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How Does the $10,000 Cap on State and Local Taxes Impact the Housing Market in New Jersey?

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Abstract:

Purpose: *The Tax Cuts and Jobs Act caps deductions on federal individual income tax returns for State and Local Taxes (SALT) at $10,000 became effect January 1, 2018. It is unclear how this cap impacts high property states like New Jersey, which has one of the highest property tax rates of in the country and a good number of homeowners who were impacted by this cap. At 2.42 percent, New Jersey has the highest effective average property tax rate and more than double the national average of 1.07 percent. New Jersey currently has the highest property taxes in both absolute numbers and as a percentage of home value. The average 2020 home value in New Jersey was $408,517, and the average property tax bill was $9,112, which is almost three times the national average property tax of $3,300. Collectively, New Jersey has close to 2,500,000 single family homes that generate total property taxes of over $27 billion a year.*
Design/Methodology/Approach: *To better understand the relationship between house prices, property taxes, personal income and high school rankings, we collect data from various sources (NJ.com, the Division of Taxation, the St. Louis Federal Reserve Bank, and NJ Monthly) and use an ordinary least squares equation to estimate the impact that property taxes, income, and the quality of public high schools have on the average house prices across the different municipalities of New Jersey.*
Findings: *We find that municipalities with high property taxes also, on average, have high housing prices. Results show that house prices increase by close to $50,000 dollars for every $1,000 increase in the average property bill. Similarly, as expected, high average income of individuals is associated with higher housing prices. Finally, homeowners are apparently willing to pay higher prices to live in an area that has high-quality school as evidenced by our estimation results: We find that moving up ten spots in the high school rankings is associated with an increase in the average tax bill of approximately $1,940.*
Practical implications: *Collectively, this suggests that high taxes are not the reason for high housing prices, but rather something that homebuyers are willing to accept in exchange for services such as quality public schools.*

Keywords: *Housing market, State and Local Taxation, New Jersey, Real Estate Markets.*

JEL codes: *H71, K34, R30.*
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1. Introduction

Higher property values and housing wealth help to stabilize an economy and encourage economic activity as consumers feel more comfortable about their wealth situation. While the housing market is only 5 percent of the overall economy, it plays a significant role and is a leading indicator of the rest of the overall economy. As house prices increase, homebuyers are more likely to purchase furniture, kitchen appliances, etc., creating spillover (multiplier) effects in other sectors of the local economy. Thus, a stable housing market in NJ is crucial to close to 2.5 million NJ home owners who have a significant amount of net worth invested in their home and to the state as a whole.

Understanding the interconnections between home prices and effective tax rates is also important for three additional reasons. First, property and city taxes play a central role in financing local public goods in the U.S., providing close to three-fourths of local revenue and approximately 95 percent of tax revenue for independent school districts. Given the importance of the tax revenue for local goods and schools, reductions in home prices could greatly reduce local tax revenues and influence local government spending decisions. Second, localities often use property and city tax revenues to offset cuts in state tax revenues. Third, residential real property accounts for approximately 60 percent of local taxable assessments compared to commercial, industrial and farm property which accounts for around 30 percent and personal property which accounts for less than 10 percent, (Lutz, 2008).

Thus, there is a need to better understand the interactions between local taxes and how they impact property values and school funding across NJ towns.

Effective January 1, 2018, the Tax Cuts and Jobs Act caps deductions on federal individual income tax returns for State and Local Taxes (SALT) to $10,000 a year. This limitation applies to the combined total of property taxes and state and local income taxes of the taxpayer and may have a profound impact on the home prices across towns in New Jersey (NJ), where real estate and income tax are amongst the highest in the nation.

At 2.28 percent, New Jersey has the highest effective average property tax rate and is almost double the national average of 1.17 percent. New Jersey currently has the highest property taxes in both absolute numbers and as a percentage of home value. Prior to the tax law change, the average 2017 home value in New Jersey was $367,036 (Figure 1 in the Appendix shows the average housing price in New Jersey), and the average property tax bill was $8,696, which is almost three times the national average property tax of $3,300. Collectively, New Jersey has a total of 2,452,282 single family homes that generate total property taxes of $20,788,294,213 a year.

While property taxes are an important source of funds for the state of New Jersey, not all counties have the same property tax average or tax rate. Appendix A shows the average property taxes and effective tax rates for all 21 New Jersey counties which vary greatly: Bergen, Essex, Morris, and Union counties all have an average property tax above $10,000. In contrast, Cumberland County has an average property tax of $4,213. It bears repeating that these are the *average* property tax bills by county.

