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Deja Vu All Over Again: The Right Way to Cure New York's Looming Budget Gap

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Executive Summary

This report analyzes New York State government's fiscal history over the last three and a half decades, with a particular focus on Governor Pataki's accomplishments. It finds that fiscal crises are always preceded by periods of higher-than-normal spending, and that reducing spending is the only successful way to solve a crisis. Tax increases, such as those passed in the early 1970s and 1990s, exacerbate crises by reducing economic activity.

The report finds that Governor Pataki has a mixed fiscal record. In his first term, Pataki limited the annual growth in real, inflation-adjusted spending to a mere 0.6%, or a mere 0.3% if his STAR program is treated as a tax cut. This enabled him to eliminate a $5 billion budget gap—roughly the size of the gap which the state is estimated to face next year—while substantially reducing taxes. In his second term, however, the growth in real spending increased dramatically to 2.9% a year, or 2.1% if STAR is excluded. New tax cuts were also much smaller than in his first term.

The report also uses an econometric model, STAMP, to estimate how many jobs were created by the Governor's first-term tax cuts, and how many would be lost if taxes were raised next year. STAMP estimates that the Governor's income and sales tax cuts created at least 117,000 jobs since 1995—nearly one in five total new jobs. STAMP also finds that raising the income tax by imposing a $2.7 billion surcharge, as proposed by some union-affiliated groups, would cost the state 46,000 jobs.

The report concludes with specific recommendations on how the next Governor can reduce spending to close the budget gap, and rejuvenate the economy through broad-based tax cuts.

About the Author

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INTRODUCTION

The greatest challenge for New York's governor next year will be to cope with an enormous state budget shortfall while taking positive steps to promote stronger growth in a weakened state economy.

It's a tall order, to be sure, but by no means impossible—as Governor George E. Pataki showed, not very long ago.

In the mid-1990s, when New York was still feebly recovering from its worst recession in a half-century, Pataki closed a $5 billion budget gap by reducing state spending[1] and pushing through the first in a series of major tax cuts that ultimately generated at least 117,000 new private sector jobs, according to an econometric model documented in this report. Over the next few years, state revenues rose to new heights, even while the state tax burden relative to personal income dropped to its lowest average level in nearly 30 years.

More recently, however, Pataki has presided over a sharp resurgence in state spending, which has now reached levels that can no longer be sustained in the wake of last year's national recession, the stock market decline and the attack on the World Trade Center.

The state budget gap for fiscal 2003-04,which begins next April 1, seems likely to at least equal the $5 billion headache of Pataki's first year as governor.[2] Can the state close a gap of this magnitude without resorting to tax increases or delays in scheduled tax cuts? The answer: it not only can, but *must*—or risk igniting a new spiral of economic decline.

A review of New York State's budget policies over the past four decades—focusing on Pataki's own mixed record—provides stark examples of both the right *and* wrong ways to respond to the challenges that lie ahead. The right way would be to reverse the recent growth in spending while continuing to reduce taxes. The wrong way would be to minimize the political "pain" of spending cuts by raising taxes and fees, which would sap economic growth and competitiveness.

PATAKI'S FIRST TERM: A NEW ERA OF FISCAL RESTRAINT

When George Pataki took office as Governor in January 1995, he inherited a state budget that was geared to continue growing at the rate of 7 percent a year.[3] The new administration was able to reduce nominal budget growth to a small fraction of projected levels by concentrating on three areas:

- After nearly doubling in Mario Cuomo's last term, state-funded Medicaid costs did not rise at all in Pataki's first term; as recently as fiscal 1999-2000, state payments to Medicaid providers had risen by just 1.5 percent over the 1995 level. This successful effort to control Medicaid spending stemmed largely from cost-containment efforts, including a mandated shift of recipients to managed care programs, and a reduction in caseloads as the economy grew and welfare reforms took hold.

- The state-funded share of other health and social welfare spending[4] has been virtually frozen throughout Pataki's tenure. (In both the welfare and Medicaid categories, which comprise about 20 percent of the total state funds budget, a crucial assist came from the reformist policies of New York City Mayor Rudolph Giuliani.)

- The full-time equivalent (FTE) headcount of state workers was reduced by 20,000 during Pataki's first year and a half as governor. Several smaller state agencies were eliminated or consolidated into larger departments.

