Upside Down & Backwards
Taxes in New Jersey
By Jon Shure
January 2003

WHO PAYS?

No one consciously designed it this way. New Jersey's tax structure has evolved over time. The local property tax—actually a real estate tax—is a holdover from colonial times. The state sales tax was established in 1965, ending a long period during which state government took in relatively little in revenue from citizens and provided relatively little in terms of services as compared to other states, especially northeastern neighbors. The state income tax came along in 1976, the response to a state Supreme Court ruling requiring a new system to pay for schools in view of the unconstitutionality of relying so heavily on local property taxes for that purpose.

Even this brief history shows the interconnectedness of taxes in New Jersey, especially the link between the local property and state income tax: one created expressly to reduce the burden of the other in a way that aimed at taking more from those best able to pay and less from those least able.

It is crucial, then, to consider New Jersey's major taxes as a whole when analyzing how equitable and efficient the system is and how effectively it does or does not meet the need of providing services to citizens. Indeed, looking at any tax in isolation can provide a distorted view. The income tax, for example, might look pretty good in that it exempts anyone making less than $20,000 a year (rather generous, but some states exempt much more) and waits until a married couple earns over $150,000 before charging its top rate. And yet the income tax has come under recent criticism from those who complain that so much of its burden is concentrated on such a relatively small percentage of state residents—those with the highest incomes.

The property and sales taxes, on the other hand, are frequently criticized for being regressive, which is to say that they take a larger share of a poor person's income per year than a rich person's. There are, however, who argue in favor of their fairness on grounds that people have some control over where they live and what they spend and could, at least theoretically, reduce their burdens by making different choices.

Add to this the emotional impact of taxes. Very few people think they are undertaxed, a feeling that might come more from the gut than out of knowledge of actual tax rates and burdens. What's needed, then, is an assessment of how the tax burden in New Jersey falls on people at various income levels. With that information, policymakers and average people can know who pays what, and in what ratio to others.

That information is now available from the Washington-based Institute on Taxation and
Economic Policy. ITEP's just-released report, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, provides state-by-state data on the non-elderly family tax burden for each 20 percent of the population, according to its income.

The bottom line for New Jersey:

**This continues to be a state where the combined impact of sales, income and property taxes is that the lower someone's income, the higher percentage of that income they pay in those three taxes. In a word, the state/local tax structure in New Jersey is regressive.**

Though the poorest people in New Jersey pay slightly less in taxes as a percentage of their income compared with seven years ago, **in only six other states do poor people pay a higher share of their yearly income in taxes than in NJ.**

### 10 STATES WITH THE HIGHEST TAXES ON THE POOR

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<th>State</th>
<th>Tax Rate</th>
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<td>Washington</td>
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<td>Florida</td>
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<td>Michigan</td>
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In New Jersey, in 2000, the lowest 20% in terms of income-those making less than $19,000 a year-paid **12.4%** of their income in the three major taxes. Most came from sales and excise taxes, with a substantial amount in property taxes and none in state income taxes. The national average is 10.4%.

The middle 20%-those making $34,000 to $56,000-paid **9.8%** of their income. For this group, property taxes replaced sales and excise taxes as the larger claim on their income. The national average is 9.4%.

The top 20% broke down as follows: the top 1%-those making more than $571,000-paid **8.2%**, compared to the national average of 7%; the next 4%-$193,000 to $570,000 in income-paid **9.4%**; and the next 15%-$94,000 to $193,000-paid **9.7%** of their income in the three taxes. Only among the top 5% did the state income tax become the form of taxation taking the largest share of their income.
As a practical matter the gap is wider still, and the overall system more regressive, when the ability of taxpayers to deduct state income and local property taxes from their federal income taxes is taken into account. The lowest 20% get no noticeable assist from deductibility; the middle 20% see their rate drop a half-point to 9.3%; but the wealthiest 1% sees a drop of two-and-a-half points, down to 5.7%. This deductibility allows people to, in effect, shift part of their tax burden to the federal government. Since those who itemize on their federal taxes tend to be wealthier they get the biggest benefits.

How the burden of a tax system falls among various income groups depends on two things: which taxes are relied upon most, and how each of those taxes is structured.

**Income taxes** typically are progressive; the wealthiest taxpayers are called upon to pay a higher rate—a higher percentage of their income—than are the poorest or those in the middle. Nationally, those at the top pay about 10 times in state income taxes what poor families pay, as a percentage of their income, and about twice what middle-income families pay. New Jersey’s income tax comes across as more progressive than the average: the lowest income people pay nothing and the people at the very top pay about 3.7 times more than the people in the middle, as a share of income.

