CITIZENS BUDGET COMMISSION

11 Penn Plaza ▪ Suite 900 ▪ New York, NY 10001

TO: Members of the Budget Policy Committee

FROM: Diana Fortuna, *President*
Charles Brecher, *Research Director*
Elizabeth Lynam, *Senior Research Associate*
Cynthia Searcy, *Research Associate*

DATE: March 2, 2001

RE: **Review of the State of New York Fiscal Year 2002 Executive Budget**

Governor George E. Pataki presented the fiscal year 2002 Executive Budget on January 16, 2001, and updated it on February 13, 2001. This memorandum reviews the proposed plan from the vantage of the Citizens Budget Commission's (CBC's) four priority concerns—achieving structural balance, promoting productivity, enhancing the state's competitiveness, and curbing debt practices that unjustly burden future generations.

The first section identifies five key components of the proposal that reflect sound fiscal policies, are consistent with the CBC's previous positions and, accordingly, should receive our support. The second section considers two policy objectives that are addressed inadequately in the Executive Budget; the CBC should recommend bolder legislative initiatives to achieve greater progress on these challenges.

Key Features Deserving Support

1. Prudent Use of the Surplus to Establish A Rainy Day Fund

Each year since fiscal year 1997-1998, unexpectedly strong economic conditions have created a cash surplus for the State. The CBC repeatedly has urged that these funds be used in a fiscally prudent manner. Instead of supporting increases in recurring operating expenses, the surplus should be used to improve the State's long-run fiscal condition through substituting pay-as-you-go capital projects for borrowing, retiring long-term debt, or establishing a rainy day fund. While past budgets have followed this advice to a limited degree, the bulk of earlier years' surpluses have been devoted to supporting ongoing operating expenses.

This year's Executive Budget proposes an historic improvement in New York State's fiscal practices—the fiscal year 2001 cash surplus would not be used to support recurring spending in fiscal year 2002. Instead, the Governor proposes depositing $1.5 billion of the surplus into a new Fiscal Responsibility Reserve (FRR). (See Table 1.) In order for the fund to function as a true rainy day fund, explicit and objective criteria for withdrawing the funds must be enacted.

Table 1
State of New York
Sources and Uses of the Fiscal Year 2001 Surplus
(dollars in millions)

Sources- total	**$3,259**
Reserved in the adopted budget	**$1,450**
Intra-year changes	**$1,809**
Receipt increases	2,780
Spending reestimates	($971)
Grants to local governments	(15)
State operations	(525)
General state charges	(391)
Debt service	4
Transfers to other funds	(44)
Uses- total	**$3,259**
Deposit to the Fiscal Responsibility Reserve	$1,479
Gap reduction- fiscal year 2002	1,200
Pay-as-you-go Capital	250
Deposit to the Debt Reduction Reserve Fund	250
Deposit to the Tax Stabilization Reserve Fund	80

Source: State of New York, Division of the Budget, *2001-02 New York State Executive Budget*, Appendix II, January 16, 2001; and *30-Day Amendments*, February 13, 2001.

The amount allocated for a rainy day fund is appropriate. The nation has enjoyed unprecedented prosperity for nearly a decade, and in the most recent years New York State's growth has exceeded that of the rest of the nation. However, such growth is not likely to continue indefinitely, and the risk of a recession is now widely recognized. A national downturn resembling the 1991-1992 recession would produce revenues for New York State $2.1 billion less than the Governor's current projections for fiscal years 2003 and 2004, and smaller shortfalls in subsequent years. If the FRR were funded at the proposed $1.5 billion level, it, combined with the current Tax Stabilization Reserve of $627 million, would provide sufficient funds to offset a recession-induced shortfall over the next two years. Abrupt service reductions or tax increases could be avoided in the future as adjustments are made to recognize the smaller economic base.