During Pataki's first term, New York State became a national leader in raising and saving money through the sale of state assets and enterprises.[5] The state and its public authorities sold off a golf course, a hotel, the New York Coliseum, the Long Island Railroad freight division, the 14th Street armory and 20 surplus mental health properties.

The Pataki Administration also contracted out the operation of Stewart Airport, the first such airport privatization in the country, and completed the

Cuomo-initiated shift of the state's income tax processing operation to a state-of-the-art automated system operated by Fleet Bank.

Job #1: Restoring the Economy

Pataki's government reforms and spending reductions made it possible to pursue his highest priority—getting New York's economy moving again by lowering taxes.

Under Pataki's original proposal, the top income tax rate would have declined from 7.875 percent to 5.9 percent, and the top bracket would have been raised from $26,000 to $50,000 for married couples (and by similar proportions for singles and heads of households).

In place of Pataki's four-year, $6.8 billion plan, the Legislature ultimately agreed to a three-year tax cut, valued at $4 billion[6] annually in the third year, that provided only half the marginal rate reduction but preserved roughly two-thirds of the average taxpayer savings in the original proposal. By 1997, the top rate had been reduced to 6.85 percent—just below the 7 percent goal of the 1987 act signed but repeatedly postponed by Cuomo. The highest bracket was raised to $40,000 for married filers, and an expansion of standard deductions first approved in 1987 was fully implemented. As a result, although the marginal rate cut amounted to just 12 percent, most taxpayers saved an average of 25 percent or more. In addition, nearly a half million low-income workers were removed from the tax rolls.

Other major state tax cuts

State tax cuts enacted since 1995 are now saving individuals and businesses in New York a total of $9.5 billon a year.[7] Most of that amount—about $8.6 billon—stems from legislation enacted during Pataki's first four years in office. In addition to the personal income tax cut, the major first-term cuts and their current values included:

- Business tax cuts with a total current annual value of roughly $1.5 billion, including a reduction of the top rate from 9 percent to 7.5 percent,[8] reductions in minimum filing fees and alternative minimum taxes, and new investment credits for the securities industry.[9]

- Sales and use tax cuts now worth more than $1 billion a year, the largest of which was a state sales tax exemption (subsequently adopted by most localities as well) for all clothing and footwear purchases under $110.

- Elimination of New York's complicated and anti-competitive estate and gift tax structure, which was replaced with a simplified tax set to equal the maximum federal tax credit for state death taxes, saving New York estates about $650 million this year.

- Other tax changes worth nearly $200 million annually, including repeal of the real property gains tax and reduction of the hotel tax, elimination of the beverage containers tax and of the tax on motor vehicle damage awards.

The tax cut payoff: More jobs for New Yorkers

Between December 1994 and December 1998, private sector employment in New York State grew by 449,000 jobs; by the end of 2001, even after the devastating losses caused by 9/11, employment was up by 642,000 jobs over the level when Cuomo left office.

What, if anything, did the 1995 income tax cut have to do with these gains? And what are the implications for future tax policy?

To answer those questions, the Manhattan Institute turned to a proven econometric tool—the State Tax Analysis Modeling Program, or STAMP. Developed by the Beacon Hill Institute at Suffolk University in Boston, STAMP was initially used to measure the effects of income tax cuts in Massachusetts and has since been adapted to almost a dozen other states. In 2000, Beacon Hill's economists issued a version of the model designed to estimate the effects of changes in New York State's personal income tax and state sales tax.[10]

The STAMP model estimates that the personal income tax and sales tax cuts enacted by the state between 1995 and 2001 resulted in the creation of more than 117,000 private sector jobs, or one-fifth of New York's net employment gain since Pataki took office. Since the model does not measure the impact of changes in other taxes, this job gain represents only a portion of the economic payoff from all of New York State's tax cuts since 1995.

STAR: In a class by itself

In addition to broad-based state tax cuts, Pataki in 1997 initiated the School Tax Reduction (STAR) program—which, as its name implies, was designed to reduce school property tax bills on owner-occupied homes. Under the STAR program, school districts are reimbursed by Albany for the cost of recognizing residential property tax exemptions that range from $30,000 to $50,000 on an adjusted full value basis, with the largest exemptions targeted to senior citizens.[11]

STAR'S budgetary cost in fiscal 2002–03 is $2.63 billion—roughly two-thirds the original value of the state income tax cut enacted in 1995.

