



Fundamental Reform: Land Use, Regulatory, and Fiscal Reform in New Jersey

A Regional Plan Association / Lincoln Institute of Land Policy Partnership Project

Over the last decade, New Jersey has emerged as a leading state for fiscal reform and land use planning. Now many in New Jersey are examining the possibilities for fundamental changes in the balance between state and local revenue collection. Some argue that this initiative should be undertaken by calling a Constitutional Convention, targeted for 2006; others argue that the legislature can and should address these issues without a convention. The overriding goal of both efforts is to re-write laws and regulations in order to shift the burden of financing public services, in particular education, away from local property taxes and onto some new array of revenues. Some say that reform should be revenue neutral, focusing solely on structural changes to the tax system; others argue that in order to keep taxes down, reform must also include finding ways to cut spending. Of particular concern to RPA is that any changes should result in reforms that improve fiscal equity and land use, rather than simply reducing property taxes.

The current system relies heavily on property taxes for revenue; for fiscal year 2001-2002 over 65% percent of all taxes collected in the state were local taxes, with over 75% of these coming from property taxes. Compare this to all municipalities in the nation, where 60% of local revenue is from local sources, and 45% is from property taxes. New Jersey's heavy reliance on local property taxes results in wide discrepancies in the resources available to different municipalities, and, ultimately, to rising property taxes that hurt lower- and fixed-income households. Heavy reliance on locally-collected property taxes also creates competition among municipalities for development that brings with it fiscal benefits. This often leads to perverse land use decisions, including limitations on residential land uses that restrict the supply of housing. Further, the system creates competition among municipalities, rather than the cooperation needed to keep down costs of providing public services. With 21 counties, 566 municipalities, 611 school districts, and 400 local authorities and fire districts, New Jersey has a highly fragmented governance structure that keeps the cost of providing public services higher than if some of these services were provided cooperatively.

Public interest in property tax reform has created an opportunity for fundamental reform of this highly fragmented fiscal system. To take advantage of this opportunity, Regional Plan Association and Lincoln Institute of Land Policy are co-hosting a series of panel discussions in anticipation of the proposed property tax convention. These forums will illuminate the relationship between fiscal policies and the landscape in which we live. The first panel, entitled "How Can We Afford Smart Growth," will educate decision-makers and the public about the financial obstacles to realizing smart growth, and will suggest tools to overcome these barriers. The second panel, entitled "Housing and School Funding," will examine reforms with the potential to ensure sufficient school funding and an adequate supply of housing. The third panel, "Differential Taxation for Land and Buildings," will address the question of whether land and buildings should be taxed differently. This paper serves as a briefing paper for the first of the panel discussions.

How Can We Afford Smart Growth?

All across the state and country, planners are espousing Smart Growth: traditional, mixed-use community development based around transit systems. Yet our fiscal policies often encourage municipalities to build in ways that subvert this model: to shun housing suitable for middle-income families, to locate low-density malls and corporate offices at the edges of towns far from transit and existing development, and to overlook and undervalue natural systems. Similarly, developers find it easier to finance, design and build cookie-cutter developments on greenfields rather than to create lasting communities in patterns supportive of long-term social, environmental and economic goals.

The blame for this lies partly in the fact that municipalities and developers face short-term financial incentives that discourage Smart Growth. What are these incentives and what needs to change so that Smart Growth becomes the first choice for developers and municipalities? This paper briefly describes the following to provide a framework for discussion:

- The impact of NJ property taxes on local government incentives;
- The infrastructure and development costs of smart growth;
- The Somerset County Regional Center: A case study; and
- Potential financing reforms

Local Government Incentives

New Jersey's local governments rely heavily on their own sources for revenue, in particular the property tax. In FY01-02, almost 65% of local revenue came from local sources, with over three-quarters of this from local property taxes. Consequently, what gets built and how much gets built has a big effect on local budgets.

New Jersey is a Home Rule state, where municipalities have enormous control over land use. Not surprisingly, they use this control to attract development that promises short term revenues and lower costs, and to shun development that will impose new costs. It is commonly believed that the most lucrative development types tend to be commercial and retail properties, while residential development is often the biggest drain financially. A study of several New Jersey municipalities by the American Farmland Trust found that for every dollar in revenue brought in by residential development, \$1.14-1.51 in costs were generated. Commercial and industrial properties, on the other hand, cost only \$0.17 to 0.34 for every dollar in revenue; agriculture and open land costs \$0.33-0.66 for every dollar in revenue.

These financial incentives have a significant effect on New Jersey's built environment. Municipalities overzone for commercial development, such as malls and office parks, and underzone for housing, especially multi-family housing. They often locate commercial zones in places that promise to be most attractive to developers and least disruptive to current residents – this tends to be on greenfields, far from existing development. Local open space protection programs, too, can be used to avoid residential development and – when not part of a larger regional open space plan – can push

development outward, creating leapfrog patterns of growth. Meanwhile, municipalities often limit zoning for all but age-restricted housing in order to avoid the costs of educating school-age children, which, on average, accounts for over half of local expenditures in New Jersey. Ultimately, this restricts the supply of housing and leads to high housing costs.

