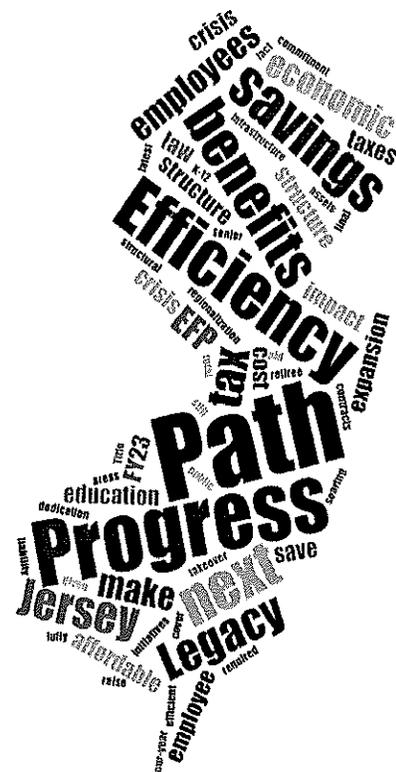


# Path to Progress

New Jersey Economic & Fiscal Policy Workgroup

August 9, 2018



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## **I. Statement of Purpose**

New Jersey faces a fiscal crisis of unsustainable legacy pension and benefit costs that suppress economic growth and competitiveness by crowding out needed investments in infrastructure, higher education, and the economic development that other states are making. This is a direct result of the failure of governors and legislatures of both parties to make the necessary pension payments. But if this crisis is not resolved, it will be impossible for us to meet our commitment to fully fund our public schools, expand preschool and make New Jersey affordable for our families, our senior citizens, and our businesses. Furthermore, New Jersey continues to struggle with inefficiencies at all levels of government. Steps have been taken in recent years, such as the two percent property tax cap, increasing employer and employee pension contributions, and creating a new prescription benefit procurement process. Still, many of the necessary reforms have been ignored due to a lack of political will.

That is why the New Jersey Legislature created the Economic and Fiscal Policy Workgroup and charged it with a broad mission – to identify ways to address soaring pension and benefit costs, hold down property taxes, make state and local government and school districts more efficient, assess the equity and efficiency of our state and local tax structure, leverage the value of state assets, and mitigate the negative impact of the federal tax law that targeted high-cost states.

## **II. Committee Process, Structure, and Membership**

The Economic and Fiscal Policy Workgroup held its initial organizational meeting on January 30, 2018. Over the course of the next several months, the Workgroup held seven meetings that included presentations by policy experts on critical issues and robust discussion of the pros and cons of potential solutions. Eventually, each member of the group was asked to submit policy recommendations based upon those presentations and discussions. The recommendations were shared with the Workgroup and aggregated into five categories:

- 1) Pension & Benefit Reform
- 2) Education Reform at the Administrative Level
- 3) County & Municipal Government Reform and Shared Services
- 4) State and Local Government Tax Structure
- 5) Leveraging Assets to Stabilize the Pension System

The Workgroup split into five subcommittees that held individual meetings to review and evaluate those recommendations. Each subcommittee then submitted a report with final recommendations to be included in this report. While the group did not vote on each individual recommendation, this report, in its entirety, represents the consensus of the assembled experts.

The issuance of this report represents the first step in what we anticipate being an ongoing process in the months ahead that will expand to involve stakeholders and the general public in an informed debate about how to put New Jersey on the path to progress.

|                                          |
|------------------------------------------|
| ECONOMIC AND FISCAL POLICY GROUP MEMBERS |
|------------------------------------------|

## Co-chairs:

- Senator Paul Sarlo - *Chairman, Senate Budget and Appropriations Committee*
- Senator Steven Oroho - *Senate Republican Conference Chair*
- Assemblyman Louis Greenwald - *Assembly Majority Leader*

## Legislative Members:

- Senator Steve Sweeney – *Senate President*
- Senator Dawn Addiego - *Deputy Minority Whip*
- Senator Anthony Bucco - *Senate Minority Budget Officer*
- Assemblywoman Eliana Pintor Marin - *Chairwoman, Assembly Budget*
- Senator Troy Singleton - *Chairman, Senate Military and Veterans' Affairs*

## Subcommittee Chairs:

- Dr. Ray Caprio - *Rutgers Bloustein School of Planning & Public Policy; Bloustein Local Government Research Center*
- Frank Chin - *Managing Director, American Public Infrastructure*
- Richard Keevey - *Rutgers University Bloustein School of Planning & Public Policy and Woodrow Wilson School of Public and International Affairs*
- Dr. Michael Lahr - *Rutgers Bloustein School of Planning & Public Policy and Rutgers Economic Advisory Service*
- Marc Pfeiffer - *Rutgers University, Bloustein School of Planning & Public Policy; Bloustein Local Government Research Center*

## Non-Legislative Members:

- Dr. Henry Coleman - *Rutgers University, Bloustein School of Planning & Public Policy*
- Lucille Davy - *Of Counsel, Mason, Griffin & Pierson*
- Feather O'Connor Houstoun - *Adviser for Public media and journalism at Wyncote Foundation*
- Ray Kljajic - *American Public Infrastructure Inc.*
- Robert Landolfi - *Business Administrator, Woodbridge Township (retired)*
- Senator Raymond Lesniak - *Chair, Lesniak Institute for American Leadership*
- Jerry Maginnis - *Rowan University, William G. Rohrer College of Business*
- Dr. Donald Moliver - *Monmouth University, Kislak Real Estate Institute*
- Dr. Joel Naroff - *President, Naroff Economic Advisers Inc.*
- Peter Reinhart - *Monmouth University Kislak Real Estate Institute*
- Kurt Stroemel – *President, HR&S Financial Services*
- Ralph Thomas - *CEO/Executive Director, New Jersey Society of Certified Public Accountants*

### **III. Executive Summary**

New Jersey State Legislative Leadership initially established the New Jersey Economic and Fiscal Policy Review Committee to examine the negative impact of federal policies on New Jersey's residents, businesses, economy, real estate values, affordability, and competitiveness and to have the committee identify strategies to mitigate the impact. The Committee's mission quickly developed into a full assessment of the long-term budget challenges facing state and local governments; the fairness, adequacy, efficiency and affordability of the state's current revenue structure across all levels of government; and how to deliver services more efficiently and cost-effectively at various levels of government. The following report of the Committee provides the findings and recommendations.

