Acting State Treasurer Ford M. Scudder

Senate Budget & Appropriations Committee, Revenue Update

May 19, 2016

Chairman Sarlo, Vice-Chair Stack, Budget Officer Bucco, and members of the Senate Budget & Appropriations Committee, I am pleased to present an update on revenue forecasts and corresponding constructive modifications to the Governor's proposed Fiscal 2017 Budget. I am joined today by 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.

In short, the updated revenues and proposed spending adjustments that I will present today are reflective of a pretty straightforward formula. National downward trends in capital gains and other extraordinary sources of volatile tax revenues are impacting New Jersey, which has caused us, like OLS this morning, to lower our projected revenues across both Fiscal 2016 and 2017. However, a responsible Fiscal 2016 Budget and the strong underlying economy in New Jersey have left us capable of addressing disappointing revenue news with reasonable spending restraints.

Before providing more detail via the packet of updated charts, please let me submit some high level commentary to put the changes in context. Over the past few weeks the federal government and a number of states, including California, Connecticut, Massachusetts, and Pennsylvania, have all announced declines in actual or projected personal income tax receipts. The IRS data speak to the heart of the matter. At the federal level, revenues from January through April of 2016 saw an increase of 4.1% in withholding over the same period of 2015, but final and estimated payments were down 3.1%, and refunds were up 5.1%. All told, this led to an income tax revenue decline of 0.5% at the federal level.

I would love to be here to report that New Jersey is an outlier to the national phenomenon of reduced personal income tax revenue, which seems primarily attributable to a decline in unearned income, but unfortunately that is not the case. In fact, the revenue declines have been largest in those states like ours with highly progressive tax systems, and smallest in states with flatter tax structures.

I want to emphasize that revenues in New Jersey continue to grow. However, the growth is less than previously projected. While the overall revenue picture across Fiscal 2016 and 2017 is negatively impacted by the national phenomenon of a reduction in unearned income, the economy in New Jersey remains stronger than it has been in a decade. The State's unemployment rate stood at 4.4% at the end of March 2016 which was -0.6 percentage points below the national rate of 5.0%. Economic conditions in both the State and the nation are continuing to improve and expected to continue that trend.

In particular, the labor market continues to expand for both the State and the nation as a whole, which is important because jobs growth is the foundation for any recovery. New Jersey does seem well positioned in this regard since the State saw payrolls increase by 58,400 jobs over the last five months of 2015. Continued growth in jobs will support further growth in both consumer spending and the housing market. This has borne true in retail sales data, as well as housing data. Year-to-date single-family home sales through April are +19.8% higher than a year ago, total year-to-date home sales as of April are +18.5% higher than a year ago, and the share of mortgages in foreclosure had fallen by 1.5 percentage points year-over-year through the end of the first quarter.

Transitioning to the update package that we have prepared and distributed for your review, both Treasury and OLS, on balance, are reporting lesser rates of revenue increases than prior forecasts, with the bulk of the change in each case in the Gross Income Tax.

Turning first to the page headed "FY 2016 Fund Balance," you can see that we are now projecting total revenues in Fiscal 2016 of $33.198 billion. For major tax revenues, this remains an increase over 2015 by nearly $450 million, though for all revenues, it is $603 million less than we had anticipated as of the Governor's Budget Message in February. After accounting for increased lapses and a decline in anticipated supplemental needs, the reduced revenue leads to a decline of $239 million in our projected ending fund balance, which we now estimate at $548 million.

Before moving to Fiscal 2017, please let me provide some additional color on the performance of individual revenues in Fiscal 2016.

- Last year at this time, you may recall my predecessor saying that Treasury believed a good portion of the increase in final payments in FY2015 to be a one-time event based upon capital gains realizations in the fall of 2014. This was an assessment that was not shared by OLS, but in retrospect much more of the increase was a one-time event than any of us believed at the time. I provide this commentary simply to point out that our reliance on taxing extraordinary sources of income like capital gains, bonuses, and the like is not just a detriment to economic activity in New Jersey, but also to the budget process.