However, while STAR represents a major savings for eligible homeowners, it cannot accurately be described as a "state tax cut" in the usual sense. The program doesn't actually reduce state taxes; rather, it effectively shifts part of the local school tax burden from individual homeowners to state taxpayers (most of whom don't benefit from the program).

Because STAR requires an annual appropriation, the program technically is classified as state aid to education[12]—although it obviously differs as much from other forms of spending as it does from traditional forms of state tax relief.

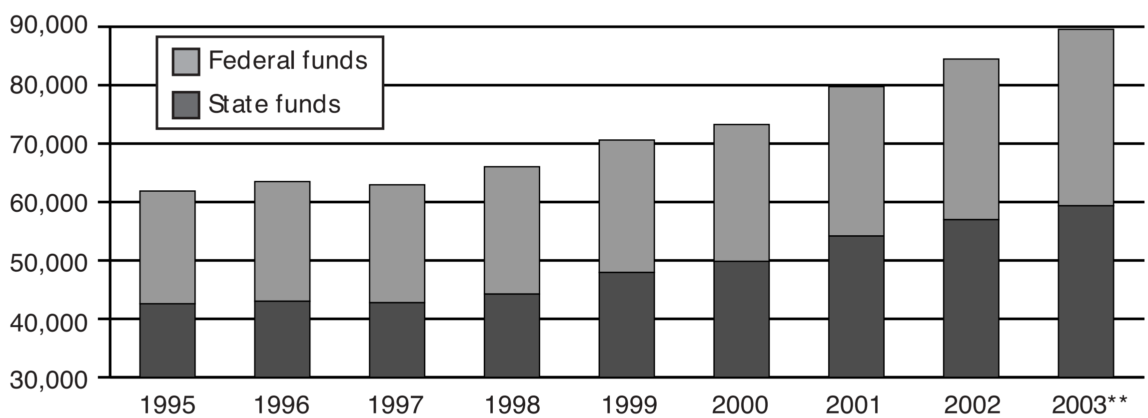
Regardless of how STAR is classified, this much is clear: the program represents only a temporary interruption in the steady growth of the school tax burden on most homeowners, because the Legislature rejected Pataki's proposal to tie STAR tax exemptions to an inflation-based cap on school district spending. If recent increases in many districts are any indication of the general trend, it appears most school tax bills will rise above their pre-STAR levels within the next few years.

PATAKI II: OLD BUDGETARY PATTERNS RE-EMERGE

State funds spending under Pataki's first three budgets grew by an annual average of just 1 percent, or half the inflation rate. But as illustrated in Chart 1, state spending in fiscal year 1998–99 shot up by 8 percent—four times inflation, the fastest growth rate since 1994–95 (which, not coincidentally, was also an election year). The budget adopted in 1998 would have been even larger if Pataki had not used his line-item veto to block some $760 million in spending additions by the Legislature.[13]

After a relatively restrained increase of 4 percent in 1999–00, state growth accelerated to 9 percent in 2000–01—the biggest since the mid 1980s. This was followed by state spending increases of 5 percent and 4.2 percent, respectively, in fiscal years 2001–02 and 2002–03. State spending was allowed to continue increasing at twice the inflation rate even though the Sept. 11 attack, which occurred just before the half-way point of fiscal 2001–02, was followed by what the Governor called the steepest revenue decline since the Great Depression.

Chart 1: Mostly Upward
The New York State Budget*, Fiscal Years Ending 1995–2003
(in millions of current dollars)



*Includes appropriations for STAR property tax relief ** Projected

Source: Division of the Budget

The average annual state spending increase since 1998 has been 6.1 percent. If STAR is excluded from annual spending totals, the average spending growth rate from fiscal 1998 through fiscal 2003 (as projected) has been 5.1 percent—still more than double the inflation rate.

Continuing growth in debt

One of the fastest growing spending categories under Pataki's tenure has been debt service, which in fiscal 2002-03 is projected to reach about $3.6 billion annually—up $1.1 billion from fiscal 1994–95 and $500 million over the 1997-98 level.[14] Debt service is projected to rise another $1 billion a year by fiscal 2006-07.

The increase in debt service costs stems largely from a 40 percent increase in total state-supported indebtedness over the past eight years,[15] including 2003 projected bond issuances. Although this represents less than half the 10 percent average annual increase in borrowing under Governor Cuomo, the amount of outstanding debt relative to New Yorkers' personal income remains almost as high as it was when Cuomo left office—projected at 5.7 percent for 2002-03, compared to 5.9 percent for 1994–95.[16] This is roughly double the national average debt burden relative to income, according to Moody's Investor Service. New York's state debt is also double the national average on a per-capita basis, exceeded only by states that rely far more heavily on the state than on local governments to finance capital improvements.