#### **A. Pension and Benefit Reform**

According to the Pew Charitable Trusts, the condition of New Jersey's pension system ranks among the most underfunded in the country. The State's combined pension and retiree health benefit liabilities of \$151.5 billion are four times the size of the State's annual budget; and more than three times the size of the State's bonded debt. That public employee debt represents \$16,772 for every one of New Jersey's nine million residents, it will continue to grow every year. Without changes to the pension and benefit structure, the cost of pensions and benefits will rise by \$4.1 billion over the next four years and eat up 26 percent of the state budget.

##### **Recommendations – Pension System:**

- Shift new state and local government employees and those with less than five years of service in the Public Employees' Retirement System and the Teachers' Pension and Annuity Fund from the current defined benefit pension system to a sustainable hybrid system and preserve the current system for employees with over five years of service who have vested contractual pension rights.

##### **Recommendations – Health Benefits and Other Benefits:**

- Shift all state and local government employees and retiree's health care coverage from Platinum to Gold.
- Require all new state and local government retirees to pay the same percent of premium costs they paid when working.
- Merge the School Employees Health Benefits Program into the larger State Health Benefits Plan and make the plans identical in coverage.

- Cap accrued terminal leave payouts for state and local retirees at \$7,500 or the amount currently earned, and makes those payments based on average career salary.
- Require state and local governments to pay the first \$15,000 of remaining earned sick leave immediately or allocate it on a pre-tax basis to retiree healthcare premiums for qualifying employees and pay the remaining amount over five years.
- Require an ongoing third-party audit of health care claims
- Require families with multiple State or local government employers to select only one health care plan from one employer.

## **B. Education Reform at the Administrative Level**

The Economic and Fiscal Policy Workgroup focused on two major reform areas that have a direct impact on both education quality and property taxes: School District Regionalization and Special Education. School districts with less than 1,000 students cost taxpayers 10 percent to 15 percent more per pupil than larger districts and are unable to provide as diverse a curriculum. Meanwhile, extraordinary special education costs that should be a state responsibility burden local school districts and property taxpayers, and too often prevents parents from getting the education their children need and deserve.

### **Recommendations:**

- Merge all K-4, K-5, K-6, K-8, and K-9 school districts into K-12 regional districts to improve the quality of education and promote efficiency.
- Permit the establishment of two countywide school district pilot programs.
- Move toward full State funding and administration of Extraordinary Special Education.
- Establish a State-level group to address students for whom an Individual Evaluation Placement (IEP) team is considering a residential program.
- Establish a Special Education Study Commission to review the current capitation formula that provides all districts with the same special education aid regardless of how many special education students they serve.
- Reform the hearing process for special education placements and disputes by appointing Office of Administrative Law judges with experience in special education who would hear only special education cases within the 60-day timeline.

### **C. County and Municipal Government Reform**

New Jersey has taken steps to encourage municipal shared service agreements and joint meetings in order to better achieve economies of scale. In 2007, New Jersey established The Local Unit Alignment, Reorganization and Consolidation Commission (LUARCC) to study and report on the structure and functions of county and municipal government. One of LUARCC's primary responsibilities is to determine the appropriate allocation of service delivery responsibilities from the standpoint of efficiency. However, with LUARCC having failed to fulfill that mission, New Jersey currently lacks a coordinated effort to identify the level at which key services can be provided most efficiently.

#### **Recommendations:**

- Re-establish the Legislature's County and Local Government Study Commission which disbanded in 1992 and consolidate it with LUARCC.
- Authorize the Commission to undertake a study of shared services to identify the proper size, scale and level of government at which various services – from 911 calls to code enforcement to health services -- can be delivered most efficiently and cost-effectively and make recommendations for legislation based on those analyses.
- Reestablish a program within the Division of Local Government Services to effectively promote and encourage shared services and the recommendations of the Commission.
- Require the merger of municipal courts with small caseloads, as recommended by the New Jersey Supreme Court Committee on Municipal Court Operations, Fines, and Fees, and develop proposals to address other issues raised by the panel.
- Create a Property Tax Assessment Study Commission to study the State's tax assessment practices and make recommendations for countywide or regional tax assessment to ensure consistency and efficiency.
- Require municipalities, their board(s) of education and any local authorities to meet at least twice a year to discuss shared services and other matters of mutual concern and encourage these groups to meet with their neighboring entities for the same purpose.
- Require shared service agreements to have alternate dispute resolution provisions, performance evaluation criteria, a formula-based or defined negotiating process for fee schedules and exit provisions.

- Prioritize resolving how civil service and tenure issues get managed when local units want to share service.
- Authorize county governments to provide the full range of local police services (in full or in part) to help municipalities lower their costs.
- Encourage “joint meetings” for public service agencies and change name to “regional service agencies.”
- Allow municipalities and counties to provide their annual audits using the national standard governmental accounting report (GASB or GAAP) in lieu of the current annual audit in order to facilitate uniformity.

