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ABSTRACT

Public schools in New Jersey are financed primarily by local property taxes. This system of finance is unconstitutional, according to the New Jersey Supreme Court, and therefore it must be revised. The proposals for revision range from very slight increases in state school aid to complete state financing of schools, but all of the proposals shift at least part of the burden of school finance from local property taxes to state taxes. Thus, all of the proposals for revision provide some relief from property taxes. This paper examines the economic effects of this property tax relief, especially the effects on our hard-pressed central cities. The current system of school finance in New Jersey is unfair primarily because some school districts receive an excessive share of non-residential property taxes. It is also unfair because it encourages exclusionary zoning and because Federal tax laws treat homeowners and renters differently. It is inefficient because the property tax, despite its appeal as a revenue source, has undesirable long-run effects on the growth of central cities. An increase in state aid to schools would reduce these inequities and inefficiencies in proportion to the size of the increase. In particular, more state aid would lower property taxes, raise property values, lower rents, and help revitalize our dying cities. (Author/JM)

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ECONOMIC EFFECTS OF REFORMING SCHOOL FINANCE

Prepared for the New Jersey Education Reform Project

by

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CONTENTS

1. INTRODUCTION AND SUMMARY

Public schools in New Jersey are financed primarily by local property taxes. This system of finance is unfair and inefficient. It is also unconstitutional, according to the New Jersey Sup. 'me Court, and therefore it must be revised. The proposals for revision range from very slight increases in state school aid to complete state financing of schools, but all of the proposals shift at least part of the burden of school finance from local property taxes to state taxes. Thus, all of the proposals for revision provide som: relief from property taxes. This paper examines the economic effects of this property tax relief, especially the effects on our hard-pressed central cities.

The current system of school finance in New Jersey is unfair because there are drastic differences among school districts in taxable property value per pupil. There are two reasons for these differences. First, some school districts are almost entirely residential while others have a substantial amount of industry. Residents in school districts which happen to have industry within their boundaries pay less for schools than residents in school ditricts without industry. This violates the basic principle of tax equity which requires equal treatment of equals.

Differences in wealth are a second source of differences among school districts in taxable property value per pupil. Homes are more valuable in wealthy communities so these communities can raise a given amount of revenue for schools with a lower tax rate than poorer communities. Thus, while residents of wealthy communities may pay more tax dollars per pupil, they are paying a smaller fraction of their income and wealth. The unfairness of this situation is largely a matter of personal values. However, in two respects it contributes to the unfairness of the system. First some, wealthy school districts use their low tax rates to attract more than their share of industry and second, the system is maintained by means of exclusionary zoning practices. Zoning ordinances which effectively exclude low income people even if they are willing to pay their share of taxes are unfair.

One last inequity of the current system of financing schools is the differential treatment of homeowners and renters under Federal tax laws. These laws permit homeowners to deduct property taxes while renters cannot. Thus, they discriminate against renters and therefore against central cities where most rental housing is located.

The current system of school finance in New Jersey is inefficient because it has distorted the pattern of urban development and contributed to many of the problems of central cities. Its reliance on local property taxes has raised rents, lowered property values, and discouraged investment in buildings. This has contributed to the exodus of people and jobs from the central cities and to the growth of central city slums. (All of these side effects of the system of school finance are explained in greater detail in section 3).

Many of the inequities and inefficiencies of the current system can be alleviated in New Jersey by increasing the role of the state in financing schools. The benefits of an increase in state aid to schools are proportional to the size of the increase, so a larger increase in state aid will provide greater fairness and more efficiency than a small increase. Therefore, this paper recommends a very substantial increase in state aid to schools.

In summary, the current system of school finance in New Jersey is unfair and inefficient. It is unfair primarily because some school districts receive an excessive share of non-residential property taxes. It is also unfair because it encourages exclusionary zoning and because Federal tax laws treat homeowners and renters differently. It is inefficient because the property tax, despite its appeal as a revenue source, has undesirable long-run effects on the growth of central cities. An increase in state aid to schools would reduce these inequities and inefficiencies in proportion to the size of the increase. In particular, more state aid will lower property taxes, raise property values, lower rents, and help revitalize our dying central cities. Therefore, it is the conclusion of this paper that state aid to schools should be increased substantially.