The state's debt would be even higher if Pataki had not used nearly $1 billion in surplus funds to pay off some high-interest bonds over the past two years. However, after allowing little net increase in state-supported debt over the past three years, the Governor's 2002-03 budget called for a net increase of $2.2 billion in outstanding debt this year, with a further $2 billion increase by fiscal 2006-07.

More money, but fewer state tax cuts

While state spending was increasing, the state's tax-cutting pace slowed dramatically in Pataki's second term. Putting aside the state-subsidized STAR tax exemption, the biggest state tax cut initiated by Pataki since 1998 has been the phase-out of the gross receipts tax on energy services, which is expected to generate net savings of more than $400 million per year for affected companies and their customers when fully effective in 2005. Other tax cuts have been more narrowly targeted—a shift away from the broad-based approach favored by the Governor in 1995-98. Moreover, as part of the financing for the expansion of Health Care Reform Act (HCRA) programs, Pataki initiated two cigarette tax increases, totaling 94 cents per pack, that raised tax receipts a net $500 million.

As the economy improved and revenues increased beyond projections after 1997, Governor Pataki began to accumulate a budget surplus that peaked at a record level of well over $3 billion in 2001. Before 2001, he resisted legislative efforts to commit this money to new spending programs. Indeed, disputes over the size and availability of the surplus are one reason for the record delays in adoption of the state budget in recent years.

Thanks to Pataki's jealously guarded surplus, New York State was able to keep its head above water financially despite last year's stock market meltdown and World Trade Center attack, which caused the state's tax revenues to drop by more than $2 billion in a single year. However, because the surplus is now virtually gone and the state has continued to increase its spending beyond the inflation rate, the day of fiscal reckoning has merely been postponed until 2003.

RELIVING THE PAST

The accelerated growth of the New York state budget since 1998 is not an anomaly. Indeed, it represents a shift back towards the heavy-spending pattern established under Pataki's last elected Republican predecessor, Nelson Rockefeller, and renewed under the last Democrat to hold the governor's office, Mario Cuomo.

Despite a long tradition of public sector activism under the leadership of liberals from both parties, New York's state taxes and spending weren't far out of line with national norms before Rockefeller took office as governor in 1959. Even in 1962, three-quarters of the way through Rockefeller's first term, New York's state tax burden relative to income was still *below* average, and its budget was only slightly above average on a per-capita basis.

Between the early 1960s and mid-1970s, however, state taxes and spending in New York rose significantly faster than the average for all states. Albany's outstanding state debt quadrupled, also far outstripping the pace of borrowing in other states. To compound matters, each of these trends was being duplicated in New York City. By 1974, both the state and city had developed significant annual cash shortfalls—problems they rolled over from one year to the next with the aid of short-term borrowing.

By the time Democrat Hugh L. Carey became governor in January 1975, New York State's economy was in steep decline, having lost nearly 400,000 jobs over the previous five years. The state Urban Development Corp. had defaulted on a bond payment, creating a crisis of investor confidence in all New York debt. Last but not least, New York City was headed for virtual bankruptcy.

Declaring that "the days of wine and roses are over," the Democratic governor reversed some of the most economically damaging fiscal trends set in motion by his Republican predecessors. While many elected officials over the years have enunciated the goal of "doing more with less," Carey was one of the few to have actually accomplished it.

While state budgets throughout the country grew rapidly as inflation approached double-digit heights during the late 1970s and early 1980s, New York's per-capita spending increased much more slowly than the average. In fact, the New York State budget under Carey didn't grow at all after adjusting for inflation—even though, during this same period, Albany assumed full financial responsibility for the four-year colleges of the City University of New York and for the operating expenses of the statewide court system.

The Carey Administration also reduced taxes—cutting the top income tax rate on wages and salaries by a full third, from 15 percent to 10 percent, eliminating the state's unincorporated business tax, and expanding investment incentives for manufacturers. To be sure, these efforts were made easier by rising inflation, which rapidly pushed taxpayers into higher income brackets and thus drove up revenues even as tax rates were being lowered. Nonetheless, the cuts represented a welcome reversal of state policy from the Rockefeller era.