2. Proceed With Important Tax Cuts

In our 1996 report *Budget 2000 Project*, the CBC identified lower state and local taxes as key to New York's competitiveness and recommended significant reductions in the personal income tax, the gross receipts tax, and the real property transfer and gains taxes. Significant cuts in all three have been enacted. The State's income tax burden has been reduced substantially in recent years. For example, the rate at the top income bracket is 6.850 percent, compared to 7.875 percent in 1994, 8.860 percent in 1984, and a high of 11.130 percent in 1978. New York's top income tax rate is now lower than those in 16 other states and is close to New Jersey's 6.37 percent. Last year a six-year phase-out of the gross receipts tax was enacted, and utilities became subject to corporate income taxes instead, leading to an 80 percent reduction in their tax rates. The real property gains tax was eliminated beginning in mid-1996 and real property transfer tax rates have been reduced.

The annual value of tax cuts enacted since fiscal year 1995 will be $10.1 billion in fiscal year 2002, $1.0 billion more than in this fiscal year. (See Table 2.) From fiscal years 2002 to 2005, an additional $1.8 billion in already enacted tax cuts are scheduled to be phased-in. These cuts are concentrated in the personal income, energy, business, and estate taxes. The most important of the planned reductions is the gross receipts tax on energy.

Table 2
State of New York
Value of Tax Reduction Programs by Year of Enactment
Fiscal Years 2000-01 to 2004-05
(dollars in millions)

Fiscal Year Enacted	Value of Tax Reduction* 2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
1994-95	$1,718	$1,691	$1,719	$1,769	$1,797
1995-96	5,100	5,362	5,675	6,016	6,359
1996-97	232	238	249	239	241
1997-98	1,407	1,685	1,728	1,834	1,881
1998-99	553	668	781	792	802
1999-00	43	234	325	371	377
2000-01	84	272	569	926	1,250
Total	**$9,137**	**$10,150**	**$11,046**	**$11,947**	**$12,707**

Source: State of New York, Division of the Budget, *Summary of Tax Provisions in State Fiscal Year 2000-01 Budget*, August 2000.

These planned tax cuts should be implemented, but they should be accompanied by measures that achieve long-run balance in the State's budget. Because of imprudent uses of previous years' cash surpluses, the fiscal year 2002 budget will have a $1.6 billion deficit under Generally Accepted Accounting Principles (GAAP), and the projected gaps will grow to $2.6 billion and $2.9 billion in fiscal years 2003 and 2004, respectively. In order to bring the budget into structural balance, the tax cuts must be accommodated by limiting expenditure growth and enhancing the productivity of the State's workforce.

It is worth noting that a major overhaul of the State’s budget process is still badly needed. Essential reforms include:

- a requirement that the State balance its budget according to GAAP;
- preparation of a multi-year financial plan at the time the budget is adopted, so that the public can understand how current actions affect the future;
- a clearer presentation, so that the public could better understand what the budget includes;
- binding revenue forecasts and other reforms, to make it more likely that the State adopts its budget before the April 1 deadline; and
- greater participation by rank-and-file legislators and improved public disclosure during budget deliberations.

3. Initiate A Constitutional Amendment To Limit Debt

In the last decade New York State's debt has more than doubled, reaching $37.1 billion in fiscal year 2001. 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 the general election. The State has avoided this procedural limit by creating public authorities, which are empowered to borrow using forms of debt that are not GO and do not require voter approval. Less than 12 percent of the State's outstanding debt is GO debt; the remainder takes "backdoor" forms, primarily lease-purchase agreements with authorities.

In May of 2000 the Legislature enacted the Debt Reform Act of 2000, which placed a statutory limit on new debt issued by the State. When the limits are fully effective in fiscal year 2014, debt outstanding will be capped at 4 percent of the State's personal income and debt service will be limited to 5 percent of total receipts. However, the phase-in provisions in the law are generous; during the initial years the law provides little constraint on borrowing.

A critical fiscal reform proposed in the Executive Budget is a Constitutional amendment to limit State debt. The existing limits need revision. Requiring voter approval in order to issue general obligation debt has proved easy to circumvent through "backdoor" borrowing involving arrangements with various State authorities, and this form of borrowing remains largely unconstrained. Statutory limits enacted last year 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 through 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 rate to increase to uncompetitive levels in order to cover 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. The CBC is drafting a constitutional amendment that reflects this "affordability" approach.

