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Contacts

Susanne Siebel +1.212.553.1809
Associate Lead Analyst
susanne.siebel@moodys.com

Douglas Goldmacher +1.212.553.1477
Analyst
douglas.goldmacher@moodys.com

Orlie Prince +1.212.553.7738
VP-Sr Credit Officer/ Manager
orlie.prince@moodys.com

Leonard Jones +1.212.553.3806
MD-Public Finance
leonard.jones@moodys.com

Local government - New Jersey

Municipalities look to save time and money with improved assessment process

Several New Jersey municipalities, mainly in Monmouth and Somerset counties (both Aaa stable), are proactively addressing the state's chronic tax appeal issue. While most municipalities reassess their tax bases irregularly, municipalities in these counties are adopting a systematized approach that will improve the accuracy of assessed values. The strategy looks to reduce costly tax appeals that can lead to revenue shortfalls and short-term borrowing, sometimes on a regular basis. In extreme cases, tax appeals can cause considerable financial distress. Certain municipalities have even had to issue debt to pay for lost appeals, peeling municipal resources away from funding operations.

» **The commonly used revaluation process can cost municipalities money.** Faulty valuations lead to incorrect tax bills and lost tax appeals. If a municipality loses an appeal, it must refund the taxes paid causing potentially serious budgetary pressure via tapping reserves or issuing debt.

» **Annually reassessing the tax base can help save time and money in the long term.** Proactive reassessments on a more frequent basis keep valuations more accurate. The process reduces tax appeals and tax refunds, while improving budgeting accuracy. The steps are crucial because money spent on refunds is essentially a deadweight loss to a municipality.

» **Monmouth County has adjusted the tax appeal calendar to improve budgeting accuracy.** Unlike other local governments in the state, Monmouth municipalities adopt budgets after the tax appeals process is finished. This allows them to set a tax rate to avoid revenue shortfalls.

Commonly used revaluation process can cost municipalities money

Throughout New Jersey, the most common reassessment practice is for municipalities to conduct revaluations every 10 years to make assessed values equal to 100% of the market value of the taxable properties within a community. These revaluations require a reappraisal of all parcels of land and internal review of buildings in the tax base to assign an estimated full and fair value — a process that includes analyzing recent comparable sales. The potential problem is that over a 10-year span, or longer, after a full revaluation has been completed, changes in the overall economy and real estate markets can produce large enough deviations between the market value and assessed value of properties, meaning assessed values are frequently wildly off the market valuations. The deviation is exacerbated by the fact that different parts of a municipality are likely to change in value at different rates.

While, given human nature, a certain number of appeals are inevitable, the potential inaccuracies can lead to lost tax appeals on the part of the municipality. Most tax appeal cases are settled, though failure to reach an agreement can cause a judge to rule.

Lost tax appeals can strain a municipality's finances if the appeal is large enough. A material lost tax appeal can cause a municipality to utilize a significant portion of its reserves or issue debt to finance settlements, both of which can apply credit pressure to an issuer.

For example, Piscataway Township (Aa2) in Middlesex County (Aa2 stable) issued bonds to settle tax appeals. The series 2009, 2011A and 2011B tax appeal refunding bonds, totaling $12.7 million in principal, accounted for $2.0 million or 17.5% of the township's fiscal 2016 debt service. While the township is strong enough to manage the additional debt service costs, tax appeal debt service is a deadweight loss. Unlike debt service for capital improvements, the funding source does not pay for civic improvements but instead is a source of financial friction.

In an extreme situation, Atlantic City (Caa3 positive) demonstrated how much significant tax appeals can have on a municipality's financial position. While the city has recently settled with its largest taxpayers, the city had faced tax appeals amounting to $190 million, or 0.73x of its fiscal 2016 operating revenues, owed to just MGM Mirage and Borgata Hotel Casino and Spa.

New Jersey municipalities are on the hook for lost property tax revenues, a potential source of credit pressure

In New Jersey, a municipality is responsible for collecting and remitting all property taxes to its respective county and school districts regardless of how much is actually collected. This structure is a credit risk for municipalities because if a tax appeal (or other factors) leads to unrealized revenues, the municipality is still required to make the county and school districts whole. The lost revenue is taken from the municipality's operating revenues. While a lost appeal does allow the city to reduce its share of the county tax bill, the budget impact can still be considerable.

Annually reassessing a portion of the tax base can help save time and money in the long term

In contrast to the typical revaluation process, Monmouth County, Somerset County and other scattered local governments across the state have become proactive in managing their rateable base. The municipalities do this by annually conducting reassessments of their tax base and maintaining all individual assessments at current market value. These local governments recognize the detrimental effects that tax appeals have had on municipalities, and ultimately the taxpayers, and have taken the initiative to maintain an accurate tax base without waiting a decade. In most instances, local governments taking this new approach began with a full traditional revaluation to bring their rateable base to 100% of full estimated market value. The annual reassessment requires the municipality to internally inspect 20% of the parcels in the town so that every five years 100% of the internal data is refreshed. As another cost savings, as opposed to the use of an outside consultant, the local assessor is responsible for annually resetting the assessment of each property to its current market value.