Moreover, the current tax system creates competition rather than cooperation among municipalities, with winners and losers, but no net increase in overall property taxes. Those who lose tend to be those who can least afford it: distressed urban areas, where the tax base has shrunk as people have moved out. Here, local governments are forced to increase the tax rate on the remaining population (which tends to be less able to pay high taxes, and more in need of services). Higher tax rates further discourage investment, pushing it outward to the suburbs and rural fringe, where tax rates tend to be lower.

While the developing suburbs can win in the short term, in the long term this system hurts them too. In order to raise money to pay for new services or capital costs, local governments often face the choice of increasing property taxes, cutting spending, or attracting new development to expand the tax base. Elected officials, under pressure to keep taxes low without cutting services, often choose to attract more development, which leads to the need for more services or facilities, and so on. As the municipality becomes built-out with no land available for new development, taxes must eventually rise.

Fundamental reform is needed to break the cycle of disinvestment in urban areas, development on the suburban fringe, a restricted housing supply, and rising property taxes. Such reform needs to change local government incentives to encourage land use decisions that make sense in the long run – socially, environmentally, and financially – rather than being forced by immediate circumstances to encourage sprawling development.

The Infrastructure and Development Costs of Smart Growth

While some studies suggest that Smart Growth costs less than sprawl over the long run, specific Smart Growth projects – such as the development of a transit village – may be quite costly up front. They may require extensive infrastructure investments beyond the capacity of a local government or a developer to deliver, including such things as land assembly, acquisition of open space, streetscaping, greenway and park development, green infrastructure construction, road construction and improvements, and water and sewer system upgrades, among others.

While some of these costs can be defrayed by state and federal funding sources – such as grants from the New Jersey Office of Smart Growth – some communities find that funding these projects is a significant hurdle even with grants. Possible sources of revenue include public-private partnerships, special improvement districts, or tax increment financing. It is also reasonable to consider new regional or state-wide funding sources to cover some of the costs of local Smart Growth projects so long as the project

embodies Smart Growth principles that, in the long run, benefit the state or region as a whole.

Developers, too, face financial incentives that discourage smart growth in favor of generic developments on greenfields. In fact, sometimes zoning makes this the only legal choice. But even when developers are encouraged to create more sustainable patterns of development, higher up-front costs of smart growth can inhibit such investment. Greenfield developments can be cheaper and easier to build than infill, which may have higher planning and design costs due to the need to accommodate existing structures and development patterns. Regulatory hurdles may dissuade developers from taking on a project; this is particularly true when brownfields are present, which may have the added cost of environmental cleanup. In addition, residents may be unreceptive to the added density typical of smart growth; community objections and stalling tactics (such as lawsuits) can be an unpredictable cost of development.

Even when the community and the regulatory structure welcome smart growth, developers who favor this form of development can be thwarted by traditional financing practices. As Christopher Leinberger has pointed out, most financiers understand only a limited range of development types, all of which are stand-alone, automobile-oriented single-use structures that, when combined, generally form low-density sprawl. Getting financing for buildings that fall outside of these conventional types – for unique mixed-use buildings in existing centers, for example – can be an uphill battle often requiring higher projected rates of return.

Further, Leinberger writes that lending practices favor short-term investment antithetical to the creation of a durable built environment. Typical measures of return on investment only consider revenues generated over a period of 7-10 years; revenues generated beyond that are not even factored in to the decision about whether to invest. As a result, standard investment practices are biased in favor of buildings that create quick returns on investment; developers have no incentive to invest in assets that generate returns beyond the 7-10 year horizon. And yet durable, long-term investment is exactly what communities need to prosper over the long run.

Smart Growth in the Somerset County Regional Center: A Case Study

Given the financial structures described above, it is no wonder that durable, well-designed developments that support transit and respond to natural systems are not being built as readily as many people would like. What policy reforms can change this dynamic so that smart growth can become a more affordable and attractive option for both municipalities and developers? Where can revenue be found to implement specific Smart Growth projects?

RPA, with funding from the Lincoln Institute of Land Policy, has been working with the Somerset County Regional Center (SCRC) to find answers to this question. The SCRC is a 25-square mile stretch of sprawling suburban landscape, consisting of the Boroughs of Raritan and Somerville and portions of the Township of Bridgewater. RPA and LILP have worked with the Regional Center since 1999, when RPA helped direct the

Somerset County Regional Center Vision Initiative, an ambitious planning effort that resulted in a regional vision plan that is now guiding the Regional Center communities toward a more sustainable future.

RPA's work with the SCRC envisions the Center as a more compact, transit-oriented place shaped by natural systems. In particular, the vision is organized around three organizing principles:

- "Points" refers to connecting and strengthening the sub-centers in the three municipalities;
- "Lines" exploit the potential of the road network to connect communities; and
- "Planes" reinforce the role of natural systems in shaping redevelopment.

