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**INSTITUTIONS MATTER:
Can New Jersey Reverse Course?**

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Institutions Matter: Can New Jersey Reverse Course?

1. INTRODUCTION

New Jersey entered the current recession in a weakened fiscal and economic condition. With the state's economy and revenues closely linked to Wall Street, the collapse of the financial sector and its aftershocks—rising unemployment and falling income—leave New Jersey facing “a historic revenue collapse, and the most significant downturn in its modern history,” according to the state's treasurer.¹ The current recession is severe, but this fiscal dilemma is not new. The state has experienced structural deficits regularly over the past 20 years.²

In the fall of 2008, Governor Jon Corzine announced the state faced a \$400 million deficit. By the spring, the shortfall swelled to \$7 billion, with incoming revenues insufficient to cover the \$33 billion FY 2009 budget. The state's pension system is underfunded by \$56 billion, and outstanding debt totals \$45 billion, largely assumed in the last 15 years.

With the proposed FY 2010 budget, the governor announced savings were found with the help of \$2 billion in federal stimulus dollars; \$1 billion in tax increases, including a new income tax bracket of 10.75 percent on those earning over \$1,000,000;³ and \$4 billion in spending cuts, including deferred payments to the state's pension fund and furloughs for state employees (figure 1).⁴

¹ Adriene Lu, “New Jersey faces ‘historic’ tax-revenue drop,” *The Philadelphia Inquirer*, April 7, 2009, http://www.philly.com/inquirer/local/nj/20090407_New_Jersey_faces__quot_historic__quot_tax-revenue_drop_1.html.

² According to the FY 2009 Budget Message, New Jersey's budget has not been in structural balance (with recurring revenues matching recurring expenses) in 20 years. However, an analysis of budget data (see figure 2) shows that budget balance was achieved during some years in this period. Office of Management and Budget, “Budget in Brief,” *State of New Jersey FY 2009 Budget* (Trenton, February 26, 2008), 15, http://www.state.nj.us/budget09/budget_summary.pdf.

³ The property tax deduction for non-seniors will be suspended this year. Taxes will be imposed on lottery earnings over \$10,000. There will be a 25 percent increase on the tax on alcohol, a 12.5 cent increase on cigarette taxes, an extension of the 4 percent surcharge on the Corporation Business Tax that was set to expire, an increase in payroll taxes for unemployment benefits, and new fees for sportsman licenses.

⁴ Furloughs were met with resistance with unionized workers initiating a lawsuit against the governor. The furloughs were ruled legal in April 2009.

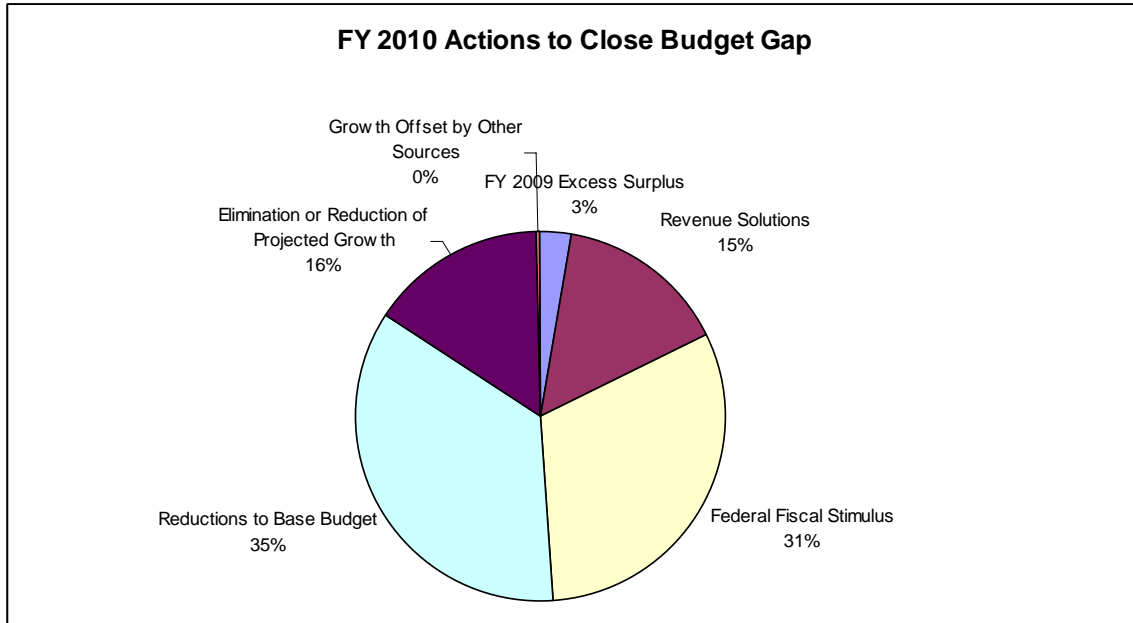


Figure 1

But, budget balance was temporary, and the scenario continued to worsen. In April 2009, revenue projections were \$800 million lower than initially anticipated. Property tax rebates were cancelled for those earning \$75,000 or more (excepting the elderly and disabled). Property tax deductions for those earning over \$250,000 were also cancelled. In June, the treasury secured a \$2 billion line of credit from J.P. Morgan Chase for the new fiscal year.⁵ And, by June 30th, a balanced budget was announced. These measures have bought the state some time, but leave the underlying causes for New Jersey’s fiscal and economic crisis unaddressed. The state’s problems are likely to continue, if not worsen, in the near future.

Though the magnitude and depth of the current recession is unprecedented, New Jersey’s perennial budget shortfalls and the growth in taxation on all levels are the result of years of poor fiscal choices which have gradually weakened the state’s once strong economy.

⁵ The full line of credit will cost \$2.3 million for every \$250 million borrowed. If all \$2 billion is used, total interest will cost \$18.4 billion. See John Reitmeyer, “Beefed-up taxpayer group weighs in on N.J. budget,” *New Jersey Star Ledger*, June 10, 2009, <http://www.nj.com/news/ledger/jersey/index.ssf?/base/news-14/124460685050150.xml&coll=1>.

New Jersey is ranked 46th in economic freedom,⁶ with the highest state and local tax burden in the nation, at close to 12 percent of average income.⁷ New Jersey's income tax is highly progressive, with a top bracket of 10.75 percent on income over \$1,000,000. The corporate tax is a flat rate of 9 percent—the sixth highest in the nation. The sales tax is exemption-laden, leading the state to raise rates, most recently in 2006, from 6 to 7 percent. In addition, New Jersey levies many smaller taxes on services and activities. Between 2002 and 2007, the state created 102 small taxes and fees, all of which combine to create a narrow-base, high-rate system of tax. Property taxes have increased steadily over the past 30 years, averaging \$6,787 per capita in 2008.⁸ Since 2000, New Jersey has lost technology and information sector jobs and gained low-wage service sector jobs and public sector jobs. New Jersey's population growth has slowed and out-migration has increased.

Increased taxation is meant to support public spending. Growth in New Jersey's budget is driven, in theory, by citizen preference for a certain level of government services and the taxation necessary to support it. However, the government of New Jersey has resorted to fiscal evasion⁹—avoiding the rules meant to constrain spending—and has sustained spending growth through fiscal illusion,¹⁰ obscuring the full costs of policies by relying

⁶ Jason Sorens and William P. Ruger, *Economic Freedom in the 50 States: An Index of Personal and Economic Freedom* (Arlington, VA: Mercatus Center, 2009), 35.

⁷ The Tax Foundation, "New Jersey's State and Local Tax Burden 1977-2008," <http://www.taxfoundation.org/research/topic/44.html>.

⁸ Authors' calculation. Does not include the property tax rebate. Average property taxes vary by county, ranging from an average of \$10,380 per capita in Essex County to an average of \$3,545 per capita in Cumberland County. See State of New Jersey Department of Community Affairs, Division of Local Government Services, Property Tax Information data, <http://www.nj.gov/dca/lgs/taxes/taxmenu.shtml>.

⁹ We define fiscal evasion as the avoidance of constitutional and legislative prohibitions on spending and debt. Evasion is accomplished through the design of weak budget rules, the lax enforcement of well-designed rules, and the weakening of accounting standards—enabling the government to systematically spend more than is collected in revenues. New Jersey is not the only state to depart from constitutional constraints on spending. According to Richard Briffault, "One of the most striking aspects of state constitutional law of state and local finance is the enormous gap between the written provisions of state constitutions and actual practice." Richard Briffault, "State and Local Finance," in *State Constitutions for the Twenty-First Century, Volume 3*, G. Alan Tarr and Robert F. Williams, eds. (Albany: State University of New York Press, 2006), 212.

¹⁰ The successful evasion of budget rules is sustained by diluting the perceived cost of spending to voters. Spending growth has been partially obscured to the citizenry through the state's reliance on debt and intergovernmental aid. These mechanisms encourage "fiscal illusion" by separating the source of revenue from the time and place in which spending occurs. Debt places the cost of projects on future taxpayers. Additionally, most of New Jersey's debt was raised without voter approval, weakening the most direct

on intergovernmental aid and debt to achieve the current level of spending. The state has long emphasized current spending at the expense of higher taxes for future taxpayers. The costs of this approach are now coming due.

In this paper we present a series of reforms based on the successful experience of other governments. We begin with a background discussion of the challenges New Jersey will face in implementing these reforms by reviewing the state of the state and the loss of the “Old-Time Fiscal Religion,” the foundation of public finance until the Keynesian revolution of the 1940s.¹¹ We explain the limits of public policy and government intervention. We explore the importance of inter-jurisdictional competition and direct democracy and conclude with recommendations for institutional and policy reforms.

2. THE STATE OF THE STATE

New Jersey’s recent experience contrasts sharply with its modern history. In the last 150 years, the state underwent two economic transformations, moving from an agricultural to a manufacturing economy at the turn of the 20th century and then to a knowledge-based economy by the end of the 20th century, “and each time successfully reinvented itself—by itself.”¹² Both transformations “took place in a public policy vacuum.”¹³

check on spending—democratic voice. Intergovernmental aid spreads the cost of spending across a wider set of taxpayers (e.g., state income taxpayers) while concentrating spending benefits on particular groups or regions (e.g., local school districts), thus lowering the relative price of such spending to beneficiaries, and weakening accountability.

¹¹ See James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, The Collected Works of James Buchanan, 2nd ed., Vol.8 (Indianapolis: Liberty Fund, 1999), http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=1097&chapter=103137&layout=html&Itemid=27. “The history of both fiscal principle and fiscal practice may reasonably be divided into pre- and post-Keynesian periods. The Keynesian breakpoint is stressed concisely by Hugh Dalton, the textbook writer whose own political career was notoriously brief. In the post-Keynesian editions of his *Principles of Public Finance*, Dalton said: “The new approach to budgetary policy owes more to Keynes than to any other man. Thus it is just that we should speak of “the Keynesian revolution.” We may now free ourselves from the old and narrow conception of balancing the budget, no matter over what period, and move towards the new and wider conception of balancing the whole economy.”

¹² James W. Hughes and Joseph J. Seneca, “Then and Now: Sixty Years of Economic Change in New Jersey,” *Rutgers Regional Report*, Issue Paper No. 20, Edward Bloustein School of Planning and Public Policy at Rutgers University, January 2004, 4.

¹³ *Ibid.*, 5.

From mid-century into the 1960s, the state's economy was robust, growing steadily and at times dramatically. Between 1960 and 1970, the state added 589,199 jobs, increasing employment by 29 percent, a record not yet surpassed.¹⁴ During this period, the state had no sales tax and no income tax. As the manufacturing sector declined in the 1970s, New Jersey lost jobs, while the service and information sectors began their acceleration, creating another boom period between 1980 and 1990 during which the state added 589,100 jobs. New Jersey's fortunes began to change in the 1990s. Job growth, still robust in the financial services, technology, and business and services sectors, was not at the same level as in previous decades.

The late 1960s to the present is a period of active state, and local, government growth. In 1966 the state instituted a sales tax of 3 percent to pay for the expansion of the state's college system. Today it is 7 percent. In 1976, a nearly flat income tax was adopted (2 percent on those earning below \$20,000 and 2.5 percent on those earning above \$20,100) to provide supplemental revenues for schools and local budgets and to lower local property tax burdens. Today, the income tax has six brackets with a new top rate of 10.25 percent on those earning over \$1,000,000. Property tax relief was not achieved with the new income tax, and property taxes have risen each year since 1978. Numerous other taxes have been levied during this period, most recently the addition of 102 new smaller taxes and fees between 2002 and 2007. The result of this period has been the gradual erosion of the state's economic and financial resiliency.

New Jersey's spending growth in the late 1990s coincided with signs of anemia in the state's economy. Between 2000 and 2005, New Jersey began to lose high-paying service and manufacturing jobs, replaced by low-paying service jobs and public-sector, taxpayer-dependent jobs. Public sector growth was most pronounced on the local level in education.¹⁵ Between 1990 and 2002, local government added 45,400 jobs and the state added 7,900, nearly all due to education.¹⁶

¹⁴ Ibid., 5.

¹⁵ According to James W. Hughes and Joseph J. Seneca, between 2000 and 2005, New Jersey lost 18,700 jobs in financial services, information and professional and business services, and 117,600 high-paying advanced services and manufacturing jobs. Job growth occurred in lower-paying sectors. Education and

Three indicators—spending (appropriations) as a percent of state domestic product (GDP),¹⁷ debt as a percent of GDP, and the size of federal transfers in New Jersey’s budget—capture the erosion of New Jersey’s economic resiliency and the creation of the current fiscal crisis.

Public spending in New Jersey doubled in real terms, as a percentage of GDP, between 1971 and 2008 (figure 2).

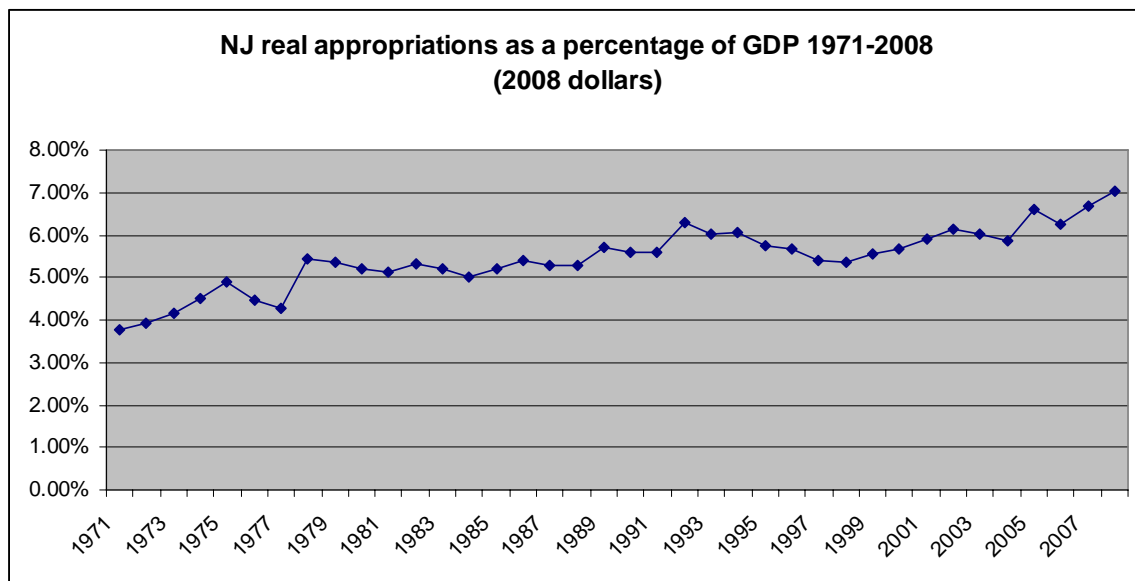


Figure 2

In the last ten years, the proportion of government spending to state GDP increased from 5.4 percent in 1997 to 7.05 percent in 2008 (figure 3).

health care gained 60,800 jobs; leisure and hospitality gained 35,900 jobs; and other services gained 16,500 jobs. See Hughes and Seneca, “New Jersey’s New Economy Growth Challenges,” *Rutgers Regional Report*, Issue Paper no. 25, Edward J. Bloustein School of Planning and Public Policy at Rutgers University, July 2006, 3.

¹⁶ Hughes and Seneca, “Then and Now: Sixty Years of Economic Change in New Jersey,” 23.

¹⁷ We use appropriations between 1951 to the present, as stated in the FY 2010 budget. See <http://www.state.nj.us/treasury/omb/publications/10bib/BIB.pdf>.

