

**Remarks of David J. Rosen
Legislative Budget and Finance Officer
To the Assembly Budget Committee
March 31, 2005**

GOOD AFTERNOON AND THANK YOU FOR THIS OPPORTUNITY TO APPEAR BEFORE THE COMMITTEE. AS ALWAYS, THE OFFICE OF LEGISLATIVE SERVICES STANDS READY TO ASSIST YOU DURING THE NEXT TWO MONTHS OF HEARINGS WITH INDEPENDENT AND NONPARTISAN ANALYSES OF EACH DEPARTMENT'S BUDGET. WE BEGIN TODAY WITH A BRIEF BUDGET OVERVIEW AND THEN A LOOK AT THE STATE'S REVENUE PROSPECTS.

EACH YEAR PRESENTS NEW AND SIGNIFICANT CHALLENGES TO THE LEGISLATIVE BUDGET COMMITTEES. THIS YEAR YOU FACE A PERSISTENT IMBALANCE BETWEEN EXPECTED SPENDING AND RECURRING REVENUES, WITHOUT THE OPTION OF THE LARGE-SCALE BORROWING THAT SUPPORTED THE LAST THREE BUDGETS. AS WAS CLEAR FROM THE TESTIMONY OF 170 WITNESSES DURING YOUR THREE PUBLIC HEARINGS, THE BUDGET PLAN BEFORE YOU LEAVES MANY NEEDS UNFULFILLED. YET AS AUSTERE AS THIS BUDGET MAY SEEM TO SOME, IT DOES RELATIVELY LITTLE TO REDUCE THE STRUCTURAL DEFICIT THAT WILL CONFRONT THIS COMMITTEE AGAIN NEXT YEAR.

BUDGET OVERVIEW

THERE ARE ANY NUMBER OF WAYS TO SLICE THE BUDGET PIE. WE CAN BEGIN BY CONSIDERING THE "ON-BUDGET" AND "OFF-BUDGET" PIECES. THE GOVERNOR'S TOTAL SPENDING PROPOSAL FOR FY 2006 IS \$40.7 BILLION, DOWN FROM \$41.2 BILLION IN FY 2005. OF THAT AMOUNT, \$27.4 BILLION IS THE ON-BUDGET PART - - DOWN ABOUT \$1 BILLION FROM \$28.4 BILLION IN FY 2005. THE REMAINDER IS \$13.3 BILLION IN OFF-BUDGET APPROPRIATIONS, COMPRISING FEDERAL FUNDS AND SOME DEDICATED ACCOUNTS AND REVOLVING FUNDS. THIS OFF-BUDGET SPENDING IS PROJECTED TO GROW BY ONE-HALF BILLION DOLLARS ABOVE THE FY 2005 LEVEL.

THE OFF-BUDGET APPROPRIATIONS ARE NOT REFLECTED IN BUDGET LINE ITEMS AND ARE GENERALLY NOT THE FOCUS OF THE ANNUAL BUDGET HEARINGS, BUT THE AUTHORITY FOR THESE APPROPRIATIONS IS INCLUDED IN LANGUAGE AND OTHER PROVISIONS OF THE ANNUAL APPROPRIATIONS ACT. THE STATE CONSTITUTION VESTS THE POWER TO APPROPRIATE IN THE LEGISLATURE, AND EVEN OFF-BUDGET FUNDS ARE SPENT ONLY WITH YOUR APPROVAL.

TODAY, I WILL FOCUS PRIMARILY ON THE ON-BUDGET APPROPRIATIONS THAT ARE CUSTOMARILY THE SUBJECT OF THESE HEARINGS. OF THE GOVERNOR'S \$27.4 BILLION PROPOSAL FOR FY 2006, THE LARGEST SLICE GOES FOR STATE AID TO LOCAL GOVERNMENTS -- \$11.4 BILLION, OR 41% OF THE BUDGET. MOST OF THESE FUNDS (\$9.0 BILLION) ARE ALLOCATED TO LOCAL SCHOOL DISTRICTS. STATE AID IN FY 2006

IS UP ABOUT \$400 MILLION, PRIMARILY BECAUSE OF INCREASED COSTS FOR TEACHERS' PENSIONS, SOCIAL SECURITY, AND POST-RETIREMENT MEDICAL BENEFITS AND INCREASED DEBT SERVICE COSTS FOR SCHOOL CONSTRUCTION.

