



president's message

BY JOAN VERPLANCK

## A Business Perspective from Shaw and Einstein

If the juxtaposition of the two household names of George Bernard Shaw and Albert Einstein with the plight of business seems a stretch, read on. Back in 2004, the Enterprise Trust Fund at the New Jersey Chamber of Commerce funded research triggered by Governor McGreevey's FAIR Tax Plan. Most people in the business community thought the proposal anything but fair, and wanted some idea of the potential impact. There was uneasiness surrounding anything referred to as a "Millionaires Tax" that actually captured half-millionaires. As the state budget ballooned, there was concern that the revenues from the hike wouldn't be enough or, worse, that it would be *more* than enough to fund new employees and programs that would be paid for well into the future.

And this is where George Bernard Shaw comes in. His assertion that a government that robs Peter to pay Paul can always depend on the support of Paul, was right on the money. So long as the tax hit is focused on a relatively small cohort of taxpayers, the rest are more than happy to accept it. Unfortunately, millionaires aren't all they're cracked up to be, and this recession may make believers of us all.

The brief research overview on page 7 provided by Mark Boyd, former NJ Department of Labor Commissioner, demonstrates that what we are experiencing today is startlingly close to what was predicted, which often happens if your assumptions are based on facts. Mark uses data to explain how our progressive tax code has turned revenues upside down, creating a shortfall that we should have seen coming. For example, taxable income in New Jersey fell \$9.62 billion between 2002 and 2003 -- and \$8.5 billion of the fall came from taxpayers with income of \$500,000 or more. Evidently this wasn't taken into account when fashioning the FAIR Tax.

Flash forward to 2009. We are about to temporarily raise the tax rate of those making \$500,000 or more from

8.97 percent to 10.25 percent in New Jersey. These will also be the folks who lose their property tax deduction. The federal government is going after the same cohort of taxpayer, further exempting those at the lower end of the scale and ramping up tax rates on the "high wage" earners. Has anyone noticed the economic downturn and the number of casualties on Wall Street and in the financial services industry, which constitutes the lion's share of our upper echelon of taxpayers?

Here we go again. It appears that five years from now I'll be able to dust off this article as we revisit the issue and recognize just what these new tax increases have done to our economy.

And this is where Einstein comes in. "Insanity: doing the same thing over and over again and expecting different results." ❖

Joan Verplanck

President of the New Jersey Chamber of Commerce.

# After the Windfall Comes the Whirlwind

BY MARK BOYD



**“A government that robs Peter to pay Paul can always depend on the support of Paul.”**

— George Bernard Shaw

This brief research report, presented as it was written in 2004, is the work of Mark Boyd, former New Jersey Department of Labor Commissioner. In it, he asserted that a progressive state tax code sets the stage for a revenue shortfall during an economic decline in which taxable income falls. The situation is comparable to a business that’s dependent on only a few big customers, some of whom recently won the Lottery. Boyd cautioned state governments not to become dependent on a progressive tax because it does not provide stable, long-term financing.

On April 29, 2004, before a special joint session of the New Jersey Legislature, Governor McGreevey announced the “FAIR Tax Plan” in an effort to provide property tax relief for the state’s long-suffering property taxpayers. The FAIR plan proposes a new 2.6 percent rate on taxpayers with incomes of \$500,000 or more, bringing the top marginal General Income Tax (GIT) rate to 8.97 percent. Governor McGreevey believes that this tax will raise \$800 million, which will provide direct property tax relief to seniors who will see their Homestead Rebate increase from \$775 to \$1,200, and another 1.17 million taxpayers with incomes of under \$125,000 will see an increase in their maximum rebate to \$800. The governor believes that this plan is fair because the new tax will only impact approximately 28,500 taxpayers while providing tax relief to millions of voters. However, before the Legislature implements this tax increase it is critical that it considers the volatility that this new tax will bring to the state budget process. This investigation need look no further than the volatility of the past two budget cycles as a result of fundamental changes made to the GIT during the 1990s.

