and municipal bonds. The state can, and such a step requires a different form. The federal government is forced to distinguish between different groups of married and unmarried taxpayers, because some states have community property laws. There is no need or justification for some of these distinctions in New Jersey, and a different set of forms and rates would be required. New Jersey can achieve most of the benefits of simplicity for many taxpayers by permitting them to file a copy of their federal tax return, using the information which is pertinent.

The "piggy-back" tax also allegedly reduces administrative cost. But a cooperative audit program already in use for other taxes will achieve the same effect without sacrificing the State's interests to federal agencies involved in administering their own laws with only secondary interest in the varying income tax laws of the states. If proposed legislation providing for optional federal collection of state income taxes is enacted, it might then become advisable to restructure a state income tax. But that time is not yet.

The disadvantages of a "piggy-back" income tax can be serious. The state may not wish to accept for its own tax policies the decisions of a national Congress on such questions as depletion allowances. It might not want to adopt, sight unseen, the entire structure of the Internal Revenue Code. And once wedded to the structure as a whole, individual departures would be extremely difficult. There is even serious legal doubt whether the State Constitution will permit delegation of the State's policy-making powers to Congress.

Non-resident Income

New Jersey's geography makes it a common occurrence for non-residents to earn at least a portion of their income within the State. The Committee believes it important, from the standpoint of equity and revenue, that non-residents should be subject to the personal income tax, in proportion to the amount of their income

earned in New Jersey. Court decisions support such action. A proper method of calculating a non-resident's tax liability would be: he shall first determine his income in the same manner as would a resident. The non-resident tax liability would then be reduced to the percentage which his New Jersey adjusted gross income bears to his total adjusted gross income. In other words, if he makes half his income in New Jersey, he would pay half the amount a New Jersey resident would pay on the same amount of total income.

Rates

Income tax rates approximately half the existing New York rates would produce an estimated \$550 million the first full year, a sufficient amount of new revenue to achieve the tax reform charted in this Report. The Committee recommends a rate structure at approximately half the New York rates up to a taxable income level of \$23,000. While New York's rates reach 14 per cent at that level and remain constant after that, the Committee proposes continuing the rate schedule until it reaches 14 per cent at the \$500,000 level. This creates a slightly more progressive tax structure than New York's.

There should be only one tax rate schedule. Joint returns should be permitted, but the concept of income-splitting included in the federal tax should be avoided to prevent discrimination because of marital status and to simplify administration.

Credits and Exemptions

In another departure from federal income tax, the Committee after careful study, believes New Jersey should use a personal credit of \$15 per person, instead of the \$750 personal exemption provided in the federal law. Under this system, a taxpayer would determine his liability without subtracting \$750 per person from his gross income. But after his tax had been calculated, he would subtract \$15 per person from the amount due. For lower income people, the \$15 credit would provide a greater tax reduction than the \$750 exemption. For higher income people, the \$750 exemption is worth more. For people with adjusted gross income at the 1 per cent tax level, the \$750 exemption is worth only a \$7.50 tax reduction. For those in the 14 per cent bracket, the \$750 exemption is worth \$105 in tax reduction. Thus, the personal credit of \$15 would make the tax more progressive. In addition, many low-income people would receive an additional credit of \$5.00 per person under the recommended substitute for the sales tax clothing allowance. For those whose income tax liability is zero, there would be a cash rebate from the sales tax. And those over 65 would be allowed a credit

of \$30 per person, paralleling the doubled personal exemption under the federal tax law.

For a family of five, total income tax credits would wipe out any income tax payment below an adjusted gross income level of approximately \$6,000.

Deductions

In general, allowable deductions for determining adjusted gross income for New Jersey tax purposes should follow current federal regulations for 1972. However, where there is compelling reason, the State should depart from the federal Internal Revenue Code. Present federal regulations are basically sound, historically proven and generally acceptable to taxpayers.

One deduction which should receive future detailed study is the controversial depletion allowance. These allowances are built into federal law as incentives for development of natural resources. Twenty-eight of the 42 states which have personal income taxes follow the federal provisions. The allowances are controversial and complex. They are of sufficient impact to merit special, intensive study in the near future.

