# ANALYSIS OF THE NEW JERSEY

# FISCAL YEAR 2002 - 2003 BUDGET

# TAX AND REVENUE OUTLOOK

PREPARED BY

OFFICE OF LEGISLATIVE SERVICES

NEW JERSEY LEGISLATURE

APRIL 2002

# NEW JERSEY STATE LEGISLATURE

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# THE FY 2002 AND FY 2003 TAX AND REVENUE OUTLOOK

## Introduction

This report has been prepared by the Office of Legislative Services (OLS) to assist the Senate Budget and Appropriations Committee and the Assembly Budget Committee as they develop the FY 2003 appropriations act. The OLS revenue estimates reflect a careful review of current State revenue collections, historical revenue collection patterns, and a variety of economic data and forecasts.

The *OLS Tax and Revenue Outlook* focuses on FY 2002 and FY 2003 revenues. Our analysis is complicated by an estimated $2.5 billion worth of tax and other revenue enhancement proposals announced by the Governor in the FY 2003 budget. All of these proposals require Legislative approval. Moreover, the most important of them remain unclear at this point with regard to details and implementation. Against this backdrop of uncertainty, our report reflects the following:

! In FY 2002, the OLS's revenue estimates are $228 million below the Executive budget estimates (page 4).

! In FY 2003, the OLS's revenue estimates are $275 million below the Executive budget estimates (page 5).

! Over both fiscal years, the OLS's revenue estimates are a total of $503 million lower than the Executive budget estimates.

! Absent other spending and revenue decisions, the year-end balance at the close of FY 2003 would be only $23.5 million if the OLS revenue estimates were applied to the Governor's budget proposals (page 6).

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## Recap: FY 2002 Collections to Date

Revenue collections through the first nine months of FY 2002 continue to reflect a year-long slide and are now more than 5% *below* the same period in FY 2001. The last complete fiscal year in which collections from the State's major tax revenues fell below the prior year's was FY 1990, although the State's other tax and non-tax revenues increased enough for FY 1990 to end with 1.3% budgeted revenue growth. FY 2002 is likely to mark the first time in at least several decades that total State budgeted revenues fall below the level of the prior year.

The primary cause of New Jersey's sharp decline in revenues is the gross income tax (GIT). Through the end of March, income tax revenue is running over $600 million *below* the same period last year, a decline of 12.5%. Moreover, so far this year this tax revenue is running about $1.0 billion behind the original targets anticipated when the revenues were certified in June, 2001.

Figure 1 displays recent annual State tax revenue growth rates for the gross income tax compared with all other State budgeted revenues. The Executive's FY 2002 estimates mark a dramatic shift in the collection pattern.

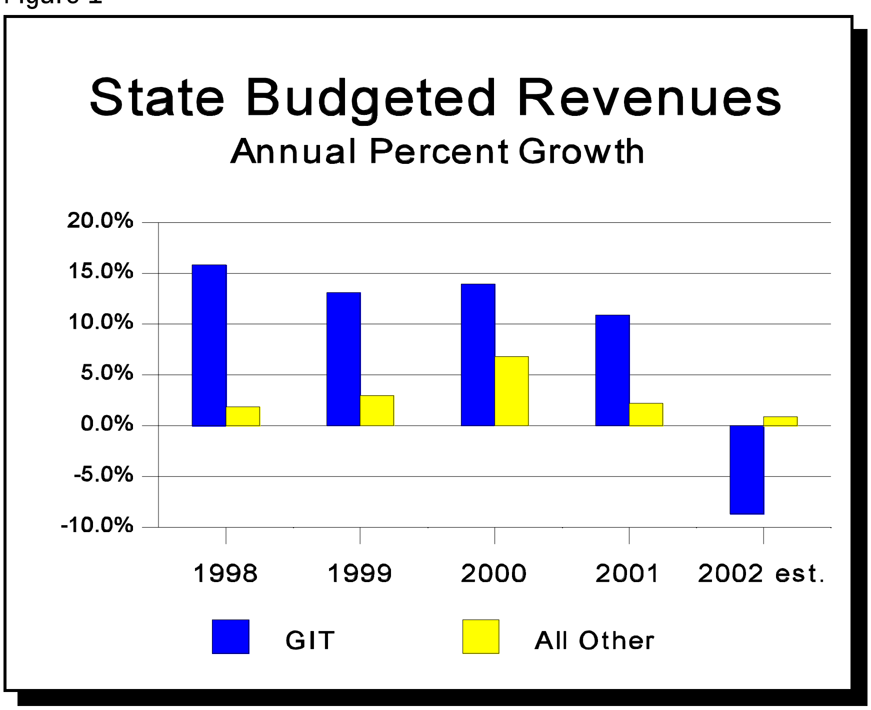
- The GIT growth averaged over 13% annually from FY 1998 through FY 2001. The Executive is now estimating a 9% *decline* in FY 2002.

- Growth in all other revenues has been more modest and steady, ranging between 1% and 7% from FY 1998 to FY 2001.

- For FY 1998 through FY 2001 the GIT accounted for about two-thirds of all State budgeted revenue growth. In FY 2002 the GIT accounts for about two-thirds of the revenue shortfall from the certified targets.

Figure 2 contains a more detailed display of current year revenue collections through the end of March. Certain individual revenues will be discussed in greater detail in the following pages as part of the OLS revenue estimates for FY 2002 and FY 2003.

Figure 1



# Recap: FY 2002 Collections to Date

Figure 2
## FY 2002 Year-To-Date
## Selected Revenue Comparison
Through the End of March 2002 vs. March 2001
($ millions)

| Revenue Source | FY 2001 Actual Year-To-Date | FY 2002 Actual Year-To-Date | FY 2002 Actual Year-To-Date % Change | FY 2002 Year-End Treasury % Change Target |
|---|---|---|---|---|
| Gross Income Tax | $5,035.4 | $4,403.5 | (12.5)% | (9.4)% |
| Sales Tax * | 3,779.9 | 3,881.9 | 2.7% | 2.5% |
| Corporation Business Tax | 733.8 | 603.4 | (17.8)% | (35.4)% |
| Lottery | 505.5 | 519.7 | 2.8% | 7.1% |
| Motor Fuels * | 342.6 | 338.8 | -1.1% | 2.4% |
| Motor Vehicle Fees | 289.0 | 283.7 | (1.9)% | (11.5)% |
| Casino | 253.1 | 259.3 | 2.5% | 2.3% |
| Inheritance Taxes | 361.8 | 387.7 | 7.2% | 8.4% |
| Insurance Premiums | 191.5 | 204.4 | 6.7% | (0.7)% |
| Cigarette (Budgeted) | 133.5 | 129.6 | (3.0)% | (4.1)% |
| *Cigarette (Total)*** | *288.5* | *284.6* | (1.4)% | *(2.5)%* |
| Petroleum Products * | 145.4 | 143.6 | (1.3)% | 1.9% |
| Alcohol Excise * | 53.4 | 53.4 | 0.1% | (4.9)% |
| CBT -- Banks & Financials | 33.0 | 26.0 | (21.3)% | 28.9% |
| Realty Transfer * | 55.2 | 57.3 | 3.8% | 8.8% |

*Sources: Year-To-Date revenues are from Treasury's monthly cash reports. The year-end Treasury percentage change target is based on the March revised revenue estimates for FY 2002 contained in the proposed FY 2003 budget.*
*The gross income tax, sales tax, and corporation business tax target rates exclude tax amnesty. The corporation tax target rate also excludes amounts for limited liability corporations.*
** Revenues represent eight months of cash collections. All others represent nine months of cash collections.*
*** Cigarette (Total) includes $155 million deposited directly into the off-budget Health Care Subsidy Fund in both FY 2001 and FY 2002.*

## Fiscal Year 2002 Revenue Estimates

Figure 3 presents the FY 2002 revenue certification from the Appropriations Act (July 2001), the Executive's March revisions, and the OLS's forecast as contained in this report.

Figure 3
Fiscal Year 2002 Revenue Estimates
($ millions)

| | Approp. Act (7/1/01) | Revised Executive (March) | Executive Changes | Office of Legislative Services (April) | Difference OLS vs. Revised Executive |
|---|---|---|---|---|---|
| Gross Income Tax | $8,545 | $7,241 | ($1,304) | $6,880 | ($361) |
| Sales Tax | 6,137 | 5,901 | (236) | 5,940 | 39 |
| Corporation Business Tax | 1,434 | 842 | (592) | 950 | 108 |
| CBT -- Net LLC | 420 | 220 | (200) | 220 | 0 |
| Other Revenues | 6,336 | 6,189 | (147) | 6,176 | (14) |
| Total, Original Base | $22,873 | $20,393 | ($2,480) | $20,166 | ($228) |
| Supplemental Revenues Used to Close the Budget Shortfall: | | | | | |
| New Revenues | 0 | 249 | 249 | 249 | 0 |
| Fund Transfers | 0 | 214 | 214 | 214 | 0 |
| Grand Total, All Funds | $22,873 | $20,856 | ($2,017) | $20,629 | ($228) |

*See Appendix for additional detail. Numbers may not add due to rounding.*

### FY 2002 Executive:

- In March the Executive revised estimates for all revenues downward by $2.0 billion from the level certified in the FY 2002 Appropriations Act.
- The net $2.0 billion shortfall consisted of $2.48 billion in reductions from the original base, offset by $463 million in new revenues or transfers from other funds.
- The largest revenue reduction is for the income tax, down $1.3 billion.
- Corporation tax revenues are down $592 million for regular payments and down $200 for net payments by LLC's.

### FY 2002 Office of Legislative Services:

- The OLS's revenue estimates are $228 million below the Executive's total.
- The OLS concurs with the Executive's estimates for new revenues and transfers from other funds.
- The OLS's income tax estimate is down an additional $361 million.
- The OLS's regular corporation tax estimate is $108 million higher, but the OLS accepts the Executive's net LLC estimate.

## Fiscal Year 2003 Revenue Estimates

Figure 4 presents the Executive's FY 2003 revenue estimates and the OLS's forecast as contained in this report.

Figure 4
Fiscal Year 2003 Revenue Estimates
($ millions)

| | Executive | % Change 02 to 03 | Office of Legislative Services | % Change 02 to 03 | Difference OLS vs. Exec. |
|---|---|---|---|---|---|
| Gross Income Tax | $7,740 | 6.9% | $7,430 | 8.0% | ($310) |
| Sales Tax | 6,194 | 5.0% | 6,235 | 5.0% | 41 |
| Corporation Business Tax* | 820 | (2.6)% | 825 | (13.2)% | 5 |
| Other Revenues | 6,483 | 4.0% | 6,471 | 4.0% | (12) |
| Total, Existing Funds | $21,236 | 1.8% | $20,961 | 1.6% | ($275) |
| Executive Proposals for New Revenue: | | | | | |
| Business Tax Changes | 1,003 | | 1,003 | | 0 |
| Other Tax & Fee Changes | 424 | | 424 | | 0 |
| Tobacco Securitization | 1,075 | | 1,075 | | 0 |
| Total Revenue Proposals | $2,502 | | $2,502 | | $0 |
| Grand Total, All Funds | $23,738 | 13.8% | $23,463 | 13.7% | ($275) |

*See Appendix for additional detail. Numbers may not add due to rounding.*
** The OLS corporation tax estimate for FY 2003 consists of a $925 million base less a $100 million reduction for the temporary federal depreciation allowance tax change. The OLS baseline growth rate is -2.6%.*

### FY 2003 Executive:

! The Executive expects total revenues to grow by $2.9 billion, or 13.8% over FY 2002.

! Existing revenues are expected to increase by only $380 million from FY 2002, up 1.8%.

! Various revenue changes proposed by the Executive account for about $2.5 billion in additional revenues, including about $1.0 billion in business tax changes and $1.1 billion in tobacco securitization (Appendix page A5).

### FY 2003 Office of Legislative Services:

! The OLS's revenue estimates are $275 million below the Executive's total.

! The OLS estimates that existing revenues will increase by $332 million from FY 2002, up 1.6 %.

! For purposes of comparability, the OLS traditionally assumes that proposed Executive revenue changes will take place. The OLS accepts the Executive's estimates, but cautions that there are significant uncertainties regarding these amounts.

## Budgetary Impact of the OLS Revenue Estimates

For the current and upcoming fiscal years, the OLS's revenue estimates are a total of $503 million lower than the Executive's estimates. This difference amounts to about 1.1% of the $44.6 billion total revenues over the two year period. However, the difference constitutes 2.1% of the revenues anticipated to be available to support the FY 2003 budget.

As part of its analysis, the OLS typically recalculates the State's year-end budgeted balance based solely on the revenue forecast difference between the Executive and the OLS. Figure 5 assumes that the spending plan and tax law changes in the FY 2003 Executive budget will be followed. However, any calculation of the actual balance must take into account numerous spending decisions as well as anticipated revenue. Decisions on these and other matters will be made by the Executive, both budget committees and the full Legislature over the next two months.

Figure 5
OLS Adjusted FY 2003
Year-End Balance

| | |
|---|---|
| Executive Estimate | $526,500,000 |
| OLS Revenue Adjustment | ($503,000,000) |
| OLS Estimate | $23,500,000 |

As is shown in Figure 5, the Executive estimates an FY 2003 year-end balance of $527 million. All other things being equal, the lower OLS revenue estimates would produce a year-end balance of $24 million, $503 million less than the Executive.

Because this analysis does not address possible changes to appropriations, Executive spending patterns, the Executive's proposed revenues changes, or other non-tax revenues, it is premature to draw conclusions about actual year-end balances from this analysis of State revenues.

### Budget Uncertainty

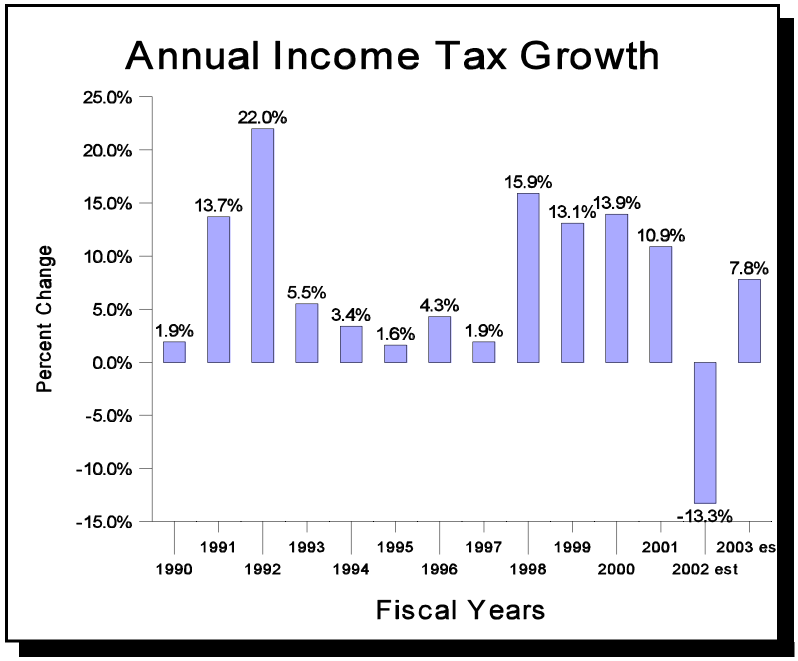
It is crucial to note that the FY 2003 budget proposal includes a number of important revenue proposals which will require Legislative action. These changes, worth about $2.5 billion, play a central role in this and future budgets. The proposals include significant changes in the taxation of businesses, a cigarette tax increase, adjustments to the inheritance tax, various fee changes, postponements of certain previously enacted tax changes, and the securitization of a long term revenue stream from the national tobacco settlement. Although all of these proposals have revenue expectations attached to them, the two most important ones -- business tax restructuring and tobacco payment securitization -- are also the vaguest at this point. Changes in these proposals could significantly affect the FY 2003 budget and the year-end balance.