The fundamental question that the Legislature must answer is why, during a mild economic downturn in tax years 2001 and 2002 in which individual incomes were stable and

the unemployment rate never even reached 6 percent, the state budget was rocked by multibillion dollar deficits in budget years 2002 and 2003? The answer lies in the tax policies that were implemented in the past decade. These changes transferred the GIT burden from low and middle-income taxpayers and dramatically increased the burden on wealthy taxpayers. The premise of “progressive” taxation was aggressively pursued, but the result was an unstable tax base that fluctuates dramatically. A new tax on the wealthiest New Jerseyans will accelerate this trend. When the economy is booming, money will flow into the state treasury at an unprecedented rate and the legislature will be happy to spend this windfall, but when the economy stalls, the revenue drop will be catastrophic. Future legislatures will be left having to raise taxes dramatically on the middle class to make up the revenue or else dramatically cut spending.

The history of the GIT in New Jersey is relatively short. First implemented in 1976 under Governor Byrne the GIT had only two tax rates; 2 percent on taxable income up to \$20,000 and 2.5 percent on income above \$20,000. Governor Kean added a third bracket in 1983 of 3.5 percent on taxable income above \$50,000. In 1990 Governor Florio implemented a major increase in the GIT by doubling the top rate to 7 percent. This tax increase triggered a “tax revolt” that propelled a Republican Legislature into power in 1992 and Governor Whitman in 1994. Upon her taking office, Governor Whitman began the process of reducing Governor Florio’s tax increase. However, Whitman’s deepest tax cuts did not go to high-income families; they went to low and moderate-income taxpayers. Whitman lowered the rate for the lowest income tax rate 30 percent while the reduction for the highest rate was only 9 percent. This lowered the lowest tax rate to 1.4 percent and dropped the highest rate to 6.37 percent on incomes over \$150,000. After these tax cuts were implemented, the Whitman administration then raised the minimum taxable income threshold, before any GIT was due

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## After the Windfall

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from the taxpayer, beginning in Tax Year 1999. After 2001, any taxpayer with an annual taxable income under \$20,000 is not subject to any GIT.

The public policy question at issue is the limits of progressivity in the tax code. The original two-rate system implemented by Governor Byrne was moderately progressive. Governor Kean made the tax rates more progressive by adding a new rate on incomes above \$50,000, and

