Friends of Local Government
Policy Paper Series

Appropriating Energy Tax Receipts: The New Normal for New Jersey

Angie McGuire
Alan Zalkind
The Center for Government Services
Rutgers, The State University of New Jersey

Volume 5, Number 1
March, 2013

NJLM EDUCATIONAL FOUNDATION, INC

Preface

This is the seventeenth paper in NJLM Foundation's "Friends of Local Government" Policy Paper series. This paper was authored by Angie McGuire, Ph.D and Alan Zalkind, Director of the Center for Executive Leadership at Rutgers, the State University of New Jersey.

All of these policy papers are available on the Foundation's website at www.njlmef.org

On behalf of the Board of the NJLM Educational Foundation, we thank Professors McGuire and Zalkind for these contributions, and believe you will find this paper informative.

We would also like to note the support of the Foundation's Board for this project, as well as staff from the New Jersey State League of Municipalities.

Michael F. Cerra, Policy Advisor
NJLM Educational Foundation
222 West State Street
Trenton, New Jersey 08608
www.njlmef.org

About the Contributing Authors

Alan Zalkind is the Director for Rutgers Center for Government Services (CGS) and the former director of Rutgers Executive MPA and MPA programs in Newark. He has extensive experience as a manager in the public sector and as a management consultant for government agencies. He has obtained an MA, MPA and M.Phil from New York University.

Angie McGuire, Ph.D. is the director for Rutgers Center for Executive Leadership (CELG) in Government, an assistant professor and director of the Rutgers Executive MPA program in Camden. Her research and teaching in public management span strategic planning, economic development and leadership topics. She has served in the public and non-profit sectors.

Energy Tax Receipts – Budgets are driving policy changes, should they?

Even before the Great Recession began in 2008, the state was mired in fiscal problems. Decades of spending obligations that exceeded revenues resulted in budget imbalances and created an annual scramble to find sources of funds. When budgets are tight, as they have been in the public sector, fiscal solutions often result in policy shifts. Across the country public managers are changing course in spending practices to eliminate or outsource services, cut payrolls and improve efficiencies by sharing services. Budget shortfalls have resulted in some tough action to reduce long-term spending.

The conversations about control over government spending have been linked to the need to control rising property taxes. New Jersey property taxes, which fund schools and local governments, are considered some of the highest in the nation. These two budget phenomena have been very much linked in the debate over how to use Energy Tax Receipts, a tax that was supposed to offset local property taxes.

This paper does not address how the state arrived at the current level of debt and financial quagmire; it does explore one of the budget actions that seem to be creating policy retrospectively. Specifically, the focus here is on the repurposing of tax dollars collected for municipalities and intended to mediate property taxes - but instead have been appropriated by the state to bridge budget gaps. The current policy debate is moving away from the intended use of the tax to a shouting match about the roles of different levels of government. The state now asserts that taking the money from property tax relief provides a protection to tax payers, that the holding of the funds prevents towns from spending. The state contends that the ETR funds are withheld from municipalities in support of a policy to reduce inefficiencies in local governments.

What policy is being debated?

There is no debate over how the Energy Tax Receipts (ETR) funds are supposed to be used: the tax was created to be a source of local municipal funds, specifically to reduce local property taxes. However, the state now retains a significant portion of the roughly $1B collected annually for property tax relief. The legislation enabling the tax required the funds to be distributed back to the municipalities, and for the most part the funds were returned to the towns. However, as early as 1982, the state, facing budget shortfalls, began to "keep" a portion of the monies collected on behalf of the towns. Over time, the portion retained by the state grew, and by 2006, municipalities were receiving about 50% of the monies collected. The state repurposed the tax, without rewriting the legislation enabling the tax.

Repurposing tax dollars to achieve a balanced budget is not uncommon in public finance. Public financial management references a normative model that describes budget actions as intentionally rational. This theory describes the means and ends justification of allocation of scarce resources when a chief executive makes decisions to allocate scarce resources in a given year. Indeed, early uses of ETR funds by the state were explained as paying for the cost of tax collections. However, by the mid-80's the state was diverting monies to the general fund to cover unfunded state programs. Based on an assumption of scarce resources, a rational model supports the need for the executive branch to make decisions in order to "facilitate the efficient conduct of pubic business" (Miller, 1991).

Much like a private firm that might take profits from one division and use them to invest in another product line, the state decided to use the ETR Property Tax Relief funds, collected in the form of a tax from utility companies, to fund the state's General Fund for other expenses.

