



**FUNDAMENTAL PROPERTY TAX REFORM:
LAND USE, REGULATORY AND FISCAL REFORM IN
NEW JERSEY**

**SHOULD LAND AND BUILDINGS BE TAXED
DIFFERENTLY?**

A Policy Roundtable Sponsored by Regional Plan Association and the Lincoln Institute of Land Policy

Wednesday, March 23, 2005
The Joseph C. Cornwall Center for Metropolitan Studies
Rutgers University, Newark, NJ

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Regional Plan Association

**FUNDAMENTAL PROPERTY TAX REFORM:
LAND USE, REGULATORY AND FISCAL REFORM**

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Roundtable 3
Should Land and Building Be Taxed Differently?

Wednesday, March 23rd, 2005
The Center for Law and Justice
123 Washington Street
Rutgers University
Newark, New Jersey

3:00pm	Registration and Reception
4:00pm	Welcome <i>Christopher Jones, Regional Plan Association</i> <i>Armando Carbonell, The Lincoln Institute of Land Policy</i>
4:15pm	Differential Taxation: Should Land and Buildings Be Taxed Differently Moderator: <i>Director Stephanie Bush-Baskette, The Joseph C. Cornwall Center for Metropolitan Studies</i> An Overview of Differential Land Taxation: How Does It Work <i>Professor Brendan O'Flaherty, Columbia University</i> Implementing a Differential Tax System: Case Studies <i>David Brunori, Lincoln Institute Fellow</i>
5:15pm	Legislative Response <i>Former Assemblyman Michael J. Arnone (R) (invited)</i> <i>Assemblyman William D. Payne (D-29)</i>
5:45pm	Questions and Answers
6:20pm	Concluding Remarks <i>Thomas G. Dallessio, Regional Plan Association</i>

Fundamental Reform: New Jersey's Property Tax Burden

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 goals 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 was held on February 23, 2005, and was entitled "How Can We Afford Smart Growth?" The second panel, entitled "Housing and School Funding" held on March 9, examined 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 on March 23rd the question of whether land and buildings should be taxed differently in order to increase density. This paper serves as a briefing paper for the third of the panel discussions.

Should Land and Buildings Be Taxed Differently?

The effect of our present system, which taxes a man for values created by his labor and capital, is to put a fine upon industry, and repress improvement. The more houses, the more crops, the more buildings in the country, the better for us all, and we are doing ourselves an injury by imposing taxes upon production of such things¹.

Property Taxation as Land Use Policy

Taxation has two distinct but equally important functions: first to raise revenue for funding governmental activities and second to encourage or discourage social or economic practices by the imposition or relaxation of tax levies. Thus, a tax can be used by public policy not only to provide for administrative or capital expenses, but also to promote or restrict market activity². There are many examples of taxation as an instrument of public policy: a levy on cigarettes both brings monies to the coffers and controls consumption, while an import tariff protects domestic industries. Tax policy is useful for it provides ostensible freedom of choice as well as a powerful incentive for private activity to conform to the government's policy objectives.

The policy benefits of real property taxation have been questioned across the nation. Currently property taxes in New Jersey are levied on the combined value of land and buildings. Because the bulk of the tax is levied upon the value of improvements on the land rather than on the value of the land itself, any development would subject the owner to an increased tax burden. In effect the property tax has actually served to penalize constructive development and to encourage non-productive land speculation.

In New Jersey, land and building assessments are determined separately. That means we have an opportunity to see how much tax falls on each component of someone's home or business. In Jersey City (with a rate of 4.462% in 1999) about 20% of real property tax revenue came from land. That means that about 80% of its revenue came from buildings³.

By taxing the combined values of land and buildings an incentive is put in place in the real estate market to minimize development. When faced with the possibility of building up a site, a property owner will be penalized if he or she builds to the maximum capacity of its lot. Given that the bigger the building the more taxes you have to pay, there is a clear disincentive to dense development.

Because of this disincentive, some reformers have argued that the tax would be more neutral in its effect if taxes were based on land value alone or more heavily on land, without consideration of the value of improvements or buildings.

¹ Henry George (1885) quoted in: Arthur O'Sullivan. *Urban Economics*. McGraw-Hill, 2003. Page 162

² John Mikesell. *Fiscal Administration. Analysis and Implications for the Public Sector*. Harcourt, 1999. Pages 275-314

³ "The Property Tax Crisis in Paterson" in: www.urbantools.net

The premise of this approach is that increases in the value of a site are generally attributable to public investment in its surroundings and therefore is logically more subject to public recapture, whereas improvements on the site can be ascribed to the owner's efforts and investments. In theory, it will promote larger buildings and maximize development capacity, prevent land banking and derelict areas, and promote rehabilitation and redevelopment.