I will repeat this as often as I possibly can: our progressive tax code makes us far too reliant upon extraordinary sources of income from our highest income earners. For instance, while many of the top taxpayers only file extensions in April, so we won't have a full gauge of their Tax Year 2015 payments until October, initial data indicate that tax receipts from the top taxpayers will drop by approximately 40% year over year. Not only does that reliance impair the accuracy of revenue forecasts due to the volatility it creates in tax receipts, but there is also an especially painful result on State services when inevitable, but mostly unforeseeable, declines in revenues occur. During their April testimony and again this morning, our counterparts at OLS highlighted this same issue when they discussed the tremendous inherent forecast uncertainty in New Jersey.

- The Corporation Business Tax also remains incredibly volatile, though our forecast for FY16 remains the same as in the Governor's Budget Message. Through April, revenues were down 10.6% year-to-date, as compared to our forecast of a decline of 12%.
- At the time of the Governor's Budget Message, we projected 5.0% growth in the Sales Tax for Fiscal 2016. With receipts up 5.2% year-to-date, we have kept our forecast unchanged for this line item as well.
- The net decline of $253 million in "Other" tax and non-tax revenues is primarily attributable to two adjustments. First, due to continued litigation by plaintiffs who were not party to the lawsuit, the Exxon settlement will now not be available in FY16 as anticipated, even though both the State and Exxon have agreed to the settlement and the funds sit in an escrow account. Given the historically large value of the settlement, in addition to the already sizable reduction in surplus prior to the effect of this protracted pretense, we would encourage those parties involved to give up their quest and instead think in the best interest of all citizens of the State.

  Second, due to low energy prices in concert with a mild winter, we have reduced our anticipated revenue from energy sales and corporate profits for 2016 by a combined $119.6 million. While over the past few years we have gained improved insight into the trends in energy sales and use tax payments by major utilities, the structure of the tax—with prepayment of half the year's estimated payments in May of each year and a large dedication to the Energy Tax Receipts Property Tax Relief Fund—still lends itself to the potential for dramatic, unforeseen volatility in the on-budget portion of the tax.

Aside from those major changes, there are minor adjustments based on trend growth rates in the Casino Revenue Fund, the Motor Fuels Tax, the Cigarette Tax, and the Corporation Banks and Financial Institutions Tax that, in the aggregate, sum to a net decrease in anticipated revenue of approximately $5 million.

- With respect to spending in Fiscal 2016, we are recognizing a decrease in supplemental spending needs projected in February of $81 million—more than half of which is attributable to the lack of any major snowstorms after January—in addition to an increase in net underspending, or lapses, of $283 million. Trend savings across programs account for most of the projected underspending; thankfully the strong economy is allowing for lower spend across many of the State's social programs.

Prior to transitioning to Fiscal 2017, I believe it is important to emphasize that despite the forecasted decline in revenues, we are not suggesting any programmatic changes to budgeted appropriations in 2016. We will continue to properly manage the budget with an eye toward ending the year with a larger surplus, as we want to keep the State on the upward trajectory developed in that regard over the past few years.

Turning now to the page headed "FY 2017 Revised Budget," we are now projecting total revenues of $34.591 billion, a net decrease of $241 million compared to our estimate as of the Governor's Budget Message.

Notably, we are decreasing our estimate for the Gross Income Tax by $443 million to $13.98 billion. This estimate reflects both a lower base and reduced growth rate, now projected at 3.5% prior to accounting for the use of some TANF funds to pay a portion of the EITC and Lottery withholding adjustments, which brings the topline growth rate to 4.3%. Speaking high level, this estimate takes into account both the flat start to the year for capital markets, as well as the apparent loss of our previously most wealthy citizen. Those facts, in concert with the previously described overreliance on unearned income of our Gross Income Tax, greatly reduce the potential growth rate in the GIT.

Diving deeper into our GIT forecast, it may be helpful to break down our analysis into the Gross Income Tax's payment components:

- First, we anticipate that employer withholding --- the largest single component of the GIT --- will grow at 3.5%, consistent with continued steady growth in employment and wages as our economy continues to recover. In particular, with our unemployment rate as low as it is, there is no longer much, if any, so called "slack" in the labor market, meaning we should begin to see upward pressure on wage growth, helping drive withholding growth.
- Second, we expect that estimated payments will grow at 3.7%, consistent with moderate growth in non-wage income.
- Third, we believe that the increase in estimated payments will ultimately constitute neither an overpayment nor underpayment against final tax liability, resulting in flat final payment totals year-over-over and refunds growing slower than income at 2.5%.