Projections of the State's year-end balance are a static image of a moving target. Because of the large number of changes that occur in both spending and revenues throughout any fiscal year, the surplus changes significantly between the enactment of the annual appropriations act and the end of the fiscal year and a review by State auditors. Historically, spending is adjusted and new revenue measures are instituted during the fiscal year when such actions are necessary to maintain an adequate balance.

# Gross Income Tax

The gross income tax (GIT) has become the State's most important tax revenue source. FY 1991 was the last year in which State sales tax revenues exceeded income tax revenues as the biggest contributor of dollars. Since then the income tax has been the largest revenue source each year, accounting for 38% of State revenues by FY 2001.

Figure 6




Perhaps more important than the income tax's role as the largest revenue source has been its contribution as the fastest growing revenue.

- Between FY 1997 and FY 2001 the income tax grew by an average of 13.4% each year.

- The income tax accounted for two-thirds of all State revenue growth between FY 1997 and FY 2001 ($3.1 billion in GIT growth out of $4.8 billion in total revenue growth).

## What Goes Up, Must Come Down?

The same forces that fueled the income tax's robust growth in the late 1990's have had a similarly powerful impact in reverse in FY 2002. Surging tax liabilities by upper income taxpayers drove total revenue collections up rapidly. Likewise, falling incomes among upper income taxpayers are pulling tax liabilities and State revenue collections rapidly downward.

As has been discussed in the past, taxpayers earning $100,000 or more account for about 13% of all taxpayers, but contribute 75% of income tax revenues. Many high income taxpayers receive significant portions of their income from non-wage sources such as capital gains, stock options, bonuses, and various forms of business income. These kinds of income are much more volatile than wage income. For example, in the late 1990's capital gains income averaged 40% growth each year and business income averaged 18% growth each year. By contrast, income from wages averaged less than 8% growth during the same period.

Recently however, certain kinds of non-wage income have fallen sharply. Nationally, capital gains distributions from mutual funds fell by a remarkable 78% in 2001 (Figure 7) and the overhang of unrealized capital gains has plummeted 98% since 1999 (Figure 8).[1]

[1] Investment Company Institute, *Mutual Fund Industry Developments in 2001*, Perspective, vol. 8, No. 1, February 2002.

## Gross Income Tax (Continued)

Figure 7

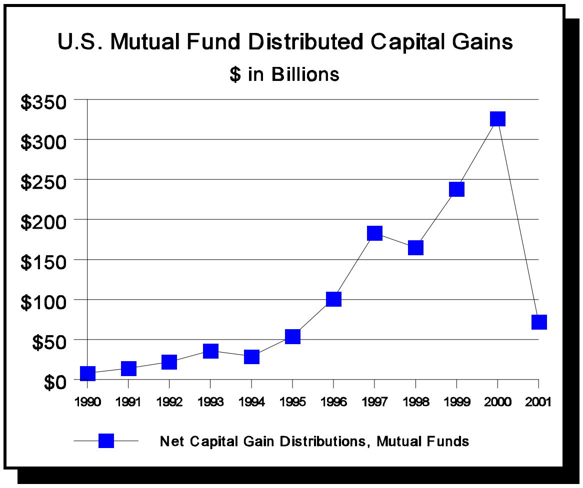
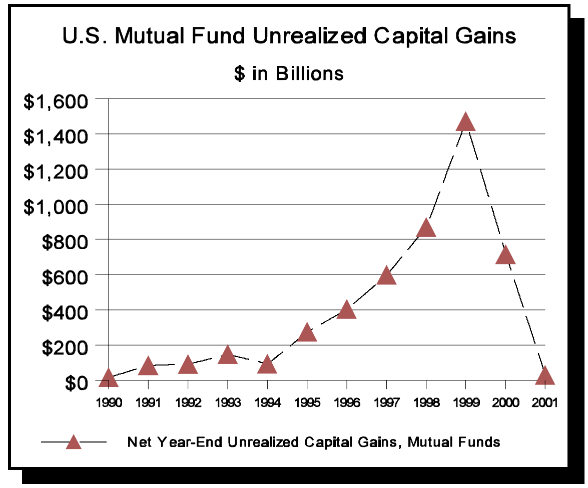



Figure 8




### Tax Brackets Matter: So Does the Kind of Income

It is precisely due to rapid growth in non-wage income by upper income taxpayers that GIT revenues could have grown annually by between 11% and 16% in recent years, even though growth in total personal income ranged between 4.7% and 6.8%.[2] Total income growth is much less important for measuring State income tax revenues than the *kind* of income that is growing and the *tax brackets* in which that income is growing.

For example, $100,000 of income growth for a high income family generates $6,370 in tax revenue for the State (at the 6.37% marginal tax rate). On the other hand, if ten middle class families earning about $60,000 each benefitted from a $10,000 salary increase, that $100,000 of combined increased income only generates $2,450 in tax revenue for the State (at the 2.45% marginal tax rate). This example works just as well in reverse, where the State faces significantly greater tax revenue declines from income losses of the high income family than from the many middle income families.

Moreover, the kind of income also plays an important role. As was discussed on the prior page, certain kinds of non-wage income, such as capital gains or business income, are subject to much greater fluctuations each year than wage income. In New Jersey, some 80% of capital gains income is realized by taxpayers in the highest tax bracket, making this particularly volatile income source generally subject to the highest tax rates. When capital gains are rising, tax revenues can soar, but when capital gains are falling, tax revenues can quickly tumble.

The interaction between the different tax brackets (marginal tax rates) and the various kinds of income taxpayers receive help explain the strong income tax revenue growth between FY 1997 and FY 2001 and the sharp decline in income tax revenues in FY 2002.

For a further discussion of the "boom" and "bust" in State tax revenues in recent years, please see page A10 in the appendix of this report.

[2] See figures from the Council of Economic Advisors in the appendix.

# Gross Income Tax (Continued)

## FY 2002

Figure 9 displays the FY 2002 and FY 2003 revenue estimates for the Executive and the OLS. The Executive estimates $7.291 billion in FY 2002, an 8.7% decline from FY 2001. The OLS estimates $6.930 billion in FY 2002, a 13.3% decline from the prior year.

The FY 2002 Executive and OLS income tax revenue estimates are driven by declining non-wage income and the reality of falling year-to-date revenue collections. *Through the end of March, nine months into the fiscal year, GIT collections are running a startling 12.5% behind the same nine month period in FY 2001. New Jersey income tax revenues have never fallen this sharply before, either during prior recessions or when tax rates were reduced.* The previous low point for GIT revenue was 14 years ago, in FY 1988, when receipts fell by 1.9%.

Estimated Payments: The most important reason for the sharp decline in receipts so far this fiscal year is the remarkable *28% decline in the first two quarterly estimated payments of FY 2002*. Estimated payments are made each quarter by taxpayers who receive significant amounts of non-wage income.

### GIT Components

In analyzing the GIT, it is helpful to break up the revenue stream into four basic components:

1. Withholding collections are paid throughout the year by employees through their employers as a deduction from each paycheck, bonuses and some stock options;
2. Estimated quarterly payments generally are paid in the months of September, January, April, and June by taxpayers with significant non-wage income;
3. Final year-end payments are the familiar payments made by April 15th each tax filing season. As with estimated payments, taxpayers who must make large final tax payments generally have significant sources of non-wage income;
4. Refund payments are paid by the State, largely in the spring and summer, to taxpayers whose April 15 tax filings show payments exceeding their tax liability.

Figure 9
Gross Income Tax Revenue Estimates
$ Millions

| Category | FY 2002 | | | | FY 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| | Executive | | OLS | | Executive | | OLS | |
| | Amt | % Chg | Amt | % Chg | Amt | % Chg | Amt | % Chg |
| GIT Base | $7,241 | (9.4)% | $6,880 | (13.9)% | $7,740 | 6.9% | $7,430 | 8.0% |
| Amnesty | $50 | | $50 | | | | | |
| Tax Changes | | | | | $38 | | $38 | |
| Total | $7,291 | (8.7)% | $6,930 | (13.3)% | $7,777 | 6.7% | $7,468 | 7.8% |

# Gross Income Tax (Continued)

Both the Executive and the OLS expect estimated payments to decline again in April and June. The Executive projects declines of about 10% while the OLS projects declines of about 20%.

Final Year-End Payments: Estimated payments are usually a reliable indicator of final year-end payments that taxpayers will make in April. Last year when estimated payments were up over 30%, final payments jumped by 19%. This year the Executive is projecting final payments will drop by 15%. The OLS is projecting a 25% decline.

Refund Payments: In addition to the sinking estimated payments, *refund payments are up 39% so far in FY 2002*. Historically, growth in refunds has been closer to 10%-12% annually. This year's jump is primarily connected to the decline in non-wage income, and provides an additional indicator that taxpayers' final payments will decline in April. The Executive estimates refunds will increase by about 9% for the remainder of FY 2002. The OLS estimates refunds will increase by 20% for the rest of the fiscal year.

Withholding Collections: The largest component of regular income tax collections is from *employer withholding* collections. Withholding receipts are down 3.4% so far in FY 2002. However, withholding collections in March were up over 6%, an encouraging sign that the declines seen so far this fiscal year may be over.

The 3.4% decline is somewhat misleading, in that more than just regular employee wages are subject to withholding requirements. Most kinds of stock options and income from bonuses also require employer withholding. Some of the decline in withholding collections in FY 2002 is due to falling income from stock options and bonuses. Unfortunately, the actual amounts cannot be determined as tax collection data do not separate these sources from regular wages.

The Executive and the OLS estimate that withholding collections will grow for the rest of this year. As noted above, declines in stock option and bonus income have masked some underlying strength in wage income, and the 6% growth in March withholding collections is encouraging. The Executive estimates 8% growth while the OLS estimates 6% growth.

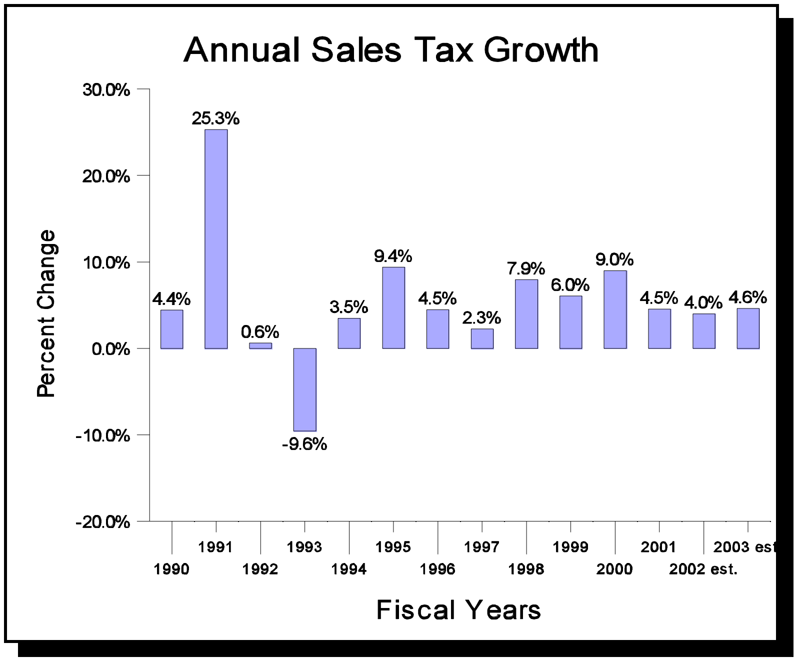
## FY 2003

Both the Executive and the OLS estimate a return to growth in GIT revenue for FY 2003. As is shown in Figure 9, the Executive estimates $7.777 billion, or 6.7% growth. The OLS estimates $7.468 billion, or 7.8% growth. Despite the slightly higher growth rate, the OLS amount is $309 million lower than the Executive's amount due to the OLS's lower estimate of the FY 2002 GIT base.

While the OLS begins with a lower base than the Executive, the assumptions about growth into FY 2003 are similar. Both expect growth in estimated payments and final payments to exceed 10%. The OLS anticipates slightly higher growth in FY 2003 because of certain timing issues -- the OLS assumes lower estimated payments for the first two quarters of tax year 2002 (the end of FY 2002), which will in turn require *larger* estimated or final payments later for tax year 2002 (the beginning of FY 2003). The OLS assumes refund payments will increase by only 10% following the jump in FY 2002, a somewhat lower rate than the Executive. On the other hand, the Executive estimates 8% growth in withholding, while the OLS estimates somewhat lower 6% growth.

## Sales Tax

Figure 10




A decade ago the sales tax was displaced by the income tax as New Jersey's largest single State tax revenue source. However, the sales tax continues to provide about one quarter of the State's budgeted revenue and this tax source has been less volatile. Between FY 1994 and FY 2001, growth in the sales tax has ranged between 2.3% and 9.4%, averaging about 5.8% per year.

Due to the mild recession in 2001 and the expected modest paced economic recovery in 2002 and 2003, both the Executive and the OLS expect sales tax growth in FY 2002 and FY 2003 to track below the 5.8% average rate seen during the long period of economic growth of the last decade.

### FY 2002

Sales tax collections through the end of March are running about 2.7% ahead of the same period one year ago. While low by recent historical standards, this growth rate actually represents a solid recovery from a very weak performance during the first quarter of the fiscal year. Receipts during the first three months actually declined by 0.4% compared with the same months in FY 2001. In particular, sales in September dropped sharply, falling by 8.3% as the State and the nation came to grips with the September 11th terrorist attacks. Since then consumer behavior has picked up, boosted in part by a jump in motor vehicle sales encouraged by manufacturers' attractive financing deals in the fall and winter months. Sales tax collections since the end of the first quarter are up by 4.6% over the same period in FY 2001. At least in terms of consumer behavior, the effects of the mild recession and September 11th appear to have been brief.

The Executive is estimating that sales tax revenues will continue to grow modestly for the remainder of the fiscal year. Over the next few months the Executive expects an average growth of 2.6%. In addition, the Executive is estimating the tax amnesty program will yield $50 million for the sales tax, pulling the year-end growth rate up to 3.3% and the total revenue up to $5.951 billion.

