Fiscal Year 2014 Budget Briefing

By David Rousseau
Tax and Budget Analyst

The $33 billion (technically $32.977 billion) Fiscal Year 2014 budget is the second-largest spending plan in New Jersey history. It was approved in June by the legislature and signed by the governor without any line-item vetoes.

However, the strong bipartisan support of the budget should not be seen as an indication that New Jersey’s fiscal situation is rosy. Not only does the budget include a high degree of risk, it fails to meet needs that have gone unmet since the start of the Great Recession.
In Dueling Revenue Estimates, the Difference of Just One Percent Could Threaten Surplus

No surprise that the Office of Legislative Services (OLS) and the Christie administration came up with slightly different numbers about tax collections over two years. Between FY 2013, which ended June 30, and FY 2014, the administration expects to collect $64.008 billion; OLS thinks revenues in both years will yield $700 million less. Is such a small difference material? It could be.

Last year, OLS projected a shortfall of $628 million and the administration ended up having to move hundreds of millions in spending around to produce a balanced budget. The same thing could happen again.

Here’s why it matters: The projected surplus for FY 2014 is only $300 million, less than one percent. That’s not much of a cushion in the eyes of the credit rating agencies – or anyone else.

Each May, with ten months of tax collections in hand, the administration and OLS present their year-end projections to the budget committees. Most years, the two projections are very close. Not so in May 2013: The administration assumed $31.195 billion in revenue; $259 million more than the $30.936 billion assumed by OLS. This nearly 1 percent difference is one of the largest ever so late in the fiscal year.

Since the adoption of the budget, the administration and OLS have updated their estimates based on May’s collections and a snapshot of the major taxes. OLS has reduced its projected shortfalls the corporate and sales taxes so that the two estimates are narrowing. OLS still expects a shortfall in FY 2013 but one lower than its $259 million May projection.

With so many moving parts the final numbers for FY 2013 will not be known until an audit is released in December or January. Only then will we know if the $467 million surplus assumed in this year’s budget will be realized or not. However, an accurate projection will be possible in September when the year-end revenues are confirmed by the administration. If the FY 2013 collections are closer to the administration numbers, then the current growth rates assumed by both the administration and OLS will be sufficient to meet the projections (excluding internet gaming).

All of this back and forth has a significant impact on the recently enacted budget. Its $32.813 billion in revenue is $441 million above the late May OLS projection of $32.379 billion. The difference for FY 2014 is due primarily to the differences in FY 2013 projections. Except for the $130 million disagreement about internet gambling revenues, OLS and the administration are very close together on their views of the economy and the rate of revenue increase.
A true reading of FY 2014 revenue will likely not be available until early January 2014 when important income tax and sales tax collections are known. A wild card for FY 2014 could be the income tax where both the administration and OLS interpreted the spike in income tax payments toward the end of calendar 2012 to taxpayers avoiding higher federal rates on capital gains beginning in 2013. If both underestimated the amount of one-time revenue then they may be overestimating FY 2014 income tax revenue.

“Past performance is no guarantee of future results” warn the mutual fund ads. So too with the records of OLS and successive administrations. But in 2013, OLS was more accurate in its projections. Last year the difference between OLS and the administration was $628 million ($154 million for FY 2012 and $474 million for FY 2013). For FY 2012, audited revenue was $317 million below the administration’s final target, offset partially by spending coming in $194 million lower, thereby cutting the opening surplus for FY 2013 by $123 million. In FY 2013, the administration has reduced its estimates by $538 million, which is actually more than the $474 million potential shortfall estimated by OLS last June.

A side note on the competing projections: For the past two years, Democratic leaders have insisted that they must use the governor’s projections, rather than the lower estimates provided by OLS, since the governor has sole power to certify the revenue in the budget. But this is not the case: the legislature has chosen to use the higher estimates to avoid the politically distasteful task of filling in the hole with higher revenue, reduced spending or some combination. This explains why the Democratic majority chose in 2011 to use the OLS estimates for FY 2012 that were higher than those of the administration. This allowed legislators to fund their favored priorities with the higher revenue rather than making painful cuts.

David Rosen, the OLS budget expert, reminded the budget committee this spring that the governor’s certification was a ceiling, not a floor. In other words, the legislature could use lower estimates and pass them along to the governor, who could either certify them or stick with the higher projection. However, the governor’s power is restricted to increasing the budgeted revenues, not the spending. The single result of a higher ceiling would be to increase the budgeted surplus.