2. WHY THE CURRENT SYSTEM IS UNFAIR

The current system of school finance in New Jersey is unfair. There are three aspects to this unfairness. First, school districts have vastly different levels of assessed property valuation per pupil. Second, school districts have an incentive to use low-density zoning ordinances to exclude lower-income families from districts with low school property tax rates. Third, federal tax laws give homeowners preferential treatment in comparison to renters and this in effect discriminates against residents of central cities. We will examine each of these inequities separately.

2.I Differences in Assessed Valuation

To demonstrate the unfairness of differences in assessed property valuation, let us compare two New Jersey school districts, Secaucus and Plainfield. The data for this comparison are presented in Table 1. Secaucus is highly industrialized while Plainfield is an urbanized area with relatively little industrial property. Average family income is almost the same in these two districts; it was less than two percent higher in Plainfield in 1970. However, school expenditures per pupil in Secaucus were 25% higher in 1971-72 while the school property tax rate was only about <u>one-third</u> of the rate in Plainfield. How can Secaucus raise more revenue with a lower tax rate than Plainfield if incomes and therefore house values in the two districts are nearly equal? The answer is that Secaucus has a great deal of industrial activity while Plainfield has relatively little. As a result, the assessed valuation per pupil in Secaucus is nearly four times the assessed valuation per pupil in Plainfield. In other words, Plainfield residents would have to pay four times as much in taxes to achieve the same level of expenditures per pupil as Secaucus. This is unfair.

Table 1

	Secaucus	Plainfield	Englewood Cliffs	Princeton
Enrollment (1972)	1,832	9535	1219	3675
Average Family Income (1969)	$12,451	$12,671	$25,029	$19,955
Expenditure per Pupil (1971-72)	$1,312	$1050	$1647	$1518
School Tax Rate (1972)	1.10%	3.09%	1.13%	1.64%
Valuation per Pupil (1971-72)	$134,753	$35,031	$162,337	$93,522

SOURCES:

New Jersey Education Association, Basic Statistical Data of New Jersey School Districts: 1973 Edition.

United States Census of the Population, 1970. General Social and Economic Characteristics: New Jersey.

The comparison of Secaucus and Plainfield illustrates the unfair distribution of non-residential property tax revenues among school districts with similar income levels. However, income levels vary widely among school districts in New Jersey and differences in income or wealth may also be responsible for large differences in assessed valuation per pupil.

Homes are more valuable in high-income school districts. Thus, even without industry, high-income school districts are able to enjoy greater expenditures per pupil with lower school property tax rates than poorer school districts. Residents of these high-income school districts pay more tax dollars per pupil but they are paying a smaller fraction of their income than residents of poorer school districts.

Every possible combination of income level and industrial activity may be found among New Jersey's school districts. For example, Englewood Cliffs is a high-income suburban school district with substantial industry. As indicated in Table 1, Englewood Cliffs spends 57% more per pupil than Plainfield with a tax rate just over one-third as high. An example of a high-income suburban area with relatively little industry is the Princeton Regional school district which spends 45% more per pupil than urban Plainfield and has a tax rate just over one-half as high.

The real issue is whether schools should be financed by taxes which vary with the benefits received or taxes which vary with the ability to pay. The current system of school finance is based primarily on taxation according to the benefits received. Thus, residents of high-income school districts pay for their own schools, but despite their high incomes, they do not contribute property taxes to other school districts. Advocates of taxation on the basis of ability to pay consider this system unfair.

