Acting Treasurer Ford Scudder April Budget Testimony **April 5-6, 2016**

Thank you for your kind invitation to discuss Governor Chris Christie's proposed Fiscal 2017 Budget.

Please let me take a moment to introduce my colleagues at the table this afternoon: Thomas Neff, Deputy State Treasurer; David Ridolfino, Acting Director of the Office of Management and Budget; and Mary Byrne, Deputy Director of the Office of Management and Budget.

This being my first appearance before your Committee to discuss the Budget, I thought it might be helpful to quickly address a few items at the outset. First, while I realize the Committee has grown accustomed to the silver-tongued oration of my predecessor, I trust that you won't hold it against me if I take a more plain-spoken approach.

Secondly and more seriously, I did want to let you know that I have already developed a deep appreciation for the complexity of the budget approval process, its importance, and the special role that the Budget Chair and members play in budget introduction and enactment. I know that you spend endless time away from your families and other jobs in order to create a better budget. I will try and be thorough but to the point in today's proceeding. I also would like to assure you that should you have any questions or concerns that cannot be answered today, we will do our best to respond to you and your staff in a timely and orderly fashion.

I will start with a brief overview of what I believe to be the overarching themes of the Governor's $34.8 billion budget proposal before turning to some specific discussion points that I believe may be of particular interest to this Committee, as well as to the citizens of New Jersey who we are all privileged to serve.

Fundamentally, this Budget reflects and advances the Governor's continuing strategic priorities: providing a more efficient and structurally sound State government, enhancing New Jersey's economic competitiveness, and maintaining high-quality, critical safety-net supports and services for New Jersey's most vulnerable citizens.

I want to stress that as we advance those priorities, we continue to make significant progress in the structural integrity of the Budget. For Fiscal 2017 our budgeted surplus is at a 10-year high and is more than double the level of the Governor's first Budget. Our use of nonrecurring revenues and savings is less than one tenth what it was in 2010. Our annual pension payment has moved from zero in 2010 to a record high of $1.9 billion in Fiscal 2017. And the Unemployment Insurance Trust Fund, which after years of diversions reached a peak deficit of $2.1 billion, is now running a more than $1 billion surplus.

Bearing in mind that high level understanding, I would like to dig right in with our expectations for the close-out of Fiscal 2016 and then move onto the Governor's Budget for Fiscal 2017.

We started the current fiscal year with an opening fund balance of $823 million. Total revenue for Fiscal 2016 has largely met expectations and is now projected at $33.8 billion, a net reduction from the Appropriations Act of $122 million that approximates the increase in the Earned Income Tax Credit to 30% from 20% of the federal EITC level.

After adjusting resources and appropriations, respectively, for an anticipated $226 million in lapses and $279 million in supplemental needs, the result is a projected ending fund balance of $787 million, which represents an increase from the amount budgeted as of the Fiscal 2016 Appropriations Act.

While revenue growth for Fiscal 2016 was running ahead of estimates as of the release of the Governor's Budget Message, by the end of February growth had dropped below the annualized rate contained in the Governor's Budget Message. Based on preliminary revenue data through the end of March, however, we continue to believe that revenues are aligned with our estimates.

In particular, gross income tax receipts, which have grown 2.6% year-to-date, are running behind the projected annual growth rate of 3.8%. However, I would note that tax year refunds provided through March are currently running $271 million dollars ahead of last year's pace. The number of refunds processed through March is 16% higher than the amount processed last year through the same time period, and we have no reason to expect a significant increase in the total number of refunds issued this year.

While a portion of the increased dollar amount of refunds so far this year relates to the expansion of the EITC, we are also simply processing refunds faster. If you'll recall, refund processing was slowed early last spring on account of a suspected breach of taxpayer information within the tax preparation software community. Processing is faster this year both because of the lack of any similar tech breach, as well as continued process improvements within the Division of Taxation and the Division of Revenue and Enterprise Services. After accounting for the increased level of refunds, we believe Gross Income Tax receipts are in line with our forecast.