## **D. State and Local Tax Policy**

The Economic and Fiscal Policy Working Group was established to develop policy responses to a federal tax plan that limited the SALT deduction. The new federal policy has compounded residents’ concerns regarding property taxes which rank at the top of most polls. The \$28.8 billion in property taxes collected in FY2017 were twice as much as the \$14.4 billion in State income taxes and three times as much as the State’s \$9.4 billion in sales taxes. To address the serious burden of property taxes, the Work Group recommends the following:

### **Recommendations:**

- Enable Subchapter S-Corporations, Limited Liability Corporations (LLCs) and Partnerships to pay State taxes equivalent to the Gross Income Tax obligations of their owners and partners, thus making the State tax payments deductible on their federal taxes.
- Split revenue from Payments in Lieu of Taxes (PILOTs) among municipalities, school districts and counties based on current property tax ratios, and revisit the law establishing the formula for calculating the “annual service charge” that is the PILOT. Require governing body approval and spending justification for levy cap increases based on added assessments and new PILOT revenue.
- Undertake a comprehensive analysis of New Jersey sales tax exemptions to simplify the tax code.

- Revise New Jersey’s property tax relief programs to ensure that property tax relief is provided equitably and is allocated to reduce property tax payments for New Jersey owner-occupied homeowners to the greatest extent possible.
- Establish a permanent Economic and Fiscal Policy Review Commission made up of economists, academics and tax experts to provide an ongoing review of taxation best practices and report back to the Governor and the Legislature on an ongoing basis.
- Permit a Gross Income Tax deduction for charitable donations to New Jersey-based charitable organizations.
- Focus additional tax incentives towards small businesses to support more entrepreneurs with facilities located in New Jersey.
- Permit a *revenue-neutral* county or multi-county/regional 1% Sales Tax option paid partly by out-of-staters to be used to potentially cut property taxes by more than \$1 billion if all counties participate.

## **E. Leveraging Assets to Stabilize Pension System**

The State shifted ownership of the State Lottery to State pension funds, resulting in a \$13 billion reduction in the unfunded pension liability. This form of asset transfer provided a framework for an important pension funding solution. Governments at all levels own, operate, manage or otherwise control a wide range of assets and activities. Many of these assets have an inherent value that goes unaccounted for because there has been no incentive to capture the “market” value of these assets. Capturing these inherent values would reduce the unfunded pension liability thereby freeing current and future budgetary resources for other needed investments such as infrastructure, education, public safety, and social safety net programs.

### **Recommendations:**

- Explore the viability of transferring major assets such as the New Jersey Turnpike system to the State pension system to lower the unfunded liability and generate new revenue streams for the pension system.
- Develop an inventory and establish values of State assets and study those assets to evaluate which are best suited for dedication to State pension funds. The State could also provide funding and/or technical assistance to local governments that are interested in the concept of transferring their assets as a form of pension contribution.

- Develop legislation to lay the framework for any future public asset transfer. The legislation would outline the authorization process and transfer procedure as well as permit the creation of limited liability companies that could be delegated the power of the governmental entity to operate the asset. It would also set forth a procedure for local governments to dedicate local assets in lieu of cash pension contributions.

## **IV. Pension and Benefit Reform**

The fiscal future of New Jersey is bleak. The State has struggled to balance its budget for two decades. According to the Pew Charitable Trusts, New Jersey's pension system ranks among the worst-funded in the country. Pension underfunding and the increasing costs of providing health benefits for current and retired employees are the principal reasons for poor credit ratings and poor outlook for New Jersey's finances. The \$4.1 billion increase in pension and benefit costs over the next four years exceeds projected revenue growth, threatening the ability of the State to continue basic state responsibilities, including school aid, Medicaid and transportation. To achieve a sustainable system for retirees while maintaining New Jersey's fiscal integrity, both the pension and health benefit funding crises must be addressed simultaneously.

While the Police and Firefighters System (PFRS) and Public Employees' Retirement System (PERS) funds that provide pensions to county and municipal employees are 71.5% funded, the seven State-funded pension systems, including the Teachers' Pension and Annuity Fund (TPAF), are just 55.8% funded. Furthermore, based on Governmental Accounting Standards Board (GASB) standards, the State's FY2017 audited financial statement puts the "Net Pension Liability" of the seven State funds at \$115 billion. It is estimated the TPAF will be depleted by 2029 and the state Public Employees' Retirement System by 2034. Furthermore, the "Net Liability for Other Postemployment Benefits," principally for health benefits, is \$36.5 billion and, unlike the pensions, no funds have been set aside to address these liabilities. The State also pays the school districts' share of retiree costs for pensions and health benefits, as well as the employers' share of Social Security for current employees.

Based on GASB standards, the State's combined pension and retiree health benefit liabilities of \$151.5 billion are four times the size of the State's annual budget; and more than three times the size of the State's bonded debt. In FY 2019, \$3.2 billion was appropriated from the state budget to cover pension payments for teachers and state employees. By 2023, \$6.6 billion will be required from the state budget to complete the ramp-up to 100 percent funding of the Actuarially Required Contribution (ARC) for that year. The ARC will reach a zenith of \$7.1 billion in 2030.

In FY 2019, \$3.4 billion is appropriated for health benefits for current State employees, retired teachers and retired State employees. Unless changes are made in the benefit structure or system-wide changes are implemented to manage health care that reduce costs, these costs are projected to increase by \$700 million – an average increase of five percent a year – over the next four years alone. Additionally, in 2022 the federal Cadillac Tax, a 40 percent excise tax on generous health benefits, will take effect. These reform will mitigate that potential tax.

