STATE OF NEW JERSEY

Department of the Treasury
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Opening Statement Before The
New Jersey Senate Budget Committee
April 1, 2014

Chairman Sarlo, Budget Officer Bucco, distinguished members of the Senate Budget & Appropriations Committee – thank you for your kind invitation to introduce Governor Chris Christie's proposed Fiscal 2015 budget.

Allow me to introduce my colleagues at the table this afternoon: Charlene Holzbaur, Director of the Office of Management and Budget, Robert Peden, Deputy Director of the Office of Management and Budget, and Dr. Charles Steindel, Treasury's Chief Economist.

Let me move now to an overview of the Governor's $34.4 billion budget proposal.

Broadly stated, the Governor's fiscally disciplined budget protects services and benefits for the most vulnerable New Jerseyans, keeps faith with our statutory commitment to our employees' retirement security, maintains support for expanded access to health care, increases funding for education and many important programs, and continues to fund the pro-growth business tax reforms we began in 2011--- all while devoting fully 94 percent of year-over-year growth to public employee pensions, public employee health benefits and debt service. Indeed, absent those three categories of spending, this budget will still see the State spend less next year than it spent in Fiscal Year 2008.

You have the Budget Summary and the Detailed Budget. Over the coming weeks you will explore the proposed budget with my Cabinet colleagues, so I will not take up your time with minute detail. Instead, I would take this opportunity to touch on a few major budget-related topics that I believe are of particular interest to this committee and New Jerseyans generally.

Let me begin by offering some detail with respect to how we plan to close out Fiscal Year 2014.

We are recognizing a net reduction in projected revenue of $251 million against the Appropriations Act.

As I stated in legislative and press briefings at the time of the Governor's Budget Message, we reduced our expectations for the Gross Income Tax by $111 million, largely to reflect an accounting-related reduction to the Fiscal 2013 base; we thus preserved the original projected rate of growth. Based on estimated and withholding payments, as well as refund transactions to date, we are sanguine that this year's income tax filing season will meet our revised expectations.

You will observe that a $126 million decrease in the Casino Revenue Fund accounts for roughly half the net reduction in projected revenue for Fiscal 2014. As I noted some weeks ago, we had expected that the introduction of Internet-based casino gambling would help lift overall gambling activity in Atlantic City and all related revenues. Clearly, the results so far have not met our expectations. Although I will accept full responsibility for misapprehending the short-term impact of Internet gaming, I remain bullish over the medium and long term: despite lingering challenges with respect to geolocation technology and limited payment processing options, we have seen enormous and growing interest in this form of gaming. As of February 28, there were 248,241 Internet gaming accounts, up more than 25 percent from the previous month. Daily revenues in February saw a 21 percent increase over January. Trends are clearly moving in the right direction.

Turning to the spending side, we will recognize $694 million in spending lapses in 2014. We believe in managing the State budget throughout the fiscal year; every year, there are opportunities to realize savings that offset additional needs and any shortfall in revenues. Although this year's adjustments largely reflect dozens of surplus balances and routine reductions in spending against budgeted projections, I would like to touch on two of the more significant adjustments.

First, we expect to lapse a total of $120 million in certain post-retirement medical and prescription drug balances. We have reserves to recognize these savings and pay anticipated claims for State active and retired employees' and retired teachers' health expenses through the end of the current fiscal year.

We are also recognizing some savings this and next fiscal year pursuant to adjustments in actuarial assumptions and methods with respect to the pension system. The revised July 1, 2012 actuarial valuations calculate the State and local employers' normal cost contributions using all member contributions as an offset to the gross normal cost. As the actuaries have pointed out, this was the methodology used to determine the State and Local employers' normal cost contribution prior to the enactment of the 2011 pension reforms and "is consistent with the methodology typically used by contributory public-sector retirement systems to calculate the employer's normal cost contribution." The pension boards have reviewed and accepted the latest valuation reports reflecting this approach. In addition to saving the State $80 million in Fiscal 2014 and $116 million in Fiscal 2015, this will save New Jersey's local government employers about $270 million over the two years at minimal impact to funding levels. That's tantamount to a roughly 9 percent increase in municipal aid or property tax relief.