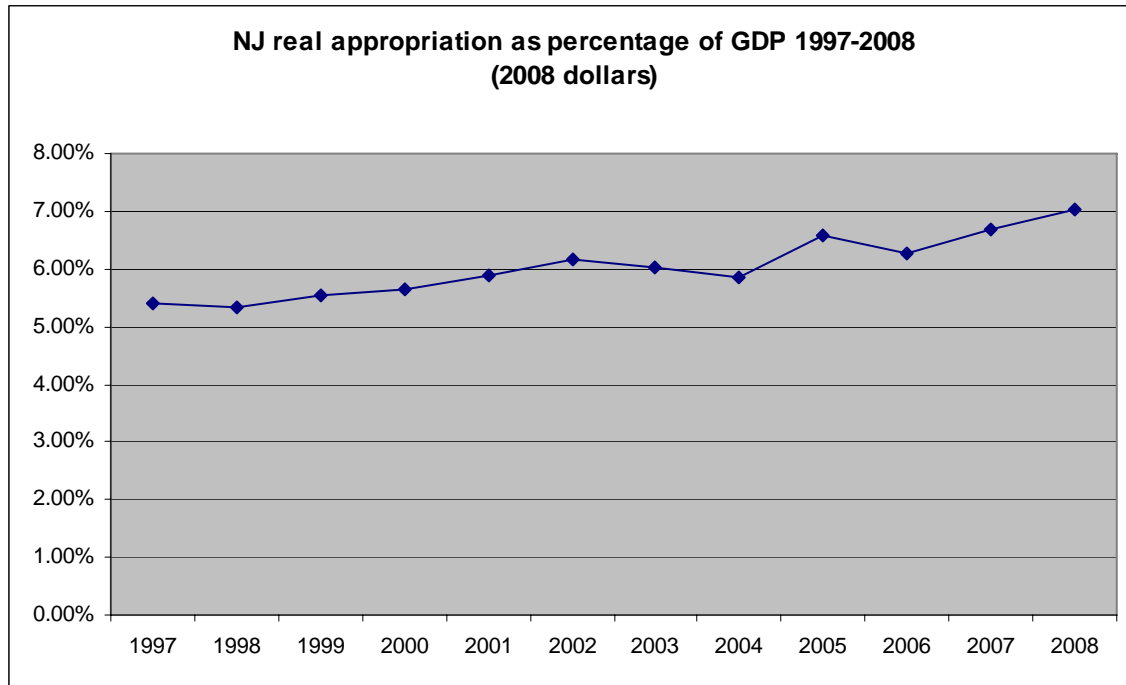


Figure 3

Most economists agree that some level of public of spending is necessary, but too much public spending can hurt economic growth.¹⁸ In addition to consuming a larger portion of the state’s income, government spending dedicates resources to activities that may or may not be needed in society. Because government cannot calculate economic profit and loss, it cannot ultimately know whether alternative ways of spending money create value, and thus cannot know what resources are most urgently needed in society.¹⁹ What individuals want can only be revealed through voluntary trade. Government has no access

¹⁸ The literature on government size and its effects on economic growth is voluminous. See, for example, Robert J. Barro, “Economic Growth in a Cross Section of Countries,” *Quarterly Journal of Economics*, 106(2) (1991); E.A. Peden, “Productivity in the United States and its Relationship to Government Activity: An Analysis of 57 Years, 1929-1986,” *Public Choice* 69 (1991): 153-173; James Gwartney, Randall Holcombe, and Robert Lawson, “The Scope of Government and the Wealth of Nations,” *Cato Journal* 18, no. 2 (1998); and Daniel J. Mitchell, “The Impact of Government Spending on Economic Growth,” *Backgrounder*, no. 1831, The Heritage Foundation, March 31, 2005. On the effects of fiscal policy, see, for instance, Alberto Alesina, Silvia Ardagana, Roberto Perotti, and Fabio Schiantarelli, “Fiscal Policy, Profits, and Investment,” (NBER Working Paper No. 7207, July 1999).

¹⁹ This is known as the “economic calculation problem,” and is the major reason why central planning in a socialist economy is impossible. See chapter XXVI, “The Impossibility of Economic Calculation under Socialism,” in Ludwig von Mises, *Human Action*, Fourth Edition, ed. Bettina B. Greaves (Irvington: Foundation for Economic Education 1996), <http://mises.org/humanaction/chap26sec1.asp> and Friedrich Hayek, “The Use of Knowledge in Society,” *American Economic Review*, XXXV, no. 4 (September 1945): 519-30, <http://www.econlib.org/library/Essays/hykKnw1.html>.

to this information as it operates outside market exchange. As a result, government allocates resources according to political criteria, which does not often lead to rational allocation.²⁰

Government policy most often entails the forced migration of resources from the decentralized realm of individual decision making (markets), to the centralized control of the public sector. As more resources are transferred, however, the process of entrepreneurial discovery is gradually replaced by a command-and-control regime, which is ultimately irrational.²¹

It is not only the amount of public spending relative to GDP that matters, but the way in which spending in New Jersey has grown, by relying on debt and intergovernmental aid. Both of these mechanisms encourage “fiscal illusion,” obscuring the full costs of policies to voters.

New Jersey state-level debt more than doubled in real terms from 4.4 percent of GDP in 2001 to 9.48 percent of GDP in 2008 (figure 4). Debt jumped between 2003 and 2006, due to the \$3.3 billion tobacco settlement securitization in 2003 and a \$7.3 billion debt issuance in 2006. In 2008, debt totaled \$5,187 per resident, or \$20,748 for a family of four.

²⁰ Kenneth Arrow’s Impossibility Theorem demonstrates that no system of voting can convert the ranked preferences of individuals into a community-wide ranking while also meeting a certain set of reasonable criteria, such as absence of dictatorship. In other words, governments cannot possibly aggregate individuals’ preferences and make collective decisions that would satisfy everyone as if unanimity was achieved. Arrow demonstrated the limits of collective choice in a democratic system of majoritarian voting. See Kenneth Arrow, “A Difficulty in the Concept of Social Welfare,” *Journal of Political Economy* 58, no. 4 (1950): 328–346.

²¹ See Israel Kirzner, *Discovery and the Capitalist Process* (Chicago: University of Chicago Press, 1950).

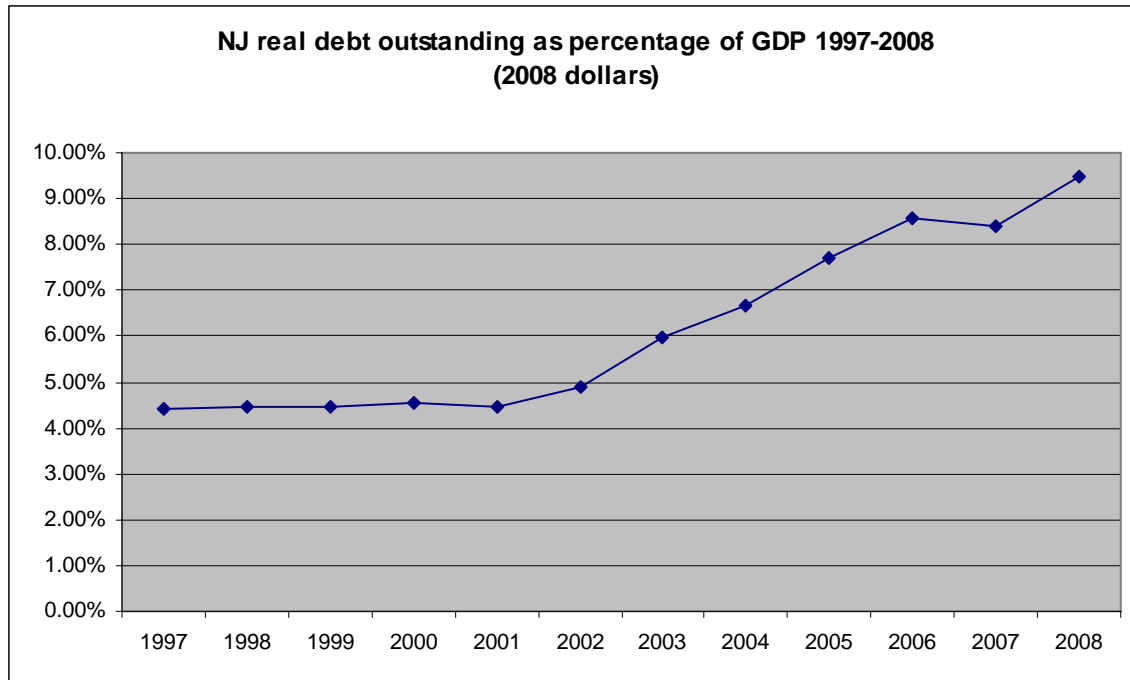


Figure 4

In the last 15 years, federal grants to New Jersey have increased by 20 percent in real terms (figure 5). Today, federal funds represent roughly 24 percent of New Jersey’s budget. The largest cost driver in this category is Medicaid, since states must match part of the cost of the program.

Intergovernmental aid, as spending that is not raised through direct state taxation, creates “fiscal illusion.” Fiscal illusion occurs when the full cost of expanded spending is spread across all federal taxpayers (or over time, in the case of debt), thus diluting the perceived cost of such spending to state taxpayers and elected officials. Federal grants are designed to augment state spending in areas important to the federal government, effectively nationalizing activities that were previously in the domain of the state or local government or the private sector. Additionally, federal grants often stimulate additional state spending on federally designated activities, leading the state to expand its budget beyond what is provided by the federal grants.

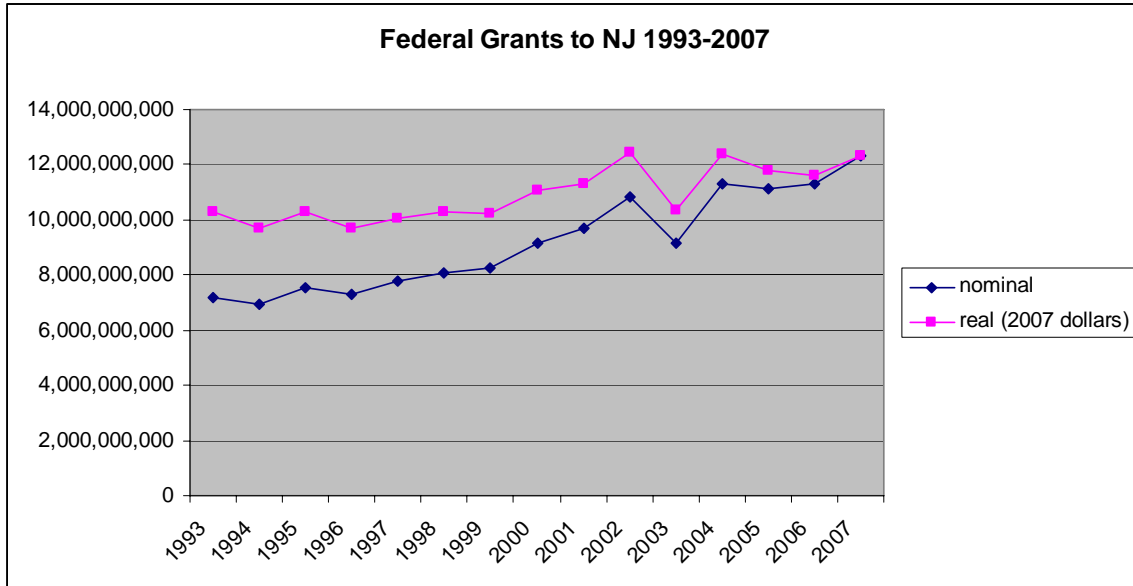


Figure 5

Grants-in-aid became a feature of state budgets during the Johnson Administration’s Great Society and War on Poverty initiatives. Major new federal programs were created in education, welfare, transit, urban aid, criminal justice, and the arts. The magnitude and scope of new federal initiatives transformed state government finances and eroded the policy and fiscal autonomy of state governments.²² Between 1965 and 1969, New Jersey’s budget doubled in nominal terms from \$584 million to \$1.08 billion. While many federal programs were eventually scaled down or eliminated in the 1970s and 1980s, others remained, and still more were added, receiving variable levels of federal funding over the decades.

3. THE LOSS OF THE “OLD-TIME FISCAL RELIGION”

Before the rise of Keynesianism in the 1940s, the “classical” principles of public finance prevailed. In sum, governments should adopt the same set of financial principles as private households.²³ One should not spend more than one earns. Debt is limited to

²² Federal grants-in-aid change the division of responsibility within the federal system and “involve a revision of the Constitution but without formal amendment.” See Richard E. Wagner, *Public Finance: Revenues and Expenditures in a Democratic Society* (New York: Little Brown and Company, 1983), 466.

²³ See James Buchanan and Richard E. Wagner, *Democracy in Deficit, The Political Legacy of Lord Keynes* (Indianapolis: Liberty Fund, 2000). See also Barry Poulson, “Abandoning the Old-Time Fiscal Religion,” available at Vote on Taxes Committee; Bryce Wilkinson, “Restraining Leviathan: A Review of

financing extraordinary items and events—such as war and natural disasters.²⁴ Prudent fiscal conduct on the part of government means that taxes are kept to a minimum necessary to finance some public goods (e.g., justice, public safety, and the enforcement of property rights and contracts).

These principles were the basis of fiscal conduct until mid-20th century, enshrined in the notion of tax finance, i.e., that taxes (not debt) are the only source of public revenue. Until World War II, the federal government repaid debts incurred for wars. The public treasury was usually balanced or in surplus.²⁵ Government deficit spending or debt finance was considered profligate and immoral, since it imposes a burden of payment on future generations. Fiscal discipline was based on the principle that current generations should pay for current spending, since only individuals who must foot the bill can fully evaluate public-spending proposals.²⁶

These classical principles of prudent fiscal management encouraged an efficient size of government and thus supported long-term sustainable prosperity. Keynes overturned this order, claiming government could manage the economy using public debt as leverage. In the case of public debt, however, the public does not fully observe the source of government revenue and perceives spending as less costly than it actually is. Thus, public demand for spending tends to increase over time, and as taxpayers do not give up anything in the present when the government raises money through bonds, they have less incentive to monitor how the government spends revenues raised by bonds. Unlike private debt, with public debt there is no claim against private assets. The liability for

the Fiscal Responsibility Act 1994” (Wellington: New Zealand Business Roundtable, 2004); Barry Poulson, "Tax and Expenditure Limits: A Road to Fiscal Discipline,"

http://www.voteontaxes.com/images/Tax_Expenditure_Limits_A_Roadmap_to_Fiscal_Discipline.doc.

²⁴ Even infrastructure was not always within the purview of the state. Assets such as bridges and roads were often privately financed and built in 19th-century America. The New Jersey Turnpike is an example.

²⁵ Buchanan and Wagner, *Democracy in Deficit*, 15. As Buchanan and Wagner explain, “Until 1946...the story of our fiscal practice was largely a consistent one, with budget surpluses being the normal rule, and with deficits emerging primarily during periods of war and severe depression. The history of fiscal practice coincided with a theory of debt finance that held that resort to debt issue provided a means of reducing present burdens for the obligation to take on greater burdens in the future. It was only during some such extraordinary event...that debt finance seems to be justified.”

²⁶ Knut Wicksell, "A New Principle of Just Taxation," in *Classics in the Theory of Public Finance*, R. A. Musgrave and A. T. Peacock, eds. (London: Macmillan, 1958), 72-118.

debt is not tied to public officials or to individual members of the community. Moreover, bondholders do not necessarily care how the government spends the money raised by bonds. They buy debentures because they anticipate a positive return.

The last 40 years of Keynesian economics demonstrate that high levels of public debt and spending create inflation and low growth.²⁷ In the present era, governments realize that if they present policy proposals with a price tag attached to them, they will find few takers, but if they do not reveal the full bill, voters are more likely to accept such policies. This is the core of fiscal illusion.

By contrast, prudent fiscal management minimizes the amount of resources in the hands of government and promotes robustness and resilience in economies, enabling them to better navigate crisis and recover from shocks. Robustness and resilience depend on the degree to which individuals, especially entrepreneurs, can adapt to changing circumstances. When the government's share of resources is small, it permits for a more decentralized, and thus, faster, response to economic shocks.²⁸ Private citizens can amass savings to use for financing private equity and entrepreneurship.

4. THE RULES THAT DO NOT BIND

Government policy also often forces resources from the decentralized realm of individual decision making (i.e., markets) to the centralized control of the public sector. The transfer of such resources leads to a process wherein a command-and-control regime, which all too often turns out to be irrational, gradually replaces entrepreneurial discovery.²⁹ The most powerful checks on this migration of resources are institutional arrangements that constrain elected officials. These include constitutional and statutory rules, which limit

²⁷ See for instance, Gwartney et al., "The Scope of Government and the Wealth of Nations."

²⁸ For a discussion of robustness, see Peter T. Leeson and J. Robert Subrick, "Robust Political Economy," *Review of Austrian Economics* 19 (2006): 107-111.

²⁹ See Israel Kirzner, *Discovery and the Capitalist Process*. Only entrepreneurs, operating in the marketplace, are able to respond to individuals' preferences. Entrepreneurs constantly strive to satisfy consumers' demands, using market signals to calculate the profits and losses resulting from their activities. Because they stand to profit, entrepreneurs face strong incentives to discover what consumers want (and in doing so, correct past misallocations of resources).

spending, and interjurisdictional competition, which encourages governments to compete for citizens, by offering different mixes of goods and services and levels of taxation.³⁰

New Jersey’s budget—like all state budgets—is developed under constitutional and legislative rules. The effectiveness of budgetary rules depends on how they are designed³¹ and the extent to which those rules are enforced. A well-designed rule may still be ignored through a lack of enforcement. Rules meant to constrain spending growth in New Jersey, such as the state budget spending cap, are weakly designed and contain many exceptions. Strict constitutional rules on the issuance of debt have been relaxed through judicial interpretation, highlighting the problem associated with enforcement. We begin by reviewing the major constitutional and statutory rules affecting the development of New Jersey’s state budget and how these rules have been evaded, contributing to the current crisis.

4.A. Constitutional Rules

New Jersey operates on an annual budget (July 1 to June 30), submitted by the executive to the legislature for approval. The state’s constitution requires a balanced budget.

The debt limitation clause restricts long-term borrowing to 1 percent of total appropriations, unless higher amounts are specifically approved by voters at a general election. Short-term borrowing to cover cash flow needs is not prohibited by the constitution. In December 2008, the constitution was amended to require voter approval for debt issued by public authorities.³²

4.B. Legislative Rules

³⁰ This is referred to as “Tiebout Competition.” Municipalities compete for citizens and capital by offering different mixes of public spending and taxation. Citizens “vote with their feet” and sort themselves through the process of choosing which municipality suits their preferences. See Charles Tiebout, “A Pure Theory of Local Expenditure,” *The Journal of Political Economy* 64, no. 5 (1956): 416-24.

³¹ See David M. Primo, *Rules and Restraint: Government Spending and the Design of Institutions* (Chicago and London: University of Chicago Press, 2007), 4. “Effective rules may be designed in theory, but in practice rules are designed by individuals with interests leading to the enactment of ineffective rules, or such outcomes may arise as the result of political compromise necessary for its enactment.”

³² New Jersey Constitution, art. 8, sec. 2, <http://www.njleg.state.nj.us/lawsconstitution/constitution.asp>.

In 1990, the legislature enacted a spending cap on the Direct State Services portion of the budget, which accounts for 20 percent of total spending. The cap law excludes the majority of New Jersey's budget: the Property Tax Relief Fund, state aid, grants-in-aid, and debt. The cap may be overridden by a two-thirds majority vote.

In the same year, the legislature created a Surplus Revenue, or Rainy Day Fund. The fund receives 50 percent of the difference between the amount of revenue certified by the governor in the annual appropriations act for the current fiscal year and the actual collections realized for the year.³³ The fund may be used when anticipated revenue is less than what is certified.