2.2 Exclusionary Zoning

Under the current system of school finance in New Jersey, school districts have a financial incentive for exclusionary zoning. The amount of property taxes a family pays is proportional to the value of its property, not to the number of school-age children in the family. A low-income family with several school-age children living in a small, inexpensive house in a wealthy school district with a low tax rate is subsidized by its higher-income neighbors. In most suburban school districts, the higher-income neighbors object to paying this subsidy so they pass exclusionary zoning laws which require minimum lot sizes and prohibit apartments. This insures that homes in the local area will have high property values and thus generate more property taxes per school-age child than smaller homes or apartments. If high-income school districts allow a large number of low-income families to move into the school district, property tax rates must rise to maintain the existing level of expenditures per pupil. This provides an important incentive for the exclusionary zoning that characterizes many New Jersey school districts. These zoning practices are unfair because they exclude families from some communities and school districts even if the families would be willing to pay their share of school taxes. They are excluded because they cannot afford expensive housing. In this way the current system of school finance artificially restricts the mobility of low-income families. An increase in state school aid which helped to reduce property taxes would alleviate this situation.

2.3 Federal Tax Discrimination

The third inequity in the current system of school finance is the result of differential Federal tax treatment of homeowners and renters.

Federal tax laws allow homeowners to deduct property tax payments from their taxable income while renters cannot deduct any part of the property tax burden they bear. This differential treatment discriminates against central cities since a disproportionate share of rental housing is located there. The obvious remedy for this problem is a change in federal tax laws, but in the absence of Federal action, the states can reduce the inequity by reducing the property tax burden. This relief provides more help for renters than for homeowners and therefore helps to redress the inequity. Thus, an increase in state school aid which led to lower property taxes would reduce housing costs by a larger amount in central cities than in suburbs and rural areas, making the central cities more attractive as a residential location. This would allow those people who prefer to live in central cities to do so without paying such a large financial penalty. The result would be a fairer system of school finance and a fairer system for choosing where to live.

3. WHY THE CURRENT SYSTEM IS INEFFICIENT

The current system of school finance in New Jersey is inefficient. Its reliance on the property tax distorts the pattern of urban development and exacerbates many problems of the central cities. Specifically, the use of property taxes to finance schools lowers property values, discourages investment in buildings, and raises rents. We will discuss each of these three effects of property taxes in turn.

3.1 Property Values

Higher property taxes lead to lower property values. To illustrate this relationship, let us compare two New Jersey school districts with roughly equal school expenditures per pupil. Union Township spent $1,079 per pupil in 1971-72 while East Orange spend $1,100 per pupil. However, the school property tax rate is only 1.28% in Union Township while it is 2.83% in East Orange. Thus, to achieve roughly the same level of school expenditure per pupil as Union Township, the tax rate in East Orange must be more than twice as high as in Union Township.

Suppose a contractor builds a house in Union Township at a cost of $30,000 and an identical house in East Orange which also costs $30,000 to build. If both houses are assessed at a full value of $30,000, the school taxes in Union Township will be $384 every year and the school taxes in East Orange will be $849 every year. Because a potential buyer must pay so much more in school taxes every year in East Orange for the same level of school expenditure per pupil, he will not be willing to pay as much for the house there as he will for the same house in Union Township. In other words, higher property taxes reduce the market value of property.

In slightly more technical terms this relationship between property values and property taxes can be expressed in the following way. The value of a piece of property is determined by the stream of net benefits from the property over its lifetime. This stream of net benefits is equal to the stream of income from rents minus the costs of maintenance and property taxes. For owner-occupied housing, a rent equal to the value of the housing services provided by the property is imputed to the owner. When property taxes are reduced, property owners retain a larger share of rental income and the stream of net benefits is increased for each year of the life of the property. The effect of a tax cut on the market value of the property is therefore much larger than the amount of tax savings in any one year. Whether it is expressed in terms of the difference in taxes between Union Township and East Orange or in terms of a stream of benefits, the same relationship holds true. Higher property taxes lead to lower property values and therefore an increase in state aid to schools which enabled school districts to reduce property tax rates would lead to higher property values.

3.2 Investment in Buildings

Higher property taxes discourage investment in buildings and lower property taxes encourage it. This effect is manifested in three ways.

First, new construction is more profitable and therefore more likely in school districts with lower taxes. State school aid legislation which increased the fairness of the system of school finance in New Jersey would undoubtedly encourage new construction in those school districts which have the heaviest school property tax burden under the current system. Second, there is an incentive for new construction to take the form of taller buildings when property taxes are reduced. This is likely to stimulate the economies of our central cities and encourage a higher density pattern of urban development. Third, lower property taxes provide an incentive for greater investment in the maintenance of older buildings. This is likely to slow down the process of deterioration and abandonment which afflict many neighborhoods in our central cities. Let us take a closer look at these three aspects of the relationship between property taxes and building investment.