Let me now turn to several matters with respect to Fiscal Year 2015.

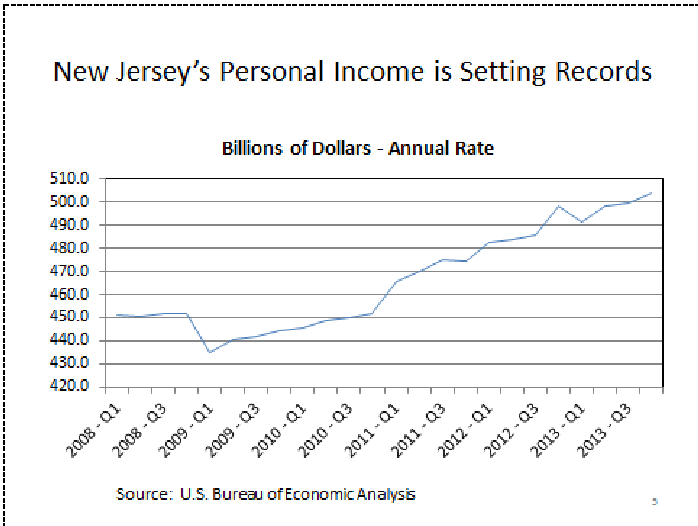
We project that total revenues will increase by 5.8 percent in Fiscal 2015. In assessing whether or not this is reasonable, I would invite you to take four important points into consideration.

First, New Jersey's economy is continuing to expand. Personal incomes have been rising to regular new all-time highs. Our personal income growth from the third to fourth quarter last year ranked 6^{th} in the nation and was stronger than any other state in the Mideast region.

Over the last 14 months, unemployment has dropped farther and faster in New Jersey than in every other state except Nevada and the two Carolinas, from 9.1 percent in December 2012 to 7.1 percent in February 2014, while New Jersey's labor participation rate and share of working-age population actually employed has remained consistently higher than the national average.

New Jersey homebuilding has seen a steady rise since 2010, and has recently accelerated. The number of permits granted in the state this February was 67 percent higher than a year earlier, while the national increase was 6.9 percent. To put this in perspective, more permits were granted in New Jersey last month than in all of New England. Notwithstanding weather challenges, for the first two months of the year we are off to the best permitting start since 2008. At the same time, single-family home sales have consistently outpaced the nation, especially over the course of 2013. Auto sales---a key contributor to our sales tax---have also been rising steadily, though the hard winter has recently seemed to have some depressing effect.

Second, over 40 percent of our State revenue comes from a Gross Income Tax that is one of the most "progressive" state income taxes in the nation. To illustrate: in 2012, the 40,000 filers comprising the top 1 percent in income paid an effective tax rate that was 90 times that of the two million filers making up the bottom half in income. One consequence of a highly progressive rate structure is volatility or extreme sensitivity to ups and downs in overall economic performance, especially the non-wage income of upper-income taxpayers such as dividends and capital gains. History strongly supports our expectation that we will see a relatively accelerated rate of growth as we continue to emerge from the Great Recession and personal incomes continue to rise (see related chart). Of course, the flip-side --- as we so painfully experienced just a few years ago --- is an accelerated rate of declining growth or even contraction as the economy slows down.



Third, not all State revenue is tax revenue or necessarily tied to economic performance. This means that we must use a different set of metrics to gauge the likelihood of realizing such revenues. We would argue that, in at least some cases, this warrants a much lower assignment of risk. Examples would include spending down available fund balances or anticipating receipts from a bond refunding transaction or a signed legal settlement.

Finally, the Governor's budget includes a variety of modest adjustments in tax policy and administration to close loopholes, increase consistency and support fairness. These adjustments will also raise some additional revenue, contributing to the overall projected growth rate with somewhat less sensitivity to general economic performance. If we discount for these adjustments, the Governor's budget actually anticipates a baseline revenue growth rate of 5 percent (compared to the 5.8 percent figure previously cited).

Please allow me to anticipate some of your questions with respect to these tax policy adjustments.