The combined \$4.1 billion increase in State funding for pensions and health benefits over the next four years is \$200 million more than State revenues are projected to grow during that same time period (assuming three percent growth) – and that does not include a minimum of \$3 billion in other spending needs and priorities that will be incurred.

The Task Force has identified the following actions as necessary to improve the fiscal future of the State. These options are designed to save at least 30 percent of the projected \$4.1 billion cost increase for pensions and health benefits by FY 2023 and to lower the long-term unfunded liability for pension and retiree health benefits. All of the savings from pension and health benefit reforms should be dedicated to pension funding.

### **Recommendations – Pension System:**

Fixing the State's pension system is a complex issue. Policymakers need to guarantee the long-term fiscal viability of the pension funds to ensure their ability to continue to provide current employees and retirees with the pensions they have earned without the funds becoming insolvent. When addressing these issues, policymakers must consider the heavy burden that already exists on New Jersey taxpayers, as well as the importance of competing budget priorities. Furthermore, any plan needs to balance the competing interests of employees, retirees and taxpayers within the context of existing laws, court rulings and legal opinions that limit the range of policy options.

To make the pension system sustainable for the long term, the Workgroup recommends the following:

- Shift from the current defined benefit pension system to a sustainable hybrid system that combines the best elements of both a defined benefit, maintaining a traditional annuity-based pension, and defined contribution system. Several states, most notably Rhode Island, have developed hybrid models over the past eight years. Development of a final plan for New Jersey's pension systems will require additional analysis with an actuary to determine long-term cost savings, budgetary impact, and timing for implementation. That plan should be developed over the next four months so that it can be considered by the Governor and the Legislature as part of the upcoming budget process. Based on our preliminary analysis, the plan that best blends short-term budget savings with long-term pension viability while meeting current legal and contractual standards will prove to be a hybrid pension system.

The hybrid system we are recommending would:

- Preserve the current defined benefit pension system for non-uniformed state, county and municipal government and school district employees who have five years of service and vested contractual pension rights as of the date of enactment of the new pension legislation.
- Create a blended defined benefit/defined contribution plan for new non-uniformed state, county and municipal government and school district employees and those with less than five years of service. Two options to consider would be to (1) provide a defined benefit pension for the first \$40,000 of income and establish a cash balance account within the pension system that guarantees a minimum return of four percent, or half of what the pension system earns, on all income above \$40,000; or (2) shift entirely to a cash balance account for this group.
- Provide an option allowing employees in the blended system to opt out of the cash balance account in favor of a 403B or 457 plan (the equivalent of a private sector 401K plan for government employees) similar to the TIAA-CREF plan provided by state college faculty.

- Increase the retirement age for full benefits for all new and non-vested employees to the retirement age required in that year for the collection of full Social Security benefits (currently 66 years, two months, and rising to 67 for those born after 1959). As under current law, those who retire prior to the full statutory retirement age would have their final pensionable income reduced by three percent for each year (0.25 percent per month) below the Social Security age at which they retire.
  
- Change the pension system to require retirees returning to government service in a full-time or high-paid capacity to suspend their pensions, be reenrolled in the pension system from which they retired, make their pension and health benefit payments, and accrue additional years of service during that time that will increase their future pension benefits.

The recommendation to move to a hybrid system reflects the consensus of the Economic and Fiscal Policy Workgroup that the continuation of the current system is unsustainable. Years of underfunding by the State government and years of less-than-adequate contributions by employees prior to FY 2012 has created a current unfunded liability of \$41 billion in the pension funds for teachers and state employees that will rise to \$51 billion by FY 2023 based on Treasury projections that use accounting methodology that is less stringent than GASB.

Recognizing that most private companies and some governments have shifted their employees entirely to defined contribution plans, the Pension and Benefit Reform subcommittee vigorously debated the merits of the hybrid approach, which the U.S. Bureau of Labor Statistics calls a “soft freeze,” compared to the “hard freeze” recommended by the Healey-Byrne Commission in 2015 that would have frozen all current employees at the level of pension benefits they have already earned and shifted them immediately to a cash balance plan or a 401K-style model for the remainder of their working careers.

While the “hard freeze” would have immediately frozen the State’s unfunded liability and might have saved more money in the long run, it is clear that it would have added \$1.5 billion per year to the amount that State taxpayers would contribute to the system over the next decade. Furthermore, the “hard freeze” approach would have had a major impact on the lives of tens of

thousands of government employees in their 40s and 50s who had made career decisions based on their pensions and would have gone far beyond the changes of Chapter 78. Finally, the “hard freeze” would violate N.J.S.A. 43:3C-9.5 that establishes “a non-forfeitable right to receive benefits as provided under the laws governing the retirement system or fund upon the attainment of five years of service” for all state and local government employees hired prior to July 1, 2010. This contractual right, backed by court rulings and official legal opinions, would effectively exclude two-thirds of state and local government employees from any “hard freeze” plan.

The hybrid approach provides long-term savings by shifting state and local government employees with less than five years of service and new hires into a plan that could continue to provide a defined benefit pension on the first \$40,000 of income, while shifting the remainder of their retirement obligation into either a cash balance system with a four percent guaranteed return or into a defined contribution plan. This will produce an immediate savings in both the unfunded liability and in the required contribution in the same way that the 2011 law did by limiting pensionable income for new hires to the Social Security limit (currently set at \$128,400 in 2018).

