

TESTIMONY PREPARED FOR PRESENTATION TO THE
SENATE BUDGET & APPROPRIATIONS COMMITTEE
CATHERINE Z. BRENNAN
OFFICE OF LEGISLATIVE SERVICES
APRIL 5, 2016

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE.

EACH YEAR, FOLLOWING THE GOVERNOR'S ANNUAL BUDGET MESSAGE, THE OFFICE OF LEGISLATIVE SERVICES (OLS) PREPARES AN INDEPENDENT ANALYSIS OF THE MAJOR TAX REVENUES AVAILABLE FOR APPROPRIATION. WE OFFER OUR REVENUE ESTIMATES AT THE BEGINNING OF THE BUDGET HEARING PROCESS AND THEN PRESENT ANY REVISIONS TO OUR ESTIMATES AT THE FINAL BUDGET HEARING IN MAY.

YOU HAVE EACH RECEIVED A COPY OF OUR "TAX AND REVENUE OUTLOOK" THAT CONTAINS OUR REVISED REVENUE ESTIMATES FOR THE CURRENT FISCAL YEAR (FY 2016), AS WELL AS OUR PRELIMINARY REVENUE ESTIMATES FOR FY 2017. THIS REPORT WAS PREPARED BY THE REVENUE, FINANCE AND APPROPRIATIONS SECTION OF OLS IN COLLABORATION WITH THE LEGISLATIVE BUDGET AND FINANCE OFFICE.

REVENUE ESTIMATING AND REVENUE MONITORING IS A YEAR-ROUND FUNCTION FOR BOTH THE EXECUTIVE AND OLS. FOLLOWING THE GOVERNOR'S ANNUAL REVENUE CERTIFICATION, BY JULY 1 OF EACH YEAR, REVENUE COLLECTIONS ARE TRACKED AND EVALUATED AGAINST EXPECTATIONS. INDEED, WE AND OUR COUNTERPARTS IN TREASURY MONITOR REVENUE COLLECTIONS AND TRENDS DAILY, AND ON A MONTHLY BASIS PROVIDE YOU WITH STATUS UPDATES. REVENUE STATUS REPORTS ARE AVAILABLE TO YOU THROUGH THE MONTHLY ISSUANCES OF THE TREASURER'S OFFICE AND THE MONTHLY OLS REVENUE SNAPSHOT.

AS YOU KNOW, IT IS AT THIS TIME OF YEAR, FOLLOWING THE GOVERNOR'S BUDGET MESSAGE THAT THE EXECUTIVE PROVIDES ITS OFFICIAL REVISION TO THE ORIGINAL (JULY 1ST) REVENUE CERTIFICATION FOR THE CURRENT FISCAL YEAR, AS WELL AS ITS FORECAST FOR THE YEAR AHEAD, AND THAT THE OLS SIMILARLY UPDATES ITS PREVIOUS FORECAST FOR THE CURRENT YEAR, AND PROJECTS NEXT YEAR'S REVENUES.

WE TAKE VERY SERIOUSLY OUR RESPONSIBILITY TO PROVIDE YOU WITH OUR BEST REVENUE ADVICE. IN DETERMINING OUR ESTIMATES, WE RELY ON A REVIEW OF CURRENT STATE REVENUE COLLECTIONS, HISTORICAL REVENUE COLLECTION PATTERNS, REVISIONS

TO STATUTORY LAW, A VARIETY OF ECONOMIC DATA AND FORECASTS, REVENUE TRENDS IN OTHER STATES, AS WELL AS OUR PROFESSIONAL JUDGMENT.

WE KNOW THAT IF THE REVENUE FORECAST WE PROVIDE IS INCORRECTLY TOO LOW, YOU WILL BE FORCED TO CONSIDER DIFFICULT BUDGET DECISIONS THAT MIGHT NOT OTHERWISE BE NECESSARY. LIKewise, WE APPRECIATE THAT OVERLY OPTIMISTIC FORECASTS MAY REQUIRE EVEN MORE PAINFUL MID- OR END OF YEAR CORRECTIONS TO MAINTAIN A BALANCED BUDGET.