The OLS is somewhat more optimistic than the Executive and assumes the recent 4.6% growth pattern will continue for the remainder of FY 2002. When the $50 million for tax amnesty is included, the OLS estimates year-end growth of 4.0% and a total collection of $5.990 billion, $39 million above the Executive's target.

### FY 2003

The Executive and the OLS both see underlying growth in the sales tax of about 5.0% in FY 2003, a fraction below the recent average. When factoring in the one-time tax amnesty amount from FY 2002, total growth will be 4.6%. The Executive's total for FY 2003 is $6.227 billion. The OLS's total, which starts from a slightly higher base, is $6.268 billion, $41 million above the Executive's target.

## Corporation Business Tax

The corporation business tax (CBT) has long been the State's third largest tax revenue. However, its overall importance in the structure of State budgeted revenues has been declining. The Executive notes that in FY 1982 the CBT accounted for 15.1% of State budgeted revenue, but that by FY 2001 it had declined to 6.6%. Furthermore, the Executive projects that the CBT will continue to decline to 3.6% in FY 2003 in the absence of a series of proposed tax changes.

Describing and explaining the CBT has become a challenge. Figure 11 displays revenue estimates for the base portion of the tax, plus a number of distinct components, some of which are temporary, some permanent, and some proposed. In addition, temporary federal tax changes regarding the increased depreciation allowance are also affecting the estimates.

### FY 2002

The original revenue estimate certified by the Governor last summer anticipated $1.85 billion for FY 2002. Those estimates have been reduced significantly due to a sharp drop in regular CBT collections and a downward revision in the estimate for taxes paid by limited liability companies (LLC's).

Through the end of March, regular CBT collections are down nearly 20% compared to the same time last year. The Executive now estimates that base collections will fall to $842 million in FY 2002, a 35% drop from FY 2001. The Executive has also reduced the estimate of revenues from LLC's from the certified $420 million to only $220 million. The Executive also anticipates $50 million from corporations making payments under the tax amnesty program.

Figure 11
Corporation Business Tax Revenue Estimates
$ Millions

| Category | FY 2002 | | | | FY 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| | Executive | | OLS | | Executive | | OLS | |
| | Amt | % Chg | Amt | % Chg | Amt | % Chg | Amt | % Chg |
| CBT Base | $842 | (35.4)% | $950 | (27.1)% | $820 | (2.6)% | $925 | (2.6)% |
| Energy | $0 | | $0 | | $31 | | $31 | |
| LLC's | $220 | | $220 | | | | | |
| Amnesty | $50 | | $50 | | | | | |
| Tax Changes* | $0 | | $0 | | $1,003 | | $1,003 | |
| Fed. Depr.** | $0 | | $0 | | $0 | | ($100) | |
| Total | $1,112 | (20.0)% | $1,220 | (12.2)% | $1,855 | 66.8% | $1,860 | 52.4% |

* Tax changes include $36 million from the proposed delay in the next phase of the Subchapter-S corporation reductions.

** Federal tax law changes have temporarily increased the corporate depreciation allowance over the next several years (Job Creation and Worker Assistance Act of 2002, P.L. 107-147).

## Corporation Business Tax (Continued)

The OLS agrees that the CBT revenue picture has deteriorated sharply in FY 2002. However, the OLS is somewhat less pessimistic about baseline revenues this fiscal year. The year-to-date decline in collections, while precipitous, is not as severe as the 35% decline anticipated by the Executive. The OLS believes baseline CBT revenues will decline by 27%, reaching $950 million, or $108 million more than the Executive. The OLS, lacking specific taxpayer data, accepts the Executive's estimates for LLC revenue and tax amnesty revenue as reasonable.

### FY 2003

The CBT revenue estimates rely heavily on tax changes to be proposed by the Executive. According to the Budget, the Executive will propose statutory reforms to the CBT that will increase revenues in FY 2003 to the same $1.85 billion level that had been certified in the FY 2002 Appropriations Act.

Legislation to implement the Executive's proposals was not introduced as of the writing of this report. However, the Budget notes that the "proposal will provide for an alternative minimum assessment" that will be "based not just on corporate profits, or on a company's physical presence in the state, but on their economic presence in New Jersey, including their payroll, property and sales within the state." Each corporation would "calculate its tax under the current corporate business tax structure and under the alternate assessment, and would pay the greater of the two."

The Executive estimates that CBT revenues will continue to decline to $820 million in FY 2003, in the absence of the proposed tax changes. *Effectively, the tax changes would have to raise just over $1.0 billion in FY 2003 for the Executive to reach its budgeted target of $1.85 billion.* The budget also anticipates $31 million in CBT payments from certain energy-related corporations (see the appendix for greater detail on the distribution of revenue from energy and public utilities).

The OLS's estimates for the CBT assume that baseline revenues will decline from $950 million in FY 2002 to $925 million in FY 2003, about $105 million above the Executive's estimate for FY 2003. In addition to the baseline amounts, the OLS accepts the Executive's estimate of $31 million in energy-related corporations and includes the Executive's assumption that various tax changes will raise about $1.0 billion. The OLS also makes a $100 million downward adjustment for the temporary increase in the federal depreciation allowance that will affect New Jersey corporate tax liabilities.

The most confusing aspect of the FY 2003 CBT revenue estimate involves the proposed tax changes. The CBT is under normal circumstances the most difficult tax revenue to estimate. This difficulty stems from a combination of uncertainty regarding NJ corporate profits, from the fact that in any given year corporations may pay taxes, allocate tax credits or receive refunds for *several different* tax years, and from the lack of published data comparable to the *Statistics of Income* for the gross income tax. This year, neither the underlying corporate data nor the specifics of the proposed future legislation are available, making the forecasting situation more problematic than usual.

As a result, the OLS is unable to make an independent assessment or estimate of how much revenue the Executive's proposal would generate. *For display purposes only, the OLS accepts the Executive's target of $1.0 billion in revenue from the tax changes.* The OLS also notes particular concern regarding the ability to design and target corporate tax law with enough precision to generate the specific revenue amounts required by the Executive's proposal. The lack of specificity in the proposal, the likely difficulty in accurately forecasting the impact of an enacted proposal, and the magnitude of the anticipated revenue enhancement, make this item an extremely important element in the budget considerations.

## The Inheritance Tax

Inheritance tax collections after the first nine months of FY 2002 are running about 7% ahead of the same period in FY 2001. The Executive and the OLS concur in the expectation that growth of about 8% will continue for the remainder of the fiscal year, raising $518 million in FY 2002.

In FY 2003 the Executive estimates the 8% rate of growth will continue for a total of $560 million. The OLS assumes a somewhat more cautious 5% growth rate for FY 2003, for a total collection of $545 million, $15 million less than the Executive.

However, both FY 2003 estimates include an assumption that the Legislature will pass proposed legislation to offset the impact of the phase-out of the State credit under the federal estate tax. The Executive estimates that the first step of the phase-out will reduce NJ estate tax revenues by $72 million in FY 2003. The OLS believes this estimated potential revenue loss amount to be reasonable.

The inheritance tax consists of two very different parts. One part is the transfer inheritance tax, which is applied to the transfer to certain beneficiaries of all personal property and New Jersey real property having an aggregate value of $500 or more. The second part is the estate tax, which absorbs the value of any federal estate tax credit remaining after transfer inheritance taxes have been paid. This is often referred to as a "sponge tax" or a "pick-up tax." Since the NJ estate tax amount is based on the federal estate tax, the elimination of the federal credit will reduce NJ tax revenues.

If the State does not pass legislation uncoupling from the federal estate tax, State revenues will be $72 million less than estimated by the Executive and the OLS.

## The Cigarette Tax

In the previous year, FY 2001, the cigarette tax raised $228.4 million for the State Budget and an additional $155 million for the off-budget Health Care Subsidy Fund (total = $383.4 million). Cigarette sales have been declining by several percent each year, and the Executive is currently estimating that the tax will bring in $219 million on-budget in FY 2002. The OLS concurs with this estimate. The $155 million for the Health Care Subsidy Fund remains constant from year to year.

For FY 2003 the Executive is proposing a 50 cent per pack increase in the cigarette tax, from the current 80 cents to $1.30 per pack. After adjusting for a reduction in cigarette sales of about 7% due to the tax increase, the Executive estimates this tax increase will raise an additional $200 million. Total on-budget cigarette tax collections will grow to $412 million.

The OLS concurs with the Executive's FY 2003 estimate. The estimate of an additional $200 million from a 50 cent increase in the cigarette tax is within a reasonable range. If no sales were lost due to the higher prices that follow the tax increase, then the State would collect an additional $240 million. However, some sales reduction must be expected, either from reduced smoking or from sales lost to other states.

The OLS notes that when cigarette tax rates were increased by 40 cents in 1998, the revenue estimates assumed sales would decline by about 14%. Those estimates turned out to be quite accurate, missing the mark by only a few million dollars. Since that time, cigarette prices have doubled due to a federal tax increase and the impact of the national tobacco settlement. The proposed 50 cent tax increase is proportionately smaller today than the 40 cent tax increase was in 1998. As a result, the price impact will also be proportionately smaller and the assumption of a 7% sales decline is reasonable.

## Tobacco Securitization

The Executive is proposing to securitize (borrow against) a significant portion of the anticipated future revenue stream from the State's portion of the national tobacco settlement. According to the Executive, as much as $8 billion may flow to the State over the next 25 years. The Executive proposes to sell the rights to a portion of that revenue stream to the private market, generating $1.075 billion for the FY 2003 Budget. The budget document describes this sale as "similar to that of the State lottery: an immediate, lump sum payment in place of smaller, annuity-type payments distributed over many years."

However, the lottery analogy only goes so far. What may be more important is the basis the lottery winner uses to make his choice. A lump sum payment may be selected because it facilitates a capital investment (e.g., a home purchase), or because the lottery winner believes that he can invest the lump sum payment and spin off higher earnings than an annuity would have paid. In the proposed budget, neither scenario holds. The State is preparing to deposit the $1.075 billion into the General Fund where it will be spent in FY 2003.

Securitization involves the transferring of the rights to the future Tobacco Settlement Funds (TSF) to an independent entity established by the State. The entity sells the rights to those payments, in turn, on the open market, for a profit and yield to the investors. The State would receive an up-front payment, while the investors retain the rights to the funds until they are repaid. The State then may have divested itself of any risk of default on the part of the companies who fund the TSF. That risk will be borne by the investors, who will be compensated with a higher interest rate.

Important considerations involved in securitization are the timing of the issue (demand may be insufficient), the yield on the issue (raising the interest cost will boost demand, but may make the sale unattractive), and the terms of the issue (most issuances require early repayment). If the issue terms involve full capture of all TSF amounts, the State is unlikely to have any residual amounts available to the General Fund until most of the principal is retired.

Evaluation of the securitization initiative will have to await the proposed legislation. For the purposes of projecting State revenues in this report, the OLS uses the same $1.075 billion as used by the Executive. However, the OLS notes that this amount is merely a recommendation. The future revenue stream of New Jersey's tobacco settlement funds could support any number of different securitization amounts, both higher and lower than the Executive's recommendation. The actual amount will depend on the specifics of the securitization proposal, the outcome of the securities sale, and the Legislative and Executive policy decisions regarding how much of the securitization proceeds are allocated to the FY 2003 budget.

## The Remaining Revenue Differences

The remaining divergence between the OLS and the Executive is relatively minor and involves small differences based largely on current revenue growth patterns. Overall these differences are not significant. The first two tables in the appendix display all the revenue differences in greater detail.

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## Appendix Contents:

Page

## Detailed Fiscal Year 2002 Revenue Estimates
$ Millions

| Revenue Source | Approp. Act | Executive Revised | OLS | Diff: OLS - Executive |
|---|---|---|---|---|
| Major Taxes: | | | | |
| Sales Tax, Total | $6,137.0 | $5,951.0 | $5,990.0 | $39.0 |
| *Sales Tax, Base* | *6,137.0* | *5,901.0* | *5,940.0* | 39.0 |
| *Sales Tax, Amnesty* | *0.0* | *50.0* | *50.0* | *0.0* |
| Corporation Business Tax, Total | 1,854.1 | 1,112.0 | 1,220.0 | 108.0 |
| *Corporation Business Tax, Base* | *1,403.0* | *842.0* | *950.0* | *108.0* |
| *Corporation Business Tax, Amnesty* | *0.0* | *50.0* | *50.0* | *0.0* |
| *Corporation Business Tax, Energy Contribution* | *31.1* | *0.0* | *0.0* | *0.0* |
| *Corporation Business Tax, Limited Liability Corp's* | *420.0* | *220.0* | *220.0* | *0.0* |
| Motor Fuels | 537.0 | 529.0 | 529.0 | 0.0 |
| Motor Vehicle Fees | 396.8 | 393.4 | 393.4 | 0.0 |
| Inheritance Taxes | 540.0 | 518.0 | 518.0 | 0.0 |
| Insurance Premiums | 303.0 | 307.0 | 307.0 | 0.0 |
| Cigarette | 221.0 | 219.0 | 219.0 | 0.0 |
| Petroleum Products Gross Receipts | 224.0 | 220.0 | 220.0 | 0.0 |
| Corporation Business - Banks and Financial | 67.0 | 67.0 | 45.0 | (22.0) |
| Alcoholic Beverage Excise | 82.0 | 76.0 | 80.0 | 4.0 |
| Realty Transfer | 87.0 | 86.0 | 86.0 | 0.0 |
| Savings Institutions | 11.0 | 6.0 | 11.0 | 5.0 |
| Tobacco Products Wholesale | 15.0 | 12.0 | 12.0 | 0.0 |
| Public Utilities Excise | 8.7 | 8.7 | 8.7 | 0.0 |
| Subtotal, Major Taxes | $10,483.6 | $9,505.1 | $9,639.1 | $134.0 |
| Misc. Taxes, Fees and Revenues | | | | |
| Public Utility Taxes (State retention) | $68.4 | $68.4 | $68.4 | $0.0 |
| Transitional Energy Facility Assessments | 126.4 | 225.5 | 225.5 | 0.0 |
| Medicaid Uncomp. Care Reimbursement | 412.0 | 405.4 | 405.4 | 0.0 |
| Various Treasury Fund Balance Transfers | 0.0 | 73.0 | 73.0 | 0.0 |
| Other | 1,254.9 | 1,207.6 | 1,207.6 | 0.0 |
| Subtotal, Misc. Revenues | $1,861.7 | $1,979.9 | $1,979.9 | $0.0 |
| Interfund Transfers | | | | |
| State Lottery Fund | $765.0 | $747.0 | $747.0 | $0.0 |
| Tobacco Settlement Fund | 365.2 | 357.1 | 357.1 | 0.0 |
| Unclaimed Personal Property Trust Fund | 198.0 | 198.0 | 198.0 | 0.0 |
| Various Statutory and Other Fund Transfers | 0.0 | 141.0 | 141.0 | 0.0 |
| Other | 229.9 | 221.0 | 221.0 | 0.0 |
| Subtotal, Interfund Transfers | $1,558.1 | $1,664.1 | $1,664.1 | $0.0 |
| TOTAL GENERAL FUND | $13,903.4 | $13,149.1 | $13,283.1 | $134.0 |
| | | | | |
| Property Tax Relief Fund (Income Tax), Total | $8,545.2 | $7,291.0 | $6,930.0 | (361.0) |
| *PTRF, Base* | *8,545.2* | *7,241.0* | *6,880.0* | *(361.0)* |
| *PTRF, Amnesty* | *0.0* | *50.0* | *50.0* | *0.0* |
| Casino Revenue Fund | 363.0 | 350.0 | 350.0 | 0.0 |
| Casino Control Fund | 59.7 | 64.6 | 64.6 | 0.0 |
| Gubernatorial Elections Fund | 1.5 | 1.5 | 1.0 | (0.5) |
| GRAND TOTAL, ALL FUNDS | $22,872.8 | $20,856.2 | $20,628.7 | ($227.5) |