As with the state budget, municipal, county, and school budgets must be balanced annually and are also subject to spending caps. The Municipal Budget Cap Law was enacted in 1976, with the state income tax, as part of the promise to reduce local property taxes.³⁴ The municipal cap contains numerous exceptions: capital projects, debt service, employee pensions, and health care costs, leaving 25 to 40 percent of a municipality's budget outside of the spending cap.³⁵ Counties operate under a similar budget cap.

The school district budget cap instituted in 1995 includes automatic adjustments: enrollment increases, certain capital outlays, courtesy busing, special education in excess of \$40,000, and expenditures associated with opening a new school, insurance, and domestic preparedness.

5. FISCAL EVASION

New Jersey's budgetary rules have proven ineffectual in limiting the growth of public spending and debt. Legislative spending caps are weak and only apply to a fraction of

³³ The fund excludes income tax revenues which are statutorily dedicated to the Property Tax Relief Fund, and used for school funding, municipal aid, and individual property tax relief programs.

³⁴ New Jersey Property Tax Convention report, 52. Municipalities and counties may not increase their appropriations by more than 2.5 percent or the Implicit Price Deflator for State and Local government, whichever is less, over the previous year's expenditures. The spending cap is raised to 3.5 percent in years when the deflator is greater than 2.5 percent.

³⁵ The law also permits localities to "bank" any difference between actual and permitted spending for use as an exception to its appropriation in the next two succeeding budget years.

spending, allowing the state to continue unsustainable fiscal practices. In addition, the state supreme court has allowed the state to evade constitutional limits on the issuance of debt. Ineffectual budget rules and weak enforcement of other well-designed rules were supplemented by poor accounting practices and budget gimmicks, such as granting pension contribution deferrals to state and local governments, relying on one-shot revenue sources to balance the budget, and failing to report debt in the state's budget.

5.A. The Treatment of Debt

While the New Jersey Constitution's debt limitation clause restricts borrowing by requiring voter approval, the New Jersey Supreme Court has permitted broad exceptions to this rule, allowing the state to issue debt through independent authorities and to use debt to balance the state's operating budget.

In at least 33 states, independent authority debt has become more common in recent years as a source of financing capital projects, emerging as a "particularly blatant evasion" of debt limitation clauses contained in state constitutions.³⁶

The New Jersey Supreme Court has ruled that independent authority debt (also known as contract debt since it represents a contract between the treasury and the authority) is backed by the state's *promise* to make an annual appropriation to repay the debt. This "subject-to-appropriation" debt, the court has contended, is unlike other forms of state-issued debt, which are backed by the state's *guarantee* to use its taxing powers to repay it. In other words, the state is not legally obligated to pay subject-to-appropriation debt.

The issuance of debt by independent authorities increased rapidly in the 1990s. Today, total state debt amounts to \$45 billion, or 11.25 percent of state GDP. New Jersey's annual debt service is \$3,478 per capita, compared to a state median of \$700 per capita,³⁷ making New Jersey the sixth-most indebted state. Of this total, voters have only approved \$2.8 billion in general obligation debt. The largest piece of New Jersey's total debt is

³⁶ Briffault, "State and Local Finance," in *State Constitutions for the Twenty-First Century*, 221.

³⁷ *State of New Jersey Debt Report and Addendum*, November 2008, http://www.state.nj.us/treasury/public_finance/pdf/2008%20Debt%20Report.pdf.

\$27.3 billion in subject-to-appropriation debt, most of it issued through the Economic Development Authority (EDA) and the Transportation Trust Fund Authority.³⁸ In November 2008, voters approved a referendum to limit this practice via a constitutional amendment requiring voter approval for the issuance of independent authority bonds.

Several bond issues have prompted criticism not only due to the absence of voter approval, but also for their purpose. Debt has been issued to balance the state's budget. And, in spite of the amount of state and local tax revenues dedicated to school districts, debt has been issued to finance school construction projects.

In 2000, the Whitman administration issued \$8.6 billion in School Facilities Construction Bonds to meet the court's 1997 mandate to upgrade school buildings in Abbott districts.³⁹ This bond issuance, the largest in the state's history, became the basis for a court case brought by former Bogota, N.J. mayor, Steve Lonegan.

Lonegan v. New Jersey argued that the issuance of debt without voter approval violated the constitution's debt limitation clause.⁴⁰ The court split the case. In *Lonegan v. New Jersey I*, the court only considered the issuance of school construction bonds. They ruled 6-to-1 that this debt was *sui generis* or one of a kind, with constitutional underpinnings in both the educational provision, and the school fund provision of the constitution. The court reasoned that since the debt is subject to appropriation by the legislature, it is not

³⁸ Other authorities include the Building Authority, the Educational Facilities Authority, the Garden State Preservation Trust Fund, Health Care Facilities Financing Authority, and the Sports and Exposition Authority.

³⁹ Of this amount, \$6 billion was to be used for Abbott districts and \$2.6 billion for other New Jersey school districts.

⁴⁰ The constitution's debt limitation clause states, "The Legislature shall not, in any manner, create in any fiscal year a debt or debts, liability or liabilities of the State, which together with any previous debts or liabilities shall exceed at any time one per centum of the total amount appropriated by the general appropriation law for that fiscal year, unless the same shall be authorized by a law for some single object or work distinctly specified therein. Regardless of any limitation relating to taxation in this Constitution, such law shall provide the ways and means, exclusive of loans, to pay the interest of such debt or liability as it falls due, and also to pay and discharge the principal thereof within thirty-five years from the time it is contracted; and the law shall not be repealed until such debt or liability and the interest thereon are fully paid and discharged. Except as hereinafter provided, no such law shall take effect until it shall have been submitted to the people at a general election and approved by a majority of the legally qualified voters of the State voting thereon. New Jersey Constitution, art. 8, sec. 2, para. a, <http://www.njleg.state.nj.us/lawsconstitution/constitution.asp>.

binding; thus, the state doesn't have to pay it. Further, as a practical matter, the state cannot default on its debt without a substantial negative impact on its credit rating and access to financial markets.

In *Lonegan II* the court considered the general practice of issuing public authority debt without voter approval, excluding for school construction. The court nearly reversed its vote in a 4-to-3 decision, expressing reservations about public authority debt, but found the practice did not violate the state's constitution, since the debt is not "legally enforceable against the State."⁴¹

In 2004, the McGreevey administration borrowed \$1 billion against New Jersey's share of the national tobacco settlement, and issued \$900,000 in bonds against the motor vehicles surcharge. The proceeds were used to balance the FY 2004 and FY 2005 budgets. These bond issues were challenged in court by State Senator Leonard Lance and Assemblyman Alex de Croce,⁴² who argued that issuing bonds to pay for general operating expenses violated the state constitution's revenue clause.⁴³

The court agreed, acknowledging that relying on bond proceeds as revenue "belies the common sense notion of a balanced budget and is contrary to the framer's original intent in the Appropriations Clause...bond proceeds scarcely resemble revenue."⁴⁴ However, it permitted the governor a "one time pass" reasoning that renegotiation of the budget in July 2004 would disrupt the operation of state government.⁴⁵

With the new debt limitation provision in place, subject-to-appropriation debt is likely to decline. However, shortly before the legislature voted in June to place the debt limitation referendum on the November ballot, Governor Corzine issued \$3.9 billion in school construction debt. The \$8.6 billion in Education Facilities Bonds had largely been

⁴¹ *Stop the Debt.Com LLC v. State of New Jersey, et al.*, 176 N.J. 2, 819 A.2d 395.

⁴² Steve Lonegan and Stop the Debt.com LLC joined in the lawsuit.

⁴³ New Jersey Constitution, art. 8, sec. 2, para. 2 .

⁴⁴ <http://iplaw.rutgers.edu/ols/ols08022005.pdf>.

⁴⁵ As a consequence, the State Superior Court extended the Supreme Court's ruling to prevent the state from using the net proceeds of bonds to refinance or pay off existing bonds.

wasted. Two-thirds of the planned new school buildings were not built. In spite of accusations of corruption surrounding the initial bond proceeds, the governor and legislature voted to issue the additional bonds in order to meet the court's requirements under the Abbott decisions.⁴⁶

The treatment and expansion of debt in New Jersey highlights the importance of the courts in setting the fiscal climate. In spite of a constitutional limitation, the courts have given the state wide latitude to use debt for a variety of purposes. Such over-reliance on debt enabled the state to ignore its perennial fiscal instability, borrowing to hide shortfalls in the general fund. In addition to producing structural instabilities, bond issuances added the expense of debt service to the budget and caused New Jersey's creditworthiness to decline.⁴⁷

5.B. The Pension System

New Jersey has also relied on accounting tactics to mask increasing state obligations and provide local governments with property tax relief. The most dramatic example of this is found in how the state has managed its public pension system in the last two decades.

New Jersey's pension fund faces a potential \$56 billion unfunded liability (up from \$18 billion in 2006), which rises to \$130 billion when post-retirement medical and prescription drug benefits and stock market losses are factored in. Until recently, New Jersey's pension system was considered sound. In 2000 the plan was funded at 111.4 percent (the ratio of valuation assets to accrued liabilities) with a market value of \$85.8 billion. Today it is funded at 50 percent.

Like many states, New Jersey expanded its pension system during the 1990s when the stock market was booming. In addition to benefit expansions, New Jersey's pension

⁴⁶ Dunstan McNichol and Chandra M. Hayslett, "State funds \$4 billion in new school," *The New Jersey Star Ledger*, July 9, 2008.

⁴⁷ In July 2004, in response to the New Jersey Supreme Court's ruling to permit the state to borrow \$1.9 billion to balance the budget, Standard & Poors Ratings Service and Fitch Ratings lowered New Jersey's general obligation bond rating from AA to AA-, and their rating on state appropriations-backed debt from AA- to A+.

system was weakened by changes in the methodology used to value the fund, and the granting of “pension holidays” to state and local governments.⁴⁸ Pension holidays allowed state and local government employers to defer contributions to the pension system between 1997 and 2003.

The Pension Revaluation Act of 1992 changed the valuation methodology from book value to actual market value. This change allowed the state to report a higher rate of return on the fund (from 7 to 8.75 percent) while letting localities reduce their pension contributions in FY 1992 and FY 1993 by a total of \$1.5 billion. In 1994 the Pension Reform Act replaced the entry age normal method with the projected unit credit method. Employer pension contributions fell by \$1.49 billion.

Until 1997, full annual employer contributions were made to the plan. As the state itself recognized, “offsetting normal employer contributions with surplus pension assets is not a prudent practice.”⁴⁹ Federal rules permit states to defer payments to public pension funds when the funds contain excess assets. However, once the fund’s assets were exhausted, the pension plan was under-funded, and employer pension contributions became much higher than they otherwise would have been.⁵⁰

Pension deferrals, while providing short-term budget relief to state and local governments, also create fiscal illusion. In the short-term, governments adjust their behavior, dedicating revenues meant for the pension system to other areas. When scheduled contributions resume, governments find they are unable to pay the full amount because they have treated temporary payment reductions as permanent, necessitating a

⁴⁸ In 1997, the Pension Security Plan allowed the state to issue \$2.8 billion in pension bonds. The bonds were issued to eliminate a \$4.25 billion unfunded liability that surfaced when the Whitman administration entered office. At the end of Governor Florio’s term, the state reported \$9.6 billion in debt. However, an additional \$1 billion in additional debt had been issued during Governor Florio’s term and not recorded, and a further \$4.5 billion in unfunded liabilities was “footnoted” on the state’s balance sheet, bringing total state debt of \$14.75 billion. The pension bond issue enabled the state to refinance its total debt by reducing the total amount and paying a lower rate of interest over a shorter period. The proceeds of the bond sale were deposited into the pension system.

⁴⁹ *Report of the Benefits Review Task Force*, December 2005, http://www.state.nj.us/benefitsreview/final_report.pdf.

⁵⁰ *Ibid*, *Report of the Benefits Review Task Force*, 17.

“phase-in” of contributions. Phased-in contributions allow local governments to gradually adjust to paying the full contribution. In 2003, local governments gradually began to increase their contributions in increments of 20 percent a year, until they reached 100 percent in 2008. Phase-ins, by continuing to delay full contributions to the system, increase the amount needed to fully fund the pension system.

Deferred contributions and methodology changes were coupled with a series of pension enhancements. In 1999 benefits were extended to surviving spouses, increasing liabilities by \$500 million. In 2001 legislation increased the size of the Public Employees Retirement System and the Teachers Pension and Annuity Fund by 90.9 percent, with liabilities growing to \$4.2 billion. Other legislation included increased benefits for prosecutors and workers compensation judges.

The state is attempting to curb bad practices. In 2007, Governor Corzine promised “serious restructuring” of the pension system.⁵¹ A few minor changes were made. The Public Employee Pension and Benefits Reform Act of 2008 raised the retirement age from 60 to 62; Lincoln’s birthday was eliminated as a state holiday; and income eligibility requirements for a teacher’s pension were increased to \$7,500, saving the state \$6.4 billion by 2022. Yet, the recession is leading to a repeat of past mistakes. In March 2009, the legislature approved the governor’s proposal to allow municipalities to defer, for the next year, half of their payments into the pension system to prevent an increase in property taxes.

6. FISCAL ILLUSION

Fiscal evasion—avoiding the rules meant to constrain spending—has been sustained in New Jersey, in part, through fiscal illusion. The full costs of spending have been partially obscured by the state’s reliance on debt and intergovernmental aid.

⁵¹ David W. Chen, “Session Over, Corzine Vows to Keep up Fight on Benefits,” *The New York Times*, December 19, 2006, <http://query.nytimes.com/gst/fullpage.html?res=9B01E3D71331F93AA25751C1A9609C8B63>.

In a federal system, a resident falls under the jurisdiction of multiple levels of government. In the United States, a resident is under the jurisdiction of the federal government, a state government, a county, and possibly a municipality. These jurisdictions rely on the same taxpayers to function. The risk is that multiple layers of government exhaust the same tax base. The way to limit this risk is through competition at all levels of government.

Every jurisdiction in a federal system offers a range of public goods and services paid for by taxpayers. Jurisdictions compete for taxpayer dollars through the level of taxation and mix of goods and services they provide.⁵² When governments make poor fiscal choices or under- or over-provide certain goods, elected officials may be voted out of office, but taxpayers may also choose to “vote with their feet,” and move to locations which offer a different mix of goods and services at a different price.

The three crucial conditions for interjurisdictional competition are: the political autonomy of lower levels of government, the free movement of goods and people, and the absence of aid transfers from higher to lower levels of government. When these three conditions are met, they create a “market-preserving” federal system, which uses taxpayer preferences to constrain elected officials’ choices.⁵³

The rules that constrain government through competition are vital to maintaining the market-preserving system of federalism, as they make government commitments credible to taxpayers. When the rules maintaining a federalist structure are weakened, so are the checks on government, and socially destructive policies favoring narrow interest groups can be more easily implemented.⁵⁴

⁵² See Charles Tiebout, “A Pure Theory of Local Government Expenditure,” *The Journal of Political Economy* 64, no. 5 (1956): 416-424.

⁵³ See Barry Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics and Organization* 11, no. 1 (1995): 1-31.

⁵⁴ As James Madison, writing in Federalist Paper No. 51, explained: “But what is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself. A dependence on the people is, no doubt, the primary control on the government; but experience has taught

During the 20th century, federal mandates and aid transfers have weakened one of the auxiliary precautions necessary to federalism—interjurisdictional competition. Mandates impose policies and often pass on the costs of such policies to recipient governments. Federal transfers erode state and local policy autonomy by inducing further spending or directing state and local resources to areas that may not need it. New Jersey’s political and fiscal autonomy has been eroded by the growth of federal grants-in-aid and unfunded mandates. This is repeated on the local level, with state aid acting to erode competition among New Jersey’s municipalities.

6.A. Federal Funding

6.A.1. Mandates

Twenty-seven percent of New Jersey’s budget is dedicated to federal grants-in-aid. Grants-in-aid are the policy priorities of the federal government, but they are administered by the state (and local) government.

Grants-in-aid have several important features. First, a federal grant affects how states choose what goods to provide and in what amount, and may lead to the over- or under-provision of goods actually demanded by state (or local) citizens.⁵⁵

Secondly, federal grants allow state and local beneficiaries to spread program costs across all federal taxpayers. Since state and local recipients of federal grants do not bear the full costs of program spending up front, they perceive the costs of public spending differently and may demand more spending than they otherwise would.⁵⁶ In essence, the source of taxation (federal revenues) and the place of spending (state and local

mankind the necessity of auxiliary precautions.” Alexander Hamilton, James Madison and John Jay, *The Federalist Papers*, Benjamin Fletcher Wright, ed. (New York: MetroBooks, 2001), 356.

⁵⁵ Grants-in-aid change the division of responsibility within the federal system. Through grants the federal government may nationalize what would otherwise be state activities. Thus, “Grants involve a revision of the Constitution but without formal amendment.” See Richard Wagner, *Public Finance: Revenues and Expenditures in a Democratic Society* (Boston: Little, Brown and Company, 1983), 466.

⁵⁶ Lars P. Feld and Christoph A. Schaltegger, “Voters as a Hard Budget Constraint: On the Determination of Intergovernmental Grants,” *Public Choice* 123 (2005): 148.

beneficiaries) are separated, leading to “grant illusion.”⁵⁷ Further, when federal funds are used to augment state or local budgets, they act to “bail out” the lower level of government, softening the “hard budget constraint,” thus dulling (or even encouraging) the consequences of poor fiscal choices on the state and local level.⁵⁸

Grants weaken state and local political autonomy. When the state accepts federal funding, it is engaged in a contract with the federal government and must adhere to the conditions the grant imposes.⁵⁹ One condition attached to some grants is the matching requirement, which stipulates that states commit some of their own resources as a condition of receiving federal aid. The purpose is that states supplement, rather than substitute, their funds for designated activities.⁶⁰ The matching requirement has an unintended effect. In order to qualify for federal funding, states dedicate more resources than they otherwise would have to areas where there isn’t much need, leaving other areas under-funded.⁶¹

Medicaid is a matching grant. It is also the most significant and fastest growing federal program, representing nine percent of the state’s budget. It was created in 1965 to cover basic health care and long-term services for low-income individuals, the elderly, and the disabled. New Jersey began participating in 1970, the last state to do so. New Jersey must match 41.22 percent of the costs of the program, with the federal government contributing the balance.⁶² Of New Jersey’s 8.5 million residents, 997,300 participate in

⁵⁷ Ibid. See also chapter 10 in James Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, in *Collected Works of James Buchanan*, vol. 4 (Indianapolis: Liberty Fund, 2001).

