



Report of the
Budget
Transition Advisory Committee

Submitted to Governor-elect Phil Murphy and Lieutenant
Governor-elect Sheila Oliver

January 1, 2018

EXECUTIVE SUMMARY

For decades, NJ was a shining example of fiscal prudence. The state enjoyed strong growth and an AAA credit rating. During the 1990s, as the economic growth lagged, NJ policymakers departed from this stable financial course. This resulted in eleven credit downgrades in the past eight years. Today, NJ's appropriation credit stands two downgrades away from junk bond status. The state's massive pension obligation is a major reason for these downgrades but insufficient revenues, other debts, and increasing costs are fueling further economic instability.

The Trump Administration's tax and budget policies make "digging out of this hole" even harder. These policies directly harm almost every aspect of NJ residents' lives (e.g. reductions in health care and food assistance programs) and their economic security (capping property tax deduction and other tax changes that disproportionately negatively impact NJ).

Despite all of these pressing challenges, the most immediate challenge facing NJ is the state's current budget, which could be running a significant deficit. The Transition Committee and staff will not have the most accurate data until the Governor takes office, but there will be very little time to respond to the current budget and start planning for the FY19 budget which also appears to very challenging on many fronts.

No one solution is going to fix the state budget and it will take many years to "right the ship." Some core principles that should guide the Governor include:

- (1) **Protect Public Safety.** We must ensure that we protect NJ residents' safety and health. We live in a complicated world with many security threats and NJ must be vigilant.
- (2) **Invest and Grow NJ's Economy and Jobs.** Despite limitations, NJ must invest in improved transportation infrastructure, educating our children, meeting our pension obligation, advancing clean energy, and other key priorities to drive economic growth.
- (3) **Ensure Fairness.** Past policies have not given many NJ residents a "fair deal." An increase in the state minimum wage will be a great start and one that will help the state budget by increasing economic activity.

Further, the Budget Policy Transition Committee recommends that the Governor consider the following recommendations to bring NJ back to fiscal stability:

I. Priority: Generate adequate revenue

- i. Legalize sale of cannabis
- ii. Close Corporate Business Tax loopholes
- iii. Raise the marginal tax rate on those earning over \$1 million (while monitoring outmigration of high-income taxpayers)
- iv. Work with NJ's congressional delegation to change Federal laws that prohibit the states from capturing sales tax on some of the ecommerce activity
- v. Partner with other states to limit the carried interest loophole

II. Priority: Make government more efficient

- i. Take a technology-based multi-agency enterprise approach to the way it handles delivering services to its residents, including reviewing underperforming programs
- ii. Remove unnecessary requirements for occupational licenses on certain professions

- iii. Improve State's allocation of federal funds by tapping into available grants for the State agencies and hiring federally-funded State government employees

III. Priority: Address the underfunding of the public pension system

- i. Revisit the current pension payment plan to ensure it is robust enough to stabilize public pension system
- ii. Reduce expenditures on high-fee outside pension managers

