

## **The Fiscal Impact of Senate Bill No. 786**

### **Report Prepared for**

**The Enterprise Trust at the New Jersey Chamber of Commerce**

**April 3, 2008**

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### **EXECUTIVE SUMMARY**

The attached report focused on the financial estimates produced by the Office of Legislative Services and presented to members of the legislature in relation to paid family leave legislation. The following are highlights of the report:

- Economic forecasts typically err on the side of optimism and typically understate costs while overstating revenues and benefits. The fiscal estimate for S-786 is no exception.
- The analysis indicates that the fiscal estimate is overly optimistic about the long-term solvency of the program and its ultimate impact on employees.
- The analysis fails to account for the likely implications of current business conditions and trends, and in particular, the impact of consensus forecasts that we are now in recession, that growth is likely to subside or become negative, that unemployment is likely to increase and that indicia of worker distress are likely to materialize in the near term.
- Failure to reflect these forces likely results in systematic underestimation of program costs and overestimation of wage-based tax revenues on which the program relies. Without the basic data used, it is not possible to estimate the magnitude of this error, but it is assured to be too large simply to ignore.
- Since the underlying analysis addresses only three years, the conclusion that the program will be solvent must be substantially discounted.
- The estimate of the fiscal impact showing accumulated fund balances in excess of \$15 million for 2009 – 2011 are accounting fictions that distort and inaccurately characterize the timing of revenue and costs of the program.
- The estimates of the number of claimants are not verifiable or reliable.
- The growth of claims is most likely too low, and the conjectured growth is inconsistent with actual claims data from California. In addition, these programs tend to grow as knowledge of their availability and benefits become widely known by word of mouth and observation.
- The fiscal estimate ignores important costs and shifts others to time periods not covered in the report.
- Most critically, the fiscal estimate does not take into account known and important changes in economic activity in state labor markets.

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## I. INTRODUCTION

This report was prepared in response to a request from the Enterprise Trust at the New Jersey Chamber of Commerce for an analysis of the potential fiscal impact of Senate Bill No. 786 (the Bill). Following initial consultations about data sources and previous analyses of the Bill, this report focuses on the estimated fiscal impact prepared by the Office of Legislative Services (OLS).<sup>2</sup> In that context we highlight five sources for concern about the basis of the OLS estimates, each of which bears on the reliability or accuracy of the estimates as a guide to reasonably expected fiscal implications of the Bill. These issues are:

- Likelihood of substantial estimation errors;
- Reliance on unreliable or unknown data;
- Use of idiosyncratic accounting measures;
- Use of unrealistic growth rates for program revenues and costs; and,
- Systematic biases tending to overstate long term program solvency.

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1. The authors are respectively President and Senior Research Analyst of Darby Associates, an economic policy oriented consulting company in Washington, DC. They have written widely on matters of regulation and public policy – communications and information technology, health care, environment and others. They recently authored a major report submitted to the US Department of Labor as part of its review of the Family and Medical Leave Act of 1993 ([Benefits and Costs of the Family and Medical Leave Act of 1993: A Consumer Welfare Perspective, February 2007](#)). Both are Fellows of the American Consumer Institute, a 501-c-3 institution focused on consumer welfare analysis (<http://www.theamericanconsumer.org/>) and both have extensive University teaching experience. Credential details are available on request.

2. Legislative Fiscal Estimate, Senate, No. 786, State Of New Jersey, 213th Legislature, February 1, 2008.

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Discussion of these issues reflects a significant scaling back of our original intention, which was to provide an independent estimate of the fiscal impact of the Bill. It turned out that the data necessary for making reliable estimates were not available, nor were the baseline data used by OLS in preparing the estimate. Thus, we are constrained to provide a methodological and conceptual critique based on our best understanding of largely undisclosed methods of analysis and data on which the fiscal impact estimate is based.

## II. OVERVIEW OF BENEFITS AND COSTS OF SENATE BILL NO. 786

The Bill adds benefits to the current New Jersey temporary disability insurance (TDI) system and would provide eligible workers up to 6 weeks paid leave during the year following childbirth or adoption, or to care for a family member with a serious medical condition. Eligible workers include all private and public sector employees, except for federal government workers, now subject to the unemployment compensation laws.

To pay for these benefits, the Bill would impose a separate tax on the wages of all employees in the state, including school district, county government, and other employee groups who generally do not now pay into the existing TDI program. The Office of Legislative Services summarized the tax provisions as follows.

Beginning January 1, 2009, the additional tax rate would be 0.09 percent and will increase to 0.12 percent on January 1, 2010. The revenue generated by this additional tax will be deposited into the Family Temporary Disability Leave Account within the State TDI fund. Paid Family Leave (PFL) benefits would be made available from this account beginning July 1, 2009. An amount not to exceed \$25 million will be transferred from the State TDI fund to the new account to support start-up costs. Any such transferred funds must be repaid starting January 1, 2011 and must be completely repaid by December 31, 2015.