Since there is substantial within-county variation in many cases, it can be assumed that there are several other New Jersey counties in which a substantial portion of homeowners has tax bills in excess of $10,000 even though the county average may be below that threshold, and hence would be affected by the new cap on the deductibility of such taxes for federal tax purposes. While this cap on the SALT deduction may reduce demand for homes in some towns, in other low tax areas it may have little to no impact, or even increase the demand. Thus, it is unclear how the cap on SALT impacts the housing market across the state of NJ.

This study helps to determine the impact that the SALT deduction limitation has on the NJ housing market. This information helps inform realtors, homebuyers and policy makers of the impact that the tax law change will have on the housing market across the different counties of NJ and help them better prepare for how the change will impact them individually and locally.

2. Literature Review

The incidence of the property tax, meaning who really pays and bears the brunt of the tax, is still one of the most controversial and longest debated issues in local public finance. In general, economist are divided into two opposing views. The benefit view, first supported by (Tiebout, 1956) and expanded by (Hamilton, 1976), which suggests that property taxes are simply a user charge for local public services. Tiebout's model suggests that higher property tax towns also provide a higher level of government services, such as better schools, closer commute, lower crime, etc.

Since homebuyers who are paying higher taxes are getting more services, this model suggests that people choose to live in and are willing to pay higher property taxes because they enjoy the higher level of services. Under this scenario, the tax law change should have very little to no impact on the demand for homes and thus the home prices in higher tax areas, because homebuyers will continue to choose to "vote with their feet" and live in these high tax counties because they provide the government services they enjoy. This theory also suggests that some municipalities' home values may hold up better under the cap on SALT deductions than others.

In contrast, the tradition view by (Musgrave, 1951) and later supported by (Oates, 1969) treats property taxes as an excise tax. Musgrave argued that the current homeowner will bear the burden of all future higher property taxes, thus reducing

the demand and the price of homes in higher tax areas. The traditional model suggests that towns with higher tax rates will have a more pronounced reduction in home prices from the tax law change relative to towns with lower effective tax rates, since homebuyer's will choose to live in low tax areas.

A new version of the traditional model, is the capital tax (new) view. The new view treats the property tax as a tax on capital with a distortionary effect on the use of capital. Under the capital tax view derived by (Mieszkowski, 1972) and elaborated by (Zodrow and Mieszkowski, 1986; Wassmer, 1993; Zodrow, 2001a; 2001b; 2006), property taxes are a tax on the use of capital (the home) and thus inefficiently distorts resource allocation by driving capital investment out of high tax jurisdictions and into low tax jurisdictions. Similar to the traditional model, under the capital tax view, NJ towns with higher tax rates will have a disproportionate fall in home prices as it drives homebuyer's to NJ towns with lower tax rates. It is quite clear that theory alone cannot answer how the change in the tax law will impact the NJ housing market.

3. Research Methodology

In this project, we examine the regional impacts of the $10,000 cap to the SALT deduction on the housing prices across the different NJ towns. We hypothesize that the housing prices and their response to changes in property taxes vary across NJ towns since property owners are affected to varying degrees by the cap on the SALT deduction. We employ a regression approach to estimate the following equation:

$$HP = \alpha + \beta_t\,(t\,) + \beta_{cap}\,(\text{Cap}) + \beta_r\,(r) + B_I(I\,) + B_{Commute}Commute + B_{Schools}\,Schools + \varepsilon_i$$

where HP is the average home price for each municipality in NJ, t is the amount of the average tax bill by municipality, and Cap is a dummy variable for the periods with the cap on property tax rates. To control for economic impacts, the model includes the cost of borrowing to buy a house, r representing the 30 year mortgage interest rate and I representing real personal income. To control for local services, the model includes *Commute* representing the commute time to NYC, and *Schools* representing the school rankings to capture the quality of the schools for each town, as well as α and β's which are parameters to be estimated and ε_i is an error term. We do this for all the towns in NJ for which data are available for the variables mentioned above

3.1 Data

Data is collected from the websites of NJ.com, Division of Taxation, the St. Louis Federal Reserve (FRED), and NJ Monthly. There are 567 municipalities that are included in the nj.gov database on mean tax bills and the mean housing prices per

municipality. Unfortunately, some of the tax bill data was clearly miscoded. Municipalities with such incorrect information were excluded from the analysis. We then merged the housing and tax data with the ranking of New Jersey public high schools which is published bi-annually by NJ Monthly. While we have some reservations about the publication's methodology, we feel that many individuals who plan to relocate to one of these communities do pay attention to such measures. We assigned the mean rank of high schools to municipalities with more than one high school. Regional high schools were counted towards the municipality in which they are located. Table 1 shows the means and standard distributions of the relevant variables.

