Remarks of David J. Rosen
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While each new budget year offers a unique set of problems and possibilities, some of the landscape's features are familiar. The Fiscal Year 2008 budget will once again challenge the members of this committee and the Legislature to provide important public services in the face of tight resource constraints and a lingering structural deficit. Today, I will offer a brief overview of the Governor's budget proposal and provide an initial review of the State's revenue outlook.

The Governor has proposed a spending plan of $47.8 billion for FY 2008, comprising $33.3 billion in on-budget appropriations and another $14.5 billion in authorizations for off-budget spending. The proposal increases on-budget appropriations by $2.2 billion (7.1%).

The policy centerpiece of this budget is the enhanced homestead property tax relief program, which will increase spending for direct payments to homeowners and tenants by $1.2 billion.

Other notable increases include:
$580 million for State Aid for local school districts,
$300 million for employee salaries and health benefits,
$221 million for Medicaid (General Assistance Health Care), and

$40 million for child welfare reforms.

The details of these and other budget features are currently being studied by the OLS budget staff and will be reflected in the department-by-department analyses that you will receive.

The Governor warned that while this budget might be boring, the State's fiscal problems have not been resolved. He is correct - - at least with respect to the fiscal problems. The FY 2008 budget is supported by some growth in revenues, but also by a significant draw-down of surplus funds. The fiscal year is projected to open with a balance of $1.9 billion and close with only $600 million. This leaves a $1.3 billion resource hole to be filled in FY2009. In addition this budget proposes to meet only one-half of the State's annual responsibility for public employee pensions - a decision that saves over $1 billion this year, but increases the unfunded liability going forward.

The Governor's budget projects a FY 2009 structural deficit of $2.5 billion, and that is a plausible estimate.

REVENUES

I would now like to discuss the State revenue outlook for FY 2007 and FY 2008. OLS comes before you each year at the beginning and the end of the budget hearing process to present its view of revenues available to support the budget proposal. Late last week you received the *OLS Revenue Outlook* booklet containing our revenue forecast and other related information. The forecast in the *Outlook* matches the forecast that we presented to your Assembly counterparts two weeks ago, except with respect to the fiscal impact of one of the Governor's proposed initiatives. I will discuss that shortly.

We have identified six revenues for which we differ with the Executive forecast. The issues between us are not about projecting economic activity or forecasting growth, but rather how to interpret the current cash collection patterns. From our perspective, each of these six revenues is underperforming expectations in the current fiscal year and, absent special circumstances, underperformance in the current year translates into lowered expectations for the next.

Overall, the OLS is projecting revenues $625 million below the Executive's estimates for the two fiscal years combined. These initial OLS estimates are $299 million below the Executive in FY 2007 and $326 million below the Executive in FY 2008. The differences, which are summarized in figures on pages 4 and 5 of the *Outlook*, are in the income tax, sales tax, insurance premiums tax, realty transfer fee, corporation tax on banks and financial institutions, and the cigarette tax. For all the other revenue sources, we are concurring with the Executive estimate at this time.

- The primary difference is in the **gross income tax (GIT)**. The OLS projects FY 2007 GIT revenues will be $205 million below the Executive's level and that FY 2008 GIT revenues will be $227 million below. The reasons for this difference will be explained shortly.

- OLS projects the **sales tax** will be $50 million lower in FY 2007 and $55 million lower in FY 2008 than the Executive estimates. Reflecting the rate and base changes enacted last July, the Executive expects growth by the end of FY 2007 to reach 24.5%, but growth through the end of February is only 20.5%. To achieve the Executive's target will require growth of nearly 30% for the last five months of the fiscal year. February's growth was encouraging, but each prior month this fiscal year underperformed expectations. Accordingly, the OLS is taking a slightly more cautious view and estimating $50 million less in FY 2007. The OLS accepts the Executive's growth estimates for FY 2008, but the lower FY 2007 base rolls over into the lower total for FY 2008.

- OLS projects that the **insurance premiums tax** will be $18 million lower in each fiscal year than the Executive estimate. This tax is paid primarily in two payments, one on March 1 and the second on June 1. Collections from the first payment are almost complete, but running about 10% below last year's pace. The Executive assumes only a 5% decline. Based on current collections, we anticipate continued weakness in June, and that shortfall will roll over into next year.
- Compared to the Executive, OLS estimates that the **realty transfer fee** will generate $11 million less in FY 2007 and $10 million less in FY 2008, also based on current FY 2007 growth trends. This has not been a good period for home sales.

- Based on weaker year-to-date cash collections in FY 2007, OLS projects that the **corporation tax on banks and financial institutions** will bring in $10 million less in each fiscal year than does the Executive.

