CITIZENS BUDGET COMMISSION

One Penn Plaza ▪ Suite 640 ▪ New York, NY 10119

Testimony to the Ravitch Commission
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Thank you for the opportunity to testify today. I am Carol Kellermann, President of the Citizens Budget Commission (CBC). Founded in 1932, the CBC is a nonpartisan, nonprofit civic organization devoted to influencing constructive change in the finances and services of New York City and New York State government.

An effective mass transit system is vital to New York's economic health, and its current financial problems are so serious as to threaten the region's future. Your Commission is a major opportunity to create change and build a solid foundation for the coming years. To make a positive impact the Commission must: (a) define the problem in a way that is factually accurate and easily understood by the public, and (b) identify solutions that provide cash in the short-run and – even more critically – put the MTA on a new financial footing that will serve it well over the longer run. The CBC would like to be helpful on both counts.

Defining the Problem

The public needs to understand that the issue is not simply to find enough money for the MTA to get through the next couple of years. The system's fiscal woes are rooted in a financial structure that falls short on four important criteria:

1. Adequate revenues – the current arrangement leads to big budget gaps. The latest projections for operating expenses are a cash deficit of about $900 million in 2009, with growing deficits each year thereafter. In addition, there is a shortage of new capital, and heavy reliance on borrowing for future capital will only increase future budget gaps due to rising debt service.
2. Reliable and predictable revenues – current sources linked to real estate transactions and other financial transactions are highly volatile. This leads to boom years with "extra" money and sudden fall-offs creating budget gaps that are hard to manage.
3. Fair revenues – the agency has no clear standard for how to set fares and tolls; all increases are perceived by the public as unfair, and fare setting is highly politicized.
4. Strong incentives for efficiencies – large tax subsidies can underwrite inefficiencies in the forms of higher than necessary compensation for unionized workers and of poorly planned capital investments. Tax subsidies need to be tied to structural incentives to keep compensation at competitive levels and to prioritize capital investments rationally. Without such changes, providing new dedicated taxes could have the perverse effect of widening budget gaps through generous wage settlements and growing debt service that consume all the available revenue.

In order to have a legacy worthy of your efforts, the Commission should address these structural issues.

The Solution – guiding principles

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A revised financial structure for the MTA should be guided by principles that are responsive to the above suggested criteria. The CBC identified such principles in our 2006 report on *How to Balance the MTA's Budget*. A copy of the report summary is enclosed, and an updated overview follows.

1. *The MTA should have a budget balanced according to generally accepted accounting principles* (GAAP). This differs from the current modified cash basis of budgeting; it would require treating depreciation as an operating expense and dealing adequately with the funding of retiree health insurance benefits (known in the accounting world as "other post-employment benefits" or OPEB). This will require a multi-year phase-in, because large sums are involved. (Recall that after the 1975 New York City fiscal crisis, it took seven years to phase in the GAAP balance requirement for the City.) This is not just an arcane accounting issue; unless the budget is truly balanced, the problem will get worse in the future.
2. *The cost of MTA bridge and tunnel operations should be covered by user fees (tolls).* Users of these facilities should not be subsidized by taxpayers; they can and should pay their own way. This is not a controversial principle; it is already followed. In fact, these operations currently generate a surplus that is helpful for principle #4 below.
3. *For mass transit, fares should cover half (or some other fixed percent) of operating costs.* Riders get a real and valuable benefit from their use of these facilities; accordingly, they should pay for some share of the costs. Deciding on an appropriate basis is necessarily somewhat arbitrary, but the CBC finds 50 percent to be an intuitively justifiable standard. It is slightly higher than the practice at the MTA in most past years and at the high end of the distribution among U.S. mass transit systems, but it is well below the figure in London and some other large systems. Whatever is set as a fair proportion, the equally important principle is linking fares to costs. This would create an incentive for efficiency. Riders would understand that each collective bargaining settlement and each bond issue requires a corresponding fare increase – creating pressure on management to bargain hard on the public's behalf and plan capital investments wisely. It also would depoliticize fare increase decisions by giving them predictability and a justifiable rationale.
4. *A cross subsidy from auto users should cover 25 percent of the costs of mass transit.* Auto use generates costs to the broader public in the form of air pollution and other negative externalities; accordingly, auto users should pay fees that cover more than the direct costs of roads, bridges and tunnels. This additional fee should be dedicated to supporting mass transit services, because auto users benefit from the reduced congestion that these options make possible. The cross subsidy can come from a variety of sources including tolls above cost for bridges and tunnels, dedicated vehicle registration and drivers' license fees, fuel taxes, and others.
5. *A tax subsidy should cover the remaining 25 percent of mass transit operating costs.* Mass transit deserves a tax subsidy because it provides broad benefits in the form of a more efficient economy and access to an expanded labor supply. The tax should be borne by residents and/or businesses statewide or regionally, reflecting the wide area that benefits from MTA services.
6. *The source of mass transit capital funding (net of federal funds) should vary depending on the type of need.* The three types and sources are:
    a. Regular repair and replacement - These items should be financed with operating revenues using the 50-25-25 approach. This is consistent with the concept that depreciation is an operating expense which should be covered with operating revenues.
    b. Restoring a state of good repair – Overcoming past neglect is a challenge that should be shared broadly rather than placed on the shoulders of current users. Accordingly, these needs should be financed with a tax subsidy provided by State government.

c. System expansion – These investments provide long-term benefits and are appropriate for long term borrowing. They should be funded via MTA revenue bonds with debt service covered under the 50-25-25 approach.