Meanwhile, Sales Tax receipts have grown 4.8 % year-to-date, more or less the 5.0% projected rate of growth, and preliminary March revenue numbers show year-to-date corporate business tax receipts at -14.5% growth, once again approximating the estimated annual rate of growth of -12%.

We will of course continue to monitor tax receipts, especially throughout the all-important month of April. As I know the members of this Committee well appreciate, the New Jersey tax code is incredibly progressive. The April final tax payments would represent our fourth-largest single revenue source if separated from the GIT, even though only approximately one quarter of NJ taxpayers owe final payments in any given year. Meanwhile, the top 1% of taxpayers provide over 35% of the State's Gross Income Tax receipts, while just the top 100 filers pay over 5.5% of all GIT payments. This reality—with such a small segment of the population driving GIT revenues and so much of the revenue collected so late in the fiscal year—creates heightened volatility in tax receipts, severely increasing the complexity of the annual budgeting process.

Assuming our revenue and spending targets are met, the Fiscal 2016 ending fund balance of $787 million becomes the opening fund balance for Fiscal 2017. At this time, we are projecting total tax and non-tax revenues of $34.8 billion, a modest 3.1% increase year-over-year.

We are similarly budgeting Fiscal 2017 appropriations at $34.8 billion, representing growth of 2.2% against the Fiscal 2016 adjusted appropriation. This budget would produce an ending fund balance of $790 million, which would represent the largest budgeted ending fund balance in a decade.

I am aware that there are some who have advocated spending down the surplus. Be advised that despite our progress, New Jersey's surplus is still viewed by rating agencies as too low, especially in light of our dependence on volatile revenue sources like high income residents and corporate returns.

Job creation in New Jersey has accelerated, with more new jobs created in 2015 than in any other year in this millennium. In fact, our unemployment rate is less than half what it was just six years ago and has dropped well below the federal rate. In conjunction with an improving employment picture, low oil prices continue to provide a positive catalyst for net energy-consumer states like ours. On the flip side, however, our revenue estimates are necessarily tempered by the modest economic growth rate nationally, as well as the volatile start to the year for financial markets.

It is this economic backdrop that provides the basis for our Fiscal 2017 revenue forecasts. As is true of any year, most of the anticipated revenue growth is derived from our three major sources of tax revenue. At this time, we are projecting 4.8% growth in the Gross Income Tax, 3.0% growth in the Sales Tax, and 0% growth in the Corporation Business Tax. We believe these are reasonable estimates.

- As it relates to the Gross Income Tax, the inherent projected growth rate is actually 4.2%, but increases to 4.8% after netting out certain adjustments related to the increase in the Earned Income Tax Credit. While job growth is strong in the aggregate, continued consolidation in some of our higher-paying industries as well as volatile financial markets soften our projections.
- The projected increase in the Sales Tax is less than what we have experienced so far this fiscal year, as certain cyclical increases tend to moderate at this point in the economic cycle. In addition, we expect subdued spending growth rates in certain categories of durable goods.
- I would like to provide a little more context to the flat growth forecasted for the CBT, as there are two primary reasons you might expect its rate of growth to be higher. Recent history has shown that revenues from the volatile CBT have followed an alternating path of large percentage increases followed by large percentage decreases. In other words, after negative growth during Fiscal 2016, recent experience would suggest positive growth in revenues next year. In addition, our economy is doing well, with Sales Tax revenues up and job creation strong. Each of those data points would tend to suggest strong corporate profits. However, we are not expecting net CBT growth in Fiscal 2017, as this is the first year of the impact of recently enacted legislation allowing for the conversion of BEIP grants to tax credits.

Before leaving the revenue side of the ledger, I would like to provide just a few more highlights.

