# Remarks of David J. Rosen
# Legislative Budget and Finance Officer
# To the Assembly Budget Committee
# April 4, 2013

As you begin your consideration of the Fiscal Year 2014 Budget, we come before you to offer an update on the current year's budget situation, an overview of the Governor's Budget Recommendation and a discussion of the revenue estimates.

At this time last year I testified that we were optimistic about the State's economy and predicted that revenues would grow at a faster pace than in recent years. That part of our message was not universally heard. We also said that the growth we anticipated was somewhat less robust than that assumed by the Executive. Finally, I observed that there was a greater risk that our forecast would prove to be too optimistic rather than too pessimistic. That observation proved accurate.

Our message is much the same this year. The economy is improving, with signs of a broadening recovery. Our revenues will continue to grow and the two largest tax sources are likely to exceed their pre-recession peaks. The Administration, however, anticipates even more robust improvement, particularly over the next few months.

Let me begin by reviewing the revenue picture for the past year. Since May 23, 2012 when the Treasurer last came before you the State's revenue collections have trailed the Executive's expectations.

The official State audit revealed that revenues for 2012 came in $318 million below the Administration's estimate. Treasury was able to partially offset this shortfall by reducing FY 2012 outlays by $195 million. The closing balance for Fiscal Year 2012 was the smallest in a decade, as a percentage of the budget, and left the opening balance for the current fiscal year $123 million below the level certified by the Governor in late June.

Almost from the start of FY 2013 actual revenue collections lagged the Administration's projections. Through the first four months of the fiscal year the shortfall against the Administration's targets was $263 million. In the immediate aftermath of Sandy there were additional hits to revenue and two months later the shortfall had grown to $426 million. In December and January, revenues improved somewhat as the result of taxpayers adjusting their behavior to federal tax law changes and some bounce back of the sales tax as the Sandy recovery started.

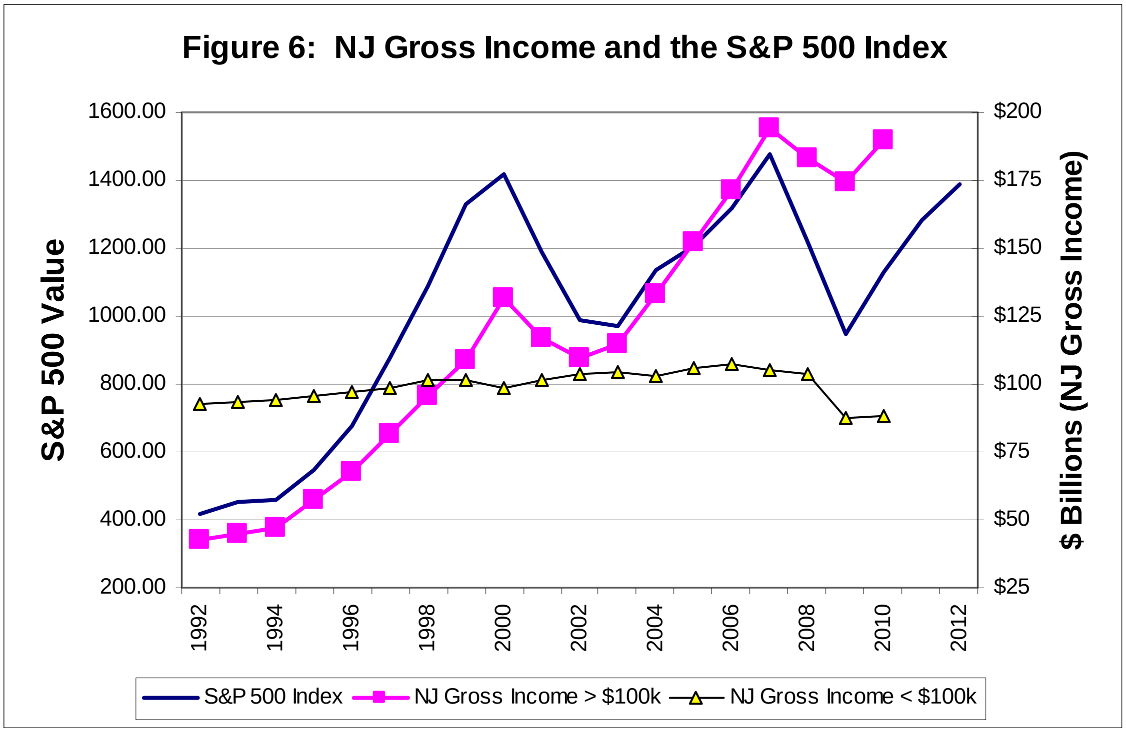
In the Governor's Budget Message (GBM) on February 26, the Administration reduced its FY 2013 revenue forecast by a total of $406 million. The GBM revenue adjustments reflect a dichotomy. The Administration increased its FY 2013 forecast for the Gross Income Tax (GIT) by $406 million, while reducing the forecasts for all other revenues by a combined $812 million.