A land tax is also appealing from a Smart Growth perspective. Because it would encourage property owners to use their land to maximum capacity, development is more likely to occur in developed areas near existing infrastructure where land values are highest. By establishing incentives to build compact urban agglomerations, the propensity toward sprawling low-density environments would be reduced. This potential to align property tax mechanisms with efficient land use incentives should be considered in if New Jersey has a genuine opportunity for fundamental reform of the property tax system.

Such a tax can take two forms: the *land-tax* or tax levied only on land and the *two-rate-tax*, in which land and buildings are taxed at different rates⁴. We will compare below these tax alternatives to the current property tax, but first let's look at the general features of the New Jersey Property Tax system.

New Jersey Property Tax at a Glance

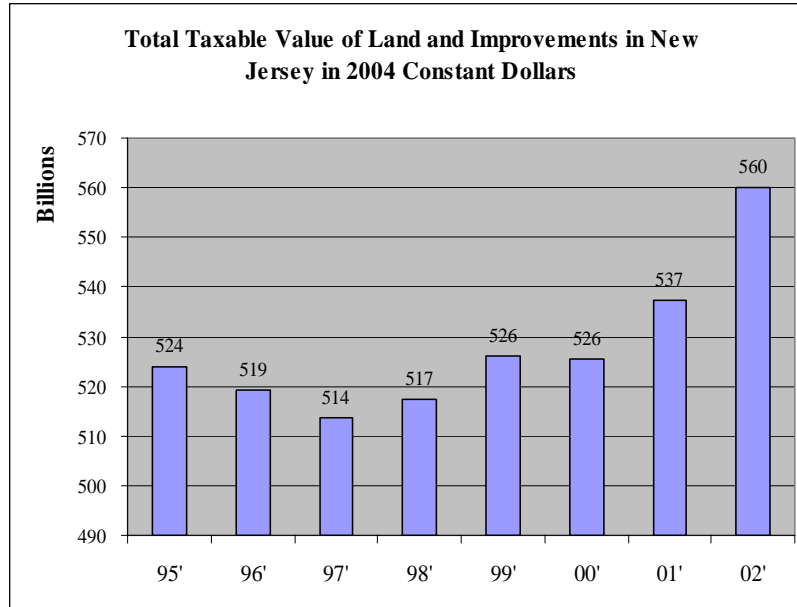
The New Jersey Division of Taxation defines the Property Tax as an ad-valorem, local and residual tax based on the assessment of land and real estate times a tax rate, with the purpose of financing the municipalities, counties and school districts of the State⁵.

It is important to note that although the property tax is an ad valorem, or tax on value, based on real estate assessments (land + improvements), the tax rate is driven by the budgetary needs of local governments. As a residual tax, it is used to fill whatever gap is left in a municipal or county budget after needs have been established and all other revenue accounted for. Before addressing the tax rate alternatives and mechanics of differential taxation in more detail, let's look at the relation between assessments, tax levy and government expenditure in New Jersey:

⁴ Other "Differential Taxes" have been proposed in New Jersey: the SLERPC that would tax according to areas of the State Plan and the New Jersey Future Tax Rate Plan that would impose a uniform rate throughout the State.

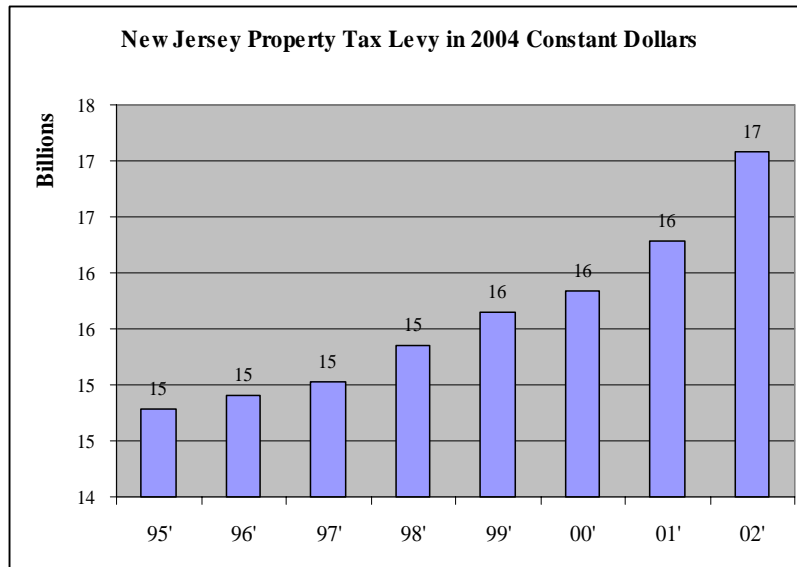
⁵ www.state.nj.us/treasury/taxation/

In 2002 the total taxable value of land and improvements in New Jersey (the tax base) was \$560 Billion, an increase of 6% from 1995.