Again, the combined net result of this trend growth in wage income and low growth in non-wage income is net fiscal year growth of 3.5% that increases to 4.3% based on adjustments related to funding of the EITC and accounting for changes to Lottery withholding.

While continued job growth and slight increases in the rate of inflation would suggest that growth in Sales Tax receipts can continue at approximately the same pace we have seen this year, we are maintaining our more cautious estimate of 3.0% growth in Fiscal 2017. The rate of growth in the Sales Tax typically follows something of a wave pattern declining from higher rates of growth, such as we are seeing now, to more moderate levels over the medium term. We believe that we will experience such a reduction in the growth rate over the course of Fiscal 2017. First, purchases of certain consumer durables, such as automobiles, are starting to level off. Second, the continued shift toward remote Internet and catalog sales is continuing to erode our bricks-and-mortar Sales Tax base.

Meanwhile, the shift of the receipt of the Exxon settlement into Fiscal 2017, along with a number of other items that experienced smaller shifts, delivers a total increase in "Other" revenues of $67 million. Increases in the Casino Revenue Fund and the Cigarette Tax are offset by declines in Fringe Benefit Recoveries, Medicaid Uncompensated Care, Energy taxes, the Motor Fuels Tax, and the Corporation Banks and Financial Institutions Tax.

As I discussed when we were here in April, one of the primary pain points of operating at a low surplus, in concert with such a high tax burden and volatile tax structure, is an abundance of difficult appropriations decisions, particularly in years like this one.

For Fiscal 2017, we could not maintain a reasonable fund balance without engaging in such difficult decision-making. The Governor's desire was to provide the least disruption possible to necessary, ongoing State services and programs, while still yielding a closing fund balance that can account for our inherent revenue volatility.

In order to achieve that goal, we are proposing three main programmatic changes for Fiscal 2017. These decisions were not made lightly, and we encourage the members of this Committee to work with us in a concerted effort to protect at least the level of surplus proposed so that going forward we are better able to withstand our known revenue volatility.

- The first change is to slow the implementation schedule of the conversion of BEIP grants into tax credits. The Administration clearly acknowledges the importance of investment in New Jersey by the business community to continue our strong employment trends, and has made concerted efforts to make the State more hospitable to business, such as via the corporate tax cuts and switch to single-sales factor earlier in the Administration, as well as recent announcement of the $380 million decrease in unemployment insurance taxes. Legislation enacted in January calls for outstanding BEIP grants to begin being credited against corporate tax returns starting in Fiscal 2017, but we felt that modifying that payment schedule would be less disruptive to the people and businesses of the State than suspending or canceling a program already in process. Our proposal is fairly simple. EDA will continue accepting and processing applications to convert grants into credits. But the payment schedule of those credits will be slowed, with only 5% of past amounts due being paid in 2017, instead of the more aggressive 30% set forth in current legislation. This modification manifests itself as an increase in Corporation Business Tax revenue in FY17, thus the positive variance of $135 million shown on the fund balance sheet versus the Governor's Budget Message. It is also worth highlighting that this programmatic change accounts for nearly half of the difference between the Treasury and OLS estimates for CBT and total revenue in Fiscal 2017.