The main problem with this allocation shift was that the state's role was prescribed to be manager of the funds, not municipal benefactor. While a benefactor might decide how much to allocate for local property tax relief, the state was reallocating dollars taxpayers expected to have used for another purpose. The courts have ruled that this taking is allowable, but a reasonable question needs to be asked: who should be involved in a policy discussion when tax monies are repurposed?

History and background

There are two sides to every story, but typically there is a chain of evidence that all can agree on, and then proceed to interpret differently. Such is the case with the Energy Tax Receipts collected from utilities and passed on to consumers in water, gas, electric, cable and phone bills.

The facts most people agree on are that since the early 1900's the state, like many other states, has allowed the application of gross receipts taxes and a franchise taxes on utilities.

> The history of Public Utility/Energy Taxes is clear. These taxes were imposed to compensate municipalities for the benefits that the utilities derived from their use of the public's rights of way. In lieu of other taxes, the proceeds are supposed to flow into municipal budgets to reduce the amounts that would need to be raised through property taxation. This is not "aid" provided by the "State." It is – or, at least, it is meant to be – just compensation provided by certain utilities to municipal property taxpayers for the economic benefits that those utilities derive from the use of public rights of way (NJLM, 2012).

Municipalities, within whose jurisdictions the utilities operated, collected the taxes to compensate for the use public right of ways, and in lieu of local property taxes. There are, of course, complex algorithms to determine the amount of the tax and how it was to be distributed to municipalities; but for purposes of this analysis, the formulas are not in dispute. Funded by a number of sources over the years, and known by other names, the intent of the ETR fund is well documented; the energy tax receipt was not conceived of as a re-distributive tax. The tax, intentionally designed to be collected and used for local purposes, was one of three main funding sources envisioned to support local governments (Pierson). The structure of local government financing in the state was dependent on a framework, as one ex-state official describes it, “a three legged stool” to which the energy tax, property tax and other fees contributed. The original Public Utilities Gross Receipts and Franchise Taxes (PUGRAFT) had two components. The Gross Receipts portion of the tax was in lieu of state, county, school and local taxes on personal property and materials other than land and buildings (NJSLOM, 3). The Franchise tax portion was based on the relationship between the valuation of the property of public utility corporations located in, on or under public highways in a taxing district to the total properties owned by the corporation (Pierson, 66).

A myriad of changes in the tax have transpired. In the 1970’s when energy costs soared, an unintended raise in the cost of the tax caused a review of how the tax was assessed. By 1987, the basis of the tax was recalibrated to reflect the units of power, or service, used (power or gas). In an Op-ed in the New York Times the Utilities Association expressed their awareness of the importance to the use of the ETR to fund local governments.

> “Local officials quickly found uses for the increased revenue and, as tax collections rose to $800 million, they became too much of a temptation for the state to ignore. Since 1982, more than $500 million has been skimmed from the fund for state purposes, revenues that otherwise would have gone to municipalities…the (New Jersey Utilities) association realizes that the gross-receipts and franchise taxes have become too much a part of the local budget process to be reduced to earlier levels…”(Schwarz, NYT June 7, 1987)

After resetting the basis of the tax post energy crisis, the following decade brought deregulation of energy and utility companies. The changes resulted in new formulas, protecting the revenue stream as a source of local revenues. The state successfully maintained the tax now renamed Energy Tax Receipts in 1999, and the tax department concluded that the tax levy:

- would no longer be connected to commodity costs or volume but to corporate earnings and sales of energy;
- protects the tax base — and ability to make disbursements to municipalities, while leveling the playing field for instate and out of state energy suppliers;
- Supports competition among energy providers with result of cheaper energy (Wood, 2001).

The annual Department of Treasury report on Tax Expenditures, noted the disposition of Energy Tax Revenues to be: “Revenues are deposited into an account that is used to fund the Energy Tax Receipts Property Tax Relief Fund, which is distributed to municipalities in accordance with P.L. 1997, C 167”; but the fund was only partially distributed (Fulmer, 2010). Despite legislative intent, the courts have upheld the state’s right to preempt the legislative intent of the tax.

Public spending policy questions: re-purposing municipal tax revenues?

The central point of contention between the state and municipalities centers on the use of taxes collected. Because the state grouped funds transferred back to municipalities as "state aid" the line items, which included Consolidated Municipal Property Tax Relief Aid (CMPTRA) and Energy Tax Receipts (ETR) property tax offsets, carried symbolic language – they were labeled state aid not dedicated tax streams.