According to OLS, tax receipts expected to be received under these provisions will be sufficient to pay for all expenditures thereunder, so that the Paid Family Leave (PFL) program would not affect the General Fund. Specifically, according to OLS: “...the costs of the PFL program will be entirely paid by revenue generated through the

employee tax.” (Emphasis added.)

The Bill provides for a state disability benefits fund (Fund) that will serve as a temporary source of cash loans to support initiation of the program and to underwrite its start-up costs. OLS surmises that the Fund will scarcely be used and projects that the program will generate tax revenues in excess of expenditures to claimants in the first year and annually thereafter. OLS predicts that the Family Temporary Disability Leave Account (FTDLA) will be solvent and self sustaining immediately. Specifically, OLS forecasts that the FTDLA will generate a cumulative surplus in excess of \$15 million in each of the first three years.

### III. DISCUSSION OF THE OLS ANALYSIS OF FISCAL IMPACT

To evaluate this claim we turn now to details of the Legislative Fiscal Estimate – its data sources, its assumptions and methods, and the reliability of its conclusions. We note at the outset the lack of transparency with respect to the methods and data used to generate the estimates of fiscal impact. For the most part we, and other third party analysts, are constrained to guess at or simply do without information necessary to analyze the basic conclusion that the program will be self sustaining and not draw on other sources for support. Absent critical details about the basis for the fiscal impact assessment, we are left to the more general critique which follows.

Substantial estimation errors are likely and apparent in the fiscal analysis. All forecasts of future economic events outcomes are contingent on a complex vector of forces and events. They are therefore subject to considerable uncertainty. Economic forecasting errors are the rule rather than the exception. Errors in estimation may be significant. And, it should be no surprise that economic forecasts typically err on the side of optimism and understate costs while overstating revenues and benefits. This fiscal assessment is no exception.

While it is a relatively simple matter to list the main drivers of the cost of the Fund (the number of employees, the number who become claimants, the basis for the claim, the average level and duration of the claim, etc.), it is quite another to estimate these reliably and to predict

them in the context of an uncertain future economic environment. The same holds as well for the main drivers of revenue (number of workers, average wages, etc.) being paid into the fund. While the tax rate is fixed by the Bill, the number of workers, their incomes, and other key determinants are subject to uncertainty and likely to vary with future economic circumstances in ways not clearly recognized or spelled out in the assessment. OLS recognizes that errors are involved in estimation. It cites a clause in the bill that allows for borrowing of up to \$25 million from the TDI fund for any actual deficit as a result of estimating errors.

The fiscal impact analysis fails to account for the likely implications of current business conditions and trends, and in particular the impact of consensus forecasts that we are now in recession, that growth is likely to subside or become negative, that unemployment is likely to increase and that other indicia of worker distress are likely to materialize in the near term. Failure to reflect these forces almost certainly results in systematic underestimation of program costs and overestimation of wage-based tax revenues on which the program relies. Without the basic data used in the assessment, it is not possible to estimate the magnitude of this error, but it is assured to be too large simply to ignore in any assessment of future program solvency.

The OLS analysis extends to only three years and for that reason its conclusion that the program will be solvent must be substantially discounted. The conclusion is based on the implicit assumption that all relevant costs and benefits will be realized in the next three years. Thus, the assessment does not reflect historical, long term trends in New Jersey labor markets. In effect the analysis ignores any fiscal impact beyond calendar year (CY) 2011, despite the fact the program is for the long term and that its major implications will not be realized until CY 2012 and beyond. And, as detailed below, the major start-up costs are shifted to future time periods beyond the horizon of the OLS analysis, which effectively takes a substantial amount of cost out of consideration entirely.

The Summary Fiscal Impact Estimate reflects accounting fictions. The fiscal impact estimate displays prominently on the first page a table showing a first year surplus that accumulates and continues through CY 2011. It is based on idiosyncratic and misleading accounting statements. The CY 2009 account surplus balance of \$15.7 million is an artifact of

the annualized revenue estimate from which is subtracted only a half year of estimated costs. The surplus is imaginary since revenues are for one year and costs for six months. This accounting fiction is carried through into CY 2010 and 2011. The reported accumulated surplus follows from this unexplained accounting aberration.

The estimated surplus in the first year is substantially overstated due to omission of any and all start-up costs. The summary estimate counts only the prospective costs of estimated outlays to cover projected claims and administrative costs, but completely ignores OLS' own estimate of \$12.5 M as the cost for setting up the system. OLS assumes that this cost can be deferred and recovered in annual increments of \$2.5 M per year in the 2011-2015 time frames.<sup>3</sup> Since the study focuses on a three year timeframe, back loading recovery of administrative cost to the out years is tantamount to simply ignoring them. If the administrative start-up costs are included in the OLS fiscal assessment, the fund surplus is dramatically lessened to \$3.2 M in the first year. Even then, it still reflects only a half year of claims and a full year of tax revenue.