## Detailed Fiscal Year 2003 Revenue Estimates
$ Millions

| Revenue Source | Executive | % Change | OLS | % Change | Diff: OLS - Executive |
|---|---|---|---|---|---|
| Major Taxes: | | | | | |
| Sales Tax, Total | $6,227.3 | 4.6% | $6,268.0 | 4.6% | $40.7 |
| *Sales Tax, Base* | *6,194.3* | *5.0%* | *6,235.0* | *5.0%* | *40.7* |
| *Sales Tax, Casino Comp.'s* | *33.0* | | *33.0* | | *0.0* |
| Corporation Business Tax, Total | 1,854.8 | 66.8% | 1,859.8 | 52.4% | 5.0 |
| *Corporation Business Tax, Base* | *820.0* | *(2.6)%* | *925.0* | *(2.6)%* | *105.0* |
| *Corporation Business Tax, Energy Contribution* | *31.4* | | *31.4* | | *0.0* |
| *Corporation Business Tax, Restructuring* | *1,003.4* | | *1,003.4* | | *0.0* |
| *Corporation Business Tax, Fed. Depreciation* | *0.0* | | *(100.0)* | | *(100.0)* |
| Motor Fuels | 528.0 | (0.2)% | 540.0 | 2.1% | 12.0 |
| Motor Vehicle Fees | 451.9 | 14.9% | 451.9 | 14.9% | 0.0 |
| Inheritance Taxes, Base | 488.0 | (5.8)% | 473.0 | (8.7)% | (15.0) |
| Inheritance Tax Change | 72.0 | | 72.0 | | 0.0 |
| Insurance Premiums | 318.0 | 3.6% | 318.0 | 3.6% | 0.0 |
| Cigarette | 212.0 | (3.2)% | 212.0 | (3.2)% | 0.0 |
| Cigarette Tax Change | 200.0 | | 200.0 | | 0.0 |
| Petroleum Products Gross Receipts | 225.0 | 2.3% | 225.0 | 2.3% | 0.0 |
| Corporation Business - Banks and Financial | 70.0 | 4.5% | 50.0 | 11.1% | (20.0) |
| Alcoholic Beverage Excise | 76.0 | 0.0% | 82.0 | 2.5% | 6.0 |
| Realty Transfer | 88.0 | 2.3% | 88.0 | 2.3% | 0.0 |
| Savings Institutions | 5.0 | (16.7)% | 11.0 | 0.0% | 6.0 |
| Tobacco Products Wholesale | 13.0 | 8.3% | 13.0 | 8.3% | 0.0 |
| Public Utilities Excise | 8.7 | 0.0% | 8.7 | 0.0% | 0.0 |
| Subtotal, Major Taxes | $10,837.7 | 14.0% | $10,872.4 | 12.8% | $34.7 |
| Misc. Taxes, Fees and Revenues | | | | | |
| Public Utility Taxes (State retention) | $68.4 | 0.0% | $68.4 | 0.0% | $0.0 |
| Transitional Energy Facilities Assessment | 226.2 | 0.3% | 226.2 | 0.3% | 0.0 |
| Medicaid Uncomp. Care Reimbursement | 414.2 | 2.2% | 414.2 | 2.2% | 0.0 |
| Other | 1,303.5 | 1.8% | 1,303.5 | 1.8% | 0.0 |
| Subtotal, Misc. Revenues | $2,012.3 | 1.6% | $2,012.3 | 1.6% | $0.0 |
| Interfund Transfers | | | | | |
| State Lottery Fund | $797.0 | 6.7% | $797.0 | 6.7% | $0.0 |
| Tobacco Settlement Fund | 1,351.7 | 278.5% | 1,351.7 | 278.5% | 0.0 |
| Unclaimed Personal Property Trust Fund | 255.0 | 28.8% | 255.0 | 28.8% | 0.0 |
| Other | 283.5 | 17.6% | 283.5 | 17.6% | 0.0 |
| Subtotal, Interfund Transfers | $2,687.2 | 61.5% | $2,687.2 | 61.5% | $0.0 |
| TOTAL GENERAL FUND | $15,537.2 | 18.2% | $15,571.9 | 17.2% | $34.7 |
| | | | | | |
| Property Tax Relief Fund (Income Tax), Total | $7,777.0 | 6.7% | $7,467.5 | 7.8% | (309.5) |
| *PTRF, Base* | *7,739.5* | *6.9%* | *7,430.0* | *8.0%* | *(309.5)* |
| *PTRF, Abrogation of Tax Agreement* | *37.5* | | *37.5* | | *0.0* |
| Casino Revenue Fund | 360.0 | 2.9% | 360.0 | 2.9% | 0.0 |
| Casino Control Fund | 62.7 | (2.9)% | 62.7 | (2.9)% | 0.0 |
| Gubernatorial Elections Fund | 1.5 | 0.0% | 1.0 | 0.0% | (0.5) |
| GRAND TOTAL, ALL FUNDS | $23,738.4 | 13.8% | $23,463.1 | 13.7% | ($275.3) |

## FY 2002 Supplemental Revenues Used to Close the Budget Shortfall
$ in Millions

| Revenue Item | Amount |
|---|---|
| Tax Amnesty Program (P.L. 2002, c.6) | $150.0 |
| Extension of Transitional Energy Facility Assessment (P.L. 2001, c.433) | $99.0 |
| New Jersey Redevelopment Authority (P.L. 2002, c.12) | $18.5 |
| New Jersey Health Care Facilities Financing Authority (P.L. 2002, c.8) | $16.5 |
| Other Resources and Fund Balances (unspecified sources, Treasury) | $38.0 |
| State Disability Benefit Fund (P.L. 2002, c.7) | $50.0 |
| UMDNJ Self Insurance Reserve Fund (P.L. 2002, c.12) | $25.0 |
| New Jersey Insurance Development Fund (P.L. 2002, c.12) | $46.0 |
| Tobacco Settlement Fund, NJ Insolvent HMO Assist. Fund (P.L. 2002, c.12) | $8.9 |
| Medical Malpractice Reinsurance Recovery Fund | $11.1 |
| Total | $463.0 |

## FY 2003 Executive Proposals for New Revenue

$ in Millions

| Revenue Item | Amount |
|---|---|
| Business Tax Changes | $1,003.0 |
| Tobacco Settlement Securitization | $1,075.0 |
| Cigarette Tax Rate Increase (from 80 cents per pack to $1.30 per pack) | $200.0 |
| Increase License and Registration Fees (cars, trucks, tractors, boats) | $24.3 |
| Eliminate Discount Purchase of Drivers' Abstracts (insurance and credit Co's) | $27.0 |
| Increase DEP Fees | $18.0 |
| Increase Various Other Fees | $5.6 |
| Changes to Estate Tax to Uncouple from Federal Estate Tax Credit | $72.0 |
| Abrogate Reciprocal Income Tax Agreement with Pennsylvania | $37.5 |
| Impose Sales and Use Tax on Complimentary Rooms and Meals | $33.0 |
| Repeal of Recently Enacted Tax Reduction for Cigars and Tobacco Products | $7.0 |
| Total | $2,502.4 |

# Public Utility Tax Revenue

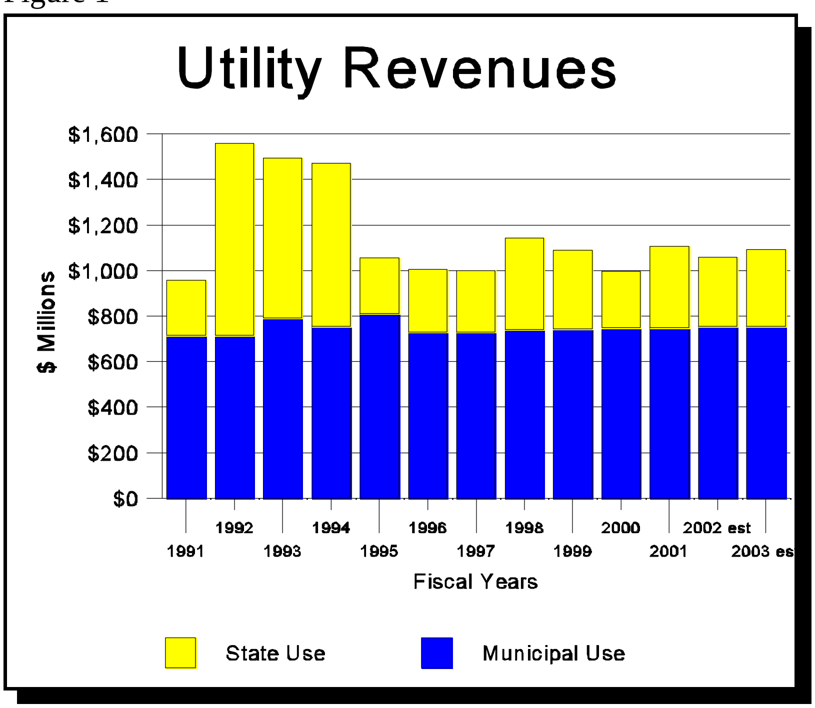
Fiscal Year 2003 will be the sixth year under the revised system of public utility, energy and telecommunications taxation. P.L.1997, c.162 repealed the 1940 State tax system of franchise and gross receipts taxes imposed on regulated gas and electric utilities and telecommunications utilities operating in New Jersey, effective on January 1, 1998. Energy utilities are now subject to the sales and use tax, the corporation business tax (CBT) and the transitional energy facility assessment tax, a temporary tax which phases out over time. Telecommunications utilities became subject to the CBT under this act.

Figure 1 below displays public utility revenues between FY 1991 and FY 2003. The revenues are divided into two categories: *Municipal Use*, which is generally "off budget" and *State Use*, which is generally "on budget." Collections through FY 1997 were under the old public utility tax system. The State Use portions in FY 1992 to FY 1994 included large scheduled prepayments from large utilities pursuant to statutory changes at that time. Since FY 1998 taxes have been collected under the current law.

Figures 2 through 7 display the actual and anticipated revenues from the replacement taxes between FY 1998 and FY 2003 in greater detail. The figures were prepared by the Department of Treasury.

P.L 1997, c.167 replaced the complex aid distribution formulae that were contained in the franchise and gross receipts statutes and provided a new system for the distribution of State aid to municipalities. In FY 1998, $740 million from the taxes listed in Figure 2 were credited to the Energy Tax Receipts Property Tax Relief Fund and distributed to municipalities according to the new formula. The amount credited to this fund was $745 million in FY 1999, $750 million in fiscal years 2000 and 2001, and $755 million in 2002. For FY 2003 the distribution was scheduled to increase by about $18 million, but the Executive budget recommends $755 million, the same as FY 2002.

Figure 1




From a budgeting perspective, the tax revenues credited to the Energy Tax Receipts Property Tax Relief Fund are considered "off budget" and therefore not included in either the anticipated revenues or the amount of State aid appropriated in the annual appropriations act.

The transitional energy facility assessment (TEFA) was originally scheduled to end in FY 2002. However, P.L. 2001, c.433, extended the assessment through FY 2006. For FY 2002 through FY 2004, the 2001 assessment rates will be used. The TEFA then phases down in FY 2005 and FY 2006, and under current law will not exist in FY 2007.

Figure 2

**Actual Public Utility Tax Revenue Fiscal Year 1998**

($ Millions)

| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
|---|---|---|---|
| Sales and Use Tax | $6.7 | $510.2 | $516.9 |
| Corporation Business Tax | $3.9 | $229.8 | $233.7 |
| Transitional Energy Facilities Assessment (TEFA) | $314.9 | | $314.9 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $68.4 | | $68.4 |
| Public Utility Excise Tax Water and Sewer Utilities | $9.2 | | $9.2 |
| Total | $403.1 | $740.0 | $1,143.1 |

Source: Department of Treasury, February 1999.

Figure 3

**Actual Public Utility Tax Revenue Fiscal Year 1999**

($ Millions)

| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
|---|---|---|---|
| Sales and Use Tax | | $528.2 | $528.2 |
| Corporation Business Tax | $37.4 | $216.8 | $254.2 |
| Transitional Energy Facilities Assessment (TEFA) | $228.0 | | $228.0 |
| Customer Specific Tax | $2.5 | | $2.5 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $68.7 | | $68.7 |
| Public Utility Excise Tax Water and Sewer Utilities | $8.9 | | $8.9 |
| Total | $345.5 | $745.0 | $1,090.5 |

Source: Department of Treasury, January 2000.

| Figure 4<br>Actual Public Utility Tax Revenue Fiscal Year 2000<br>($ Millions) | | | |
|---|---|---|---|
| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
| Sales and Use Tax | | $540.3 | $540.3 |
| Corporation Business Tax | | $155.6 | $155.6 |
| Transitional Energy Facilities Assessment (TEFA) | $164.0 | $54.1 | $218.1 |
| Customer Specific Tax | $2.6 | | $2.6 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $71.2 | | $71.2 |
| Public Utility Excise Tax Water and Sewer Utilities | $9.1 | | $9.1 |
| Total | $246.9 | $750.0 | $996.9 |
| Source: Department of Treasury, March 2001. | | | |

| Figure 5<br>Actual Public Utility Tax Revenue Fiscal Year 2001<br>($ Millions) | | | |
|---|---|---|---|
| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
| Sales and Use Tax | | $640.0 | $640.0 |
| Corporation Business Tax | $86.6 | $110.0 | $196.6 |
| Transitional Energy Facilities Assessment (TEFA) | $231.8 | | $231.8 |
| Customer Specific Tax | $2.6 | | $2.6 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $70.2 | | $70.2 |
| Public Utility Excise Tax Water and Sewer Utilities | $8.9 | | $8.9 |
| Total | $400.1 | $750.0 | $1,150.1 |
| Source: Department of Treasury, April 2002. | | | |

Figure 6
## Anticipated Public Utility Tax Revenue Fiscal Year 2002
($ Millions)

| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
|---|---|---|---|
| Sales and Use Tax | | $608.6 | $608.6 |
| Corporation Business Tax | | $141.8 | $141.8 |
| Transitional Energy Facilities Assessment (TEFA) | $225.5 | $4.6 | $230.1 |
| Customer Specific Tax | $2.3 | | $2.3 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $68.4 | | $68.4 |
| Public Utility Excise Tax Water and Sewer Utilities | $8.7 | | $8.7 |
| Total | $304.9 | $755.0 | $1,059.9 |

Source: Department of Treasury, April 2002.