- First and foremost, in keeping with Governor Christie's continued commitment to enhance New Jersey's economic competitiveness, this Budget does not include any broad-based tax or fee increases. On the contrary, the Budget preserves the full phase-in of the business tax reduction initiative approved by the Legislature in 2011, as well as providing for the conversion of BEIP grants into tax credits as approved by the Legislature earlier this year. Additionally, the

Administration is firmly committed to working with this Committee and the entire Legislature on finding additional avenues for tax relief, such as repealing the anti-competitive and outdated Estate Tax, as a requisite effort to retain capital, businesses and jobs in New Jersey going forward. While the revenue forecast does not reflect any changes to the Estate Tax, pending further discussions with the Legislature, I would be more than happy to entertain further discussion about that particular tax and how eliminating it is in the long-term economic interests of our State's business climate and all New Jersey taxpayers.

- Second, Governor Christie's proposed Fiscal 2017 Budget continues his commitment to reducing the State Budget's reliance on non-recurring resources, down dramatically from a high of over 13% in Fiscal 2010 to less than 1% in Fiscal 2017. There always will be some non-recurring resources in the State Budget, whether in the form of revenues or savings. But the Governor has clearly established a new and much more sustainable and responsible baseline. By way of examples: we are now fully embedding the cost of BEIP grants in the Budget. There are no revenues included from major asset sales, concession payments, or debt restructurings.

In sum, our revenue estimates are prudent—consistent with our steadily growing economy yet also slightly below five-year average growth rates.

Moving next to the expense side of the ledger, this Budget was crafted in part around taking the next step in the phase-in toward full payment of the actuarially required pension contribution (or ARC). Inclusive of the $555 million increase in the defined benefit pension contribution, the Governor's Budget proposes a $1.86 billion pension payment. This represents the largest pension payment in our State's history, more than double the Fiscal 2015 amount.

With this contribution, Governor Christie will have contributed almost $6.3 billion to the pension plans, far more than any previous Governor and indeed approaching twice the amount contributed under the previous five administrations combined.

To ensure that we can afford this sizeable increase in pension funding, as well as other investments, the Governor's budget calls for the plan design committees to work together to identify and approve $250 million in cost savings in public employee and retiree health care costs. While we continue to believe that broader, longer-term reforms are necessary, we cannot allow the dramatic escalation in health care costs to continue unabated, thus the need in this Budget to make a down payment on future reforms.

There are a multitude of imminently reasonable plan design changes that can be made to our health plans to help us reach that goal, all of which have been utilized successfully in private and public plans elsewhere across the country. Indeed, most of the potential changes do not shift costs to employees, but instead simply contain the most inefficient spending within the health care system, eliminating situations whereby taxpayers and public employees pay more than necessary for the same results.

If the committees succeed, as we believe they can and expect they will, the more than 500 counties, municipalities, fire districts, authorities, school districts and other local governments that voluntarily participate in the State plans would save approximately $200 million annually. And for those local governments that do not use the State plans, they would have a less expensive State plan to consider, so their own plans would feel pressure to control costs in order to stay competitive. This constitutes significant, meaningful property tax relief.

Moreover, these reforms are not just good for government budgets and taxpayers. They are good for the public employees themselves, who would save approximately $100 million annually on their health insurance premiums. With incentives aligned across the board, we trust that both plan design committees will continue to work proactively toward finding savings that are universally positive for taxpayers and employees, and we hope that this Committee will be supportive of these efforts as well.

Even with such health benefit savings, however, the budgeted increase in pensions and health benefits accounts for 78 percent of the forecasted spending increase in the Budget.

With your permission Mr. Chairman, let me stop here for a moment. Consistently throughout the budget process, Administration officials, as I am sure is true of each of you, are presented with appropriation requests that are worthy of consideration. While prioritization is inherently part of any budgeting process, given the financial circumstances in our State resulting from decisions dating back to before most of us were here, time and again we have to deny such requests, as well as strip from the forthcoming Budget many requests approved previously in prior Budgets.