THE SECOND LARGEST COMPONENT IS FOR GRANTS-IN-AID TO VARIOUS INDIVIDUALS, INSTITUTIONS, AND ORGANIZATIONS -- \$9.1 BILLION, OR 33% OF THE BUDGET. GRANTS-IN-AID IN THE PROPOSED BUDGET ARE DOWN ABOUT \$1 BILLION FROM THE CURRENT FISCAL YEAR, DUE LARGELY TO THE \$1.1 BILLION REDUCTION IN HOMESTEAD PROPERTY TAX RELIEF PAYMENTS TO INDIVIDUALS.

COMBINED, STATE AID AND GRANTS-IN-AID ACCOUNT FOR NEARLY THREE-QUARTERS OF THE STATE BUDGET.

THE THIRD LARGEST COMPONENT OF THE STATE BUDGET IS FOR THE OPERATIONS OF STATE DEPARTMENTS, INCLUDING SALARIES AND BENEFITS FOR STATE EMPLOYEES AND RETIREES. THE GOVERNOR'S BUDGET PROPOSES \$5.9 BILLION FOR STATE OPERATIONS IN FY 2006, ABOUT 22% OF THE BUDGET, AND UP ABOUT \$150 MILLION FROM FY 2005.

THE LAST TWO PIECES OF THE BUDGET PUZZLE ARE CAPITAL CONSTRUCTION AND DEBT SERVICE. ABOUT \$1.1 BILLION, OR 4% OF THE BUDGET, IS ALLOCATED FOR CAPITAL CONSTRUCTION, DOWN ABOUT \$30 MILLION FROM FY 2005. THE BULK OF THIS MONEY GOES TO THE TRANSPORTATION TRUST FUND. FOR FY06, DEBT SERVICE ON GENERAL

OBLIGATION BONDS ACCOUNTS FOR \$185 MILLION (LESS THAN 1%) IN THE GOVERNOR'S PROPOSED BUDGET, DOWN FROM \$441 MILLION IN THE CURRENT FISCAL YEAR. THIS DECLINE IS DUE TO RECENT REFINANCING OF EXISTING BONDS. WHILE THE NOMINAL DEBT SERVICE IN THE BUDGET IS DECLINING, PLEASE NOTE THAT MORE THAN A BILLION DOLLARS TO PAY DEBT SERVICE ON NON-GENERAL OBLIGATION DEBT IS SPREAD THROUGHOUT OTHER PARTS OF THE BUDGET.

IT IS THESE COMPONENTS OF SPENDING-- STATE AID (41%), GRANTS-IN-AID (33%), STATE OPERATIONS (22%), AND CAPITAL CONSTRUCTION AND DEBT SERVICE (4%) -- THAT YOU WILL BE REVIEWING DEPARTMENT BY DEPARTMENT OVER THE COMING WEEKS. OLS STAFF WILL PREPARE DEPARTMENTAL BUDGET BRIEFING BOOKS FOR YOU PRIOR TO EACH HEARING, AND ARE AVAILABLE TO ASSIST YOU AS NEEDED. NOW, LET ME TURN TO THE STATE'S REVENUE PICTURE.

REVENUES

ONE OF THE ROLES ASSIGNED TO THE OFFICE OF LEGISLATIVE SERVICES DURING THE BUDGET PROCESS IS TO OFFER YOU AN INDEPENDENT ASSESSMENT OF STATE REVENUES. IN ADDITION TO MONITORING REVENUE COLLECTIONS THROUGHOUT THE

YEAR AND PROVIDING YOU WITH MONTHLY REVENUE SNAPSHOTS, WE TYPICALLY APPEAR BEFORE YOU TWICE DURING THE LEGISLATIVE BUDGET PROCESS TO DISCUSS THE OVERALL REVENUE PICTURE. YOU HAVE BEFORE YOU A COPY OF THE ANNUAL *OLS TAX AND REVENUE OUTLOOK*. IN IT WE EXAMINE THE REVENUE FORECASTS FOR TWO FISCAL YEARS, 2005 AND 2006.