- The second programmatic change is to increase by $25 million the reduction in the appropriation of State dollars for Charity Care. After accounting for the federal match, this represents a reduction in hospital funding of $50 million. More than 700,000 additional New Jerseyans have signed up for health insurance since 2012 via the expansion of NJFamilyCare and launch of the federal exchange. The increase in the number of insureds in New Jersey has led to a substantial decline in uncompensated hospital care and an even larger accompanying increase in Medicaid dollars flowing to our hospitals. Both of these were key expectations of the Governor and the Legislature when you jointly made the decision to expand our State's Medicaid program. With such significant new dollars flowing into our hospitals, it is appropriate to reduce the investment of limited State assets commensurately. As the federal match for Charity Care is recognized on Schedule 1, this change leads to a decrease of $25 million in the "Other" line item.
- Finally, we are proposing to increase the Gross Income Tax withholding schedule for Lottery jackpot winners. At present all Lottery winnings above $10,000 face withholding of 3% for State Gross Income Tax, much lower than our highest marginal tax rate of 8.97%. Going forward, large jackpots winnings will face immediate withholding at the highest tax rate. This is absolutely not an increase in taxes owed, and we have no desire to dilute the value of Lottery winnings. But this simple, common sense change will help ensure that existing tax liabilities are ultimately collected on winnings—without leakage due to enforcement issues. We believe this will increase FY2017 GIT revenues by $25 million. Ironically, had this proposal been in place a month ago, income tax collections in 2016 would have been approximately that much higher due to the $429 million Powerball Jackpot. Again, this is not a tax increase, but only a way to ensure enforcement and collection of existing liabilities.

These are constructive suggestions, but these proposals are made with full knowledge that this is a budget process. We look forward to considering constructive ideas others may have so we can work together to maintain a responsible level of surplus.

Following the forecasted changes in revenues and proposed changes in appropriations for Fiscal 2017, we anticipate a closing fund balance of $613 million. Aside from those just outlined, there are no other major programmatic changes proposed in Fiscal 2017. In particular, I would point out that we are still on track to increase the pension contribution to 3/10ths of the actuarially recommended contribution (or ARC) in Fiscal 2016 and 4/10ths of the ARC in Fiscal 2017.

I would stress, however, that this lower closing fund balance is after our proposed solutions. This lower level of surplus heightens the need to reach the $250 million in health benefit savings assumed in the Budget. Management representatives will be meeting with labor representatives of the State Health Benefits Plan (SHBP) PDC later this week to continue discussing savings ideas. At this point, there continue to be positive discussions with the SHBP PDC.

Unfortunately, as an unfavorable update to comments I made last week, members of the NJEA made clear on Monday that the union members of the School Employees' Health Benefits Program (SEHBP) PDC will oppose even reasonable changes to plan design that would lower cost for their members without any corresponding decrease in service or quality. For instance, their opposition to so-called Medicare Advantage Plans that have been implemented in other states, as well as other reasonable changes will not only deny their own members savings and better care, it could potentially trigger offsetting negative budget consequences that impact all citizens, including their own members.

If the plan design committees are unable to agree on reasonable savings like Medicare Advantage Plans or out-of-network cost controls, the Legislature will need to act in their stead. Toward that end, we look forward to working with this Committee to explore amendments to the laws that created the PDCs or budget language to institute reasonable health benefit reforms. Alternatively, without either PDC or legislative action, we will be forced to cut funding to the cost drivers in the State Budget, including State services for all New Jerseyans and institutions that employ many members of the teachers unions that are making reasonable cost controls out of reach.

In conclusion, yet again the most significant variance from the Governor's Budget Message, as estimated both by Treasury and OLS, pertains to the Gross Income Tax. It is important to keep the big picture in context, however:

- Our budgeted surplus continues to grow over prior years, though more modestly.
- State cash flow continues improving.
- Our scheduled pension payments are unchanged, increasing dramatically over prior years.
- Our use of one-shot resources is still reduced considerably from the Budget inherited at the start of the Administration.
- Our spending restraints remain in place.
- And our revenue projections, though slightly more optimistic than OLS, are well within reasonable parameters, and, in most cases, below five and ten-year averages. Prudent planning and an improving economy have helped us weather the revenue forecast reductions.

Thank you for your kind attention. We will be happy to entertain your questions.

FY 2017 Budget

May 18, 2016

STATE REVENUES
FISCAL YEARS 2016 AND 2017 ESTIMATES
(thousands of dollars)