Through February major revenues are up 4.4% compared to last year, although if you make an appropriate technical adjustment the real growth rate is 3.6%. To reach the revenue targets originally certified for FY 2013 would require revenue growth of 12% for the remainder of the fiscal year. To reach the GBM's reduced FY 2013 targets will require growth of 9.8% for the rest of the year. OLS is projecting overall growth of 7.2% in the remaining months – a doubling of the year-to-date growth rate. Even with this doubling, the OLS forecast is $302.4 million less than the GBM for FY 2013.

Let's disaggregate the revenues. The good news is that the GIT, our largest revenue source, will come in higher than either the Administration or OLS anticipated last Spring, growing by between 8 and 10 percent.

In 2012, employment in New Jersey increased by 66,400, the best year since the recession hit. This is good news, especially for the people who have found work, but it has surprisingly little impact on the income tax. If each of these 66,400 people gained $50,000 in taxable income, the State would see an increase of less than one half of one percent in the GIT total. Similarly wage growth for those already employed at a job paying less than $100,000 is likely to have contributed no more than 1% growth to the GIT.

As we have discussed before, the explanation for GIT growth is the stock market and high income individuals. The 30% of taxpayers with income in excess of $100,000 account for 68% of gross income and pay 84% of the total charged tax. These higher-income taxpayers have significant amounts of non-wage income, and, as is demonstrated by the graph in Figure 6 of the *Tax and Revenue Outlook*, their income moves up or down with the swings in the stock market. In 2012 the Standard and Poor's 500 Index, the broadest measure of the stock market, gained 13% for the year.




Here is a factoid that underscores both the dependence of the GIT on higher income taxpayers and the volatility of their income. In 2008 when the market collapsed, the GIT dropped 17.8% in FY 2009. To have produced an equivalent GIT loss from taxpayers earning less than $100,000 would have required the each of those 1.9 million tax filers to lose all of their income.

This year the GIT is benefitting from more than just good stock market performance. In anticipation of higher Federal tax rates coming in 2013, high income taxpayers sought to maximize income realization in 2012. This produced a windfall in New Jersey that may total $150-250 million. This shift in the timing of income realization will produce 3 to 5 times as much additional revenue in FY 2013 as the 66,400 new jobs.

Through the end of February, the GIT collections appear to be up 8.6% compared to the same period last year. Growth in December and January was particularly strong, up nearly 20% in each month, fueled by higher estimated payments and withholding on bonuses. The February collection number was muddled because of a delay in paying refunds. Adjusting for this refund delay, GIT revenues are effectively growing by 6.7%. To hit the Executive's FY 2013 target for the GIT will require growth of 10.4% between March and the end of the Fiscal Year. While such growth is possible, the OLS is slightly more cautious than the Executive. Nevertheless, the OLS's $12.075 billion estimate for FY 2013 assumes 4.0% growth in withholding collections, 10% growth in quarterly estimated payments, 20% growth in April and May final tax payments, and 12% growth in refund payments (to cover the significant refund delay from February). The Executive, which has not shared its forecast for the components, would need somewhat stronger growth rates than are assumed by OLS. For FY2013 the OLS forecast is $98 million below GBM, a difference of less than one percent.