The Cuomo Era: back on the Wrong Track

Thanks largely to Carey's budget and tax policies, the Empire State emerged from the oil price shocks and stagflation of the 1970s and early '80s well positioned to gain from the national economic expansion that began in 1983. A growing economy offered a golden opportunity to further reduce and reform the state's taxes, and to eliminate the accumulated deficit that required a costly annual spring borrowing approaching $4 billion.

Revenues at the height of the 1980s boom would have been sufficient to pay down the accumulated state deficit and to significantly reduce taxes, while continuing to support annual budget growth equal to the cost of living index.

However, under Governor Mario M. Cuomo, most of the new money pouring into the state treasury was simply plowed into new spending at rates well beyond inflation. During Cuomo's 12-year tenure, from 1983 to 1995, the state funds budget more than doubled.[17] Most of the increase came during Cuomo's first two terms, when spending rose at the fastest rates, in both nominal and inflation-adjusted terms, since the destructive heyday of the Rockefeller administration.

In addition to big increases for welfare, Medicaid and aid to public schools, Cuomo vastly expanded the state bureaucracy, adding 31,000 workers to the state payroll during his first seven years in office. Budget shortfalls forced him to make some reductions in this total after 1990—but by 1994, state government employment had risen back over 242,000, some 16,000 more workers than when Cuomo took office.

Meanwhile, the state's tax policy from 1983 to 1995 was consistent only in its inconsistency. Some of Cuomo's budgets called for tax cuts, others called for tax increases, and still others called for a mix of both. The Cuomo Administration's only significant tax reductions—the personal income tax cuts of 1985 and 1987—were enacted in years when revenues were growing fast enough to support real spending increases as well.[18] But when the economy faltered at the end of the decade, tax cuts were permanently sidetracked and other tax rates were increased.

The state budgets of 1989 through 1994 raised state taxes and fees by a cumulative total of $8.4 billion, including the $3.3 billion value of the scheduled, but repeatedly postponed, phases of the 1987 income tax cut. Spending growth finally slowed, but not nearly enough to reflect the even steeper drop in recurring revenues. The Governor and the Legislature patched over their growing budget holes with borrowed money and often outrageous fiscal gimmicks, including the state's notorious "sales" of some highways and prisons to its own public authorities and a $400 million pension fund raid later ruled unconstitutional.[19]

Spending Restraint: How Pataki Stacks Up

Governor Pataki's budget messages have regularly invited comparisons of his own spending record with those of his immediate predecessor and his counterparts in other states.

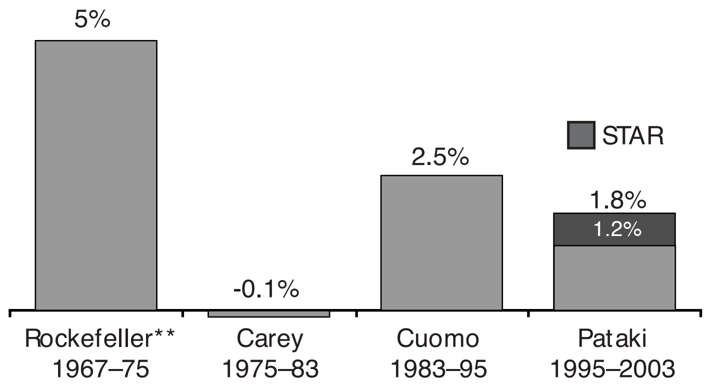
So how does he actually stack up?

Compared to Presidents Clinton and Bush, Pataki enjoys a very slight edge in the fiscal restraint department: Total federal outlays[1] have risen about 40 percent over the past eight years, while state funds spending is on track to rise 39 percent during roughly the same period.[2]

Pataki also kept a tighter lid on his budget than most other governors—at least during his first five years in office. That's the conclusion to be drawn from Census Bureau statistics for fiscal years 1995 through 2000, which show general expenditures[3] by New York State rose by 18 percent, compared to 32 percent for all states.

When the focus shifts to a comparison of Pataki and his predecessors as governor of New York, the answer depends on how spending is counted, for which time period—and which previous governors are included in the comparison.

Average Annual Growth In State Funds Spending (inflation-adjusted*)



* Based on Consumer Price Index for all urban consumers in northeastern NJ and NY
** Includes Wilson Administration

Sources: Executive Budgets, State Comptroller's Annual Financial Reports

On the surface, it's no contest: the state funds budget rose by an average of 4.2 percent a year under Pataki (3 percent if STAR is excluded), compared to 6.9 percent under Mario Cuomo, 7.4 percent under Hugh Carey, and 11.2 percent in the final two terms of Nelson Rockefeller (including the one-year administration of his successor, Malcolm Wilson).

