An across-the-board state income tax cut would be detrimental to New Jersey’s future because it would do nothing to create jobs and grow the economy while disproportionately helping those who need it least and eroding public capacity to invest in the true building blocks of job growth and a strong economy.

The state’s finances are in no shape to absorb the revenue loss that an income tax cut would create – and even if they were, there are more effective ways for the state to invest those dollars in proven methods to grow the economy and create good jobs and shared prosperity.

Background

After two years of negotiations on various types of tax cuts with legislative leaders, the administration has sent a clear signal that it might return to its initial 2012 proposal of a 10-percent across-the-board income tax cut. The governor’s closest economic advisor has identified this type of tax cut as the top priority for the governor’s “second term economic agenda.”

Details of the likely proposal have not been released. But, based on the 2012 tax-cut plan, here are what appear to be reasonable assumptions of what could be proposed this year:

• A 10 percent reduction in all state income tax rates

• The tax cut would be phased in over three calendar years, with a 3.33 percent reduction in the first year that grows to a 6.67 percent reduction in the second year before reaching the full 10 percent reduction in the third year. (The cost to the state would be borne over four fiscal years, since fiscal years do not match up with calendar years.)

• The 2010 cut to the state Earned Income Tax Credit (EITC) for low-income working New Jerseyans would be restored to 25 percent of the federal credit.

• The argument in favor of the tax cut would be that the state’s fiscal house is in order, and therefore it is time to cut taxes to spur economic activity and create jobs.
The proposal would result in an annual revenue loss of approximately $1.54 billion once fully phased in.²

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**Tax Cuts as Economic Boon: A Discredited Theory & Flawed Strategy**

The assertion that tax cuts will increase economic activity, produce badly needed jobs and grow New Jersey’s faltering economy is fictional.

For 30 years, tax cutters have invoked supply-side economics as the rationale for pushing tax cuts. Simply put, the theory is that a reduction in tax rates will increase economic growth and, as a result, increase tax collections. That is, if one pays less in taxes the result, in aggregate, will be increased revenues because of the additional economic activity supporters claim a tax cut would produce. When tried in the real world, it makes no sense – as shown by decades of experience.

States that enacted major personal income tax cuts in the 2000s, before the most recent recession hit, were as likely to lose economic ground as to gain it.

Of the six states that enacted large personal income tax cuts in the years before the recession, three saw their economies grow more slowly than the nation’s in subsequent years, and the other three saw their economies grow more quickly. And the three that grew quickly are, unlike New
Jersey, major energy-producing states that benefitted from an increase in production and a sharp rise in oil prices in the years after they cut taxes.

Similarly, the biggest tax-cutting states of the 1990s – all of which enacted substantial personal income tax reductions – grew jobs during the next economic cycle (2000-2007) at an average rate one-third that of states that were more cautious. And the biggest tax-cutting states also had slower income growth. In none of these states did personal income growth in the next economic cycle exceed inflation. (New Jersey was one of the big ‘90s tax-cutting states but is not included in these averages because it raised taxes in 2004, which helped offset the ‘90s cuts.)

And what about states without any income taxes at all? Despite being held up as models of economic growth by some policymakers, the economies of these states – on the whole – have fared no better over the past decade than those of so-called “high-tax” states – like New Jersey. And the no-tax states that have done well in recent years have advantages like oil and natural gas that have nothing to do with tax policy. (The “high-tax” states are actually weighed down by New Jersey's economic performance in the 2000s, which was laggard due to the aforementioned 1990s tax cuts and other factors unrelated to taxes.)
Meanwhile, the academic literature overwhelmingly mirrors real-world experience: There is simply no consensus whatsoever that cutting taxes boosts states’ economies and creates jobs.

While many studies find no correlation between state tax levels and economic performance, some find that higher state taxes are associated with better economic performance when those taxes pay for higher-quality education, better infrastructure and other important public goods. As for studies that link lower taxes and economic growth, they lack consistency as to which taxes matter most for economic growth, or which time periods or economic measurements matter—and even when these studies conclude taxes’ effect on state economies are statistically significant, the effect should be viewed as of such negligible economic significance that it should not be allowed to drive decisions as to whether taxes should be increased or cut.5

There is more real-world evidence available right here in New Jersey, from the expiration of an income tax surcharge on the wealthiest New Jerseyans. This surcharge expired on December 31, 2009, producing a significant tax cut for some residents just as the full effects of the Great Recession hit New Jersey. This tax cut saved taxpayers with incomes over $400,000 between $600 million and $1 billion each year. Over the four years the tax cut has been in place, high-income families have enjoyed between $2.5 and $4 billion in tax cuts.