⁵⁸ See Edward K. Hamilton, “On Non-constitutional Management of a Constitutional Problem,” *Daedalus* 107 (1978): 111-28. “...we do not know what disciplinary forces can resist impulses to excessive spending when the spender bears no responsibility for raising the revenue being allocated.”

⁵⁹ With increased federal money comes increased federal control of state policy. In theory, states are free to refuse federal money. However, this presents a “prisoner’s dilemma” problem for state government. A state may reject a federal grant and choose to set its own policies; however, that state’s taxpayers will continue to pay federal taxes to finance the grant program for the rest of the states.

⁶⁰ U.S. Government Accountability Office, “Federal Grants” GAO/AIMD-97-7,1.

⁶¹ Charles Levine and Paul Posner, “The Centralizing Effects of Austerity on the Intergovernmental System,” *Political Science Quarterly* 96, no. 1 (1981): 68.

⁶² Matching payments from the federal government depend on the amount the state spends on eligible services, and the Federal Medical Assistance Percentage (FMAP) – based on the average per capita income in the state. In FY 2009, the FMAP ranged from 83.62 percent in Mississippi to 56.2 percent in Wyoming. By law the FMAP cannot be lower than 50 percent. See The Henry J. Kaiser Family Foundation, “Kaiser State Health Facts,”

<http://www.statehealthfacts.org/comparetable.jsp?typ=2&ind=184&cat=4&sub=47&sortc=6&o=a>.

the program, costing roughly \$9 billion in FY 2009, of which New Jersey contributed \$3.56 billion.

To receive federal funds, states must agree to offer certain services.⁶³ States control their level of participation by opting in or out of additional services.⁶⁴ Medicaid is, in effect, 50 distinct programs in the United States, depending upon which options each state chooses to provide. At least one federal law increased eligibility or expanded benefits each year between 1984 and 1991, which, in addition to demographic changes, increased the program's costs to the federal and state governments.⁶⁵

New Jersey participates in most of these expanded provisions and has the highest income threshold maximum for child eligibility, making it one of the most costly Medicaid programs in the nation.⁶⁶ Between 1995 and 2000, New Jersey's Medicaid expenses grew only 2 percent, compared to 5 percent nationally.⁶⁷ However, in 2000, Medicaid costs rose by 12 percent, leading to an enrollment freeze on adult coverage. Since that time, costs have risen about 7 percent a year.⁶⁸ Rising health care costs and a state campaign to expand coverage increased the number of recipients by 37 percent between 1990 and 1995.⁶⁹ State spending on Medicaid doubled from \$1.8 billion in 1996 to \$3.34 billion in 2007.

⁶³ These include inpatient and outpatient services, physician services, medical and surgical dental services, nursing facilities for those 21 and older, home health care for nursing facility patients, family planning services and supplies, rural health clinic services or individual ambulatory services offered by a rural health clinic, laboratory and x-ray services, pediatric and family nurse services, federally qualified health-center services and other ambulatory services, nurse-midwife services, early and periodic screening, and diagnosis and treatment for persons under 21.

⁶⁴ New Jersey also provides the following optional services: treatment in residential treatment centers, optometry services and eyeglasses, dental care, prescription medicines, chiropractic services, psychologist services, prosthetics and orthotics, podiatry services, prescription medicine necessary during long-term care, durable medical equipment, hearing aid services, transportation, personal care services, licensed practitioner services, private duty nurse, services in a clinic, physical therapy, occupational speech therapy, inpatient psychiatric care for individuals between the ages of 21 to 65, and intermediate care facilities for the mentally retarded.

⁶⁵ Carol S. Weissert, "Medicaid in the 1990s: Trends, Innovations, and the Future of the PAC-Man of State Budgets," *Publius* 22 (1992): 101.

⁶⁶ Michael Sparer, Sherry Glied and Megan Vanneman, "Medicaid in New Jersey: Options for Reform," (white paper, Hall Institute of Public Policy New Jersey, 2006).

⁶⁷ *Ibid.*, 4.

⁶⁸ *Ibid.*, 5.

⁶⁹ *Ibid.*

Congressional passage of the State Children’s Health Insurance Program (SCHIP) in 1997 has added to New Jersey’s growing health-care budget. New Jersey operates “one of the most generous SCHIP programs in the nation,”⁷⁰ expanding coverage to children up to 350 percent of the poverty level—becoming one of a few states to cover parents (with federal dollars) and single adults (with state dollars).⁷¹ In 2001, New Jersey expanded SCHIP again, permitting coverage—funded with state dollars—for single adults with incomes at or below 100 percent of the federal poverty level. New enrollment was frozen in 2002. As the economy began recovering in 2004 and 2005, the state began a new program of encouraging Medicaid/SCHIP enrollment.⁷²

Since state governments cannot run deficits, when Medicaid (and SCHIP) costs escalate,⁷³ states have three choices: cut the program, increase taxes, or take money from other programs.⁷⁴ The federal stimulus of 2009 provides an additional \$1.06 billion for enhanced Medicaid funding in FY 2010. The rationale for this infusion is that it will free up resources for other areas of New Jersey’s budget. But by expanding the program, enrollment will increase and the state will need to spend more to meet the matching requirement, leaving the state with fewer resources to spend in other areas. If Medicaid enrollment does not recede when the federal stimulus funds are spent, New Jersey will be left with a permanently larger Medicaid program to support.

6.A.2. The Federal Stimulus

The effects of federal spending in New Jersey’s budget over the past 40 years are magnified by The American Recovery and Reinvestment Act of 2009 (ARRA). ARRA, meant to help states navigate the recession, directs \$17.5 billion to New Jersey (\$7.5

⁷⁰ Ibid.

⁷¹ Ibid., 6.

⁷² These included distributing Medicaid/SCHIP applications to all school children eligible for school lunches.

⁷³ The risk of participation in a continually expanded program became clear to states during this period of Medicaid expansion, leading some governors to express concern in 1990 that Medicaid was becoming a “backdoor effort to enact a national health insurance program using the states’ credit card as the financing mechanism.” See *National Governors’ Association Bulletin* 24, December 7, 1990, 3.

⁷⁴ Weissert, “Medicaid in the 1990s” (1992).

billion in tax breaks, and \$10 billion in spending). In FY 2010, New Jersey will spend \$2.2 billion in stimulus dollars. Over one-third is dedicated to Medicaid. Another \$1.05 billion is for spending on education. The remaining 22 percent is for infrastructure and transit projects across the state (figure 6).

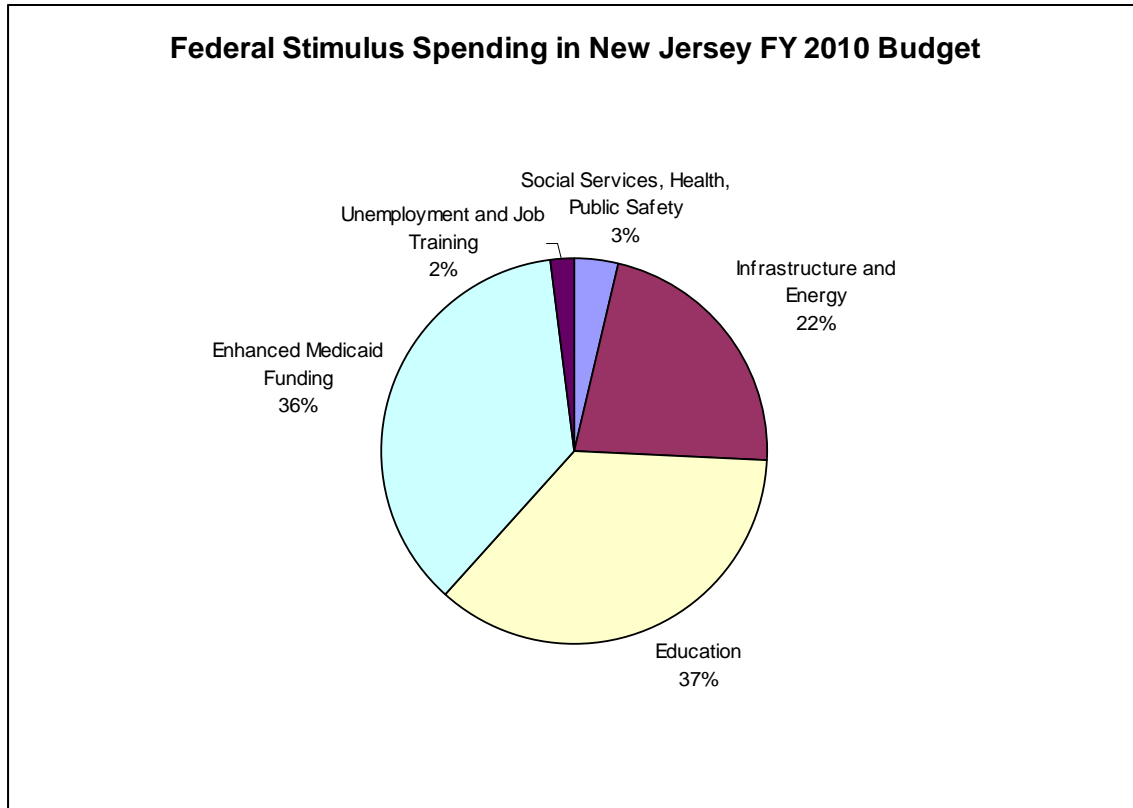


Figure 6

The intent of the stimulus is threefold: help states cover budget shortfalls, provide increased assistance to the poor, and jumpstart the economy through government spending for education, transit, and infrastructure projects.

The stimulus is unlikely to achieve these aims. Bailout funds do not address the underlying causes for New Jersey’s eroded fiscal condition. Subsidization only reinforces the practices that created the present crisis. With the current budget, the governor is repeating past mistakes—deferring pension contributions, expanding spending, and raising taxes. The actual cuts to the budget do not bring it anywhere near balance. When

stimulus funds recede, New Jersey will need to find a way to support expanded federal programs, a larger pension burden, and new education programs. On the national level, the cost of the stimulus will be paid for in debt—borne by future taxpayers.

As intergovernmental aid, stimulus spending encourages fiscal illusion. Temporary budget balance is achieved in part with federal grants. As discussed, federal grants change behavior on the state level, stimulating spending either through matching requirements, or by allowing states to free up funds to expand spending in other areas, thus increasing the total size of the state budget. Since the stimulus will be paid for in debt, that is, future taxation, the costs of spending are lessened for present beneficiaries. This ultimately erodes accountability for how public funds are spent, weakening the link between beneficiaries and taxpayers, and diminishing citizen voice in how the public sector spends taxpayer funds.

6.B. Municipal Government, Intergovernmental Aid, and State Mandates

The local level also bears the costs of the state government's fiscal policies. Court mandates on schooling and affordable housing, state-negotiated public pension benefits, and intergovernmental aid to municipalities and school districts change the tax and spending incentives facing local governments. State mandates have steadily increased property taxes while eroding local autonomy in the provision of services and control over the growth of spending on the local level. Just as federal grants-in-aid change the incentives facing state government, the Property Tax Relief Fund and state aid programs targeted at the municipal level have the effect of promoting fiscal illusion and subsidizing inefficiencies in local budgets.

New Jersey has the second highest level of property tax per capita in the United States, an average of \$6,787. The property tax's steady increase, 7 percent a year on average (see

figure 7), has been the source of citizen discontent and likely one of the drivers behind New Jersey's loss of 377,000 people between 2000 and 2006.⁷⁵

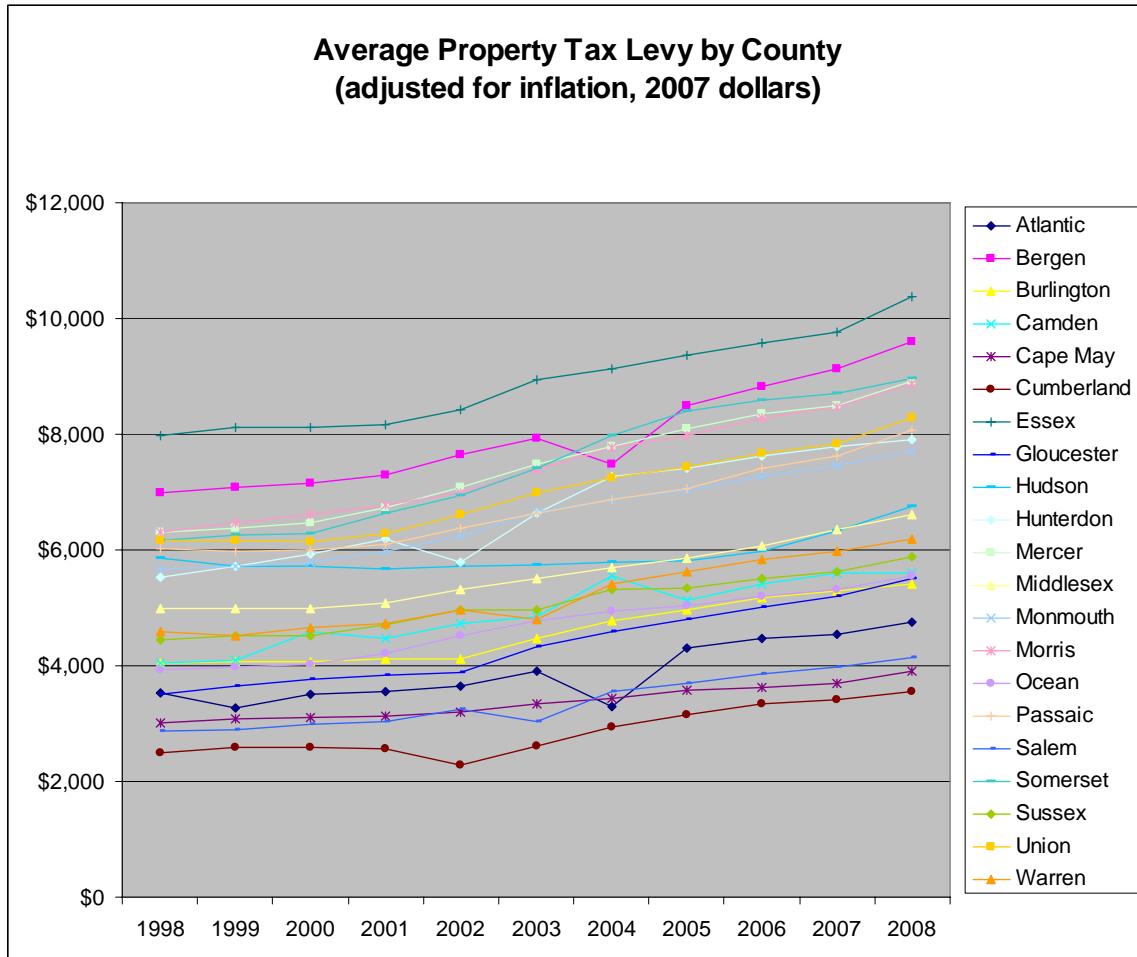


Figure 7

The variety of corporate forms and number of municipalities in New Jersey is an outgrowth of the state's population growth and economic development during the 19th and early 20th centuries.⁷⁶ Municipal incorporation served as a means of private zoning⁷⁷

⁷⁵ Joseph Seneca and Richard Hughes, *Where Have All the Dollars Gone?* (New Brunswick: Rutgers Regional Report, Edward Bloustein School of Planning and Public Policy at Rutgers University, Issue Paper No. 26, October 2007), http://policy.rutgers.edu/news/reports/RRR/RRR_October_2007.pdf.

⁷⁶ New Jersey was the first colony to have no unincorporated land. By 1693, the land was divided into East Jersey and West Jersey, each consisting of 12 townships. Between the Revolutionary War and the early 19th century, most municipalities were formed around the construction and payment for toll roads. See Alan Karcher, *New Jersey's Multiple Municipal Madness* (New Brunswick, New Jersey and London: Rutgers University Press, 1998), 54.

and a means of settling disputes over tax rates, the use of revenues, or control over private activity.⁷⁸ Municipal creation boomed between 1834 and 1957, their number increasing from 125 to 568, as “citizens sought to meet the problems of local government in growth areas by creating new governmental units.”⁷⁹ Described as “largely a series of declaration of independence,”⁸⁰ an average of five new municipalities were added every year between 1840 and 1920. The 1926 decision by the U.S. Supreme Court to allow local governments to use zoning to determine land use “rendered moot the option of creating a new municipality.”⁸¹ By the 1950s, the total number of municipalities remained set at 567.⁸²

The advent of zoning was followed by a major fiscal stress test of local budgeting practices. During the Great Depression, many New Jersey municipalities, along with the rest of the nation, saw a significant drop in economic activity and thus revenues, leading 87 municipalities and 2 counties to default.⁸³ By 1936, 8 municipalities recovered as public projects were cancelled, 28 municipalities were paying in scrip, and 12 towns were insolvent.⁸⁴

While municipal default was driven by an unprecedented collapse in revenues, many towns faced structural budgetary problems due to accounting practices, such as

⁷⁷ See Robert H. Nelson, *Zoning and Property Rights* (Cambridge: MIT Press, 1977).

⁷⁸ Alan Karcher notes the most prevalent factors in the creation of many municipal governments were disputes over road jurisdiction, control over schools, the creation of commuter towns around railroads or factories, and alcohol licensing. See *New Jersey's Multiple Municipal Madness*.

⁷⁹ Michael A. Egerton, "Modern Forms of Municipal Government," *State Commission on County and Municipal Government* (Trenton, NJ, 1992), 2, http://www.njstatelib.org/NJ_Information/Digital_Collections/DIGIDOX1.php

⁸⁰ John P. Snyder, *The Story of New Jersey's Civil Boundaries 1606-1968*, (Trenton: New Jersey Department of Environmental Protection, 1969), 23.

⁸¹ The U.S. Supreme Court ruling in *Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926), permitted government, rather than private interests, to regulate land use in a community via zoning ordinances. See Karcher, *New Jersey's Multiple Municipal Madness*.

⁸² In 1997 the township of Pahaquarry, with a population of less than twelve people, was dissolved and incorporated into neighboring Hardwick Township, bringing the total number of municipalities in New Jersey to 566.

⁸³ Karcher, 196.