A pattern similar to the GIT applies to the seven other FY 2013 revenues for which OLS has a different estimate than GBM: CBT, Inheritance, Cigarette, Realty, Petroleum Products, Casino and Alcoholic Beverage. In each instance, OLS assumes that the growth for the rest of year will exceed the year-to-date growth rate and in each instance the GBM assumes an even stronger acceleration in the final quarter. This pattern is clearly depicted in Figure 3 of the *Tax and Revenue Outlook.*

**Figure 3**
**FY 2013: Differing Assumptions of Revenue Growth Acceleration**
**$ in Millions**

| | Growth Through February FY13 | Estimated Growth Remainder of FY 2013 OLS | Estimated Growth Remainder of FY 2013 Executive | Difference Between OLS and Executive in FY 2013 |
|---|---|---|---|---|
| Gross Income Tax* | 6.7% | 8.4% | 10.4% | -$98.0 |
| Corporation Business Tax | -4.4% | 17.4% | 26.1% | -$82.0 |
| Inheritance Tax | -6.4% | 12.5% | 31.8% | -$40.0 |
| Cigarette Tax | -4.6% | -2.5% | 6.5% | -$21.7 |
| Realty Transfer Fee | 7.2% | 30.4% | 60.8% | -$22.0 |
| Petroleum Products Tax | -7.9% | 2.3% | 16.5% | -$13.0 |
| Casino Tax | -11.6% | 2.9% | 15.9% | -$10.0 |
| Alcohol Beverage Tax | 0.6% | 4.9% | 15.1% | -$5.0 |

* 6.7% rate is adjusted to account for the $120 million delay in refund payments in February of 2013.

In both FY 2013 and FY 2014, OLS agrees with the GBM estimate for the Sales Tax, the State's second largest revenue source.

Overall, OLS projects $302.4 million less revenue in FY 2013 than does the GBM.

For FY 2014 the difference between OLS and GBM is $334.7 million, but the explanation for the difference does not involve growth rates. The 2014 OLS and GBM assumed growth rates for the various revenues are quite similar. The forecast variance flows from the fact that OLS applies the growth rates to lower assumed bases for FY2013.

Over the two fiscal year, OLS projects $637.1 million less than the GBM

In addition to these revenue forecasting differences, we need to make note of another potentially significant revenue issue for FY 2014. The GBM assumes that the introduction of internet gaming will generate $180 million in casino tax revenue. OLS has been unable to identify any independent source that endorses such an estimate and, despite several explicit requests, the Executive has offered no analysis to support its estimate. We would welcome receipt of such analysis, but remain skeptical that such a significant FY 2014 revenue receipt is realizable.

For the purposes of today's presentation we have assumed that the State will garner the full $180 million, however, a significant downward revision in this estimate is possible when we present updated revenue estimates in May.

Besides the tax revenues that we have been discussing, there are two other considerations that we should raise. First, the GBM assumes that the General Fund will receive a $166 million infusion from municipal affordable housing trust funds in FY 2013. This matter is still before the courts and it is not clear when or if those funds will be received.

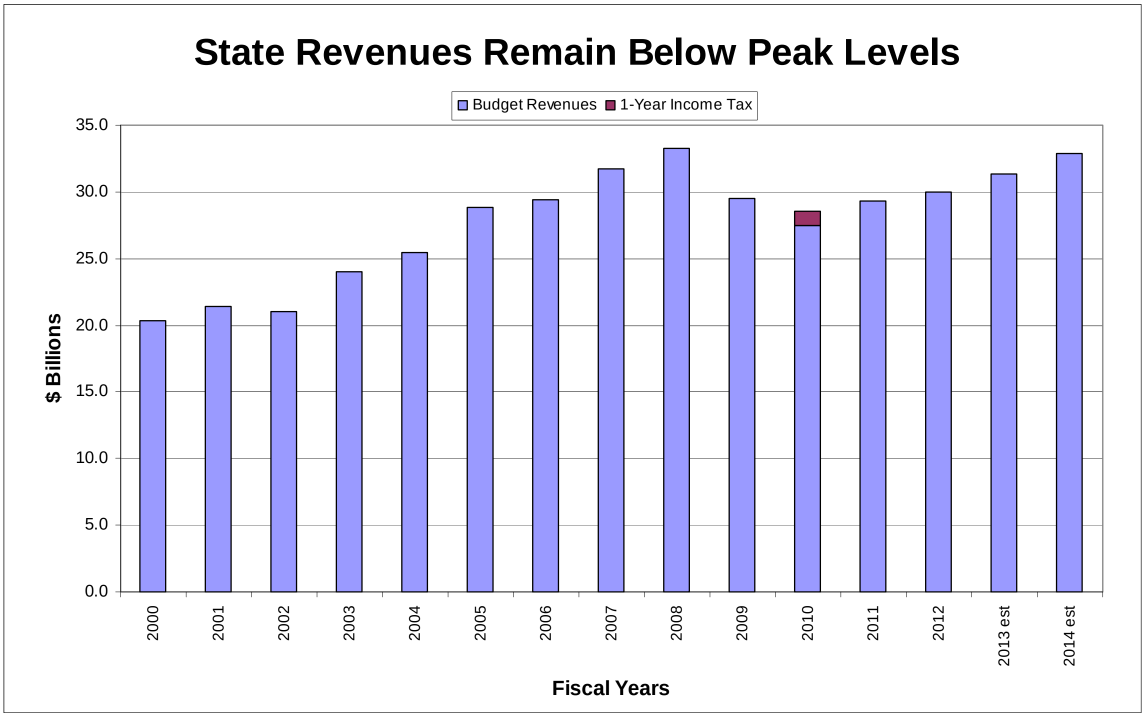
The GBM also assumes that the State will receive a payment of $120 million in FY 2013 from the vendor selected to operate the State Lottery. The State must conclude negotiations with the single bidder quickly if the revenue is to be realized in FY 2013.