IV. Priority: Create a culture of fiscal responsibility

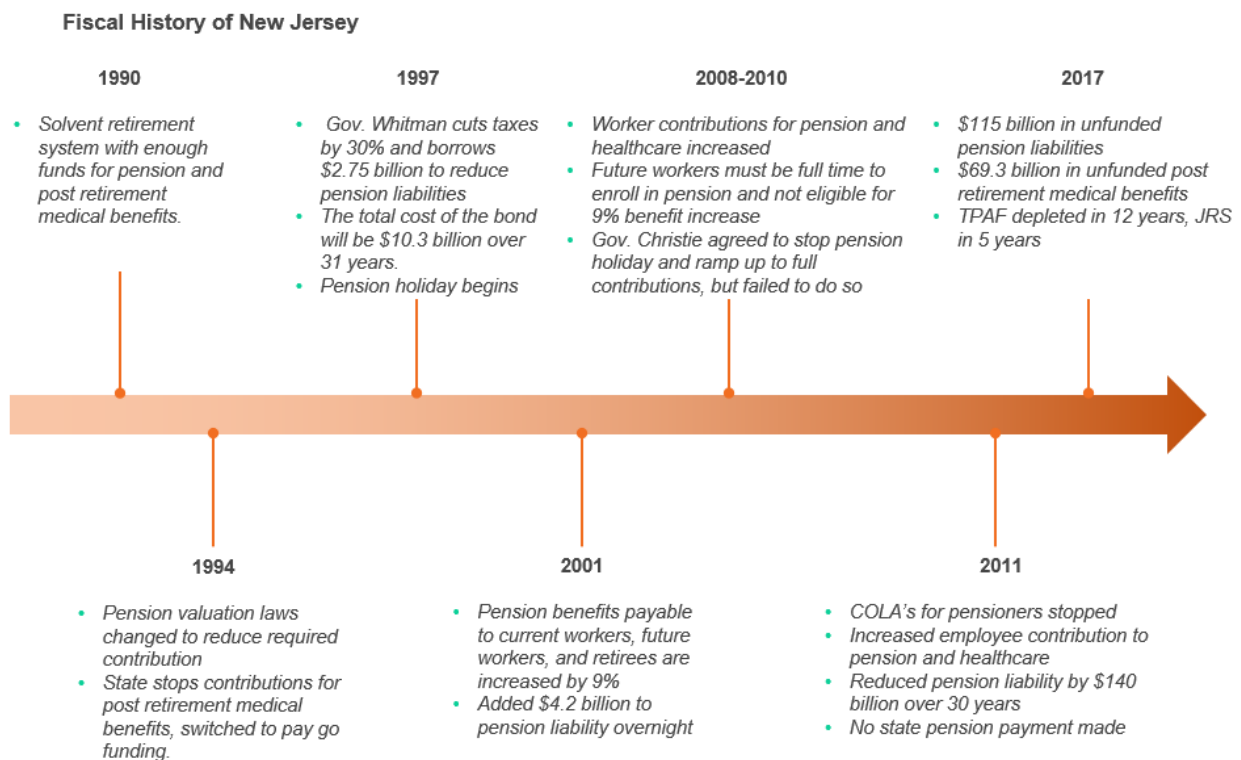
- i. Revive/reconstitute the Governor's Council of Economic Advisors to monitor interactions between the economy and the state finances
- ii. Mandate better reporting on outcomes from EDA subsidies and improve evaluation
- iii. Produce multi-year financial plans, complete with debt affordability analysis
- iv. Institute requirements for development and maintenance of the state's rainy-day fund (stabilization funds)

REPORT

HISTORY

New Jersey used to be an economic engine with an AAA credit rating. During the 1990s, as the economic growth started to lag the national average, policymakers departed from this stable financial course and pursued budgetary policies that have led to New Jersey’s current fiscal instability.

These trends accelerated after the economic boom of the late 1990s subsided, resulting in a series of budget shortfalls in the early 2000s. All branches of government have played roles in increasing the amount of debt, neglecting to make contributions for future pension and health benefit expenses. The courts allowed borrowed funds to be used as general revenue until 2004 when the New Jersey Supreme Court ended the practice through the decision in *Lance vs. McGreevey*.



Under Governor Christie’s administration, the state’s structural deficits have stayed high. The New Jersey State budget has increased from \$29.4 billion in FY 2011 to \$34.6 billion in FY 2018, with FY 2018 being the largest budget in State history. In spite of the significant growth in spending and revenue over this eight year period, the Christie budgets have exacerbated the structural budget problems facing New Jersey. The current administration took credit for balancing the budget in 2011, but skipped the \$3 billion pension payment and didn’t fully fund the school aid formula or the state’s property tax rebate program. As a result, for FY 2019, the structural deficit is estimated to exceed \$8.7 billion.

The journey to our current fiscal state has left us with some alarming facts:

- New Jersey is ranked dead-last among the 50 states by Mercatus Center on short and long-term solvency.