The annual reassessment process has two main benefits for the local government (see Exhibit 1). First, the reassessments allow the tax assessor to be more agile and responsive to changes in appreciating or depreciating real estate markets. In an appreciating real estate

market, the assessor has the ability to increase parcels' value at the true market value leading to overall tax base growth. By the same token, the assessor can reduce values in a depreciating market to ensure the stated assessed value does not exceed its market value. If the assessed value exceeds market value and an appeal is filed, the local government automatically loses the appeal because it is illegal to tax a property at more than its estimated market value.

The second benefit generated from annual reassessments is an overall more accurate rateable base. When property assessments are continually reviewed, both the individual properties and the entire rateable base become more accurate. The accuracy of the base allows the local government to properly set appropriate tax rates and a total levy to support that year's operating expenditures. The greater the accuracy of a base's assessment, the greater the probability the municipality will receive the full budgeted revenue because there will be fewer appeals that can reduce the taxable value. Further, when the individual parcels of land are correctly assessed, the surrounding parcels can be assessed more accurately and consistently. Both the number of appeals and the dollar amount of appeals granted to the taxpayer could be reduced, indicating that the continual reassessments are more accurate and efficient.

Exhibit 1

Newer assessment model has benefits over revaluation system

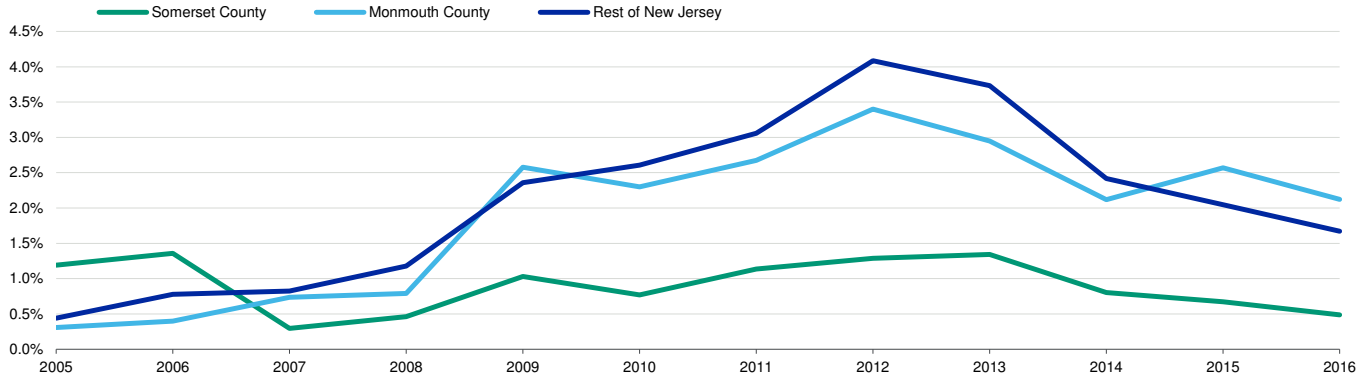
Annual Reassessment Process	Traditional Revaluation Model
20% of tax base is reviewed annually, meaning the whole base is reviewed every five years	Typically occurs every 10 years, tax base is not reviewed until the tax base's coefficient of deviation* is greater than 15%
Allows municipalities more flexibility to react quickly to changing real estate and macroeconomic changes	Reduces municipalities' ability to adjust quickly to changing market conditions.
Greater probability of collecting 100% of tax revenue because of lower chance of appeals	Lost appeals likely to lead to lower tax revenue collection

*As defined by the State of New Jersey's Department of the Treasury, "the coefficient of deviation is the average deviation of individual assessment-sales ratios from the overall average assessment-sales ratio of all sales occurring in a taxing district without regard to any property characteristics."
Source: Moody's Investors Service

Somerset County has been at the forefront of active tax base management since 1989 when the Township of Bernards began an annual reassessment program. Since then, other local governments in the county have followed and benefitted as displayed in Exhibit 2. As a whole, the county has historically experienced fewer tax appeals per parcel than the rest of the state despite not all municipalities in the county having switched to the annual reassessment model. Even during the economic downturn beginning in 2008 when appeals were extremely frequent, Somerset County continued to see fewer tax appeals in relation to its total parcel count than the rest of the state.

Exhibit 2

Somerset County has had fewer appeals than the rest of the state, demonstrating the effectiveness of the newer assessment model



Source: State of New Jersey, Department of Local Government Services 2005-16

Monmouth County historically experienced a similar number of appeals to the rest of the state until 2014 when the county began the Assessment Demonstration Program (ADP). ADP's purpose is to enhance the management of a municipality's tax base through policy changes and updated technology. While the percentage of appeals increased in 2014 when the program started, we anticipate Monmouth County's appeal count to fall as the shock of the new process subsides.