Property taxes are literally taxes on buildings. They raise the cost of owning property and thus discourage the production of buildings. The comparison of Union Township and East Orange illustrates this effect. If a contractor can get a higher price for his buildings in Union Township where property taxes are lower, he will prefer to build in Union Township and not in East Orange. Thus, the higher property tax rate in East Orange discourages construction there. More importantly, a reduction in property taxes would increase the profitability of owning buildings and thereby stimulate new construction. This effect would be especially strong if the tax reductions were largest in areas with the highest existing tax rates.

The second effect of lower property tax rates on construction activity and investment in buildings is the stimulus for taller buildings. On a given piece of land, a lower property tax rate makes it profitable to invest more money in buildings on that land. Lower property tax rates raise the value of land and therefore it becomes efficient to economize on the use of land by building taller, more expensive buildings. In other words, as the value of the land rises, taller buildings must be built on it to pay for the extra land cost. Since property tax reductions would raise land values and the profitability of investment in property, they would stimulate construction of taller buildings.

These taller buildings encourage higher density living. High property taxes have artificially stimulated suburbanization by discouraging investment in buildings. There are several reasons why the time may be ripe for a movement to higher density living. The energy crisis has increased our awareness of the costs of commuting from distant suburbs. Higher residential densities mean less travel and therefore less pollution as well as less energy use. Congestion would increase but slower speeds in traffic may be largely offset by shorter travel distances. In any case, staggered work hours, highway tolls, special bus lanes, and mass transit are all better approaches to the problem of congestion than a high property tax rate. Congestion is not a valid reason to oppose lower property taxes.

In recent years, more new apartments and condominiums have been built than unattached homes. Thus, a trend toward higher density living is already underway. This trend, especially if it is stimulated by lower school property taxes, can play an important role in revitalizing our central cities.

Suburbanization has been occurring for at least the last eighty years and many forces in addition to property taxes are responsible for the process, but there are some people who would prefer to live in the central city if they did not have to pay an unfair price in terms of undermaintained housing, inferior schools, and higher property taxes. An increase in state school aid which enabled school districts to reduce property taxes would help to eliminate these unfair burdens of living in the central city.

The third aspect of the relationship between property taxes and investment in buildings follows the same principle as the first two aspects. Lower taxes mean greater profitability and therefore greater incentive to invest. The only difference is that most of the buildings in urban areas are not new. They cannot be moved to another school district and most of them cannot be made taller. Nonetheless, these buildings are affected by a reduction in property taxes.

One of the most serious aspects of the urban housing problem is the deterioration of housing through lack of maintenance. Recent studies by Dr. George Sternlieb, of Rutgers University, conclude that a substantial part of this lack of maintenance is the result of financial inability. Most owners of deteriorating buildings would prefer to maintain their investment, but they cannot profitably do so. Lower property taxes would provide direct financial relief for this problem, leaving landlords with more money for necessary maintenance.

Therefore an increase in state aid to schools which enabled school districts to lower their property taxes would stimulate the construction of new and taller buildings and the maintenance of existing buildings. It would also allow people to choose between the central city and the suburbs without having to pay an unfair price for living in the central city.

3.3 Rents

Homeowners benefit directly from lower property taxes, but renters receive benefits only through the effect of taxes on rents. Property taxes are a cost of business for landlords and when taxes go up so do rents. Conversely, if property taxes go down, so will rents. However, rents will respond to changes in taxes with a time lag. To see how this happens, it helps to recall the conclusion of the previous section that lower property taxes stimulate construction. As new construction is completed, competition for tenants is stiffened. Landlords do not lower their rents out of concern for their tenants, but because they are forced by competition to lower them or to lose tenants and end up with vacancies which earn no rent. In a period of chronic inflation and rising property taxes, declining rents are rare, but there are examples of this phenomenon. Office rents in downtown Manhattan fell substantially when the World Trade Center was built. Rents throughout Seattle fell during the period of the largest layoffs at Boeing. The competition of the marketplace does enforce the law of supply and demand. Thus, if increased state aid to schools permits lower property taxes, there will be competitive pressure on rents to fall.

