

ACHIEVING A BETTER BALANCE:
RECOMMENDATIONS FOR THE NEW YORK STATE BUDGET
FOR FISCAL YEAR 2003

A Report of the
Citizens Budget Commission
March 21, 2002





Founded in 1932, the Citizens Budget Commission (CBC) is a nonpartisan, nonprofit civic organization devoted to influencing constructive change in the finances and services of New York State and New York City governments.

This report was prepared under the auspices of the CBC's Budget Policy Committee, which we co-chair. The other members of the Committee are: Lawrence B. Buttenwieser, Denis Curtin, Evan A. Davis, Stephen DeGroat, Cheryl Cohen Effron, Roger Einiger, Bud H. Gibbs, Kenneth D. Gibbs, James F. Haddon, Walter Harris, Craig M. Hatkoff, H. Dale Hemmerdinger, Fred Hochberg, Peter C. Kornman, Robert Kurtter, John R. Miller, Norman N. Mintz, Lionel I. Pincus, Robert E. Poll, Lester Pollack, Jules Polonetsky, Carol Raphael, Edward L. Sadowsky, Bart Schwartz, Barry F. Sullivan, Merryl Tisch, Lesley Daniels Webster, and Stephen H. Weiss.

The Budget Policy Committee has responsibility for developing the Commission's positions on the New York State and New York City annual operating budgets. This year the Committee is releasing a report with recommendations for adoption of the fiscal year 2003 New York State budget.

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March 21, 2002

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INTRODUCTION & SUMMARY

Governor George E. Pataki presented his Executive Budget for fiscal year 2003 on January 22, 2002. Consistent with legal requirements, he updated the proposed budget with the 30-Day Amendments on February 21, 2002. The State Legislature is now reviewing the Governor's proposals, and it is scheduled to adopt a budget before the new fiscal year begins on April 1, 2002. This report presents the Citizens Budget Commission's recommendations to the Legislature for changes it should incorporate in the adopted budget.

The Citizens Budget Commission (CBC) has reviewed the Executive Budget from the perspective of four critical goals for State finances. These are making New York State more economically competitive, improving the productivity of the operations of State government, promoting long-term or "structural" balance in State finances, and using public borrowing authority in an appropriate and affordable manner. These principles point to six shortcomings, summarized below.

◆Rapidly Rising Expenditures in a Recession

The Executive Budget increases spending by 5.0 percent at a time when receipts are expected to be \$2.7 billion less than they were in fiscal year 2001.

◆Acceleration in Medicaid Cost Increases

Health spending for the Medicaid program increases by 9.8 percent. The spending increase is driven by underlying growth in the program stemming from existing law and by the Health Care Reform Act of 2002, which funds wage increases for workers at public and private health care facilities throughout New York State.

◆A Precariously Balanced Budget

The Governor has proposed closing the State's \$5.7 billion budget gap with \$1.5 billion in actions that are risky for the State's long-term financial health, the appropriate use of \$2.0 billion in accumulated reserves to cover shortfalls, \$2.0 billion in measures with recurring value, and \$240 million in miscellaneous actions.

◆No Significant Improvement in Flawed School Aid

Despite proposed spending of \$17 billion, the school aid program remains inadequate in minimizing inequities among wealthy and poor districts. While the Flex Aid proposal improves district management of resources by permitting greater flexibility of funds, it does not address the flawed distribution of aid.

◆Inadequate Debt Limits

The proposed budget increases outstanding debt, which is already excessive, 4.3 percent to \$39.3 billion in fiscal year 2003. Current limits on debt have provided some measure of discipline but need to be strengthened; they become meaningful only in future years and could be changed. To address this problem, the Governor has once again submitted a constitutional amendment to the Legislature.

◆Diminished Accountability

The budget process and presentation are getting worse. Three of the last four budgets have been more than 100 days late, and the use of accounts entirely off the budget to support program spending is rising.

To address these shortcomings the Citizens Budget Commission makes five recommendations. They should be incorporated in the adopted budget for fiscal year 2003. These recommendations are summarized below.

◆**Reduce Spending to Reflect Economic Realities**

Growth in the budget should be reduced to more manageable levels through three strategies. First, productivity improvements in State operations should be pursued to reduce spending while continuing to deliver quality services. Second, Medicaid costs should be contained to 5 percent growth rather than 9.8 percent. Third, unneeded school aid distributed to wealthy districts through the State Tax Relief program should be eliminated; wealthy districts are able to self-finance higher-than-average per pupil spending with relatively low tax rates on their own property values.

◆**Balance the Budget More Soundly**

Legislative leaders should consider two ways to increase recurring receipts and promote structural balance. First, the sales tax on clothing under \$110 should be reinstated with a portion of the receipts dedicated to expanding the earned income tax credit; this would generate \$400 million annually. Second, tax cuts enacted in 2001 should be postponed until economic conditions improve; this would generate \$300 million.

◆**Initiate Meaningful School Aid Reform**

A more rational system for distributing school aid should be adopted to direct aid where it is needed most. The new system should eliminate or redistribute aid that is currently poorly targeted to wealthy districts and create equity in local tax effort by taking into account the burden of providing services for large populations of low-income residents.

◆**Establish a Constitutional Debt Limit**

New legislation should begin the process of amending the Constitutional debt limit. A better limit would be one that considers the burden associated with repaying debt together with three other relevant factors: the full range of resources available in the state or local economy to repay debt; other long-term liabilities such as unfunded pension obligations that limit the ability to repay debt; and the division of responsibilities between a state and its localities.

◆**Make the Budget Process More Timely & Transparent**

State leaders should reform the broken budget process and require better accounting for public resources. The period for consideration of the Executive Budget should be extended and the State Comptroller should be given the power to establish a binding revenue forecast at a certain point in the process. The State should be required to prepare a four-year financial plan following Generally Accepted Accounting Principles to prevent year-to-year cash manipulation. Finally, off-budget expenditures should be eliminated and shown in a consolidated budget and multi-year financial plan.

SHORTCOMINGS IN THE EXECUTIVE BUDGET

The Executive Budget is a complex document authorizing spending of nearly \$89 billion. It would support essential State services and provide significant aid to local governments across the state, but it also suffers from six significant shortcomings that are described more fully below.

RAPIDLY RISING EXPENDITURES IN A RECESSION

The economic context in which the Governor proposed his budget is well known. A national recession had already begun before the horrific terrorist attacks of September 11, 2001. Those events accelerated the downturn and had distinctly harsh impacts on the economy of New York State. Despite the troubled economic outlook, the Executive Budget proposes to increase overall State spending by \$4.2 billion or about 5 percent, well in excess of the projected rate of inflation. Such increases may not be sustainable.

The Economic and Revenue Forecast

The United States is in a recession that began in March of 2001.¹ Slowed growth stemming from a weak manufacturing sector was exacerbated by the bursting of the high-tech investment bubble in 2000, and profits dropped precipitously. To combat the deteriorating economic climate, the Federal Reserve began an aggressive policy to lower interest rates in January 2001. Then, on September 11, 2001, the struggling economy was shocked by the terrorist attacks, and the economy fell into a deeper recession.

The New York State economy was also slowing throughout early 2001, as the manufacturing sector and

the financial and business service sectors faltered. The situation worsened with the destruction of the World Trade Center by terrorists. The finance, transportation, and communications industries were disrupted, and tourism was severely curtailed. Economic activity in Lower Manhattan, including the Stock Exchange, was shut down for days after the attack as immediate response efforts were initiated in the area.

As a result of the attack and the deeper-than-expected recession, the Executive Budget forecast a \$1.2 billion shortfall in General Fund receipts below those in the fiscal year 2002 enacted budget. In March 2002 the Governor announced that tax receipts in January and February fell \$500 million below Executive Budget projections bringing the total current year shortfall to \$1.7 billion. To address the fiscal year 2002 shortfall, the Governor initiated spending reductions of \$454 million in October of 2001, has announced further efforts will be made to reduce spending, and is using previously accumulated reserves.

The combination of the slowdown evident prior to September 11 and the direct impact of September 11 on the New York State economy dampens the economic outlook for calendar 2002 and fiscal year 2003. Indeed, the New York State economy is expected to undergo a sharp but short contraction, with a substantial loss of jobs and a steep decline in income.

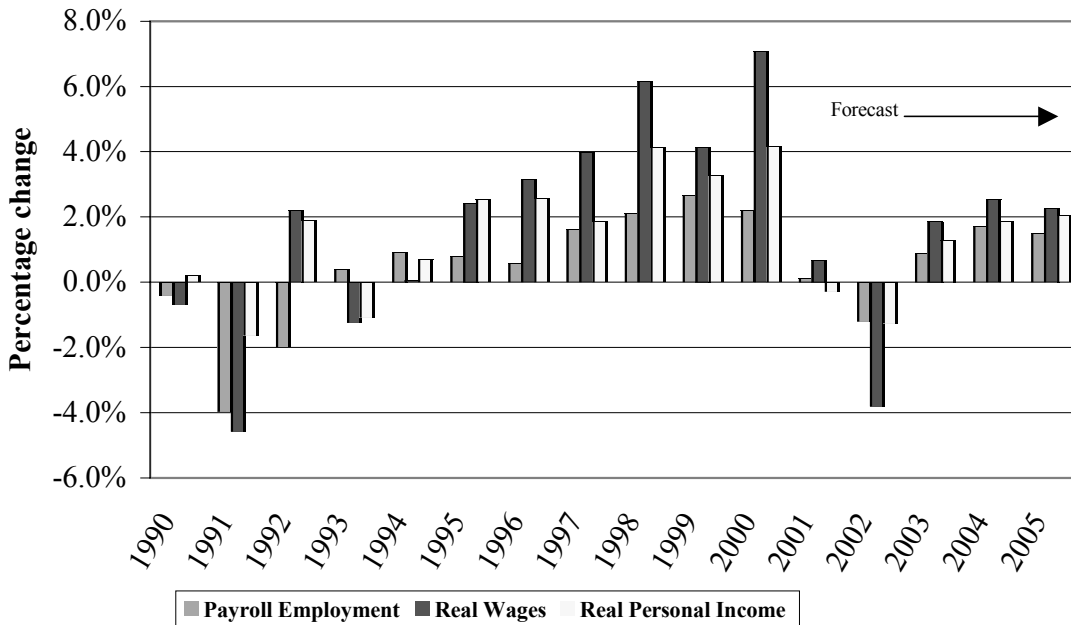
The State Division of Budget (DOB) forecast for the national economy is that the recession continues from the second half of 2001 through the first quarter of 2002.² For New York State, DOB expects total employment and wages to drop 1.2 percent and 3.8 percent, respectively, in calendar 2002. (See Figure 1.) Personal income is expected to decline by 1.3 percent in real terms.