In 2006, the Division of Local Government Services issued a Local Finance Note advising municipalities that the state aid funds from multiple accounts would be combined including the funding from the ETR and CMPTRA; the total funding for FY 2007 was then established at the total of the combined state aid funding sources. This marked the first time the state aid funding sources were combined – and used - by the state to hold flat the overall level of funds provided to municipalities.

In fiscal year 2007, state aid accounts were held at the 2006 levels, and since then the annual state budget approved by the governor had decreased the broad category of budget labeled "state aid" to municipalities. Behind this reduction loomed a larger debate as to the value of municipalities.

It is common today to urge towns and cities through out the state to merge, to be more efficient; and yet the discussion with citizens on what jurisdictions provide value, and how to measure that value, continues to be vague and limited between those who would divert public finances to other levels of government

In 2008, facing the Great Recession, the governor proposed cutting "state aid" to all towns under 10,000 people, to encourage mergers and reduce administrative costs. In fiscal 2011 the governor's budget eliminated a larger portion of revenue to municipalities. Suddenly the language of budget cuts was not about returning the locally collected property relief tax, but language about the role and purpose of local municipalities. Administrations spoke of the cut in funds as a tool for limiting spending by towns, which was identified as the cause of property taxes increases. The state exerted its control over the municipal spending by "starving" the budgets. Subsequently, the legislative and executive branches followed with tools for municipalities to control the growth of local budgets, including relief from binding arbitration and help with pension and health care costs – all expenses controlled by state regulation.

Repurposing tax dollars to accomplish policy goals is not uncommon in public budgeting. In this case it appears that the initial repurposing was intended to transfer funds from local municipalities to the state during a fiscal crisis. But another purpose is now reflected in language adopted by the administration and some of the legislature: repurposing of funds to force the consolidation of local and county governments and school districts.

Budgeting for policy

Public budgeting is dominated, at all levels of government, by continuing high demands for government services and large budget deficits. The long-term budget outlook is bleak. Structural budget problems in funding health care and education will continue to plague state and local government budgets even as recovery from the recession begins (Philip & Pattison, 2010). The Great Recession has led to a national "local squeeze" that will be felt for years to come. The nation's ongoing housing crisis and fragile economic recovery point to the likelihood of additional cuts in federal and state aid, and greater demand for services all presage a rough road ahead for local governments (Pew Charitable Trusts, 2012). Across the country local municipalities are faced with aid cuts, revenue shortfalls and a compelling need for more services for citizens.

What is different in New Jersey is that our conversation about the budget cuts is led by the state calling for fewer local governments and reduced services, not because the local governments have exceeded their budgets, but because the state has taken local taxes for use at the state level. The public discourse is created by the budget; Miller argues that "…finance departments create the reality that organizations have by symbolically, ritualistically and rhetorically coping with the most critical problem each organization has, namely, resource constraints." Analysis created for budgets begins to frame policy retrospectively (Miller, 101).

Municipality's explanation for the problem with Energy Tax Receipts:

Energy Tax Receipts are one leg of a three-legged stool intended to provide sufficient revenue sources to manage local service delivery. Local finance experts devised the system to ensure a balanced source of revenue for towns. Property taxes, Energy Tax Receipts and other revenue sources (including aid programs and fees) were the three legs. Since 1982, the state began keeping a portion of the Energy Tax Receipts to balance the General Fund.

The straw that broke the proverbial camels' back came in 2010 (fiscal 2011), when without warning, the state decided to keep more of the funds to cover general obligations. Municipalities were caught in the same fiscal crisis as the state, but were blind-sided by the state's "taking" of municipal revenues that had been labeled 'state aid' rather than Property Tax relief. Quoted from the League's then Second Vice President and Mayor of East Windsor, Janice S. Mironov:

> "A promise made should be a promise kept, and municipal officials have not forgotten and will not sit quietly by while municipal funds continue to be diverted for state use. State officials are quick to announce a 2 percent spending cap for municipalities, passage of so-called "toolkit" legislation, and a claim of no new state taxes. Yet at the same time they are diverting huge amounts of municipal monies from energy tax receipts. In effect, state officials are transferring their problems down to local officials and increasing local property taxes. The state

> must be held accountable to towns and local property taxpayers. We call for an immediate and full restoration of this vital property tax relief funding" (NJLM, 2011).