In response to recent court decisions, two of the changes clarify statutory intent with respect to technical business tax issues. A third would simply extend existing penalties for passing a bad check for tax payments to electronic payments.

A fourth adjustment would adopt a New York State-style sales tax nexus standard for determining when out-of-state retailers must collect and remit New Jersey sales taxes. This is a simple matter of fairness or tax parity for thousands of New Jersey's main street businesses who have had to compete with out-of-state mail order or Internet sellers who don't collect our taxes. Let me take a moment to emphasize an important point: this is <u>not</u> a new tax. Rather, this change only concerns the determination as to who bears the responsibility for *collecting*---as opposed to *paying*---a tax that has always been due. Consumers have always been obligated to pay Sales and Use Tax on their purchases. Under longstanding law, if the retailer doesn't collect the tax and turn it over to the State, the consumer must report and pay the tax.

A fifth adjustment would have UEZ zone-certified businesses pay the same, discounted 3.5 percent Sales Tax as retail customers pay on their purchases at zone-certified businesses. Again, this is a matter of simple tax parity. In addition, according to information developed by an independent consultant, only one in five businesses in our UEZs are in fact zone-certified.

Finally, we appreciate the intense interest in our proposal to extend the Tobacco Products Wholesale Sales Tax to electronic cigarettes and related “vaping” devices. Our goal is to achieve rough parity with the tax burden on conventional cigarettes. Why? Our main concern is public health. Contrary to the claims of some users, e-cigarettes have not been shown to be a “safe” alternative to regular cigarettes, nor are they a proven path to smoking cessation. The FDA has not approved e-cigarettes as smoking cessation aids. In fact, researchers at the University of California recently found that adolescents who used vaping devices were more likely to smoke cigarettes and less likely to quit smoking. Nonetheless, we intend to include an exemption for vaping products that are produced, marketed and prescribed as an FDA-approved smoking cessation aid.

The New Jersey Legislature has already joined the U.S. Congress and the European Union in treating e-cigarettes as equivalent to conventional cigarettes for certain purposes, restricting sales to minors and subjecting their use under the State’s smoke-free air laws. Tax parity is the logical next step: as a matter of tax policy, why should we favor one form of delivering highly addictive, tobacco-derived nicotine over another, especially in light of the unknown health risks and the obvious marketing focus on youth and young adults?

Please allow me now to touch on the expense side of the ledger.

As the Governor has emphasized, fully 94 percent of the projected year over year 3.5 percent growth in the budget will support public employee pensions, public employee health benefits and debt service. About one quarter of the total $34.4 billion budget is comprised of a $2.25 billion contribution to the pension system (the largest in State history), $3.1 billion for active and retiree health benefits, and $3.3 billion in debt service supported by appropriations. Together, these costs will have consumed fully 60 percent of our overall revenue growth since 2010. In a nutshell, these numbers frame the Fiscal 2015 budget.

Many of you will be interested to know how the Governor’s decision to expand New Jersey’s $12 billion federally-supported Medicaid program has impacted our Fiscal 2014 and 2015 budgets. In summary, we are now projecting net savings to the Fiscal 2014 budget in excess of the initial estimate of $185 million and are projecting additional savings of $181 million for Fiscal 2015. Although that’s good news for the budget and the more than 100,000 New Jerseyans newly enrolled in Medicaid, these savings do not include Affordable Care Act-related fees. We have budgeted over $39 million to reimburse Medicaid managed care organizations for the ACA’s Health Insurance Providers Fee, and another $21 million that the State must pay as an employer in its own right under the ACA’s Transitional Reinsurance and Comparative Effectiveness Research Fees. I respectfully suggest that ACA fees and charges are a serious long-term budget consideration.

The Governor's budget provides a record $12.9 billion in school aid, inclusive of a $37 million increase in aid to schools and almost $450 million in additional direct State payments for education such as pensions, post-retirement medical benefits and teachers' Social Security. The increase in aid to schools builds on last year's legislatively-approved allocation to provide an additional $20 per pupil to support enrollment growth and the introduction of new assessments. No district will receive less K-12 formula aid than it did in Fiscal 2014.