According to the Executive Budget forecast, the con-

¹ The Business Cycle Dating Committee of the National Bureau of Economic Research reported that the recession began in March of 2001. See State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002, p. 87.

² State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002, p. 87.

Figure 1
Change in Employment, Real Wages, and Real Personal Income
New York State, 1990 to 2005



Source: State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002.

Note: Inflation adjustment based on the regional consumer price index series from U.S. Department of Labor, Bureau of Labor Statistics, *CPI for All Urban Consumers (CPI-U), NY-Northeastern, New Jersey*.

traction will be brief. In calendar year 2003, DOB expects New York State to recover, with employment and real wage growth of 0.9 percent and 1.9 percent, respectively. Personal income in 2003 is expected to grow 1.3 percent. The 2004 and 2005 economic forecast reflects continued growth of 1.7 and 1.5 percent in employment, 2.5 and 2.3 percent in wages, and 1.9 and 2.1 percent in personal income.

After declining more than 5 percent in fiscal year 2002 in constant dollar terms, all governmental funds tax receipts are expected to decline another 0.4 percent in fiscal year 2003. In real terms, consumption, business, and "other" taxes are expected to decline for the third consecutive year while the personal income tax will remain flat. Constant dollar tax receipts are expected to be \$2.7 billion less in fiscal year 2003 than in fiscal year 2001.

The Governor's Spending Proposals

During this brief but severe revenue contraction, the Executive Budget proposes a spending increase of 5.0 percent. (See Table 1.) Total or "All Funds" spending for fiscal year 2003 will reach \$88.9 billion, an increase of \$4.2 billion. More than half of the new spending is by the Department of Health, where a 9.9 percent increase adds \$2.5 billion. Most of this increase is attributable to rising Medicaid costs, a phenomenon discussed more fully below.

Other large increases are proposed for aid to local school districts and for subsidies to the Metropolitan Transportation Authority. An increase of \$490 million is proposed for school aid. The increase in school aid results from two factors; a cost of living adjustment for senior citizens under the School Tax Relief (STAR) pro-

Table 1
State of New York
All Funds Cash Disbursements by Function, Fiscal Years 2002 and 2003
(dollars in millions)

Function	Fiscal Year		Change	
	2002	2003	Dollars	Percent
Medicaid/Health	\$25,064	\$27,544	\$2,479	9.9%
School Aid ^a	16,263	16,753	490	3.0%
Economic Development/Gov Oversight ^b	797	1,132	335	42.0%
Transportation	4,768	5,057	288	6.0%
Social Services	7,849	8,114	264	3.4%
Mental Hygiene	4,784	5,041	257	5.4%
State Charges	3,615	3,868	253	7.0%
Environment/Parks	1,038	1,132	94	9.0%
General Government	1,333	1,414	81	6.1%
Judiciary	1,427	1,480	53	3.7%
Other Education	3,442	3,476	34	1.0%
Higher Education	5,524	5,551	27	0.5%
Public Protection	3,163	3,117	(46)	(1.5%)
Debt Service	4,185	3,666	(520)	(12.4%)
All Other ^b	1,421	1,544	123	8.6%
Total	\$84,673	\$88,885	\$4,212	5.0%

Sources: State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002; State of New York, Division of Budget, *30-Day Amendments*, February 21, 2002.

Notes: ^a School Aid includes the School Tax Relief (STAR) program.

^b Includes \$23 million for the "All Other" and \$248 million for the "Economic Development/Government Oversight" categories of spending added in the 30-Day Amendments.

gram, and aid from school year 2001-02 being paid out in fiscal year 2003 because of the mismatch between the school year and the fiscal year. On a school-year basis, nominal school aid is held constant. The fourth largest dollar increase for a functional area, \$288 million, is for transportation. The Governor proposes to provide additional support to the Metropolitan Transportation Authority to stave off a fare increase through at least November 2002.

Other notable changes include a 42.0 percent increase in the Economic Development and Government Oversight category and a 12.4 percent decrease in debt

service. In his 30-Day amendments, the Governor added \$248 million for the Empire Opportunity Fund (EOF), which provides capital funds for economic development outside New York City. When fully implemented, the EOF would support more than \$2 billion in spending on economic development projects such as high tech/bio tech research and development centers.

A three-part debt-restructuring program will reduce debt service by \$520 million from fiscal year 2002. First, the State is refinancing outstanding bonds to take advantage of lower interest rates. Second, it is planning to issue newly created bonds backed by the personal

income tax in place of other appropriation-backed authority borrowing. These bonds' more direct link to dedicated revenue is expected to lower interest rates and debt service costs. Third, the State plans to use reserves to retire \$250 million in outstanding debt at the end of fiscal year 2002 in order to lower future years' debt service costs.

A spending increase of 5.0 percent is difficult to justify in a recession. It is worth noting that on a "state funds" basis (which excludes spending supported by federal aid) proposed spending grows by a lower 2.0 percent. The difference between "all funds" and "state funds" growth stems from rapidly rising costs in Medicaid and other health programs, where the Executive Budget expects increased federal reimbursement. Spending on health care adds nearly 3.0 percent to State spending in fiscal year 2003.

However, the state funds growth rate may be understated. The State has counted on supporting a portion of the large increase in the Department of Health spending with federal aid that is not likely to materialize. Some of the spending supported in the all funds budget with federal aid may in actuality be transferred to state funds. In order to slow growth in spending, it is critical that State leaders focus on containing rising Medicaid costs.

World Trade Center Recovery Spending

The spending growth described above does not include federal funds designated for relief and recovery efforts from the attacks on the World Trade Center. The Executive Budget anticipates \$3.7 billion in fiscal year 2003 in federal aid for these purposes, and the bulk of the funding is paid to the City of New York although it first flows through the State. However, the budget appropriately treats this unusual aid as an extraordinary

category of receipts and disbursements and does not include it in the previous categories of "all funds" spending.

The Executive Budget does not include any special State-supported assistance to the City of New York for recovery efforts. There are no new programs of assistance that benefit New York City, many existing aid programs are cut in real terms, and the disproportionate burden placed on localities generally (and the City of New York in particular) due to New York State's unusual system for financing Medicaid and public assistance is unaltered.

Mayor Michael Bloomberg, in his preliminary budget for the City of New York's fiscal year 2003, has requested a variety of State actions to help the City in its recovery.³ Some, notably a restoration of the \$114 million Stock Transfer Incentive Fund, would require additional State spending, and should be judged by State officials based on overall statewide priorities. Others, however, do not require additional State funds and might be helpful to the City. Among these "no cost" proposed actions are approval of an increase in the local cigarette tax, an early retirement initiative for municipal workers, and changes in the local finance laws relating to debt restructuring. While separate from the State budget, measures that are helpful to the City should be part of the current legislative agenda.

ACCELERATION IN MEDICAID COST INCREASES

In the Governor's proposal, Department of Health spending is to increase 9.9 percent or \$2.5 billion.⁴ Of this, \$2.1 billion is additional Medicaid spending. (See Table 2.) Other health programs, including an expansion of the Child Health Insurance Program (CHIP), add \$381 million.

³ City of New York, Office of Management and Budget, *Financial Plan Fiscal Years 2002-2006*, Volume 1, February 13, 2002, pp. 33-40.

⁴ On a general fund basis, the spending increase is much lower, 0.4 percent. The disparity between all fund and general fund spending stems from an increase in flows through State special revenue funds to finance health spending. The funding from special revenue sources created by 2002 legislation allows the State to shift \$289 million in spending from the general fund to other funds.

Table 2
Disbursements for Health Care Programs
State of New York, All Funds, Fiscal Years 2002 and 2003
(dollars in millions)

	<u>Fiscal Year</u>		<u>Change</u>	
	<u>2002</u>	<u>2003</u>	<u>Dollars</u>	<u>Percent</u>
Medicaid	\$21,549	\$23,652	\$2,103	9.8%
General Fund	6,138	6,160	22	0.4%
State Special Revenue Funds	1,208	2,060	852	70.5%
Indigent Care	838	1,000	162	
Nursing Home Provider Assessments	-	463	463	
HCRA Pool Transfers	263	540	227	
Tobacco Settlement Transfer	91	91	-	
Federal Special Revenue Fund	14,203	15,433	1,230	8.7%
Other Health Programs	\$3,060	\$3,442	\$381	12.5%
Child Health Plus	744	1,050	306	41.1%
EPIC	401	458	57	14.2%
Other	1,915	1,934	18	1.0%
Medicaid Administration	\$455	\$450	(\$5)	-1.1%
Total	\$25,064	\$27,544	\$2,479	9.9%

Source: State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002.

The increase in Medicaid spending has two sources. First, the underlying growth in Medicaid expenses stemming from existing law and medical care inflation is 7.2 percent.⁵ Second, in mid-January, a week before the Executive Budget was due to be released, the Governor and the Legislature enacted the Health Care Reform Act (HCRA) of 2002, which contained new spending initiatives.

In fiscal year 2003, HCRA 2002 will increase spending by \$428 million. (See Table 3.) By fiscal year 2005, additional spending for HCRA 2002 will reach \$882 million annually. Over the next four years, the additional funds committed as a result of HCRA 2002 total \$2.4 billion.

The major policy decision in HCRA 2002 that increases spending is a "workforce recruitment and retention initiative" for public and private health care providers. In essence, the State has agreed to fund a major part of the wage increases agreed to by health care providers as part of their collective bargaining with the largest health care workers' union. In fiscal year 2003, spending for wage increases for health care employees will be \$392 million. Over three years the cost to support the promised raises will increase to \$812 million per year. In the fourth year a promise was made to increase the funding for raises for personal care workers by \$367 million, taking the total annual commitment to \$1.2 billion in fiscal year 2006.

⁵ State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002.