Summary of Recommendations:

New Jersey should adopt a graduated personal income tax to restore balance and equity to its tax structure. The tax should be levied at approximately half the New York State income tax rates, to produce about \$550 million in new State revenue in the first full year. Its terms and administration should generally follow the federal pattern, including deductions and withholding. A personal credit instead of an exemption, should be used, however, to make the tax more progressive. Tenants may deduct 20% of their rent in computing taxable income.

Taxes on Alcoholic Beverages, Cigarettes and Gasoline

Taxes on liquor and beer are heavily influenced by competitive conditions. For instance, the \$2.30-a-gallon tax on liquor is on a comparable level with tax rates in surrounding states. An increase now, after a \$.50-a-gallon increase in 1969, would likely reduce sales and tax revenues. Thus, the Committee recommends no change in the current rate.

Taxes on wines, on the other hand, can be raised modestly without harming the competitive position of New Jersey.

The Committee recommends:

That taxes on still wines be raised from the present \$.10 per gallon to \$.20, on vermouth from the present \$.15 per gallon to \$.30, and on sparkling wines from the present \$.40 per gallon to \$.50. The estimated additional revenue is \$1 million.

New Jersey's beer tax of 3 1/3 cents a gallon has been unchanged since it was first imposed in 1933 and is virtually the lowest in the nation. Rates in neighboring states would permit a long overdue increase.

The Committee recommends:

That the tax on beer be increased from the present 3 1/3 cents a gallon to 10 cents a gallon, producing a revenue increase of \$9.6 million a year.

New Jersey now taxes cigarettes at 14 cents a pack, producing \$123,804,999 in revenue in 1971. Over the years, sales of cigarettes have been subject to short-run declines, due to recurrent health hazard warnings from the U.S. Surgeon General's Office. But in the longer run, sales have moved upward. There is evidence that increases in the tax rate per pack of cigarettes produce a diminishing yield for each cent increase. However, this trend does not justify maintaining the rate at its current level.

The Committee recommends:

That the cigarette tax rate be raised from 14 cents a pack now to 18 cents. Increased revenue is estimated at \$30 million a year.

The present motor fuel tax rate of 7 cents a gallon is comparable with surrounding states. It produced total net revenue of \$210,255,461 in 1971. The current rate should not be changed. However, some definitions and technical provisions of the law should be modified to eliminate payment of the tax by counties, municipalities and aviation fuel purchasers, who must then apply for a rebate. Reducing the necessity of paying rebates would cut costs for the State and the organizations obtaining the rebates.

D: Reform of Tax Administrative Procedure and Appeals

Tax reform requires a throughgoing revision of the myriad procedural rules which govern the assessment, collection and review of the many taxes which make up New Jersey's system of State and local taxation. Only the most adept tax practitioners can now thread their way through the procedural maze which grew year by year.

Tax returns, refund claims, statutes of limitations, lien provisions, and interest and penalties are only some of the provisions which need to be standardized. A Uniform Tax Procedure Act exists, but it has been largely ignored because of the tendency to include procedural rules in each new tax statute.

The Committee recommends:

1. Revision of the tax laws in order to collect and restate in one place all of the general procedural requirements and provisions to eliminate inconsistency and redundancy.

2. Establishment of a ruling section in the Division of Taxation to provide advance rulings to taxpayers in a manner similar to the issuance of rulings by the U.S. Internal Revenue Service.

3. A study to devise a tax form package for small business which would include simplified short forms of tax returns which would for a given business all be due on the same date, to minimize the inconvenience and expense of multiple returns.

A taxpayer's right to contest imposition of a tax is now beset with expensive, time-consuming burdens. There are no established procedures for informal review within the Treasury Department. The Department has no authority to compromise tax claims. Formal administrative review is available only before the Division of Tax Appeals, an agency within the Treasury Department lacking the attributes of a court. The Division is subject to pressures from the department and from outside, because its members serve on a part-time basis and may freely engage in the private practice of law even though they bear the title of "judge." Full judicial review is available only through a costly appeal to the Appellate Division of Superior Court.