4. Curtail and Scrutinize "Pork" Spending

An increasingly problematic feature of New York State budgets is the growth of spending on projects sought by individual legislators to benefit particular constituents, but without a broader public review. Too often such projects do not address the State's most important unmet needs. Such projects are appropriately labeled "pork," and recent estimates are that pork absorbs over $1 billion of the State budget, a notable increase from previous years.

The Executive Budget would not eliminate all such pork, but it takes a meaningful step in that direction. The Governor proposes no new money for the Community Projects Fund, a budget item containing pork projects that will have a fund balance of $338 million at the end of fiscal year 2001. (See Table 3.) The current balance in the account would be spent by the end of fiscal year 2003, and this form of pork would be eliminated thereafter. Although there are many other pork items in the budget that also should be subject to more careful scrutiny, eliminating new money for the Community Projects Fund is an important first step.

Table 3
New York State General Fund
Community Projects Account
(dollars in millions)

	Fiscal Year						
	1997	1998	1999	2000	2001	2002	2003
Beginning balance	$0	$75	$170	$313	$263	$338	$188
New appropriations	$158	$204	$311	$78	$200	$0	$0
Disbursements	($83)	($109)	($168)	($127)	($125)	($150)	($188)
Ending balance	$75	$170	$313	$264	$338	$188	$0

Sources: State of New York, Office of the Comptroller, Office of Fiscal Research & Policy Analysis, *Comptroller's Annual Report to the Legislature on State Funds Cash Basis of Accounting,* fiscal year 1997 to 2000 editions; and State of New York, Division of the Budget, *2001-02 New York State Executive Budget,* January 16, 2001.

The Community Projects Fund is a clear target for elimination because it is easy to identify and track spending from this fund. Other forms of pork spending are implemented through Memoranda of Understanding among legislative leaders and the Governor, or through agency budget items whose purposes are not clearly identified. More should be done to identify appropriations made at the behest of individual members. Shining a spotlight on the issue, perhaps by designating budget categories to trace pork spending, would improve fiscal accountability and likely reduce future pork.

5. Downsize the Prison System

In fiscal year 2001, the State is spending about $2.3 billion to house and supervise about 69,000 people in its correctional facilities. For more than a decade the prison population and budget grew dramatically. The Executive Budget reflects a change in this trend. In fiscal year

2002, the number of inmates under the supervision of the Department of Correctional Services is projected to decrease, primarily due to a reduction in new admissions. A smaller prison population makes personnel reductions possible through attrition. The number of correction officers needed to run the system would be reduced by 414.

Adjusting the Department's staffing to fit its workload makes sense and should be supported. However, more proactive policies could be initiated to further reduce the size of the prison population. In a report released last May, *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. Legislative leadership is needed to expand the reach of current alternatives to incarceration.

Even greater reductions in the inmate population would be achieved by reforming the Rockefeller Drug Laws. Providing drug treatment for more offenders of those laws would reduce further the significant number of people incarcerated for drug crimes while better serving their needs without compromising public safety. The current drug laws are costly and inefficient at meting out prison terms that fit the crime. The Legislature should adopt a budget that reduces the size of the prison system and moves beyond the Governor's proposals in order to better manage drug offenders at a reduced cost to taxpayers.

Proposals Requiring Dramatic Improvement

1. Incentives for Local Governments to Lower Taxes

As noted earlier, since 1995 the State has made considerable progress in bringing its major taxes into line with those of the rest of the nation. However, many New Yorkers still bear uncompetitive tax burdens because their local taxes, notably those of school districts and counties, are too high. In the most recent year for which comparable data are available, New York's local government taxes as a share of personal income and capital gains (7.4 percent) was the highest of all the states, well above the next most burdensome state (Maine, at 5.7 percent) and nearly double the national average (4.2 percent).