From a purely practical standpoint, this is where the balance between tax policy and appropriations comes into balance. In a perfect world, at the end of the budget process, the marginal benefit of the last dollar of State spending would be precisely equal to the marginal cost of the last dollar of taxes raised. As it happens, though, there are diminishing returns to government spending and increasing costs to higher levels of taxation. Accordingly, unless a State is running at an acceptable surplus, the bar for new spending needs to be set high, for otherwise such spending would likely represent a net negative to the State's citizens.

In the case of New Jersey, our tax burden is perhaps the highest in the nation, reducing capital investment and driving out our most productive citizens as we were reminded pointedly yet again last month with the recognition that our former wealthiest citizen has now officially moved to Florida. We also have a large structural deficit resulting from overly generous, pay-as-you-go health benefits packages for public employees, decades of deliberate underfunding of the pension, and far too high a general cost of State and local government. Accordingly, without any changes to the status quo, the standard for any new spending in New Jersey, by necessity, must be almost unreachable.

Indeed, the Budgets during the Christie Administration have been put together in precisely that fashion. Taxes have been cut whenever possible, the growth in our debt has slowed, and debt has been issued only for critical needs. Meanwhile, new spending programs have been few and far between, as core spending has remained flat for the past five years. In part that is due to reducing the size of the State workforce by approximately 10,000 positions since the beginning of the Administration.

As part of that effort to continue reducing the cost structure of State and local government, I commend the Legislature for the bipartisan reforms made earlier in this Administration, as they have helped save billions of dollars for State and local government. Like the Governor and my predecessor before me, though, I too would urge the Legislature to engage in discussion of further pension and health benefit reform, as we are on an unsustainable path. It is simply unreasonable to suggest that funding public employee health care at current levels carries greater benefit to the citizens of New Jersey than the cost it exerts in terms of added taxes and foregone priorities. Whatever issue each of you is most passionate about would receive much greater attention in the State Budget if we could come together around further pension and health benefit reforms.

Moreover, I would urge tremendous caution as it relates to the currently proposed constitutional amendment. If you think we can't pay for high quality proposals now, just wait to see the draconian cuts and harrowing choices that the amendment would require. The proposed constitutional amendment requires that contributions to the various pension systems take precedence in the Annual Appropriations Act over all other State spending except for debt service on General Obligation Bonds and also imposes a requirement for quarterly pension payments. Under such a system, flexibility to adjust to economic changes similar to what occurred in 2009-2010 and again in 2014 will no longer exist.

And that’s even assuming that lenders would support the dramatic increase in working capital required to support quarterly payments—an assumption that is both imprudent and unrealistic. The State currently has to borrow money every July to help fund critical programs and aid payments until its cash flow becomes positive in mid-April. Simply put, Wall Street will not lend us the money if we show the State’s cash flow turning positive near the last day of the fiscal year. Even if such a borrowing were achievable, the spike in debt service to cover full quarterly pension payments could easily increase interest costs by more than $100 million annually.

We all want to see a fully funded pension and a comfortable retirement for our past employees, but the current proposal would spell fiscal calamity for the State. This would literally put education, transportation capital, hospitals, the social safety net, a prosperous job market, and the environment all secondary to the pensions of public employees, with benefit levels that could never be changed. The remaining 90% of New Jersey residents would become second-class citizens to current and retired public employees. Our collective ability to serve the public good would be minimized far into the future, with few new public service priorities ever able to be accomplished again.

With that difficult fiscal backdrop in mind, I will close by highlighting a few noteworthy spending items of the fiscal 2017 budget.

