

**Remarks to the Senate Budget and Appropriations Committee  
by David J. Rosen, Legislative Budget and Finance Officer  
May 25, 2010**

When we appeared before you in early April we projected that the State would have \$249 million less revenue from fiscal years 2010 and 2011 than was estimated in the Governor's Budget Message (GBM). At that time we discussed the uncertainty surrounding final income tax payments for tax year 2009, as well as questions about the direction of sales tax and corporation business tax collection patterns. Our posture was somewhere between cautious optimism and hopefulness. I regret to report today that the revenue situation is considerably bleaker than we had hoped.

For fiscal year 2010, OLS is estimating \$402 million less than in the GBM. For fiscal year 2011 we are estimating \$365 million less than the GBM. Together, that is a total of \$767 million, and assuming we are correct, represents a very significant problem.

The largest difference is in the Gross Income Tax (GIT), with the OLS estimates for the two fiscal years being a total of \$425 million below the GBM. It appears that we have missed the FY2010 GIT target by about \$300 million. The income tax shortfall, about 3% of the original estimate, is not so large in absolute terms. However, the GIT shortfall is significant because it happened so late in the fiscal year

and so suddenly. Through March the components of the income tax performed as we had anticipated and in April and May there were no surprises from withholding, estimated payments or refunds. The story on the income tax is our failure to achieve the level of final payments that was anticipated. The tax filing deadline extension prolonged the period of uncertainty and it was only in the last week that it became clear that we fell well below our target. This year the April Surprise was not recognized until the middle of May.

We are, of course, trying to understand what happened. As we have discussed repeatedly over the years, income tax collections from high income individuals is the most volatile component of our tax mix. If we assume that the shortfall in final payments was concentrated among high income taxpayers, who make most of the final payments, then we might conclude that there was about 5% less taxable income from this group of taxpayers. This is certainly possible in a year in which the federal government and most states missed their final payment targets, but we thought we had adopted sufficiently modest expectations. In the last few days, however, we have developed another hypothesis, which is plausible if still unproven.

Last Spring, New York State adopted a three-year increase in their income tax rates. They created a new 7.85% bracket at \$300,000 and a new 8.97% bracket at \$500,000. This was significant for New Jersey because our residents with New York income pay tax to New York on that income and then take a credit for those payments against their New

Jersey liability. The determination of how much revenue gets deflected from Trenton to Albany is very complicated because for each taxpayer it is affected by the differences in tax bases and rates in the two states and the taxpayer's individual circumstances. Last Spring the Division of Taxation, using actual taxpayer records, attempted to simulate the effect of the New York change. They concluded that New York's action would cost us about \$300 million in FY2010 and both the Administration and OLS used that estimate in our projections.

We now suspect that the simulation rested upon an incomplete understanding of the New York State law. While the New York statute looks like an increase in marginal tax rates – that is, a rate applied only to income above certain thresholds – a more obscure provision outside of the tax tables themselves effectively makes the new rates flat – that is, the new rates apply to every dollar of taxable income. Contemporaneous reports by the New York Division of Budget, the New York Legislature, the press and professional tax information services all referred to the changes as marginal rate changes and omitted mention of the so-called recapture provision making the rates flat.

Let me explain why this issue is significant. If the 8.97% rate at \$500,000 were, in fact, a marginal rate it would have no impact on the first \$500,000 of taxable income. However with the recapture provision that income would be subject to a \$10,000 tax increase and the taxpayer might therefore be able to take an additional \$10,000 credit against New Jersey tax liability. We estimate that there are

more than 20,000 New Jersey residents with incomes above \$500,000 who are subject to New York State income tax. If that is correct, the simulation done last Spring would have missed more than \$200 million of adverse impact on New Jersey from these taxpayers. Since the recapture provision also affects many New Jersey residents with incomes below \$500,000 as well - - the failure to account for this obscure provision of New York law could explain all or some of the shortfall. In the days ahead we will try to work with the Division of Taxation to test our hypothesis.

Back in April our biggest concern was the sales tax, which we feared might be more than \$300 million below the GBM over the two years. In late April, however, we found that March sales tax collections had grown by more than 8% from the March, 2009 level. While one month does not make a trend (and this was, after all, only the second positive month in the last two years), we are more optimistic about the sales tax than we had been. The OLS revised sales tax forecast for the two years is \$148 million below GBM. Unfortunately, the separately accounted sales tax collections for electricity and natural gas have dropped significantly this year and will be lower than previously anticipated next year as well. It appears that over the two years energy sales tax and corporation business tax receipts will be more than \$176 million lower than GBM.