**Half a Million Working Families Continue to Feel Effect of 2010 Tax Increase**

For the fourth year in a row, half a million New Jersey working families will receive less money from the Earned Income Tax Credit than they received in April 2010. Some families will lose as much as $330 and over the four years will have lost more than $1,300. The average family has lost $124 each year, for a cumulative total of nearly $500, from this common-sense tax credit that rewards hardworking but low-income New Jerseyans.
What’s worse, almost 18 percent of EITC filers who applied for their refunds in April 2012 for the tax year 2011 have yet to receive their payments because of the treasury’s fraud screening process aimed exclusively at low-income working families. The result: 98,812 families are yet to receive about $53.5 million in sorely needed payments that were due over a year ago. Democrats have tried three times to restore the full 25 percent EITC to undo the tax increase that they and the governor imposed on these families in 2010. But the governor has conditionally vetoed the measure twice (in addition to one outright veto), arguing that EITC restoration must be part of a broader tax cut.

This year, in the “get-out-of-Trenton-early” budget deal, the legislative leadership took EITC restoration off the table. Effectively, half a million working families are being held hostage to political games as the governor and legislative majority dance around proposals for unaffordable tax cuts. It was the Democratic majority that supplied the votes to enact the EITC tax increase in 2010. Both the governor and legislative leadership say they would like to restore the EITC, but apparently not enough to actually do so.

Meanwhile, OLS has disclosed the 2012 launch of a fraud screening process by the treasury aimed exclusively, it appears, at lower-income working families. As of March 2013, 98,812 EITC applicants were yet to be paid for a 2011 tax credit. That is almost 18 percent of all EITC claimants who are still waiting for a refund that should have been paid in the spring of 2012. So far, 453,000 of 560,000 applicants have been paid; 7,238 or 1.5 percent have been denied $5.3 million.

The Division of Taxation explains that filers were required to supply additional information and either have not provided it or the it’s is “still under review.” The division further stated that they anticipated a very low number of the pending claims would actually be paid even though only 1.5 percent of earlier claims were denied. What “additional information” beyond the W-2 form do families earning low wages have to file? Capital gains on credit default obligations?

If treasury is correct, the number of New Jersey filers receiving a federal EITC who will also receive a state EITC will decrease from 91 percent in tax year 2010 to 80 percent in tax year 2011, according to OLS. This would be the lowest level of participation since the first years of the program about a decade ago.

This close attention to the tax returns of filers who owe no New Jersey taxes is curious. The potential savings from reviewing these EITC filings is miniscule compared to what might be realized from equally close inspection of the rest of the state’s nearly 5 million tax returns, which generated over $12 billion.

Senate Majority Leader Weinberg’s call for committee hearings on the delay in processing refunds that were due in April should be expanded to include the massive withholding of EITC payments that were due in April 2012.
Even if Housing Fund Diversion is OK’ed by Courts, Other Hurdles Face Administration’s Use of This Revenue

The final budget for the fiscal year that ended June 30 included $164 million in revenues that the administration is seeking to divert from a housing trust fund held by municipalities to assist working families, seniors and people with special needs. While the state and advocates continue the battle over this diversion’s legality, the timing of any potential funds remaining – and the amount of such funds – remains unknown. The head of the Department of Community Affairs has testified he has no idea how much revenue may actually be diverted if the state’s legal efforts are successful, adding that it could be as low as $50 million.

Since the $164 million is in the FY 2013 budget, the administration has likely taken accounting actions to reflect it as FY 2013 revenue even though the cash has not actually been received. Such “accruals” are not unusual at this time of the year as the administration closes the books on the past fiscal year. The administration has also likely used language in the FY 2013 Appropriations Act to justify using these funds to offset housing-related costs that were previously paid out of the general fund, thus providing the $164 million in anticipated budget relief.

Two issues about this $164 million remain.

First, it is the state auditor who decides if the “accrual” holds up, as he does on all similar transactions. If the state doesn’t receive the money from the municipalities before late August or early September, the auditor may not allow the accrual. Even if the state does receive the money, will it be less than $164 million and by how much? Under either of these scenarios, the closing surplus for FY 2013 – and thus, the opening surplus for this year’s budget – will be reduced. Even if the surplus is reduced by the full $164 million, it shouldn’t produce any “balanced budget” issues for FY 2013, since there is a projected $466 million surplus. However, it would have a noticeable impact on the FY 2014 budget.