AND WHILE WE DO OUR BEST TO MINIMIZE ERRORS IN THE PREPARATION OF OUR ESTIMATES, AS FRANK HAINES HAS SUGGESTED, FORECASTING ENTAILS RISK. WHAT WE KNOW FOR CERTAIN IS THAT NEITHER THE EXECUTIVE, NOR THE OLS WILL BE 100 PERCENT CORRECT. SHOULD OUR REVENUE FORECASTS BE OFF JUST ONE PERCENT, AN ACADEMICALLY ACCEPTABLE RATE OF ERROR, WE WOULD STILL—BASED ON THE FY 2017 PROPOSAL—MISS THE MARK BY \$347.4 MILLION DOLLARS, AN AMOUNT THAT IS EQUAL TO ABOUT HALF (44%) OF THE EXECUTIVE’S BUDGETED SURPLUS.

NOW LET ME NOW TURN TO OUR FORECASTS. OVER THE TWO FISCAL YEARS COMBINED – FY 2016 AND FY 2017 - THE AGGREGATE OLS ESTIMATES ARE \$162.1 MILLION BELOW THE EXECUTIVE’S FORECAST. SPECIFICALLY, IN THE AGGREGATE, THE OLS IS BELOW THE EXECUTIVE BY \$73.2 MILLION IN THE CURRENT YEAR, AND BY \$88.9 MILLION IN FY 2017, A DIFFERENCE OF LESS THAN 0.2 % (TWO-TENTHS OF ONE PERCENT) OVER THE TWO FISCAL YEARS. WE ARE LARGELY IN AGREEMENT WITH THE EXECUTIVE WITH RESPECT TO ITS FORECAST FOR THE GROSS INCOME TAX AND THE SALES TAX OVER THE TWO FISCAL YEARS, BUT OFFER A SLIGHTLY DIFFERENT PERSPECTIVE ON COLLECTIONS FROM THE CORPORATION BUSINESS TAX, THE INHERITANCE TAXES, AND THE CIGARETTE TAX.

FOR THE CURRENT FISCAL YEAR, THE EXECUTIVE IS PROJECTING GROSS INCOME TAX (GIT) COLLECTIONS OF \$13.758 BILLION, A REDUCTION OF \$172.0 MILLION OVER THE AMOUNT CERTIFIED IN JUNE, A YEAR OVER YEAR INCREASE OF 3.8%. THIS REDUCTION CAN LARGELY BE ASCRIBED TO AN OFFSET OF AN ESTIMATED \$122.0 MILLION FOR THE ENHANCEMENT OF THE STATE’S EARNED INCOME TAX CREDIT (EITC), FROM 20% TO 30% OF THE FEDERAL BENEFIT AMOUNT.

IN ADDITION TO THE ENHANCED EITC, COLLECTIONS FROM WITHHOLDINGS FROM EMPLOYEE WAGES, WHICH TYPICALLY ACCOUNT FOR ¾TH’S OF ANNUAL GIT REVENUES, ARE TRENDING WEAKER. LACKLUSTER WITHHOLDINGS MAY BE PARTIALLY EXPLAINED BY WEAKER BONUS PAYMENTS (WHICH WERE REPORTEDLY DOWN 9% IN 2015), BUT MAY

ALSO BE A REFLECTION OF CURRENT WAGES. MORE BROADLY, WE WOULD NOTE THAT THE RELATIVELY WEAK RECENT PERFORMANCE IN WITHHOLDINGS IS CONSISTENT WITH THE EXPERIENCE OF STATES ACROSS THE MIDATLANTIC REGION (DE, MD, NY, PA AND NJ) DURING THE LAST QUARTER OF 2015.

IN ADDITION TO THE CONCERN SURROUNDING WITHHOLDING, THE GIT HAS ALSO EXPERIENCED A SURGE IN REFUND PAYMENTS IN THE CURRENT YEAR. REFUNDS ARE RUNNING 26.8% AHEAD OF LAST YEAR'S PACE, DUE IN PART TO THE EITC, WHICH IS A REFUNDABLE TAX CREDIT, AND IN PART TO IMPROVEMENTS IN REFUND PROCESSING BY THE DIVISION OF TAXATION.

BASED ON THESE UNDERLYING TRENDS, THE OLS CONCURS WITH THE EXECUTIVE'S INCOME TAX ESTIMATE FOR THE CURRENT YEAR. HOWEVER, SHOULD THE REFUND SURGE NOT ABATE AS EXPECTED, WE MAY ADJUST OUR ESTIMATE ACCORDINGLY WHEN WE COME BACK BEFORE YOU LATER THIS SPRING.