⁸⁴ *Ibid.*, 195.

overstating revenues to conceal their debts.⁸⁵ The state called for reform, requiring municipalities to adopt cash budgets.

Significantly, state-administered municipal aid programs were expanded. The state gradually began to take over the levying and distribution of local revenue sources.⁸⁶ The intent was to rescue and stabilize local governments, but in doing so, the state helped to weaken the “hard budget constraint” facing municipalities, laying the groundwork for future municipal dependencies and inefficiencies. Municipalities could now budget under the promise of aid, rather than the penalty of potential default. Revenue-sharing and redistribution arrangements also produce other unintended fiscal effects. By homogenizing municipal budgets and policies, state aid weakens competition among local governments, which compete for citizens by offering different mixes of goods and taxes. This expansion of state aid also provided an opportunity for the state to funnel locally levied and collected revenues into its own coffers.

The process of the state assuming control of local revenue sources and redistributing revenues according to revised formulas continued into the early 1970s. Until the 1960s, municipal governments in New Jersey collected taxes on several sources, including the Business Personal Property Tax and the Financial Business Tax. Both sources of taxation were assumed by the state, which took over the administration tax and redistribution of the revenues. Part of these formerly local revenues was returned to municipalities, and part retained or “skimmed” by the state.⁸⁷ These municipal-aid streams were eventually

⁸⁵ Ibid., 196.

⁸⁶ The precedent for the state controlling local revenues occurred in 1884 with the Railroad Tax Act and the enactment of levies on railroads and railroad property. These levies were determined by a state, rather than a local, Board of Assessors, thereby inserting the state into the local property tax assessment process. Cities with Class II Railroad property shared these locally-collected revenues with the state. This concept of revenue-sharing between the local and state government was extended in 1938 to public utilities in order to help municipalities navigate potential bankruptcy. The Franchise and Gross Receipts Tax collected by the state government on public utilities was distributed to localities according to a formula as an additional source of municipal revenue on top of other locally collected and administered taxes. The state retained a portion of the tax, known as “the state skim,” a practice often criticized by municipalities who viewed the revenue as belonging to local government. See “A Short and Simple Glimpse at the Property Tax in New Jersey,” http://www.njslom.org/tax_brochure.html.

⁸⁷ When the state assumed collection for the Business Personal Property Tax in 1970, it promised to return all of the revenues to the localities. When it assumed collection of the Financial Business Tax, which had formerly been divided between the host municipality and the host county, the levy was doubled, with the

gathered into the Consolidated Municipal Property Tax Relief program and Energy Tax Receipts program in 1996. The growth of municipal aid continued with the creation of the Property Tax Relief Fund in 1976. In addition, the state operates two other municipal aid programs: Extraordinary Aid—for municipalities under unexpected and exceptional budgetary stress⁸⁸—and Urban Aid—for cities with higher poverty levels suffering from eroded local tax bases. Property tax revenues, on average, make up about 40 to 50 percent of municipalities’ budgets.⁸⁹

Budget caps have failed to control spending in schools, municipalities, and counties. Property tax reform has been on the agenda of the state and municipal governments several times in the past.⁹⁰ In 2006, the issue was the subject of a special session of the legislature called by the governor which resulted in multiple hearings, 4 reports, and 200 recommendations for reform. However, the recommendations of the committee did not make much progress—the commission was disbanded in December 2006—leaving the perennial issue of New Jersey’s rising property taxes unresolved.

The commission, according to some legislators, also failed to consider “critical Constitutional issues, such as which branch of government should control school funding, land use, State debt, and State spending caps...proving that the Joint Committee shunned addressing the real issues that could have produced significant results in terms of reducing or controlling the property tax burden.”⁹¹

The costs of state mandates vary according to municipality. Mandates cover many areas: environmental protection, schooling, public safety, health, and engineering. The township

new distribution set at 50 percent for the State and 25 percent for the host county and 25 percent for the municipality. These were bundled into the Public Utility and Gross Receipts and Franchise Taxes. In 1982, the state “skimmed” \$32 million from the fund for state programs.

⁸⁸ To receive Extraordinary Aid, the municipality must demonstrate that it has taken meaningful steps to resolve budgetary shortfalls, such as improving tax collection, management efficiencies, privatization of services, or sharing services. See <http://www.state.nj.us/dca/lgs/lfns/02lfns/mc-2002-2.pdf>.

⁸⁹ Author’s calculation. Data taken from New Jersey Division of Local Government Services.

⁹⁰ See http://www.njslom.org/tax_reform_04-2003.html.

⁹¹ Senate Republican Leader Leonard Lance and Assemblyman Richard Merkt, Minority Statement, Dissent from the *Report of the Joint Legislative Committee on Constitutional Reform and Citizens Property Tax Constitutional Convention*, 87.

of Hardyston in Sussex County estimates 77 state or federal mandates are imposed on their budget.⁹² The most significant of these are related to pension benefits for police, firemen (0.25/\$100 payroll), and teachers, (.0927/\$100 of payroll) and insurance costs for municipal employees (\$750,000 annually). Federal mandates, such as No Child Left Behind, are also passed down to the local level of government.

Aside from the costs to local taxpayers, mandates compromise the effectiveness of local governments. Municipalities are less responsive to the demands of citizens when they are forced to provide a level of services determined by the state or the federal level. Ideally, services should be provided by the lowest level of government possible where the actions and their costs are most visible to citizens. To what extent individual municipal governments are operating efficiently is unclear, if the design of policy and budgets is intertwined with state policies and aid streams.

Federal aid to the states, state aid to municipal government, and reliance on debt have clouded the full costs of spending to New Jersey's citizens. Fiscal illusion occurs when voters do not know how much revenue local government obtains from higher government grants. This causes voters to perceive that local services cost less than they actually do, leading voters to supporting greater local spending than they might otherwise.⁹³ This, coupled with the effects of unfunded state mandates, which passes on the costs of state policies to local governments, has led to a steady increase in New Jersey's property taxes—the earliest and strongest sign of the state's unsustainable fiscal path.

7. BRANCHING OUT: WHEN COURTS SET POLICY

In addition to the constitutional and statutory rules under which the executive and legislature budget, the New Jersey Supreme Court has taken an active role in designing state and local policies. In particular, the court's rulings on school funding, the *Abbott* decisions, and the subsequent legislative implementation of these decisions have

⁹² See <http://www.njslom.com/Hardyston-Twp-Mandates-Analysis.pdf>.

⁹³ Geoffrey K. Turnbull, "The Overspending and Flypaper Effects of Fiscal Illusion: Theory and Empirical Evidence," *Journal of Urban Economics* 44 (1998): 1-26.

profoundly altered New Jersey's tax regime and budget practices, leading to dramatic increases in income and property taxes.

In 1970, the Newark-based legal advocacy group, the Education Law Center (ELC), brought a case to the New Jersey Supreme Court on behalf of urban students, challenging the constitutionality of funding schools almost exclusively by property taxes.⁹⁴ The New Jersey Constitution states all students are guaranteed a "thorough and efficient system of free public schools."⁹⁵ The case rested on the claim that over-reliance on property taxes discriminated against children in poor districts and created disparities in education quality since districts with high property values could spend more than districts with low property values.⁹⁶ The court ruled in favor of the plaintiff in *Robinson v. Cahill*, directing the state to find an alternative way to fund schools.

The Public School Education Act (1975) attempted to close this disparity by mandating a minimum level of per-pupil funding via a combination of local property taxes and state aid. The court was not satisfied and closed the schools.

To meet the court's ruling, in 1976, the legislature instituted a state income tax with revenues constitutionally dedicated to a Property Tax Relief Fund to be used mainly to

⁹⁴ Elaine M. Walker and Dan Gutmore, "The Issue of Civic Capacity in Urban Educational Reform: The Case of New Jersey's Thirty Poorest Districts," *Journal of Negro Education* 71, no. ½ (Winter-Spring 2002): 62.

⁹⁵ The "thorough and efficient clause," Article I, Section IV of the State Constitution reads, "The Legislature shall provide for the maintenance and support of a thorough and efficient system of free public schools for the instruction of all the children in the State between the ages of five and eighteen years."

⁹⁶ The case was part of a wave of school reform touched off in California two years earlier. In 1971, in the *Serrano v. Priest* decision, the California court determined the local property tax is not a just way to fund education because poor districts will naturally lag in funding behind their wealthier counterparts. Several states, including Hawaii, California, Florida, Wisconsin, and Michigan have education systems that are nearly entirely state-funded, with no funding decisions made at the local level. See William N. Evans, Sheila E. Murray, and Robert M. Schwab, "Schoolhouses, Courthouses, and Statehouses after Serrano," *Journal of Policy Analysis and Management* 16, no. 1 (Winter, 1997): <http://www.jstor.org/mutex.gmu.edu/stable/pdfplus/3325882.pdf>. Since *Serrano v. Priest*, a general trend has emerged in which state funds to school districts are determined by districts' perceived needs rather than their number of students. Funds may be allocated based on students' income levels, number of English language learners, students with disabilities, or other factors that may help determine the necessary resources for education. In the *Serrano* decision, spending was capped in wealthy districts and a portion of their property taxes was redistributed to increase spending in low-income districts.

supplement school budgets, with smaller amounts dedicated to municipal aid and individual property tax rebates. The initial income tax was nearly flat: 2 percent on those earning less than \$20,000 and 2.5 percent on those earning \$20,100 and higher.

The income tax was to enable the repeal of some business taxes while lessening reliance on property taxes.⁹⁷ After the first year the Property Tax Relief Fund was in place, it failed to meet this objective. In 1977, property taxes fell by more than 17 percent, but state spending increased by 26 percent. By 1978, property taxes began increasing again by 2.4 percent. In FY 1979, revenues lagged behind appropriations by \$100 million.⁹⁸ By 1981, aid for schools began to outpace income tax collections. Property taxes began growing at 10 percent annually—what they had averaged between 1962 and 1977.⁹⁹

In the same year, the ELC brought a new lawsuit, contending the state’s remedy for schools in poor districts was insufficient. The case of *Abbott v. Burke* set in motion two decades of litigation over school funding, facilities construction, curriculum standards, and the provision of pre-school education in the 31 court-designated Abbott districts.

In 1990 the court required the state provide “parity aid” to Abbott districts, ensuring they spend *as much as* the wealthiest district per pupil. Abbott districts were also to be given “parity plus” for supplemental programs “to wipe out disadvantages as much as a school district can.”¹⁰⁰

To comply, Governor James Florio implemented the Quality Education Act (QEA), ending automatic payments to wealthy districts and increasing aid to poor and middle-income districts via income-tax increases.¹⁰¹ The combined funding redistribution and

⁹⁷ Richard C. Keevey, “State Fiscal Changes: The Long Road from Planning to Implementation,” *Public Budgeting and Finance*, Winter 1981: 27.

⁹⁸ *Ibid.*, 33. The budget was balanced with prior-year surpluses, one-time revenues, and appropriation adjustments.

⁹⁹ *Ibid.*, 30.

¹⁰⁰ See *Abbott v. Burke II*, 119 N.J. 287, 575 A.2d 359 (1990).

¹⁰¹ Deborah Yaffe, *Other People’s Children: The Battle for Justice and Equity in New Jersey’s Schools* (New Brunswick, NJ: Rutgers University Press, 2007).

rate hike sparked a tax revolt that cost the governor re-election. The QEA was overturned by the court, which gave the state until 1997 to comply with its original ruling.

In 1997 Governor Christie Whitman introduced the Comprehensive Educational Improvement and Financing Act (CEIFA) in which the “thorough” portion of the constitution’s education clause was defined as delivering new Core Curriculum Content Standards, and “efficient” was defined as the cost of education in a hypothetical “model school district” (as opposed to the wealthiest district).¹⁰² CEIFA aimed to control costs in Abbott districts by capping spending in non-Abbott districts. The act allowed non-Abbott districts to spend more only if they indicated any additional spending as “not constitutionally required on school budget ballots.”¹⁰³ Non-Abbott districts, on average, did spend beyond the cap, and thus CEIFA failed to meet the court’s test of parity aid.

In *Abbott V*, the court instituted “an ambitious agenda” of school reform: all-day pre-school for three- and four-year-olds, social and health services, and school building upgrades in Abbott districts.¹⁰⁴

The cost of compliance with the court’s rulings is reflected in the growing progressivity of New Jersey’s income tax (table 1).

¹⁰² Ibid.

¹⁰³ Ibid.

¹⁰⁴ Ibid.

Income Bracket	1976 Byrne	1982 Kean	1990 Florio	1995 Whitman	1996 Whitman	2004 McGreevey	2008 Corzine	2009 Corzine
<10K	0%	0%	0%	0%	0%	0%	0%	0%
<\$20K	2%	2%	1.9%	1.4%	1.4%	1.4%	1.4%	1.4%
\$20.1K - \$35K	2.5%	2.5%	2.375%	2.212%	1.75%	1.75%	1.75%	1.75%
\$35.1K-\$40K	2.5%	2.5%	2.375%	2.212%	1.75%	1.75%	3.5%	3.5%
\$40.1K - \$50K	2.5%	3.5%	2.375%	2.212%	1.75%	1.75%	5.525%	5.525%
\$50.1K-\$70K	2.5%	3.5%	3.325%	2.975%	2.45%	3.5%	5.525%	5.525%
\$70.1K-\$75K	2.5%	3.5%	5%	4.25%	3.5%	5.25%	5.525%	5.525%
\$75.1K-\$80K	2.5%	3.5%	5%	4.25%	3.5%	5.25%	6.37%	6.37%
\$80.1K-\$150K	2.5%	3.5%	6.4%	6.013%	5.525%	6.37%	6.37%	6.37%
\$150.1K- \$400K	2.5%	3.5%	6.65%	6.58%	6.37%	6.37%	6.37%	6.37%
\$400.1K-500K	2.5%	3.5%	6.65%	6.58%	6.37%	8.97%	8.97%	8%
>\$500.1K- \$1,000,000	2.5%	3.5%	6.65%	6.58%	6.37%	8.97%	8.97%	10.25%
>\$1,000,000	2.5%	3.5%	6.65%	6.58%	6.37%	8.97%	8.97%	10.75%

Table 1

Between 1998 and 2007, the state dedicated \$62 billion in income-tax revenues to schools. Last year, \$11.5 billion was budgeted for schools, or 35 percent of the total

budget. In spite of this spending, revenues have not met all of the costs of the Abbott rulings. In the past 15 years, governors have relied increasingly on debt, issuing over \$11 billion in school facilities construction bonds.

New Jersey has the second-highest per-pupil spending in the nation. In 2004, average spending per pupil was \$16,888, compared to \$8,306 on average nationally for districts with over 15,000 students.¹⁰⁵ The majority of spending has been concentrated on the 31 Abbott districts. Since 1998, on average, 53 percent of school aid has been awarded to Abbott districts, with 47 percent of school aid spread across the remaining 580 school districts.¹⁰⁶ State aid comprises nearly 78 percent of Abbott school budgets, with property tax revenues accounting for 14 percent and federal aid making up 8 percent on average (see figure 8). The reverse is true of the remaining school districts. On average, non-Abbott schools rely on property tax revenues, which comprise 72 percent of spending. State aid represents 24 percent of school budgets, on average, with the federal share averaging 4 percent (see figure 9).

¹⁰⁵ <http://www.state.nj.us/treasury/omb>.

¹⁰⁶ There is a range of total aid awarded in individual Abbott districts. Under *Abbott IV-V*, each district must present its case to the Department of Education. Hoboken City receives the least of the Abbott districts, with 25 percent of its funding coming from state aid. Camden City, by contrast, receives the most, with 90 percent of its school budget comprised of state aid, representing over \$500 million in FY 2008. See <http://www.state.nj.us/education/guide/2008/abbott.pdf>.