The Division of Tax Appeals has trial jurisdiction over all tax matters except those relating to the transfer inheritance tax, an exception created many years ago to permit members of the division to handle estate matters in their private law practices. The exception results in having inheritance tax cases heard initially in the Appellate Division of Superior Court, a tribunal ill-suited for dealing with cases involving the introduction of factual evidence. The expense of such appeals deters most claimants.

There is no body of written decisions of the Division of Tax Appeals to guide taxpayers and administrators. The Division's proceedings are subject to long delays because of crowded dockets.

Two recent legislative commissions have urged creation of a judicial tax court with full-time judges. Both the American Bar Association and the New Jersey State Bar Association have also recommended such a tax court, which would be removed from politics and would have the time, expertise and temperament to afford speedy and relatively inexpensive relief to taxpayers.

The Committee recommends:

- 1. Review within the Division of Taxation of all matters within its jurisdiction, following the pattern of the Appellate Division of the U.S. Internal Revenue Service, with the right to compromise a tax determination.**
- 2. Creation of a judicial tax court to review all tax disputes at the trial level. The court would be in the judicial system with full-time, tenured judges.**
- 3. Creation of a small claims section of the tax court to provide speedy and inexpensive relief to taxpayers making claims which involve sums under \$2,000.**

Pari-Mutuel and Gaming Revenues

Pari-mutuel betting and gaming involve consideration not only of their potential government revenue, but also philosophical, moral, and social questions. The Committee considered the revenue potential alone, since the other questions involve policy decisions which go beyond taxation.

The Committee considered pari-mutuel betting, the State lottery, off-track betting and casino gambling as revenue sources.

Pari-mutuel betting: The State receives about \$35 million a year as its share of pari-mutuel wagering at four horse race tracks. It is doubtful that any more than nominal increases in revenue could be obtained from pari-mutuel betting. Lengthening the racing season, which already totals 380 track days, or adding tracks would probably only spread more thinly the supply of qualified racing entries available in the East. The effect could even be counterproductive.

State Lottery: New Jersey's State lottery has been the most successful venture of its kind. Net revenues of \$33.4 million were produced during the 1971 fiscal year. The Lottery Commission is anticipating a 9 per cent decrease for the current fiscal year and another decrease of 7 per cent in 1972-73. The loss of novelty effect and competition from other states following the New Jersey model make these declines in estimated revenue reasonable. A forecast of any substantial expansion in revenue would appear to be unrealistic.

Off-track Betting: New York City's Off-Track Betting Corporation projects a profit of \$31 million for its first full year of operation ending June 30, 1972. Manhattan, with its high density pedestrian traffic pattern, affords an unmatched area for operation of off-track betting. There is evidence that most OTB bettors are experienced at

betting, indicating that OTB may be conducted at the expense of pari-mutuel revenues and possibly bookies. An OTB operation in New Jersey would lack some of the advantageous conditions which exist in New York City. The revenue potential, therefore, appears to be considerably less in New Jersey. A special study to determine the feasibility and revenue potential of OTB in New Jersey might disclose whether it warrants further consideration.

Casino Gambling: There are two types of casino gambling establishments: the flamboyant Las Vegas-Reno type and the regulated, less flamboyant gaming rooms in such places as Monaco, London, France, Germany and the Caribbean area. The Nevada Gaming Commission reported \$39.3 million in revenue for the 1970 fiscal year.

When a committee of the New Jersey Legislature reviewed the subject of casino gambling in 1971, there was much uncertainty about the revenue potential. One study projected net revenues could reach \$24 to \$72 million after 14 years. Nevada's gambling revenues currently fall within this range at \$39 million. It is clear that while casino gaming could contribute some State revenues, the amounts would be small in proportion to needs and too unpredictable to provide a reliable fiscal base.