The state sees the problem quite differently:

While acknowledging the original intent of the PU-GRAFT tax plan to fund local municipal expenses and reduce property taxes, the state takes a larger view of the use of municipal funds. Like all levels of government, the state faces expanding pension obligations, unfunded federal mandates, rising health care costs and the need to rebuild vital state infrastructure. Without the ability to create new sources of revenues, the state turned to existing revenue sources, notably ETR, as a source for fixing budget gaps as early as 1982. The revenues are captured "below the line" in the Treasury budget since they do not require any offsetting appropriation by the state. Subsequently, and in a related activity, monies returned to the municipalities were categorized as state aid – a catchall term for accounts transferred by the state to municipalities that includes both CMPTRA and ETR. By Fiscal 2009, the state began withholding all but flat budget transfers, and in 2010 (fiscal 2011) the state slashed the return of funds to municipalities through these programs.

Framing the policy question – how to use the money

So – as the facts diverge, so does the policy discussion.

The narrative adopted by the state has morphed from a question of executive judgment and a requirement to intervene in the allocation of scarce resources, to one of actively restricting spending by municipal governments through the restriction of revenues. The state now holds that local governments are inefficient, and that property taxes are too high due to local mismanagement and inefficiencies. This argument has been transported to budget policy, and used as the basis for decreasing the funding of local property tax relief funds. Starve the beast.

Some of the shift in policy implemented by the state is communicated through Local Finance Notes – communication to municipal finance officers by the Department of Community Affairs, Division of Local Government Services. When the 2006 budget crisis temporarily shut down Trenton, the state of the state was apparent, and the Division of Local Government Services was charged with creating policy to reduce the funding going to municipalities. The policy decision was to squeeze funding available to municipalities and adopt the prevalent thinking about overspending in municipalities by encouraging shared services and reducing the amount of money spent in local municipalities. The state had its narrative: the towns are the problem.

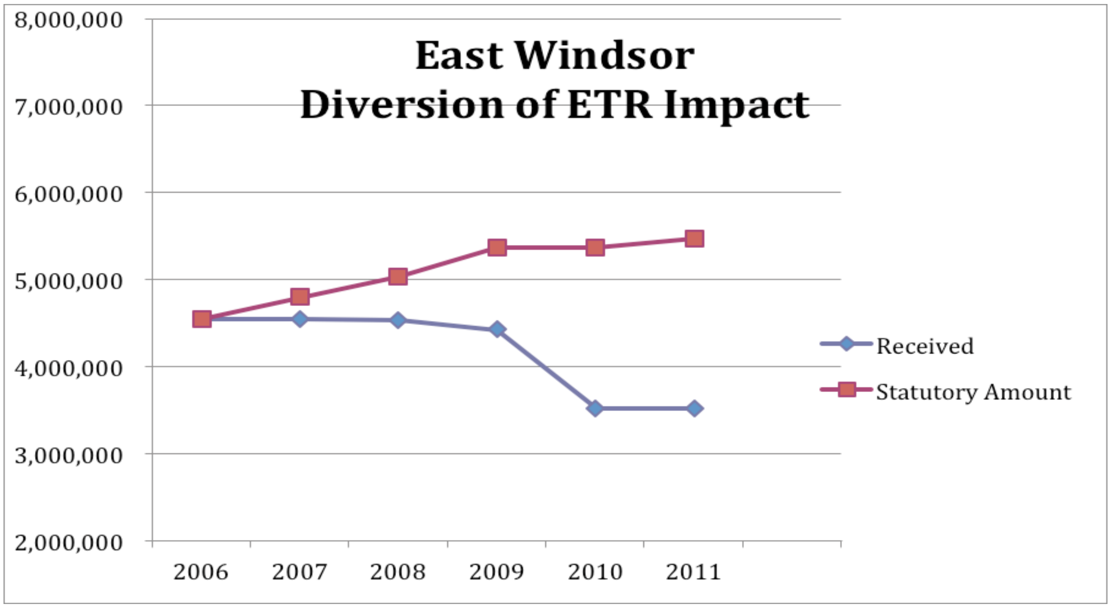
Simultaneously, municipalities around the state raised the flags: unfunded mandates, binding arbitration, combined with pension and health benefits cost increases to decimate local spending plans. The municipal narrative turned with force on Trenton; relieve these burdens that are driving property taxes to higher levels, and do not re-appropriate money that the legislature intended for local use. The municipalities' stance reflects a disdain for the use of the line item veto to take away funds intended to provide property tax relief. If the state had not taken the money, the municipalities contend they would be able to reduce or hold constant property taxes.

Energy Receipts Tax and Municipal Budgets – East Windsor as an example

Home rule has been decried by the state; however, residents who vote on school budgets and elect local officials should have a say in the diversion of local taxes. We suggest that the diversion of funds such as the ETR from municipal budgets to state spending accounts would benefit from public scrutiny.