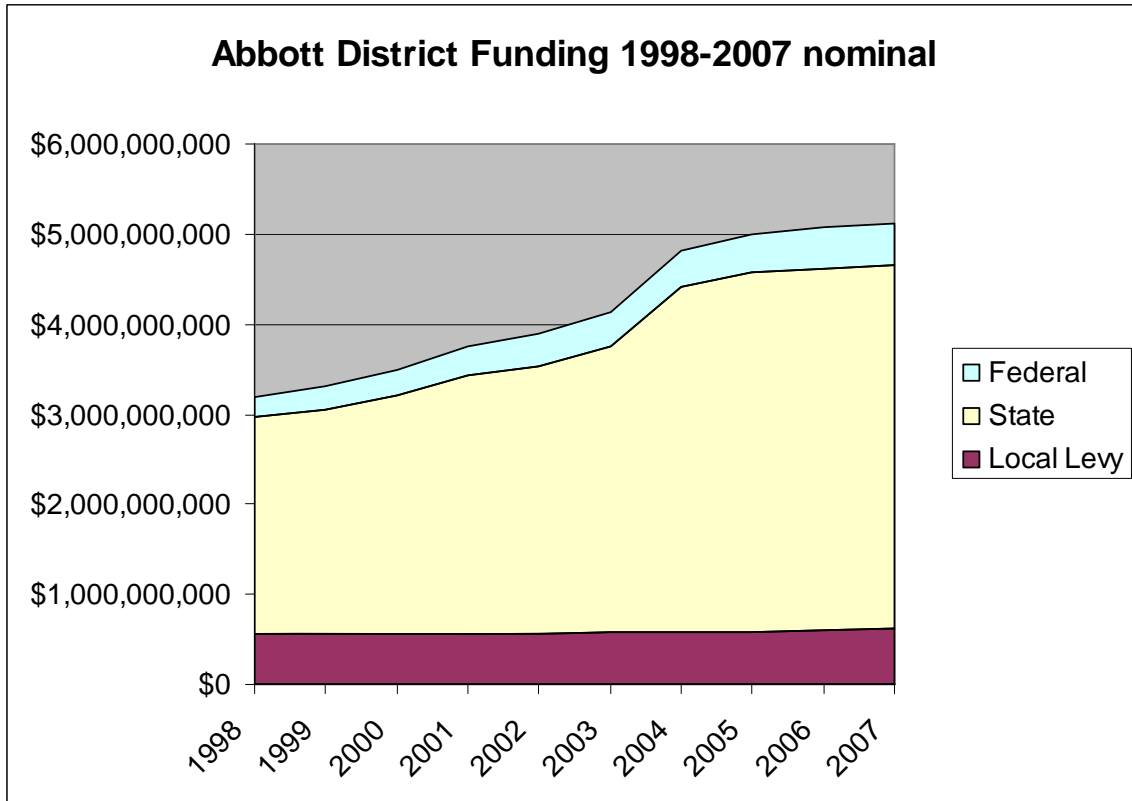


Figure 8

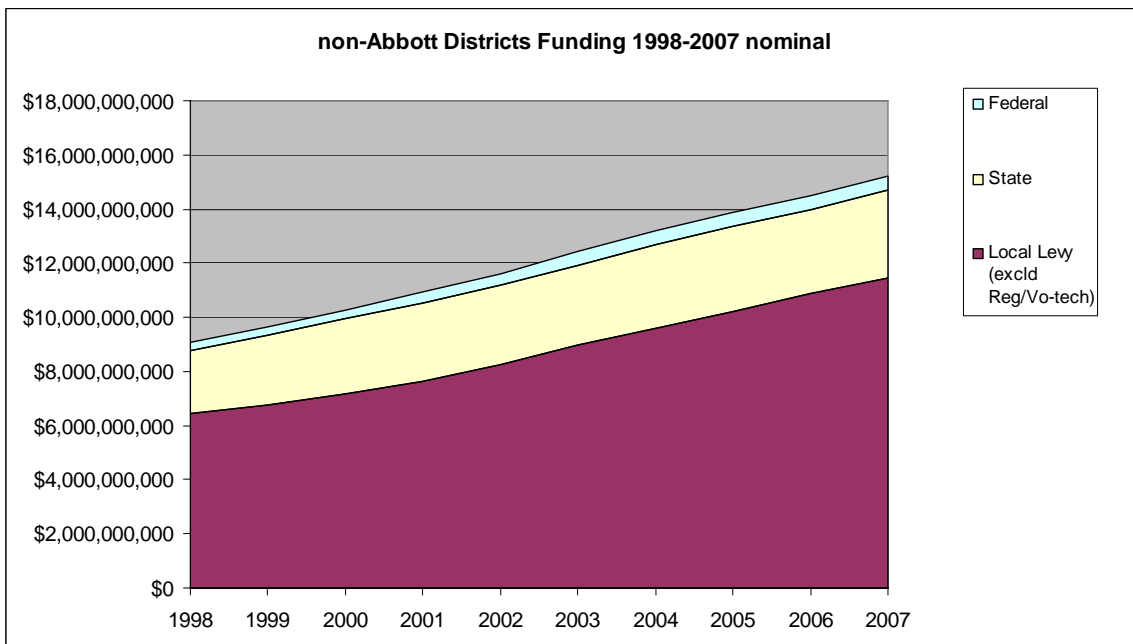


Figure 9

While *Abbott IV* and *V* required poor districts to spend as much per pupil as wealthy districts, middle-income districts were not subject to the same mandate. Income tax dollars from those living in middle-income districts were dedicated to better-funded school districts, producing an inequity between Abbott and middle-income districts.¹⁰⁷

The Abbott decisions have been criticized on several grounds. First, the decisions have not achieved the stated goal of equity, since 49 percent of poor students live outside of the Abbott districts.¹⁰⁸ To remedy this, Governor Corzine successfully changed the school funding formula in 2009. The new formula distributes state aid to districts based on the individual proportion of low-income, special needs, and limited English proficiency students, tying aid to the student, not the district.¹⁰⁹ While the change eliminates the Abbott district distinction, Abbott districts still receive over half of state aid. In addition, by tying aid to the student, those children eligible for Abbott aid in a given school district bring with them the requirements of the Abbott decisions. For example, a non-Abbott school district with an Abbott child would have to provide full pre-school for “Abbott aid” students. In one sense, the formula change is a means to impose the costs and requirements of the Abbott decisions on non-Abbott districts.

Evaluations indicate that in spite of the redistribution of resources to Abbott districts, outcomes have barely improved.¹¹⁰ (See box: “Has Abbott Worked?”) A more significant criticism is that the court broadly misinterpreted New Jersey’s constitution,

¹⁰⁷ To remedy this inequitable distribution in non-Abbott districts, schools in all districts are permitted to apply for eight different types of supplemental formula aid.

¹⁰⁸ *New Jersey Fiscal 2009 Budget in Brief*, <http://www.atate.nj.us/treasury/omb>.

¹⁰⁹ The act proposes state aid flow through two channels: wealth-equalized aid, allocated based on districts’ ability to raise revenue, and categorical aid, based on the number of students in each district requiring special funding. Each district would be given a base amount of aid determined by the number of students enrolled in preschool, elementary, middle, and high schools. Additional aid would be given for the number of at-risk students, bilingual education, special needs children. Aid would be adjusted for the cost of education in different geographic areas of the state.

¹¹⁰ Herbert J. Wallberg’s analysis of “high-poverty, high-performance” school districts, also known as “outliers,” indicates that successful student performance is contingent on factors other than dollar resources, including: strong principal leadership and teacher commitment, experimentation with teaching methods, high expectations and focus on achievement and academic success, and decentralized budgeting and management. See Eric Hanushek, *Courting Failure: How School Finance Lawsuits Exploit Judges Good Intentions and Harm Our Children* (Stanford: Hoover Press, 2006), 80-99.

which states, “The Legislature shall provide for the maintenance and support of a *thorough and efficient system of free public schools* for the instruction of all the children in the State between five and eighteen years.”¹¹¹ The court abbreviated this language and broadened its intent, arguing the constitution guarantees a thorough and efficient “education” rather than a thorough and efficient “system” of free schools, leading the court to become involved in setting curriculum standards.¹¹² Further, the court ignored explicit language and expanded education to three- and four-year-olds.¹¹³

New Jersey illustrates the dynamic of policymaking—past policies generate unintended present consequences. Unintended consequences often lead policy makers to undertake more interventions, producing more distortions,¹¹⁴ making piecemeal reform difficult, if not ineffectual. New Jersey’s only possible route to reform is to simplify the current framework and return to the institutional environment under which it developed into a thriving economy during the 19th and 20th centuries.

For New Jersey to regain its position as an economic leader, it must restore competition and direct democracy in its local governments and in the state government. Reform of New Jersey’s fiscal institutions and the restoration of the classical principles of public finance and competition are the keys to reestablishing an environment in which entrepreneurs, businesses, and individuals can create, contribute, and flourish.

¹¹¹ New Jersey Constitution, art. 8, sec. 4, para. 1.

¹¹² Paul Moonshine, “Abbott Funding: New Jersey’s Court needs a preschool education,” *The New Jersey Star Ledger*, March 29, 2009, http://blog.nj.com/njv_paul_mulshine/2009/03/abbott_funding_new_jerseys_cou.html.

¹¹³ Peter J. Maze, “New Light on New Jersey’s ‘Thorough and Efficient’ Education Clause,” *Rutgers Law Journal*, Vol. 38: 1087 (2007): 1140-1141. New Jersey has provided supplemental funding to local schools for education since 1817, but abuses by the legislature, including tapping into the State’s School Fund, culminated in the “Act to Make Free the Public Schools of the State in 1871,” providing the rationale and method for state funding to local school districts. Examining the debates that led to the 1875 Constitution’s “thorough and efficient” language reveals the framers were not departing, but rather supporting, the 1871 act. Specifically, that a free public education is guaranteed for children aged 5 to 18—through a statewide property tax distributed to school districts based “solely on the population of school-aged children,” regardless of the wealth of the county or municipality.

¹¹⁴ See Sanford E. Ikeda, *Dynamics of the Mixed Economy: Toward a theory of Interventionism* (London: Rutledge, 1997).

Has Abbott Worked?

Educational Outcomes

While it is difficult to compare academic achievement across time periods, evidence indicates that Abbott money has had little effect on improving student performance. The current method for assessing student performance is the High School Proficiency Assessment, instituted in 2003. Students have not been tested consistently before this time, making it difficult to measure the impact of Abbott on student performance.¹

By current measures, Abbott districts still lag behind their peers in test scores and graduation rates. In the 2004–2005 school year, two decades after *Abbott I*, Newark, with a student population of 41,710, was one of the highest-funded districts in the state, spending \$21,978 per pupil, with a student-teacher ratio of twelve-to-one.² Test scores are rising in absolute terms, and relative to the rest of the state. However, Newark test scores are still significantly below state averages. About 60 percent of fourth graders passed the state’s Language Arts Literacy Exam, compared to a state average of 80 percent. Newark’s graduation rate was 92 percent in 2007; yet, only 45 percent of the city’s eleventh-graders passed the High School Proficiency Assessment (HSPA).

Complicating matters, the state offers two exit exam options. For students who fail the HSPA three times, there is the Special Review Assessment (SRA). Described as a “backdoor route to graduation,”³ objections have been raised to the SRA by the legislature and Department of Education, with the State Board of Education offering a resolution to phase it out, suggesting, “districts that disproportionately rely on the SRA...develop a plan to reduce the number of students using it and to report annually their progress in reducing this level of dependence.”⁴

In 2008, as a compromise, the Board decided the Core Curriculum Standards would be revised, and students taking either the HSPA or the SRA must demonstrate they grasped content standards in order to pass. State reliance on SRA examinations has dropped since 2005, but Abbott districts have trended in the opposite direction, with Newark an important exception.⁵

The court placed a clear emphasis on increased funding as the answer to improving student performance. Their decisions reflected the belief among the educational establishment in the 1970s that education is an “output,” which can be improved by increasing the “input.” But that has not been the case.

The lackluster performance of these schools is also related to the fractured relationship between beneficiaries and providers. Abbott districts receive the majority of their funding from state aid rather than local tax revenues. The incentive to make optimal use of this funding and to monitor school performance is minimal. In addition, taxpayers in districts receiving state aid may not be benefiting from lower property taxes, because officials in local government prefer to work the increased revenue into their budgets, rather than returning it to taxpayers via a municipal tax cut.⁶

¹ Williamson M. Evers and Paul Clopton, “High-Spending, Low-Performing School Districts,” in *Courting Failure: How School Finance Lawsuits Exploit Judges Good Intentions and Harm Our Children*, ed. Eric Hanushek (Stanford: Hoover Press, 2006), 135.

² *Ibid.*, 136.

³ <http://www.nje3.org/>.

⁴ <http://www.state.nj.us/education/assessment/hs/sra/041008sramemo.pdf>.

⁵ <http://www.nj.gov/education/assessment/hs/sra/update/additional.pdf>. In 2007, four of Newark’s high schools relied less on the SRA than they did in 2005.

⁶ This is known as the “flypaper effect.” When state aid is used to reduce local taxes, the aid is generally returned to tax payers at a ratio lower than dollar for dollar. Upon receiving state aid for education, local officials essentially have three choices: they can use the additional revenue to lower property tax rates; they can spend the money on more education; or they can direct the money to another use of municipal money.

Incentives may be such that either of the latter options appears more attractive to policy makers than lowering local citizens' property taxes. See Timothy Goodspeed, "The Relationship between State Income Taxes and Local Property Taxes," *National Tax Journal* 51, no. 2; Daphne A. Kenyon, "The Property Tax—School Funding Dilemma," Lincoln Institute of Land Policy (2007).

8. POLICY RECOMMENDATIONS

Today, New Jersey is overburdened with legislation and a complex system of taxation. In spite of constitutional constraints, poor fiscal choices have prevailed for a period of decades. Increases in spending have been partially obscured to voters via debt, intergovernmental aid, and budget gimmicks. By using non-tax sources of revenue, the state and municipal governments sustain spending growth beyond what taxpayers might otherwise support, through fiscal illusion. When they do not bear the full costs, state taxpayers may demand more public spending than if they paid for spending in full.

New Jersey must reform its fiscal institutions—the rules under which elected officials budget. A recent Mercatus study ranked New Jersey 43rd in fiscal policy.¹¹⁵ Re-establishing fiscal prudence requires a) constitutional rules that constrain state and local government spending and b) policies that promote the best use of public money. Other states have been successful in constraining spending and, as a consequence, may be more resilient during periods of crisis.

1. Create Effective Constitutional Rules to Constrain Spending

Colorado's Taxpayer Bill of Rights (TABOR) is regarded as the most successful constitutional constraint on government spending in the United States.¹¹⁶ TABOR restricts growth in tax revenue and spending to the sum of inflation and population growth. It is a simple rule and thus, hard for elected officials to avoid and easy for taxpayers to evaluate. For example, if inflation is 3 percent a year and population growth

¹¹⁵ Ruger and Sorens, *Freedom in the 50 States*. Fiscal policy includes local budget constraints—the extent to which local governments depend on their own resources rather than grants from higher levels of government.

¹¹⁶ For an in-depth treatment of TABOR, see Barry Poulson, "Tax and Spending Limits: Theory, Analysis, and Policy," Issue Paper 2-2004 (Golden, CO: Independence Institute, 2004); Barry Poulson "Colorado's TABOR Amendment: Recent Trends and Future Prospects," Americans for Prosperity Foundation (July 2004); Poulson, "Local Tax and Spending Limits in Historical Perspective," Americans for Prosperity Foundation (2006); and Poulson, "Colorado's Taxpayer Bill of Rights (TABOR) Amendment: An Experiment in Direct Democracy," Americans for Prosperity Foundation (2009).

is stable, government can only increase spending by 3 percent in nominal terms. If tax revenues increased more than 3 percent in that same year, the surplus is rebated to taxpayers. If government wants to spend beyond this level, they must ask citizens through ballot measures (i.e., citizen initiatives).¹¹⁷

TABOR limits have been considered by many other states since TABOR was enacted in 1992.¹¹⁸ Interestingly, TABOR was enacted through the citizen initiative process. TABOR is an extension of the statutory budget limits put in place in the 1970s. TABOR has been very effective at controlling spending, returning billions to Colorado's taxpayers. By relying on direct democracy and operating under a simple rule, TABOR fosters discipline in spending. Legislators must present the amount, the purpose, and time in which they intend to spend funds to citizens well in advance of the ballot measure. When a tax surplus results and taxpayers decide funds should be returned to taxpayers, the state is forced to reduce the level of taxation within the limit set by inflation and population growth. TABOR automatically forces government to reduce taxation to the level that reflects the amount citizens wish to spend.

In addition to reflecting voters' preferences, direct democracy forces transparency in public policy. When elected officials operate under a specific mandate limiting how much they can spend and must ask voters to spend more, this creates an explicit contractual relationship between taxpayers and elected officials. Taxpayers have a clearer picture of how funds are spent, since they must explicitly approve spending and taxation on ballots.¹¹⁹

¹¹⁷ New Jersey does not currently have an initiative or referendum process. Legislation was introduced in 2001–2002 proposing a modified form, limiting what citizens can place on the ballot to issues of government reform and procedures to limit the frequency of initiatives. See Craig B. Holman, "An Assessment of New Jersey's Proposed Limited Initiative Process," Brennan Center for Justice at NYU School of Law (December 2000),

<https://www.policyarchive.org/bitstream/handle/10207/8720/njproposedlimited.pdf?sequence=1/>.

¹¹⁸ See Barry Poulson, "Tax and Spending Limits."

¹¹⁹ This stands in contrast to taxpayers as auditors: monitoring spending by reading budgets in an attempt to figure out post-appropriation, how government dedicated funds to various spending programs.

	RPCGDP- CO (\$)	93-07 %	RPCS- CO (\$)	93-07 %	RPCGDP- NJ (\$)	93-07 %	RPCS- NJ (\$)	93-07 %
1993	37,290		3,821		43,936		2,640	
1994	38,456		3,863		44,436		2,700	
1995	39,324		3,921		44,893		2,572	
1996	40,221		4,177		45,696		2,594	
1997	44,114		4,230		46,548		2,511	
1998	45,882		4,395		48,214		2,577	
1999	47,953		4,706		48,722		2,698	
2000	47,820		4,447		49,344		2,792	
2001	47,078		4,639		49,958		2,948	
2002	46,652		5,124		50,086		3,080	
2003	46,452		4,764		50,789		3,055	
2004	47,101		4,496		51,883		3,037	
2005	48,397		4,491		51,899		3,419	
2006	48,694		4,719		52,545		3,291	
2007	48,513	30.10	4,895	28.12	53,108	20.88	3,548	34.39

RPCGDP-CO: real per capita GDP in Colorado in 2007 dollars

RPCS-CO: real per capita spending in Colorado in 2007 dollars

RPCGDP-NJ: real per capita GDP in New Jersey in 2007 dollars

RPCS-NJ: real per capita spending in New Jersey in 2007 dollars

Sources: CO CAFR, NJ CAFR, US Census, and BEA

Table 2

TABOR's effects on government growth are noticeable. Between 1993 and 2007, per capita real public expenditure increased by 28.12 percent in Colorado. Over this same period, real state GDP increased by 30.1 percent. The increase in real public spending tracked the increase in real income. The opposite picture emerges in New Jersey, where, during the same period, real spending increased by 34.39 percent and state GDP increased by only 20.88 percent. Public spending in New Jersey increased by far more than its GDP (see table 2). While real per capita spending has increased in Colorado, spending has not overtaken real GDP growth.

TABOR has constrained government by giving taxpayers a say in the level of spending and taxation. Between 1998 and 2008, two out of the six ballot measures seeking approval to spend excess revenues were passed, and four defeated.¹²⁰ Taxpayers judged four measures directed funds to undesirable uses. Between 1992 and 2008, eight ballot measures proposing tax increases were introduced, and one passed. Four property tax ballots were introduced between 1996 and 2006, and two passed. Both measures provided tax relief to specific groups, such as the elderly. The defeated measures proposed property tax increases. TABOR also requires voter approval for general obligation debt. Between 1995 and 2005, of the four ballot measures to raise debt, two passed.

As an effective spending constraint, TABOR-type rules are often resisted by legislatures and interest groups.¹²¹ Constituencies that have actively tried to amend it criticize TABOR as “undemocratic,” arguing fiscal decisions should be left to elected officials. In 2000, Amendment 23 was passed, establishing a constitutional mandate for education spending. The amendment allows education spending to increase faster than TABOR’s rule (inflation plus population growth).¹²² Moreover, in 2005, Referendum C was passed, suspending TABOR temporarily. The adoption of Referendum C shows that TABOR is a very constraining rule and that voters who have an interest in higher government spending would like to see it repealed.¹²³

New Jersey should amend its constitution and adopt a taxpayer bill of rights limiting spending growth to the sum of inflation and population growth.¹²⁴ New taxes, spending,

¹²⁰ For a history of Colorado’s ballots, see <http://www.leg.state.co.us/lcs/ballothistory.nsf>. See also Poulson, “Colorado’s Taxpayer Bill of Rights (TABOR) Amendment: An Experiment in Direct Democracy.”