Summary: The prospect of achieving revenue increases from present gambling sources appears slight. Additional betting or gaming afford no more than a hope of speculative, far-off State revenues. Thousands of New Jersey homeowners and other property taxpayers will be in even more dire circumstance than now if the State relies on additional gaming revenues to provide for real and present needs.

The Committee concludes:

Even the most optimistic projections of revenues from gaming cannot and will not solve the State's revenue problems and cannot be relied upon.

The revenue potential from other forms of gambling does not appear to justify the difficulties of administration and the costs of policing. Throughout history no successful methods have been devised to capture revenues for any jurisdiction from illegal gambling.

In order not to overlook potential sources of revenue not in conflict with public policy, the subject of gambling and gambling revenues might be reviewed by a study group authorized to probe thoroughly all of the issues and revenue prospects,

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Combined Effect of Revenue Recommendations

The Committee's recommendations for the adoption of non-property tax revenues sufficient to assure the elimination of the projected fiscal gaps for 1975 and 1980, and to permit the massive property tax reductions recommended by the Committee, to be implemented primarily through the recommendations of Part II and Part III of the Report, may be summarized as shown in Table S-4.

The effect of these revenue recommendations overall has been tested to determine their influence upon the distribution of the tax burden of the state-local revenue system, as compared with the present system described in Part I of the Report. These tests include measures of effective tax rates, progressivity and income elasticity of the restructured tax system.

Effective Tax Rates. The correction of the past pattern of regressivity in the incidence of New Jersey taxes as shown by their "effective tax rates" is a notable accomplishment of the new system, demonstrated in Table S-5.

Progressivity. The progressivity indices for the present system and the proposed restructured system are shown in Table S-6. Again the table demonstrates that the recommended restructuring will convert a regressive tax system into a proportional tax system, which is something few states can boast about.

Income Elasticity. It is not possible to project the income elasticity of the new system in the same terms as were used for the existing system, for lack of adequate historical data of the system that is proposed. In lieu of that approach used for the present system, however, it is possible to assess the income elasticity from the changes in the recommendations. As compared with an income elasticity of the entire present state revenue system of .98 (see Part I, Table 9) the corporate income tax had an income elasticity index of 1.49 and the sales tax 1.44. Both of these sources are emphasized in the recommendations. In addition, the extreme income elasticity of the proposed income tax is evident from its progressivity index of 2.40. The combined effect of adding \$867.5 million from these highly income elastic sources to the present state revenues of \$1.6 billion is certain to increase greatly

the income elasticity of total state revenues, due to the weight that the new sources will have as a percentage of the total.

The increase in the progressivity index of the total system from .72 to .93 also indicates greatly increased elasticity of the total system. While the progressivity index is computed as of one point in time, and the elasticity index is a measure of the yield over time, an increase in the progressivity index by 30% may well indicate that the income elasticity index will increase at least that much, especially in light of the sources of new money.

This means an income elasticity index of state revenues may be predicted upwards of 1.30, thus practically closing the previous gap between this index and the income elasticity of expenditures. As the two indices of income elasticity come together, the recurring financial crises in the state budget process will be minimized if not avoided entirely.

TABLE S-4

STATE OF NEW JERSEY ESTIMATED NET ADDITIONAL REVENUE EFFECTS OF PROPOSED TAX LAW CHANGES

	\$ (Millions)
ABC	
Liquor	0
Wine	1.0
Beer	9.6
Cigarettes	30.0
Financial Business Tax, Other Than Commercial Banks	2.0
Sales Tax	237.55
Personal Income Tax	550.00
Corporation Business Tax	90.0
Business Personal Property Tax	27.5
Retail Gross Receipts Tax & Unincorporated Business Tax	-21.6
Transfer & Inheritance Tax	0
Total Estimated Net Additional Revenue	<u>926.1</u>

TABLE S-5
STATE OF NEW JERSEY
COMPARATIVE EFFECTIVE TAX RATES BY INCOME CLASSES
UNDER THE COMMITTEE'S RECOMMENDATIONS
AND THE PRESENT REVENUE SYSTEM
(In % without offsets for federal income tax deductions)

