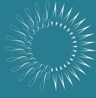
A fact sheet from  THE PEW CHARITABLE TRUSTS | Nov 2017

Evidence-Based Policies Could Strengthen New Jersey's Fiscal Health

New Jersey faces significant fiscal challenges, including chronic budget shortfalls, substantial long-term obligations, and rising costs for services. These difficulties have led to 11 downgrades from rating agencies in the last seven years. Overcoming them will not be easy, but evidence-based policies can help put the state on stronger financial footing.

Over the past several years, The Pew Charitable Trusts has compiled a significant body of research highlighting how well states perform on fiscal issues, including debt management, budget reserve policies, and assessments of the impact of tax incentives. A wide range of stakeholders has begun using Pew's research, among them business groups; journalists; state legislative committees; credit-rating agencies; and national organizations representing governors, legislators, and budget directors.

Drawing from this research, Pew helps advance sound, data-driven decisions and practices that build fiscally well-managed states. Its staff also works with individual states to enact targeted, evidence-based solutions to pressing challenges. Some of these ideas are outlined below. Please contact us if you have any questions about the information provided and how to apply it to New Jersey.

Develop a plan to regularly evaluate economic development tax incentives

Key points:

- About 30 states conduct regular evaluations on the results of economic development incentive programs.
- New Jersey has committed billions of dollars to future incentive payouts in recent years but lacks a process to regularly evaluate them.
- The state has contracted with researchers from Rutgers, the state university of New Jersey, to complete a one-time study of incentives by 2018.

About 30 states have processes in place to regularly evaluate economic development incentives. These processes generally require nonpartisan staff or experts from outside of government to study the results of these programs on a recurring multiyear cycle. Incentives are one of the primary tools that states use to try to create jobs, attract businesses, and strengthen their economies. By evaluating incentives regularly and rigorously, states are reaching valuable conclusions on what is working well and what can be improved.

When lawmakers have this information, they use it. Policymakers in Alabama, Florida, Indiana, Maryland, North Dakota, Oklahoma, Oregon, Washington, and other states have made changes to incentives that were consistent with the evaluations' findings or recommendations. Changes both large and small—from ending ineffective programs to subtly modifying the design or administration of incentives—can greatly improve the effectiveness of state economic development efforts.

Few states have expanded their use of incentives as aggressively as New Jersey in recent years. Lawmakers approved bipartisan legislation in 2013 that consolidated several incentives into two primary programs, one focused on creating and retaining jobs and the other on real estate development. As lawmakers intended, this overhaul led to a substantial increase in the value of incentives awarded to businesses. The New Jersey Economic Development Authority (EDA), the state's lead business development organization, has authorized more than $5 billion in grants and tax credits since the 2013 law was enacted, in many cases committing to provide incentives for 10 to 20 years.

Despite the state's heavy use of incentives, New Jersey lacks a regular process for evaluating them. Under the 2013 law, it is scheduled to complete a "comprehensive review and analysis" of incentives administered by the EDA by July 1, 2018. In 2016, the EDA contracted with researchers from Rutgers' Edward J. Bloustein School of Planning and Public Policy to complete the evaluation. The law, however, requires only a one-time evaluation.

Regular high-quality evaluations could help New Jersey answer key questions regarding the state's use of incentives. For example, critics have noted that many recent incentive deals are aimed at New Jersey firms that are moving within the state. They argue that these deals do little to boost net economic activity. On the other hand, the EDA and other defenders of the incentives say that the companies they have helped were at risk of leaving the state. They also argue that the assistance is the only way to get major businesses to relocate to impoverished cities such as Camden.

Evaluations in other states have helped answer the questions that are relevant to this debate, such as to what extent incentives influence business decisions as opposed to rewarding what companies would have done anyway, and how incentives are affecting net economic activity. While the Rutgers study could begin to answer these questions, examining incentives on an ongoing basis would be more likely to help New Jersey policymakers ensure that these important programs are effective and affordable.

Study debt affordability to understand financial liabilities

Key points:

- 29 states regularly publish debt affordability studies to evaluate their ability to repay outstanding debt obligations, compare debt levels to peer states, and project future debt liabilities.
- New Jersey does not conduct a study that analyzes the affordability of state debt.
- The state has the third-highest total long-term debt in the country.

Twenty-nine states regularly produce debt affordability studies. At a minimum, these analyses include metrics such as debt service to revenue, projections of debt obligations and/or capacity beyond the current fiscal year, a regular publication schedule, and analysis of a state's capacity to support its debt. These studies contextualize a state's debt and evaluate its capacity to afford current obligations or expand borrowing.

When policymakers have the tools to understand the fiscal impact and affordability of debt over time, they can make more informed decisions about prioritizing and funding projects. States often issue bonds to finance major expenses, such as repairing bridges and tunnels and building schools. By spreading the cost among current and future taxpayers, states can invest in the long term while still paying for day-to-day expenses. However, debt financing can limit future budget flexibility if debt service costs become unsustainable. Evaluating the long-term affordability of state borrowing can help policymakers examine the trade-offs of funding and financing strategies.