The top rate of the state income tax in New Jersey is 6.37%. This is paid on income earned by a family in excess of $150,000 or by a single filer in excess of $75,000. A dozen states have a higher top rate, suggesting that their income tax is more progressive. But in many states the top rate is paid at a much lower income level than in New Jersey, which can be a more regressive tendency.

New Jersey is among 17 states that offer a state Earned Income Tax Credit similar to the federal EITC as a way to ease the tax burden of working poor families. However, of the 17, only New Jersey cuts off eligibility for the program at $20,000 instead of the federal level of more than $34,000.

**Property taxes** are considered to be at least somewhat regressive: on average, poor families pay a higher percentage of their income in the form of these taxes than any other group; the wealthiest pay the lowest. At first this can seem hard to grasp. After all, wealthy people living in very expensive homes pay far higher property taxes than people living in modest ones. The reality, however, is that for average families a home is almost all of their total wealth, while for the wealthiest citizens, a home usually represents a very small share of total wealth. So a tax on the value of their home applies to almost all of the assets of middle-income families while hitting a smaller share of the wealth of high-income families.

Additionally, the value of one's house as a share of their total income tends to drop at higher incomes. So a typical middle-income family's home might be worth double their annual income while the home of a very rich person might be only one-and-a-half times total income.

Property tax rates vary considerably from place to place in New Jersey. But the most salient feature of the tax is the extent to which New Jersey relies on it as compared to other states. In New Jersey, local property taxes make up nearly 50% of all state and local tax...
collections, compared to the national average of 30%. New Jersey's property tax per capita routinely leads the nation. This heavy reliance on property taxes helps to regressively skew New Jersey's overall tax structure.

**Sales and excise taxes** are seen as highly regressive. On average the poorest families pay almost seven times as high a share of their income in these taxes as the richest families; middle-income families pay more than four times the rate of that paid by the wealthiest. This, too, can seem counter-intuitive. Don't people who have more money buy more things and so pay more in sales taxes? In truth, though, spending as a share of income is lower for the richest people than for the poorest. So sales taxes take a larger share of a low- or middle-income person's income than they take from the income of the richest people.

Since the wealthiest people are able to save a much larger portion of their incomes each year than middle-income families-and the poorest families usually can't save at all-sales taxes are inherently regressive. On average, sales and excise taxes combined take 7% of a poor person's income, 4.8% of a middle-income person's and 1% of the wealthiest taxpayers' income. In New Jersey those taxes take 7.2% of the income of the poorest residents, 3.9% of a middle-income person's and 0.9% of the wealthiest taxpayers' income.

Excise taxes hit lower-income people especially hard because it is not usually the case that wealthy people keep buying more goods subject to these taxes as their income rises. Indeed, state excise taxes across the nation on gasoline, cigarettes and beer take about 1.4% of the income of the poorest families, 0.7% of the income from middle-income families and 0.06% of the income of the best-off families.

In one important aspect, New Jersey's sales tax is less regressive than in many other states: it exempts the purchase of groceries from sales tax. On the other hand, New Jersey's cigarette tax is second highest in the US.

**WHO KNOWS?**

A noted, the tax-burden information in this report comes from the Institute on Taxation and Economic Policy. It is based on a model constructed by ITEP and updates a report the organization most recently produced in 1996. In the interim of seven, no information has been available about how taxes in New Jersey fall on various income groups.

That is a long time to wait for data that has such serious implications on the well being of New Jersey residents. And if ITEP no longer wanted to produce its model, New Jerseys and residents of most other states would be in the dark. There are just three exceptions. Maine, Minnesota and Texas have laws on the books requiring those states to conduct what is called "tax incidence" reports on a regular basis. The laws are similar:

**MAINE:** By October 1 of each even-numbered year the state must prepare and release a report on how tax burdens affect various income groups. Whenever a proposal is before the legislature that would raise, lower or redistribute taxes by more than $20 million a report showing how the proposal would change tax burden must be prepared by the state if requested by the joint standing legislative committee with jurisdiction over tax issues.
MINNESOTA: By March 1 of each odd-numbered year the state must prepare a tax burden report. When a proposal that would raise, lower or redistribute taxes by more than $20 million is before the legislature, the state must prepare a report if requested by the committee with jurisdiction over tax issues.