Has it worked to boost the state’s economy? The answer is clearly no.

Four years of more income for wealthier New Jerseyans accompanies one of the most sluggish crawls out of the recession of any Northeastern state. New York has fully recovered all the jobs lost and added 50 percent more, Pennsylvania has 80 percent of its jobs back, but New Jersey has restored just over half.6 No state has a larger share of its workforce suffering long-term unemployment than New Jersey.

Stepping back, there are a number of common-sense reasons why the evidence – both in the real world and academia – fails to support personal income tax cuts as a strategy for boosting state economies. For example:

• **Other factors are much more important to a state's economic growth.** Trends in the national and international economy, the education of a state’s workforce, the proximity to major markets and the mix of industries in a state are among the major factors that determine the growth of state economies. Differences among states in state personal income taxes, by contrast, are a very minor issue.

• **State and local taxes help pay for services that residents and businesses want and need.** State and local taxes are often higher in some locations than others because they are financing higher-quality public services: better schools, universities, roads and mass transit; more public recreational facilities; or better police protection. When higher taxes pay for better services, they not only may have no adverse impacts on business and job location decisions whatsoever, but likely even have positive impacts (when, for example, the reduction in other business costs exceeds the taxes themselves).
It’s a zero-sum game. Because states must balance their budgets, tax cuts must be paid for. One way to do so would be to hope that existing revenues grow quickly enough to cover the cost of the cut, as well as any ongoing state spending that is usually covered by those revenues. This is the mythical “tax cut that pays for itself.” Much more likely, states will pay for tax cuts by reducing services, failing to adequately meet growing needs, raising other taxes – or all three. These actions slow the economy and offset any economic benefit of the tax cuts.

Across-the-Board Income Tax Cut Would Disproportionately Benefit Upper-Income New Jerseyans

An across-the-board income tax cut benefits New Jersey households least in need of relief at the expense of those under the greatest financial stress.

New Jersey’s income tax was enacted in 1976 with a single purpose, as enshrined in the state Constitution: to provide property tax relief. So if New Jersey’s income tax revenues are reduced by 10 percent, or about $1.5 billion a year, there is much less state funding for mitigating property taxes, which eat up a far greater share of middle-class family incomes than wealthy family incomes.

When New Jersey slashed its income tax in the mid-1990s, the result over the next decade (until the state in 2004 raised some income taxes) was predictable: There was a revenue loss over the decade of about $14 billion as households paid less in income tax. Because of multiple changes in tax laws, it is not simple to track how this tax cut reduced revenue to the constitutionally dedicated Property Tax Relief Fund. But on the whole, the tax cut meant that there was much less money available that decade to mitigate the burden of property taxes. The bottom line: Overall state and local taxes actually increased for more than 90 percent of New Jersey households; only households with annual incomes approaching $200,000 saw an actual tax cut.7

Besides the revenue it produces to meet New Jersey’s needs, the income tax has equity built in: If you don’t make the money, you don’t pay the tax. Particularly in a deep recession, if someone does not get a bonus, suffers a loss of overtime, gets reduced to part-time or is laid off, their reduced income tax bill reflects their economic reality. This is not the case with property taxes, which tend to go up regardless of one’s ability to pay. Moreover, New Jersey’s income tax rates, like those of most states and the federal government, are graduated. That means the rates rise with income. The highest rates apply only to those that are comfortably affluent, if not plain wealthy: Almost 40 percent of the state income tax is collected from the two percent of New Jersey households that enjoy $500,000 or more of income.

All the measures available point to a steady erosion of New Jersey’s middle class. Not only are average incomes not keeping up with inflation, they are declining. And it’s only getting worse. For example, even as the recession bore down on New Jersey in 2010, gross income actually
increased by $12.9 billion statewide – but 49 percent of the gains went to the top 1 percent. An across-the-board income tax cut would only serve to accelerate this trend.