Table 3
Disbursements Authorized by the Health Care Reform Act of 2002
State of New York, All Funds, Fiscal Years 2003 to 2006
(dollars in millions)

	<u>Fiscal Year</u>			<u>3-Year</u>	<u>4-Year</u>
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Total</u>	<u>Total</u>
Workforce Recruitment/Retention	\$392	\$643	\$812	\$1,847	\$2,214
Hospitals	129	244	333	706	706
Nursing Homes	133	186	186	505	505
Personal Care	117	200	280	597	964
Free Standing Clinics	13	13	13	39	39
Breast/Cervical Cancer	\$3	\$4	\$4	\$11	\$11
Medicaid for Working Disabled	\$33	\$41	\$41	\$115	\$115
Empire Blue Cross/Blue Shield Foundation	\$0	\$25	\$25	\$50	\$50
Total	\$428	\$713	\$882	\$2,023	\$2,390

Source: Citizens Budget Commission staff estimates based on data supplied by the New York State Division of Budget, the New York State Senate, and the New York State Assembly.

Other smaller initiatives in HCRA 2002 include the expansion of Medicaid coverage for women with breast or cervical cancer, the expansion of Medicaid for the working disabled, and the formation of a foundation with 5 percent of the proceeds from the conversion of Empire Blue Cross Blue Shield from non-profit to for-profit status. These initiatives add \$56 million in fiscal year 2003, growing to \$130 million in fiscal year 2005.

Medicaid cost increases approaching 10 percent are not justified. Despite enrollment declines averaging 0.3 percent annually since 1994, New York's expenditures have grown 3.0 percent per year in real terms.⁶ New York State's system is one of the most expensive in the country. (See Table 4.) In 1998, the latest year for which comparative data are available, average Medicaid payments per beneficiary were \$7,907 in New York, more than twice the national average of \$3,501. The State's

higher costs are driven mainly by its generous long-term care system, which has more relaxed Medicaid eligibility standards and relies much less on Medicare and third party insurance or private payers than do other states. The daily reimbursement rate for nursing homes is 61.4 percent higher than the national average and Medicaid pays 64.7 percent of nursing home costs in the State compared to a national average of 39.5 percent. Relatively high hospital costs are also part of the problem; the average cost for a hospital admission in New York State is nearly one-third above the national average.

The structure of New York State's Medicaid program does not promote efficiency, and it places an unusual and difficult fiscal burden on localities. The State-directed rate-setting system encourages hospitals to focus on obtaining enhanced subsidies through rate increases. As a result, they have become reliant on State bailouts and

⁶ According to New York State Department of Health data, the average monthly Medicaid enrollment in fiscal year 1994 was 3,020,866. An eight-month average of the monthly data for fiscal year 2002 is 2,835,954. The New York State Division of Budget reports that the Executive Budget reflects an expectation that enrollment will increase by about 100,000 in fiscal year 2003.

Table 4
Selected Characteristics of Health Care Costs
New York State and National Averages

<u>Indicator</u>	<u>United States</u>	<u>New York State</u>	<u>NY as % of the U.S.</u>
Avg. Medicaid Payment per Beneficiary (1998)	\$3,501	\$7,907	225.8%
Avg. Cost per Hospital Admission ^a (2000)	\$6,649	\$8,745	131.5%
Avg. Reimbursement Rate/Day-Nursing Home Care (1998)	\$98	\$159	161.4%
Avg. Nursing Home Cost Paid by Medicaid ^b (1998)	39.5%	64.7%	NAP

— Sources: Average payment per beneficiary for calendar year 1998 is from U.S. Congress, House of Representatives, Ways and Means Committee, *The 2000 Green Book*, <<http://aspe.hhs.gov/2000/gb/sec15.txt>> (November 27, 2001); cost per hospital admission for calendar year 2000 data is from American Hospital Association, *Hospital Statistics* (Chicago, Illinois) 2002 edition, p. 167; cost per day in a nursing home for calendar year 1998 is from Charlene Harrington, James H. Swan, Valerie Wellin, Wendy Clemena, and Helen M. Carillo, *1998 State Data Book on Long Term Care Program and Market Characteristics* (San Francisco: Department of Social & Behavioral Sciences, University of California and Department of Health Services Organization and Policy, Wichita State University, November 1999); and average nursing home cost paid by Medicaid for calendar year 1998 is from the Public Policy Institute of the American Association of Retired Persons.

Notes: ^a The cost per admission shown is the expense incurred by all short-term acute care hospitals not operated by the federal government, adjusted to exclude outpatient expenses.

^b Does not include expenditures for other long-term care facilities such as Intermediate Care Facilities for the mentally retarded.

less focused on how to deliver better services at lower costs.⁷ The expensive and inefficient system places a burden on local governments as well. New York State is unusual among states in that it requires counties to contribute 10 percent of the non-federal share for long-term care and 50 percent of the non-federal share for most other services. Thus, the localities must bear the fiscal burden for an extremely expensive system they do not control. For New York City, the mandated Medicaid costs are \$3.5 billion per year.

With the enactment of HCRA 2002, State leaders agreed to increase health spending in fiscal year 2003 at the expense of all other functions. The Executive Budget shows the inherent trade-off—to finance a real increase in Medicaid spending of 9.5 percent at a time

when the State faces large revenue shortfalls, spending on everything else is reduced 1.5 percent.

A PRECARIOUSLY BALANCED BUDGET

The combination of economic contraction, slowed revenue growth, and new health care initiatives added to previous expenditure commitments created a budget gap for fiscal year 2003 estimated at \$5.7 billion on a cash basis. The Executive Budget proposes to close this gap with \$1.9 billion in recurring resources, \$2.0 billion from various cash reserves, \$240 million in miscellaneous actions, and \$1.5 billion of risky or non-recurring measures. (See Table 5.) The last category of initiatives is most problematic, causing the budget to be balanced in a precarious fashion.

⁷ For a full discussion of the system's problems see Steve Malanga, "How Political Malpractice Crippled New York's Health Care," *City Journal*, Summer 2001 <http://www.city-journal.org/html/11_3_how_political.html> (March 14, 2002).

Table 5
State of New York
Gap Closing Actions in the Fiscal Year 2003 Executive Budget
(dollars in millions)

Budget Gap	\$5,700
Gap Closing Actions	
Appropriate Recurring Actions	\$1,911
October Actions	\$880
Hiring Freeze and Agency Initiatives	396
Debt Service Savings	225
Powerball Lottery	125
Lottery Enhancements	74
Video Lottery Terminals	60
Executive Budget Actions	\$1,031
No Growth in Local Aid Programs	550
Reductions in State Operations	323
Fines & Fees Increases	68
Mental Hygiene Revenue Increases	36
Savings from Science, Tech. & Academ. Res. Office	35
Public Protection Program Savings	19
Appropriate One-Shots	\$2,148
Use of Fiscal Responsibility/World Trade Center Reserves	1,133
Use of Federal Welfare Surplus	885
Additional Tax Audit Revenue	130
Imprudent/Risky Actions	\$1,534
HCRA Budget Relief	862
Draw Down of Cash Balances	490
TAP Restructuring	182
Other Miscellaneous Actions	\$107
Total Gap Closing Actions	\$5,700

Source: Citizens Budget Commission staff analysis.

On a Generally Accepted Accounting Principles (GAAP) basis the all funds budget has a deficit of \$1.1 billion in fiscal year 2003. The use of reserves accumulated in prior years causes the imbalance under GAAP.

Recurring or Prudent Actions

In October of 2001, after assessing the impact of September 11 on the State economy, the Governor sought to reduce costs in fiscal years 2002 and 2003. He imposed a hiring freeze, intended to reduce the State workforce by 5,000 positions through attrition. He froze discretionary agency spending and began to restructure and refinance State debt. Also in October, the Legislature approved measures to increase revenues from gambling. The State joined Powerball, the popular multi-state "big game," allowed video lottery terminals in more locations, and authorized the construction of additional casinos on Native American land. During the same week, the Legislature authorized a new structure for State borrowing backed by the personal income tax. Together these items are projected to yield recurring budget relief of \$880 million in fiscal year 2003.

In the fiscal year 2003 Executive Budget the Governor proposes initiatives estimated to provide additional recurring budget relief of \$1 billion. The largest item-expected to save \$550 million-is a freeze in local aid grants. The second major item is a reduction in State operations of \$323 million. The agencies were asked to find funds in their own budgets to cover the required collective bargaining increase. Thus, State operations spending will increase by \$22 million rather than a previously projected \$345 million. To cover the cost of the collective bargaining increase, the workforce will be reduced by about 1,700 positions. Other restructuring at several small agencies will produce \$54 million. On the revenue side, the Governor has proposed raising \$68 million from fine and fee increases in fiscal year 2003 and a revenue enhancement program for Mental Hygiene of \$36 million.

Prudent Use of Reserves

The Governor proposes to use reserves set aside during the economic expansion to close gaps in fiscal years 2002 and 2003. About \$3.5 billion in reserves had been accumulated, including \$1.7 billion in the Fiscal Responsibility Reserve Fund, \$885 million in federal funds through the Temporary Assistance to Needy Families (TANF) program \$250 million in the Debt Reduction Reserve Fund, and \$700 million in the Tax Stabilization Reserve Fund. Only the Tax Stabilization Reserve Fund, which is restricted to use in the event of a mid-year imbalance in the General Fund, will remain intact after fiscal year 2003.

Of these reserves, the State used about one-quarter in fiscal year 2002 to cover losses stemming from the recession and the September 11 attacks. About \$600 million was withdrawn from the Fiscal Responsibility Reserve Fund. With the Executive Budget, the Governor indicated he plans to use the \$250 million in the Debt Reduction Reserve to retire debt at the end of the fiscal year.

To help balance the fiscal year 2003 budget, the Executive Budget relies on \$2.0 billion in reserves. The Executive Budget draws down the remaining \$1.1 billion in the Fiscal Responsibility Reserve and \$885 million in accumulated TANF surplus funds.

Federal welfare reform, enacted in 1996, provided New York State with an annual TANF block grant of \$2.4 billion. To qualify for that grant, the State is required to spend 75 percent of a benchmark determined by the level of spending at the inception of the TANF program. This requirement, known as Maintenance of Effort (MOE), is \$1.7 billion. Thus, the State must spend at least \$1.7 billion, and could spend \$4.1 billion or more on welfare and welfare-to-work programs. From January of 1995 to October of 2001, the number of people receiving TANF cash assistance dropped from 1.2 million to 600,000. The combination

of falling caseloads and a fixed federal grant resulted in annual TANF surpluses. These surplus funds could be used in three ways—to enhance welfare and welfare-to-work activities, to supplant general fund spending on ongoing welfare activities, or to build up reserves to offset the added cost of future caseload increases. New York State has done all three, and it has an accumulated TANF surplus estimated at \$885 million at the start of fiscal year 2003.