- New Jersey’s unfunded pension liability is the 4th highest among the 50 states.
- New Jersey’s appropriation debt is rated only three notches above junk debt. In downgrading state’s debt for the 11th time in 8 years, Moody’s indicated that the lowered rating was “based on the state’s weak budgeting condition”.
- New Jersey ranks 50th among the 50 states in the balance of payment with the Federal Government. In 2015, each New Jersey taxpayer received \$2,659 LESS on average in federal spending than what he/she paid in Federal taxes.

Many of the key factors that made New Jersey great are still in place. We are an essential element of the economic corridor in the Northeast. Our colleges and universities, such as Princeton and Rutgers, continue to attract the best talent from around the globe. Many of the state’s industries still enjoy great success, including pharmaceuticals which continues to attract life sciences start-ups.

Our state now needs leadership. It will take more than just one term of any administration to bring New Jersey back to its glory days. However, Governor-elect Murphy has an opportunity to put in place people and processes that will eventually bring the State back to the fiscal and economic health that it once enjoyed.

A SNAPSHOT OF FY 2018 IMPLICATIONS FOR FY 2019

- The Murphy Administration on January 16th, 2018 may start with a budget gap resulting from forecasting of revenue that may have been too optimistic, spending money not included in the appropriations, and expecting savings that didn’t materialize (*Table I*).
- Corporate Income Tax and Sales Tax receipts in the first five months of FY 2019 have been lower than expected. In anticipation of lower federal tax rates in 2019, many corporations have pushed 2018 earnings into the next year.
- Additional revenue reductions are likely due to the reduction of the state sales tax and gradual elimination of the estate tax.
- In the past eight budgets, New Jersey has heavily relied on almost \$9 billion in non-recurring revenue to meet many recurring expenses. The FY 2018 budget includes over \$1.1 billion in non-recurring revenue such as revenue from asset sales, legal settlements and delaying payments, a revenue stream that will not be available to the incoming administration.
- The state has accumulated approximately \$36 billion in state-revenue supported debt, and servicing that debt now costs the state 11% of the annual budget revenues.
- A large portion of the state’s revenue is dedicated to a particular program or purpose because of court mandates, contractual obligations, referendums, and federal rules that take flexibility away from the Legislative and the Executive branches.
- The budget is further adversely affected by the proliferation of business subsidies (i.e., “tax expenditures”) granted to businesses over the eight years. According to the Office of Legislative Services (OLS), in FY2018, the state’s business incentive programs may cost approximately \$630 million. Further uncertainty is introduced through sale of the credits or the timing of a subsidy recipient fulfilling all eligibility requirements. State needs a thorough performance audit of the various incentive programs administered by the Economic Development Administration (EDA).
- The State Treasurer’s recent announcement to drop the expected rate of return on pension investments from 7.65% to 7% will significantly increase the required pension contribution the State will need to make for FY 2019 and beyond.

Table I: Unforeseen budgetary costs and unrealized savings would further adversely affect the FY2018 state budget.

Issue	Amount	Comment
Medicaid Reimbursement	\$301-\$600 million	The DHHS Inspector General, on November 28, 2017, found that between Public Consulting Group (a contractor hired by the state to develop the Medicare reimbursement rates) included certain unallowable costs between 2003 and 2015. CMS is expected to demand reimbursement.
Increase Tax Collections	\$200 million	The budget assumes savings from the Christie Administration's initiative to increase staff and encourage voluntary compliance.
State Health Plan Savings	\$125 million	In addition to normal risks in estimating employee and retiree health care costs, the budget assumes these savings from future plan design changes, which requires approval by plan design committees. The current status is unknown.
Anticipated Budgetary Savings	\$50-\$82.5 million	The budget assumes \$50 million in statewide savings initiatives and \$32.5 million in savings from management efficiencies that will be reallocated from departmental appropriations to provide adequate funding for employee health benefits and negotiated compensation increases.
Opioid Funding	\$200 million	Governor Christie has announced an expanded role for the state government in addressing the opioid crisis without identifying a revenue source.
NJDOT Winter Operations	\$25-50 million	<i>FY18</i> provides \$10.4 million for winter storm response. Average spending on these costs over the last five years is \$63-\$64 million with a high of \$112.7 million (FY 2015).