Part of the budgeted growth in debt service consists of $83 million to support the State's $1.6 billion capital construction program for higher education, comprised of the voter-approved $750 million Building Our Future Bond Act and four other bonding programs administered by the Educational Facilities Authority (EFA). With legislative concurrence, the Administration has approved 176 projects at 46 institutions. In May 2013, we issued the first $100 million under the Building Our Future Bond Act. In January, the EFA sold bonds to fund two of its grant programs (the Equipment Leasing Fund and the Technology Infrastructure Fund), and this spring and summer, we will be issuing additional bonds under two other existing higher education bonding programs that are also part of the $1.6 billion commitment. Grant agreements for those programs that now have funding have been finalized with the various institutions. To receive payment, institutions must present requisitions documenting their actual project-related expenses. We are just now starting to see requisitions for reimbursement against the $100 million under the Building Our Future program, and we expect a step-up in activity in the near term.

Finally, knowing of the Chair's and other members' strong interest in the subject, I would to close with a few observations concerning the State's debt.

I cannot deny that New Jersey, like many states, faces challenges. As our most recent Debt Report documents, our total outstanding obligations as of June 30, 2013, stood at $78.4 billion. Per capita bonded debt was $4,023, the fourth highest among the states.

Although the <u>size</u> of challenge is obviously important, the <u>management</u> of that challenge is of at least equal importance. I want to assure you that this Administration takes its responsibility to manage the State's debt exposure extremely seriously and, together with our partners in the Legislature, we have much to be proud of. To prove this, "let facts be submitted to a candid world:"

- Almost half of our total outstanding obligations are non-bonded obligations, including net pension obligations and net other post-employment benefits. This is, by far, the fastest-growing component of our outstanding debt. The good news is that, together, we have established a track record of affirmatively managing these obligations. We have already enacted reforms that immediately reduced the pension plans' unfunded accrued liability by 31% and the State's liability for post-employment benefits by $10.3 billion. As the Governor has made clear, we can and must do more. Let's not invite future generations of New Jerseyans to remember 2011's reforms with nostalgia as the apogee of responsible public financial stewardship in the State House.

- Bonded debt accounts for just over half of our total outstanding obligations. The good news is that we have in fact slowed the pace of new issuance over the past few years. After adjusting for inflation, total bonded obligations grew 2.3 percent last year. General obligation debt per capita is actually lower now than in 2010.

- Over the past four years, we have aggressively taken advantage of the low interest rate environment to restructure our outstanding debt, realizing many hundreds of millions in budget savings while maintaining a strict policy of conditioning every deal on the realization of both net present value and nominal debt service savings without any extension of maturities.

- We reduced the State's exposure to complicated and risky derivatives or swap agreements from $4.2 billion as of June 30, 2010 to $1.3 billion as of June 30, 2013. Variable rate demand bonds requiring ongoing letter of credit support have been reduced from $2.3 billion to $447.9 million. This is a very significant achievement.

- The ratio of debt to personal income is a key metric in assessing the State's relative capacity to manage debt. After a rapid increase over the course of a decade, our ratio of debt to personal income has stabilized at approximately 7.6 percent since 2009. This compares favorably to other urban, affluent Northeastern states, and is substantially below Connecticut and Massachusetts, which both enjoy slightly higher personal income per capita.

- At $3.3 billion, Fiscal 2015 debt service supported by appropriations will amount to 9.6% of the State's $34.4 billion proposed budget. To put this into perspective, an independent analysis last year found that New Jersey's debt service ratio was appreciably less than that of peer states including California, Connecticut, Massachusetts, and New York.

Again, I will not deny the challenges we face. But, as we move forward, I hope the observations I have made will help put the challenge into perspective and focus our collective attention and efforts on that aspect of debt management that at the same time presents both the single greatest challenge <u>and</u> the single greatest opportunity: public employee pensions and benefits. We have proven our capacity to deal with these challenges; now let's reach further.

I suspect that I have strained your patience and will therefore stop here. Thank you again for the opportunity to appear before you. I will be happy to entertain your questions.