Unlike the “hard freeze,” however, the hybrid approach does not add a budget-busting \$1.5 billion increase to the short-term taxpayer liability because the 80 percent of employees with more than five years of service would continue to make their full contributions to the pension system, and new hires and those with less than five years of service would continue to contribute on their first \$40,000 of income if that hybrid option is selected.

The hybrid plan should go beyond the 2011 pension law in requiring the pension system to reduce its future liability not just to a 20-year amortization schedule, but to a 15-year amortization schedule in the years following completion of the ramp-up to the full ARC; the State is now in the sixth year of a planned 10-year ramp-up to full funding by FY 2023. The plan should include a mechanism that allows the state to lower pension payments in a major recession and automatically ramp up to full funding when revenues rebound.

The plan should shift the current 7.5 percent return-on-investment assumption rate for the State’s pension system to seven percent or a rate commensurate with the system’s long-term historic

earnings, but on a graduated schedule that avoids fiscal cliffs, such as the insurmountable \$1.2 billion increase in taxpayer contributions from FY 2022 to FY 2023 that would be required by lowering the assumption rate from 7.3 percent to 7.0 percent in a single year. The plan should also include a self-regulating mechanism that automatically adjusts investment assumption rates up or down based on long-term results.

While some of these reforms are accounting changes, they enable the state to stabilize its pension payments in the short term while the long-term savings from the new hybrid system take effect. Following FY 2023, the Governor and the Legislature should make it a priority to annually make the full ARC payments to the pensions systems.

Unlike the pension funds for teachers and most state employees, the Police and Firefighters Retirement System (PFRS) is now managed jointly by the unions and local government officials and nearing sufficient funding levels at 73.5% to be able to consider restoration of cost-of-living increases long before other state or local government pension systems in New Jersey. The PFRS will be required to raise its contribution rates or cut benefits if it fails to meet investment projections, as the building trades unions in the private sector already do.

The PFRS Board may wish to consider similar reforms for new employees and/or those with less than five years of service, including lengthening service requirements from the current “20 and out” rule for full pension payments, as a way to improve its funding ratio, lower contribution rates or speed up restoration of cost of living adjustments (COLAs).

### **Recommendations – Benefits:**

New Jersey’s current health benefits system for State employees and teacher and State government retirees is a Platinum-level system with an actuarial coverage of 97 percent of total health care costs – the highest percentage of any government health care system in the nation. Current employees pay an average of 21 percent of the cost of coverage – about nine times as much as retirees pay. The \$1.4 billion cost of coverage for current state workers is less than the \$2 billion cost of retiree health benefits. While major savings have been achieved over the past several

years, health benefit costs for employees and retirees are projected to grow by \$700 million over the next four years. Because the State self-funds its health care coverage, almost 90 percent of that cost increase will be borne by taxpayers.

- Our core recommendation is that the state shift from Platinum-level health care coverage to Gold-level coverage for state employees, state retirees, and teacher retirees with an actuarial value of 80 percent that is comparable to the best private sector corporations in New Jersey after FY2019 when state collective bargaining contracts expire. The shift from Platinum to Gold would save an estimated \$587 million on employee and retiree health care premiums for the State budget and \$69 million for current State workers on their premium cost-sharing payments in FY2020, with savings projected to rise to \$675 million for the State and \$79.7 million for employees in FY2023. County and municipal governments and school districts currently enrolled in the State Health Benefits Plan and School Employees Health Benefits Plan would save at least \$600 million a year for property taxpayers and over \$100 million for employees by a similar shift when their contracts expire over the next several years. Total local government savings would top \$1.4 billion for taxpayers and \$230 million for employees if all plans made the same shift.

While the Gold plan would be the new standard coverage for both State and local government employees and retirees, we recommend that the state develop Silver and Bronze plans to offer to employees with a lower premium sharing.

- Require new retirees to pay the same percent of premium costs they paid when working. Current state employees contribute 21% of the total \$1.75 billion cost of their health care coverage, while new retirees since 2016 contribute only \$50 million of the \$2 billion total cost of retiree healthcare coverage. New retirees contribute toward their healthcare coverage based on the amount of their individual pension, regardless of whether they are working or have other family income, making New Jersey the only one of the 45 states that provide retiree healthcare coverage where retirees do not pay the same or more than current employees for their healthcare coverage. For example, an employee who pays 22 percent of his or her health care premium while working is likely to pay just nine percent if he or she takes early retirement. This change would produce \$16 million in combined savings for states and local governments in the first year, and an additional

\$16 million each year after that, growing to a projected \$500 million in savings over the next 25 years.

- Merge the School Employees Health Benefits Program (K-12 and county colleges) into the larger State Health Benefits Plan and make the plans identical in coverage. This would provide \$43 million in immediate savings for school districts and county colleges and \$11 million for their employees.
- Cap accumulated terminal leave payments (sick leave and vacation days) for all new and non-vested state and local government employees at \$7,500 and, upon the expiration of current contracts, require all future terminal leave payments to be made at the average pay rate at which they earned based upon a determination of average salary by the State pension system. This cap would be binding on all future collective bargaining and individual employment contracts funded with state or local tax dollars.
- Allow governments to set aside up to five years of accumulated sick leave payments to cover projected premium cost shares for retirees who have earned lifetime healthcare coverage on a pre-tax basis for those retirees.
- Require governments to pay the first \$15,000 of remaining accumulated absence leave immediately and spread the remaining amount over five years.