Item	Under \$3,000	\$3,000 to \$5,000	\$5,000 to \$7,500	\$7,500 to \$10,000	\$10,000 to \$15,000	\$15,000 to \$25,000	\$25,000 and Over
Old Structure							
No offsets except ex- porting to out-of- state stockholders, etc.*	20.3	16.9	15.2	13.6	12.9	11.5	7.2
Recommended							
New Structure With- out Sales Tax Changes	14.8	13.6	12.9	12.8	12.1	11.8	11.7
With all Changes	15.8	14.4	13.4	13.9	13.2	12.8	12.3

* These rates are the "state-local taxes plus federal individual income taxes" shown in Part I, Table 21, less the "federal individual income taxes" shown in the same table.

TABLE S-6
STATE OF NEW JERSEY
COMPARATIVE PROGRESSIVITY INDICES OF THE
PRESENT TAX SYSTEM AND THE RECOMMENDED
TAX SYSTEM

	Unweighted Progressivity Index	Weighted Progressivity Index
Old structure with sales tax at \$520 million69	.72
Old structure with sales tax changes recommended71	.73
Recommended new structure without changes in sales tax93	.92
Recommended new structure including sales tax changes	.93	.93

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Statement Of Senator J. Edward Crabel

I have given careful consideration to the overall recommendations of the Governor's Tax Policy Committee. May I say first that during the months that I have worked on this Committee I have developed a respect for the sincerity and integrity of my fellow Committee members and I recognize the considerable efforts made by the Committee in drafting these recommendations.

Many of these recommendations I agree with and support. But, there are very serious faults with the report that make it impossible for me to support some of the Committee's major proposals. In summary, these include, as far as I am concerned, the proposed statewide property tax plan, the reduced tax burden on business which result in an unjustified tax windfall, increased tax penalties on our people in the form of higher excise taxes and sales taxes, lack of real relief for rent-paying taxpayers and particularly those with modest incomes, and the fact that the Committee carried on its work virtually in secret.

I do approve the proposals to shift to state government the responsibility for welfare and court services. Similarly, I agree that the cost of senior citizens' exemptions should be paid for by the State. The basic concept of substantial tax relief for real property owners, with the resulting shift of financial responsibility to state resources, is a sound idea. I also support completely the recommendations of Task Force F, on which I served, and which appear in Part IV of the Committee's report. Moreover, there are numerous lesser proposals for reform which would produce greater tax equality and which should be adopted by the Legislature.

I further recognize that reforms of this magnitude require the enactment of new tax measures on the State level. Assuming that *continuing* real property relief is unequivocally guaranteed, I would be prepared to support a state income tax. This tax, as proposed, at the very least, should be revised and should provide a deduction for college tuition to assist our citizens who are faced with the problem of financing college costs.

Since I am in agreement with many portions of the Committee's recommendations, it is disappointing to me that the Committee's proposal contains, in my opinion, such serious drawbacks that I cannot endorse it in its entirety.

The following comments are based upon my understanding of the Committee's final recommendations. Unfortunately, a final draft of the Committee's full report was not available to the members of the Committee even as late as the middle of February. In the absence of final text, the Committee's position on certain details remains unclear. Based upon the drafts which were circulated among the Committee's members, there are portions of the Committee's program which I feel are contrary to the best interest of the state and its residents and inconsistent with the Committee's stated objective of tax reform and tax relief. These are the portions of the Committee's report that I reject.

1. I am opposed to the proposed statewide property tax as presented. Such a tax will have the effect of cancelling out all or most of the benefits of the real property tax relief that we promised to homeowners in many communities throughout the State. In these communities, homeowners will end up paying a new personal income tax, a new statewide property tax and a sales tax on clothing and services without receiving any meaningful real property tax relief.

In addition, such a major new tax source will provide the Legislature with too easy a means for raising substantial sums of money in the future on a real property tax basis. This, I believe, is the wrong kind of taxing power to create at this time.