The Executive Budget proposes to use the entire TANF surplus to substitute for general fund spending on three functions. First, \$420 million would be used for education-related fiscal relief. The largest item in this category is the proposal to support \$345 million of the college Tuition Assistance Program (TAP) with TANF funds. Smaller education-related uses of TANF funds include \$50 million for pre-kindergarten programs and \$25 million for additional school programs, such as extended school-day programs and school-based health centers. Second, youth programs for pregnancy prevention and employment training will be supported with \$27 million in TANF funds. Third, \$438 million will cover expenses associated with the Earned Income and the Child and Dependent Care Tax Credits.

To use the TANF surplus in the proposed fashion, the State must have the approval of the federal government. Most welfare experts believe that the federal government will approve the use of the funds; under TANF guidelines the grant can be used to support a broad range of services.

Reserves are appropriately used during economic hardship to avoid a sharp reduction in services. State leaders were prudent in allowing the funds to accumulate, and it is appropriate to propose using \$2.0 billion in reserve funds in the fiscal year 2003 budget. However, while the use of reserves to support ongoing operations helps solve the fiscal year 2003 problem, it does not help balance the budget in future years.

Risky or Imprudent Actions

To close the rest of the budget gap, about \$1.5 billion, the Executive Budget relies on three risky or imprudent items. Of these, questionable financing arrangements for the HCRA 2002 initiatives is the largest, \$862 million. Inappropriate drawing down of reserves at various State entities represents another \$490 million. Finally, the Governor proposes to save \$182 million from the State's Tuition Assistance Program (TAP) in an inequitable manner.

Although HCRA 2002 is troubling on a number of fronts, it is particularly troubling because so much of the spending increase is expected to be financed with risky or non-recurring revenues. (See Table 6.) Of the HCRA 2002 revenue changes, only \$294 million are realistic or recurring. These include a cigarette tax increase of \$251 million in fiscal year 2003. The tax per pack of cigarettes will increase from \$1.11 to \$1.50. The other recurring action is to cancel the scheduled elimination of the covered lives assessment, a tax on health insurers. The assessment was to decrease by \$40 million in fiscal year 2003; it will now help finance HCRA 2002. Finally, a small fee increase for certificate of need applications contributes \$3 million annually.

The risky or non-recurring revenue sources tapped in HCRA 2002 finance about 71 percent of the program's cost, or \$735 million in fiscal year 2003, and grow to 80 percent of costs by fiscal year 2005. They include the following:

- ◆ An increase from 50 to 53 percent in the federal share of Medicaid (Federal Medical Assistance Percentage or FMAP);
- ◆ The use of 95 percent of the proceeds from the Empire Blue Cross/Blue Shield conversion over three years;
- ◆ Various schemes that require federal approval to increase the limit on Medicaid payments to hospitals serving high-need clients; and
- ◆ Federal reimbursement for a new tax on nursing home receipts.

Table 6
Revenue and Budget Relief Actions in HCRA 2002
All Funds, Fiscal Years 2003 to 2005
(dollars in millions)

	Fiscal Year		
	<u>2003</u>	<u>2004</u>	<u>2005</u>
Total Support for HCRA 2002	\$1,029	\$1,527	\$1,575
Realistic/Recurring	\$294	\$314	\$314
Cigarette Tax Increase	251	251	251
Tax on Insurance Industry	40	60	60
Certificate of Need Fee Increase	3	3	3
Risky/Non-recurring	\$735	\$1,213	\$1,261
FMAP Increase	366	706	754
Proceeds from EBC/BS Conversion	-	333	333
Increased Medicaid Upper Payment Limit	195	-	-
Federal Reimbursement-Nursing Home Assessment	174	174	174
Share Supported by Risky/Non-recurring Sources	71.4%	79.4%	80.1%

Source: Citizens Budget Commission staff estimates based on data supplied by the New York State Division of Budget, the New York State Senate, and the New York State Assembly.

The federal government reimburses states for Medicaid expenditures at different rates depending on per capita income. New York State receives the lowest FMAP rate allowable, 50 percent, because of its relatively high personal income. However, the State also has a large Medicaid eligible population and has been attempting unsuccessfully to increase its FMAP for a number of years. The director of the federal Office of Management and Budget has in recent public statements rebuffed expectations for an increase in FMAP, on which the State is relying for \$366 million in fiscal year 2003 and twice that in 2004.⁸

The State Division of Budget anticipates that the conversion of Empire Blue Cross/Blue Shield from a non-profit to a for-profit insurance company will generate \$1 billion over three years. Despite the calls of health care advocates to use the proceeds to invest in long-term improvements in health care in the State, only 5 percent

of the proceeds, or \$50 million, will fund a foundation with that public purpose. Utilizing 95 percent of the revenues from the conversion to support ongoing spending is poor fiscal management--the asset sale will generate three years of income for the State and then it will be exhausted, adding to the State's long-term structural imbalance. Moreover, the assumption that the conversion will generate \$1 billion is based on an out-dated estimate; the market value of Empire Blue Cross/Blue Shield may be significantly lower. If the stock that will convert it to a profit-making company sells for less than \$1 billion, the State will have additional unfunded HCRA 2002 spending.

The other funding source for HCRA 2002 is an increase in special, earmarked revenues for Medicaid payments to nursing homes, which requires federal approval. Through a complex arrangement, the State hopes to gain more federal aid than otherwise would be

⁸ Raymond Hernandez, "White House Casts Doubt on Money for Health Plan," *The New York Times*, January 18, 2002.

the case for its payments to nursing homes under the Medicaid program. The gain is expected to total \$289 million annually, with about \$115 million in private nursing home revenue and about \$174 million in new federal aid substituting for State payments.⁹ In recent years, the federal government has been attempting to prevent states from manipulating the Medicaid rules to cover more of their costs than would be funded by the FMAP rate, the intention of the State's plan. If the federal government does not accept New York's nursing home tax as legitimate, then the State will be left to self-finance a greater share of HCRA 2002.

Another \$573 million of savings expected from HCRA is generated from a newly-approved federal waiver of the State's Medicaid upper payment limit and from transfers or off-budget receipts from a health care initiatives account to the State general fund. The upper payment limit increase will provide budget relief only in fiscal year 2003.

The Governor's budget also relies on \$490 million in transfer of reserves or cash balances in accounts the State maintains for its affiliated entities. Balances held by SONYMA, the Housing Finance Agency and the Environmental Protection Fund contribute \$300 million. A variety of smaller funds provide the remainder. These resources are one-shots, and the recurring spending supported by them will need to be covered by other sources in later years. In addition, these reserves or balances may be needed by the entities in the future, and the current "raids" on these funds may create future difficulties for the organizations.

The final problematic budget balancing strategy is a restructuring of the TAP program. TAP provides grants to college students based on income; students with the lowest income receive \$5,000 and students with the highest incomes (\$80,000 is the maximum) receive \$500 per year.

The Governor proposes to hold back one-third of a student's grant until he or she graduates. For a low-income student, the amount postponed would equal \$1,667 per year compared to \$167 for a student at the maximum income. Because many students need their grant in advance to attend school, the State will set up a \$10 million loan fund for students who cannot borrow money elsewhere. At graduation, the State would pay the "performance" third of the grant, plus any interest the student had to pay as a result of borrowing. The Governor is expecting \$182 million in savings in fiscal year 2003 from moving to this "performance award" structure.

This TAP proposal has three problems. First, it is regressive, having a greater impact on the poor than others. Second, it is expensive; it represents a loan from students, much of which the State will eventually have to repay with interest. Third, it is a "one-shot" saving, because the State must eventually pay the grants it postponed in a subsequent year.

The precarious balance in the fiscal year 2003 Executive Budget is achieved by relying to a great extent on non-recurring resources. More than half of the fiscal year 2003 budget gap is closed with \$3.1 billion of non-recurring resources; the appropriate use of accumulated reserves comprises \$2.0 billion and other non-recurring items represent \$1.1 billion. While the use of some one-time reserves is prudent in the current extraordinary economic circumstances, the heavy reliance on one-shots in the Executive Budget creates unsustainable expenditure levels in future years. According to the Executive Budget, the State faces budget gaps of \$2.6 billion and \$3.0 billion in fiscal years 2004 and 2005, respectively.

Moreover, the gaps reflected in the financial plan do not take into account three major risks. Accounting for these risks increases the gaps by \$1.1 billion to \$3.7 bil-

⁹ This calculation assumes that 75 percent of the nursing home days are eligible for reimbursement by Medicaid. The New York State Senate Finance Committee and Division of Budget provided the reimbursement rate used in the calculation.

lion in fiscal year 2004 and \$1.7 billion to \$4.7 billion in fiscal year 2005. (See Table 7.)

The Executive Budget assumes that the current recession will be over by the second quarter of 2002. Consequently, the gaps in the Executive Budget are based on receipts growth of about 3 percent for fiscal year 2004 and 5 percent for fiscal year 2005. If the State's recovery follows the pattern of the early 1990s, however, the budget gaps will be \$190 million and \$530 million larger in the two out-years of the plan.

The financial plan makes no provision for wage increases from the renewal of expiring contracts with unionized workers. Contracts with most of the major public employee unions expire toward the end of fiscal

year 2003. A wage increase based on the projected rate of inflation would add \$210 million and \$419 million to the gaps.

A final major risk stems from HCRA 2002. The cost of the raise for health care workers balloons in the second and third year. A large portion of the financing is based on an unlikely FMAP increase. Without that component of the financing, the gaps will be \$706 million and \$754 million higher in fiscal years 2004 and 2005, respectively. Also at risk is the estimated valuation of the Empire conversion. For each \$100 million that the conversion falls short of the \$1 billion target, the State will end up financing \$33 million per year in HCRA expenses from other sources.

Table 7
Projected Budget Gaps, Fiscal Years 2004 and 2005
State of New York, All Funds Cash Basis
(dollars in millions)

	Fiscal Year	
	2004	2005
Receipts	\$88,934	\$93,020
Disbursements	91,545	96,055
Financial Plan Gaps	(\$2,611)	(\$3,035)
Risks to the Financial Plan	(\$1,106)	(\$1,703)
Slower Recovery ^a	(190)	(530)
Collective Bargaining ^b	(210)	(419)
Health Care Financing ^c	(706)	(754)
Risk-Adjusted Gaps	(\$3,717)	(\$4,738)

Source: State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002.