Figure 7
## Anticipated Public Utility Tax Revenue Fiscal Year 2003
($ Millions)

| Revenue Source | On-Budget (State Use) | Off-Budget (Municipal Aid) | Total |
|---|---|---|---|
| Sales and Use Tax | | $642.3 | $642.3 |
| Corporation Business Tax | $31.4 | $112.7 | $144.1 |
| Transitional Energy Facilities Assessment (TEFA) | $226.2 | | $226.2 |
| Customer Specific Tax | $2.3 | | $2.3 |
| Franchise and Gross Receipts Tax Water and Sewer Utilities | $68.4 | | $68.4 |
| Public Utility Excise Tax Water and Sewer Utilities | $8.7 | | $8.7 |
| Total | $337.0 | $755.0 | $1,092.0 |

Source: Department of Treasury, April 2002.

## *Revenue Boom and Bust in Recent Fiscal Years*

Revenue collection patterns are clearest in the rear-view mirror. At the end of the 1990's, New Jersey State tax revenues benefitted from a surge in collections sparked largely by the growth in income from a booming stock market. In FY 2002, State tax revenues are suffering a sharp decline, again largely due to the fallout from a stock market bubble collapse that began in the Spring of 2000.

### Overview: Quarterly Tax Revenue Growth Rates

Quarterly tax revenue data permit an overview of revenue collection trends, while smoothing monthly fluctuations that result from accounting procedures and from the timing of certain tax payments. Figure A displays year over year growth rates of combined quarterly revenue collections for the State's 14 major tax revenue sources from the beginning of FY 1997 through the second quarter of FY 2002. These 14 revenues typically account for between 80% and 85% of the State's annual budgeted revenues.

State tax revenues grew strongly between FY 1998 and FY 2001, averaging about 6.7% growth per year. In 15 of the 16 quarters growth exceeded 5%, and in four quarters growth exceeded 10%. However, since the 3rd quarter of FY 2001, revenue collection growth rates have dropped sharply, first falling below 5% in the final quarter of FY 2001 and then dropping into negative territory in the first two quarters of FY 2002, the current fiscal year.

**Figure A**

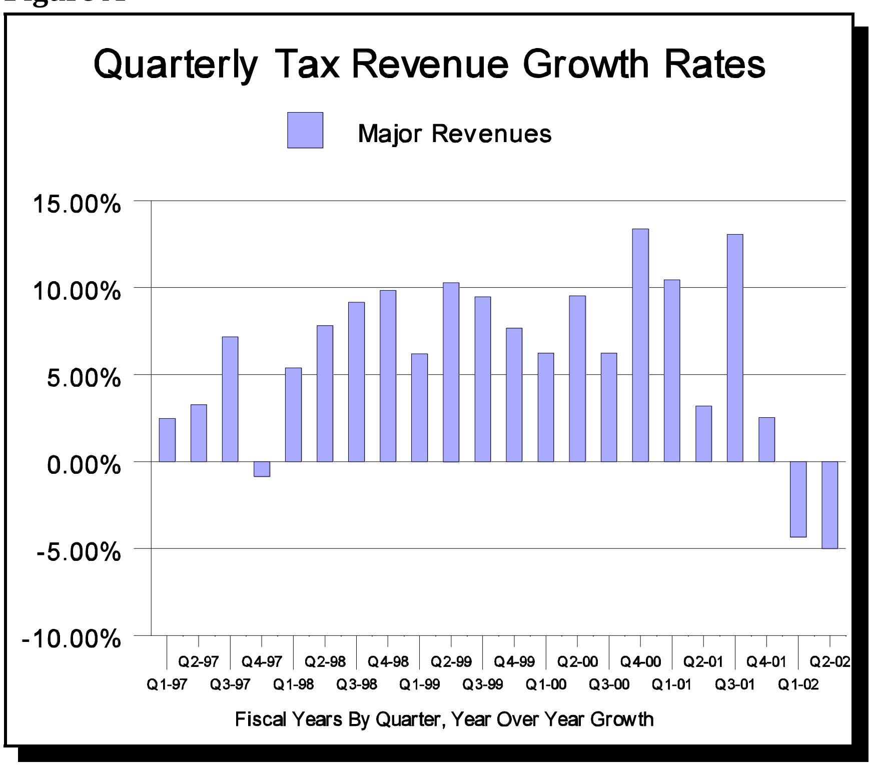
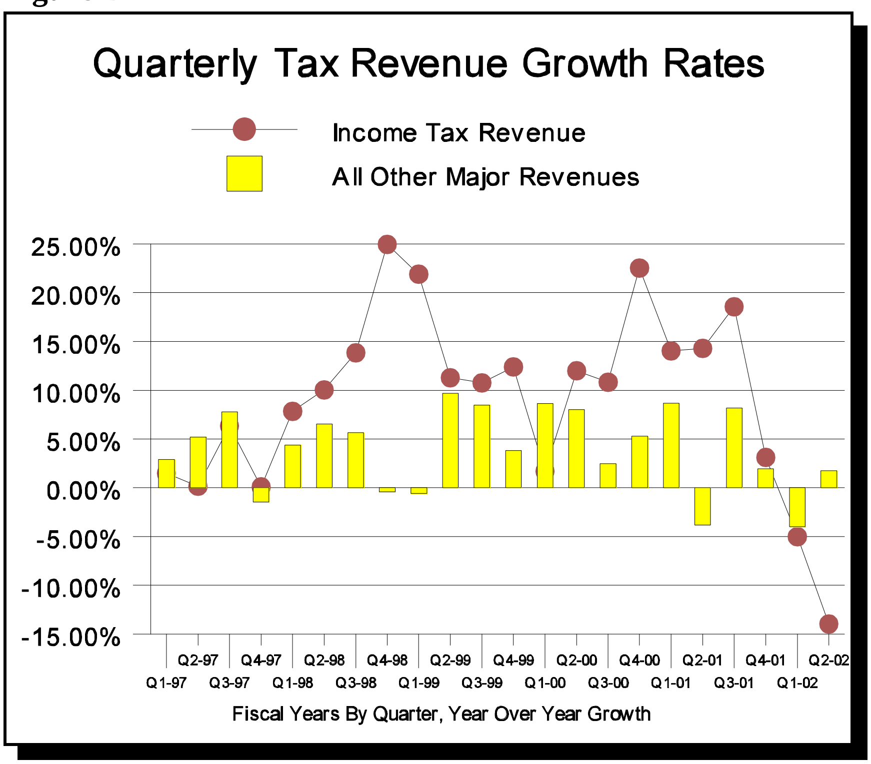


Figure B displays the quarterly revenue growth rates from Figure A, but separates the gross income tax from all other major revenues. Two distinct patterns emerge. During the four years between FY 1997 and FY 2001, income tax growth exceeded 10% in 13 out of 16 quarters, averaging 13.4% growth overall. Growth in all other revenues never exceeded 10% and averaged a much lower 4.6% growth rate. As a result of these two very different revenue growth patterns, the income tax accounted for two-thirds of all State revenue growth during these four fiscal years.

However, growth has fallen sharply since the 3rd quarter of FY 2001. Income tax growth fell below 5% growth in the 4th quarter of FY 2001 and continued into negative territory in each of the first two quarters of FY 2002. All other major revenue growth also slid, dropping into negative growth in the 1st quarter of FY 2001 before rebounding to slightly positive growth in the 2nd quarter. *Since the gross income tax is the State's largest tax revenue source, the dramatic shift from nearly 20% growth in the 3rd quarter of FY 2001 to a nearly 15% decline in the 2nd quarter of FY 2002 is the primary reason for the State's revenue shortfall in FY 2002.*

**Figure B**



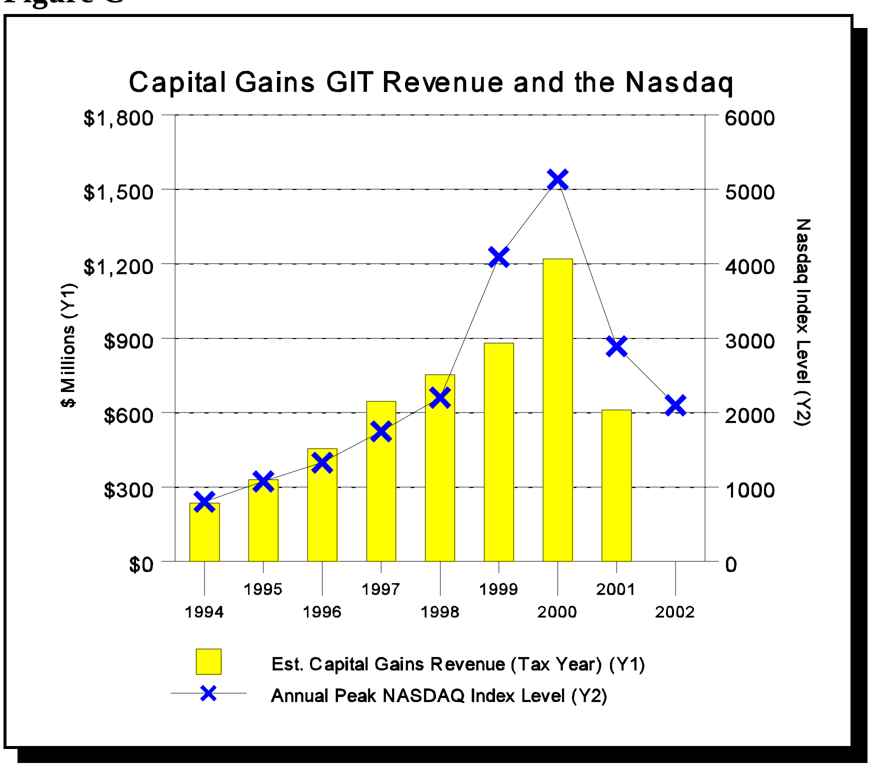
## Why the Income Tax is Crucial

The gross income tax is New Jersey's most important State tax revenue. It not only accounts for more than 35% of total budgeted revenues, but as discussed on page A11, the income tax accounted for two-thirds of all revenue growth in the late 1990's. This tax's importance is manifest both when revenues are rising and when revenues are falling. The Executive's recently revised revenue estimates for FY 2002 indicate that $1.3 billion of this year's projected $2.0 billion revenue shortfall (about two-thirds) is due to the income tax. The OLS's revenue estimates contained in this report, suggest that more than 70% of the revenue shortfall is due to the income tax. The Executive is now estimating that income tax revenues will decline by 8.7% in FY 2002, while the OLS is estimating this revenue will decline by 13.3%.

## The Importance of the Stock Market for Income Tax Revenues

The income tax's strong growth between FY 1997 and FY 2001 is closely tied to the remarkable stock market boom in the second half of 1990's. As the Nasdaq index rushed relentlessly past 5,000 points, as the Dow Jones Industrial Average surged past 11,000, as market transactions volume soared, individual income from capital gains, stock options and bonuses also soared. Capital gains, for example, increased by about 40% per year on average between tax year 1994 and tax year 1999 (the latest year with completed and published data). Figure C displays estimated capital gains income tax revenue and the *peak* values of the Nasdaq since 1994. The OLS estimates that capital gains income tax revenue grew from about $235 million in tax year 1994 to between $1.2 billion and $1.4 billion at its peak in tax year 2000. An estimated 50% decline in tax year 2001 would represent a $600-$700 million reduction in tax revenues from capital gains income alone.

**Figure C**



While the causal link between stocks and capital gains is more complex than Figure C suggests, the similar growth pattern between the Nasdaq and capital gains tax revenue on the way up is likely to be followed by a similar pattern on the way down, *but with a lag*. Even as stock values began to plunge from their peak early in the year 2000, tax revenues continued to soar because the huge volume of equity sales included large unrealized gains from the boom years that investors sought to cash in before stock values fell too far. However, while the impact of the stock market drop on State tax revenues may be lagged, it cannot be avoided.

## What has Happened to Capital Gains?

The stock market decline that began in the year 2000 continued in 2001. Accordingly, the remaining overhang of unrealized gains was significantly reduced from the levels at the beginning of the previous year. For example, during most of 2001, the Nasdaq had an index value consistently below 2,000, more than 60% below its peak level the previous year. While New Jersey specific income data on the value of stock market gains are not available, some national data provide an indication of the massive impact the recent market slide could have. According to the Investment Company Institute,[1] total capital gain distributions paid by mutual funds fell from $326 billion in tax year 2000, to $72 billion in 2001 -- a 78% decline (Figure D). *Taxable* household capital gain distributions fell from $99 billion in 2000 to $16 billion in 2001 -- an 84% decline. Moreover, the value of ***unrealized gains*** in mutual fund portfolios has plummeted from $1,472 billion in 1999 to $31 billion in 2001, a 98% decline over 2 years (Figure E). This mutual fund data suggests the level of capital gains reported by taxpayers should drop significantly and could take years to recover to prior levels.