Source: State of New Jersey Division of Taxation

The tax levy in New Jersey combined for the State increased by 13% between 1995 and 2002 to \$17 Billion as the following table shows:



Source: State of New Jersey Division of Taxation

The increases in the tax base and tax levy, as shown above, show the growth in municipal government services. Between the last two censuses of governments (1997 and 2002) local government expenditure increased in the State by 11% to \$33 Billion in 2004 dollars, compared to a __ increase in property tax. The property tax accounted for 49% of the revenue in 2002, with state and federal aid accounting for the largest share of the remainder.

In the context of a stated goal of the proposed New Jersey Property Tax Convention, we will look at alternatives offered by differential taxation while keeping revenue neutrality in the overall tax levy. Holding total revenue constant, we will address

the potential benefits of putting in place incentives for development in the real estate market by taxing only land or buildings at a lower rate.

Differential Taxation Alternatives

Real property is required in New Jersey to be assessed at some percentage of true value established by the county board of taxation in each county. All 21 counties in New Jersey have chosen 100%. As described earlier, true value is considered to be the combined value of land and improvements.

Given that assessments are determined by market forces, tax policy has only two alternatives to modify the calculation of the tax levy and its burdens. First, it can change the basis of valuation (in this case by excluding buildings from the value of property), or it can adjust the tax rates under the residual mandate of the property tax to achieve different policy and revenue outcomes.

To start, let's look at a base case that uses the existing mechanics of the property tax. The combined taxable value of land and improvements is multiplied by the tax rate to get at the tax bill. The following is an example for a given property based on the Division of Taxation Website:

Assessed Value	\$200,000
x General Tax Rate	.03758
Tax Bill	\$7,516

To determine values and rates would change under differential taxation, three scenarios are explored here.

- First is the current tax system in which land is assumed to represent 25% of the value and buildings the other 75%. The same tax rate is applied to both components of valuation.
- Second is the land-tax where only land is considered for the assessment and only the tax rate on land is used.
- Third is the two-rate tax where both land and buildings are assessed but differential rates are used for each one.

The following table summarizes these three scenarios:

Scenario	Assessment			Tax Rate		Tax Bill
	Land	Improvements	Total	Land	Improvements	
Current System	\$50,000	\$150,000	\$200,000	0.03758	0.03758	\$7,516
Land Tax	\$50,000	-	\$50,000	0.15032	-	\$7,516
Two-Rate Tax	\$50,000	\$150,000	\$200,000	0.09395	0.01879	\$7,516

As seen in this table, revenue is the same for the three scenarios achieving revenue neutrality. The differences in the alternatives are to be found by looking at the components considered for assessment and their tax rates.

The current system uses an assessed value of land and improvements of \$200,000 (\$50,000 for land and \$150,000 for buildings) and a rate 0.03758 for both land and buildings.

The land-tax scenario takes into account only the assessed value of land and its tax rate. In order to achieve revenue neutrality when the tax base is only 25% of the value of the base case, the rate had to be increased from 0.03758 to 0.15032, or four times as high. The tax bill, however, remains constant at \$7,516.

The two-rate-tax takes both land and building assessed values but uses a different tax rate for each of them. In this case the land tax rate more than doubles from 0.03758 to 0.09395, while the improvements tax rate decreases by 50% from 0.03758 to 0.01879.

Under the land-tax and two-rate-tax just described, buildings and improvements are exempted to varying degrees from taxation. Under the current system, an owner that doubled the value of improvements would see his tax bill rise by \$5,637 (\$150,000 times 0.03758). Under a land tax system, his bill would not rise at all. Under the two-rate system, it would increase to \$2,819.

The example demonstrates the mechanics of how the differential tax alternatives remove disincentives to development. However, there are several pros and cons of these systems that must be considered in evaluating their prospects in New Jersey.

Pros and Cons for Land Taxation in New Jersey

A good way to assess the track record of differential taxation is to look for examples where the measure has been implemented. Pennsylvania is the only state in the nation granting cities outright the option to levy different rates.

The state went from two cities in 1975 (Pittsburgh and Scranton), to 20 in 2000 who practiced this reform. All these cities, located in the midst of impoverished Appalachia, are developing 16% more per year than their neighbors according to researchers, and growing denser, meaning they can provide public services like mass transit at lower cost.