With the exception of #2, these principles are not now followed. In the latest year for which GAAP-based data are available (2006), the MTA incurred a deficit of $528 million; in the current year mass transit fares are estimated to cover only about 45 percent of transit operating costs; fees from auto users cover only about 14 percent of transit operating costs; and borrowing is used to finance the bulk of all three types of capital expenses.

The Solution – getting specific

Following the CBC's principles would have significant implications for the ways in which the MTA is financed. Substantially more money will be needed, and the specific sources of that new money can be identified.

The MTA faces even larger budget gaps than current cash-based budgeting suggests. Applying GAAP concepts to the MTA's current (July 2008) expenditure estimates, gaps grow from $2.7 billion (or 21 percent of projected expenditures) in 2009 to $4.0 billion (or 28 percent of projected expenditures) in 2012. A focus on expenditure savings in both operations and the capital program and a phase-in of the depreciation and OPEB expenses can lower these immediate needs, but under any reasonable scenario, substantial new revenues are needed.

The biggest source of new money should be the cross-subsidy from auto users. The projected revenues from this source in 2012 fall about $1,745 million short of the 25 percent target. Thus a major challenge for the Ravitch Commission is to identify ways to more than double auto cross-subsides for mass transit. Simply increasing tolls on TBTA facilities in proportion to subway fares will not do the job, but toll increases of 50 percent over the next four years could yield about $400 million annually. Our preference is to accompany more modest TBTA toll increases with a combination of new sources:

- *A revised congestion pricing plan or tolls on East River Bridges, with net new revenue dedicated to the MTA.* One option is to impose tolls on the East River bridges equal to those charged for the MTA bridges and tunnels connecting central Manhattan to the other boroughs. A quick and rough estimate of the net yield (after bridge maintenance expenses) of this option is about $650 million annually. A more comprehensive congestion pricing system is a second option; its yield varies with the fee, but it could be substantially more than for bridge tolls alone.
- *Increased fees for drivers licenses and/or auto registration fees dedicated to the MTA.* New York has relatively low vehicle registration fees. A 2006 study found that average annual vehicle registration fees range from $12 in South Carolina to $435 in Maine; at $32, New York State had the 8th lowest average registration fees in the country. Based on a 2002 Regional Plan Association paper, we estimate increased fees on auto registration of $50 yield about $250 million annually, and increases in drivers license renewal fees from under $6 to $50 annually would yield nearly $300 million. Larger increases, of course, yield even more.

  Alternative approaches for raising additional revenues from auto use fees can be adapted from pilot programs in Oregon and Washington. The pilot program in Oregon has shown the viability of a mileage based fee on vehicles collected at the gas pump; a voluntary demonstration program in the

Seattle region is experimenting with GPS technology to impose fees that vary with the number, time of day, and location of miles driven.

- *Increased fuel taxes.* New York ranks fourth highest of the 50 states in its taxes on motor fuel. Nonetheless, in a 2004 report the Regional Planning Association estimated that an increase of 10 cents per gallon would be practical and would yield an estimated $300 million annually. Increased fuel taxes make good economic sense, but are unattractive in a climate of rapidly rising gasoline prices. In the long-run the yield from these taxes may decline as cars become more efficient.

Regular and sizable fare increases are essential. Under current policies by 2012 fare revenues will fall from the current 45 percent to 39 percent of mass transit operating expenses. That would be $1,355 million below the recommended 50 percent share. This suggests an increase in average fare rates of 29 percent from current levels would be needed by 2012. Keeping the fare share at the current 45 percent of operating expenses rather than 50 percent would reduce this requirement to $791 million, or a 17 percent average rate increase. Future fare increases should be made predictable for riders; their timing should be linked to the annual budget cycle or to the implementation of employee wage increases agreed to in collective bargaining (a major factor driving cost increases).

Major new tax subsidies are not essential. In 2007 tax subsidies to the MTA were at a record level, primarily because property transaction taxes reflected the bubble in the real estate sector. As a result, the MTA had a cash surplus and tax revenues were an unusually high 33 percent of transit expenses. In the coming years these revenues are expected to decline substantially, but they will still be 27 percent of projected expenses in 2012. Under the 50-25-25 principles, no new taxes are needed.

If a new fare policy were to set the coverage ratio at the current 45 percent rather than 50 percent, then modest new tax subsidies might be needed. This approach would require raising an additional $300 million in new taxes in 2012. In another context (analyzing revenue sources to finance State education aid increases to comply with the CFE decision) the CBC recommended that the least economically harmful way to raise substantial funds is to broaden the base (rather than raise the rate) on existing sales and business income taxes. Such base broadening and restructuring can be packaged in a variety of ways; we estimated the potential yield at up to $2.6 billion annually depending on the range of sales tax exemptions eliminated and the specific business income tax allocation rules that are revised. A copy of the CBC working paper on "Tax Revenue Options" is enclosed.

Our thoughts in this testimony are focused on the issue of how best to raise new revenue, but as representatives of the CBC we can't close without also noting the need for containing expenditure increases. We have some work underway in cooperation with the MTA on challenges in implementing the capital program, and we anticipate exploring opportunities for greater productivity in operations as part of CBC's future agenda. These issues can be a topic for additional discussions; improving the MTA's financial outlook will be a priority for us in the coming year and likely longer.

We hope you find these thoughts and suggestions helpful as your Commission pursues its charge. We would be glad to work with you as you develop recommendations that can provide the funding MTA needs in an effective way. Thank you