Consider the impact by income group. A family right in the middle 20 percent of New Jersey households, earning between $45,000 and $72,000, would see an average $1.65 per week tax cut, not enough for a half-gallon of milk. In that middle bracket, on average, the tax decrease represents just 0.1 percent of a household’s total income. On the other hand, a family in the top 1 percent, with an annual income of more than $797,000, would enjoy an average extra $274.10 per week, enough for two orchestra seats at a Broadway play. In this bracket, on average, the tax decrease represents only 0.7 percent of a household’s total income – but that income is far greater, which causes the disparity. (*For a full breakdown of the tax cut’s impact by income level, see Appendix A.*)

Under an across the board income tax cut, the top 20 percent of New Jersey households would reap 80 percent of the cut, while the remaining 20 percent of the cut would be spread among the bottom 80 percent. The top 1 percent would receive 39 percent of the cut, and the top 5 percent would receive 58 percent.
Tax Cuts Are a Poor Investment Strategy for New Jersey’s Future

If New Jersey’s finances were strong enough to fund a tax cut – and they’re not – there are more effective ways to grow our economy and create good jobs.

Much of the political discussion about tax cuts in New Jersey in recent years has centered on the question of “affordability.” But framing the question in this simplistic manner ignores the deeper fiscal challenges facing the state, as well as the broader question of whether a tax cut would be money well spent.

The Great Recession wreaked havoc on state budgets across the nation, and New Jersey was no exception. New Jersey’s revenues dropped dramatically – by 15 percent – from the peak of 2008 to the low point of 2011. Income tax revenues fell even more sharply, by 20 percent.

But while income tax revenues have largely recovered and state spending has increased, funding for many important state programs – including property tax relief – has not.

Since 2008, after adjusting for inflation, direct property tax rebates and credits are down by 82 percent; state aid to towns and counties is down 47 percent; total support for four-year public colleges and universities is down by 10 percent; and operating aid for county colleges is down by 12 percent. While total state support for K-12 education – which includes district costs for teacher pensions and Social Security – has risen by 14 percent over the same period, this increase still falls more than $600 million short of the $2.2 billion in state cuts to other property tax relief programs.
What’s more, today state revenues in New Jersey do not keep up with the state’s obligations. This is called a structural deficit – a system built to fail.

That deficit in New Jersey is now estimated at $6.9 billion, assuming full funding for pension payments. This is little changed from the estimated $8 billion structural deficit four years prior. In fact, the structural deficit actually owes more now to underfunding of statutory obligations (the deficit four years ago was driven by a number of one-time factors, like the expiration of the income tax surcharge, reductions in federal stimulus funding and slow revenue growth). To meet statutory funding levels, school aid would need to be increased by nearly $1.5 billion in the fiscal year starting this July 1, while property tax rebates would need to increase by more than $1.8 billion and municipal aid would need to rise by nearly $1 billion next year as well.9

In short, New Jersey’s fiscal house is far from being in order.

But even if it were, spending $1.5 billion a year on an income tax cut would not be the most effective way to grow the economy and create good jobs.

Consider where high-paying jobs have gone when they left New Jersey. They did not go to Tennessee or Nevada or other states with low tax rates. No, the thousands of jobs that Sanofi-Aventis and Roche transferred went to notoriously high-tax San Francisco, New York City and Cambridge, Massachusetts. The problem is not high taxes but the failure to exploit New Jersey’s assets: location, quality work force, strong communities with outstanding public schools, globally recognized research universities and a well-functioning infrastructure.

Like other assets, these require attention and continuing investment to sustain their value. This is the essential part of the policy conversation that is missing. Creating widely shared prosperity and reversing the shrinkage of the middle class requires that New Jersey take the lead in building the foundation in the following areas:

• **Location:** New Jersey is in the middle of the world’s largest market and abuts New York City and Philadelphia. Having a diverse collection of convenient, bustling, verdant, livable communities with great public schools acts as a powerful magnet to those who want to be near, but not in, those cities.

• **Infrastructure:** Convenient transit to New York City and Philadelphia is reflected in the price of housing; buyers pay a premium to live in Summit, Madison, Ridgewood or Metuchen, all of which enjoy frequent rail service to New York. Instead of elevating this issue and with it the need for greater capacity, New Jersey withdrew from building a needed third rail tunnel under the Hudson River, rejecting two-thirds funding from the federal government and the Port Authority.
• **Quality Public Schools:** When LG Electronics’ CEO was asked to explain the decision to bring hundreds of high-paying jobs to a new headquarters in Bergen County, he did not reply with an answer about personal income tax rates or even business tax subsidies. Instead, he simply said he wanted the children of his employees to attend the schools there. Instead of advertising that New Jersey public school students are second in the nation, many policymakers have publicly savaged public schools and disrespected teachers, and the state has placed an artificial cap on the salaries of superintendents.