In the short-run, before new construction has time to occur, renters may find themselves paying higher state taxes without offsetting benefits from lower property taxes. (Of course if they are in a poor school district, they may get better schools.)

This unfair treatment of renters can be offset if a state income tax is used to finance increased state aid to schools by allowing renters a tax credit on their state income tax equal to a percentage of their rent. This tax credit would recognize the fact that a substantial share of the property tax on rental units is paid by the tenants. That is, the landlord passes on any tax increase by raising the rent. Since homeowners receive tax benefits from lower property taxes a tax credit for renters would make the shift from local property taxes to state income taxes a more equitable system for everyone.

Rents and property values are related. In a world without property taxes, higher rents lead to higher property values. However, property taxes are a wedge between rents and property values, driving rents up and/or property values down. If landlords could raise their rents by $100 every time their property taxes went up by $100 without fear of losing tenants, then the market value of rental property would not be affected by changes in property tax rates. Alternatively, if landlords could not raise their rents at all when their property taxes went up by $100 for fear of losing tenants in a weak market, then the market value of rental property would fall considerably. Both of these extreme situations are unlikely and in general a change in property taxes will affect both rents and property values.

Thus, the burden of the property tax falls partly on the landlord, whose property value is reduced, and partly on the tenant, whose rent is increased. Consequently, both landlord and tenant will benefit from increased state aid to schools if it enables school districts to lower their property tax rates.

4. CONCLUSIONS

All of the arguments presented in this paper lead to the conclusion that a substantial increase in state aid to schools is a highly desirable response to the mandate of the New Jersey Supreme Court for the reform of school finance. The larger the increase in state aid to schools, the greater will be the fairness and efficiency of the new system. The benefits are proportional to the size of the increase.

Property taxes are a reliable source of revenue in the short-run, but the long-run effects are to discourage new development and to erode gradually the existing tax base. By substantially increasing the role of the state in school finance, New Jersey can help to reverse the destructive trend toward higher and higher property taxes. Alternative revenue sources, especially a state income tax, have much less harmful side effects.

In addition to greater fairness in school finance, a substantial increase in state aid to schools would have several desirable side effects. As local property taxes were reduced, property values would rise, rents would fall, new construction would be stimulated, the central cities would be in a much better position to compete with the suburbs for people and jobs, the discriminatory effects of Federal tax laws would be reduced, and the practice of exclusionary zoning would lose its financial incentive. These effects would not occur overnight and they do not represent a panacea for the problems of modern society, but they are important and significant benefits and should not be overlooked in the process of revising the system of school finance in New Jersey.

Urban property tax rates in New Jersey exceed the state average by 50%, so the undesirable effects of property taxes are most severe in the central cities. Thus, increased state aid to schools, which tends to equalize property tax rates as well as reduce them, will have an especially large impact on the central cities. If property tax rates are lowered everywhere, higher density living is stimulated and this helps the central cities. If, in addition, property tax rates are lowered by a greater amount in the central cities than elsewhere, there will be an even larger stimulus to activity in the central cities. Lowering both relative and absolute tax rates will help the central cities retain and attract industry and employment. This in turn will foster further growth of activity in the central cities. Since many central city problems are closely related to unemployment, this stimulus to the urban labor market may also help to reduce the cost of social services in central cities. Central cities play a very important role in our economy and we are wasting many of their resources and efficiencies under our present system of taxation which discourages their development.

In sum, there are many reasons to believe that a large state role in financing schools is a highly desirable policy with significant side effects on the economy of the state, especially the central cities. The basic issue involved is who pays for schools and a fairer sharing of the burden means that some people will pay less and some will pay more. There is no way to avoid this fact, but it does not justify the current unfair system. From the viewpoint of the state as a whole, a large increase in state aid to schools would improve the fairness and the efficiency of the system. Therefore, New Jersey should increase state aid to schools by a very substantial amount.

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