Pittsburgh, which from 1980 to 2000 taxed land six times higher than buildings, renewed its urban core without substantial federal subsidy and created an urban park out of its most prime location, the Golden Triangle, without an agonizing citizen's effort to overcome developer resistance. However, the city returned to the conventional property tax in 2001, pointing to hardship that new assessments on land put on many property owners, chiefly that underdeveloped land. Already it has seen a steeper drop in

construction starts, (38.1%), than in the rest of Pennsylvania (1.5%)⁶, according to opponents and critics.

The Pittsburgh case allows us to consider the benefits and pitfalls of differential taxation. On the one side, implementation of the measure appears to have increased new construction and resulted in compact and more Smart Growth oriented development. On the other side, the effects of the tax greatly change the real estate market environment leading to new burdens to owners with less developed land. Given that land was taxed almost 6 times higher, parcels with low density carried the heavier side of the tax shift.

The case provides one of the few empirical tests that highlight three basic issues - equity, administrative feasibility, and the efficiency and effectiveness of the tax –that are generally cited by proponents and critics⁷.

Equity: The basic equity consideration advanced by the proponents is that since a large share of land-value increases are a result of population growth and public and private improvements by others, the community has the right to recapture the unearned increment. Opponents, while not disputing the basic premise of the origin of land-value increases, raise the objection that improvements are already taxed by the income and capital gains taxes.

Opponents also argue that a land-value tax may adversely affect the desirability and availability of centrally located low-income housing. Low-income areas tend to be nearer to central areas where higher-value development would be most encouraged by the tax. In order to compete for sites, low-income housing would have to be very dense or it would be displaced by more intensive nonresidential uses or by more expensive residential buildings.

Those lower-income tenants and homeowners who are not physically displaced would be adversely affected by the tax to the extent their properties are relatively land intensive. A land tax or two rate tax will shift the burden away from the occupants of capital intensive properties to land intensive users. According to the opponents, then, the differential taxes may be regressive rather than progressive.

Administrative Feasibility: Opponents doubt administrative feasibility: Can the site actually be assessed independently of its improvements? Some opponents contend that the demand for urban land is derived from the intensity and character of the demand for structures in general and that the character of improvements on particular sites shapes the demand for the sites themselves. Therefore, it is impossible to assess as if buildings were not on land.

⁶ “Where a Tax Reform Has Worked” www.progress.org

⁷ The following analysis is based on: Donald G. Hagman. *Windfalls For Wipeouts: Land Value Capture and Compensation*. American Planning Association, 1978. Chapter 17

Proponents note that values are now separately assigned to buildings and land in American property-tax systems, so it must be possible and it is necessary to allocate between land and building values to determine how much of the asset can be depreciated for income tax purposes, with only improvements being depreciable.

Those favoring the land-value tax also suggest it will tend to cure the problem of underassessment of real property. The reply, well-taken by the opponents of the tax, is that underassessment has less to do with the form of the property tax than with the will to assess properly and to spend the money necessary to attain quality assessment.

Efficiency and Effectiveness: The basic differential taxation scenario is that the most efficient use of land is to have it devoted to its highest and best use from an economic point of view. The high land tax would cause efficient allocation because landowners would make the highest and best use of each building site. Economic forces plus the tax would automatically provide good, that is, efficient, land planning.

Proponents argue that a greater amount and better quality of development will flow from the greater incentives for development. The tax will thus foster a reduction in building rents as a result of the increase in the supply of buildings. Proponents argue too that in the long run the rise of land prices will stabilize because of the anti-speculation effects of the tax. Meanwhile, the “untaxing” of buildings and improvements would remove disincentives that discourage or penalize wealth-creating effort and density.

A major concern of land-value tax opponents is that such taxation could stimulate overdevelopment, which would lead to the overcongestion of urban areas, creating in turn a host of other problems. Social amenities such as open spaces and recreational land, theatre districts, shopping areas, and hotel districts may be forced out of the central areas if sites are pushed to a higher use. Opponents maintain that it is not important simply to stimulate development but to direct it in socially desirable channels.

Opponents also charge that "taxation can never take the place of wise and efficient land-use planning." Some of the desirable goals, such as the recapture of socially created values and the control of urban sprawl, could be realized in more direct, effective, and efficient ways by a better use both of available land-use planning and taxation systems.

Questions to Consider

- Given these considerations are differential taxes appropriate for New Jersey?
- What would it require politically and legally to institute them?
- Would the Property Tax Convention take this issue as one possible issue to tackle?
- Are the expected benefits of “un-taxing” improvements worthwhile?
- Will New Jersey accept a more sustainable built environment, and will a differential tax live up to the expectation? Or will this lead to a new version of the ratables chase?