Notes: ^a Estimate based on the impact on personal income tax collections if personal income grows at the average annual rate experienced from 1992 to 1995.

^b Assumes wage increases at the rate of inflation.

^c Assumes no increase in FMAP.

NO SIGNIFICANT IMPROVEMENT IN FLAWED SCHOOL AID

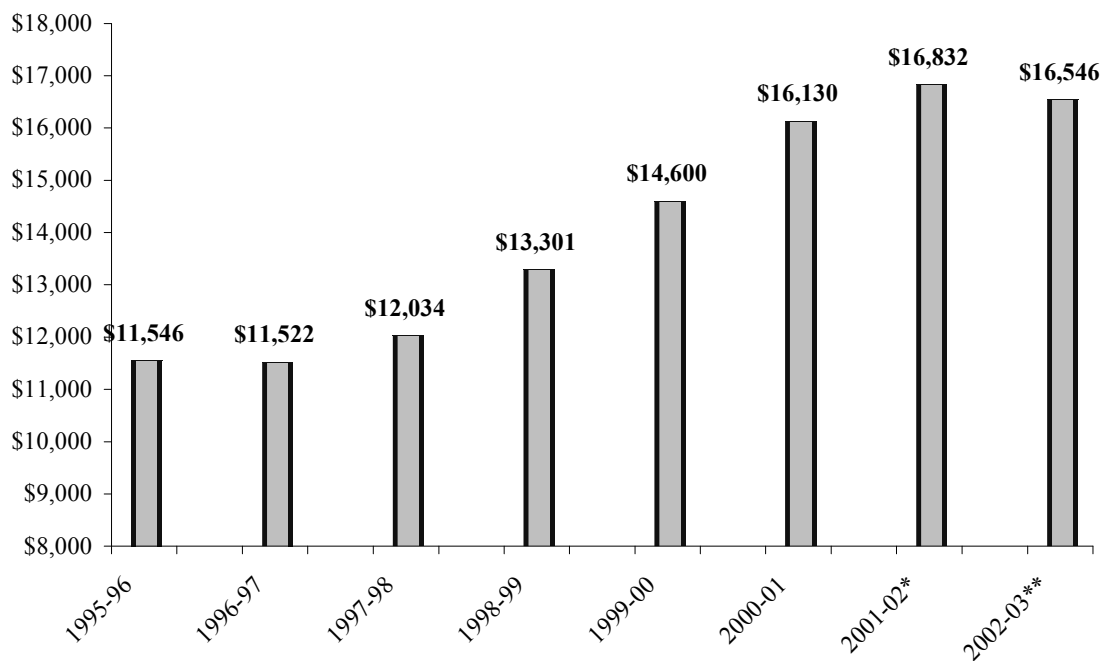
Over the past five years, when the economy was thriving, New York State made a major commitment to increase school aid, but left the long-term problem of inequitable local school financing unsolved. The Governor's latest budget proposal reverses the trend of significantly increased aid, but continues to ignore the need for basic reform in the distribution of school aid.

The Governor proposes that school districts take a reduction of \$284 million (in constant 2002 dollars) in aid from last year to this. From school year 1995-96 to school year 2001-02, school aid increased at an annual rate of 6.5 percent, after adjusting for inflation. In real

terms, more than \$5.3 billion was added. (See Figure 2.)

A major part of the growth is attributable to the School Tax Relief (STAR) program. STAR was enacted in 1997 as an incentive for local school districts to reduce property tax rates by replacing some local tax revenues with STAR aid. STAR aid, in constant 2002 dollars, has grown from \$630 million in school year 1998-99, the first year it became available, to \$2.7 billion in school year 2002-03. On average, STAR has increased \$386 million per year, accounting for more than half the total growth in school aid. The underlying real growth in non-STAR school aid averages \$328 million per year, or about 2.6 percent annually.

Figure 2
State of New York
Total School Aid, School Years 1995-96 to 2002-03
(constant 2002 dollars, in millions)



Sources: State of New York Division of the Budget, *Description of New York State School Aid Programs*, Table II-A and Table II-E, 1996-97 to 2002-03.

Notes: * 2001-02 Enacted Budget Estimate.

** 2002-03 Executive Budget Proposal.

Inflation adjustment based on the regional consumer price index series from U.S. Department of Labor, Bureau of Labor Statistics, *CPI for All Urban Consumers (CPI-U), NY-Northeastern, New Jersey*.

Although it distributes \$17 billion per year, New York State's school aid system fails to perform the essential function of adequately equalizing resources among rich and poor districts. According to *Education Week* magazine, only 13 states do a worse job equalizing resources than New York.¹⁰ Supreme Court Justice Leland DeGrasse found New York's system illegal when he ruled for the plaintiffs in the Campaign for Fiscal Equity case in January of 2001. Judge DeGrasse concluded that, "The State's school aid distribution system has for over a decade prevented the New York City public school system from receiving sufficient funds to provide its stu-

dents with a sound basic education."¹¹ The Governor has appealed the ruling.

In New York, not enough aid is directed at high-need districts and too much aid is directed at low-need districts. The wealthiest districts in the State outspend the poorest by a ratio of nearly 2:1. (See Table 8.) The wealthiest districts have seen school aid per pupil increase 8.5 percent in real terms in the period 1994 to 1999 (the most recent year the data are publicly available). This allowed them to decrease their local tax effort per pupil by 2.3 percent. Over the same period, the 50

Table 8
State of New York
School Aid and Local Revenue Per Pupil for the Wealthiest and Poorest School Districts
(constant 2002 dollars)

	<u>School Year</u>		<u>Change^a</u>	
	<u>1993-94</u>	<u>1998-99</u>	<u>Dollars</u>	<u>Percent</u>
50 Wealthiest^b	\$17,464	\$17,217	(\$247)	-1.4%
State Aid	1,394	1,512	119	8.5%
STAR	-	188	188	
General	1,394	1,324	(69)	
Local Revenues	16,070	15,705	(366)	-2.3%
Enrollment (# of pupils)	72,383	77,508	5,125	7.1%
50 Poorest^b	\$8,753	\$9,880	\$1,127	12.9%
State Aid	6,764	7,641	877	13.0%
STAR	-	147	147	
General	6,764	7,494	730	
Local Revenues	1,988	2,239	251	12.6%
Enrollment (# of pupils)	53,604	64,333	10,729	20.0%

Source: New York State Education Department, Fiscal Analysis and Research Unit, master data files available at <http://www.oms.nysed.gov/faru/Profiles/profiles_cover.htm> (February 11, 2002).

Notes: ^a Dollars have been adjusted for inflation using the regional consumer price index series from U.S. Department of Labor, Bureau of Labor Statistics, *CPI for All Urban Consumers (CPI-U), NY-Northeastern, New Jersey* for the school year.

^b The 50 wealthiest and poorest districts in the state for each year were selected based on the Combined Wealth Ratio, a measure the State Education Department uses to account for income and property wealth in each district.

¹⁰ *Education Week*, Quality Counts 2002: Building Blocks for Success, January 10, 2002, <http://www.edweek.org/sreports/qc02/reports/equity-t1.htm> (February 24, 2002).

¹¹ *Campaign for Fiscal Equity (CFE), Inc. v. State of New York*, January 10, 2001, p. 134.

poorest districts had aid increases of 13.0 percent but increased their local effort by 12.6 percent.

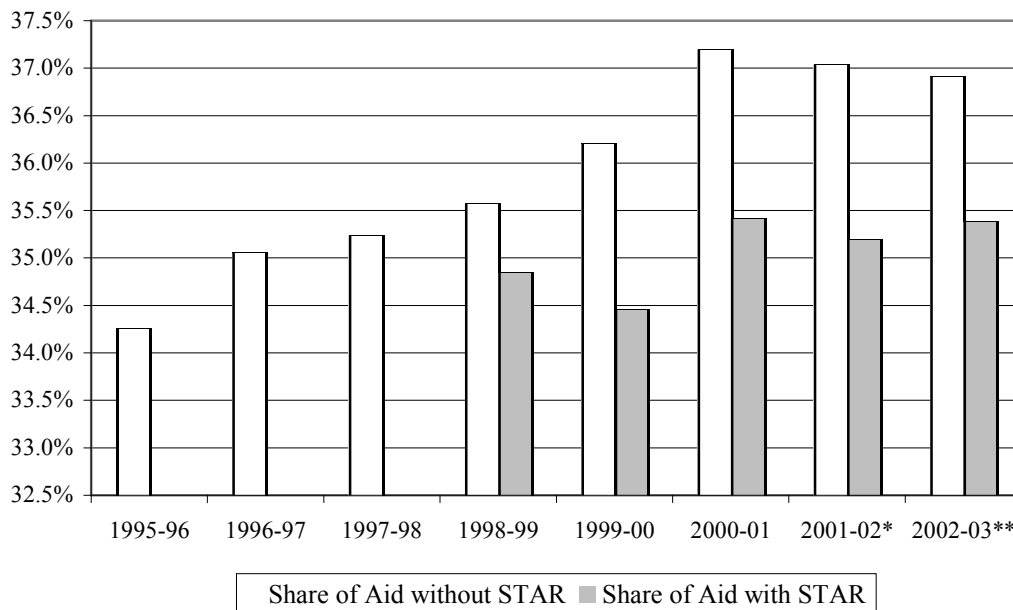
The aid distributed under STAR is especially skewed toward wealthier districts, because STAR aid is distributed based on property wealth. In 1998-99, the first year of STAR, about \$188 per pupil went to the wealthiest districts while \$147 per pupil went to the poorest. Since a major portion of the growth in school aid results from the expanding STAR program, the problem of inequitable finance has grown much worse than if the

increased aid had been through the regular, though still problematic, aid formulas.

Taking New York City as an example of a high-need district illustrates the problem. Under the Executive Budget the City's share of non-STAR school aid for school year 2002-03 would be about 36.9 percent. With STAR, however, the City's share of total aid drops to 35.4 percent. (See Figure 3.)

STAR is not the only problem. The formulas that

Figure 3
New York City's Share of Statewide School Aid
School Years 1995-96 to 2002-03



Sources: State of New York Division of the Budget, *Description of New York State School Aid Programs*, Table II-A and Table II-E, 1996-97 to 2002-03. STAR aid for New York City is provided by the New York City Office of Management and Budget.