2. I am also opposed to the overall effect of the Committee's entire tax package which will raise additional hundreds of millions of dollars from individual taxpayers while the overall tax burden on business will be decreased. Although the total tax yield in the State will be increased by hundreds of millions of dollars, I estimate that the business community will have its overall tax burden decreased by \$100 to \$200 million.

I previously indicated to the Committee that my objections to the business windfall and to the statewide property tax could be eliminated if real property could be classified according to use. This would permit us to channel real property tax relief only to home owners thereby avoiding unintended relief to landlords or the general business community. Under such circumstances, I could also be prepared to consider a proposal for a statewide property tax which would not be applicable to owner occupied residential property. Classifications

of property would also permit the proposed income tax to be at a much lower rate than that proposed by the Committee.

In addition, I am not satisfied that the Committee has studied fully whether business in New Jersey pays its proportionate share of the total tax burden in the State. Certainly, business' proportionate share of the tax burden should not be reduced, as the Committee's report recommends, in the absence of a clear justification for such action.

3. I do not approve the specific recommendations for increases in the various excise taxes that have been proposed by the Committee. I am strongly opposed to the recommendations that clothing be taxed under the sales tax because it penalizes those least able to afford the increase. If the Committee has found it impossible to repeal or decrease the sales tax at the same time that they have proposed an income tax, at the very least, they should have avoided recommendations which would make this tax even more oppressive.

4. I am greatly concerned because the Committee's proposal fails to provide any meaningful assistance to rent-paying taxpayers, particularly those with modest incomes. Most of these families reside in the older cities where the major tax relief to be provided under the Committee's package will be on real property. Few low income families own their own homes. This relief, therefore, will flow to their landlords without any likelihood that much, if any, of this relief will benefit the tenants.

At a time when the housing shortage is creating substantial pressure for rent control or other forms of tenant relief, it seems inconceivable to me that we could proceed with a tax reform program which overlooks the very group which requires assistance the most. The proposal I made for classification of property would eliminate the tax windfall to landlords and businesses, thereby lessening the amounts of money necessary to implement a reform program. This would provide the Committee with greater fiscal flexibility and permit it to reconsider ways in which it could assist this needy group.

Moreover, it should be noted that a major justification for the Committee's program of tax reform is the disproportionate tax burden on the lower income groups. Yet, a review of the taxes paid by persons earning under \$7,500. indicates that 60 to 75% of their total taxes are attributable to real property taxes. Most of these taxpayers, however, do not own their own homes and, as I have pointed out, they can expect little or no real relief from this program.

5. It is my understanding that the final draft of the Committee's report recommends elimination of veterans' exemptions and the tax exemptions enjoyed by many other groups on the local level. While I fully concur with the concept of minimizing the exemptions that should be granted from real property taxes and favor their repeal insofar as governmental bodies are concerned, I do not concur with extending such repeal to groups such as veterans. The people of this state have repeatedly reaffirmed and supported such an exemption and I would recommend its continuance.

6. Finally, I take exception to the results of the continued insistence of the Committee that its determinations be carried out behind closed doors. By excluding the public, the Committee has denied to itself the resources available throughout the entire State that would have assisted with a problem as complex as tax reform. The Committee has also denied to the public the opportunity of following and comprehending the reasoning of the Committee in reaching the conclusions that it has on this package. As a result, the general public and the Legislature will be handed a package of tax reforms near revolutionary in character without any of the interested persons and groups having had an opportunity to understand the basis for the proposals and to recommend or suggest legitimate modifications.

By so doing, the Committee has insulated itself from the heat these proposals are certain to generate, but they have in no way dissipated this pressure. The Committee has merely insured that this pressure will focus full force upon the Legislature, a body that neither created these proposals nor fully comprehends the reasons for them. Such a procedure can only work to the detriment of the beneficial parts of the program itself.

I firmly believe that this program would have been a stronger one and more realistic in terms of its reform proposals if the Committee membership had availed itself of the public responses that now will be heard only after the Committee has completed its task and in an atmosphere of controversy.