But these nominal numbers include no adjustment for the annual inflation rate, which was much lower in the late 1990s than in the previous two decades. When spending is converted into constant dollars, a somewhat different pattern emerges among the four administrations.

During these years, New York State lost a half-million private sector jobs—its sharpest employment decline since the Great Depression. Nearly two thirds of the job losses occurred in New York City, which had enacted its own substantial tax increases under Mayor David Dinkins.

THE CHALLENGE AHEAD—AND HOW TO RESPOND

A clear pattern emerges from New York State's budgetary history over the last 40 years: big state spending and tax increases lead to job losses, while fiscal restraint and tax cuts coincide with job gains.

The two deepest and most sustained recessions in New York's recent history occurred in the 1970s and the early 1990s. Both downturns came on the heels of substantial increases in broad-based state tax increases, compounded by tax hikes on the local level. Yet these tax hikes didn't close budget gaps—they only made them worse.

Conversely, New York State's economy has been strongest when governors virtually froze spending while pushing through deep reductions in broad-based taxes.

What the past can teach the future

Governor Pataki's Executive Budget for 2002-03, issued in January 2002, estimated that the state would face a budget gap of $2.8 billon in 2003-04. However, given the decline in revenues and increase in spending reflected in this year's adopted budget, it seems likely the gap will have swelled into the

Inflation-Adjusted State Spending Increases by Gubernatorial Term*

Term and state fiscal years	Total (millions of 2001 dollars)	Average annual change
Rockefeller III, 1967–71	9,297	7.9%
Rockefeller-Wilson IV, 1971–75	3,170	2.2%
Carey I, 1975–79	717	0.5%
Carey II, 1979–83	(1,042)	-0.7%
Cuomo I, 1983–87	$9,604	5.7%
Cuomo II, 1987–91	$2,153	1.1%
Cuomo III, 1991–95	$1,405	0.7%
Pataki I*	$1,312	0.6%
Excluding STAR	$701	0.3%
Pataki II*	$6,028	2.9%
Excluding STAR	$4,451	2.1%

* Including STAR. State spending figures from the New York State Division of the Budget for all years were adjusted to reflect inflation as reported in the U.S. Department of Labor Consumer Price Index (CPI) for All Urban Consumers, NY-NJ-CT-PA.

Adjusting for inflation, as shown in the chart, Pataki held state funds budget growth to a much lower annual average than either Cuomo or Rockefeller-Wilson. Not counting STAR, Pataki allowed spending to grow at less than half Cuomo's average annual rate. But in real terms, the governor who did the best job of holding down the budget was Carey, who actually *decreased* spending by an annual average rate of 0.1 percent.

A somewhat different picture emerges when spending is broken down into four years gubernatorial terms, as shown in the table.

As shown above, nearly three quarters of the real spending increase under Cuomo was packed into his profligate first term (i.e., from state fiscal year 1982–83 through 1986–87). State funds spending in Pataki's second term increased at the fastest average rate since Cuomo's first term, whether or not STAR is included in the total.

Carey had the most consistent record among the last five governors—allowing virtually no annual budget growth on an inflation-adjusted basis in *either* of his two terms.

Differences of just a couple of percentage points in the annual spending rate over a few years can lead to differences of billions of dollars in a budget as large as New York's.

For example, if Pataki had duplicated Carey's feat—allowing annual state funds budget increases equal to no more than average inflation rate of 2.4 percent over the last eight years—state funds spending would now be $7.8 billion lower. That would have been more than enough to finance a 25 percent across-the-board income tax cut—which, according to the STAMP econometric model, would be sufficient to generate over 100,000 new jobs. On the other hand, if Pataki during his two terms in office had increased spending at the same average rate as Cuomo did over his entire tenure, the budget would now be $3.5 billion larger—and the looming budget gap would be that much bigger.

neighborhood of $5 billion or more by the time the next budget is unveiled in January 2003.

Can the state make up a shortfall of this magnitude without resorting to tax increase or delays in scheduled tax cuts? It not only can, but in light of the record, it *must*—or risk igniting a new spiral of economic decline.