• **High Quality, Educated Workforce:** New Jersey has the nation’s highest proportion of scientists, engineers and researchers, which was cited by Bausch and Lomb’s CEO for its move to Bridgewater.

• **Research Universities:** New Jersey is home to Princeton and Rutgers, two globally recognized research universities. The recent consolidation of the UMDNJ’s medical and dental schools with Rutgers is a step in the right direction. Along with the first higher education bond issue in 23 years, this marks the kind of attention required if New Jersey is to maintain its magnetism for enterprise and research.

• **Immigrant Gateway:** Only California and Texas have a higher percentage of foreign-born residents. The economic contributions of New Jersey’s immigrant community are outsized (the state would be in a depression, not just a recession, without them), yet little attention is given to this economic resource. The failure to include eligibility for student financial aid in the recent legislation to grant in-state tuition to unauthorized New Jersey high school graduates is an example of a lost opportunity.

The reason to list these foundational assets is to highlight the absolute need for continuing investment and re-investment to maintain and revitalize New Jersey’s competitive edge. Should state finances rebound sufficiently to balance current spending with current revenues and beyond, then the issue is how best to invest the fruits of economic growth in order to create a bright economic future for the state.

The alternative to returning 58 percent of an income tax cut to the top five percent of taxpayers is to invest in the state’s future – to the benefit of all its residents. Specifically:

• Eliminate the uncertainty plaguing the Transportation Trust Fund by dedicating revenues to upgrade the state’s deteriorating transit infrastructure and continue exploration of financing a third tunnel to New York.

• Maintain and increase the state’s support of high-quality preschool for children from low-income families, specifically by expanding financing of preschool to the majority of poor children now living in non-*Abbott* school districts.
• Stop shifting the costs of public colleges and universities to financially stressed middle- and working-class families by increasing operating support for higher education.

• Use increased income tax revenues to increase operating support for both public schools and county colleges.

• Focus attention and resources on promising collaborations among public and private research universities, businesses, nonprofit corporations like teaching hospitals and other enterprising entities to regain the state’s standing as a center of research, innovation and enterprise.

In short, an across-the-board income tax cut puts New Jersey’s economic prospects at risk. The sensible course is to emphasize investment in proven assets and increased opportunity for striving families, not to invest essential state revenues in a failed economic-growth model that will largely benefit those who are already doing quite well.
Appendix A

<table>
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<th>Income Range</th>
<th>Bottom 20%</th>
<th>Low-Mid 20%</th>
<th>Middle 20%</th>
<th>Mid-High 20%</th>
<th>Next 15%</th>
<th>Next 4%</th>
<th>Top 1%</th>
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<tbody>
<tr>
<td>Less Than $23,000</td>
<td>$14,000</td>
<td>$33,000</td>
<td>$58,000</td>
<td>$94,000</td>
<td>$167,000</td>
<td>$398,000</td>
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| Tax Change as % of Income | -0.3% | -0.2% | -0.1% | -0.2% | -0.3% | -0.5% | -0.7% |
| Average Tax Change       | -$42  | -$63  | -$86  | -$188 | -$520 | -$1,792 | -$14,253 |

| % with Income Tax Cut | 56% | 81% | 93% | 97% | 99% | 100% | 100% |
| Avg. Tax Cut for Those w/ Cut | -$75 | -$77 | -$92 | -$195 | -$527 | -$1,795 | -$14,253 |

| Share of Tax Cut | 2% | 3% | 5% | 10% | 21% | 19% | 39% |

Source: Institute on Taxation and Economic Policy microsimulation model, January 2014
Endnotes

1 Presentation by Bob Grady to the Common Sense Institute of New Jersey, November 2013, http://www.csinj.org/2013/12/bob-grady-delivers-presentation-at-csinj-gathering/
2 Four-year fiscal impact estimate assumes income tax growth of 6.1 percent, which is the 25-year average.
9 New Jersey Office of Legislative Services, Estimate of Fiscal Year 2015 Structural Deficit, August 2013, and Estimate of Fiscal Year 2011 Structural Deficit, July 2009.