Table 1. *Means and Standard Deviations of Variables Used in Estimations*

	Mean	**Standard Deviation**
Dependent Variable		
Mean housing price by municipality	$376,910	$210,237
Independent Variables		
Mean property tax bill by municipality	$9,137	$3,665
Mean income by county	$63,014	$12,970
Rank of High School	N/A	N/A

Source: *Own study.*

The housing price variable, the variable for the mean tax bill by municipality, and the mean income by county all show a good amount of variation. This variation is visible in Appendix A.

Table A1 shows that the average tax bill by county varies greatly from the lowest amount of $4213 in Cumberland County to the highest average tax bill in Essex County of $11,878. The difference is almost triple the amount. Not only do the tax bills vary greatly, so do the effective tax rates. Table A1 shows that the tax rate in Cape May is 1.31%, while in Camden County the rate more than double at 2.94%. Table A2 shows there is also great disparity in the per capita income across counties. This variation in per capita income may impact the ability of homeowners to be able to afford high house prices and high property taxes. Similarly, Figure A1 shows tremendous variation in average house prices across New Jersey counties.

3.2 Estimation Results

For the 142 municipalities for which we have information on all the variables mentioned above, we regressed the mean selling price of houses in a municipality on its average tax bill. Results are presented in Table 2. It is presumably not plausible to claim that individuals move to an area *because of* the high taxes, but *despite of* them since those towns often have positive attributes such as schools that are perceived to be of high quality or closer commutes to New York City.

However, we start out with this estimation to see to what extent the relationship between tax bills and housing prices changes as we introduce other variables.

Table 2. *Results of Ordinary Least Squares Regression of Housing Prices on Property Taxes (Standard Errors in Parentheses)*

	Mean housing price by municipality
Mean property tax bill by municipality	48.96*** (2.53)
Constant	-70,468.40*** (28,864.22)
Observations	142
R-Squared	0.729
*** statistically significant at 1% ** statistically significant at 5% * statistically significant at 10%	

Source: *Own study.*

As can be seen in Table 2, the coefficient estimate is highly statistically significant and quite large in magnitude and will serve as a reference for the subsequent estimation as mentioned above.

In this next estimation, we regress the mean selling price of houses in a municipality on its average tax bill, the mean per capita income at the county level, and the ranking of its high school. The income variable is expected to have a positive relationship with the housing prices since individuals are in affluent areas are better able to afford to move to and live in high-price areas. The expected coefficient estimate on the high school rank variable is negative since a higher rank stands for a less well-ranked school and we expect housing prices to be higher in areas with highly-regarded public schools. Results for that estimation are shown in Table 3.

Table 3. *Results of Ordinary Least Squares Regression of Housing Prices on Property Taxes, Income, and High School Ranking (Standard Errors in Parentheses)*

	Mean housing price by municipality
Mean property tax bill by municipality	42.97*** (3.51)
Mean income by county	1.59* (0.84)
Rank of High School	-194.46 (140.51)
Constant	-85,857.38 (65,668.36)
Observations	142
R-Squared	0.741
*** statistically significant at 1% ** statistically significant at 5% * statistically significant at 10%	

Source: *Own study.*

The effect of the tax bill on housing prices is lessened compared to the previous regression (it goes from an increase in housing prices of about $49,000 for every $1,000-increase in the average tax bill to about $43,000), which supports the notion that high taxes are not the reason for high housing prices, but rather something that homebuyers are willing to accept in exchange for services such as quality public schools. The mean income does have a statistically significant, positive impact on housing prices that is rather substantial in magnitude: on average, an increase of $1,000 in mean income is associated with an increase of $1,590 in the mean housing price. Finally, housing prices are moderately strongly related with the high school rank (correlation coefficient of 0.61).

Regarding the high school rank variable, we find that moving up one spot in the rankings is associated with an increase in the average tax bill of approximately $194. However, that estimate is not statistically significant at conventional levels (p-value = 0.17).

4. Conclusions

The Tax Cuts and Jobs Act which caps deductions of State and Local Taxes (SALT) at $10,000 a year on federal individual income tax returns can be expected to have a larger impact on New Jersey homeowners than those in many other states. We use data from a variety of sources to construct a data set that allows us to estimate a number of determinants of the mean housing price in dozens of New Jersey municipalities. While the property taxes, income, and high school rankings are important factors, soon-to-be released data on housing prices will shed light on the impact of the change in tax law on the New Jersey real estate market.