**Figure D**

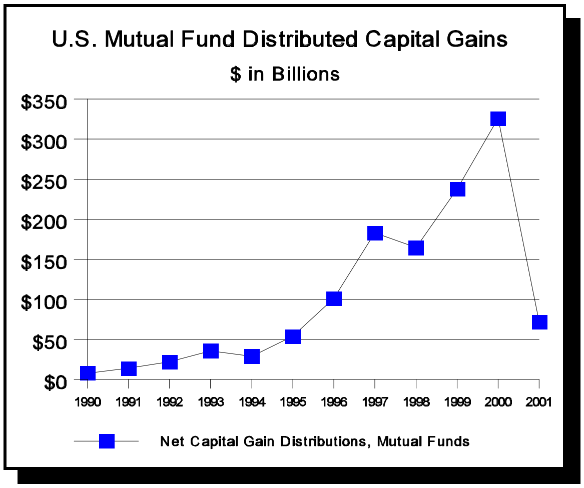
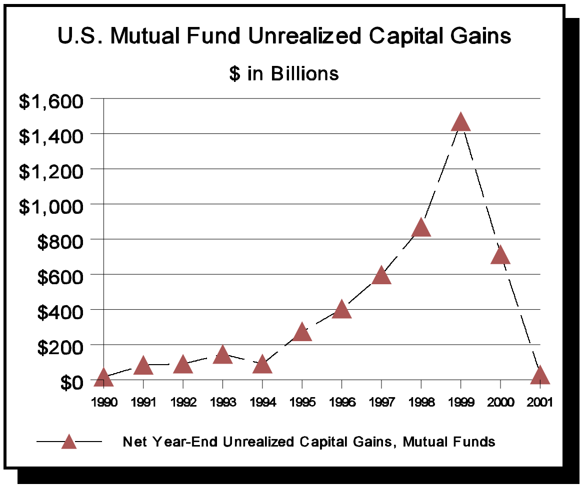



**Figure E**

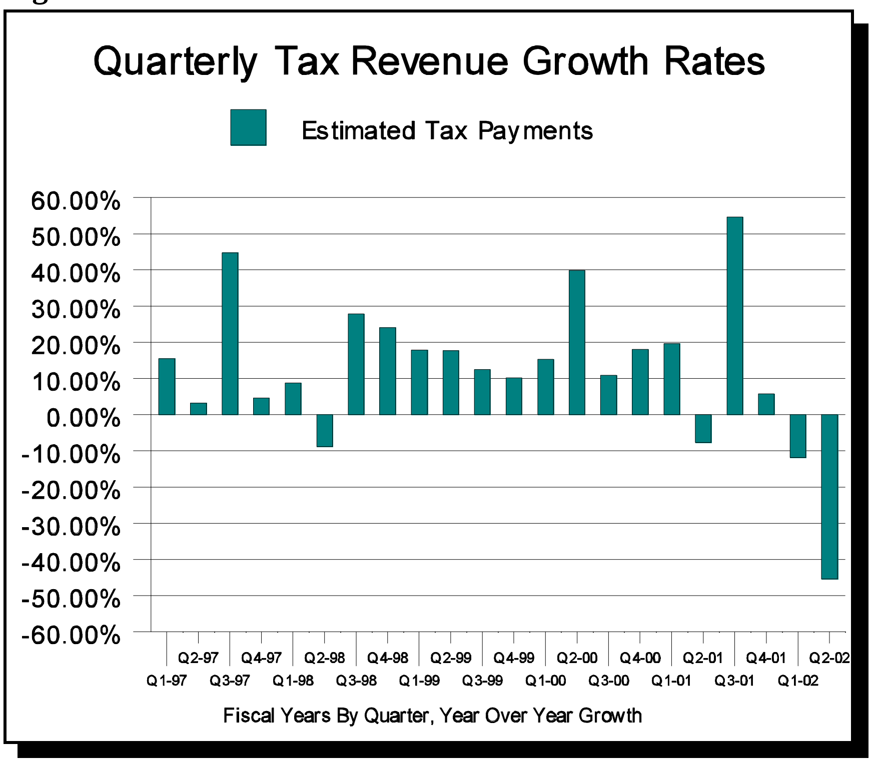



[1] Investment Company Institute, *Mutual Fund Industry Developments in 2001*, Perspective, Vol. 8, No. 1, February 2002.

## Does the State Have any Evidence of Booming and Declining Capital Gains Income?

The actual tax year 2000 and 2001 data for capital gains are not yet available. However, certain kinds of regularly reported tax data provide strong evidence of a "last hurrah" for capital gains income in tax year 2000, and a sharp decline in tax year 2001. Income taxes on non-wage income like capital gains are primarily paid each quarter through *estimated tax payments* and during the April tax filing period through *final year-end tax payments*. Figure F displays year over year growth rates for estimated tax payments by quarter. Between the 2nd quarter of FY 1998 and the 3rd quarter of FY 2001, growth in estimated tax payments exceeded 10% twelve times. Between FY 1997 and FY 2001, quarterly estimated tax payments grew by an average of 17.4% per year. Likewise, final year-end payments grew by an average of 19.4% over this same period. Estimated tax payments and final tax payments are strongly correlated, and they are the primary means by which taxes on non-wage income such as capital gains are paid.

**Figure F**




Based on national figures indicating a sharp decline in non-wage income such as capital gains from mutual funds, New Jersey non-wage income would be expected to fall significantly in tax year 2001. Such a fall should result in weakening and declining quarterly estimated tax payments and lower final year-end tax payments. Indeed, as the sharp drop in the last three quarters of Figure F shows, estimated quarterly tax payments did begin falling sharply from the prior remarkable levels of growth. The first estimated payments made for tax year 2001 occurred in the 4th quarter of FY 2001 (April and June), and these payments grew by only 4%. Moreover, the next two estimated payments in the Fall and Winter of 2001 (the beginning of FY 2002) are actually down by an average of about 28% from the same time a year ago, indicating that non-wage income has declined dramatically. Further income tax collection declines are likely when taxpayers make their final 2001 tax payments in April of 2002.

Capital Gains in Other Guises: The capital gains data do not represent the entire impact of stock-driven income growth. The increasing use of stock options as a form of employee compensation and the impact of stock values on profits from partnerships, S-corporations and other small businesses which are taxed under the gross income tax are substantial. Unfortunately, State and federal income statistics do not track income sources such as stock options. Employers withhold on income from most employment incentive stock options, but the withholding data do not distinguish between regular wage income and stock option income. Accordingly, the impact of the recent stock market boom and the subsequent stock market decline on New Jersey income tax revenue is larger than it appears when only considering income labeled as capital gains.

## New Jersey is Not Alone in Feeling the Stock Market Backlash

Other states are also seeing sharp declines in income tax revenues. The most notable is California. The California Legislative Analysts's Office (LAO) recently estimated that total FY 2001-02 California income tax revenues would decline by 19% below the previous year. According to the LAO, "Although the economic slowdown has had some adverse impact on overall wages and business profits, the main factor behind the drop in Personal Income Tax liabilities has been the plunge in stock market-related options and capital gains."[2] The LAO is estimating that capital gains and stock option income will drop by 60% in the tax year that just ended. Just as in New Jersey, California is reporting that estimated and year-end tax payments in the December through January period "plunged by over one-third." This sharp decline indicates that "tax liabilities associated with high income returns are falling by more than anticipated." The LAO also anticipates final payments in April will be much lower than previously anticipated.

[2] California Legislative Analyst's Office, *The 2002-03 Budget Bill: Perspectives and Issues*, February 20, 2002.

## The Corporation Business Tax Shortfall is Also Significant

The second most important source of the shortfall in State tax revenues in FY 2002 is the corporation business tax (CBT). The certified revenues underlying the FY 2002 Appropriations Act assumed $1.85 billion would be raised by the CBT, but the Executive's revised estimates have dropped to $1.11 billion, a $740 million reduction that accounts for about one-third of the total shortfall. The shortfall consists of two primary components: 1) continued erosion of baseline CBT collections due to declining profits and increased use of tax credits, and 2) an overestimate of new revenues from a closing of a loophole involving certain limited liability companies.

**Figure G**

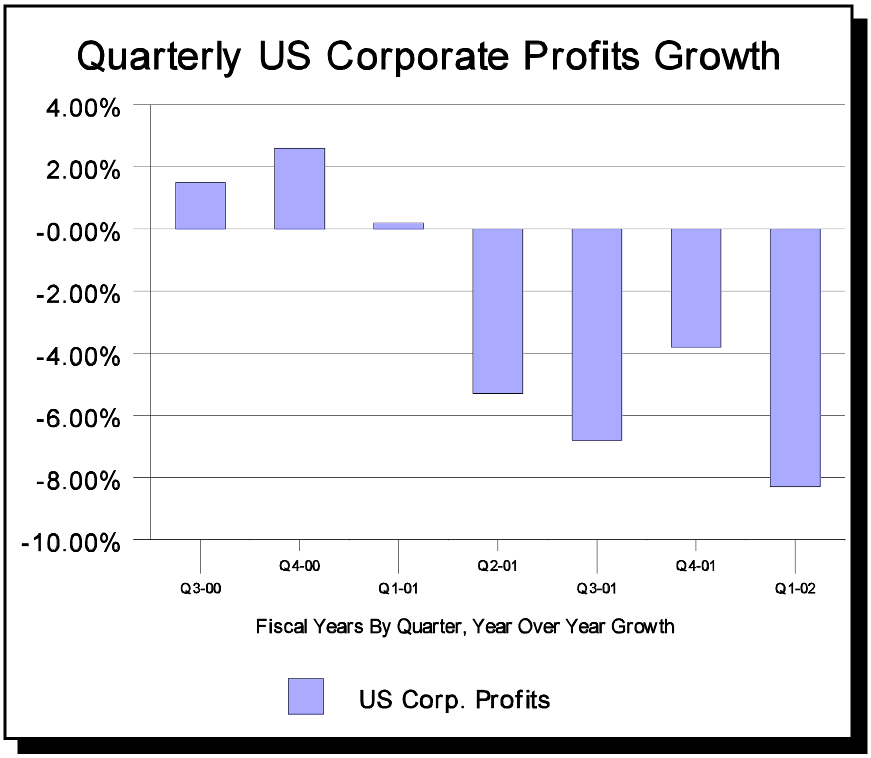



Figure G displays the year over year growth rates for quarterly US corporate profits according to the Bureau of Economic Analysis. Profits started declining in the 2nd Quarter of FY 2001 (4th Quarter of calendar year 2000) and have been falling ever since. Declining profits will invariably create downward pressure on tax liabilities. In addition, the New Jersey Department of the Treasury reports that the use of tax credits has increased from less than $2 million per year in the early 1990's to over $80 million per year by the late 1990's, further reducing tax liabilities.

The DiFrancesco Administration and the Legislature attempted to address a growing erosion of CBT tax revenue from the expanded use of limited liability companies within the structure of larger corporate entities. P.L. 2001, c.136, attempted to close certain loopholes involving limited liability companies. In February and in early June of last year the Treasury estimated this legislation would increase CBT revenues by $100 million in FY 2002. That estimate was increased to $420 million when the Governor certified revenues for the FY 2002 Appropriations Act at the end of June. The recently revised Executive estimate anticipates only a $220 million net revenue gain from this tax change, accounting for $200 million of the CBT's $740 million shortfall.

# *New Jersey Review and Economic Outlook for 2002-2003*

*State of New Jersey*
*Council of Economic Advisors*
*February 2002*

The Office of Legislative Services thanks the Council for permitting the reproduction of its annual economic report in the following appendix pages of the FY 2002-2003 Revenue Analysis.

# NJ Review & Economic Outlook for 2002-2003

**Forecast Summary: "After the damages of recession and the shocks of terrorism, there will be a modest recovery in jobs, income and investment in the 2nd half of 2002"**

***Joseph J. Seneca, Chairman***

**NJ Forecast 2002-03 ………………………..**

Although 2001 ended with fewer jobs, higher unemployment and much slower growth in retail spending compared to a year earlier, the 2001 recession appears to be mild and likely of average duration. The 2002-03 outlook for NJ is based on a flat 1st half 2002 followed by a modest paced recovery.

| Summary: New Jersey Forecast (% Chg) | 2002 | 2003 |
|---|---|---|
| Gross State Product (Current $) | 2.2% | 4.5% |
| Personal Income (Current $) | 2.0% | 4.8% |
| Retail Sales (Current $) | 1.4% | 5.1% |
| Consumer Price Index (All Urban) | 2.0% | 2.2% |
| Total Non-Ag Employment | 0.2% | 1.0% |

The forecast is for Gross State Product to advance 2.2% and 4.5% in 2002 and 03. Inflation remains stable at, or near, 2%. Personal income growth lags GSP at 2.0% in 2002, but wage gains in 2003 boost personal income by 4.8%. Retail spending adds only 1.4% in 2002, but recovers with a +5% increase in 2003.

For 2002, employment recovers slowly with a gain of fewer than 10 thousand jobs. As the recovery broadens in 2003, employment growth accelerates, led by improvements in selected growth industries (clusters), for a gain of about 40 thousand jobs. Despite those job gains, an expanding labor force holds the unemployment rate near the 5% level.

Among the US-wide factors contributing to this outlook are a continuation of low interest rates, low inflation, low energy prices, increased federal spending (security and defense), and scheduled reductions in federal tax rates.

A number of regional/local factors were factored into the New Jersey forecast. On a positive side is the absence of excesses, such as high office vacancy rates and stocks of unsold homes. The forecast anticipates a return to above average growth for the State's growth industries (clusters) led by pharmaceutical (healthcare) businesses. Also, the Outlook anticipates sectors related to safety and security to outperform the general economy.

The US capital goods sector, which accounted for much of the Nation's decline in industrial production and is underrepresented in New Jersey, should not restrain a mid-2002 recovery. We have not assumed a post-September 11th federal stimulus in this forecast. That, in addition to increased defense spending and contracting expenditures should increase the likelihood of a recovery of the State's economy in 2002-03.

The likelihood of the recovery being a modest one at best is reinforced by a much-weakened New York City economy that typically exerts a strong influx on Northern NJ businesses. Current forecasts by NYC officials anticipate an extended period weaker in the City's tourism business, financial businesses and all consumer-related sectors during this forecast period. Another weak sector is foreign trade. The strong dollar and economic weakness of our major trading partners imply that we cannot expect any significant growth in the State's $20+ billion export sector.

**The US Economy……………………………**

March 2001 marked the end of a record 10-year expansion and was the start of the 10th recession since WWII commenced. This recession was marked by sharp declines in industrial production and sales that weakened nearly all regions of the US.

Almost all factory sectors have declined, especially capital goods, technology and aircraft. Large declines in communications equipment impacted New Jersey disproportionately, but modest gains in pharmaceuticals partially offset these losses.

Despite nine months of recession, **consumer spending** actually increased throughout 2001, albeit at lower rates of growth. Low inflation, low cost financing, tax rebates, mortgage refinancing and a modestly healthy labor market combined to support consumer spending. NJ benefited from surging outlays for consumer durables (autos), spurred by zero or low cost dealer financing. Expenditures for energy and utilities declined as lower fuel prices and moderate weather combined to ease expenditures. Later in 2001 spending fell sharply on transportation and recreation.

**Residential real estate** displayed little change in 2001 from very high levels of sales and home starts, as declining mortgage rates made homes more affordable. The **commercial real estate** sector weakened during the year following the demise of start-up dot.coms, downsizing at manufacturers and capital goods producers. Increasing vacancy rates and softening rental rates were typical in most regions.

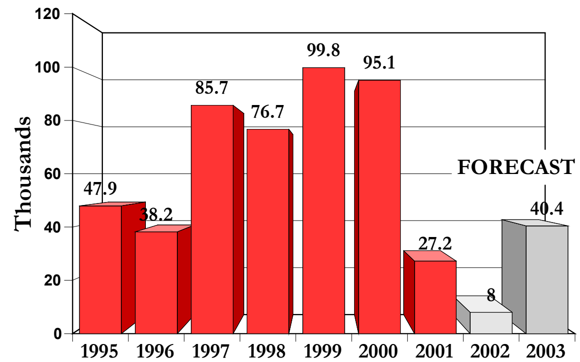
**Labor markets** continued to ease during the year with the 4th quarter US unemployment rate at 5.6%, up from 4.0% one year ago. Most job losses were in manufacturing and transportation. Services recorded a small decline led by losses in temporary help services.