Second, if the auditor rules that the revenue is not valid for FY 2013, the state will likely continue to try to use the revenue in FY 2014. Aside from the issue of how much money will actually be left to use, the state will be limited in how it uses the funds, since the broad language that was included in the FY 2013 Appropriations Act was eliminated by the legislature in the FY 2014 budget bill. Thus, even if the administration collects the full $164 million – a highly unlikely scenario – it may not be able to generate a similar amount of budget savings since the use of the money will be dictated by the underlying statute, which allowed for the revenue to be returned to the state if it was not used. Of course, the administration could request that the legislature restore the broader language so that maximum budget savings to be achieved.
Although the $164 million represents only 0.5 percent of the nearly $33 billion in revenue for FY 2014, the issue is significant since the assumed surplus is only $300 million and any loss of this revenue – coupled with the potential $130 million risk on the internet gaming revenue, which we’ll examine next – could potentially wipe out the entire surplus.

A Big, Unrealistic Bet on Internet Gambling

New Jersey’s recently enacted budget assumes $160 million in revenues from the launch of internet gambling in the Garden State. While that assumption is down from the initial projection of $180 million, the change is just cosmetic. At $160 million the projection is still over five times larger than the $30 million estimate of the OLS. This represents 30 percent of the $441 total difference between OLS and administration projections for FY 2014, and may be the greatest percentage disagreement in a single revenue projection in any budget.

Assuming that internet gambling begins in late November as required by law, the budget is assuming an average monthly revenue of $23 million (a 12-month annual revenue of $276 million). In order to generate that much revenue annually at the 15 percent tax rate, internet gamblers will need to lose over $1.8 billion. By comparison, all gamblers in Atlantic City will need to lose $2.6 billion to generate the $209 million anticipated from traditional gambling (which is taxed at 8 percent). In other words, gambling losses would need to increase by nearly 70 percent to hit the mark in the budget.

While this is clearly an unreasonable assumption, the numbers may be even harder to hit if internet gambling is not up and running by late November. The Division of Gaming Enforcement can delay the start date; its director says the agency will keep pushing to meet the deadlines but there are concerns this may not happen.

New Jersey does have one advantage. It can review the problems Nevada had getting its online poker systems up and running; those weren’t available until April of this year even though the regulations were approved in late 2011. The casino companies also have an advantage: Some of their other holdings in Nevada and Europe have already started internet gambling.

But there’s still a lot of work to do.

The state has to approve licenses for the casinos and their internet gambling partners (all 12 casinos met the initial July 1 deadline for securing a partner). By the end of this month, the state has to review applications for the casinos and their partners, as well as applications from firms that provide services like age verification, payment processing and geo-location technology. Software needs to be tested and glitches fixed before the systems can go live in late November.
The bottom line: It is unrealistic to think that internet gambling will generate $160 million for this year’s budget. The question is: Just how far off the mark will the projection be? If OLS is correct and the figure is only $30 million, that creates a $130 million shortfall – nearly half (43 percent) of the budget’s assumed $300 million surplus. Even if the actual revenue doubles the OLS estimate the shortfall would still be $100 million – a third of the projected surplus. When such an overly optimistic revenue assumption is coupled with such a small surplus, the fiscal ice we’re skating on is quite thin. Internet risks could be combined with other revenues being lower than OLS projections and the $164 million in housing funds being denied to the state to send the surplus into the lake.

Other Key Issues

In addition to the major issues we’ve outlined so far, here’s where other key issues stand in the recently enacted budget.

School Funding

While no school district will receive less total state aid than it did last year, the budget fails to fully fund the 2008 court-approved school funding formula. If the formula were fully funded, schools would receive an estimated nearly $1 billion more to improve educational quality – and provide property tax relief. While the formula should be fully funded, it’s worth noting that full funding has only happened once, in the first year (FY 2009). The next year’s budget (FY 2010) came close to fully funding the formula, but it was fueled by over $1 billion in federal stimulus funds. Faced with the loss of the federal funds and the approximately $1 billion in revenue generated from the one-year income tax surcharge, it’s not surprising that the school funding formula isn’t being fully funded. To be able to do so will require either additional state revenue or a substantial shift in funding priorities within the budget.