For the above reasons, I cannot endorse the Committee's report. But this should not be construed by anyone to mean that I am opposed to tax reform. I have been on record repeatedly as urging a program of honest tax reform to help as many of our people as possible. I continue to stand ready to support any plan that meets the goal of real reform without favoritism.

Statement Of Senator James P. Dugan

I have affixed my signature to the Committee's recommendations because I feel that considered in toto these recommendations will substantially diminish this state's reliance on the real property tax. This in itself is desirable and necessary.

I have appended this statement to the Committee's Report because I believe the Report falls short of one of the goals we should have reached—that is to make real property taxation itself, as well as our entire tax system, less regressive.

The Committee acknowledges that real property taxation is per se "harshly regressive". An option available to the Committee to make property taxation less regressive was available but rejected. Therein I believe the Committee erred.

I feel strongly that the Committee should have recommended the classification of property for purposes of levying the recommended state-wide 1% property tax. This classification would require constitutional amendment as did the farm land classification amendment adopted in 1963.

A fair system of classification could be developed with 4 or 5 categories ranging from an owner occupied residence with less than 4 dwelling units to a category containing industrial property. The residential property would be assessed at a lower percentage of its true value and the industrial property at a higher percentage.

If adopted, such a system would neutralize the shift of tax burden from industrial and commercial properties to residential properties which has taken place since 1956 consequent to the several decisions in the Switz v. Middletown cases. I believe that the consequences of the Switz cases were socially and economically undesirable and that that shift from commercial and industrial taxpayers to residential property taxpayers should be reversed.

Additionally, classification of properties will insure that parity of benefit between residential and business and industrial taxpayers is maintained after the Committee's proposed substantial reduction in real property taxes. Absent classification, I am unsure that that parity has been maintained in the Committee's recommendations. I feel that the commercial and industrial taxpayer may have achieved some advantage by the Committee's recommendation. Further, I believe that even if the commercial and industrial taxpayer's position is unchanged by the Committee's recommendations, business and industry still can and should pay a larger share of the state-wide tax burden than they are called upon to bear in the Committee's report.

The Committee's report and our study does not make a convincing case against classification. The cited ad-

monition of an obscure Minnesota tax official not to try classification is hardly persuasive. I do not doubt that the Minnesota experience in classification may be controversial. It is so because of the multiplicity of categories and the legislative ease in expanding the number of categories. We in this State could obviate both objections by constitutional fiat limiting the number of categories in our classification scheme.

The opponents of classification make the additional arguments that classification will shrink the real property tax base. It will not if we adjust the percentage of assessed value of the different categories to produce the desired \$553 million called for in the Committee's report.

I am also convinced that unless we have classification of property we will not have achieved and or may not be able to maintain in the future an acceptable level of taxes to be paid by the low and moderate income residential taxpayer. This in view of the recommended increased and new non-property taxes he will be called upon to pay.

As a companion recommendation to the proposed real property tax reduction I would recommend relief to the residential rent payer by an appropriate rent-leveling plan. To effect that relief, I hesitate to accept an income tax credit in itself as the answer. Without some system of rent-leveling, we cannot determine if the rent payer is paying a reasonable or an exorbitant rent. If the rent is reasonable, tax credit might not be necessary, if it is exorbitant a tax credit might be insufficient relief.

There is another area where I voice disagreement with the Committee report. I do so hoping to suggest improvement on the Committee's recommendations during the coming legislative treatment of these proposals.

In this respect I speak of the removal of sales tax exemption from clothing and foot wear. I have little objection to a sales tax on silk shirts, but taxing clothing sales may have attendant administrative problems which would make it difficult or impossible to effect rebates to low income families. The rebate system proposed by the Committee, even if it were to work, does not in my judgment make this tax acceptably progressive.

Finally, I view the Committee's individual and collective recommendations as a commitment to the reduction of the property tax and my support of all individual recommendations is conditioned on legislative implementation of that commitment. My support is further qualified by the views I have expressed herein, particularly those concerning classification of real property.