If Monmouth County's new policy follows a similar trend to Somerset County, municipalities have the potential to save resources in how much is paid out for appeals or assessment disputes. The five largest municipalities in Somerset County (measured in 2017 full market valuation), Franklin, Bridgewater, Bernards, Hillsborough and Warren townships' three-year average refund or reduction amounted to $174,000. In contrast, the top-five Monmouth County municipalities, Middletown, Marlboro, Howell, Manalapan and Freehold townships paid an average of $438,000 between 2014 and 2016. These figures suggest room for modest, but regular, savings for the Monmouth communities.

The differences between annual assessments and the traditional model of assessments can be seen through comparing Branchburg Township (Aa1) in Somerset County to Kinnelon Borough (Aa1) in Morris County (Aaa stable). Branchburg has participated in the Somerset County annual revaluation process since at least 2012 with positive results. Between 2013-16, the township has had, on average, 0.1% of its tax base file tax appeals. In contrast, Kinnelon, which utilizes the traditional revaluation model, experienced 1.3% of its tax base filing appeals. The two municipalities have similar wealth indicators and tax base size (see Exhibit 3) illustrating the positive effects annual reassessments can have on the number of appeals filed.

Exhibit 3

Branchburg Township had fewer filed appeals than Kinnelon Borough

	Branchburg Township	Kinnelon Borough
Moody's Rating	Aa1	Aa1
2016 Estimated Full Value ($000s)	$3,058,393	$2,128,775
2016 Estimated Assessed Value ($000s)	$3,031,296	$2,138,950
Median Family Income (MFI) as % of US	208%	231%
Number of Parcels	5,564	3,820
% of Parcels Appealed (3-year average)	0.1%	1.3%

Sources: Moody's Investors Service, township and borough user-friendly budgets, 2014-17

Fairness has surprising impact on credit quality

While the issue of fairness in tax bills seems unconnected to credit, it is, in fact, very closely connected. The temptation is to think that as long as a municipality gets its money, the way the tax levy is divided among households is irrelevant. The problem with this view is that, in addition to the sheer lack of fairness, a faulty assessment is technically illegal.

The New Jersey Constitution requires that "Property shall be assessed for taxation under general laws and by uniform rules. All real property assessed and taxed locally or by the State for allotment and payment to taxing districts shall be assessed according to the same standard of value, except as otherwise permitted herein, and such real property shall be taxed at the general tax rate of the taxing district in which the property is situated, for the use of such taxing district." This is, of course, the legal justification for tax appeals. If property is incorrectly assessed, this is a violation of that law and an owner has a right to an adjustment. From a practical point of view, a municipality can never be 100% accurate. However, the more extreme inaccuracies are clearly contrary to the intention of the state constitution.

Maintaining accurate assessments ensures that taxpayers contribute their correct portion of the total tax levy. Simplifying matters for the sake of clarity, the total tax levy should be apportioned to taxpayers based on the percentage that their property is in relation to the total tax base. For example, if a taxpayer's property assessment is 10% of the total assessed value of the tax base, a taxpayer should pay 10% of the tax levy. Without accurate assessments, it is easy for taxpayers to pay an incorrect share of the total levy.

Monmouth County has adjusted the tax appeal calendar to improve budgeting accuracy

Monmouth County, as part of the ADP, has made efforts to align the budgeting and appeal process for its municipalities in order to reduce the impact of lost appeals on their budgets. As part of an adjusted calendar, taxpayers are given their property assessments in

November and able to file an appeal through April. Once the appeal season concludes, Monmouth municipalities begin the process of adopting its budget with an accurate estimate of revenues and setting the levy to avoid a shortfall.

In other counties in the state, local governments generally begin working on and adopting a budget between January and March while the appeals season follows and runs from April to June. The tax levy, however, cannot be adjusted once its adopted in March and lost tax appeals can leave a municipality with a revenue shortfall. When a municipality loses a tax appeal, the result is an overall reduction in the taxable value of a property which reduces the total taxable value of the municipality. A reduction in the total taxable value will reduce the amount of the collected revenue because the tax rate has already been adopted.

Technological improvements contribute to improved efficiency

In addition to changes occurring in Monmouth County under the ADP program, the county has also created several technological improvements aiding in the assessment management process. One such improvement is an online appeal system, which allows a taxpayer to file appeals digitally. The online system is easier and faster for the taxpayer and more beneficial for the municipalities. The system requires all fields and contact information to be filled out before it is submitted, which can be an issue with paper appeals. Additionally, Monmouth County has shared the system with Burlington (Aa2 stable), Hudson (Aa3 stable) and Union (Aaa stable) counties through shared-service agreements.

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