FOR A SUMMARY OF THE *OLS* AND EXECUTIVE REVENUE FORECASTS YOU MAY WISH TO TURN TO PAGES 4 AND 5 IN THE *OUTLOOK*. THE TOTAL *OLS* REVENUE FORECAST FOR EACH BUDGET YEAR IS HIGHER THAN THE EXECUTIVE, BUT THE DIFFERENCES ARE NOT DRAMATIC. IN FY 2005, THE EXECUTIVE IS FORECASTING \$27.3 BILLION IN ON-BUDGET REVENUES, WHILE THE *OLS* IS FORECASTING CLOSER TO \$27.4 BILLION, A MINOR DIFFERENCE OF \$87 MILLION. FOR NEXT YEAR, FY 2006, THE EXECUTIVE IS ESTIMATING A SCANT INCREASE TO \$27.4 BILLION, WHILE THE *OLS* IS ESTIMATING \$27.6 BILLION, A DIFFERENCE OF \$200 MILLION. COMBINED, OVER THE TWO FISCAL YEARS, THE *OLS* FORECAST IS \$287 MILLION ABOVE THE EXECUTIVE FORECAST.

I WANT TO OFFER TWO OBSERVATIONS ABOUT THE REVENUE FORECAST DIFFERENCES. THE FIRST IS THAT THESE NUMBERS ARE NO MORE THAN POINT-IN-TIME PREDICTIONS AND ARE SUBJECT TO CHANGE. WHEN WE COME BACK BEFORE YOU IN MAY, WE WILL KNOW HOW THE CRUCIAL APRIL COLLECTIONS FARED AND WILL BE IN A POSITION TO REFINE

TODAY'S NUMBERS.

SECOND, OUT OF TOTAL REVENUES OF NEARLY \$55 BILLION OVER THESE TWO YEARS,

THE DIFFERENCE BETWEEN THE OLS AND THE EXECUTIVE AMOUNTS TO ONLY 0.5%.

FROM A REVENUE ESTIMATOR'S PERSPECTIVE, THIS IS BASICALLY NO DIFFERENCE AT

ALL.

OF COURSE, I RECOGNIZE THAT \$287 MILLION IN ADDITIONAL REVENUE COULD BE VERY

IMPORTANT AS YOU CRAFT THE FY 2006 APPROPRIATIONS ACT. THESE FUNDS COULD

RESTORE PROPOSED CUTS, FUND NEW PROGRAMS, OBLVIATE THE NEED FOR CERTAIN

REVENUE RAISERS, OR THEY COULD FORTIFY THE BUDGETED SURPLUS. THE

EXECUTIVE'S PROJECTED CLOSING BALANCE AT THE END OF FY 2006 IS \$401 MILLION,

A SURPLUS OF ONLY 1.5% OF ANTICIPATED REVENUES AND A VERY SMALL CUSHION

AGAINST UNFORESEEN DEVELOPMENTS. IF THE OLS REVENUE ESTIMATES ARE

CORRECT, AND IF ACTUAL SPENDING MATCHES THE CURRENT EXECUTIVE PROPOSAL,

THEN THE FY 2006 CLOSING BALANCE WOULD BE CLOSER TO \$688 MILLION, OR ABOUT

2.5% OF REVENUES. OVER THE LAST QUARTER CENTURY, NEW JERSEY'S SURPLUS HAS

GENERALLY EXCEEDED 5%, OCCASIONALLY TOPPED 10%, AND ONLY FALLEN BELOW

2% DURING ECONOMIC RECESSIONS.

LET ME NOW TURN TO SOME SPECIFIC REVENUES. THE LEVEL OF RESOURCES AVAILABLE

TO SUPPORT THE STATE BUDGET IS DRIVEN LARGELY BY THE PERFORMANCE OF THREE

TAXES THAT ACCOUNT FOR ABOUT TWO-THIRDS OF TOTAL REVENUES -- THE GROSS INCOME TAX, THE SALES TAX, AND THE CORPORATION BUSINESS TAX. AS THESE REVENUES GO, SO GOES THE BUDGET. INDEED, THE DRAMATIC AND UNPRECEDENTED 14% DROP IN THE GROSS INCOME TAX THREE YEARS AGO PRECIPITATED THE STRUCTURAL BUDGET CRISIS THE STATE HAS BATTLED EVER SINCE.