- The **cigarette tax** has been performing at levels consistent with the projections made last summer. The Executive increased their forecast by $ 5 million last month, but based on current patterns we are inclined to stay with the earlier figure. The OLS estimates $6 million less in FY 2008, due to the lower FY 2007 base.

GROSS INCOME TAX

The GIT accounts for $432 million of the estimated $625 million two-year revenue difference. The GIT is the State budget's largest single tax, generating nearly 37% of total revenues. It has also become an increasingly volatile revenue source as the dependence on high-income filers has increased. The top 1% of filers, those making over $500,000, pay 40% of the GIT – with those making over $100,000 paying over 80%. These high-income taxpayers get substantial income from volatile, non-wage sources such as capital gains, business income and partnerships.

High income individuals pay much of their income tax liabilities through quarterly estimated payments and through the final tax payments in April. These final payments will total about $2 billion this spring. To put that in perspective – if GIT final payments were a distinct tax, it would be our fourth largest revenue, just behind the corporation business tax. That this large sum comes in so late in the fiscal year and is subject to substantial fluctuations, makes it the revenue forecasting – and budget-building – wild card nearly every year.

The key to the difference between the Executive and OLS estimates for the GIT is a different view of this year's April/May final tax payments. In Figure C, you can see that the Executive is estimating $2.133 billion, while the OLS is estimating $1.977 billion, a $156 million difference. The Executive's forecast assumes growth of 17.6% from last spring while the OLS is estimating 9.0% growth. The graph also shows a third scenario in which final payments reach only $1.722 billion, or a 5% decline.

Why such divergent forecasts? There is a reason forecasters speak of the "April Surprise". Unlike withholding from wages which comes in weekly or biweekly and usually provides useful trends to track and analyze, the final payments effectively come in all at one time. And as Figure D shows the final payments can swing wildly from year-to-year, so we have to consult other data to forecast this revenue. Historically the best indicator has been the quarterly estimated payments – and particularly the fourth estimated payment that is received in December and January.

Those estimated payments averaged 9% for the first three quarters of tax year 2006 and slipped to only 5% growth during the last payment in January (about $1.05 billion total). Historically, a soft January estimated payment has signaled soft growth in final payments.

In discussions with the Treasurer's staff, they offered an intriguing explanation for the unexpectedly weak estimated payments. The Executive's forecast assumes that the estimated payments, and particularly the fourth payment, were depressed artificially because taxpayers had an unusually high level of credits from the prior year that were applied against these liabilities. Their estimate for final payments is not implausible, but requires that April and May final payments double the December and January estimated payments. The only time in the last decade that spring final payments doubled the winter estimated payment was in FY 2005 – an atypical year in which the implementation of a new tax bracket on high income taxpayers disrupted the normal pattern of payments.

An alternative forecasting approach would assume that the correlation between December/January estimated payments and April/May final payments returns to the historic pattern seen prior to FY 2005. Such a calculation suggests that final payments would decline by 5%, yielding only $1.722 billion - - $255 million below the OLS target. I should note that our nonpartisan counterparts in California have made such a dire prediction for their State's final payments this year.

Revenue forecasting is at least as much art as it is science, and we need to test the numbers that come out of our calculations against the economic world as we understand it. In this case we do not see an underlying economic explanation for the dip in final payments that is suggested by the purely mathematical application of historic ratios. Instead our forecast assumes that the mathematical relationship between estimated payments and final payments will be similar to last year, yielding 9.0% growth to $1.977 billion in revenue.

Turning to FY 2008, the OLS and the Executive agree on a modest growth rate for the GIT. Most of the difference in the FY 2008 GIT forecasts is a function of the OLS's lower base for FY 2007. However, the Governor's budget assumes that the proposed expansion of the earned income tax credit program will cost $64 million in FY 2008 – an amount that shows up as a reduction in the income tax revenue rather than as a spending item in the budget. OLS has completed an analysis of the data from the program and we believe that the incremental cost of the expansion will be only $36 million in FY 2008. This difference makes our forecast today $28 million less gloomy than it was two weeks ago.

Even with this adjustment, we recognize that our forecast injects unwelcome uncertainty into the efforts to craft the FY2008 budget. Unfortunately, greater uncertainty is a function of the increased reliance on volatile revenue sources. As with the prediction of the path of a hurricane when it is still hundreds of miles off the coast, there is little precision in projecting where the volatile April/May final payments will land. The only certainty comes at landfall. At this point we are posting the watch flags and hoping that they prove unnecessary.

In the last decade we have had both good and bad April surprises. For a revenue estimator errors in either direction are both inevitable, and discouraging. As someone who assists you in the process of crafting the budget, I much prefer positive surprises.

We look forward to working with you during the hearing process. We will be back in May to help you reassess the revenue situation.