The new system would take effect for State employees with the new contract being negotiated for FY 2020 and for local government employees between FY 2020 and FY 2022. While this plan would produce just \$4 million in savings a year for State government, it would provide major property tax savings. The plan would cut the current \$1.9 billion on the books of local government for accumulated sick leave debt by an estimated \$400 million, save local governments \$65 million a year in future accumulated sick leave debt that would otherwise be incurred, and provide one-

shot savings for local governments of about \$140 million during the initial five-year phase-in. Altogether, over the next 30 years, this plan would save property taxpayers over \$2.5 billion over 30 years.

- Require an ongoing third-party audit of health care claims to eliminate overpayments and improper payments, similar to the system created through the Pharmacy Benefit Manager program for pharmaceutical claims. Assuming a similar rate of savings achieved through the Pharmacy Benefit Manager reform, the State could save in the hundreds of millions.
- Require families with multiple State or local government employers to select only one health care plan and pay the premium cost sharing percentage of the highest salary in the family and ban future health benefit waiver payments at all levels of government. Cost savings are indeterminate, but Treasury officials believe they could be substantial.

## V. Education Reform at the Administrative Level

Education spending encompassed \$28.5 billion of the total \$65 billion that New Jersey collected in State taxes and local property taxes last year – 44 cents of every tax dollar. School property taxes totaled \$14.85 billion in FY 2018 and made up 52.4 percent of the total property tax bill. Reform designed to reduce the administrative costs of public education without negatively impacting services provided to students is critical to controlling the growth of property taxes.

The Economic and Fiscal Policy Workgroup focused on two major reform areas that have a direct impact on both education quality and property taxes: School District Regionalization and Special Education. These recommendations are designed primarily to improve the quality of education, and, secondarily, to save money.

While New Jersey ranks fourth in the nation in school spending per pupil, only 59.3% of that amount gets spent on instruction. New Jersey spends a higher percentage of its budget on support services, including general administration and operations and maintenance than New York, Pennsylvania or Maryland, and 71 percent more per pupil than the nation as a whole.

While school spending for the top three quintiles of New Jersey school districts (970 students or more) averages \$20,348 per pupil, the one-schoolhouse districts in the bottom quintile with 488 or fewer students spends \$23,824 (17 percent more per pupil). The smallest districts have a hard time offering the diversified curriculum required for a quality education, particularly in middle school. One Cumberland County school district had just five students in its 8<sup>th</sup> grade and 10 in its 7<sup>th</sup> grade last year.

The Workgroup examined the Maryland model of countywide school districts and examined the option of establishing either fully integrated countywide school districts or countywide administrative districts under which school districts would maintain autonomy but share administrative and support operations.

The State is currently required to fund 85 percent of the cost of Extraordinary Special Education for students whose special education costs more than \$40,000; State reimbursement in July 2017

covered just 45 percent of costs, saddling local districts with \$148 million in unfunded reimbursement for costs incurred during the 2016-17 school year.

For smaller school districts, increases in Extraordinary Special Education costs can wreak havoc with school budgets limited by two percent spending caps. Meanwhile, the current capitation formula that provides districts with the same funding for special education regardless of how many regular special education students they have provides no financial incentive for school districts.

### **Recommendations:**

- Merge all K-4, K-5, K-6, K-8, and K-9 school districts into K-12 regional districts to improve the quality of education and promote efficiency.
- Permit the establishment of two countywide school district pilot programs.
- Move toward full State funding and administration of Extraordinary Special Education.
- Establish a State-level group to address students for whom an Individual Evaluation Placement (IEP) team is considering a residential program. This group would be comprised of representatives from various agencies and departments responsible for the education and welfare of children. It would meet with district representatives and family to review all evaluations, and information relevant to determine if a residential placement is appropriate and if so, which facility is recommended, with the state required to pay the residential cost above and beyond the per pupil expenditure for all children.
- Establish a Special Education Study Commission charged with a range of tasks including:
  - Identifying the current programs and services that are most commonly included in the requests for extraordinary aid;
  - Identifying the particular student needs that require intensive and high cost programs, e.g. medically fragile, behavioral challenges;
  - Developing descriptions of what may be included in extraordinary costs;

- Recommending thresholds and payment structure; and
  - Identifying services that could be provided regionally to districts serving students with low incidence disabilities requiring high cost programs, e.g. therapists, medical, nursing, behavioral interventions, behavior analysts, and make recommendations for the creation and implementation of such a system.
- Reform the hearing process for special education placements and disputes by appointing Office of Administrative Law judges with experience in special education who would hear only special education cases within the 60-day timeline.

## **VI. County & Municipal Government Reform and Shared Services**

Despite being the fifth smallest state in terms of total land area (7,354 sq. mi.), New Jersey is comprised of 565 municipalities – the 17<sup>th</sup> highest in the nation. Offsetting that, New Jersey ranks 36<sup>th</sup> in number of municipalities per 10,000 population. The culture of “home rule” makes municipal consolidation exceedingly rare. However, the high number of local governments per square mile provides opportunities for improvements in service delivery and procurement that can control local property taxes.

Over the years, New Jersey has taken steps to encourage municipal shared service agreements and joint meetings in order to better achieve economies of scale. Shared service agreements consist of two or more municipalities, counties, local authorities or school districts joining together to procure or provide services. A joint meeting is a separate government agency made up of member municipalities overseen by a representative from each member and funded through property taxes raised by their members. The Department of Community Affairs provides special assistance to municipalities seeking to enter into the aforementioned agreements.

In addition, the “Local Unit Alignment, Reorganization and Consolidation Commission” (LUARCC) was established in statute in 2007 to study and report on the structure and functions of county and municipal government. LUARCC’s primary responsibility is to determine the appropriate allocation of service delivery responsibilities from the standpoint of efficiency. It is also tasked with recommending legislative changes that would encourage the more efficient operation of local government, including, but not limited to, the transfer of functions from one level of government to another and the use or establishment of regional service delivery entities. LUARCC was underfunded from the start, produced some studies, and then was effectively abandoned by the previous Administration. As a result, it has not been effective in fulfilling its mission.