Normalizing claims to an annual basis reduces the forecast surplus for each year and shows, even under the assumed fund income and outlays (to which we take exceptions below), that the fund will actually show a deficit in CY 2010. In short, the OLS estimate of fiscal impact showing accumulated fund balances in excess of \$15 million for 2009-2011 are accounting fictions that distort and inaccurately characterize the timing of revenue and costs of the program. This is in addition to other likely errors of estimation discussed further below.

Estimates of the number of claimants are not verifiable or reliable. Costs of the program are made up of administrative costs, discussed above, and paid out benefits. The latter are driven by the number of claims and the average cost per claim.

The OLS analysis of the cost to the Fund of benefits paid assumes, without a verifiable

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3. It goes without saying that costs deferred are not costs avoided and that the delay will occasion substantial unacknowledged and unaccounted interest costs. We do not estimate the amount of the cost, but note only that there is no such thing as a free lunch or loan. By deferring recovery of the start up costs, OLS indicates that the State is effectively borrowing from future tax payers or income to underwrite initiation of the program. This is a significant departure from generally accepted accounting principles widely applied in the private sector.

foundation, that there will be 38,200 claims in the first year and negligible growth in subsequent years. Neither the initial number nor the anticipated growth is shown, or likely, to be a reliable indicator of the potential cost. OLS explained that its 38,200 estimate for the number of claims "...was extrapolated using CY 2005 NJ TDI eligible pregnancy claims and analyzing California's experience."<sup>4</sup> The claims estimate is disaggregated into a) employees who would have made birth or adoption claims (29,000); b) employees who would care for sick family members (5,000); or c) claims by "laid off individuals" (3,200). We cannot verify these estimates, nor does the fiscal analysis address problems of incomparability raised by using California's experience.

OLS indicates that neither it nor the Department of Labor and Workforce Development provided "a formal estimate for S-786." Both relied instead on an evaluation of "previous similar legislation" from last year. While some of that information was provided to OLS and "is relied on heavily by OLS", none of it is disclosed in the fiscal analysis under review here. Absent the critical underlying data, we and other interested parties are left to guess at the basis of most of the fiscal analysis and to accept the conclusions without benefit of understanding their basis. We must trust, since we cannot verify the data inputs, the assumptions, the methods and the results of the fiscal analysis under review.

The growth of claims is most likely too low. OLS assumes without explanation that the number of claimants in the aggregate will increase trivially by 100 and 200 per year or by 0.26% and 0.52% respectively. No basis for this assumption is provided and we have attempted no independent estimate. However, the conjectured growth is inconsistent with actual claims data from California on which the OLS relies consistently for other guidance. The number of claims has increased in CA by 3.8%, 9.7%, and 8.3% over the previous year in 2005, 2006, and 2007 respectively. Adding credibility to a higher expected growth of claims is the OLS projection that the number of eligible employees in New Jersey will grow by 4.9% and 4.4% in 2010 and 2011

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4. In a world of imperfect data, analysts are obliged of course to make use of data that are readily available. Since California is the only state with a program similar to that being proposed in the Bill, it is on that basis a candidate for comparison. But, that may be the only one. California and New Jersey are so fundamentally and obviously different

respectively.<sup>5</sup>

Finally, it is worth bearing in mind that these programs tend to grow as knowledge of their availability and benefits becomes widely known by word of mouth and observation.

#### IV. CONCLUSION

The estimate of the Office of Legislative Services of the fiscal impact of Senate Bill No. 786 and the solvency of the Legislative Family Temporary Disability Leave Account cannot be verified with confidence. The data and methods are not fully disclosed. Some key underlying assumptions clearly bias the outcome. Our assessment indicates that the OLS fiscal estimate is overly optimistic about the long term solvency of the program and its ultimate impact on employees who may be obliged to pay more, potentially on the business community, or on the State General Fund. Application of generally accepted accounting principles commonly used to evaluate projects and programs in the private sector would dramatically modify the fiscal estimate of solvency. The estimate ignores important costs and shifts others to time periods not covered in the accompanying analysis. Most critically, the estimate does not take due account of known and potentially important changes in economic activity in state labor markets.

We would not rely on the OLS estimates of the fiscal impact of Senate Bill No. 786 as a reasonable indicator of the Bill's short or long term impact.

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in terms of labor markets, economic trends and structures, cultures, attitudes and other determinants of participation rates in such programs so as to strip comparisons of much validity or guidance to rational public policies.

5. We note that the OLS forecast of employee eligibility growth is contingent on growth of overall employment which, in light of current economic trends and potential developments, may be exaggerated.