FOR THE OUT-YEAR (FY 2017), BOTH THE EXECUTIVE AND THE OLS ARE ANTICIPATING CONTINUED MODEST GROWTH IN THE GIT. SPECIFICALLY, THE EXECUTIVE'S ESTIMATE IS ASSUMING 4.8% GROWTH IN GIT REVENUES NEXT YEAR, WHILE THE OLS IS PROJECTING 4.7%, WHICH YIELDS \$24.6 MILLION LESS THAN THE EXECUTIVE'S PROJECTION OF \$14.425 BILLION.

WITH RESPECT TO OUR SECOND LARGEST MAJOR TAX RESOURCE, THE SALES TAX, THE OLS IS, AGAIN, LARGELY IN AGREEMENT WITH THE EXECUTIVE. HOWEVER, WHILE THE EXECUTIVE ANTICIPATES 5.0% GROWTH FOR THE CURRENT YEAR, THE OLS EXPECTS THE CURRENT YEAR-TO-DATE GROWTH RATE OF 4.5% TO CONTINUE THROUGH YEAR-END. IN THE OUT-YEAR, THE EXECUTIVE IS PROJECTING 3.0% GROWTH, WHILE THE OLS IS FORECASTING 3.5%, CONSISTENT WITH AVERAGE GROWTH IN THE SALES TAX SINCE THE GREAT RECESSION. THUS, WHILE OUR DIFFERING GROWTH ESTIMATES YIELD A \$40.8 MILLION DIFFERENCE THIS YEAR, WITH THE OLS COMING IN BELOW THE EXECUTIVE, THE OLS AND THE EXECUTIVE ARRIVE AT THE SAME SALES TAX ESTIMATE OF \$9.597 BILLION FOR FY 2017 WORKING OFF OF DIFFERENT BASES AND GROWTH RATE ASSUMPTIONS.

THE TWO MAJOR TAXES ASIDE, THE OLS REVENUE OUTLOOK DIVERGES MOST DISTINCTLY FROM THE EXECUTIVE ON THE CORPORATION BUSINESS TAX (CBT). AS OUR OFFICE HAS SUGGESTED FOR A NUMBER OF YEARS NOW, THE CBT IS AMONG THE MOST DIFFICULT REVENUES TO FORECAST EACH YEAR. COLLECTIONS TYPICALLY INCLUDE BOTH PAYMENTS AND REFUNDS FROM MULTIPLE TAX YEARS AND ARE INFLUENCED BY CORPORATE ACCOUNTING PRACTICES WHICH WE CAN'T ANTICIPATE. THUS, CURRENT

COLLECTIONS ARE OFTEN OUR BEST INDICATOR, AND CURRENTLY, THE CBT IS DOWN 18% THROUGH FEBRUARY.

ACCORDINGLY, THE EXECUTIVE HAS ADJUSTED ITS FY 2016 PROJECTION DOWNWARD BY \$273.2 MILLION FROM THE LEVEL CERTIFIED IN JUNE. HOWEVER, TO ACHIEVE ITS YEAR-END ESTIMATE OF \$2.336 BILLION, THE EXECUTIVE ASSUMES A MODERATING RATE OF DECLINE. AND WHILE WE TOO ARE ASSUMING A LESS STEEP DECLINE IN THE REMAINING MONTHS OF THE CURRENT YEAR, OUR ASSUMPTIONS YIELD AN ESTIMATE WHICH IS \$56 MILLION BELOW THE EXECUTIVE'S REVISION.

HOWEVER, OUR BIGGEST DIFFERENTIAL OCCURS IN THE OUT-YEAR. FOR FY 2017, THE EXECUTIVE IS PROJECTING CBT REVENUES TO REMAIN FLAT AT \$2.336 BILLION, BASED ON THE EXPECTATION THAT UNDERLYING GROWTH FROM FAVORABLE ECONOMIC TRENDS WILL BE OFFSET BY THE IMPACT OF THE CONVERSION OF BEIP (BUSINESS EMPLOYMENT INCENTIVE PROGRAM) GRANTS INTO TAX CREDITS.

INDEED, THE IMPACT OF TAX CREDITS IS LIKELY TO BECOME AN INCREASINGLY IMPORTANT FACTOR WITH RESPECT TO CBT COLLECTIONS, AND IS A MORE PRONOUNCED FACTOR IN THE OLS ESTIMATES. WORKING FROM THE DIVISION OF TAXATION'S RECENTLY RELEASED TAX EXPENDITURE REPORT, THE OLS NOTES THAT VARIOUS CBT CREDITS ARE EXPECTED TO REDUCE COLLECTIONS BY \$113.7 MILLION IN THE CURRENT YEAR AND \$454.2 MILLION IN FY 2017. THUS AFTER ASSUMING A REBOUND IN CBT REVENUES OF 10% GROWTH IN THE OUT-YEAR, WE HAVE REDUCED OUR ESTIMATE BY THE ANTICIPATED TAX CREDIT AMOUNTS, RESULTING IN AN OLS ESTIMATE FOR FY 2017 WHICH IS \$156.0 MILLION BELOW THE EXECUTIVE'S PROJECTION.