- First, the Governor’s Budget continues to restrain the growth in discretionary State spending. Spending for the Executive Branch will increase by only 1.2%. Core State spending—in other words all spending other than pensions, health benefits and debt service, which collectively account for 95% of the growth in this Budget—has remained essentially flat for the last five years at approximately $2 billion below Fiscal 2008 levels.
- Second, total aid to schools will increase by approximately $100 million in Fiscal 2017, with formula aid making up a third of the increase. The proposed Budget also increases funding to urban school districts with large charter school enrollments, to help ensure that urban school children have improved access to education. In addition, the Budget adds Professional Learning

Community Aid, a new category of aid that provides every district the same additional per-pupil funding. All told, every school district will see an increase in aid. Moreover, if we add direct State payments for education and school construction debt service, total school aid will increase by almost $550 million to a new all-time high of $13.3 billion. From Fiscal Year 2010 to 2017, State funding for school aid will have increased by 41 percent.

- Third, the Governor's Budget continues providing over $1.5 billion of municipal aid, with all local governments receiving at least the same level of regular aid as in past years.
- Fourth, the Budget provides $2.2 billion for higher education. Support for public colleges and universities is essentially flat year-over-year. However, student financial assistance will increase, chiefly due to a 2% increase in Tuition Aid Grants.
- Fifth, when Governor Christie and the Legislature made the controversial decision to expand NJ FamilyCare, our state's Medicaid program, a key objective and expectation was that a dramatic expansion of Medicaid and Affordable Care Act exchange enrollment would lead to a significant decrease in uncompensated hospital care, historically supported through the State-funded Charity Care program.

I am happy to report that this expectation has indeed come to fruition. Now, with 434,000 New Jerseyans newly insured through NJ FamilyCare and over 285,000 insured through the federal marketplace, we are seeing the percentage of New Jersey residents who are uninsured reach all-time lows. This has led to a substantial decline in documented Charity Care claims and an even larger accompanying increase in Medicaid dollars flowing to our hospitals.

While different hospitals across the State serve different communities and correspondingly have different payer mixes, it is clear that significant new dollars are flowing into our hospitals, reducing documented Charity Care and the associated need for State funding. The Department of Health estimates that annual documented Charity Care claims have fallen by over $450 million since calendar year 2013. Comparing audited calendar year 2014 Charity Care claims to the Fiscal 2017 Budget for Charity Care yields an overall Charity Care subsidy rate of 62%, a level consistent with reimbursements provided prior to the NJ FamilyCare expansion.

Taking advantage of this historic rebalancing of health care finance and the ongoing infusion of new federal Medicaid dollars, the Fiscal 2017 budget recommends a $75 million reduction in State funding for Charity Care. This reduction is offset by an additional $15 million as part of the annualization of a physician rate increase that occurred for only half of Fiscal 2016, as well as a new $20 million increase in State funding for graduate medical education. Funding for this program will have more than tripled since Governor Christie took office, helping to ensure that New Jersey residents have continued access to an adequate number of well-trained doctors.

In total, the reduction in combined State and federal funding for hospitals—not counting the substantial impact of all the new insureds though Family Care and the exchanges—will be approximately $90 million.

- Finally, I know there is great interest in the future of the Transportation Trust Fund Authority (TTFA), including both the size of the Transportation Capital Program and, relatedly, the source of its funding. The Governor's Budget provides debt service support for the Transportation Trust Fund Authority's outstanding bonds and authorized issuance through Fiscal 2016, the last year of the current authorization period. The Fiscal 2017 Budget does not anticipate or reflect the details of any potential new authorization of the TTFA, aside from assuming for presentation purposes that the annual capital program will remain at $1.6 billion. As with past reauthorizations, however, the size of the capital program and its funding mechanism will be determined over the course of this spring via discussions between the Legislature and the Governor. We have every confidence that such negotiations will reach their natural conclusion, resulting in a new authorization prior to the end of this fiscal year, as has been the case for each of the five previous reauthorizations of the Transportation Trust Fund.

Thank you for the opportunity to appear before you to discuss the Governor's Fiscal 2017 budget, as well as your patience with my lengthy opening statement. I will be happy to entertain your questions.