	FY 2016 Budget 2/16/16	FY 2016 Revised 5/18/16	FY 2016 Change	FY 2017 Budget 2/16/16	FY 2017 Revised 5/18/16	FY 2017 Change
Major Revenues						
Gross Income Tax	$13,758,000	$13,408,000	($350,000)	$14,424,630	$13,982,280	($442,350)
Sales Tax Dedication-PTRF	728,000	724,900	(3,100)	749,500	751,100	1,600
Sales Tax	9,315,777	9,315,777	0	9,597,412	9,597,412	0
Sales Tax Dedication-General Fund	(705,900)	(702,800)	3,100	(727,400)	(729,000)	(1,600)
Corporation Business	2,335,973	2,335,973	0	2,335,973	2,470,973	135,000
State Lottery Fund	965,000	965,000	0	965,000	965,000	0
Motor Fuels	556,550	549,500	(7,050)	545,550	540,000	(5,550)
Motor Vehicle Fees	479,089	479,089	0	515,585	515,585	0
Transfer Inheritance	828,139	828,139	0	848,496	848,496	0
Casino Revenue Fund	203,171	208,660	5,489	199,927	208,548	8,621
Insurance Premium	668,656	668,656	0	688,716	688,716	0
Cigarette	163,638	170,000	6,362	126,531	149,040	22,509
Petroleum Products Gross Receipts	218,064	218,064	0	218,064	218,064	0
Corporation Banks and Financial Institutions	155,326	145,000	(10,326)	155,326	150,000	(5,326)
Alcoholic Beverage Excise	109,458	109,458	0	110,827	110,827	0
Realty Transfer	309,112	309,112	0	330,366	330,366	0
Tobacco Products Wholesale Sales	22,396	22,396	0	22,396	22,396	0
Public Utility Excise (Reform)	15,570	15,570	0	15,570	15,570	0
Total Major Revenues	**$30,126,019**	**$29,770,494**	**($355,525)**	**$31,122,469**	**$30,835,373**	**($287,096)**
Miscellaneous Taxes, Fees, Revenues, Transfers						
Other Energy Taxes	303,694	184,072	(119,622)	323,943	306,208	(17,735)
Assessment on Real Property Greater Than $1 Million	114,773	114,773	0	124,512	124,512	0
Medicaid Uncompensated Care	453,592	488,245	34,653	386,781	371,885	(14,896)
Good Driver	79,700	79,700	0	81,300	81,300	0
Hotel/Motel Occupancy Tax	100,430	100,430	0	105,452	105,452	0
Fringe Benefit Recoveries	676,180	659,910	(16,270)	763,393	712,151	(51,242)
Interfund Transfers	500,511	500,674	163	489,113	489,164	51
Casino Control	42,889	42,889	0	50,268	50,268	0
Gubernatorial Elections Fund	700	700	0	700	700	0
Other Miscellaneous	1,402,294	1,256,268	(146,026)	1,384,303	1,515,034	130,731
Total Miscellaneous Taxes, Fees, Revenues, Transfers	**$3,674,763**	**$3,427,661**	**($247,102)**	**$3,709,765**	**$3,756,674**	**$46,909**
TOTAL STATE REVENUES	**$33,800,782**	**$33,198,155**	**($602,627)**	**$34,832,234**	**$34,592,047**	**($240,187)**

FY 2016 Fund Balance

(In Millions)

	Appropriations Act	Budget Revised	May Testimony	Change to Revised
Opening Surplus	**$ 627**	**$ 824**	**$ 824**	**$ -**
Revenues				
Income	$ 13,930	$ 13,758	$ 13,408	$ (350)
Sales	9,080	9,316	9,316	-
Corporate	2,677	2,336	2,336	-
Other	8,236	8,391	8,138	(253)
Total Revenues	$ 33,923	$ 33,801	$ 33,198	$ (603)
Lapses		226	509	283
Total Resources	**$ 34,550**	**$ 34,851**	**$ 34,531**	**$ (320)**
Appropriations				
Original	$ 33,785	$ 33,785	$ 33,785	$ -
Supplemental		279	198	(81)
Total Appropriations	**$ 33,785**	**$ 34,064**	**$ 33,983**	**$ (81)**
Fund Balance	**$ 765**	**$ 787**	**$ 548**	**$ (239)**

Changes in FY 2016 Supplementals

(In Thousands)