THE GOOD NEWS IS THAT THE REVENUE OUTLOOK CONTINUES TO IMPROVE. THE INCOME TAX AND THE SALES TAX ARE UP FOR THE SECOND YEAR IN A ROW, AND THIS YEAR THE INCOME TAX IS RUNNING NEARLY 20% AHEAD OF LAST YEAR'S PACE THROUGH THE END OF FEBRUARY. PART OF THIS GROWTH COMES FROM RISING INCOMES, AND PART COMES FROM THE NEW 8.97% MARGINAL TAX RATE ON TAXPAYERS WITH INCOMES OVER \$500,000. REVENUE FROM WAGES (WITHHOLDING) ARE UP BY NEARLY 10%, AND REVENUE FROM PRIMARILY NON-WAGE SOURCES (QUARTERLY ESTIMATED PAYMENTS) ARE UP BY ALMOST 50%. THESE ARE ENCOURAGING SIGNS FOR THE TAX PAYMENTS THAT ARE DUE APRIL 15. THE EXECUTIVE HAS INCREASED ITS FY05 GROSS INCOME TAX ESTIMATE BY \$200 MILLION SINCE CERTIFYING REVENUES LAST SUMMER. THE OLS BELIEVES GIT REVENUES WILL BRING IN \$45 MILLION MORE THAN DOES THE EXECUTIVE. IN FY 2006 THE OLS ESTIMATES \$140 MILLION MORE FROM THE GIT THAN DOES THE EXECUTIVE.

THE SALES TAX HAS BEEN GROWING BY JUST OVER 4% THIS FISCAL YEAR, SLIGHTLY

BELOW THE LONG-RUN HISTORICAL AVERAGE. BOTH THE EXECUTIVE AND THE OLS BELIEVE THIS PATTERN WILL CONTINUE FOR THE REMAINDER OF THIS FISCAL YEAR, AND IMPROVE SLIGHTLY TO JUST OVER 5% GROWTH IN FY 2006. THE OLS AGREES WITH THE EXECUTIVE'S SALES TAX ESTIMATES IN BOTH YEARS.

CORPORATION TAXES ARE AMONG THE MOST DIFFICULT REVENUES TO FORECAST. IN FY 2003, THE CBT GENERATED \$2.5 BILLION, \$700 MILLION MORE THAN HAD BEEN ANTICIPATED IN THE BUDGET. A YEAR LATER, THE CBT COLLECTIONS DECLINED TO \$2.36 BILLION BECAUSE OF SOME ELEMENTS OF THE TAX LAW CHANGES, BUT THIS PERFORMANCE WAS BETTER THAN HAD BEEN FORECAST. FOR FY 2005 GROWTH WAS ANTICIPATED, BUT COLLECTIONS ARE DOWN 5% THROUGH THE END OF FEBRUARY, AND THE EXECUTIVE IS NOW PROJECTING FURTHER EROSION TO \$2.16 BILLION THIS FISCAL YEAR.

I COULD PRETEND THAT WE HAVE A GOOD UNDERSTANDING OF THESE DYNAMICS AND THAT WE RELY ON TRUSTY ECONOMETRIC MODELS THAT PLOT THE CBT WITH PRECISION, BUT WE DO NOT. THE BUSINESS TAX REFORM ACT OF 2002 HAS MADE A DIFFICULT TASK EVEN MORE DAUNTING. THE DIVISION OF TAXATION HAS NOT YET BEEN ABLE TO PRODUCE A DETAILED ANALYSIS OF POST-BUSINESS TAX REFORM ACT CBT RETURNS. SO WE DO NOT KNOW HOW MUCH OF THE REVENUE WINDFALL AND THE SUBSEQUENT DECLINES HAVE COME FROM EACH OF THE TAX LAW CHANGES AND HOW

MUCH IS ATTRIBUTABLE TO UNDERLYING BUSINESS CONDITIONS AND POSSIBLE CHANGES IN TAXPAYER BEHAVIOR. LACKING SUCH KNOWLEDGE AND OBSERVING THE CURRENT COLLECTION TRENDS, OLS ACCEPTS THE REASONABLENESS OF THE EXECUTIVE ESTIMATES FOR THE CBT.

