As you begin your consideration of the Fiscal Year 2013 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.

It is always more pleasant to start with good news and the news is good. Despite a scare or two, there is growing evidence that the national economic recovery is taking hold and New Jersey is participating in the upturn. Following a two-year revenue plunge – from fiscal year 2008 to 2010 base revenues declined by more than 17% -- fiscal year 2011 marked the beginning of recovery.

The current year’s budget was built on the assumption that revenue growth would continue. For a while that assumption looked shaky as the stock market fell sharply last summer, the European debt crisis loomed and warnings of a double dip recession were heard.

Thankfully, those concerns have abated in recent months. Economic growth has improved, employment is rising, consumers are loosening their purse strings, and the stock market has rebounded to near its peak before the Great Recession.

So far this year, revenue collections have moved in sync with economic developments. The fear of the double dip was reflected in weak sales tax growth in the first half of FY 2012. The stock market downturn yielded a drop in December and January estimated payments from higher income taxpayers and corporate tax payments showed little movement. At the midpoint of FY 2012, collections for the major tax revenues were up only 2.6%
from the same period the year before, about one-half the growth rate anticipated in the June revenue certification.

While the economic horizon is far from cloudless (Europe’s problems have been deferred, not resolved; growth estimates for several important sectors of the global economy have been reduced, and there are serious concerns about energy prices and supply stability), most economists are optimistic for the coming months and next year.

Both the OLS and the Executive project modest growth for the remainder of FY 2012 and accelerating growth for FY 2013. However, the Executive’s growth assumptions are somewhat more enthusiastic than those of the OLS.

The Executive projects total State revenues at $29.691 billion for FY 2012. The OLS estimates $29.546 billion, or $145 million less than the Executive. That is a difference of only 0.5%.

For FY 2013, the Executive projects total revenues of $31.858 billion, or 7.3% growth. The OLS projects $31.466 billion, or 6.5% growth -- $392 million below the Executive’s estimate. That is a difference of 1.2%.

Over the two years the difference between our estimates and Executive’s is $537 million.

It is worth noting, that under either the Executive or the OLS forecast, FY2013 revenues will remain significantly below our peak collections of five years earlier.
Our *Tax and Revenue Outlook* book, which you have in your packets, presents the revenue forecasts in some detail. For most revenues OLS and the Executive either agree, or the differences are minor. In some instances OLS has a higher estimate and in others the Executive is higher. With one notable exception, these differences are nearly offsetting.

Let me focus now on the Big Three tax revenues – the sales tax, the corporation business tax, and the Gross Income Tax (GIT) – that account for over 70% of the budgeted revenues each year.
The Sales Tax

As I mentioned earlier, the sales tax underperformed expectations during the first half of the fiscal year, leading both the Executive and the OLS to reduce our sales tax estimates for FY 2012. The Executive reduced its forecast by $82 million, from the amount certified in June to a revised $8.071 billion, and is projecting solid growth of 3.9% for the remainder of the fiscal year. The OLS is slightly more optimistic. Thanks to several strong months recently, we assume 4.5% growth for the remainder of FY 2012, yielding $8.085 billion, or $14.0 million more than the Executive’s forecast.

For FY 2013, both the Executive and the OLS assume 4.7% growth, near the long-term average for the sales tax. However, that growth from the OLS’s slightly higher base yields $8.467 billion, $17.7 million more than the Executive’s projection of $8.449 billion for FY 2013.

The Corporation Business Tax (CBT)

The CBT is difficult to estimate, as collections in any given fiscal year reflect a combination of payments and refunds from several tax years. In addition, corporate profits reported to stockholders are not necessarily reflective of the profits subject to State taxation. As a result, CBT collection patterns often appear inexplicable to those following corporate profits data.

CBT collections so far this year are marginally ahead of modest expectations, and the Executive has increased its forecast for FY
2012 by $53.0 million from the amount certified last Summer to $2.314 billion, 3.9% above the prior year. The OLS believes this is a reasonable target and agrees with the FY 2012 forecast.

For FY 2013, the Executive assumes the growing economy and healthy corporate profits will yield strong growth of 10.9%. The forecast is for $2.566 billion next year. The OLS believes that strong revenue growth from the CBT is likely at some point, but we are taking a slightly more cautious approach and assuming 7.6% growth to $2.49 billion, or $76.0 million less than the Executive. Over the last two decades the CBT has averaged about 7.6% growth, and the OLS believes performance at that level is a reasonable expectation early in the economic recovery.

**The Gross Income Tax (GIT)**

It seems that every Spring the GIT is the central focus of this conversation. And today is no different with the GIT accounting for nearly all of the net forecasting difference between OLS and Executive in each year.

