NEW JERSEY POLICY PERSPECTIVE

The 8% Solution:
A Plan to Share the Burden of Balancing the Next State Budget

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"Trenton, We Have a Problem"

The process of fashioning the New Jersey state budget this year was nothing short of traumatic. As revenues plunged far below expectations, policy makers found themselves searching for ways to put the budget into balance. Major actions taken included increasing the tax on cigarettes, closing loopholes in the Corporate Business Tax, borrowing against a portion of the state's anticipated tobacco settlement funds, freezing local and school aid and-last but certainly not least-cutting spending for many programs and freezing spending on others.

With planning now underway for the next budget-Fiscal Year 2004-there is every indication that things will be just as tight as they were this year. According to press reports, the state could have a shortfall of more than $4 billion. And plugging that gap could well be even more difficult because so many of the fixes used in the current budget were one-shot in nature and won't be available next year.

This situation is not in the best interests of the men, women and children for whom state programs are an important part of the social safety net. And that means it is not in the best interests of the state as a whole. We are only as strong as our weakest citizens.

With a backlog of policy measures that were still waiting to be undertaken when the state budget was flush, New Jersey can ill afford another round of deep cuts. There is a need to find alternatives to budget actions that threaten to diminish the quality of education, health care, housing assistance, environmental protection and other important services. With that in mind, New Jersey Policy Perspective has been researching the potential impact of a temporary, targeted increase in the state income tax for the highest income households in the state.

The 8% Solution

The current top rate for the state Gross Income Tax in New Jersey is 6.37%. It is levied on every taxable dollar that married people make above $150,000 and that single people make over $75,000.

Of the 40 states that have an income tax, at least 23 have a higher top rate than New Jersey's. The highest is North Dakota at 12%.

In most states, the top rate takes effect at a much lower income level than in New Jersey. Oregon, for example, levies 9% on incomes for couples starting at $12,550.

Under NJPP's proposal, two new, temporary rates would be added to the New Jersey Gross Income Tax:

- **A top rate of 8% on incomes exceeding $1 million ($500,000 for single tax filers).**
- **A rate of 7% on income between $500,000 to $1 million ($250,000 to $500,000 for singles).**

At both of these income brackets only about 10% of filers do not have "married" filing status.

The increases would be for tax years 2002, 2003 and 2004.

At most, 2 percent of New Jersey tax filers would be affected by the higher rates. Those making more than $1 million in 2000 numbered a record high of 12,365, or 0.5% of all filers. Of that group, 2,734 had incomes exceeding $3 million. The average income of those making more than $1 million was $3.2 million, and the average income of the segment making more than $3 million was $8.85 million.

Applying the new rates to the state's projected revenue figures shows that the targeted tax increases would produce additional revenue in the amounts of:

$555.8 million in 2002
$595.5 million in 2003
$668.4 million in 2004...

...for a total revenue boost of $1.82 billion over the three-year life of the tax increase. It could be argued that the state's projections are rosy and that actual revenue will be lower. In any case, the targeted tax increases will take in a significant amount of money from a relatively small group-those who are the most well-off and who got the bulk of the benefits from previous state and federal income tax cuts.

What It Is...and Isn't

- This is not, and should not be presented as, true tax reform. Much about the structure of taxes in New Jersey needs to be changed in order to assure adequate resources and assess the burden of paying for government services in a more just way. But that effort will, in all likelihood, have to wait until prosperity returns. In the meantime, targeted tax increases are a way to make sure that a sputtering economy's impact on the state budget is more widely shared than would otherwise be true.
- A case can be made that targeted tax increases have a more beneficial effect on the economy than do budget cuts. The rationale was clearly spelled out by Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag in a report for the Center on Budget and Policy Priorities. Since virtually every dollar in the state budget pays a salary or provides a service, every dollar cut deprives someone of purchasing power or assistance they need in order to get by. While tax increases also take money out of the economy, increases targeted to the highest incomes have less of what economists call a contractionary impact than do budget cuts. That is to say that additional money paid

by the wealthiest in taxes is more likely to come from savings while lower income people, out of economic necessity, spend a higher percentage of their earnings than do the wealthiest. In addition, money spent by lower income people is more likely to be spent in New Jersey.

- The reduction of the rates of New Jersey's income tax in the second half of the 1990s and of federal income tax rates over the past two years has been a boon to the highest income households. Up until last year these tax breaks came at a time when the stock market bubble and surging capital gains income fueled record gains in the revenue derived from the state income tax (though the revenue would have been still higher had the rates not been cut). In the current economic downturn, it could be argued that the state no longer can afford these rate cuts. Those who would pay this tax increase are the same people who have gotten the biggest reductions from the slash in state and federal income tax rates over recent years.
- As a political issue, there is evidence of public support for targeted tax increases designed to minimize budget cuts. Last year, when a coalition called One Connecticut: Campaign to Fight Poverty and Build Economic Security put forward a tax increase on incomes of $1 million or more, a Quinnipiac University poll last May found that 71% of those surveyed favored the idea, including 56% of Republicans and 84% of Democrats. The coalition, made up of advocates working on housing, hunger and health care, as well as unions, succeeded in getting the measure through both houses of the legislature only to have it vetoed by the Governor. Then, in December 2002, the Governor reversed course and endorsed the proposal as a way to ease the burden of balancing the next state budget. Interestingly, polling data shows that when increases are confined to the relatively small number of households whose incomes are clearly out of the reach of the average taxpayer-and the vast majority of above-average taxpayers-much of the political resistance is overcome. Indeed, a Quinnipiac poll of New Jersey residents in December 2002 found 74 percent of respondents favored state tax increases instead of aid freezes that would force property taxes to go up.
- In addition to the plans in Connecticut, several other states have enacted temporary, targeted income tax increases or taken similar steps to mitigate the impact of the weak economy on those in need. North Carolina increased its top rate to 8.25% from 7.75% for tax years 2001-2003; Oklahoma raised its top rate to 7% from 6.75%, a change triggered by state law requiring an increase when revenues fail to meet the level of appropriations; Massachusetts postponed a scheduled reduction in the 5.3% top rate until at least 2008; the Oregon legislature placed on the ballot an increase in the top rate for the years 2002-2004.

The amount of money this tax change would raise will not be enough all by itself to fill a budget gap of the magnitude that New Jersey faces this year. In fact, it won't come close to doing that. But it will help to prevent bigger budget cuts and it will start to recoup some of the money New Jersey lost because the income tax was cut. Today that figure stands at more than $10 billion.

This is worth doing, then, for two intertwined reasons: the money it would raise and the signal it would send that in New Jersey we are "spreading the pain" so the people most in need don't bear the brunt of the burden of balancing the next state budget.

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