Governor Pataki has correctly identified this as a problem requiring State action, but the programs he champions to deal with it are seriously flawed and should be revamped. The Executive Budget has two measures aimed at reducing local taxes. The School Tax Relief (STAR) program, which was initially enacted in 1997, would be fully phased-in in fiscal year 2002 at an annual cost of $2.6 billion. The new Co-STAR program would be authorized to grow from $50 million in fiscal year 2003 to $230 million in fiscal year 2007.

STAR is an education aid program that is intended to reduce property taxes in most school districts and the personal income tax in New York City. It replaces the local revenue with State aid. While the goal is laudable, the design of the program is seriously flawed. It disproportionately benefits wealthier school districts and fails to aid fairly districts with the most needy students. To illustrate, New York City receives just 26 percent of STAR aid payments, while it has 37 percent of the statewide school population, receives 37 percent of all other school aid, houses 41 percent of the state's population, and raises 47 percent of all local taxes. (See Table 4.) By any reasonable criteria, STAR is inequitable.

Table 4
New York City's Estimated Benefit from Co-STAR
(dollars in millions)

Entity	Local Taxes	Population	STAR	Co-STAR
New York City	$18,114	7,428,162	$670	$42
New York State	$38,345	18,206,279	$2,570	$230
New York City Share	**47.2%**	**40.8%**	**26.1%**	**18.3%**

Sources: Local taxes for New York State are for 1996 and are from Scott Moody, editor, *Facts and Figures on Government Finance* (Washington, DC: Tax Foundation, 2000); New York City local taxes are for 1996 and are from City of New York, Office of the Comptroller, *Comprehensive Annual Financial Report*, fiscal year 1996 edition. Population data are for 1999 and are from U.S. Census Bureau, Population Division, *Population Estimates.* State STAR and Co-STAR benefits are from State of New York, Division of the Budget; City STAR benefits are from City of New York, Office of Management and Budget; and City Co-STAR benefits are estimates from the New York City Council, Finance Division.

In addition to being unfair in the distribution of aid, STAR has two other related faults. First, it has not achieved the intended local tax cuts. Many school districts are taking the State's payments without making fully offsetting tax cuts. Second, efforts to oblige districts to make tax cuts by imposing spending caps have the unintended, and unfortunate, consequence of preventing low-spending school districts from making greater local efforts to better serve their students. For these reasons, the Legislature should fundamentally redesign the STAR program this year.

The proposed Co-STAR program is intended to lower county, rather than school district, taxes, but it has the same basic flaws as the STAR program. Co-STAR will lower local taxes across the State, but it will not lower them substantially where the tax burden is highest. In fact, Co-STAR's distributional effects will be worse than STAR's. Despite the fact that New York City raises almost half of all local taxes statewide, it will receive only 18 percent of Co-STAR payments. A new program to lower county (and New York City) taxes makes sense, but not in the form proposed by the Governor. A more equitable and effective program would link payments to specific county burdens imposed by the State, such as public assistance, Medicaid or Family Health Plus.

2. Distribute School Aid More Equitably

New York State's system for financing public schools is grossly unfair, and the Governor's proposal for improvement is grossly inadequate. Bolder steps are required for fundamental reform of the current system.

