REMARKS OF FRANK HAINES,
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TO THE
SENATE BUDGET AND APPROPRIATIONS COMMITTEE
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Chairman and committee members, good morning. Thank you for inviting the Office of Legislative Services to address you on the subject of the Governor's proposed budget. I intend to keep my comments brief so we can proceed to Mr. Drescher's presentation of the OLS revenue forecast.

First, let me assure you that throughout your review of the Governor's proposed budget, the staff of the OLS will endeavor to provide its usual analyses of the departmental and Judicial branch budget recommendations. We are working within a slightly truncated time frame, since the date of the budget message was pushed back a couple of weeks, but we are working hard to keep up with the schedule.

No doubt your attention is captured by the highlights of this budget. Some of them stand out in contrast to budgets of the recent past - for example, proposed increases in the State's two largest taxes, and a boost in school aid intended as a step toward full funding. And some of them are the same, such as another increment toward full contributions to State retirement system costs. At $37.4 billion by conventional measurement, it is the largest budget yet proposed. It is also the largest when measured by state and federal funds combined. The share of our revenue coming from our two broadest-based taxes, the gross income tax and the sales and use tax, would grow to 73% in FY 2019. The share from the larger one, the income tax, would grow to 43% in FY 2019 under this plan.

My purpose is to call your attention to a couple of matters this budget highlights that might not be so obvious, because they are fiscal concepts. I feel they are important enough to be weighed as you decide how much of this proposal you implement and how you might modify it. The concepts are flexibility and volatility.

Flexibility relates to the options you as policymakers have in raising and allocating the budget's revenues. You strive to evaluate needs and set priorities for State spending, and hope to achieve the best outcome you can in the face of high demand and limited funds. A balanced budget is mandatory, so you are confined by the revenue bottom line. If the bottom line is too confining, you can debate how best to grow it, and by how much.

If budget-making were that simple, it would still be a supremely difficult task. But it's more complicated. You have to parcel out certain portions of revenue only within set boundaries. And the overall spending equation - how much, for what purposes - might not properly fit within those boundaries.

There are, by my count, eleven constitutional dedications of State revenue. Prominent among them are:

> income tax revenue, and a one-half cent tax rate's worth of sales tax revenue, for aid to local governments for property tax relief and reform.

> the motor fuels tax, the petroleum products gross receipts tax and at least $200 million of annual sales tax revenue, all for transportation system costs.

> State lottery revenues, to State institutions and State aid for education.

> State payroll taxes, to benefits such as unemployment, disability, and workers compensation, and workforce training, for employees and their families.

> Casino tax revenues, a portion of corporation tax revenues, and natural resource damage settlements and awards are each dedicated to specific purposes.

Over the years as these dedications have accumulated, they seem not to have posed much of a barrier to the Legislature in crafting a budget. Unrestricted or broadly restricted revenues have been distributed across spending priorities; the larger issue was overall revenue adequacy. For example, when casino taxes fell, the same spending could be absorbed by unrestricted or similarly restricted revenue. Notably, there are common areas of dedication between the income tax, the half-cent sales tax yield and the Lottery revenue. So while flexibility may have diminished as more revenue became subject to restrictions, this did not seem to clash with spending priorities...until now.

My predecessor David Rosen alluded to this possibility a few years ago, when late in a fiscal year unexpected income tax revenue collections coincided with flat or declining unrestricted revenues. Spending had to be shifted from the General Fund to the Property Tax Relief Fund; there were limited but fortunately sufficient budget transfer options for solving the problem. Dr. Rosen noted perceptively that in the future the non-policy options might not be present.

The precipitating action that has pushed this matter to the forefront was the transfer of Lottery revenues to State retirement systems. This 30-year transaction reduces annual General Fund revenue by about $1 billion or more, and cuts spending by about the same amount in the near term. There was about $1.8 billion of General Fund spending that Lottery funds could legally support...and billions more in school aid funded by the other dedicated revenues in the Property Tax Relief Fund. The spending impacts of the Lottery transfer fell disproportionally on those costs – a $778 million reduction in the contributions to teachers' pensions, funded from income tax revenues. So the result was an FY 2018 approved budget with a small unrestricted surplus and larger restricted surplus.

If both unrestricted and dedicated revenues were to grow commensurate with the spending they each have to support, we avoid problems from diminished flexibility. But if unrestricted revenues don't grow at the right pace, the needs they support can't be sustained if they can't be shifted to dedicated sources, even if those dedicated sources are bountiful. Spending priorities are then altered, unless certain revenue choices are made. Your range of revenue options is also affected. Your policymaking choices might be different if more flexibility were present.

The Executive is asking you to revamp the FY 2018 budget plan you approved in July, in part because of diminished flexibility. The estimates for unrestricted General Fund revenues are revised downward, while income tax revenues have been revised upward. To preserve an unrestricted surplus, the Executive proposes to break a long-standing statutory link between energy tax revenue and municipal aid. The aid is not being reduced, but it would be sourced differently. Further, the Executive is asking you to approve tax changes that, while undoubtedly informed by tax policy considerations, are also in part influenced by flexibility concerns. What is obvious is that if you concur with the FY 2019 spending plan, some revenue source unconfined by constitutional dedication has to be increased.

The second theme is volatility. And here I'll be much briefer. We have frequently commented on the large proportion of income tax paid by comparatively few high-income taxpayers whose non-wage income is subject to year-to-year fluctuation. The Executive's proposal to increase the marginal GIT tax rate on income above $1 million adds to the existing degree of volatility in the State's largest revenue source. Both the revenue upside and the revenue downside are accentuated. An unforeseen downward revenue swing among this group of taxpayers can cause a major budget hole.

And of course this brings me to the matter of surplus adequacy, which we discuss in our <u>Tax and Revenue Outlook</u>. Compared to our peers, and in light of our revenue volatility, the projected surplus, 1.5 - 2 percent of appropriations, is low. It does not offer much protection against the forces that can upset a budget.

That concludes my remarks. I'll now turn it over to Mr. Drescher.