NEXT, I WOULD LIKE TO TURN TO TWO REVENUE SOURCES FOR WHICH WE ARE FORECASTING AMOUNTS ABOVE THE EXECUTIVE, THE STATE INHERITANCE TAXES AND THE CIGARETTE TAX. AS YOU ARE AWARE, THE STATE INHERITANCE TAXES CONSIST OF TWO TAXES, THE TRANSFER INHERITANCE TAX AND THE ESTATE TAX, EACH OF WHICH, HISTORICALLY, PRODUCES ROUGHLY HALF OF THE TOTAL REVENUE STREAM. BASED ON ROBUST YEAR-TO-DATE GROWTH OF 16.3%, THE OLS IS PROJECTING \$31.9 MILLION MORE THAN THE EXECUTIVE FOR THE INHERITANCE TAXES IN FY 2016. OFF OF THAT HIGHER BASE, AND ASSUMING CONTINUED, BUT MODERATING GROWTH, THE OLS ESTIMATE IS \$51.5 MILLION ABOVE THE EXECUTIVE ESTIMATE NEXT FISCAL YEAR. THUS, OVER THE TWO FISCAL YEARS, THE OLS PROJECTION FOR THE INHERITANCES TAXES IS \$83.4 MILLION ABOVE THE EXECUTIVE'S EXPECTATIONS.

THE OLS IS ALSO ANTICIPATING REVENUES WHICH ARE \$51 MILLION HIGHER THAN THE EXECUTIVE FROM THE TAX ON CIGARETTES OVER THE TWO FISCAL YEARS, INCLUDING \$15.5 MILLION THIS YEAR AND \$35.5 MILLION NEXT YEAR. ALTHOUGH TAXED CIGARETTE SALES HAVE DECLINED BY 0.45% THROUGH THE END OF FEBRUARY, THE EXECUTIVE'S FORECAST ASSUMES AN IMPROBABLE 10% DECLINE THROUGH THE END OF THE FISCAL YEAR TO ACHIEVE ITS ESTIMATE, WHILE THE OLS ESTIMATE ASSUMES A 3.0% DECLINE THROUGH YEAR-END, FOR A YEAR OVER YEAR DECLINE OF 1.3%. MOREOVER, IN FY 2017, THE EXECUTIVE ASSUMES SALES WILL DECREASE BY 6.0%, WHILE THE OLS PROJECTS A DECLINE OF 3.0%, IN LINE WITH HISTORICAL RATES.

THE "TAX AND REVENUE OUTLOOK" REPORT THAT YOU HAVE BEFORE YOU EXPANDS UPON THE POINTS I HAVE SUMMARIZED AND DISCUSSES THE MAJOR TAX REVENUE SOURCES IN GREATER DETAIL. IN ADDITION, THE OLS IS PROJECTING RELATIVELY SMALLER UPWARD AND DOWNWARD DIFFERENCES RELATIVE TO THE EXECUTIVE FOR SEVERAL OF THE OTHER MAJOR TAXES AND THOSE CAN ALSO BE FOUND IN OUR REPORT. THE OUTLOOK ALSO INCLUDES UPDATES TO LAST YEAR'S APPENDICES ON THE STATE INHERITANCE TAXES AND THE ECONOMIC DEVELOPMENT TAX CREDIT AWARDS IMPACTING THE CBT. YOU WILL ALSO FIND AN OVERVIEW OF GIT TAX RATES AND COLLECTIONS DISTRIBUTED BY INCOME, AS WELL AS AN OVERVIEW OF THE STATE'S TWO GASOLINE TAXES, THE MOTOR FUELS TAX AND THE PETROLEUM PRODUCTS GROSS RECEIPTS TAX.

WE WOULD BE PLEASED TO ANSWER YOUR QUESTIONS OR WALK YOU THROUGH ANY OF THE MATERIAL IN THE REPORT.

FOR FURTHER INFORMATION ABOUT THE OLS REVENUE ESTIMATES, PLEASE CONTACT:	
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