Remarks of David J. Rosen
Legislative Budget and Finance Officer
To the Senate Budget and Appropriations Committee
March 28, 2011

As you begin your consideration of the Fiscal Year 2012 Budget, we come before you to offer an update on the current year's budget situation, an overview of the Governor's Budget Recommendation and a discussion of the revenue estimates.

While the economic recovery has been slow and unemployment remains very high, it appears that the nation and the State are being spared the revenue shocks which marked the past several years. As a result, the FY 2011 budget, unlike its recent predecessors, has not required mid-year emergency surgery.

In terms of resources, we are doing somewhat better than was projected back in June. The closing balance for the last fiscal year (which produces the opening balance for this year) was $299 million higher than had been projected by Treasury. In addition, the Executive now estimates revenue collections for this year will beat the June forecast by $100 million.

On the spending side, the Governor's Budget Message projects lapses of $605 million and identifies $452 million of anticipated supplemental spending, for a net reduction in projected spending of $153 million.

The combined effect of these estimates – higher opening balance, more revenue and less spending - would grow the FY 2011 anticipated balance from $303 million to $855 million.

Against the projected surplus, the Governor has made a conditional recommendation for a $506 million payment toward the State’s pension obligation.

If made in FY 2011, this payment would reduce the FY 2011 balance to $349 million.

Over the next six weeks the OLS budget analysts will provide you with a detailed discussion of the large and small changes proposed for each department. Today I want to paint with a broad brush.

The FY 2012 budget, as detailed in the Governor’s Budget Message, closely resembles its predecessor.

Between FY 2011 and FY 2012, the spending of State funds would increase from $28.4 billion (or $28.9 billion if the pension payments are made in FY 2011) to $29.4 billion. The increase is possible because of projected growth in State revenue collections (about $1.1 billion) and would more than offset the loss of $824 million in non-recurring enhanced Medicaid reimbursement. (The Executive’s revenue estimate would be more than $100 million greater for FY 2012, except for the tax policy changes proposed in the budget message.)

Among the more significant features of the budget recommendation are the following:

- In the Departments of Human Services and Health and Senior Services, a number of far-reaching – and as yet not well understood – initiatives have been proposed to offset some of the non-recurring Federal money and to cover projected growth in other costs.

- In the Department of Education, a $250 million increase in formula aid to school districts (a restoration of 20% of last year's aid reduction) is more than paid for from debt refinancing savings and a fortuitous technical windfall from the operation of the formula.

- Anticipated increases in State spending for contractual State worker salary adjustments and the State-paid portion of medical costs are more than offset by the $321 million savings assumed in the budget from the Governor's proposal to reform public sector health benefits.

- Homestead benefit spending is up $180 million, restoring a portion of last year's $842 million reduction.

No doubt, these and other proposals will be the focus of committee discussion as you work through the upcoming departmental budget hearings. Now I want to turn to a discussion of revenues.

Earlier this month, a study of State revenue forecasting was released by the Pew Center on the States and the Rockefeller Institute of Government. Among the study's findings were the following:

Between 1987 and 2009, the nation-wide median forecasting error was 3.5%.

In good years, forecasts tend to underestimate revenues and in bad year forecasts tend to overestimate revenues - - - and the largest errors tend to occur on the downside.

Over time, error has been increasing as states depend more on the most volatile revenue sources.

During the 1990–92 recession, one quarter of all state forecasts missed by at least 5 percent. During the 2001–03 downturn, nearly half of all state forecasts were off by that amount. And in 2009 nearly three quarters of all forecasts overestimated revenues by 5 percent or more... In that year, the median error among states was an overestimate of 10.2 percent.

As we have noted in the past, the most difficult revenue forecasting situation is when economic conditions change. As one of my counterparts in Texas noted: “It’s the turns that kill you.”

The experience in New Jersey mirrored the national pattern. In FY 2009 State revenues declined by 11.2% and in FY 2010 they declined by an additional 3.3% - the two worst years in the past four decades. And, as in other states, the revenue forecasts by the Executive and OLS failed to anticipate the magnitude of the declines.

Fortunately in FY 2011 revenue performance is following expectations. The FY 2011 revenue revision in the Governor’s Budget Message was an increase of less than .3% above the amount certified last June. The slightly lower OLS forecast is nearly identical to the June number. For FY 2012 the Executive and OLS are projecting similar overall revenue growth of about 4%.

For FY 2011, OLS is projecting $72 million less than the Executive and for FY 2012 we are projecting $53 million less. The combined difference - - $125 million - – is less than one-half of 1% of the Governor’s recommended budget appropriation level.

