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Can't look to the state for relief With Jersey effectively broke, tax reform must depend on ironclad spending controls

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New Jersey faces unprecedented fiscal challenges a massive structural state deficit, surging state and local expenditures and an overreliance on the property tax. This primer attempts to show the baseline dimensions of the problem in order to understand the extraordinarily difficult choices that must be made in the months and years ahead.

Like all New Jersey residents, we have become addicted to Mercedes-Benz-level public services, but we want to pay only Chevrolet prices. We also cling to the notion of home rule with our 566 municipalities and 616 school districts, but we don't want to pay for that either. Share services with a neighboring town? No way.

Some of this is illogical. For example, as a result of our desire to provide excellent educational opportunities for our children, New Jersey has the highest per pupil expenditures of any state. So are the voters getting what they want? Not exactly.

Simultaneously, people strongly object to the high property taxes that make these expenditures possible and to the 3.5 percent cap on increases in school expenditures that was designed to slow hikes in those very same property taxes.

The solution? For many, it's all too simple - turn to the state, the ultimate source of funds that could substitute for the property tax. Unfortunately, the state is effectively broke. It has to surmount a \$4 billion structural deficit for fiscal year 2006 before finding the means to pay for any property tax relief/reform.

How did the state get into such a fiscal morass?

The first reason stems from the 1990s' bubble economy. After growing on average by only 2.8 percent per fiscal year from 1994 to 1997, gross income tax revenues surged by 13.5 percent per fiscal year from 1998 to 2001, propelled by capital gains linked to the stock market bubble. Unfortunately, this unprecedented revenue surge became permanently built into the state budget. Then income tax revenues plunged by 14.4 percent in 2002 and by another 1.5 percent in 2003, leaving a massive structural deficit.

The second reason was soaring operating expenditures - a 16.4 percent increase in the state budget for fiscal year 2005 alone - financed, in part, by long-term bonding since outlawed by the state Supreme Court. The result was a perfect fiscal storm that has yet to run its painful course.

However, let's assume that mission impossible - a fiscally sound, balanced 2006 state budget - is accomplished. How do we then proceed?

In 2003, New Jersey households and businesses paid \$17.2 billion in property taxes. While defining property tax relief/reform is elusive, one simple approach is to reduce this total by a significant amount. For example, a 50 percent reduction would require replacing \$8.6 billion in property taxes annually with new revenues from expanded state tax sources. A 25 percent drop would require \$4.3 billion in replacement revenue. These are daunting amounts that would increase each year in proportion to any increase in spending. Property taxes rose \$1.3 billion (7.6 percent) in 2003 and by \$1.2 billion (7 percent) in 2002. At such rates of increase, it would not take long to undo any tax reform.

The state's three largest revenue replacement sources in 2003 were the sales tax (\$5.9 billion), the gross income tax paid by individuals (\$6.7 billion) and the corporate business tax (\$2.5 billion).

To calibrate the magnitude of the trade-offs involved, a 1-cent increase in the state sales tax would yield approximately \$1 billion. A 4- to 8-cent boost in this regressive tax would cause economic damage by diverting consumer and business spending to lower-tax jurisdictions, and as a result, the increase would not yield the expected revenues even at the higher rates.

The corporate business tax has undergone a comprehensive reform to achieve equity. A doubling or tripling of the rate would be required to provide property tax relief/reform. There can be little argument that increases of that magnitude would have severe economic repercussions hurting the competitive position of New Jersey's business sector, thereby reducing employment and other tax revenues.

The income tax would have to be more than double the existing effective rates - already some of the highest in the nation at the middle and upper tax brackets given the broad definition of taxable income in New Jersey - to yield the \$8.6 billion necessary to halve property taxes.

The new "half-millionaire" tax - affecting only those 28,500 tax filers who have incomes above \$500,000 - will probably produce less than \$1 billion in the current fiscal year. Sharp increases in rates affecting taxpayers down to the \$50,000 income level would be necessary to secure the needed income tax revenues.

There are simply no easy ways around these numbers. One-shot revenue schemes help temporarily but only delay the final necessary tough reckoning. The costs of meaningful property tax reform (\$8 billion) and of closing the structural deficit (\$4 billion) would require a total of \$12 billion annually. This is equivalent to 43 percent of the \$28 billion state budget. Merlin the magician could not accomplish this feat.

Attention, then, must inevitably and necessarily be paid to expenditures. The issue is not the merits of these expenditures - most are for important purposes. Rather, it is the sheer scale and rates of increase in public spending that have created the structural deficit.

Comprehensive and mandatory spending controls are needed to close the open checkbooks of school districts, municipal, county and state governments. Because the demand for public expenditures will always outstrip the supply of tax revenues, fiscal firewalls are required to counter the unrelenting pressures of public program constituents. Otherwise, we will be on a treadmill that is set for ever-faster spending and taxing speeds.