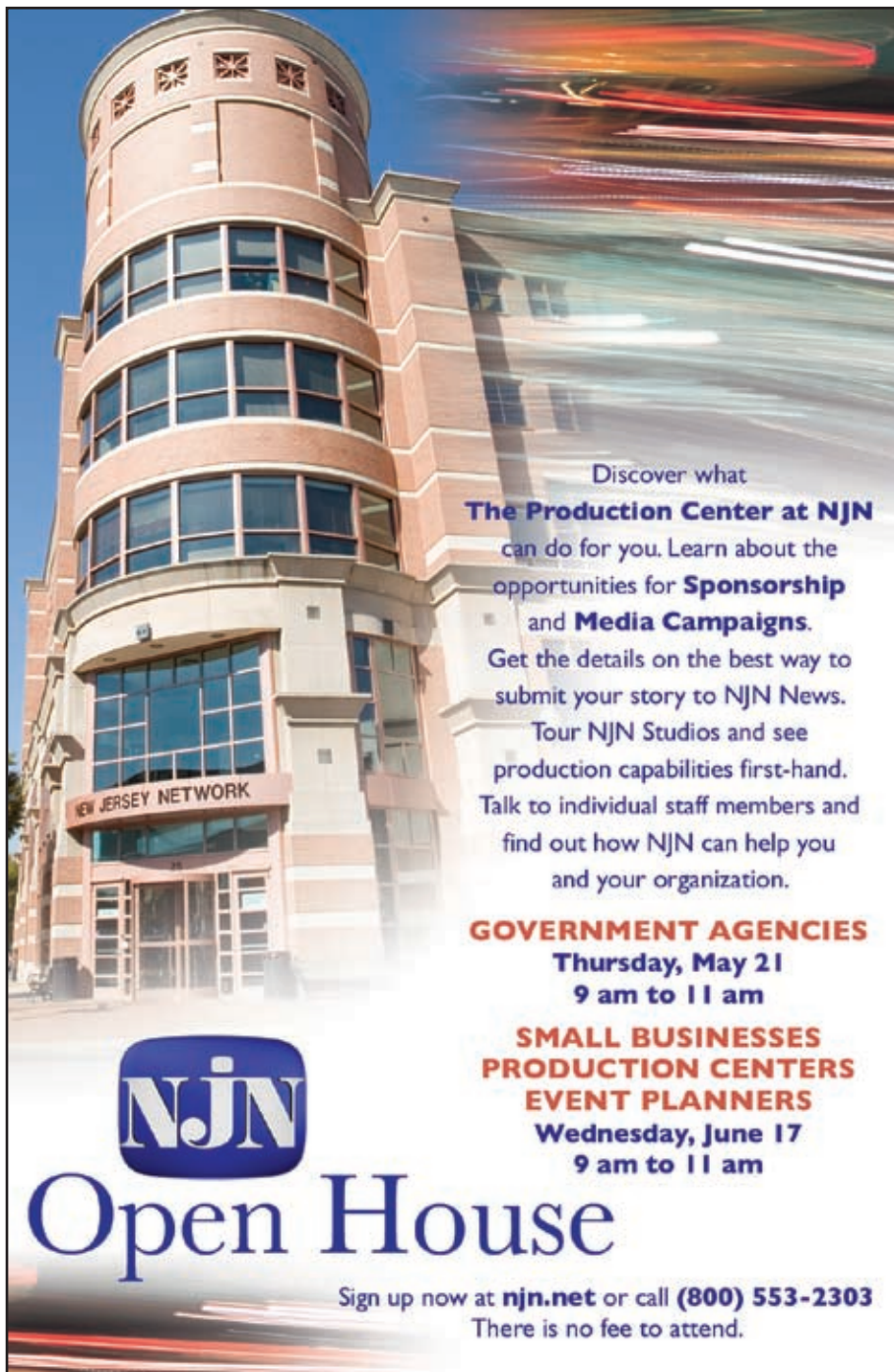
Governor Florio dramatically pressed the progressivity of the tax code by doubling the top tax rate for high-income individuals. Governor Whitman also increased the progressivity of the GIT by reducing the rates and increasing the minimum threshold for low-income earners. The net result of these tax policies was an increase in GIT collections from 1991 to 2001 of 136 percent, from \$3.4 billion to \$7.989 billion, compared to an increase of only 49 percent for the sales tax during the same period. Overall state spending increased 84.5

percent, driven by the additional revenue generated by the progressive GIT.

In Tax Years 2002 and 2003 the dangers of progressivity in the tax code were exposed. Between Tax year 2001 and 2002, taxable income in New Jersey fell \$9.62 billion, from \$188.5 billion to \$178.8 billion. What is significant about this drop is that \$9.5 billion of the fall came from taxpayers who had taxable income of \$500,000 or more. Indeed, \$8.5 billion of the decline was for taxpayers with \$1 million or more in taxable income. However, these very taxpayers are the revenue source that the budget of New Jersey now depends on. The result of this decline in taxable income was a \$1.15 billion drop in GIT revenue. Tax Year 2003 was no better than 2002 because of an additional \$100 million decline in GIT revenue because, for the first time since 1950, the United States saw Taxable Income fall two years in a row.

In conclusion, it would be appropriate for the state to consider two issues before they implement a new tax rate on New Jersey's wealthiest citizens. First, who are these wealthy taxpayers? Are they individuals who make millions every year who would hardly notice an additional 2.6 percent taken out of their paychecks and bonuses, or are they individuals who appear on the list as a one-time event due to the sale of a business or property, and who will be severely impacted by a state tax rate of nearly 9 percent on this once-in-a-lifetime event. One interesting study by the IRS of the 400 highest tax returns for Tax Years 1992 to 2000 show that only 25 percent of the taxpayers have their names appear on the list more than once and only 13 percent have their names appear more than twice.

The second issue the state should consider is far more pragmatic. By further tying future state budgets to the wealthiest taxpayers, will the Legislature be able to demonstrate the fiscal discipline to manage the tremendous fluctuations in state revenue from the GIT? Tax rates on lower income brackets have proven to be a stable source of revenue over generations. Revenue from a "millionaires tax" is about as stable as a bucking bronco at a rodeo. The ride can be thrilling, but you'll need a lot of rodeo clowns to catch you when you fall. ❖



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