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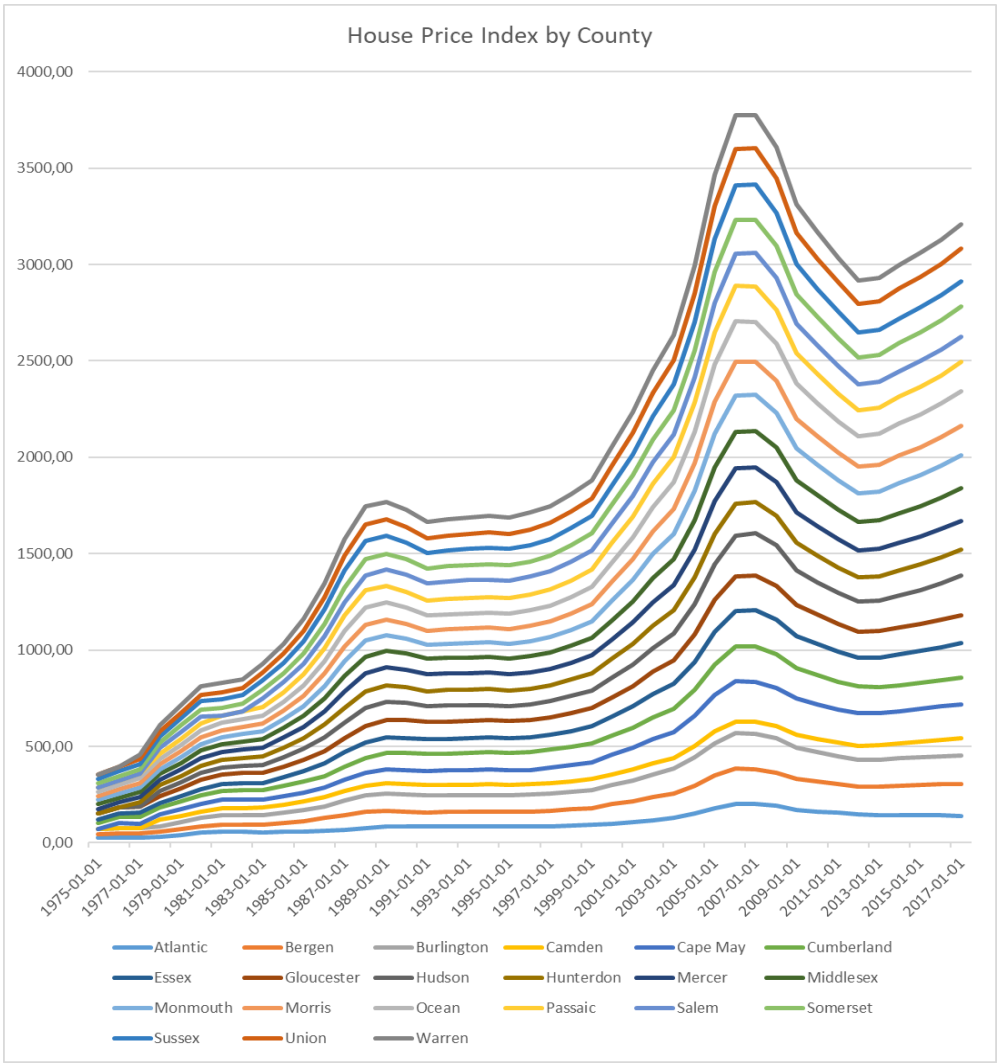
Appendix A:

Average Property Tax and Effective Tax Rates by New Jersey County		
County	Property Tax	Effective Rates
Atlantic	$6,593	2.17%
Bergen	$11,585	2.08%
Burlington	$7,200	2.42%
Camden	$6,767	2.94%
Cape May	$5.203	1.31%
Cumberland	$4,213	2.43%
Essex	$11,878	2.51%
Gloucester	$6,956	2.67%
Hudson	$9,211	2.10%
Hunterdon	$9,394	2.20%
Mercer	$8,342	2.41%
Middlesex	$8,413	2.11%
Monmouth	$8,924	1.95%
Morris	$10,294	2.00%
Ocean	$6,427	1.78%
Passaic	$9,813	2.48%

Salem	$5,547	2.54%
Somerset	$9,714	2.09%
Sussex	$7,631	2.35%
Union	$10,863	2.37%
Warren	$7,029	2.38%

Source: *Own study.*



Source: *Own study.*

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