¹²¹ California abandoned a TABOR-like proposal in the 1990s, known as GANN. See http://www.cato.org/pub_display.php?pub_id=2871.

¹²² For more on Amendment 23, see http://www.state.co.us/gov_dir/leg_dir/lcsstaff/2003/FinalReports/03GallagherFinalReport.pdf.

¹²³ Barry W. Poulson, “What Is at Stake in the Current Battle over Colorado’s Tax and Spending Limits?” *Issue Backgrounder* (Independence Institute: March 2009), http://www.i2i.org/articles/IB_2009_C_a.pdf. Ironically, the suspension of TABOR came at the time of the 2008 recession, which has limited the capacity of the state to increase its spending.

¹²⁴ A constitutional amendment may not be obtained at first. It took three ballot measures before the Colorado legislature voted in favor of TABOR (54 to 46).

or debt initiatives should be put to voters at the ballot. When state GDP per capita grows faster than inflation, the share of public spending can be reduced over time by simply following the rule (provided taxpayers do not vote for extra spending and taxation). Currently, spending in New Jersey is 7 percent of GDP. Over time this may be reduced, particularly considering that New Jersey's rate of population growth is falling.¹²⁵ The political reality of adopting such an amendment cannot be ignored. It took three attempts to amend Colorado's constitution and pass TABOR, itself the result of the initiative process and institutional entrepreneurship on the part of taxpayer groups and citizens. It is likely that constituencies that benefit from spending, such as teachers' unions, will actively oppose such an amendment to New Jersey's constitution.

2. Reform Public Expenditure

Constitutional rules such as TABOR constrain the growth of public spending over time. If we subtract out federal transfers from New Jersey's budget and apply a TABOR rule to New Jersey's spending over time, New Jersey's budget growth is flattened (figure 10). It is possible that New Jersey taxpayers would have voted to expand spending beyond this amount, but they would do so by explicitly choosing a higher level of taxation at the ballot. Instead, New Jersey's spending growth was achieved through fiscal illusion, masking the true costs of new programs to taxpayers.

¹²⁵ In 2007 population increased in New Jersey. However the rate of growth is declining. By 2009, it is possible that New Jersey is experiencing negative population growth. More people are moving out of New Jersey than moving in. Between 2000 and 2006, New Jersey lost 377,000 residents to other states. See James W. Hughes and Joseph J. Seneca, "New Jersey- Outward Bound" *New Jersey Star Ledger*, July 20, 2007.

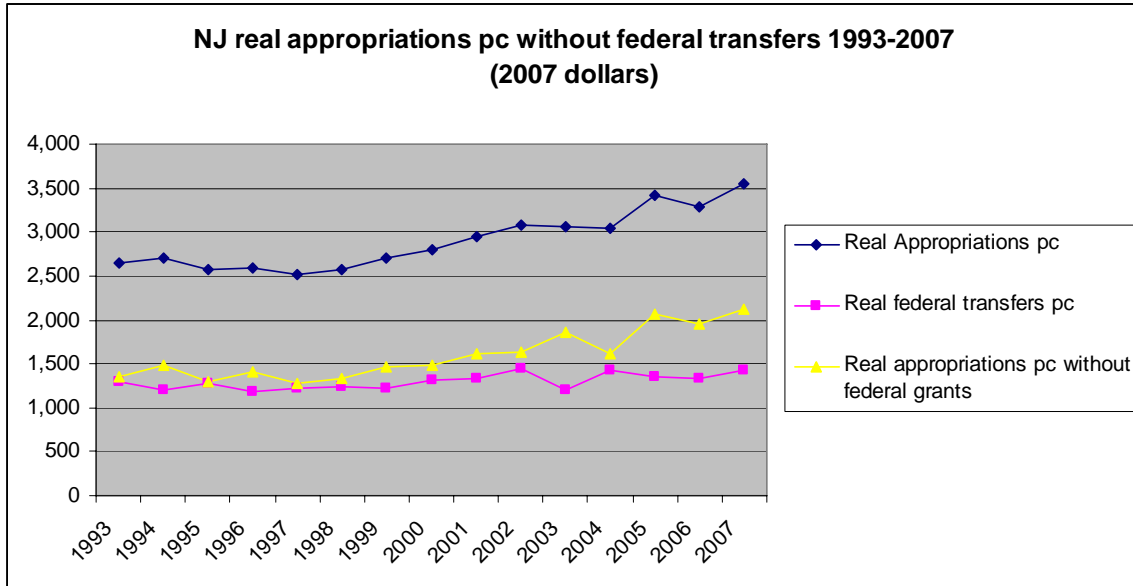


Figure 10

Reducing New Jersey’s budget through programmatic cuts faces several practical difficulties. First, much of the budget is mandated by the New Jersey Supreme Court and federal policies. Budget reform is intertwined with school reform and affected by federal actions and policies. However, by following certain principles, the state may begin to identify areas and current activities that may be devolved to local government or privatized. For instance, economist Arthur Seldon established four categories of spending, ranging from goods and services that cannot be provided by the private sector (because it is impracticable or uneconomic) to services that can.¹²⁶ This analysis provides a basis for showing that government budgets most often have enough room to reform spending.¹²⁷

A second reason to reduce spending is to simplify New Jersey’s system of taxation. In FY 2009, New Jersey finds itself with almost nothing left to tax. Property taxes are among the highest in the nation; the income tax is extremely progressive. Fees and smaller taxes have grown rapidly in recent years. It is very difficult to finance more spending out of the current tax base. The state and local governments have almost no margin of safety, and it

¹²⁶ Arthur Seldon, *Individual Liberty, Public Goods, and Representative Democracy*, in *The Collected Works of Arthur Seldon*, volume 5 (Indianapolis: Liberty Fund, 2005).

¹²⁷ See table 4 in appendix C that applies the Seldon approach to the New Jersey state budget.

is becoming less sustainable to continue the present trend in public spending. At this stage, it is likely that increases in marginal tax rates (on property or income, for instance) would not yield more revenue.

3. Create a Tax Environment that Favors Growth: Broad Bases and Low Rates

New Jersey has a high-rate, narrow-based system of taxation. It is a discriminatory system containing many exemptions, exceptions, and deductions. Such a system imposes economic costs: administrative, compliance, and behavioral. Summing these costs shows that for each extra dollar of tax revenue raised, the cost to the private sector is greater than the dollar of lost savings or consumption. The objective of tax policy is not only to reduce these costs while meeting revenue goals, but also to make the system as friendly as possible to entrepreneurship and trade. The current tax system in New Jersey is likely to drive taxpayers into tax avoidance (changing behavior or decisions to avoid taxes), tax evasion (failure to pay the tax owed), or tax flight (leaving the state).

Most of New Jersey's revenues come from four sources: corporate, income, sales, and property taxes.

The Corporation Business Tax is a flat rate of 9 percent, which accounts for 10.5 percent of revenues, roughly \$3.08 billion in 2007. The Corporation Business Tax has remained set at 9 percent since 1980 (the corporate tax was raised five times between 1959 and 1975, from 1.75 percent to 7.5 percent). Corporations are subject to the alternative minimum tax.

The Gross Income Tax accounts for 40 percent of the state's total revenues, \$11.7 billion in 2008. The income tax is highly progressive, with rates ranging from 0 percent (for the tax-free zone below \$10,000) to 10.75% (see table 1). All revenues are dedicated to the Property Tax Relief Fund to offset property taxes, with the majority distributed as school and municipal aid and the smallest portion of the fund as rebates to homeowners. The terms of eligibility and size of the homeowner rebate program have changed several times since 1976. Income tax revenues are particularly dependent on high income earners

and Wall Street bonus cycles, making this revenue source vulnerable to economic downturns. In 2005, nearly 40 percent of New Jersey's income tax revenues came from those earning over \$500,000.

In some years, property tax rebates are limited to only the elderly and disabled, or those earning under a particular income threshold. The idea behind the fund—that income tax revenues would limit the rise in local property taxes—has failed to work in practice. Over the past 33 years, income taxes have increased and rates are more progressive, and property taxes have risen each year since 1978. While state income taxpayers put an increasing percentage of their income into the Property Tax Relief Fund, they receive less of it back as homeowner rebates.

The Sales and Use Tax is the second largest source of revenue for the state, representing 29.4 percent of revenues or \$8.6 billion in 2007. The sales tax, created in 1966 at a rate of 3 percent, contains many exceptions and thus has a very narrow base. Some exemptions include clothing, food, prescription drugs, newspapers, recycling equipment, and farm supplies.¹²⁸ The narrow base and many exceptions have led the state to raise the rate of the tax multiple times, most recently to 7 percent in 2006.

The Local Property Tax, levied by municipalities for the operation of local government, accounted for \$20.9 billion in revenues in 2006. Exemptions include government property and nonprofits. In 2004, the legislature created Health Enterprise Zones to exempt medical and dental facilities in underserved areas.

¹²⁸ State of New Jersey Department of the Treasury Division of Taxation, *2007 Annual Report*, 47-50.

Tax	Rates	Revenue (\$b) in 2007	Percentage of total state revenue
Income tax (state)	1.4% to 10.75%	\$11.7b	40%
Corporate (state)	9%	\$3.08b	10.5%
Sales (state)	7% max	\$8.6b	29.4%
Property (local)	range ¹²⁹	\$20.9b	N/A
Excises (fuels, cigarettes, & insurance)	N/A	\$2.04b	6.9%
Other	N/A ¹³⁰	\$1.15b	4.9%

Table 3

In addition to these primary sources of revenue, motor fuel, cigarette, and insurance excise taxes each account for about 2 to 3 percent of revenues. New Jersey's remaining taxes each bring in less than 1 percent of revenues. They are discriminatory, targeting highly particular services and activities, including cosmetic medical procedures (rate of 6 percent), hotel/motel occupancy (rate of 7 percent, except in some tourist areas), a domestic security fee on rental cars (\$5 per day), nursing home assessments (rate of 6 percent), outdoor advertising (rate of 6 percent), vehicle tires (\$1.50 per tire), and sports and entertainment districts (rate of 2 percent). Between 2002 and 2007, the state instituted roughly 102 new taxes and fees (see table 3).

¹²⁹ Property tax rates range from a high of \$16.125 per \$100 of assessed value in Winfield Park, Union County to a low of 0.36 per \$100 of assessed value in Avalon Park Borough, Cape May County. The average for the state is \$1.87 per \$100 of assessed value.

¹³⁰ For excise and other taxes, rates vary for different goods, where some taxes are levied as sales taxes and others are levied ad valorem. Excise taxes as of 2007 include: \$2.75 per pack of cigarettes; a 2% premium on insurance risks; and \$.105 per gallon of gasoline. Other tax rates as of 2007 include: \$4.40 per gallon of liquor; \$5.00 per day on motor vehicle rentals; 5% of hotel and motel occupancy rates; and an 11-16% tax on non-exempt inheritance.

Adding to the negative effects of the tax system's narrow bases and high rates, the state also offers tax incentives. The Urban Enterprise Zone program offers incentives to businesses to locate in designated cities. New Jersey's corporate tax offers tax incentives for filmmakers, neighborhood revitalization, and economic recovery projects. Rather than creating a general, non-discriminatory environment, exceptions and breaks benefit some areas, businesses, and taxpayers at the expense of others. A fundamental flaw of tax incentive policy is that it presupposes legislators know which activities are economically or socially beneficial.

High tax rates and narrow bases create distortions as people change their decisions or put resources toward compliance, leading to a loss of value creation in society. Reform of New Jersey's tax system should follow a few basic principles. The revenue system should move towards generality in taxation. When all activities face the same low tax burden, it enables individuals and businesses to pursue the broadest range of activities and plan ahead without regard to taxation. Individuals and businesses do not spend resources toward finding loopholes and undertaking activities that promise tax breaks. Rather, they invest and produce in order to create economic value. The least distortionary tax system is one that is broad-based and low-rate. This system raises higher amounts of revenue at a lower cost to economic activity than one with high marginal rates and narrow bases.

Proposals for tax reform often stem from elected officials in need of more revenue or aim at benefiting some constituency. When designing tax policy, one must keep in mind that the natural tendency is for the tax system to be used to satisfy many different goals at the exclusion of sound taxation. The progression of tax policy and spending in New Jersey reveals that much of this system evolved due to the political pressures applied by interest groups to increase spending in certain areas, education in particular. Tax reform must not only consider how the level and kinds of taxes affect individual behavior, but that the tax system is subject to the motives of elected officials.

For this reason, the generality principle should guide tax reforms in order to constrain majoritarian politics to prevent the natural tendency toward discriminatory usage of the

taxing authority. The assumption that government requires a certain amount of revenue per period and that reform should determine the right taxing arrangement to generate that revenue should not be the aim of tax policy.¹³¹ Rather, it is important to design a tax system that is the least distortionary to economic activity and that resists the influence of interest groups which aim to use the tax system to further their own private interest.¹³²

To move New Jersey to a broad-based, low-rate system of taxation, exemptions, deductions, and breaks should be removed from its main revenue sources: corporate, sales, and income. This will enable the state to expand its taxing base, while lowering (and in the case of the income tax, flattening) the rates of tax. In the case of the income tax, a broad-based, low-rate tax system implies the same rate on all sources of income, for all persons, with no exceptions for any reason. Deductions, exclusions, and exemptions “drive a political wedge between those who are subjected to positive rates....and those who are differentially favored by zero rates.”¹³³ Importantly, exemptions, deductions, and exclusions from the tax base lead to higher rates of tax on a narrower base.

A tax system that is based on a broad base is also more stable, less subject to economic fluctuations (such as Wall Street bonus cycles or downturns in particular markets). Further, a system that is broad-based with low rates does not induce dramatic behavioral changes—for example, leading high-income earners to leave, change their activities to avoid paying taxes, or evade taxes. In the case of the sales tax, failure to tax all goods equally leads to efficiency losses as individuals engage in substitution to goods and services that are not taxed.

¹³¹ James Buchanan, “*The Power to Tax: Analytical Foundations of a Fiscal Constitution*,” *The Collected Works of James Buchanan*, Vol. 9 (Indianapolis: Liberty Fund, 1980), 68-71.

¹³² This may mean changing the level of public spending as there is no reason to assume the current level of tax revenue and public spending in New Jersey as optimal.

¹³³ *Ibid.*, 407. As Buchanan notes, “One of the most disturbing features of several modern income tax “reforms” has been the removal of persons from the tax rolls, a step that necessarily sets up the parameters for exacerbated distributional politics.”

An example to follow for New Jersey is New Zealand, which embarked on a vast tax reform in the late 1980s and early 1990s. The country had high marginal tax rates as well as many exemptions and excises. The tax reforms increased the incentives to engage in market activity because marginal rates on income were reduced (the top marginal income tax rate was halved from 66 percent down to 33 percent) and the base was broadened (the new value-added tax covers almost all sales transactions at a flat, uniform rate). The tax system was designed to be a coherent structure that would minimize deadweight losses and reduce administrative and compliance costs (e.g., most taxpayers don't even file a tax return anymore). Almost 20 years later, the tax system in New Zealand remains inspired by the broad-based, low-rate approach. The 1999–2008 Labour Government increased the top marginal tax rate on income (to 39 percent) and made a few adverse changes to the system, however.¹³⁴

4. Re-introduce Competition to Local Government

The existence of 566 municipalities is often offered as evidence of inefficiency in New Jersey's local governments. It is argued that economies of scale can be achieved through the merger of smaller towns. There is truth to this. New Jersey's municipal boundaries have been set in place since the 1950s. There is no reason to think their current arrangement is optimal. However, the state government does not know what the optimal number should be. This can only be decided by citizens on the local level. And the optimal number can only be revealed when municipalities are fiscally autonomous, by scaling back state aid and lifting mandates.

In the 1930s, many municipalities experienced fiscal stress and ended up in default. The state began a gradual program of awarding aid to municipal governments. The effect was to remove the need for municipalities to merge, dissolve, or consolidate services. State aid created a relationship of fiscal dependence with many municipal governments. The current number of municipal governments is not a cause of wasted public dollars, but a consequence. Other factors, including the advent of zoning, which eliminated the

¹³⁴ See Frederic Sautet, "Why Have Kiwis Not Become Tigers: Reforms, Entrepreneurship, and Economic Performance in New Zealand." *The Independent Review* 10 (2006): 573-597.

possibility of citizens incorporating new towns, helped make permanent New Jersey's present boundaries.

The consolidation of small towns (many of which do not receive high amounts of state aid) or the regionalization of services and their provision by the state level will not save the state money. Local autonomy is incompatible with state aid and state mandates. Reducing spending and finding the optimal number of municipalities is best achieved by reintroducing fiscal competition in New Jersey, which includes letting municipalities discover other ways of providing public goods (privatization, service sharing) and allowing local governments to compete for citizens and businesses. Reintroducing competition and markets is the surest way to reduce spending by cutting costs. Education and government services are good candidates for competition, where outsourcing, open tender, chartering, and vouchers can be used. Some spending should also be reduced through budget cuts.

5. Clarify the New Jersey Constitution's Education Clause

The legislature should consider amending the New Jersey Constitution to clarify certain clauses, in particular the education clause. The New Jersey Supreme Court has determined the policy direction of the legislature in providing public education through the Abbott decisions. In an effort to guarantee that students in poor districts receive the same quality of education as students in rich districts, the court directed the legislature to dedicate an ever-increasing amount of tax revenues to the 31 court-designated districts. In spite of this massive reallocation and the growth of the income tax in New Jersey, there has been little improvement in educational outcomes. Various resolutions have been introduced. In 2004, Resolution 38, sponsored by Senator Leonard Lance, described how the legislature should provide and fund a "thorough and efficient system of free public schools." The resolution did not pass, but was reintroduced as Resolution 44 in 2008.