Notes: * 2001-02 Enacted Budget Estimate.

** 2002-03 Executive Budget Proposal.

STAR did not begin until 1998.

direct non-STAR aid also fail to relate adequately to districts' ability to pay. The formulas include "save harmless" provisions, which protect districts from reductions in aid when their wealth increases. Currently, 44 percent of the districts in the State benefit from "save harmless" provisions.¹²

In addition, the formulas fail to adjust adequately for need. Under the non-STAR aid formulas, New York City's share of aid roughly corresponds to its share of statewide enrollment. However, New York City has among the highest-need pupils in the State. According to the most recent data available from the State Education Department, 84 percent of New York City public elementary school students qualify for free lunches compared to 33 percent in the rest of the state, and 15.7 percent of New York City students have limited English proficiency compared to 2.6 percent in the rest of the state.¹³

In the Executive Budget, the Governor proposes a modification of State aid, called "Flex Aid". Flex Aid combines 13 components of the current package of aid programs into one formula for general operating aid. About \$10 billion, or 70 percent of total school aid, would flow through Flex Aid. The new system would be simpler, distributing aid more straightforwardly. It would also permit greater flexibility on the part of localities by eliminating some of the categorical aid designations that direct funds for specific purposes rather than general support. However, it leaves intact the inequitable overall distribution of aid.

INADEQUATE DEBT LIMITS

Historically, New York State has had three problems managing debt: it borrows too much; it uses "back door"

mechanisms that circumvent procedural protections against excessive borrowing; and, at times, it inappropriately used borrowed funds. In recent years, two laws have sought to improve New York's debt practices. Although these statutory measures have been accompanied by greater discipline in State borrowing, they do not sufficiently limit debt.

In the past decade, State-supported debt grew at an average annual rate of 6.6 percent. (See Table 9.) Total debt outstanding nearly doubled, from \$19.1 billion to \$37.2 billion.

The debt burden has grown despite procedural limits. Debt carrying the full legal obligation of the State, General Obligation (GO) debt, can be issued only if the amount and purpose of the borrowing is approved by the voters at a general election. Because voters have rejected 11 of 32 bond acts placed on the ballot since 1946, the State has avoided this procedural limit by creating public authorities, which are empowered to borrow using forms of debt other than GO and do not require voter approval.¹⁴ Less than 12 percent of the State's outstanding debt is GO debt; the remainder takes "back door" forms, primarily lease-purchase agreements with authorities. Borrowing by the State's public authorities is more costly due to higher interest rates than GO debt because its repayment requires annual legislative appropriations. In the past decade, outstanding lease-purchase and other contractual arrangement debt has almost tripled, growing at an annual rate of 9.8 percent.

In response to the alarming amount of State-supported debt, the Legislature enacted the Debt Reform Act of 2000 in May 2000. It placed a limit on new debt issued by the State to be phased in over a decade. When the limits are fully effective in fiscal year 2014, debt outstanding will be capped at 4 percent of the State's per-

¹² State of New York, State Education Department, *Research Note: Wealth and Revenue Changes 1994-95 to 1998-99*, <http://www.oms.nysed.gov/faru/Research%0notes/GSRGFormattedRN> (February 11, 2002), p. 3.

¹³ State of New York, State Education Department, *The State of Learning: A Report to the Governor and the Legislature on the Educational Status of the State's Schools*, July 2000.

¹⁴ Citizens Budget Commission, *An Affordable Debt Policy for New York State and New York City*, September 20, 2000, p.3.

Table 9
State-Supported Debt Outstanding
as of March 31, Fiscal Years 1991 to 2001
(dollars in millions)

<u>Fiscal Year</u>	<u>Type of Debt</u>			<u>TOTAL</u>
	<u>General</u> <u>Obligation</u>	<u>Lease Purchase/</u> <u>Other Contractual</u>	<u>Other^a</u>	
1991	\$4,649	\$12,673	\$2,272	\$19,594
1992	5,081	16,865	1,652	23,598
1993	5,426	18,947	1,070	25,443
1994	5,370	21,843	944	28,157
1995	5,181	22,489	857	28,527
1996	5,047	25,501	753	31,301
1997	5,028	26,867	739	32,634
1998	5,033	28,827	689	34,549
1999	4,825	30,466	698	35,989
2000	4,556	31,737	636	36,929
2001	\$4,346	\$32,174	\$552	\$37,072
Average Annual Rate of Change	-0.7%	9.8%	-13.2%	6.6%

Source: State of New York, Office of the Comptroller, *Comptroller's Annual Report to the Legislature on State Funds Cash Basis of Accounting*, fiscal year 2000 and 2001 editions.

Notes: ^a Includes Tax and Revenue Anticipation Notes, Certificates of Participation, and State guaranteed authority debt.

sonal income, and debt service will be limited to 5 percent of total receipts. Although the ultimate limits are restrictive, the phase-in provisions in the law are generous; during the initial years the law provides little constraint on borrowing.

In an attempt to reduce reliance on back door debt, the Legislature passed a second measure in October 2001. The law created a new debt structure—revenue bonds backed by up to 25 percent of personal income tax (PIT) receipts. Over the next five years, the State plans to issue \$3.1 billion of such bonds. If the new bonds are judged favorably by the marketplace, the State's borrowing costs will be lower. However, the marketplace may or may not view the bonds more favorably because receipts from the PIT must still be appropri-

ated annually to pay the debt service.

The capital program proposed in the Executive Budget will increase State-supported debt \$4.6 billion, from \$37.7 billion in fiscal year 2002 to \$42.3 billion in fiscal year 2007. (See Table 10.) The plan increases State-supported debt outstanding 4.3 percent in fiscal year 2003, but calls for lesser increases in subsequent years.

In February the Governor introduced Constitutional debt limit legislation. To amend the State Constitution, legislation must be enacted by two consecutive Legislatures and be approved by voters in a referendum. If a Constitutional debt limit is passed by the Legislature this year, a referendum could be placed before the voters in 2003. If not, voters will not have a chance to consid-

Table 10
Projected State-Supported Debt Outstanding at Year-End and Debt Service
State of New York, Fiscal Years 2002 to 2007
(dollars in millions)

<u>Fiscal Year</u>	<u>Amount</u>		<u>Percent Change</u>	
	<u>Debt Outstanding</u>	<u>Debt Service</u>	<u>Debt Outstanding</u>	<u>Debt Service</u>
2002	37,650	\$4,314	1.9%	14.3%
2003	39,275	3,767	4.3%	-12.7%
2004	40,267	4,009	2.5%	6.4%
2005	41,153	4,403	2.2%	9.8%
2006	41,816	4,614	1.6%	4.8%
2007	42,259	4,771	1.1%	3.4%

Source: State of New York, Division of Budget, *2002-03 New York State Executive Budget*, Appendix II, January 22, 2002.

er this important issue until 2005, at the earliest, because a new Legislature takes office in January 2003. It is unclear whether the Legislature plans to take up the issue this session. In the past, Assembly and Senate majority leaders have been reluctant to act on the issue; each has had different views as to whether and how debt should be limited and consensus on the best course of action has not yet been reached.

DIMINISHED ACCOUNTABILITY

The current State budget process and presentation serve to undermine accountability of government. There are two symptoms of the problem--lateness and obfuscation. The first has captured the public's attention. The second, which has so far been a concern only to fiscal monitors, is perhaps the more troubling.

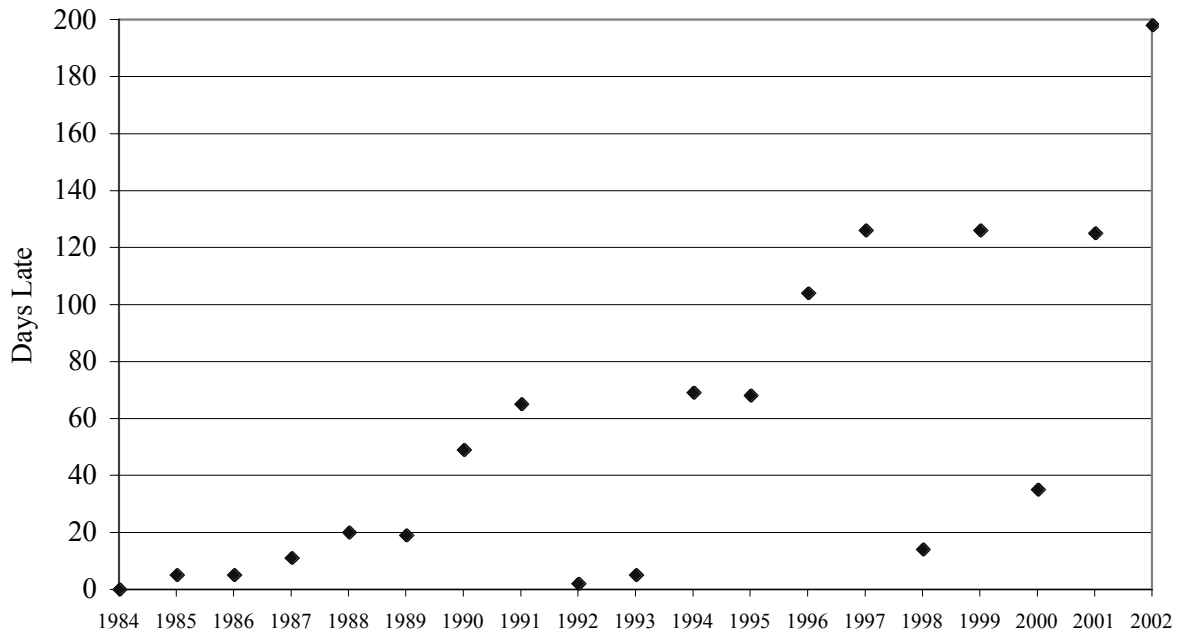
For 18 years New York has started its fiscal year without a budget. In recent years, the problem has gotten worse. Three of the last four budgets were more than 100 days late. (See Figure 4.) The most recent budget, for fiscal year 2002, marked a low-point--it was not finished until more than six months into the fiscal year.

The fiscal year 2002 budget was not only extraordinarily late, it also was poorly crafted. In August of 2001 the Legislature passed a "bare-bones" budget in an effort to force the Governor to negotiate over items that were left out or severely cut. The effort backfired as the events of September 11 took precedence for State leaders and serious negotiations never took place. Some corrective actions were taken in October of 2001, but they only partially addressed the problems. Many human service agencies and school districts were left with uncertain funding and unexpected cuts even after the October legislation.