**Other States.** The 2001 recession is a broad-based national recession that has impacted each region and most states. Employment declined on a month-to-month basis in all regions and jobless rates are rising. States with the largest number of lost jobs in 2001 were geographically diverse - led by Georgia, New York and Indiana. Many states found hospitality and tourism sectors suffered badly from the slowing economy and the impact on air travel from the terrorist attacks.

## N.J. Employment……………………………..……

Despite the onset of recession, NJ employment for 2001 was 27,200 above the 12-month average for 2000. This resulted from strong year-over-year growth in early 2001. From February through December, New Jersey lost 17,200 jobs. Averaging almost 100 thousand net new jobs in 1999 and 2000, the 01 job market was the weakest since 1992.

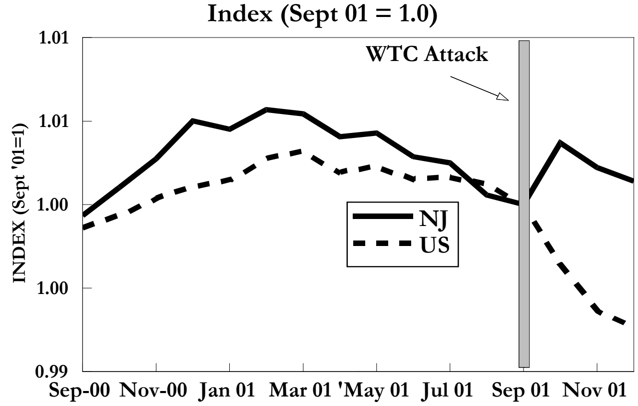
**NJ Nonag Employment, Annual Change**



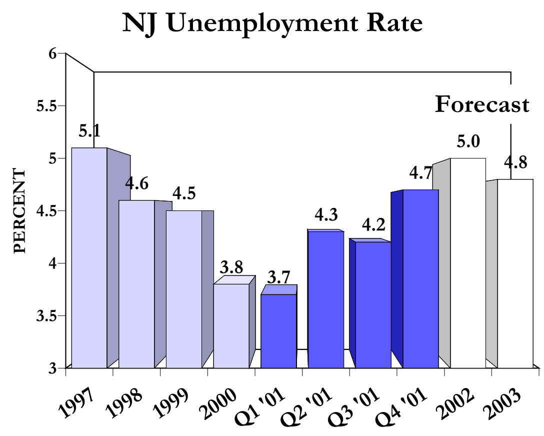

**By the end of 2001,** the State's labor market reflected the aftereffects of the national recession and mixed impacts from the WTC attack. On a monthly basis, jobs peaked in February at 4,033,800 and then paralleled national declines in employment. After the September 11th terrorist attacks, the State added jobs in October as displaced NYC businesses scrambled to locate temporary or new permanent operations in NJ. By December, several large financial/brokerage companies moved employees back to Manhattan, leaving NJ with a net gain of about 9,000 financial jobs since the September WTC attacks.

From February to December the effect of relocating employers left NJ with a net decline of 17,200, a considerably smaller loss than what would have occurred if not for the temporary relocation of NYC jobs.

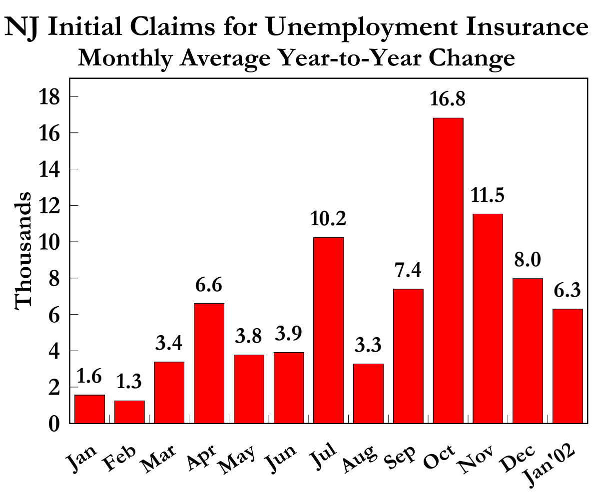
**Nonag Employment, NJ & US**
**Index (Sept 01 = 1.0)**




The NJ unemployment rate climbed during 2001, rising to an average rate of 4.7% in the 4th quarter reflecting weakened labor market conditions and significant air transportation sector layoffs. Despite the combination of a weak US economy and significant regional disruptions, the NJ rate remained well below the US rate of 5.6% for the fourth quarter. The NJ unemployment rate has been at or below the national average since January 2000.



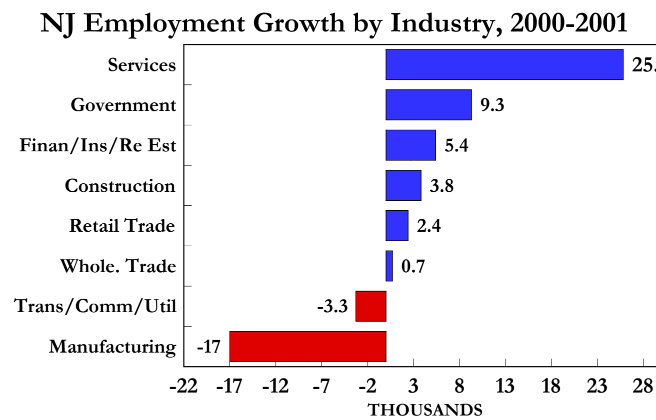

Initial claims for unemployment insurance, a leading indicator of job layoffs, began to increase in March 2001. Claims peaked in October following the WTC attacks and have since trended downward suggesting that the deterioration in NJ labor markets may be abating.




Looking forward, NJ employment is expected to stabilize in the 1st half of 2002, with annual average employment to remain slightly above the 2001 level. Although the forecast for 2003 is for a continuing modest job recovery of about 1%, the unemployment rate will continue to rise for some time. The unemployment rate should average 5% in 2002, and decline slowly to 4.8% in 2003.

**Employment By Industry ..................**

Employment change for 2001 was the net result of two distinctly different labor markets in NJ. The State's job losses were almost entirely in the manufacturing sector. Factory jobs fell by 17 thousand, or -3.7%, compared to average levels in 2000. Services, on the other hand, continued the long-term growth trend, with a gain of 25,800 over the year. Again, these changes are based on yearly averages. From February to December, service employment added only 6,700 jobs, or .5%.




While employment in most non-manufacturing sectors was growing in early 2001, the national and State economic slowdown spread to most industry sectors. By year-end, only three industry sectors; government, finance, and services, saw job gains from the February 2001 employment peak to December.

The finance/insurance/real estate industry job gain was related to the relocation of NYC financial firms mentioned earlier in this report. Government gains were attributable to increased hiring for local education and the temporary relocation of over 2,000 Port Authority of NY-NJ employees from NYC to NJ following September 11th.

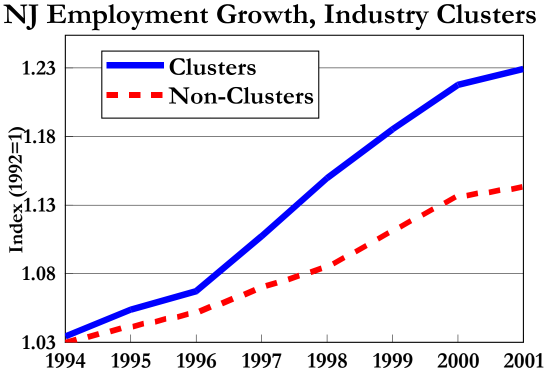
**Industry Clusters…**

New Jersey's employment growth during the 1990's was concentrated in six well-defined business clusters of economic activity - 1. information technology (IT), 2. research & technology services, 3. pharmaceuticals, 4. finance, 5. logistics, and 6. casino & entertainment.

Each cluster includes groups of interrelated industries that are characterized by competitiveness and innovation. These clusters were defined to identify producers of high value products and services that support high wage jobs. Therefore, NJ cluster industries are key to the State's outlook and overall economic health.

**NJ growth clusters**, which accounted for a disproportionate share of NJ job growth over the economic expansion of the 1990's, continued to lead even as overall growth slowed in 2001. Only 30% of the State's payroll jobs are in the six clusters, but they accounted for nearly 40% of total job growth this year. The "clusters" growth rate was about 1.0% year over year, versus non-cluster growth of 0.6%.

**NJ Employment Growth, Industry Clusters**




The gains were led by finance/insurance (2.8%) and research & technology services (1.8%).

**NJ Employment Growth by Industry Cluster, 2000-2001**

| | Number (000) | Percent |
|---|---|---|
| Finance Cluster | 5.0 | 2.8% |
| Research & Tech. Cluster | 2.6 | 1.8% |
| Pharma/BioTech Cluster | 1.2 | 1.1% |
| Casino/Entertainment Cluster | 1.2 | 1.0% |
| Logistics Cluster | 2.0 | 0.5% |
| Information Tech. Cluster | -1.7 | -0.8% |
| Cluster Total | 10.3 | 1.0% |
| Total Non-Clusters | 17.0 | 0.6% |

**The Outlook by cluster -**

**Finance -** It is too soon to assess the long-term impact of recent moves from NYC, but the weak equity markets in 2001 will continue to depress personal income gains and employment in this sector. Longer term, financial services should remain among the State's fastest growing and highest paying sectors.

**Research & technology services** cluster**,** which includes service industries such as, engineering, accounting, and testing laboratories, serves a broad national and international market and has experienced little negative impact by aggregate economic conditions and the WTC attack.

**Pharmaceuticals'** output and employment, which does not closely follow the economy's cyclical patterns, should maintain its current levels of strength for New Jersey. In addition, industry demand will continue to increase due to the demographics of an aging population. Also, the aftereffects of 9/11 has led to increased demand for vaccines and other medical products to combat the threat of bio-terrorism.

**Casino & entertainment -** Atlantic City casinos attracted fewer visitors in the period immediately after 9/11, but preliminary data for December showed a dramatic 18% increase in revenues over December 2000. The amusement sector also showed strong job growth during the summer 2001 season.

**Logistics** includes the movement and distribution of goods and passengers in the State. Air transportation declined after 9/11 as the number of flights were curtailed. The volume of goods moved will adjust to slowing overall economic conditions. However, the employment in the logistics sector has remained fairly steady in the face of the recent slowdown.

The **information technology** cluster experienced declines in 2001 stemming from the national reduction in technology capital spending. The long term restructuring in telecommunications has also cost jobs nationwide, and especially in NJ.

**Personal Income & Retail Spending**…….……

NJ personal income advanced by an estimated 5.2% in 2001, slightly ahead of the 5% US average. Wages & salaries, the largest component of income jumped by almost 6%, reflecting tight labor market conditions that existed early in the year. Overall personal income growth was restrained by slower growth in investment incomes and small business incomes (proprietor's income).

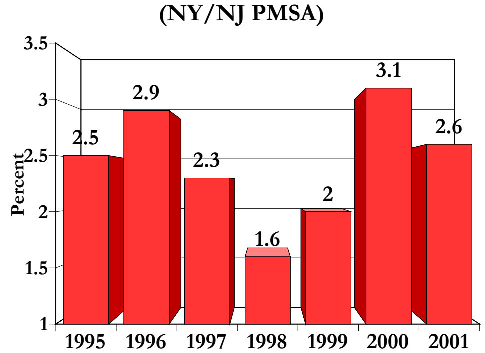
For 2002, personal income grows about 2%, constrained by sluggish job growth, lower bonuses in the finance sector, and only modest wage increases elsewhere.

For 2001, retail sales were rocked by a slowing economy, a drop in home building, the WTC attacks, and a late season drop in tourism, but were then helped by year-end sales promotions for autos. Overall sales likely increased 4 to 6% last year. The forecast for only a modest recovery and an uncertain outlook for tourism and gaming dampens the retail recovery and limits gains to 1 to 2% in 2002, but increasing to 5% in 2003.

**Consumer Prices**…………………………

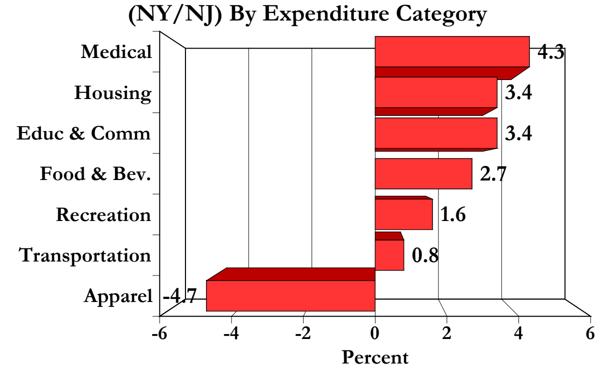
Regional prices were rising steadily through 2000 when energy costs pushed the NY/NJ CPI to a 3.1% annual increase, the sharpest rise since 1992. A slowing economy and sharp energy disinflation in 2001 held the rise in consumer prices to 2.6%, providing an unexpected boost to consumer's real income.

**Consumer Price Index, Annual Rate**
**(NY/NJ PMSA)**




Contributing factors to moderating inflation were the drop in oil from over $30 per barrel a year ago to under $20 currently, the strong US dollar combined with excess global capacity that pushed down import prices for many consumer and producer products, and retailers who engaged in heavy price discounting and cut-rate financing to draw consumers into stores through the end of 2001.

**Consumer Price Index, Annual Rate**
**(NY/NJ) By Expenditure Category**

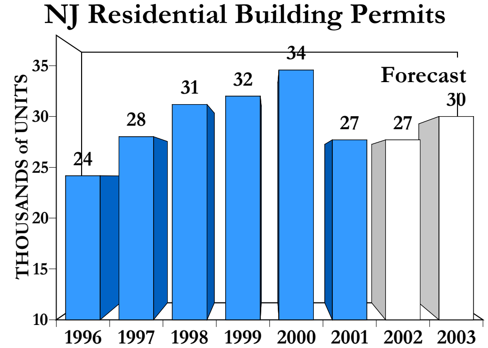



Despite the onset of recession, the cost of medical care, housing, and education/communication posted above average increases of 4.3% and 3.4%, and 3.4%, respectively. Food items rose 2.7%, while prices for recreation 1.6%, and transportation .8%, had below average increases. Prices for apparel in the region declined almost 5%.

**Investing in New Jersey** …………………..

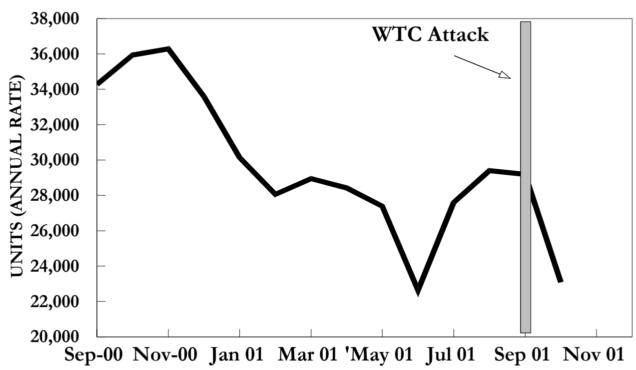
Residential building permits declined by an estimated 20% in 2001, returning to the mid-20 thousand range after three years of permits in excess of 30,000 and the decade high 34,000 new dwelling units authorized in 2000.