April is the largest collection month each year, combining regular employer withholdings, final payments for the preceding tax year and the first quarterly tax payments for the current tax year. April is the most unpredictable month for this most volatile revenue. The infamous “April Surprise” has been either unexpectedly pleasant or painful.

When we came before you last year at this time stock prices were rising and the outlook for growing tax payments by higher income taxpayers was encouraging. However, the stock market tumbled nearly 20 percent and it took the rest of the year for it to recover. As early as last Summer we had concerns about our GIT forecast.
Through most of the Fall and Winter, the Treasury reported GIT payments running more than $200 million below their forecasts. Estimated tax payments in December and January dropped, and total estimated payments for Tax Year 2011 came in flat with Tax Year 2010.

If there were a primer for GIT forecasting one of the tips would be: look at estimated payments to predict final payments. The following graph (which can also be found on page 6 of the *Tax and Revenue Outlook* book) shows how strong the link is between tax year estimated payments and the subsequent final payments due in April.

Based on this relationship, the OLS, which had anticipated growing final payments this Spring, now foresees no growth. For the other components of the GIT, the OLS expects some increased growth in upcoming quarterly estimated payments and inwithholding on employee wages, while we anticipate that refund
payments will be flat. Overall, we see underlying growth of 3.6% for the GIT in FY 2012, yielding $10.975 billion. That is $157.0 million below the Executive’s forecast of $11.132 billion, the same amount as was certified in June.

For FY 2013, the OLS projects that underlying GIT growth will accelerate to 7.0%, or about double the underlying growth we assume for FY 2012. The GIT’s average growth over the last 15 years has been about 6.2%, and the OLS anticipates that improving economic activity and stock market growth will increase tax liabilities steadily. After adjusting for existing and proposed tax changes, the OLS projects $11.529 billion in FY 2013.

The Executive projects somewhat more robust underlying growth of 8.4% for FY 2013. While this is certainly possible, the OLS is more cautious. After adjusting for the tax changes, the Executive projects $11.837 billion, or $307.7 million more than the OLS.

The revenue expectations in the Governor’s budget contain a number of considerations that are distinct from changes in the baseline collections for our various taxes. The GIT and CBT expectations were adjusted downward by a total of $194.5 million to account for the second year of a series of phased tax law changes enacted last year. In addition the GIT is reduced by another $183.3 million to reflect the first fiscal year cost of the proposed reduction in GIT rates.

On the other side of the ledger, this budget proposes to use $642 million of non-recurring “revenue-related initiatives,” up from $96 million in the current year. The most significant of these initiatives are the deposit into the General Fund for support of regular governmental functions of $200 million from the Clean Energy
Fund, $200 million from the Affordable Housing and Neighborhood Preservation fund and $75 million from the national Mortgage Servicing Settlement.

For the purposes of our presentation, OLS assumes the deposit of these monies in the General Fund and the enactment of the GIT rate reduction. Should some or all of these items not be agreed to, the bottom line calculation on the budget will change.

Revenue forecasts will always be wrong to some degree. The difference between our forecast and that of the Executive averages about 1% over the two years and while 1% is a very small margin, the $537 million difference is highly significant as you craft your budget.

In other years, when we spoke at this time I could tell you that once the April collections are tabulated much of the difference in revenue forecasts will be resolved. I cannot say that this year. OLS and the Executive have similar expectations for April. Much of the difference for this year fiscal year lies with collections that will not be known until after the budget has been enacted. And the largest difference between our forecasts rests on differences in our expectations for the rate of growth next fiscal year – not something that is likely to be resolved by the time we come back this May.

Under our Constitution the power to certify revenues falls to the Governor. The OLS revenue forecasts are provided to the Legislature for your consideration.

We have been asked over the years what is the appropriate size for a projected year-end surplus. While some experts have suggested 3% as a good surplus, there is no simple answer to that question. The adequacy of the surplus must be considered in the context of the risks in the budget. A budget that anticipates a surplus of less
than 1%, while relying on revenue forecasts that fall at the high end of the likely range, might raise concern.

I wish to offer one final observation. While our fiscal circumstances have improved, we are not out of the woods. As I noted earlier, FY2013 revenues will still lag the FY 2008 level and we face a number of spending demands over the next few years that will put significant pressure on our fiscal capacity. Last month, a distinguished bi-partisan panel issued their second *Facing Our Future* report in which they warned of severe structural budget problems facing our State. Without endorsing all of their assumptions or conclusions, I think their report is an important contribution to the ongoing discussion of New Jersey’s fiscal policies and I commend it to your attention.

As always the fiscal staff of the Office of Legislative Services stands ready to assist you as you move through this year’s budget process.