Despite the underutilization of LUARCC, most municipalities participate in some form of shared service or joint meeting. Shared services were originally authorized in 1974, have been an integral part of the local management toolbox, and are often implemented with great success. Municipal governments have engaged in hundreds of shared services over the decades for a wide range of services with each other, their county governments, boards of education, and local authorities.

They take the form of specific services and include specialized services such as cooperative purchasing or joint insurance funds.

New Jersey currently lacks a coordinated effort to identify the level at which key services, such as tax assessment, 9-1-1 emergency telecommunications, waste management and municipal courts, should be shared in order to be provide services most efficiently. When the economies of scale are identified, the State should be encouraging the sharing of services on this basis.

**Recommendations:**

- Re-establish the Legislature's County and Local Government Study Commission which disbanded in 1992 and consolidate it with LUARCC (dissolving the LUARCC). This Commission would study local government service costs, service levels, geography and related metrics to identify economies of scale and minimum service standards that will drive opportunities for shared service agreements and joint meetings that would reduce local government expenditures. Initial attention should be paid to the public safety call taking and dispatching, public health, and construction code services.
- Authorize a study of formal and informal shared services already provided by municipalities, schools, counties, and authorities. This would be enabled, in part, by data currently collected by the Division of Local Government Services. The study could be conducted by the Commission or the Division with support from the Department of Education if the agencies have the capacity to conduct the study.
- Create a program within the Division of Local Government Services to effectively promote and encourage shared services and the recommendations of the Commission and provide fiscal and personnel resources to support the activities. This could be tied into the Governor's recent appointment of two "shared services czars."
- Study the role and capacity of the Division of Local Government Services and the Local Finance Board, the State's agency for overseeing local (municipal/county/authority) governments. Time, retirements, law, fiscal practices, societal changes, and technology warrant a review of the

role and responsibilities of this agency to reflect changes since development of the underlying laws under which these agencies currently operate.

- Consolidate municipal courts with small caseloads into regionalized joint courts to achieve efficiency and cost savings, and consider other recommendations proposed by the Supreme Court Committee on Municipal Court Operations, Fines, and Fees.
- Create a Property Tax Assessment Study Commission to study the State's tax assessment practices. The Commission should: 1) examine and reconcile the different "roles of the county" in tax assessment practice and recommend specific model or models, provide a single statewide timetable going forward; 2) study different approaches to the use of technology in the assessment and appeal process to develop statewide standards and practices; and 3) study and make other recommendations that will improve the accuracy and reliability of property assessments and the appeal process.
- Require municipalities to meet with their board(s) of education and any local authorities at least twice a year to discuss shared services and other matters of mutual concern; either as whole governing bodies of all entities or groups of entities, or as committees with the meeting in public with public comment on the subject. Consider applying the same principles to governing bodies meeting with neighboring municipal governing bodies.
- Require shared service agreements to have alternate dispute resolution provisions, performance evaluation criteria, formula-based, ongoing fee schedule or negotiation processes, and exit provisions.
- Prioritize resolving how civil service and tenure issues get managed when local units want to share services. Consider previous and current efforts (i.e., S-1) to address this and the existing Common Sense Shared Service Pilot law.

- Authorize county governments to provide the full range of local police services (in full or in part) to help municipalities lower their costs and/or find ways to encourage neighboring municipalities to share police services, such as overnight patrols for joint policing.
- Encourage “joint meetings” for public services and change name to “regional service agencies.” Examples of this include police, fire, emergency management, human resources, financial operations, technology, etc. Also encourage counties, boards of education, and higher education institutions to engage in providing regional services to local government agencies and their peers.
- Allow municipalities and counties to provide their annual audits using the reporting standards of the Governmental Accounting Standards Board (GASB), Generally Accepted Accounting Principles (GAAP), and the New Jersey Comprehensive Annual Financial Report (CAFR) in lieu of the current annual audit to facilitate uniformity with other government agencies. Develop a process to ensure that data used in the annual budget that is derived from the current annual audit document is maintained.

## VII. STATE AND LOCAL TAX POLICY COMMITTEE

One mission of the Economic and Fiscal Policy Work Group was to develop policy responses to a federal tax plan that limited the SALT deduction for state and local taxes that New Jerseyans had relied upon to defray the cost of state income taxes and local property taxes. In addition to the \$10,000 cap on the SALT deduction, legislative leaders worried about the impact of the new \$750,000 limit on mortgage deductibility and the elimination of the deduction for home equity loans on New Jersey homeowners.

Concerns about property taxes rank at the top of most polls of New Jersey residents' concerns, which is not surprising because New Jersey relies disproportionately on property taxes to fund government services. The \$28.8 billion in property taxes collected in FY2017 were twice as much as the \$14.4 billion in State income taxes and three times as much as the State's \$9.4 billion in sales taxes. While New Jersey ranks 3<sup>rd</sup> in per capita income, we rank 1<sup>st</sup> in property taxes per capita (\$3,065), 7<sup>th</sup> in income tax (\$1,479) and 26<sup>th</sup> in combined state and local sales taxes collected.

With the 2 percent property tax cap, the gap in property taxes between the 14 North and Central Jersey counties in the New York metropolitan commuter basin and suburban competitors like Westchester, Rockland and Nassau counties in New York and Fairfield County in Connecticut has decreased. However, the property tax gap between Mercer, Burlington, Camden and Gloucester counties and the Philadelphia suburbs on the other side of the Delaware remains as large as ever.