	Feb 2016 Revised	May 2016 Testimony	Difference May vs. Feb	
Supplementals	**$ 278,667**	**$ 197,790**	**$ (80,877)**	
Significant Changes in Supplementals				
NJ SMART			$ 9,708	*
Nonpublic Handicapped and Auxiliary Services			5,900	*
SEMI/MAC Admin			5,755	*
Brownfield Site Reimbursement Fund			(3,500)	
Medical Malpractice			(10,000)	
Community Care Waiver Federal Revenue Shortfall			(24,000)	
Tort Claims			(25,000)	
Winter Operations			(42,125)	
Miscellaneous - None Greater than $2 million (net)			2,385	
Net Change in Supplementals			**$ (80,877)**	

* Offset by revenue change

Changes in FY 2016 Lapses

(In Thousands)

	Feb 2016 Revised	May 2016 Testimony	Difference May vs. Feb	
Lapses	**$ 226,217**	**$ 508,824**	**$ 282,607**	
Significant Changes in Lapses				
Medical Assistance and Health Services/Aging Trend			$ 95,151	
Family Development Trend			26,492	
State and Local Employee Benefits Trend			23,717	
Capital Improvement Program Balances			19,979	*
Corrections Salary Trend			16,000	
Prior Year Lapse			13,394	
Senior Freeze Trend			12,100	
Children and Families Trend			9,600	
Mental Health and Addiction Services Trend			9,459	
General Obligation Bonds - Refunding Savings			8,000	
Hospital Asset Transformation Program - Debt Service			7,255	
Central Motor Pool Carryforward Balances			7,000	
Economic Redevelopment and Growth Grants Trend			6,474	
Dormitory Safety Trust Fund Balances			5,637	*
Human Services Central Office Balances			4,234	
New Jersey Building Authority - Refunding Savings			4,205	
Developmental Disabilities Trend			3,934	
Health Trend			3,888	
Miscellaneous - None Greater than $2 million (net)			6,088	
Net Change in Lapses			**$ 282,607**	

* Offset by revenue change

FY 2017 Revised Budget

(In Millions)

	FY 2016 May Testimony	FY 2017 Budget	FY 2017 May Testimony	FY 2017 Difference
Opening Surplus	**$ 824**	**$ 787**	**$ 548**	**$ (239)**
Revenues				
Income	$ 13,408	$ 14,425	$ 13,982	$ (443)
Sales	9,316	9,597	9,597	-
Corporate	2,336	2,336	2,471	135
Other	8,138	8,474	8,541	67
Total Revenues	$ 33,198	$ 34,832	$ 34,591	$ (241)
Lapses	509			
Total Resources	**$ 34,531**	**$ 35,619**	**$ 35,139**	**$ (480)**
Appropriations				
Original	$ 33,785	$ 34,829	$ 34,526	$ (303)
Supplemental	198			
Total Appropriations	**$ 33,983**	**$ 34,829**	**$ 34,526**	**$ (303)**
Fund Balance	**$ 548**	**$ 790**	**$ 613**	**$ (177)**

FY 2017 Budget Changes

(In Thousands)

	FY 2017		
	Feb Budget	**May Testimony**	**Difference**
FY 2017 Budget	**$ 34,828,692**	**$ 34,525,593**	**$ (303,099)**
Significant Changes in Budget			
School Aid Notices			$ 29,825
Lead Testing for Schools			10,000
Alternative Benefit Program Trend			(3,000)
Non-Contributory Insurance Trend			(4,000)
Economic Redevelopment and Growth Grants Trend			(4,515)
Supplemental Security Income (SSI) Trend			(4,576)
General Assistance Trend			(6,127)
Division of Child Protection and Permanency Trend			(6,900)
Federal State Criminal Alien Assistance Program (SCAAP) Balances			(9,300)
Cost Share Agreement (CSA) Uncommitted Balances Offset			(10,000)
Brownfield Site Reimbursement Fund			(12,220)
Building Authority - Cancelled Bond Sale			(18,080)
New Jersey Transit Subsidy Offset from Clean Energy			(20,000)
School Construction and Renovation Fund Debt Service			(38,000)
Charity Care Reduction			(50,000) *
State and Education Health Benefit Fund Reserves			(59,000)
Medical Assistance and Health Services/Aging Trend			(93,032)
Miscellaneous- None Greater than $2 million (net)			(4,174)
Net Change in FY 2017 Budget			**$ (303,099)**

* Includes both State and federal funds.