The revenue analysis we present to you is preliminary. It will be updated once the April collections are in the bank. The revenue analysis we present is also advisory. OLS' only role is to provide all the members of this committee and all Legislators with the most accurate forecast we can formulate, a task we approach with humility and without any objective other than accuracy.

From a technical forecasting perspective the differences between our numbers and the GBM are small – about one percent in each year. The significance of the differences are magnified, however, by the small margin provided by the GBM's projected FY2014 closing surplus. If the OLS forecast is accurate, the revenue shortfall would substantially exceed the surplus.

It is useful to look at the revenue situation in a broader context than a one percent forecasting difference between OLS and the Executive. For FY 2014 both the Executive and OLS project that the GIT and Sales Tax will finally surpass their respective pre-recession peaks.

However, as is depicted in the graph of p. A-10 of the *Tax and Revenue Outlook*, total revenues will still be short of the 2008 peak, as the CBT, Realty, Inheritance and Casino taxes have yet to fully recover.




According to a report by the National Conference of State Legislatures, by 2013 a majority of states had returned to their pre-recession peak. New Jersey has bounced back, but more slowly than elsewhere. However, in some states the bounce back was aided by tax rate increases or burgeoning energy production - - factors that are absent in New Jersey. It is also appropriate to note that once we return to the FY 2008 revenue peak the State will not have the purchasing power it had back then. Adjusting for inflation during the interim, the same nominal revenue will be worth at least $2.5 billion less than it was in 2008.

The bulk of my comments this morning have been about the revenue situation, but most of the work that you will have to do concerns the spending side of the budget. Let offer an overview of FY 2013 spending changes.

Since the enactment of the FY 2013 Appropriations Act the Executive has identified $512 million in additional spending it believes is required. The largest component of this is the need for an additional $222 million for Medicaid and NJ FamilyCare. In addition there is a need for about $100 million to cover various fringe benefit costs, $30 million to cover DOT winter operations and $40 million to cover unspecified costs related to Sandy. Meeting some of these needs will require supplemental appropriations by the Legislature, but others can be accomplished by transfers or directory letters.

Offsetting this additional spending and helping to keep the budget balanced are $770 million in projected FY 2013 lapses. The decision to make no Homestead Benefit payments during the fiscal year ($392 million) accounts for more than half of the lapse total. In addition, debt service payments for the Transportation Trust Fund are now projected to be $110 million below the level budgeted.

The FY 2014 budget recommendations look a lot like the budget enacted for FY 2013. There are some notable differences and those will be discussed department by department in our budget analyses. I do want to highlight two of the biggest items. First, the recommendation for FY 2014 continues the seven-year phase in of full pension contributions and will require a $625 million increase. This represents one-half of the total difference between the FY 2013 Appropriations Act and the GBM recommendation for FY 2014.

Second, according to the GBM, expenditure trends for current Medicaid services will require an additional $160 million in Fiscal Year 2014, and $42 million in additional State expenditures are anticipated from increased Medicaid enrollment due to the Affordable Care Act (ACA). Fortunately, these costs will be more than offset by enhanced Medicaid matching funds for certain enrollees, resulting in an anticipated shift of $227 million from State to Federal funding, as enabled by the ACA.

As you consider these items, as well as the many others issues that will be discussed, your nonpartisan fiscal staff stands ready to assist you. Thank you for your attention this morning. We will be pleased to answer your questions.