Between $2.5 billion and $3 billion of the fiscal 2003–04 gap represents the automatic increases that would follow from the current baseline spending trend. Thus, the first order of business must be to hold the line on all agency and programmatic spending scross the board, as the Division of the Budget has already requested in its request annual "call letter" to state commissioners. To close the remaining gap, the next budget should incorporate two key objectives of Pataki's first-term budget-gap closing plan:

Downsize the workforce

Pataki deserves credit for holding down the payrolls of executive branch agencies, but much more can and should be done to decrease the state workers headcount. For example, although there have been considerable advances in office information technology since 1983, the staffs of some major administrative agencies are as large or even larger now than they were during Governor Cuomo's first year in office.[20] The state's welfare caseload has dropped nearly 60 percent, but the state departments mainly responsible for administering health and welfare programs employ almost as many staffers now as they did in 1983.[21]

To close next year's budget gap, the state will need to meet a more ambitious payroll reduction target than Pataki established in 1995–96. Reducing the executive payroll by at least 10 percent more, or roughly 20,000 positions, would save $1.35 billion a year at current average salary and benefit levels.[22]

And this exercise should not be limited to the Executive Branch of state government.

For example, at nearly $1 million per member, the budget for the New York State Legislature is by far the largest in the nation. As of July 2002, the 61 senators and 150 Assembly members had a staff of 3,805 people, or roughly 18 for each legislator. Cutting the staff by 40 percent would save New York $73 million a year.[23]

The state Judiciary has received extraordinarily favorable treatment under Pataki—a budget increase of over a half-billion dollars, or 58 percent since 1995, reflecting both an increase in capital construction costs and the hiring of an additional 2,000 court employees. In the face of a new state fiscal crisis, the courts should be asked to tighten their belts; a 50 percent rollback of new court hiring since 1995 would save $135 million.[24]

Regain control of Medicaid and other state-subsidized health programs

A long-overdue shift of most Medicaid patients to managed care, a slowdown in the national trend of health care inflation, and federal welfare reforms that led to a drop in caseloads—all these factors contributed to New York State's ability to restrain growth in previously out-of-control Medicaid budget from 1995 through 1999.

Now, however, managed care costs are rising, health care inflation is increasing, and the drop in welfare caseloads is, inevitably, slowing down. After little growth during Pataki's first five years in office, state-funded payments to Medicaid providers have risen by at least $1.6 billion since fiscal 1999–2000, including projected spending in 2003.[25] Medicaid costs are expected to continue rising at the rate of 7.5 percent a year through 2005, according to the latest Executive Budget.

To make matters worse, New York State over the past three years has been deliberately *expanding* eligibility for publicly subsidized health care beyond the bounds of the most needy population. The growing number of New Yorkers eligible for the state's Family Health Plus and Child Health Plus programs includes otherwise self-sufficient, low-income workers and their dependents who have lacked access to affordable health insurance in the past largely because New York's own state regulations priced private health insurance beyond their reach (or the reach of their employers).

While a detailed review of Medicaid reform and reduction options is beyond the scope of this paper, a few priorities are clear:

- Address a major cause of recent caseload and expenditure growth by scaling back recent Health Care Reform Act (HCRA) program expansions. Reversing HCRA increases enacted since 1999 would appear to save the state between $500 million and $750 million a year, including $200 million in new spending scheduled for fiscal 2003–04, assuming HCRA-related revenues are retained for the time being to finance core Medicaid services.

- Create private health insurance alternatives to state-funded programs for low-income working families by clearing away existing statutory and regulatory provisions that make such insurance scarce and unaffordable.

- Reduce the exceptionally wide range of optional Medicaid services provided through New York's program, and require larger co-payments for those that are retained, such as prescription drug coverage.

- Restrict the ability of affluent and middle-class elderly people to transfer assets to their children and declare themselves poor, and thus Medicaid-eligible.

- Require patient co-payments in Medicaid managed care programs.

- Eliminate the highly inefficient current structure of social services administration by having the state gradually assume full responsibility for administering welfare and Medicaid.

- Tighten Medicaid eligibility standards and make greater use of technology to reduce fraud, abuse and overpayments.

New York's Medicaid spending per recipient is roughly two and a half times the average for all other states. Even if the reforms suggested above only succeed in reducing New York's Medicaid costs by 18 percent—to a level that is still *double* the average for the rest of the nation—the state would save at least $1.25 billion a year (which would also translate into nearly $1 billion in savings for New York City and county governments).