IMPACT OF TRUMP'S TAX BILL & BUDGET

Tax Law

After Congress passed the Tax Cuts and Jobs Act of 2017, wealthier taxpayers are more likely to see tax cuts and to receive more of the benefits. While New Jersey, due to its higher proportion of high-income earners, could have benefitted from this tax cut, the \$10,000 cap imposed on the state and local income and property tax (SALT) deduction cancels out much of the expected benefit. New Jersey taxpayers will fare worse than the national average. There are ongoing discussions underway at state capitals and among the academics on ways states can restructure revenue collection to mitigate the impact of the cap on the SALT deduction. New Jersey should take a leadership role in these discussions. Governor-elect Murphy has already announced his support for providing tax deductions for those who make charitable contributions to their state or other local governments. He will ensure municipalities have the tools they need to implement this strategy at the local level. The new tax law will have the following consequences:

- **State and Local Tax Deduction**

In 2015, close to 1.8 million New Jerseyans deducted a combined \$32,240,572,000 in all state and local taxes, including property taxes, for an average of \$17,850 per filer who deducted.

New Jersey has the 3rd highest percentage in the nation (41.2%) of tax filers who claimed the SALT deduction and the fourth highest average deduction. Repealing the SALT deduction will hit New Jersey tax filers particularly hard. In addition to increasing the average tax burden on

New Jersey filers compared to the rest of the nation, repealing SALT will make it harder and more expensive to raise state and local taxes, and thus harder to generate government revenue for critical investments likes education, infrastructure, and public safety.

- **Impact on Charities**

The doubling of the standard deduction, combined with SALT deduction, means that the vast majority of people will no longer be inclined to itemize their deductions in filing their federal personal income taxes. New Jersey tax payers take close to \$5 billion in deductions for charitable contributions on their federal income taxes. Most of these contributions are directed to New Jersey's charities. A drop in these contributions will have devastating effect on New Jersey's non-profit sector and on the individuals and causes that they serve.

- **Impact on Health Care**

According to the Congressional Budget Office (CBO), repealing the individual mandate would increase the number of uninsured Americans by 13 million over ten years, and would cause average premiums to increase by 10% most years.

The Center for American Progress estimates that marketplace premiums would increase by \$1,650 for New Jersey families in 2019, and that 325,000 more New Jerseyans would be uninsured by 2025.

- **Impact on Charity Care**

The State of New Jersey's Charity Care program provides reimbursements to hospitals and other health care institutions which provide uncompensated health care to the uninsured. As recently as FY14, total charity care funding allocated to New Jersey's hospitals was \$675 million. In the FY18 budget, that number is down to \$252 million. Hospitals have been able to absorb this significant decline in funding because the number of uninsured patients using emergency services has decreased since the Patient Protection Affordable Care Act (ACA) was implemented.

With an increase in the number of uninsured as a result of eliminating the individual mandate, the costs to the state's hospitals for providing care will increase tremendously. Either the hospitals will need to absorb those costs, or the state will need to increase Charity Care funding by several hundred million dollars. Before Medicaid expansion, New Jersey hospitals received \$1.027 billion in 2010 in Charity Care funding from the state and the federal government.

- **Impact on New Jersey's Bonded Debt**

With advance-funding bonds losing their tax-free status under Congress's plan, states and local governments will lose an important tool to reduce their debt-service cost. New Jersey will be unable to refinance its debt by issuing bonds during favorable interest rate times, and more volatility will characterize the annual cost of servicing the state's debt.