The League and its members are concerned that the continuing fiscal crisis in New Jersey has caused the state to see all revenues as state revenues. In fact, the state has been using local tax revenues from accounts labeled "state aid" to avoid making deeper cuts in the state budget for many years. The state has the right to override the statutory dedication of revenues in its annual appropriations act, but that strategy has left municipalities looking like inept managers, if not villains. Although municipalities are dealing with the need to fully fund local schools, county government and municipal functions, their revenues are shrinking faster than the cost savings. This means taxpayers are still getting less for their tax dollars.

A detailed analysis of budgets from townships like East Windsor provides us with a clear view of the management of public funds. According to Mayor Mironov, her town's spending in 2012 was down from 2011, and was more than $1.4 million less than in 2009. Even with municipal expenses down year after year, property tax rates cannot be decreased – at least in part because the state has repurposed the ETR. The effect of the diversion of ETR funds exemplifies a lack of transparency in how local tax revenues are being used. Rather than leveling with citizens on the real state of the state, monies dedicated for use by municipalities have been diverted to state accounts with little discussion.



Conclusion

The conversation is about sources and uses of funding…doing what is right and doing what is legal. We suggest that that the lack of focus on the policy questions has confounded the debate. The issue of what revenue source funds what level of government is different than the debate as to whether municipalities should exist or if they should share resources.

While all would agree the two issues are related, they are two separate questions. If municipalities should be eliminated or share more resources, the voters would be adamant about the requirement. If the voters do not want to merge towns, they will not. So far, only the Princetons have undertaken a merger asked for by the voters.

Given the complexity of the laws and taxes, public discourse in 565 municipalities seems unlikely. But we have some evidence from Superstorm Sandy that underscores the role of local government in serving citizens. For the first few days, municipalities were on their own, there was no cavalry that came to help. Local governments were, and are, the front line of service delivery. Local government reflects government accountability to citizens.

The local squeeze will be felt for years to come. The nation's early stages of economic recovery, combined with the continued likelihood of additional cuts in federal and state aid, and greater demand for services all point to a difficult road ahead for local governments. The additional difficulty with the reduction in Energy Tax receipts is absolute uncertainty it creates – when are revenues firm and when are they not? Who should give notice to whom and when? After ETR, what else will the state attempt to re-claim as theirs?

References

Division of Local Government Services. (2006 28-February). *Local Finance Note 2007-6*. Retrieved 2013 01-March from New Jersey Department of Community Affairs: www.nj.gov/dca/divisions/dlgs/lfns/07/2007-6.doc

- (2008 4-March). *Local Finance Note 2008-5*. Retrieved 2013 01-March from Department of Community Affairs: www.nj.gov/dca/divisions/dlgs/lfns/08/2008-5.doc

Fulmer, C. (2010, March 1). *State of NJ Department of Treasury*. Retrieved March 27, 2013, from A Report on Tax Expenditures in New Jersey.

Miller, G. J. (1991). *Government Financial Management Theory*. (J. Rabin, Ed.) New York, NY, USA: Marcel Dekker, Inc.

NJLM. New Jersey League of Municipalities. (2013). *Local Property Taxes and New Jersey State Government*. Retrieved 2013 25-March from New Jersey State League of Municipalities: http://www.njslom.org/SG-Property_Taxes.html

NJLM. (2011). *Energizing Tax Relief: The History of Energy Utility Taxation in New Jersey*. (N. S. Municipalities, Producer) Retrieved June 3, 2012, from NJSLoM: http://www.njslom.org/energy-tax-paper.html

Philip, J. G., & Pattison, S. (2010). Public Budgeting in 2020: Return to Equilibrium, or Continued Mismatch between Demands and Resources? *Public Administration Review* , *70* (s1), s24-s32.

Pierson, A. N. (1920). *Analysis of the laws affecting municipal and county financing and taxation.*

Pew Charitable Trusts (2012, June 01). *The Local Squeeze: Falling revenues and growing demand for services.* Retrieved March 03, 2013, from The American Cities Project: www. pewstates.org/cities

Schwarz, R. M. (1987, June 7). New Jersey Opinion: The Use and Misuse of Utility Taxes. *New York Times*.

Warner, M. E. (2010). *The Future of Local Government: Twenty-First Century Challenges.* Retrieved from doi: 10.1111/j.1540-6210.2010.02257.x

Wood, K. (2001 йил 30-May). *FTA Meetings.* Retrieved 2013 01-March from Federal Tax Administrators: http://www.taxadmin.org/fta/meet/01am_pres/wood.pdf