The second symptom, obfuscation, is--not surprisingly--less widely understood. Recent actions to hide budget growth by moving spending "off-budget" have highlighted the need for a clearer and more transparent reporting structure.

In the past few years, the State has moved programs that are growing rapidly from its general fund to special revenue funds. For example, two years ago the State moved the STAR program out of the general fund. Personal income tax receipts equal to the cost of the STAR program were designated as a special revenue

Figure 4
State of New York
Budget Adoption Days Late
Fiscal Years 1984 to 2002



Source: State of New York, Office of the State Comptroller.

fund. HCRA 2002 will shift another \$500 million from the general fund to special funds, and revenues from off-budget accounts will be transferred to the budget to support health programs. Various other accounting mechanisms have also been used to "offset" general fund spending in recent years.

A more disturbing trend, however, is the growing importance of off-budget accounts in State finances. These accounts are established by the Legislature to receive and disburse designated funds. They are not fully accounted for in the budget. Receipts held in these

accounts can be moved to the fund shown in the budget, and the movement is presented on a "net transfer" line; very little detail is provided about what receipts are transferred or what programs they support. For example, in fiscal year 2001 the State enacted health care reforms (the Health Care Reform Act of 2000) which affected spending of about \$3.3 billion, both off and on the budget. About \$1.2 billion of that total involved transfers from off-budget accounts and about \$800 million was spent directly from off-budget accounts, including from an account designated to collect proceeds from the State's tobacco settlement.¹⁵

¹⁵ For a schematic showing the breakdown of off-budget and on-budget HCRA 2000 spending, see State of New York, Office of the State Comptroller, *2000-01 Budget Analysis: Review of the Executive Budget*, February 2001, pp. 48-52, www.osc.state.ny.us/reports/budget/2000/2-00.pdf (March 1, 2002).

The HCRA 2002 legislation directed additional receipts to off-budget accounts. The receipts from the higher tax on cigarettes, for example, will be placed in an account called the Tobacco and Insurance Initiatives Pool. Direct off-budget disbursements for a variety of health care programs will continue.

The growing use of off-budget accounts is disturbing because it diminishes accountability. Accountability inspires the public faith that is critical to democracy and provides support for legitimate government programs. New York State's recent reporting practices are undermining that essential public faith.

RECOMMENDATIONS FOR THE ENACTED BUDGET

Since the Governor presented his Executive Budget, the Legislature has been considering ways to change it. In the coming weeks, they should act to adopt a budget before the start of the new fiscal year. That new budget should overcome the shortcomings identified in this report by incorporating the five recommendations below.

REDUCE SPENDING TO REFLECT ECONOMIC REALITIES

The nation is in a recession, and the State has had to use \$4.3 billion of accumulated reserves to close budget gaps. Under these circumstances, a spending increase well in excess of inflation is imprudent and inappropriate.

Legislative leaders should reduce spending growth in three ways—increase productivity in State operations, Medicaid cost containment, and reduce school aid for districts that do not need it. Together these spending actions would generate \$1.4 billion in recurring savings.

Increase Productivity

The first, and, if possible the primary, means for achieving a balanced budget should be to increase the productivity of State government. Productivity initiatives make possible cost savings that do not harm, and may even improve public services.

In recent years, productivity gains in the private sector have averaged 2.3 percent per year.¹⁶ A focused effort to achieve a 2.3 percent productivity gain in State operations during fiscal year 2003 would provide \$242 million in recurring savings.¹⁷ That savings implies that the State would reduce its workforce by 3,000 positions.¹⁸ The State can accomplish this without lay-offs; full attrition of 5 percent would eliminate about 11,000 positions in fiscal year 2003.¹⁹

One of the major areas of State operations that could be further trimmed is the prison system. The Executive Budget proposes that the Department of Correctional Services workforce be reduced by 584 positions in fiscal year 2003 to reflect a reduction in the population; the State's prisons are expected to house 64,400 inmates, 8,600 fewer than in 2000. The prison population could be reduced further if the State improved and expanded its alternatives to incarceration programs for drug-addicted felons.

¹⁶ From 1995 to 2000 output per worker in the nonfinancial sector of the economy increased at an average annual rate of 2.3 percent. See Bureau of Labor Statistics, *Major Productivity and Costs Index for Nonfinancial Corporations* <<http://stats.bls.gov/LPC/Lpcover.htm#Output>> (March 2, 2002).

¹⁷ This estimate is 2.3 percent of general fund State operations and State charges for fringe benefits and pensions for fiscal year 2002; together these items total \$10,509.

¹⁸ This calculation assumes average total compensation of \$70,000 per worker, including fringe benefits and pension.

¹⁹ The attrition rate for City of New York employees is 7 percent per year. Thus, an assumed rate of 5 percent for State employees is conservative.

In a report released in May of 2000, *Making More Effective Use of New York State's Prisons*, the CBC concluded that the State could save \$100 million per year by expanding well-tested programs that substitute drug treatment and other services for the later part of prison sentences without jeopardizing public safety. Even greater reductions in the inmate population would be achieved by reforming the Rockefeller Drug Laws. The current drug laws are costly and inefficient at meting out prison terms that fit the crime. The Legislature should adopt a budget that moves beyond the Governor's proposals in order to better manage drug offenders at a reduced cost to taxpayers.

Contain Medicaid Costs

The HCRA 2002 legislation was a major policy mistake. It increases the unit cost of health care services for a State that already has some of the highest cost hospitals and nursing homes in the nation. Health care workers can and should be paid more, but unconditional subsidies to their employers is not the best way to accomplish that goal. Public funding of health services should be structured to improve efficiency and productivity, not to underwrite extraordinarily high costs.

One essential step is to reconsider the Medicaid rate increases promised by HCRA 2002. If growth in fiscal year 2003 Medicaid costs can be held to 5 percent instead of 9.5 percent, spending would be reduced \$332 million.²⁰

More comprehensive reform would yield greater sav-

ings. For example, if New York State tightened its Medicaid eligibility rules to bring the share of nursing home payments paid by parties other than Medicaid to the national average, then \$2.1 billion would be saved.²¹ If just the share of nursing home reimbursements from Medicare were brought to the national average, the State's Medicaid savings would be \$283 million.²²

Containing Medicaid costs also would provide fiscal relief for local governments. The estimated local relief from reducing the growth in Medicaid spending from 9.5 percent to 5.0 percent is about \$110 million. The budgetary savings for New York City from cost containment would be approximately \$70 million.

Cut Unneeded School Aid

School districts with relatively low tax burdens that spend well above the statewide average per pupil do not need the State's help. Eliminating STAR aid for the 200 wealthiest of the state's 700 school districts would save the State approximately \$740 million per year.²³ Savings would be greater, if more districts with above-average wealth had their aid reduced. Restructuring the remainder of the \$2.7 billion STAR program in order to distribute aid more sensibly will be discussed in the school aid section below.

BALANCE THE BUDGET MORE SOUNDLY

Rather than relying on imprudent and risky measures to balance the budget, State leaders should use two alternative strategies. First, the State should reinstate the por-

²⁰ State funds Medicaid spending between fiscal year 2002 and 2003 grows from \$7,346 million to \$8,045 (in 2002 dollars) or 9.5 percent. Allowing five percent growth would increase spending to \$7,713 for savings of \$332 million.

²¹ See Table 5 for sources and notes. Total nursing home expenditures in New York State in calendar year 1998 were \$8,538 million. Medicaid paid \$5,521 million. If Medicaid had paid the national average of 39.5 percent, total payments would have been \$3,373 million, a reduction of \$2,148 million.

²² See Table 5 for sources and notes. Nursing home payments in New York State from Medicare were 10.1 percent of the total, below the national average of 13.4 percent. If 13.4 percent of the \$8,538 million in total expenditures had been covered by Medicare, Medicaid payments would have been \$283 million lower.

²³ See Table 8 for sources and notes. In school year 1998-99 the State paid \$582 million in STAR aid. About \$160 million, or 27 percent of that amount, was paid to the 200 wealthiest districts. Applying those proportions to the \$2.7 billion STAR program proposed for school year 2002-03 yields a savings of \$740 million.

tion of its sales tax on clothing under \$110 that was eliminated unnecessarily. Second, the State should postpone scheduled tax cuts that were enacted in fiscal year 2001 until economic conditions improve. Together these measures would provide recurring receipts of \$700 million annually.

As the economy boomed over the last eight years, the State enacted tax cuts that will reach an annual value of \$11 billion in fiscal year 2003.²⁴ These tax cuts helped New York State reduce its once onerous tax burden to a more competitive level. In 1999, New York ranked 30 out of 50 states in state taxes per \$1,000 of personal income, a significant improvement from its number 14 standing in 1987. (See Table 11.) Among 12 states that may be considered New York's closest competitors, New York moved from second to fifth place over the same period.

The State's progress in reducing taxes has not been shared by local governments--local taxes remain the highest in the nation. New York State places a heavy burden for financing social welfare services on its counties and the City of New York. As a result, the local burden per \$1,000 of personal income in 1997 was \$73.28, nearly twice the national average of \$40.97 and the highest of any of its major competitor states. (See Table 12.) New York State's local tax burden was 48 percent higher than its next closest competitor state, New Jersey.

Because local taxes remain high relative to other places, the State should focus on that critical issue. The CBC and other civic groups have recommended that the State assume full responsibility for Medicaid and public assistance financing rather than require a locally raised contribution. These functions, being largely redistributive, should be supported on the broadest tax base possible.

Table 11
State Taxes Per \$1,000 of Personal Income
Selected States, Fiscal Years 1987, 1992 and 1999

<u>State</u>	<u>1999</u>		<u>1992</u>		<u>1987</u>	
	<u>Amount</u>	<u>50-State Rank</u>	<u>Amount</u>	<u>50-State Rank</u>	<u>Amount</u>	<u>50-State Rank</u>
Michigan	\$88.38	5	\$64.54	35	\$70.26	24
Connecticut	78.76	13	70.75	28	68.04	28
California	78.64	14	72.83	23	76.42	15
Massachusetts	71.58	21	71.80	25	79.05	13
New York	66.38	30	74.21	22	77.95	14
Pennsylvania	65.48	32	70.46	29	64.88	33
Georgia	63.16	33	62.93	38	63.45	35
Ohio	62.03	38	62.32	39	62.47	37
New Jersey	60.81	40	64.28	37	65.72	32
Florida	59.45	43	57.16	42	55.63	44
Illinois	58.87	44	56.26	44	56.72	43
Texas	51.34	47	56.97	43	48.44	49
United States	\$68.12		\$68.09		\$68.14	

Source: State of New York, Department of Taxation and Finance, *New York State Tax Sourcebook*, July 2001.