Higher Education

The approximately $720 million in operating aid (not including the $18 million in special aid provided to Rowan University for costs associated with the assumption of UMDNJ’s School of Osteopathic Medicine) for the state’s four-year public colleges and universities in this year’s budget continues the disinvestment trend of the last decade. This is the same amount of operating aid in each Christie administration budget, about $100 million less than in FY 2010 and about $235 million less than in FY 2006 (but $386 million less if adjusted for inflation). Despite the decline and subsequent stagnation of operating aid, total support – including fringe benefits – of $1.4 billion is about the same it was in FY 2007, and about $50 million below FY 2006’s peak (but, again, $230 million - or 16 percent - less when adjusted for inflation).
Municipal Aid

The level funding of municipal aid continues the diversion of up to $260 million in energy tax receipts that the municipalities believe they are entitled to. Returning all or some portion of this money to municipalities would allow them to restore some recent service reductions (including police layoffs in a few cities) and provide tax relief.

Direct Property Tax Relief

This budget does not provide any increase in direct relief to homeowners and maintains the same level of homestead benefit credits that was received in 2012: $518 for 491,000 senior and disabled homeowners and $409 for 346,000 non-senior homeowners. And it comes after a budget year in which no direct property tax relief was paid, due to the administration’s shifting of payments to plug a budget hole.

Pensions

The nearly $1.7 billion this budget puts towards funding the state pension system is by far the largest pension payment ever. The payment is up $650 million from last year, making it the item with the largest year-to-year increase. Even so, this year’s payment is just 42 percent of the what’s required by the actuarial standards that guided the pension reform legislation – less than the 50-55 percent level paid in FY 2008.

Although the governor and legislative leaders tout that they are complying with the law that they enacted to phase-in the state’s pension payments, in the state is still far behind. The 2011 legislation simply legislated the continuing underfunding of the system. If fully funded, the pension payment for FY 2014 would be close to $4 billion - $2.3 billion more than the amount budgeted. But as with school aid there is no way the state can make the full payment without a significant increase in revenue and/or significant restructuring of spending. Even as it stands now, the continued phase-in of pension payments will continue to put pressure on other areas of the budget each year the increase in the pension payments will continue to have first call on any revenue growth.

Budget Risk: Is Another $1 Billion Shortfall Possible?

Now that we’ve explored the micro level of a number of specific issues related to the recently passed budget, let’s zoom out and examine the budget’s risk. Every budget contains risk, the extent of which is defined by the underlying economy, the revenue and spending assumptions and the level of surplus.

On the revenue side, it is possible that collections could be short by as much as $600 million to $800 million for this budget. In addition, there are known expenses that haven’t been budgeted, including $24 million for the U.S. Senate primary and general elections, $75 million to $100 million for snow removal, New Jersey Sports and Exposition operating support and the annual
tort claims the state settles (the latter three are usually not included in the budget). And other expenses always pop up; those could add $100 million to $200 million to the total. As an offset, some spending areas always come in under-budget.

When combined, the potential revenue and spending risks in this budget could be close to $1 billion - similar to the magnitude of the FY 2013 shortfall.

It’s worth looking back on that budget to see what actions were taken to maintain a balanced budget with a reasonable surplus and how those actions may or may not be relevant to this year’s budget. Since 2001 every administration has had to make mid-year corrections to cover a shortfall; some of the actions have had real policy implications, while most have been accounting shifts.

Based on the administration’s May 2013 presentation, the combination of revenue shortfall and increased spending needs totaled approximately $1.1 billion for FY 2013: $123 million less in opening surplus than projected, $539 million less in certified revenue and $419 million more in spending. The revenue shortfall would have been even greater had the state not collected over $400 million more than it anticipated in the income tax.

This shortfall was offset by reducing the surplus from $648 million to $410 million for a “savings” of $238 million, shifting the payments of the Homestead Benefit Credit from March to August 2013 to save $394 million and spending $449 million less than anticipated. None of these actions had significant policy implications.

But these options aren’t all on the table this year. For starters, the Homestead Benefit Credit can’t be shifted because it will be paid out so early in the budget year. There is also much less of a surplus to reduce because last year’s surplus included $183 million in contingency funds to pay for the first year of a tax cut – funds that were never spent. This year’s thin surplus of $300 million will be hard to reduce by any significant amount until very late in the fiscal year. And on the spending side, 30 percent ($125 million) of the under spending last year was the product of refinancing transportation and school construction debt – an option that looks unlikely this year. Another portion of the under spending came from shifting costs to federal and dedicated state funds that may not be available for FY 2014. Looking to FY2014, if the income tax continues to perform as it has over the past few months, the collections could exceed projections enough to offset shortfalls with other taxes.

Bottom line: If this year’s shortfall reaches $1 billion, the administration will have fewer options to call on to produce a balanced budget and protect the $300 million surplus.