TEXAS: Before each legislative session the state comptroller must report on the overall incidence of school property taxes or any state tax that generates more than 2.5 percent of total state revenue. If a proposal to raise, lower or redistribute taxes by more than $20 million is before the legislature, the state must produce a tax burden report at the request of the chair of any legislative committee to which the tax bill has been referred.

In January of 2002, the Center on Budget and Policy Priorities issued a report detailing the case for state tax burden reports called *Developing the Capacity to Analyze the Distributional Impact of State and Local Taxes: Issues and Options for States*. It noted that, while states have effective ways to measure how much money a proposed tax increase would raise or how much a decrease would cost, they are far less able to say who will pay more taxes or less taxes as a result of the change.

According to the report, fewer than one-fifth of states have developed the capacity to comprehensively figure out how proposed changes in tax laws could be expected to affect the amount of taxes that people at different income levels would owe. Nor are they able to depict how the total tax obligation would be distributed across income groups. The report cited many benefits of having and using such a capacity, including:

- It would provide important information for use while debating tax policy.
- It would make sure tax proposals effect tax burden the way they are intended to.
- It would help tax changes to work in harmony with priorities shaping state spending decisions.
- Periodic analysis allows for determining whether changes in the economy result in unintended shifts in tax burdens.

A good example cited by the CBPP report: in 1997 the Governor of Minnesota proposed tax-free education accounts. The state Department of Revenue conducted a tax burden analysis which found that most of the benefits would accrue to families making more than $100,000 a year-prompting the legislature to find a different way to help low- and middle-income families pay for college costs.

WHAT TO DO

New Jersey could have a more equitable tax system, one that does a far better job than the current system of basing taxation on someone’s ability to pay.

Today the state income tax is the fairest tax in New Jersey. It takes a higher percentage of a rich person's yearly income than that of a poor person. Middle-income New Jerseyans pay a higher percentage of income into this tax than do the poor and a lower share than the rich. But the state's reliance on other major regressive taxes-local property taxes in particular—is so strong that it cannot offset the mitigating progressive aspects of the income tax as
Currently structured.

The data from *Who Pays?* and other information about taxes in New Jersey suggest that the following steps be considered:

- Increase to more than $20,000 the amount of money a family can earn before having to pay the state income tax. In 2001, 18 states had a higher income tax threshold for a two-parent family of four than New Jersey. California was highest, at $38,800, followed by Pennsylvania at $30,000.
- Expand Earned Income Tax Credit eligibility limits to match the federal EITC. In 2003, a family of four earning as much as $34,692 can receive federal benefits. State EITC benefits are available up to that level in 16 of the 17 states with a state EITC; New Jersey cuts off benefits at $20,000.
- Raise the state income tax rate when family income reaches $500,000 and again at $1 million so the tax becomes more progressive and so the state takes more advantage of the ability of higher income people to deduct state income taxes from their federal income tax.
- Reduce the burden of property taxes by having the state pay for more government services that today are funded through local property taxes-and by allowing municipalities to raise money through such other means as hotel, parking and entertainment taxes.
- Pass a law requiring the state to develop capacity to conduct an analysis of how state and local taxes in combination affect people at various income levels.
- The law should require the state to then prepare and make public such a tax burden analysis every two years and at any time a proposal is before the Legislature to raise or lower taxes by at least $20 million or shift the burden of taxes by that amount.

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This is a difficult time for New Jersey. Not only are state revenues shrinking in a recessionary economy but also cuts in federal taxes will mean less aid from Washington. Our leaders face the challenge of figuring out how to restore lost revenue and pay for necessary services. If that job weren't hard enough there is-or should be-the added burden of doing all of this in a way that doesn't make the existing tax structure even less fair than it is now.

We need to take steps to make sure the tax structure by which we pay for services in New Jersey is understood, monitored, debated-and reformed. New Jersey should not continue to be a state where less affluent people pay a higher percentage of their yearly income in taxes than do more affluent persons. That is an upside-down, backwards tax system.

**NJPP is grateful to the Institute for Taxation and Economic Policy and the Center on Budget and Policy Priorities for research, analysis and data used in this report. For information on getting ITEP's full 50-state study go to** [http://www.itepnet.org](http://www.itepnet.org).

New Jersey Policy Perspective is a nonpartisan, nonprofit organization established in 1997 to conduct research and analysis on state issues to broaden and inform debate. Our goal is a state where everyone can achieve to his or her full potential in an economy that offers a
widely shared, rising standard of living.