Trump Budget

President Trump's budget for FY2018, if enacted, would further limit the State's ability to serve its residents. The budget proposes to cut discretionary spending by \$4.3 trillion over the next 10 years. New Jersey's FY2018 budget includes \$15.8 billion in expected federal aid revenue, much of which would be placed in jeopardy. More specifically:

- The budget eliminates funding for the New Starts program, which was to be the source of funding for the Gateway Project.
- New Jersey would suffer a cut in federal Medicaid funding of over 20%. To offset the federal cuts with state spending, it would cost the state about \$31 billion over 10 years.
- The budget will require states to assume about 25% of the cost of the SNAP (i.e., food stamp) program. This would require New Jersey to spend \$306 million per year to maintain the program.
- The budget eliminates the Low Income Home Energy Assistance (LIHEAP) program, which benefits 300,000 New Jersey residents.
- The budget eliminates the Community Development Block Grant program, which provides states with flexible funding for social programs. New Jersey received \$81 million in these grants in 2016.

NEED FOR STRATEGIC BUDGET PLANNING

As many states, including New Jersey, come face-to-face with the looming deficits, best practices have emerged around the country for budget planning. While revenue increases and spending cuts can be important components of a balanced approach, their structure is also critical to the State's economy.

The reforms proposed here, which center on multi-year planning and the establishment of accountability/evaluation mechanisms, are necessary to reverse the negative fiscal trends that have resulted in one of the largest unfunded pension and health benefit liabilities and one of the smallest budget reserves in the nation.

In order to achieve success over the next four years, substantial efforts must be undertaken to institute budget planning principles that impose discipline while retaining flexibility to allow for political and economic events that will inevitably arise. The following initiatives are key:

- Establish a mechanism for reviewing the multi-year fiscal impacts of proposed legislation and policies, such as economic development tax incentives (e.g., tax subsidies) or phased-in spending commitments.
- Commit to long-term plan for increasing the State's Rainy Day Fund so that recession-induced revenue shortfalls and spending surprises can be absorbed without disrupting the normal delivery of services. A healthy surplus will prevent future credit downgrades and go a long way to restoring the State's positive credit rating.
- Commit to reducing reliance on non-recurring revenues and other one-shot gimmicks. Every effort should be made to support the State's operating budget with recurring revenues, and to minimize reliance on non-recurring revenues in the annual budget process. To the extent that non-recurring revenues are part of a budget, they should be dedicated to the extent possible to one-time, non-recurring expenditures to alleviate pressure on future budgets.
- Produce reliable revenue estimates through a consensus revenue forecasting approach that includes the legislature, the Governor, and independent experts throughout the budgeting process. Actual tax revenue have fallen short of the revenue forecast in 5 out of 8 of the Christie Administration budgets.
- Form a task force to review tax structure for residents and businesses. The three major state revenue instruments (the gross income tax, the general sales tax, and the corporate business tax) have not been modernized to reflect changing demographics, economic, fiscal, and technological circumstances.

PRIORITIZE BUDGET INITIATIVES

Budgeting pressures will continue to make it challenging to fund all of the known budget commitments and emerging funding needs from existing resources. A budget must be crafted that absorbs the increasing pension and debt service costs, investments in mass transit and transportation infrastructure, additional funding to support K-12 and higher education, and the devastating impact from the actions taken by the Trump Administration on the most vulnerable residents – the poor, the sick, the disabled, and the homeless.

A multi-pronged approach based on stronger economic growth, making required pension contributions, revenue increases, and spending cuts would close the structural gap and make the rising fixed costs affordable.