Compared to the Executive, we estimate $50 million more from the income tax in FY 2012 and $20 million less from the Corporation Business tax (CBT) in each year. We agree with the Executive estimates for the income tax in 2011 and the Sales tax in both years. We have lower estimates than the Executive in both years for the insurance premium, realty transfer, motor fuels and CBT- - Banks and Financials taxes. We also differ, by small amounts – either up or down - on a number of other revenue sources.

The details of the revenue forecasts and an explanation of the differences that exist are included in the OLS *Tax and Revenue Outlook* which we provided to you over the weekend and which is available online. The real question ought not be whether OLS or the Executive is more accurate in their current forecasts --- but rather whether the similar pictures we paint are accurate. The hardest thing in revenue forecasting is the accurate anticipation of the turns or pivots in the economy.

Let me provide you with some important examples.

As always, the CBT remains one of the most volatile revenue sources, and one of the most difficult to project. Published data on corporate profits do not neatly correlate with CBT revenue collections for a fiscal year. Tax receipts in each fiscal year include a mixture of payments, adjustments, refunds, and credits from a number of different tax years. Moreover, in FY 2011 additional risk results from the assumption that this spring will reflect a significant turning point for the CBT.

Between FY 2008 and FY 2010, the CBT plummeted by nearly $1.0 billion, from $2.97 billion to $2.0 billion, a drop of 33%. Encouragingly, the CBT is up 7.9% through the end of February. The Executive is assuming CBT growth will accelerate by 24% for the remaining four months of the fiscal year.

The OLS believes that the Executive's target is plausible, but also contains risk. The receipts for the fourth quarter of FY 2010 were the lowest in eight years. A significant rebound this year is likely given that low base and national reports of improved corporate profits. OLS' forecast is slightly more cautious than the Executive's, but would also require significant growth and a return to a strong fourth quarter. We are both banking on the CBT reaching a turning point this Spring; a turning point which is not yet clearly visible in the data.

I suspect you are tired of my annual warning about the difficulty of correctly gauging April final payments on the gross income tax and my reciting the history of "April surprises." In addition to the normal difficulty in projecting income for high-income taxpayers, this year, additional uncertainty derives from potential errors in estimating the size and timing of the impact from the one-year tax increase and the interplay of New Jersey and New York State tax changes that impact State residents who work in New York. An upward or downward "April surprise" remains distinctly possible.

The good news is that when OLS and the Treasurer come back before you in mid-May, these uncertainties – at least with respect to FY 2011 – will be largely resolved.

Speaking of good news, I think it is useful to see that the overall revenue picture as a combination of good news - after two awful years revenues appear to be growing again – and bad news – we are still well below our peak revenue years.

Even with projected growth in FY 2012, the gross income tax is estimated to produce $2 billion less than it did in FY 2008 and will still fall below the level achieved in FY 2006.

With growth projected for this fiscal year and next, the sales tax would still be below the FY 2007 level.

After falling 33 percent from its FY 2007 peak, the rebounding corporation business tax will be $500 million below that peak in FY 2012.

Of the smaller revenue sources, two that have experienced the steepest declines are the realty transfer fee which has fallen 63% from its 2008 peak and casino revenues which are down 50% from FY 2006.

When we look at overall State revenues, the Good News/Bad News story is stark. The Executive anticipates that revenues will grow in FY 2012 by more than $1 billion - - but that level would be nearly $4 billion below where we were in FY 2008.

Let me conclude these remarks with three other observations.

First, in addition to the $29 billion in State funds, the proposed budget relies on the expectation of $10.2 billion in Federal funds – a reduction from the current year, reflecting the expiration of portions of the Federal stimulus program. However, the current debate in Congress about how much and where the Federal budget should be reduced is likely to have profound implications for states. Many of the dollars that we receive are in the very discretionary programs that seem to be most in play. This is an issue that we will have to monitor between now and June and beyond June – as the Federal fiscal year does not begin until October.

Second, it now appears likely that the New Jersey Supreme Court will decide the most recent iteration of the school funding case before the FY12 budget is adopted and their decision could certainly be consequential.

Third – and this is a theme I have raised often in recent years – in a world where the average revenue forecasting error is greater than 3% and in which unexpected demands can emerge for government services – a budgeted surplus of 1% (as is proposed for FY 2012) is far smaller than one would prefer.

As you deal with these and other issues over the next three months, the staff of OLS will be available to provide you with whatever information and support the committee requires.