OLS believes that the Corporation Business Tax will be \$139 million below the GBM over the two years, but a number of other smaller revenue sources are showing signs of recovery. We think the inheritance taxes, real estate

transfer fees, and insurance premiums taxes will all outperform the GBM estimates over the two fiscal years. In addition it appears that revenues from a number of other non-tax sources will be higher than originally expected.

As I noted earlier the sum of all of these adjustments is \$767 million and, if we are correct, the budget plan before you will have to be modified to respond to this reality. The revenue shortfall spans two fiscal years and the budgetary responses can be taken in the final month of FY2010 or the FY2011 budget that you will be crafting over the next few weeks. With more than half of the shortfall projected for the current fiscal year, I suspect it will be difficult to find hundreds of millions of dollars of additional spending reductions in the remaining one-twelfth of the fiscal year, particularly given the adjustments already taken. To the extent that the additional drop in revenue this year is not matched by additional spending reductions this year, the ending FY2010 balance will be lower, which means that the opening FY2011 balance will be lower. One way or another, \$767 million (or some other number that the Treasurer may offer this afternoon) of budget solutions need to be found for the next 13 months.

As we look ahead to what has to be accomplished over the next five weeks, there are an unprecedented number of proposals before you. Besides the 33 initiatives announced by the Governor two weeks ago (most of which do not affect the budget scoring, but have been identified by the Governor as budget-related), the Governor's budget plan

appears to require a dozen or more additional legislative initiatives which have not yet been formally proposed.

In this fiscal year, the Governor's budget and our revenue forecast assume the enactment of a significant bill that would appropriate more than \$400 million in this fiscal year, deappropriate hundreds of millions from line items in FY2010 and authorize the transfer to the General Fund of large sums from the Clean Energy and the Enterprise Zone Assistance Funds.

For Fiscal Year 2011 separate legislation will be required to realize more than \$320 million of revenue enhancements that are assumed in the Administration and OLS' revenue projections. Two of the larger and more controversial items are \$65 million estimated to be raised by abolishing Bergen County's blue laws and \$45 million from the reduction in the level of the Earned Income Tax Credit.

I do not recall a year in which the Budget Committee had so much on its plate and where so much of it was unappetizing. The OLS staff stands ready to assist you in whatever ways we can.

**Fiscal Year 2010 Revenue Estimates**  
(\$ millions)

	<u>GBM Estimate</u>	<u>OLS May Estimate</u>	<u>OLS vs. GBM Difference</u>
Gross Income Tax (GIT)	\$10,393.0	\$10,113.0	-\$280.0
Sales Tax*	7,523.0	7,450.0	-73.0
Corporation Business Tax*	2,044.0	1,950.0	-94.0
Energy (Sales Tax and CBT)*	675.6	543.0	-132.6
Inheritance Taxes	506.7	560.0	53.3
Insurance Premiums Tax	423.5	446.0	22.5
Realty Transfer Fee	146.0	171.9	25.9
Assessment on Prop. > \$1 Mil.	38.7	56.0	17.3
Cigarette Tax (on-budget)	200.2	190.0	-10.2
CBT - Banks and Financials	94.4	120.0	25.6
Other Revenues	5,675.1	5,718.4	43.3
<b>Grand Total, All Funds</b>	<b>\$27,720.2</b>	<b>\$27,318.3</b>	<b>-\$401.9</b>

GIT excludes TANF/EITC shift, shown in Misc. Rev's under GBM. Numbers may not add due to rounding.  
GBM = Governor's Budget Message. \* Sales and corporate energy revenues shown separately.

**Fiscal Year 2011 Revenue Estimates**  
(\$ millions)

	<u>GBM Estimate</u>	<u>OLS May Estimate</u>	<u>OLS vs. GBM Difference</u>
Gross Income Tax (GIT)	\$9,945.1	\$9,800.0	-\$145.1
Sales Tax*	7,855.0	7,780.0	-75.0
Corporation Business Tax*	2,145.0	2,100.0	-45.0
Energy (Sales Tax and CBT)*	695.9	652.3	-43.6
Inheritance Taxes	583.1	587.7	4.6
Insurance Premiums Tax	478.0	478.0	0.0
Realty Transfer Fee	228.9	205.0	-23.9
Assessment on Prop. > \$1 Mil.	64.0	68.0	4.0
Cigarette Tax (on-budget)	200.0	190.0	-10.0
CBT - Banks and Financials	164.0	150.0	-14.0
Other Revenues	5,908.4	5,891.7	-16.7
<b>Grand Total, All Funds</b>	<b>\$28,267.4</b>	<b>\$27,902.7</b>	<b>-\$364.7</b>

GIT excludes TANF/EITC shift, shown in Misc. Rev's under GBM. Numbers may not add due to rounding.  
GBM = Governor's Budget Message. \* Sales and corporate energy revenues shown separately.