New Jersey is an active user of debt financing. According to Pew's analysis, the state has the third-highest total debt, behind New York and California (both states publish debt affordability studies). On a per-capita basis, New Jersey's debt is the fourth highest in the country. Only two states—New York and Hawaii—have a higher ratio of total debt to state personal income.

Despite the size of the state's obligation, New Jersey's use of debt is not necessarily problematic. What may concern policymakers is that it lacks a regular process to analyze the affordability of its debt. The debt report, produced by the state Department of the Treasury, does not include the robust projections, analysis, or recommendations necessary to inform policymakers and state authorities as they seek to manage New Jersey's long-term obligations.

States with debt profiles similar to New Jersey's have found debt affordability studies useful in managing their debt obligations and providing guidance on prudent levels of borrowing. Seven of the 10 highest-debt states publish these studies, including New Jersey's neighbors New York, Pennsylvania, and Connecticut. Regularly analyzing the affordability of state debt can give policymakers a deeper understanding of the state's ability to provide for the future needs of its residents.

Set rainy day fund policies using revenue volatility

Key points:

- 48 states, including New Jersey, have legally defined rainy day funds that allow them to build reserves in good times that can then be used to weather economic downturns.
- New Jersey has struggled to maintain a balance in its rainy day fund, the Surplus Revenue Fund.
- The state can build a stronger rainy day fund by studying revenue volatility and then tying deposit and withdrawal decisions to that volatility.

Every state experiences revenue volatility, the unavoidable fluctuations that occur throughout the business cycle. These swings can undermine lawmakers' efforts to accomplish budgetary goals such as reducing taxes, paying down debt, investing in infrastructure, or funding education. For that reason, states have rainy day funds—formally known as budget stabilization funds—which allow state leaders to build reserves in good economic times that can be used to weather bad economic times.

Forty-eight states have legally defined rainy day funds, though policies on how to use the funds, such as when to make deposits and withdrawals, vary. These policies can be based on a number of factors, but Pew's research has shown that tying deposits and withdrawals to revenue volatility is a best practice. Studying a state's revenue volatility can help policymakers better understand the business cycle, enabling them to set aside revenue during times of extraordinary growth. It also ensures that policymakers increase their states' reserves to a size that provides sufficient coverage in case of a revenue downturn.

In recent years, New Jersey has had trouble maintaining a balance in its Surplus Revenue Fund. Before the Great Recession, the fund held $735 million, or roughly 2.2 percent of annual state spending. In 2009, the state withdrew the fund's entire balance in response to the recession—and has not made any deposits since. New Jersey was one of only two states with an estimated zero balance in their rainy day funds at the end of fiscal year 2016.

Broadly, this savings issue is a symptom of the state's continuing structural imbalance, but it is also driven by how it saves and withdraws from its rainy day fund. New Jersey makes these decisions based on the accuracy of its revenue forecast. If revenue comes in above the forecast, the state makes a deposit to the fund; if it comes in

below the forecast, the state can withdraw. While some other states also use this method to guide their rainy day fund policies, it can be misleading and may be unrelated to the business cycle. This can lead states to fail to make deposits—or even to make withdrawals—during periods of revenue growth. For instance, in 2007, despite being in a period of expansion, New Jersey withdrew $75 million from the Surplus Revenue Fund, money that could have been used during the recession. And even though revenue grew from 2009-16, the state did not save in any of those years of growth.

A more effective savings policy is to tie conditions for deposits and withdrawals to revenue volatility. Twenty states have rainy day funds with deposit rules tied to volatility; 18 have volatility-based withdrawal conditions. These rules can take various forms, with states examining fluctuations in overall revenue, specific streams of revenue, or economic indicators such as personal income. For example, Virginia compares the performance of its major tax sources in the most recent fiscal year with the average revenue growth over the preceding six years. Half of the above-average revenue is automatically deposited in the state's Revenue Stabilization Fund. Oregon uses volatility to inform two withdrawal conditions for the state's rainy day fund. One is economic, contingent on declines in nonfarm payroll employment; the other is connected to revenue volatility, allowing the fund to be used when revenue is projected to decline 3 percent or more from the previous year's appropriations.

An important first step to establishing strong, volatility-based rules for the state's rainy day fund is to study revenue fluctuations. New Jersey could conduct regular revenue volatility studies to allow policymakers to adjust their savings policies over time. If done on a recurring basis, these studies would be an excellent tool to identify the drivers of volatility and could also increase the profile of the problems and solutions associated with revenue fluctuations.

For further information, please visit:

pewtrusts.org/fiscal-health

Contact: Catherine An, communications officer
Email: can@pewtrusts.org
Project website: pewtrusts.org/fiscal-health

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.