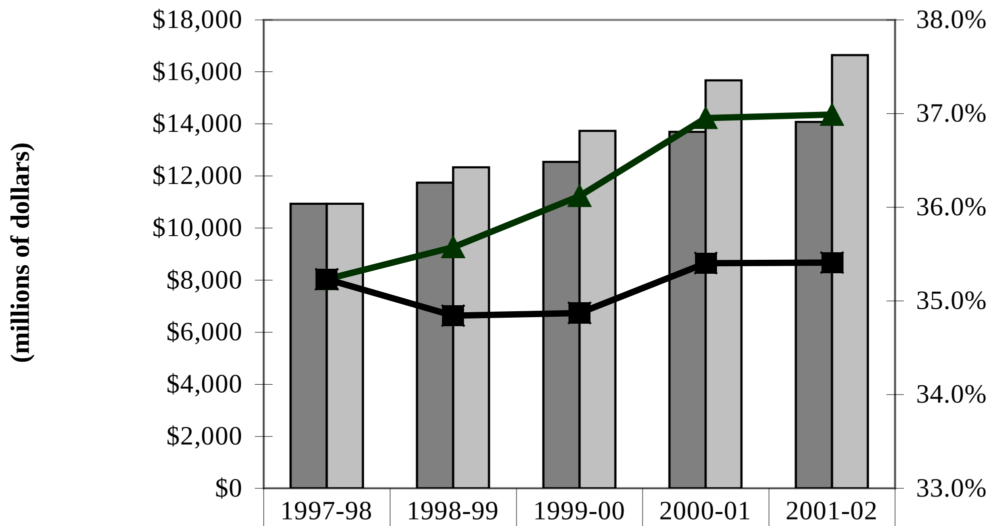
Two recent events highlight the dramatic inequities in New York's school finances. A study by *Education Week* ranked New York next-to-last behind New Hampshire among the 50 states in the overall equity of education spending. The State's efforts to equalize spending ranked 40th. In a case brought by the Campaign for Fiscal Equity, a State Supreme Court judge found in favor of the plaintiffs and used strong language to find the current system illegal:

"New York State has over the course of many years consistently violated the Education Article of the Constitution by failing to provide the opportunity for a sound basic education to New York City public school students. In addition, the State's public school financing system has also had an unjustified disparate impact on minority students in violation of federal law."

While the case is still subject to an appeal, corrective action is warranted now.

The Governor proposes to reform school finances by combining 11 of the current formulas used to distribute aid into one "Flex Aid" formula. It would be used to distribute $9.8 billion of the $14.1 billion proposed total. At the same time, the highly specific uses for which these funds were designated would be broadened in order to give school districts greater budgetary discretion. Flex Aid would represent a positive step in simplifying the complicated formulas and in better targeting resources. However, it is a very small step. New York City's share of school aid under the proposal would remain the same as last year, 37.0 percent. Flex Aid does not achieve the more fundamental redistribution that is needed. (See Figure 1.)

Figure 1
Amount and Distribution of New York State School Aid
School Years 1997-98 to 2001-02



	1997-98	1998-99	1999-00	2000-01	2001-02
Total Aid	$10,926	$11,744	$12,536	$13,694	$14,076
Total Aid w/ STAR	$10,926	$12,326	$13,731	$15,674	$16,646
NYC Share	35.2%	35.6%	36.1%	37.0%	37.0%
NYC Share w/ STAR	35.2%	34.8%	34.9%	35.4%	35.4%

Sources: State of New York Division of the Budget, *Description of New York State School Aid Programs*, 1998-99 to 2001-02 editions. STAR aid provided by State of New York, Division of the Budget and City of New York, Office of Management and Budget.

In redesigning school aid, legislative leaders should recognize that the basic goal is "equalization." Districts should be able to achieve an adequate level of per pupil spending with a tax effort that is equal to a statewide norm. To the extent a district suffers from a lower than average tax base, or from a greater than average set of student needs, State aid should help make up the difference between what is needed and what a standard tax rate yields. Adjustments for disproportionate local burdens for State mandated social welfare spending would be appropriate, but other provisions in State aid, such as "hold harmless" arrangements and specialized aid categories, distort this basic policy goal and need not be sustained.

Preliminary calculations by the CBC staff indicate that an adequate standard for equalization can be financed with currently available funds. Using the most recent State Education Department data (for the 1997-1998 school year), a targeted per pupil spending level was set at the median for districts other than New York City. Using the statewide median property tax rate and per pupil weights that account for need as established by the State Education Department, the calculations reveal that all districts could be brought to the targeted per pupil spending level with State aid payments less than was appropriated in that year. These figures are not necessarily the best basis for designing a new aid program, because the State Education Department pupil weights may not be sufficient and there is no allowance for expenditure burdens in local areas linked to mandates for local funding of Medicaid and public assistance. Further research will underlie future CBC recommendations on this subject. Nonetheless, preliminary calculations highlight that what is required is not necessarily more money, but a clearer focus on the basic purpose of State aid and the political will to pursue the goal of equalization.