I. PRIORITY: GENERATE ADEQUATE REVENUE

Generating additional revenue to meet priorities with minimum adverse impact on New Jersey residents is an option to address the State’s budget problems that must be considered carefully. However, opportunities exist for the state to capture additional funds through:

- Legalizing the sale of cannabis. This may be a gradual source of additional revenue, with some minimal contribution for FY 2019.
- Closing corporate business tax loopholes. New Jersey should enact combined reporting and close the tax loophole that allows multistate corporations to artificially shift profits to low tax states. Requiring affiliated corporations to file a combined tax return would save resources and discourage corporate taxpayers from using techniques that would minimize New Jersey taxes.
- Raising the marginal tax rate on those earning over \$1 million. The State must continuously monitor outmigration data from annual tax returns to course correct if raising this tax results in declining revenue. Based on available Federal and State data, the taxpayers with the greatest incidence of net domestic outmigration are young low-income taxpayers (below \$25,000) and older taxpayers with high incomes (above \$200,000), who are nearing the traditional age of retirement.
- Working with New Jersey’s congressional delegation and other Governors to pass S.B. 976, “Marketplace Fairness Act of 2017” which would allow the States to capture sales tax on e-commerce between the residents and vendors who do not have a physical presence in the State.
- Improve enforcement by adding auditors to New Jersey Department of Taxation. On average, each additional auditor accounts for \$1 million in additional revenue per year.
- Limit the carried interest loophole by making an agreement with neighboring states to tax the relevant earnings of private equity and hedge fund managers as income.

II. PRIORITY: MAKE GOVERNMENT MORE EFFICIENT

In our era of budget deficits, it is even more important for the State government to be **systematically more efficient**. The Governor-elect will have to find ways to “do more for less.”

- New Jersey should take a **technology-based multi-agency enterprise approach** to the way it handles delivering services to its residents.
- Remove unnecessary requirements for occupational licenses on certain professions. The State should increase opportunities for those getting out of prison by enabling them to apply for licenses.
- Review underperforming programs. States often operate programs that were designed for a set of circumstances that existed in the past and are no longer the most efficient use of the taxpayer dollars. Public agencies are trailing behind private companies at ensuring that there are financial controls in place. A robust performance audit function and monitoring of expenditures is necessary in every agency.

- Reduce our balance of payment deficit with the federal government. Untapped federal funds are available for grants to State agencies and for hiring federally-funded State government employees. For example, the federal Department of Commerce allocates \$250 million in grant money to promote economic activity in distressed areas. New Jersey currently does not receive any of those funds. New Jersey should create an Office of Grant Management for managing and maximizing federal grant funds through collaboration with agencies, local governments, non-profits, and others.
- Reduce cost to the state by expanding enrollment in the federal programs. For example, New Jersey should facilitate the purchase of health insurance through ACA exchanges and enrollment in Medicaid to reduce the cost of Charity Care.
- Revisit unnecessary and outdated regulations. Each state agency should review their regulations and requirements to see if they are effective and still serve a purpose.
- Drastic cuts in personnel have left the State agencies with a hollowed-out middle, unable to perform audit responsibilities and deliver services effectively and efficiently. Frequent internal evaluation and reengineering of the agencies by its staff is essential to ensuring the budget dollars are spent efficiently. New Jersey should also add staff where needed.

III. PRIORITY: ADDRESS THE UNDERFUNDING OF THE PUBLIC PENSION SYSTEM

Underfunding of New Jersey’s public pension over the years has resulted in a crisis that cannot go unaddressed. By FY2023, a combination of debt service cost, required pension contributions and cost of providing health benefits to public employees, will severely impact the budgeting process by consuming 33% of state revenues.

The FY2018 state budget includes \$2.46 billion in pension payments. This represents half of the full payment of the annual required contribution (ARC). Governor Christie will have contributed a total of \$8.7 billion to the pension systems in his eight years in the office, which is \$23.1 billion less than the \$31.8 billion in actuarially required payments over that timeframe. During that eight-year period, employee contributions to the pension systems will total approximately \$14.9 billion, 71% more than the State’s contribution.