²⁴ State of New York, Department of Taxation and Finance, *Summary of Tax Provisions in the State Fiscal Year 2001 Budget*, August 2000. Does not include STAR.

Table 12
Local Taxes Per \$1,000 of Personal Income
Selected States, Fiscal Years 1987 and 1997

<u>State</u>	<u>1997</u>		<u>1987</u>	
	<u>Amount</u>	<u>50-State Rank</u>	<u>Amount</u>	<u>50-State Rank</u>
New York	73.28	1	78.16	1
New Jersey	49.49	5	45.80	15
Illinois	45.97	9	47.22	12
Ohio	45.12	10	42.18	22
Texas	44.21	11	47.83	11
Connecticut	42.63	14	43.02	19
Pennsylvania	39.70	21	40.88	24
Georgia	39.50	23	38.28	29
Florida	38.90	24	40.09	31
Massachusetts	35.27	30	36.08	32
California	33.44	35	37.33	30
Michigan	\$26.80	43	\$46.17	13
United States	\$40.97		\$43.28	

Source: State of New York, Department of Taxation and Finance, *New York State Tax Sourcebook*, July 2001.

sible. As the economy recovers and State leaders think about how to position New York State for the future, part of the strategy should be to reduce the burden on localities by financing Medicaid and public assistance from statewide revenue sources.

Many of the tax reductions enacted in the last few years were recommended by the CBC in its *Budget 2000 Project* because they would improve the State's competitiveness.²⁵ CBC supported rate reductions in the personal income tax—the top rate has dropped from 7.875 to 6.850—and the reduction or elimination of some of the unique taxes on real estate transactions. The CBC also strongly supported the phase-out of the gross receipts tax on utilities, and a reduction in the State's estate tax.

Some tax reductions, however, were not required to enhance competitiveness. The most significant of these is the sales tax on clothing costing under \$110. In fiscal year 1999 New York's 4 percent state sales tax rate was

the second lowest in the nation at \$13.67 per \$1,000 in personal income, well below the U.S. average of \$22.60. The burdens for regional competitors, Connecticut, New Jersey, and Pennsylvania are \$26.34, \$18.16 and \$20.20, respectively.²⁶

While a sales tax on clothing is regressive, creating relatively higher burdens on lower income households, there are more effective approaches to creating progressivity in the tax code than eliminating this sales tax. More of the foregone revenue from sales tax exemptions benefits higher income households than lower income households. Progressivity can be achieved more efficiently by expanding the earned income tax credit and increasing the personal income tax standard deduction.

Although New York State has an earned income tax credit (EITC), New York City does not. The effect of this difference is that people for whom the State EITC eliminates tax liability still pay New York City income

²⁵ For a full discussion of CBC tax recommendations see, Citizens Budget Commission, *Budget 2000 Project: Tax Policy*, published in 1995 and available at <<http://www.cbcny.org>>.

²⁶ State of New York, Department of Taxation and Finance, *New York State Tax Sourcebook*, July 2001, p.12.

tax. The City has sought but has not yet obtained State approval for a City earned income tax credit. The State should consider using part of the sales tax receipts from reinstating the tax on clothing to deepen its EITC and to help the City pay for one. The estimated yield from reinstating the sales tax on clothing under \$110 is about \$600 million annually. If \$200 million were dedicated to well targeted measures to increase progressivity, the State would still have \$400 million in recurring resources to balance the budget.

Second, the State should postpone the tax reductions authorized in fiscal year 2001 for fiscal year 2003.²⁷ These include the reduction of the personal income tax marriage penalty, a tax credit/deduction program for college expenses, the reduction of the gross receipts tax on energy, various sales and use tax exemptions for farms and telecommunications companies, and a variety of business tax reductions. Postponing these reductions would provide \$297 million in additional receipts in fiscal year 2003.²⁸ Only tax reductions needed to improve the State's competitiveness, such as the elimination of the gross receipts tax on energy, should be reinstated when economic conditions improve. Tax reductions that are not critical for competitiveness should not be reinstated.

INITIATE MEANINGFUL SCHOOL AID REFORM

The Governor's Flex Aid proposal is inadequate. As noted above, aid to wealthy districts should be cut, and needy districts should receive a greater share of the available funds, including aid under the STAR program.

In the previously noted CFE decision, the State Supreme Court ordered the Legislature to ensure that every school district has the resources necessary to pro-

vide the opportunity for a sound basic education. In response, the Governor filed a Notice of Appeal on February 28, 2001, and the Supreme Court Appellate Division heard arguments in October of 2001. An appeals court decision is expected in the coming months. If the lower court ruling is upheld, then New York will join 19 other states under court order to reform inequitable school funding.²⁹

A decision upholding the lower court would make school finance reform a legal necessity. But even if the current system were found to be legally permissible, it is still bad policy and should be overhauled in the absence of a court order. The CBC is currently studying the issue of financing a reformed system and will release a report on the topic later in the year. Three principles underpin the Commission's research.

First, the State should eliminate or redistribute aid that is currently poorly targeted. Wealthy school districts now receive substantial State aid despite generating significant local revenue at relatively low tax rates. Furthermore, annual legislative actions hold these districts harmless from reductions and even increase their aid. These districts should not receive State aid.

Second, the new approach should create greater equity in local tax effort. Many wealthy school districts maintain low tax rates relative to other districts, in part because of the State aid they receive. A required minimum tax effort, after adjusting for the burden of providing services for large populations of low-income residents, would generate additional local tax funds in some districts and further reduce the need for State aid.

Third, if the resources created by the previous policies are exhausted before the State's neediest districts are

²⁷ With the exception of expanded "Empire Zones" for economic development, the fiscal year 2002 budget did not include a tax reduction program.

²⁸ The incremental value of postponing the phase-in of the fiscal year 2001 tax reductions is calculated by subtracting the value of the total program in fiscal year 2002, \$272 million, from the value of the program in fiscal 2003, \$569 million, presented in, State of New York, Department of Taxation and Finance, *Summary of Tax Provisions in the State Fiscal Year 2001 Budget*, August 2000.

²⁹ Dane Linn, "Financing America's Public Schools," *National Governor's Association Issue Brief*, September 1, 1998, p. 1 <www.nga.org/cda/files/PUBLICSCHOOLS.pdf> (March 5, 2002).

given sufficient aid to make available a sound basic education, then the State should identify a new, statewide source of revenue for education. Should this be necessary, revenue should be raised in a way that addresses the need for maintaining New York's competitiveness.

ESTABLISH A CONSTITUTIONAL DEBT LIMIT

A critical fiscal reform proposed in the Executive Budget is a constitutional amendment to limit State debt. The existing limits need revision. The requirement for voter approval of GO debt has proved easy to circumvent through "back door" borrowing, and this form of borrowing remains largely unconstrained. The statutory limits enacted in 2000 do not contain meaningful restraints in the short-run, and are easily subject to change in the future when they become more restrictive.

The Governor and the Comptroller have rightfully recognized that the best route to debt reform is a constitutional amendment. While the Governor and the Comptroller agree on the need for a constitutional amendment, they disagree with each other and with the CBC on the specific provisions of such an amendment. Any constitutional limit on debt should stand the test of time, enduring changing conditions in the state and serving future residents as well as current ones. Arbitrary numerical limits can quickly become outdated as circumstances change. The CBC proposed a more dynamic approach based on the concept of affordability in its September 2000 report, *An Affordable Debt Policy for New York State and New York City*.

To be affordable, the repayment of debt should: (a) not cause a jurisdiction's tax rates to increase to uncompetitive levels in order to pay for debt service, and (b) not require cutbacks in other public services that similarly cause the jurisdiction to become uncompetitive. That is, repaying debt should not require tax increases or service cutbacks that make a state less attractive than its competitors. An important implication of this approach is that "too much" debt is defined relative to other places. The danger point is not a particular number; rather, it is

a position that is relatively far out of line with other places.

The CBC approach is comprehensive in that it considers the burden associated with repaying debt together with three other relevant factors: the full range of resources available in the state or local economy to repay debt; other long-term liabilities such as unfunded pension obligations that limit the ability to repay debt; and the division of responsibilities between a state and its localities. Consideration of these factors is necessary to form a comprehensive picture of New York State's ability to borrow.

MAKE THE BUDGET PROCESS MORE TIMELY & TRANSPARENT

New York State should enact legislation to reform its budget process and presentation. Late budgets and off-budget spending undermine public trust.

Two measures would promote a more timely budget. First, the Legislature should have more time to consider the Governor's Executive Budget. This could be accomplished by either requiring the Governor to submit the Executive Budget earlier, or by changing the start of the fiscal year to some time after April 1. In a previous year the Governor voluntarily submitted his proposals in December rather than January, but this did not lead to quicker budget adoption by the Legislature. Part of the reason is that useful economic and fiscal data become available in March and April, so changing the start of the fiscal year to June 1 or July 1 might be a preferable step.

Second, in order to address the difficulty of forming a consensus on the revenue forecast for the coming year, State leaders should invest the State Comptroller with the power to implement a "binding revenue forecast" after a fixed date is passed. Although other reforms likely will be required to produce timely budgets, these two measures would provide some inducement and are constructive next steps.

To improve accountability the CBC recommends the following changes in the way the budget is presented to the public:

- ◆Present a unified statement of all spending. The public should be able to see the priorities of government fully reflected in the budget. There should be no off-budget spending.

- ◆Require a budget balanced according to Generally Accepted Accounting Principles instead of on a cash basis. If provision were made to allow the use of rainy day funds accumulated in prior years without penalty under the law, the year-to-year manipulation of disbursements and receipts and other fiscal gimmicks would be prevented.

- ◆Require a four-year financial plan with quarterly updates. Currently, the Executive Budget includes only a two-year financial plan, and no multi-year plan is required to accompany the budget that is actually adopted. In all required financial plans, the baseline assumptions should be clearly specified, and the actions proposed to close baseline gaps should be identified and explained.