This vision has the support and enthusiasm of the community and elected officials – essential early steps toward realizing the plan. There is a remarkable degree of inter-municipal cooperation. The vision has also been developed into a master plan for the center, and there has been substantial on-the-ground progress around specific initiatives.

Yet developer interest is only lukewarm, and residents – though enthusiastic about the vision plan in general – are skeptical of new higher density development proposals. The costs of implementation are also a major barrier. In addition to potentially several hundred millions of dollars in infrastructure and development costs, municipalities also lack the basic staff resources to implement such an ambitious agenda.

Potential Financing Reforms

RPA and LILP, with the help of Henry Coleman and Paul Gottlieb of Rutgers University, have examined ways of modifying this system, using the Somerset County Center as a case study, so that development patterns that make sense on a regional scale also make financial sense to the individuals – the residents, elected officials, and developers – who, ultimately, must act to realize them.

Coleman and Gottlieb have explored a wide variety of tools, focusing on five that have the potential to reduce competition among municipalities and create incentives for developers to invest in centers. These are:

Tax increment financing: Tax increment financing works by diverting the increase in taxes generated by new development to pay off bonds sold to pay for certain development costs. Using TIFs raises money for infrastructure and other costs related to redevelopment that would not have been available otherwise. Used carefully, TIFs can tip the balance toward development of properties that otherwise would be financially unattractive to developers; of course, TIFs can just as easily be used to fund a big box warehouse as a transit village. And, if development does not come through as planned, TIFs can leave a municipality with uncovered debt. Finally, if used indiscriminately, TIFs can act as a form of public subsidy to development that would have happened within the region anyway; in other words, TIFs can be simply another tool municipalities use to try to win the race for ratables.

Tax base sharing: In a tax base sharing system, different municipalities within a region pool and redistribute some or all of their revenues. Tax base sharing thus helps to reduce competition among jurisdictions for fiscally desirable development, and encourages municipalities to pursue more efficient development patterns that benefit the region as a whole. Because costs and benefits are at least partially shared, the tax burden and revenues among participating municipalities will be more equitably distributed. However, municipalities are often unwilling to enter into tax base sharing agreements for fear of losing revenue to their neighbors. The state may need to provide strong direction or incentives before municipalities are willing to adopt a tax base sharing agreements.

Shifting to a land tax from property tax: Because property taxes are a tax on improvements to land – i.e. buildings and other improvements – they deter landowners from making improvements, instead encouraging speculative landholding and inexpensive, low-density development. Economists theorize that by shifting from a property tax to a land tax, this dynamic can be undercut. A land tax bases values on the site rather than improvements to the site. Under a land tax system, sites near transit and with existing infrastructure, for example, are taxed at a higher rate than those without such amenities. Landowners of high-value sites are thus encouraged to use their land to the maximum extent possible in order to maximize their revenue and offset higher taxes; because property taxes are either eliminated or decreased as land taxes are increased, the disincentive to improve land is minimized. Investment thus flows toward high value sites, and away from low value sites; towards places with existing infrastructure, such as older cities and centers, and away from undeveloped open space and farmland. And because owners of high-value sites have the incentive to build at higher densities, housing supply will likely increase, thus lowering the cost of housing. One drawback of the land tax system is that, when shifting from the current system, setting the correct tax rates will be difficult, especially since there are few real-world examples of land tax systems from which to learn. And, while land taxes should, in theory, prompt a developer to maximize the use of property, they do not prompt the municipality to zone for Smart Growth.

Reduced reliance on local property tax: There are two components to the problem of over reliance on the property tax: first, the fact that it is a local source of revenue, and second, that it is a tax on the improvements to land rather than to land itself. The former creates the race for ratables; to the extent that municipalities have to rely on their own resources, they will compete with one another to maximize these resources. The second encourages land speculation and low-density development. By shifting some or all of the local tax burden to the state, local reliance on the property tax can be minimized.

Taxes that vary by state plan designation: Development can be encouraged by targeting property tax breaks in areas where development is desired, such as state-designated centers, and planning areas one and two. Conversely, raising property taxes in areas where development is inappropriate will discourage development. The 1988 New Jersey State and Local Expenditure and Revenue Policy Commission (SLERPC) proposed one version of such a strategy. SLERPC recommended integrating and rationalizing the patchwork of existing tax abatement, enterprise zone, and farmland assessment program to support the State Plan. The SLERPC plan would have taxed all new construction at a

state-mandated property tax rate, which would vary according to the State Plan: lower rates in urban areas, encouraging new construction in distressed urban areas, and higher rates in rural areas, discouraging it in environmentally-sensitive areas. Revenues in excess of what would have been collected by the local property tax rate would be collected in a state pool to pay for infrastructure throughout the state. One drawback to this system is that it is difficult to distinguish strong markets from weak ones; in other words, some urban areas would qualify for what amounts to a tax abatement without needing it.

Questions

Which of these potential policy tools will do the most to help realize the Somerset County Regional Center's vision? What other reforms should be considered? Will they be useful in other parts of the state as well? What other sources of Smart Growth funding can be found? If they are useful, can they be implemented as they are? Are they acceptable politically?