Christie Administration Pension Payment History					
Fiscal Year	Pension Contribution	% of Full Contribution	Full Contribution	Missing Payment	Employee Contribution
FY 2011	\$ -	0%	\$ 3,132,000,000	\$ 3,132,000,000	\$ 1,574,552,263
FY2012	\$ 484,484,000	14%	\$ 3,541,549,708	\$ 3,057,065,708	\$ 1,784,585,569
FY 2013	\$ 1,029,296,000	29%	\$ 3,605,239,930	\$ 2,575,943,930	\$ 1,890,381,838
FY 2014	\$ 699,379,000	19%	\$ 3,692,602,957	\$ 2,993,223,957	\$ 1,884,187,282
FY 2015	\$ 892,634,000	23%	\$ 3,935,776,014	\$ 3,043,142,014	\$ 1,924,939,201
FY 2016	\$ 1,307,104,000	30%	\$ 4,357,013,333	\$ 3,049,909,333	\$ 1,901,760,304
FY 2017	\$ 1,861,608,000	40%	\$ 4,654,020,000	\$ 2,792,412,000	\$ 1,983,924,211
FY 2018	\$ 2,460,632,622	50%	\$ 4,921,265,244	\$ 2,460,632,622	\$ 1,983,924,211
8-Year Totals	\$ 8,735,137,622.00	27.44%	\$ 31,839,048,870	\$ 23,103,911,248	\$ 14,928,254,879

Without proactive policy changes to increase revenues and/or reduce spending, future pension contributions will become unaffordable, increasing the risk of additional pension contribution cuts. The state’s recent legislation shifting to quarterly contributions somewhat lowers the risk of a large pension cut like the one that occurred in FY2014. However, if another late-year budget gap materializes, the state retains the flexibility to cut the last quarterly contribution or reduce the annual pension appropriation in future budgets. Any deterioration in pension fund cash inflows would diminish future assets available to pay benefits. As a result, without additional policy action to structurally balance the budget, the state would risk having to pay pension benefits directly from the general fund. New Jersey should:

- Revisit the current pension payment plan to ensure it is robust enough to stabilize public pension system.
- Reduce use of high-fee outside managers (hedge funds, PE firms) for managing pension assets. The New Jersey pension system paid more than \$659 million in fees to private fund managers in 2016, up from \$125 million in 2009, with no commensurate increase in pension reserves.

IV. PRIORITY: CREATE A CULTURE OF FISCAL RESPONSIBILITY

While budget choices are difficult everywhere, New Jersey’s failure to prioritize long term fiscal health stands out among the states.

Tax expenditures are proliferating and seem to be awarded without due process, concern about their implications for fairness, or long-run state finances. New Jersey should:

- Revive/reconstitute the Governor’s Council of Economic Advisors to monitor interactions between the economy and the state finances.
- Develop a policy framework for providing tax subsidies through the EDA with focus on small to mid-size companies. The State should mandate better reporting on outcomes and improve evaluation.
- Produce multi-year financial plans, complete with debt affordability analysis.
- Institute requirements for development and maintenance of the state’s rainy-day fund (stabilization funds).

CONCLUSION

During the campaign, Governor-elect Murphy spoke about reimagining New Jersey and reigniting the innovation and infrastructure economy at its core. New Jersey voters have given him an opportunity to do just that. Any growth story, however, needs a strong fiscal foundation with a balanced budget as a first step. The Trump tax plan, in combination with the New Jersey’s budget uncertainties, make for a difficult “Day One” for the new governor. However, we have utmost confidence that this administration can bring New Jersey back to its glory days. We are thankful for the opportunity to recommend short and long-term comprehensive strategies and will make ourselves available for support and guidance.

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The Governor, Lieutenant Governor, and the entire senior transition team staff greatly appreciate the immense amount of work, participation and expertise that all our co-chairs, committee members and deputy directors who staffed each committee provided since the transition began in November. This hard work and positive energy about how New Jersey can once again become a national leader has resulted in a robust set of recommended priorities and actions for the incoming administration to consider. As with any collaborative endeavor, many recommendations and opinions were expressed and debated during the committee meetings and the drafting of the reports by co-chairs, committee members, and Deputy Directors. The final reports may contain recommendations that do not reflect the concurrence of all co-chairs or committee members, nor of the organizations they represent. These reports are purely advisory and do not reflect the positions of the Governor-elect or any other elected official.