9. CONCLUSION

New Jersey's economic decline is contained in its *de jure* fiscal institutions—the rules under which the state's elected officials budget—and the way they are interpreted and

enforced—the *de facto* rules. These institutions and their interpretation—the state’s constitution, its laws, policy legislation, court rulings, state and federal mandates—have helped to create the present crisis. This crisis stems both from years of institutional and policy neglect that has turned a once well-managed state into a rent-seeking society, and a growing gap between the *de jure* and the *de facto* rules that check government’s activity.

Perennial budget shortfalls, a symptom of the state's growing fiscal instability, have occurred for several reasons—growing spending in times of high revenues, and significantly, an activist state Supreme Court’s mandates on school funding and rulings permitting the state to avoid and bend constitutional prohibitions on the usage of debt. Unions have left a strong mark on New Jersey’s budget, increasing the size of salaries, pensions, and health benefits, which ultimately function as mandates on lower levels of government, driving up property taxes to the second-highest per capita in the nation.

Aid (state and federal) constitutes 75 percent of New Jersey’s budget.¹³⁵

Medicaid, along with dozens of other grant-in-aid programs, occupies a sizeable and growing portion of the state’s budget. The effect of the federal stimulus package will postpone needed reforms while permanently growing the size and scope of government spending and passing those costs along to state and local governments as future taxes. Aid transfers have also altered budgeting in New Jersey’s 566 municipalities and 611 school districts, creating dependencies on aid streams while eroding control over local tax rates and the level and amount of spending on local services. The expansion of intergovernmental aid has centralized the provision of services and eroded local competition. By fracturing the relationship between those who benefit (e.g., local school districts) and those who pay (e.g., state income taxpayers), the incentive to control costs and accountability for spending has been systematically weakened through fiscal illusion.

Increased taxation is meant to support the steady growth of public spending. Growth in New Jersey’s budget is driven, in theory, by citizen preference for a certain level of

¹³⁵ New Jersey FY 2008 Budget in Brief, <http://www.nj.gov/treasury/omb/publications/09bib/BIB.pdf>

government services, and the taxation necessary to support it. However, the government of New Jersey has resorted to fiscal evasion—avoiding the rules meant to constrain spending—and has sustained spending growth through fiscal illusion, obscuring the full costs of policies by relying on intergovernmental aid and debt to achieve the current level of spending.

Over a period of years, New Jersey lost control over its budget. While the state gained more control over local budgets, it lessened the ability of local governments to set their own fiscal course. In combination, the effect of increased spending, taxation, debt, and the costs of regulatory compliance—on all levels of government—has compromised the state’s fiscal framework and made its economy less resilient to downturns, driving businesses and people out of a once-thriving state.

For New Jersey to regain its former position, the state must implement institutional reforms. These include moving the tax system to one that is broad-based and low-rate. This will enable the state to raise the revenues necessary to fund its operations while reducing the current system’s negative impact on economic activity. At the same time, the state should introduce competition in the provision of schooling through the use of vouchers, particularly in the Abbott districts, which will encourage schools to improve performance and lower costs. State aid streams, including the Property Tax Relief Fund, and municipal aid programs should be reduced and eventually eliminated as budgetary mechanisms for transferring resources. To date, the effect of these intergovernmental aid streams has been to erode local control while stimulating spending on the local level, helping to drive up property taxes in many communities. Along with this, state mandates should be reviewed and rolled back on the local level. This will help to restore competition between municipal governments for citizens and businesses, encouraging local governments to provide the mix of goods and taxes that citizens want.

Spending on the state level can only be reigned in through rules that bind elected officials from spending beyond what is fiscally sustainable. New Jersey should adopt TABOR-

type legislation, setting annual spending growth to the rate of population growth plus inflation. Anything beyond this amount should be approved by voters.

To reduce current spending, New Jersey should review the state's budget (and municipalities should review local budgets) in terms of who is the best provider of goods and services. Many items currently funded by public dollars may be provided by the private sector or partially privatized.

Short of these kinds of institutional reforms, New Jersey will continue on its present course. The current system has created strong constituencies, such as public sector and teachers unions, which benefit from the status quo and current revenue redistribution streams. Reforms must confront what is perceived as politically unpopular and avoid the temptation to tinker with the present framework with marginal changes such as increasing property tax rebates, offering tax breaks, finessing current aid formulas, or relying on federal bailouts. These actions will only mask, if not deepen, the distortions and inefficiencies in New Jersey's state and many local budgets.

Consistent and binding institutional reforms that encourage fiscal prudence will not only address the many (and interlocking) causes of New Jersey's fiscal crisis and decline, but will also send a powerful signal to citizens, businesses, and outside investors that New Jersey is committed over the long-run to returning to the guiding fiscal and economic principles which made it an economic leader.

Appendix: Features of New Jersey’s Government and Budget

A. Government Structure

New Jersey is headed by a governor who is elected to a four-year term and eligible to serve two terms.¹³⁶ The governor proposes the annual budget, oversees agencies, signs bills into law, and may call a special session of the legislature. New Jersey has a part-time legislature comprised of a 40-member senate, and an 80-member general assembly. The legislature enacts laws and may amend the constitution. The governor appoints judges, subject to approval by the senate. Judges serve seven-year terms. If reappointed, a judge serves until the age of 70. There is a State Superior Court and a Supreme Court, which is the highest court in the state, ruling on constitutional matters.

New Jersey’s guiding document is its constitution,¹³⁷ which may be amended by the legislature with a three-fifths vote of both houses, or a majority vote in two consecutive terms. Voters must approve the amendment in a general election. There is no citizen initiative or referendum process in New Jersey. In 2001, the New Jersey legislature considered bills to introduce a “limited initiative” process for the state.¹³⁸

New Jersey has a complex local government structure consisting of 21 counties, which contain in total 566 municipal governments and 611 school districts. A Board of Chosen Freeholders composed of between three and nine elected members governs the county, overseeing county departments. Municipalities are established in one of five corporate types—borough, town, city, township, or village—and operate in one of two

¹³⁶ Effective in 2009, New Jersey will institute a Lieutenant Governor position. Previously, the Senate President assumed the office of Governor when the office was vacated mid-term. This has happened twice in the last decade. Senate President DiFrancesco was appointed to complete Governor Christie Whitman’s term when she was appointed to the head the U.S. Environmental Protection Agency in 2001, and Senate President Richard Codey completed Governor James McGreevey’s term when he resigned in 2005.

¹³⁷ The modern constitution was adopted in 1947. New Jersey’s first constitution was adopted in 1776. The constitution was significantly altered and readopted in 1846.

¹³⁸ Senate Concurrent Resolution No. 8 and Assembly Concurrent Resolution No. 82 proposed to introduce a limited initiative process in New Jersey that would allow citizens to introduce initiatives in areas restricted to governmental reform, and included high thresholds for ballot qualifications and judicial review of initiatives. These measures were intended to avoid the excesses of California’s initiative process.

governmental forms—statutory or optional—determining the number of elected officials and method of appointment.

New Jersey has a tradition of “home rule,” relying on the county and municipal government to provide local needs. The state constitution and the Home Rule Act of 1917 (N.J.S.A. 40:42 *et. seq.*) permit municipalities certain powers to enable self-government.¹³⁹ These powers are granted by the state and may be altered by state law. In practice, municipalities exercise some control over local policies but are responsible for implementing and funding state mandates.

B. Budget Composition

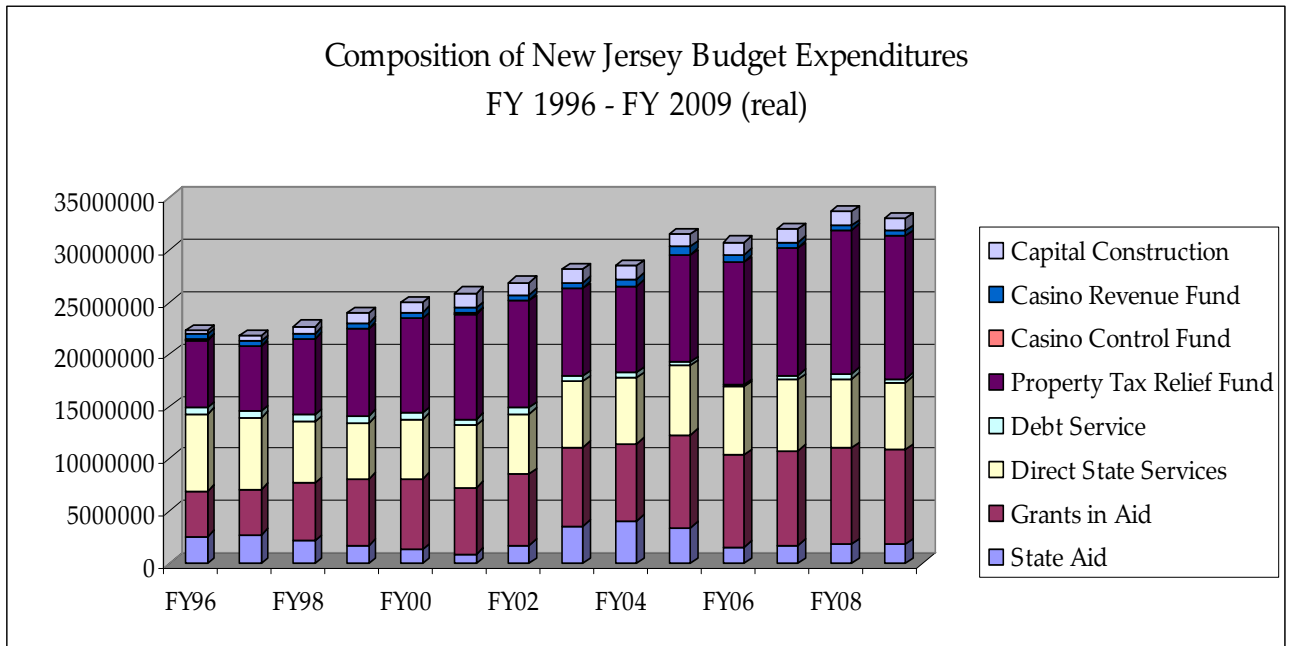


Figure 11

¹³⁹ Article IV, Section VII (11) of the N.J. State Constitution states, “The provisions of this Constitution and of any law concerning counties, shall be liberally construed in their favor. The powers of counties and such municipal corporations shall include not only those granted in express terms but also those necessary or fair implication, or incident to the powers expressly conferred or essential thereto, and not inconsistent with or prohibited by this Constitution or by law.”

NJ Budget Recommendations FY09
(\$ millions)
Total Expenditures = \$32,963,423

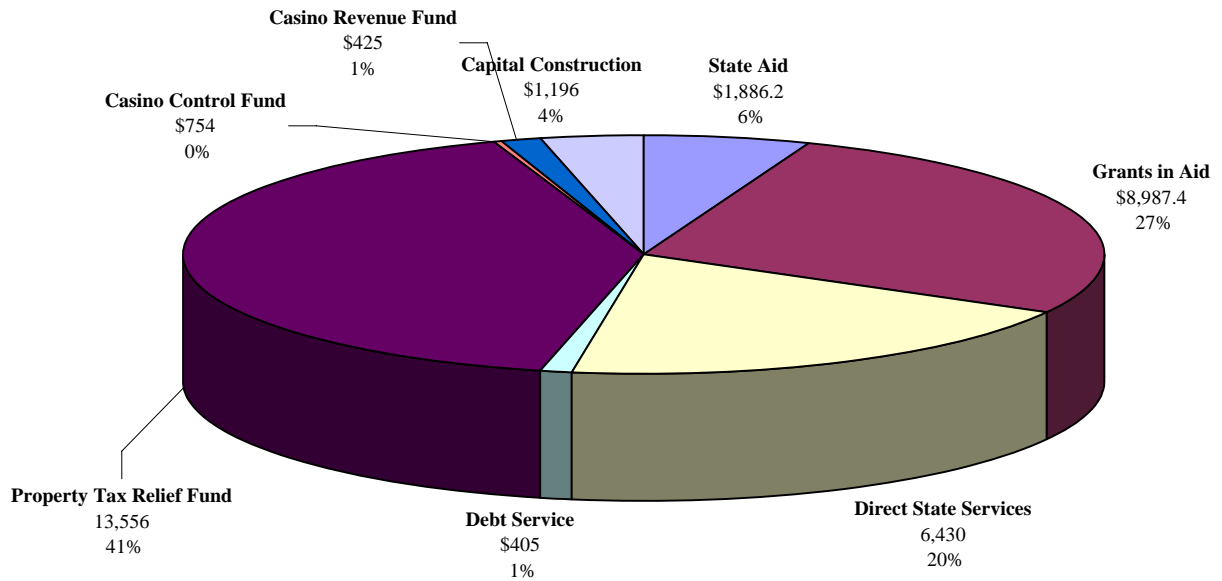


Figure 12

New Jersey’s budget is displayed in terms of the funds the state dedicates to various uses (see figures 11 and 12). These expenditure categories represent how the state finances its policies and aspects of New Jersey’s tax system.

Direct State Services

This category represents discretionary spending. It includes salaries and pensions for public sector employees, public facilities maintenance, and expenses related to the operation of government. Growth in this portion of the budget has fallen in real terms from \$7 billion in 1996 to \$6.5 billion in FY 2009, representing about 20 percent of the total budget. The public sector workforce has quadrupled since 1950 to 82,989 employees in 2007 (excluding K-12 teachers). Eighty-seven percent are represented by

one of 12 unions.¹⁴⁰ Average salaries for full-time employees nearly doubled, in nominal terms, to \$43,565 per capita between FY 1991 and FY 2007.¹⁴¹

The on-budget cost of pensions and health benefits for state employees increased in real terms from \$1.5 billion in FY 1996 to \$1.78 billion in FY 2009. This obscures the true cost of the pension plan. Over the decades, pension benefits have been expanded, increasing the state's future pension obligations. This was coupled with contribution deferrals, or "pension holidays," by state and local governments. Changes in valuation and the fall in the value of the stock market leave the pension plan currently underfunded by \$56 billion.

Grants-in-Aid

These include payments made by a third party (mainly the federal government) to the state to pay for programs and payments to individuals, including welfare, education, public safety, health, and transportation. Medicaid is the biggest cost driver, representing nearly 60 percent of grants-in-aid. Grants-in-Aid have doubled in real terms since 1996, to \$9.3 billion in FY 2009, or 28 percent of the budget. State spending on Medicaid doubled during this period, from \$1.8 billion in FY 1996 to \$3.34 billion in FY 2009.

Property Tax Relief Fund

Created in 1976 to comply with the state Supreme Court's ruling on education funding, New Jersey's Constitution requires that all state income-tax revenues be dedicated to "indirect property tax relief." Funds are distributed as aid to school districts (73 percent), aid to municipal governments (17 percent), and property tax rebates to individuals (8.4 percent).¹⁴²

¹⁴⁰ The Communication Workers of America (CWA) is the largest union in the state, representing the professional, supervisory, clerical, and administrative bargaining units, which account for 47.6 percent of the state workforce. The American Federation of State, County, and Municipal Employees (AFSCME) represents direct care workers in state institutions, mainly health and military and veterans' affairs, making up 12.2 percent of the state workforce. The Police Benevolent Union comprises 8.2 percent.

¹⁴¹ New Jersey State Government Workforce Profile, New Jersey Department of Personnel, 20.

¹⁴² Homeowner rebates vary from year to year depending on revenue collections and the policy priorities of the governor.

The Property Tax Relief Fund represents 41 percent of New Jersey's total budget. The fund has more than doubled in real terms from \$6.2 billion in FY 1996 to \$13.5 billion in FY 2009. Revenues from income taxes are distributed to lessen local reliance on property taxes. However, in the same period, property taxes have risen substantially. Most of the fund is awarded to 31 court-designated K-12 school districts (known as Abbott districts). Court rulings on the amount and scope of funding and curriculum composition have contributed to increased costs per pupil in these districts.

State Aid

Providing aid to colleges, hospitals, and municipalities, state aid remained stable in real terms from \$1.91 billion in FY 1996 to \$1.88 billion in FY 2009. While spending on state aid represents only six percent of the budget, the awarding of aid to municipal governments is the basis of a continuing debate over the efficiency of New Jersey's 566 municipal governments. Municipalities claim aid is typically insufficient to cover the cost of state mandates. The state contends many smaller municipalities have insufficient tax bases and are reliant on state aid to function. The state recommends municipalities merge or consolidate services to reduce the cost of providing aid.

Capital Construction

Funds used to finance (primarily through bonds) capital projects include wastewater facilities, public buildings, hazardous waste cleanup, open space preservation, and school construction. The fund totals \$1.19 billion in FY 2009. Most of the growth in capital construction is driven by the Transportation Trust Fund, which increased from \$196 million in FY 1996 to \$895 million in FY 2009 in real terms.

Casino Control Fund

With the legalization of gambling in Atlantic City in 1976, a fund was established to dedicate fees and taxes from casino licensing to provide marketing, police, and services to promote tourism. The fund contained \$74 million in FY 2009.

Casino Revenue Fund

Established in 1976, the fund dedicates casino tax revenues to property tax rebates, utilities, health care, and transportation expenses for eligible seniors and disabled residents. Pharmaceutical Assistance makes up the largest share at \$215.9 million.

Debt Service

Representing payments on interest and principal to service general obligation bonds, annual debt service has remained steady, amounting to \$405 million in FY 2009. Most of the state’s debt is subject-to-appropriation debt, raised by independent authorities, such as the Economic Development Authority and the Transportation Trust Fund Authority, and until November 2008, was not subject to voter approval. The issuance of subject-to-appropriation debt has driven the level of total net taxpayer-supported outstanding debt from \$2.5 billion in 1990 to \$45 billion in 2009 in real terms.

C. The Scope for Charging to Reduce Spending

The Seldon Table as applied to NJ (based on NJ 2009 budget):

Categories of public spending	Appropriations in Thousands of Dollars	Percent of Operating Budget
Category I: Public Goods with Inseparable Benefits	\$1,493,984	32.13%
Category II: Public Goods with some Separable Benefits	\$1,189,005	25.57%
Category III: Substantially or wholly separable benefits	\$1,485,927	31.95%
Category IV: Subsidies, grants, pensions and other (mostly) cash disbursements	\$481,210	10.35%
Total Operating Budget	\$4,650,126	100%

Table 4.

If one assumes that categories I and II represent the core of government spending, then almost 50 percent of New Jersey appropriations for its 2009 budget is not directly necessary to the well functioning of the economy.