**NJ Residential Building Permits**




The decrease in NJ residential permits was related to the economic slowdown exacerbated by the WTC attack, which affected jobs, incomes and consumer confidence. Home prices, however, remained firm with a year over year average gain of 10%.

**NJ Residential Permits**
**Seasonally Adjusted, Annual Rate**

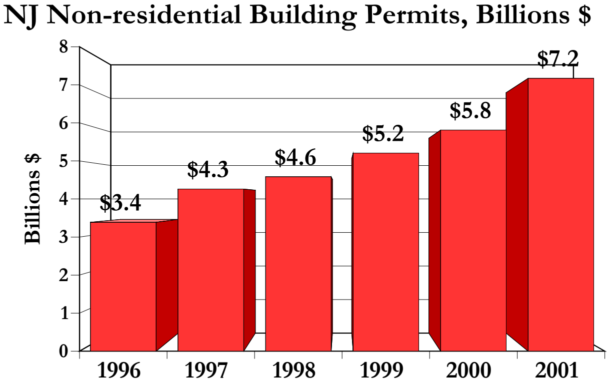



The outlook calls for housing permits to stabilize during the year at an annual rate close to the 2001 level of 27,700 units.

Although new home construction in NJ will be restrained by the scarcity and cost of buildable land, the State's demographics - including relatively low rates of new household formation and uncertain rates of future in-migration, lead to a recovery in 2003, boosting housing permits to 30,000 units.

**Total nonresidential building permits** are estimated to exceed $7 billion in 2001, an increase of over 20% from 2000. Office buildings, the largest construction subcategory, accounted for 42% of non-residential permits. Planned office space for 20 million sq. feet, if completed, would add almost 10% to the total inventory of NJ office space. Nearly 60% of all planned new office space is in four counties; Somerset, Middlesex, Monmouth, and Hudson (with Jersey City accounting for more than 25% of the State total).

**NJ Non-residential Building Permits, Billions $**




Increased office construction that coincided with a slowing demand for office space pushed vacancy rates to the 12-13% range by the 3rd quarter of 2001. The upward trend in vacancy rates is expected to put downward pressure on asking rents, and possibly delay or cancel some planned construction.

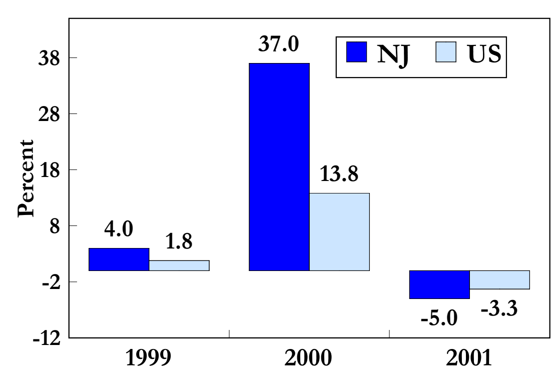
Commercial and retail construction permits increased about 15% in 2001. Over one-half of the planned new space is in four NJ counties; Monmouth, Morris, Middlesex, and Union.

In 2001, construction of educational facilities was only 13% of total non-residential permits. For 2002 and 03 spending for the multi-billion dollar public school reconstruction and construction program will accelerate and contribute to the State's economic recovery.

## International Trade ..............................

Since international trade reflects market conditions in both trading partners, a deteriorating economic environment spreads quickly. For 2001, US exports fell 3.3% while New Jersey shipments declined by 5%. The declines followed a year (2000) in which US exports rose 13% and NJ shipments grew by a remarkable 37%.

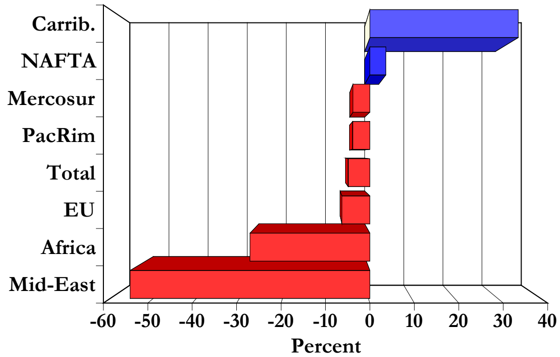
**Annual Growth in Exports- NJ & US, 1999-2001**




Exporting offered little help to New Jersey manufacturers facing weak domestic markets in 2001. The decline in overseas trade was broad-based including: technology products (computer & electronic goods -15%), transportation equipment -27%, capital goods (machinery -6%, fabricated metals -26%) and consumer products (beverages -46%, apparel -23%, furniture -5%). Exports improved for food, +21%, printing & publishing, +19%, and second-hand goods, +69%.

Geographically, NJ exports increased to the Caribbean, (+33%) and to NAFTA (+4%), led by a strong 12% increase in sales to Mexico.

**NJ Exports by Region, Percent Change 2000-01**

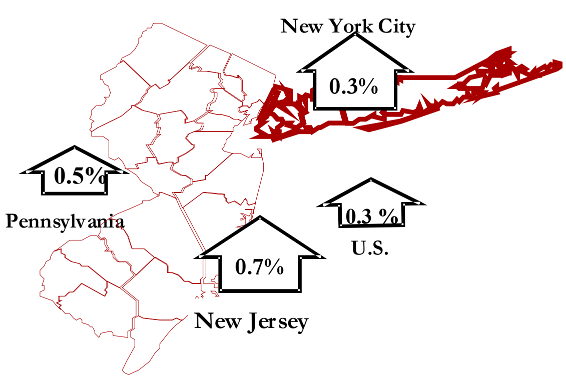



Exports declined on a year over year basis to the European Union (-6%), PacRim (-4%, with significant declines in shipments to China and Singapore), and the Mid-East (-54%). Sharply lower sales to Israel and Saudia Arabia headed the Mid-East's drop in NJ exports.

## The Region ......................................

New Jersey fared slightly better than the nation and our regional neighbors in 2001. On an annual average basis, NJ employment growth of 0.7% was above the US average of 0.3%, Pennsylvania's 0.5%, and New York State's 0.6% rate.

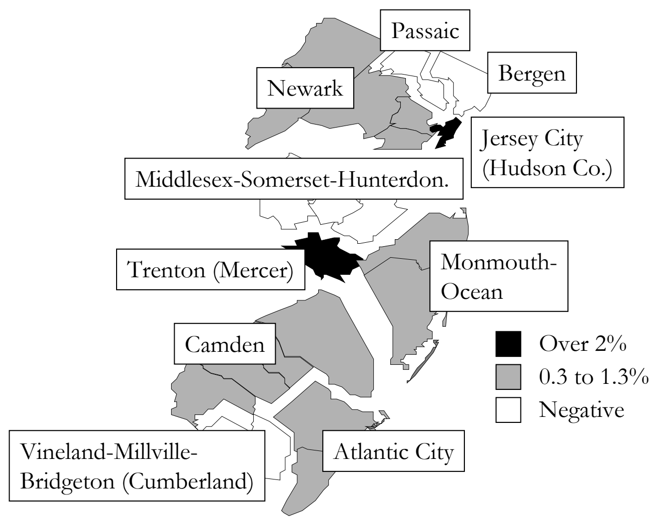
**Non-Ag Employment, Percent Change 2000-01**




New York City's labor market, which had been a driving engine for NJ, lost almost 100,000 jobs from December 00 to December 2001. Financial services, tourism and consumer industries were particularly hard hit.

## NJ Labor Markets .............................

The **Trenton** (Mercer County) and **Jersey City** (Hudson County) labor market areas experienced the highest employment growth rates in 2001, 2.6% and 2.7%. The Trenton/Mercer area growth can be largely attributed to the staffing of the new Merrill Lynch facility. Meanwhile, Jersey City continued to be the favored destination of New York City financial firms moving or expanding.




The five-county **Newark** labor area added the most jobs, 8,100 over the year, a rate of 0.8%, slightly above the Statewide average of 0.7%.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# New Jersey Review & Economic Outlook: 2002 - 2003

| *(Current $ or Nos.)* | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | Forecast **2002** | **2003** |
|---|---|---|---|---|---|---|---|---|
| Gross State Product (bill) | $279.2 | $294.1 | $319.2 | $335.5 | $355.6 | $372.7 | $ 380.9 | 398.2 |
| Personal Income (bill) | $247.4 | $260.7 | $278.3 | $291.5 | $311.2 | $327.5 | $ 334.0 | 350.2 |
| Retail Sales (bill) | $76.2 | $81.9 | $86.0 | $94.0 | $101.9 | $106.0 | $ 107.5 | 113.0 |
| New Vehicle Registrations (000's) | 533.1 | 537.6 | 550.6 | 582.5 | 663.5 | 641.9 | 599.3 | 600.0 |
| Non-Resident.Contracts (mill $) | $2,962 | $3,618 | $4,098 | $4,670 | $5,230 | $5,162 | $ 4,650 | 4883.0 |
| Residential Building Permits (No.) | 24,200 | 28,020 | 31,200 | 32,000 | 34,584 | 27,700 | 27,700 | 30,000 |
| Consumer Price Index (All Urban) | 111.3 | 113.9 | 115.7 | 117.9 | 121.6 | 124.7 | 127.2 | 130.0 |
| *(Real 1992$)* | | | | | | | | |
| Gross State Product (bill) | $250.9 | $258.2 | $275.9 | $284.5 | $292.4 | $298.8 | $299.5 | $306.3 |
| Personal Income (bill) | $222.3 | $228.9 | $240.5 | $247.2 | $255.9 | $262.6 | $262.6 | $269.4 |
| Retail Sales (bill) | $68.5 | $71.9 | $74.3 | $79.7 | $83.8 | $85.0 | $84.5 | $86.9 |
| Non-Resident.Contracts (mill) | $2,660.9 | $3,176.5 | $3,541.9 | $3,961.0 | $4,301.0 | $4,138.7 | $3,655.8 | $3,756.4 |
| Employment: | | | | | | | | |
| Total Non-Farm (000) | 3,638.90 | 3,724.60 | 3,800.80 | 3,866.1 | 3,996.2 | 4,023.4 | 4,031.4 | 4071.8 |
| Manufacturing (000) | 483.5 | 481.9 | 478.0 | 466.5 | 462.4 | 445.4 | 429.8 | 416.9 |
| Service Producing Industries (000) | 2,458.80 | 2,539.8 | 2,615.5 | 2,688.7 | 2,786.6 | 2,818.0 | 2,833.2 | 2878.0 |
| Government | 570.6 | 570.3 | 571.7 | 577.6 | 588.8 | 598.1 | 604.08 | 607.1 |
| Unemployment Rate (%) | 6.2% | 5.1% | 4.6% | 4.6% | 3.8% | 4.2% | 5.0% | 4.8% |

| **Percent Change from previous year:** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **Forecast 2002** | **2003** |
|---|---|---|---|---|---|---|---|---|
| Gross State Product (Current $, bill) | 3.9% | 5.4% | 8.5% | 5.1% | 6.0% | 4.8% | 2.2% | 4.5% |
| Personal Income (Current $, bill) | 4.9% | 5.3% | 6.8% | 4.7% | 6.8% | 5.2% | 2.0% | 4.8% |
| Retail Sales (Current $, bill) | 3.7% | 7.5% | 5.0% | 9.3% | 8.4% | 4.0% | 1.4% | 5.1% |
| New Vehicle Registrations | 4.8% | 0.8% | 2.4% | 5.8% | 13.9% | -3.3% | -6.6% | 0.1% |
| Non-Resident Contracts (Current $, r | 6.9% | 21.4% | 13.3% | 14.0% | 12.0% | -1.3% | -9.9% | 5.0% |
| Residential Building Permits (No.) | 12.6% | 15.9% | 11.3% | 2.6% | 8.1% | -19.9% | 0.0% | 8.3% |
| Consumer Price Index (All Urban) | 2.9% | 2.4% | 1.6% | 1.9% | 3.1% | 2.6% | 2.0% | 2.2% |
| Gross State Product (92$, bill) | 1.9% | 3.2% | 6.9% | 3.1% | 2.8% | 2.2% | 0.2% | 2.3% |
| Personal Income (92$, bill) | 1.8% | 3.4% | 5.1% | 2.8% | 3.5% | 2.6% | 0.0% | 2.6% |
| Retail Sales (92$, bill) | 0.8% | 5.1% | 3.4% | 7.3% | 5.1% | 1.4% | -0.6% | 2.9% |
| Non-Resident Contracts (92$, mill) | 3.9% | 18.6% | 11.5% | 11.8% | 8.6% | -3.8% | -11.7% | 2.8% |
| Employment: | | | | | | | | |
| Total Non-Farm (000) | 1.1% | 2.4% | 2.0% | 1.7% | 3.4% | 0.7% | 0.2% | 1.0% |
| Manufacturing (000) | -2.8% | -0.7% | -0.8% | -2.4% | -0.9% | -3.7% | -3.5% | -3.0% |
| Service Producing Industries (000) | 2.1% | 3.3% | 3.0% | 2.8% | 3.6% | 1.1% | 0.5% | 1.6% |
| Government | -0.5% | -0.1% | 0.2% | 1.0% | 1.9% | 1.6% | 1.0% | 0.5% |

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## OFFICE OF LEGISLATIVE SERVICES

The Office of Legislative Services provides nonpartisan assistance to the State Legislature in the areas of legal, fiscal, research, bill drafting, committee staffing and administrative services. It operates under the jurisdiction of the Legislative Services Commission, a bipartisan body consisting of eight members of each House. The Executive Director supervises and directs the Office of Legislative Services.

The Legislative Budget and Finance Officer is the chief fiscal officer for the Legislature. The Legislative Budget and Finance Officer collects and presents fiscal information for the Legislature; serves as Secretary to the Joint Budget Oversight Committee; attends upon the Appropriations Committees during review of the Governor's Budget recommendations; reports on such matters as the committees or Legislature may direct; administers the fiscal note process and has statutory responsibilities for the review of appropriations transfers and other State fiscal transactions.

The Office of Legislative Services Central Staff provides a variety of legal, fiscal, research and administrative services to individual legislators, legislative officers, legislative committees and commissions, and partisan staff. The central staff is organized under the Central Staff Management Unit into ten subject area sections. Each section, under a section chief, includes legal, fiscal, and research staff for the standing reference committees of the Legislature and, upon request, to special commissions created by the Legislature. The central staff assists the Legislative Budget and Finance Officer in providing services to the Appropriations Committees during the budget review process.

Individuals wishing information and committee schedules on the FY 2003 budget are encouraged to contact:


Legislative Budget and Finance Office
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