### **Recommendations:**

- Enact legislation enabling Subchapter S-Corporations, Limited Liability Corporations (LLCs) and Partnerships to pay State taxes equivalent to the Gross Income Tax obligations of their owners and partners, thus making the State tax payments deductible on their federal taxes. This tax payment practice was in place from 1976 to 1993 and takes advantage of the fact that the federal tax law allows corporations, but not people, to deduct the full cost of their state and local taxes.

This change will provide a \$450 million a year federal tax cut for the majority of New Jersey small business owners, professionals and their families at no cost to the State.

- Split revenue from new redevelopment-driven Payments in Lieu of Taxes (PILOTs) among municipalities, school districts and counties based on current property tax ratios for all new PILOTs and consider a phased-in 10- or 15-year claw-back on the redistribution of existing PILOT revenue to provide increased aid to school districts. Revisit the law establishing the formula for calculating the “annual service charge” that is the PILOT to ensure that is consistent with today’s economy and development and government’s fiscal environment. Require governing body approval and spending justification for levy cap increases based on added assessments and new PILOT revenue.
- Undertake a comprehensive analysis of New Jersey sales tax exemptions to simplify the tax code, benchmark our sales tax structure against other states, and make recommendations to make the sales tax fairer and more progressive. Any increase in sales tax revenue from this benchmarking would be dedicated to municipal aid increases that can only be used to reduce the property tax levy.
- Review the effectiveness and fairness of New Jersey's property tax relief programs to ensure equity, reduce administrative complexity, and target property tax reduction for owner-occupied households to the greatest extent possible. Two options include: (1) combine existing property tax relief programs totaling \$1.1 billion into a new circuit-breaker program that reimburses residents for property taxes on owner-occupied homes that exceed a certain percentage of their household income; or (2) provide a direct increase in municipal aid to reduce property taxes.
- Establish a permanent Economic and Fiscal Policy Review Commission made up of economists, academics and tax experts to provide an ongoing review of taxation best practices and report back to the Governor and the Legislature on an ongoing basis.
- Permit a Gross Income Tax deduction for charitable donations to New Jersey-based charitable organizations.
- Focus additional tax incentives towards small businesses to support more entrepreneurs with facilities located only in New Jersey.

- Permit a *revenue-neutral* county or multi-county/regional 1% Sales Tax option paid partly by out-of-staters to be used to potentially cut property taxes by more than \$1 billion if all counties participate.

## **VIII. Leveraging Assets to Stabilize the Pension System**

As has been suggested throughout this report, the long-term financial health of the State of New Jersey and its municipal governments will depend on addressing New Jersey's significant unfunded pension liabilities.

Historically, the standard approach to supporting public pension systems has been to annually make the actuarially required contributions in order to minimize the unfunded liability over time. Unfortunately, this has not been the case in New Jersey. As a result, the unfunded liability has grown exponentially and, in turn, so has actuarially required contribution.

While we are on a trajectory to making the full actuarially required contribution by FY 2023, the State may not be able to make the necessary payment without major reforms or increasing revenue. The recommendations in this section are intended to supplement the proposals by the Pension and Benefits Committee and provide additional options to help enable the State to make its pension payment.

Last year, departing from an all-cash contribution policy, the State shifted ownership of the State Lottery to State pension funds resulting in a \$13 billion reduction in the unfunded pension liability. This form of asset dedication provided a framework for an important pension funding solution. Governments at all levels own, operate, manage or otherwise control a wide range of assets and activities. Many of these assets have an inherent value that goes unaccounted for because there has been no incentive to capture the "market" value of these assets. Furthermore, these assets are not actively managed in the same way in which private enterprises are managed. They do not have the mandate, tradition, or incentive to realize economies of scale or efficient capital structures in the same way private enterprises do.

Capturing these underlying values by transferring the assets to the State's pension funds would provide a material benefit to New Jersey taxpayers by reducing the unfunded pension liability thereby freeing current and future budgetary resources for other needed investments such as education, public safety, tax relief and social safety net programs. This type of transaction would

maintain ownership of public benefit assets in the public domain, while allowing the State's residents to realize, in a very tangible way, the value of these significant enterprises.

**Recommendations:**

- Explore the viability of adding major assets to the pension system, including the New Jersey Turnpike system, in order to lower the pension system's unfunded liability and add new diversified revenue streams to the pension system.
  - a. Adding the New Jersey Turnpike system could cut the unfunded liability by \$15 billion to \$18 billion, while adding a continuing revenue stream that could grow if New Jersey adds HOT lanes to federal interstates as Virginia and Maryland did to cut congestion or if the federal government decides to permit barrier tolls in the future. Unlike previous proposals to sell the Turnpike to a private operator authorized to institute massive future toll increases, putting toll roads into the pension system would maintain public ownership and allow tolls to remain at a reasonable level.
- Develop an inventory and valuation of State-owned assets and study those assets to evaluate which are best suited for dedication to State pension funds. The State could also provide funding and/or technical assistance to local governments that are interested in the concept of utilizing their assets as a form of pension contribution. Examples of asset classes include:
  - Water and Sewer Authorities
  - Transportation Infrastructure
  - Real Estate
  - Reservoirs
  - Cell Towers
  - Intellectual Property
- Develop permissive legislation to lay the framework for any future public asset transfer. The legislation would outline the authorization process and transfer procedure as well as permit the creation of limited liability companies that could be delegated the power of the governmental entity to operate the asset. It would also set forth a procedure for local governments to dedicate local assets in lieu of cash pension contributions.