AMONG THE SECOND TIER OF REVENUES, THE BIGGEST DIFFERENCE BETWEEN OLS AND THE EXECUTIVE IS THE ESTIMATE FOR THE REALTY TRANSFER FEE. THROUGH THE COMBINATION OF A BOOMING HOUSING MARKET AND A SERIES OF FEE INCREASES, THE REVENUE FROM THIS SOURCE HAS MORE THAN QUADRUPLED IN RECENT YEARS. SO FAR THIS YEAR, RECEIPTS ARE UP BY 74%. THE OLS IS PROJECTING \$45 MILLION MORE IN FY 2005 AND \$50 MILLION MORE IN FY 2006 THAN IS THE EXECUTIVE.

FOR A DISPLAY OF THE COMPLEX CHANGES TO THESE FEES, PLEASE SEE THE APPENDIX OF OUR REPORT.

OTHER REVENUE DIFFERENCES INCLUDE OLS PROJECTING \$30 MILLION LESS OVER THE TWO YEARS FROM THE BANK AND FINANCIAL INSTITUTION COMPONENT OF THE CBT AND \$23 MILLION MORE FROM THE CIGARETTE TAX.

I NEED TO STRESS THAT THESE REVENUE ESTIMATES ASSUME \$1.26 BILLION FROM TAX AND REVENUE CHANGES PROPOSED BY THE GOVERNOR WHICH WOULD NEED TO BE ENACTED BY THE LEGISLATURE. THESE PROPOSALS ARE LISTED ON PAGES 11 AND 12 OF OUR REPORT. SOME OF THESE PROPOSALS AFFECT THE INCOME TAX (\$130

MILLION) AND THE SALES TAX (\$325 MILLION). THE LARGEST NEW REVENUE ITEM IS THE ASSUMPTION THAT THE STATE WILL SELL \$500 MILLION OF ASSETS DURING THE NEXT 15 MONTHS. OTHERS INCLUDE A PROPOSAL FOR VIDEO LOTTERY TERMINALS (\$150 MILLION) AND A TAX ON THE CABLE INDUSTRY (\$50 MILLION). LEGISLATION FOR NONE OF THESE PROPOSALS HAS BEEN INTRODUCED AT THIS TIME, AND IN SOME INSTANCES FEW DETAILS HAVE BEEN OFFERED.

TO AVOID CONFUSION ABOUT REVENUE FORECASTS, OLS ASSUMES THE ENACTMENT OF, AND ACCEPTS THE REVENUE ESTIMATES FOR, THESE PROPOSALS. ONCE THESE PROPOSALS BECOME MORE CONCRETE, OLS WILL ANALYZE THEIR REVENUE IMPACTS AND REPORT BACK TO YOU.

MOREOVER, IT SHOULD BE NOTED THAT IF ANY OR ALL OF THESE PROPOSALS ARE NOT ENACTED OR IF THEY FAIL TO GENERATE THE REVENUES ASSUMED FOR THEM, THE BUDGETARY PICTURE COULD CHANGE SIGNIFICANTLY. THIS \$1.26 BILLION IN ASSUMED NEW REVENUES DWARFS THE \$287 MILLION IN HIGHER REVENUE ESTIMATES THE OLS HAS IDENTIFIED. IT ALSO DWARFS THE PROJECTED FY06 SURPLUS, WHETHER IT BE THE \$401 MILLION EXECUTIVE ESTIMATE OR THE \$688 MILLION SURPLUS SUGGESTED BY THE OLS REVENUE ESTIMATES.

THE TREASURER AND OLS WILL RETURN IN MAY. AT THAT TIME WE SHOULD HAVE A

MUCH CLEARER PICTURE OF STATE REVENUES. UNTIL THEN, WE LOOK FORWARD TO WORKING WITH YOU DURING THE DEPARTMENTAL HEARING PROCESS AND ASSISTING YOU IN YOUR DIFFICULT CHOICES.