Cutting payroll and controlling state Medicaid costs are essential first steps towards closing a budget gap without damaging the economy. But by themselves they will not be nearly enough. Additional steps must include:

Restrain and restructure school aid

From 1994–95 through the projected totals for 2000–03, state aid to public schools has increased by more than $5 billion, the equivalent of about 6 percent a year, including several of the largest single-year school aid increases in history. Yet discontent with the state school aid formula within the public education sector has been rising right along with the dollars it consumes—because to an increasing extent, the aid is tied into specialized "spend to get" categories such as class size reduction, universal pre-kindergarten programs and building construction aid.

Closing next year's gap will, at a minimum, require a freeze in school aid payments, which would otherwise be on track to grow by hundreds of millions of dollars. An additional $365 million could be saved by reducing all formula aids by just 3 percent. In any case, the need for much greater spending restraint in this category will make it more important than ever to simplify the school aid and to redirect more money to where it is most needed—districts serving high proportions of pupils from impoverished backgrounds.

Eliminate non-essential capital financing

A contributing factor in the growth of state debt has been a growth in what might best be described as capital pork—bonded financing for "civic facilities" ranging from parking garages to sports areas to convention centers and downtown redevelopment schemes reminiscent of failed urban renewal policies of the 1960s.

The trend continues under new guises; the latest budget authorizes at least $600 million in bond financing for three programs devised by the Governor, Senate Republicans and Assembly Democrats, respectively, to promote economic development. All of these funds are supposedly designed to encourage "job creating" projects, such as incubators jointly developed by private companies and universities, with an emphasis on the trendy field of "biotechnology." However, all of the programs also have components aimed at matching local financing in the highly dubious category of civic facilities.

Capital spending should be limited to the state's core infrastructure development needs—and it needs a more transparent and credible process for identifying and setting priorities among those needs in the context of the annual budget. Eliminating scheduled economic development bonding and cutting the rest of the state's capital financing program by 25 percent would save roughly $100 million in debt service costs next year—and even under this scenario, the state's net indebtedness would continue to increase.

Enact real debt reform

Although the State Constitution requires voter approval for all general obligation debt, virtually all of the net increase in state-supported debt over the past 20 years has come in the form of non-voter approved bonds issued by public authorities through contractual arrangements that obligate the state to pay debt service through annual budget appropriations. This so-called "backdoor borrowing" has withstood legal challenges to become the dominant means of state financing.

Two years ago, the state enacted a "debt reform" bill that caps new debt at a total of 4 percent of personal income—a cap loose enough to permit billions of dollars more in debt than the Governor's latest capital plan actually calls for.

Real discipline will not be restored to the state's capital financing program until the state enacts tougher reforms restoring the constitutional restriction on non-voter approved debt.

Control collective bargaining

The state government's contracts with its largest collective bargaining units—those affiliated with Civil Service Employees Association (CSEA) and the Public Employees Federation (PEF)—expire in April 2003, at the beginning of the new fiscal year. The immense size of the next budget gap should virtually ensure that the next round of contracts includes no pay increase for state employees—repeating the pay freeze instituted by Cuomo during the state's fiscal crisis of the 1990s.[26]

Future pay increases for state workers should be linked to the unions' willingness to consider productivity improvements and real pay-for-performance incentives, as opposed to the "performance bonuses" now awarded routinely on the basis of longevity.

An additional, powerful, cost-cutting incentive can be created in state government by tying bonuses for managerial employees directly to their success or failure in meeting budgetary targets—as has been done successfully in New Zealand, for example.[27]

Pursue innovative contracting and privatization options

Although New York was a privatization leader early in Pataki's tenure, the state hasn't begun to exhaust the possibilities for selling or leasing its assets to the private sector. Moreover, much more could be done to outsource services now provided exclusively by state employees.

State assets that potentially could be transferred to private sector operators include 27 golf courses, three SUNY hospitals, various toll bridges and highways, and state-owned and -financed developments such as Battery Park City and Roosevelt Island in Manhattan.

Meanwhile, much of the state's workforce is assigned principally to administrative duties involving different levels of information processing—a function ripe for innovative contracting arrangements. The point of contracting is not simply to transfer functions to the private sector but to harness the power of competition to introduce greater efficiency and innovation to government. Thus, a true "competitization" process would allow state employees to bid against private workers to provide services.

First, however, New York State's Governor should conduct a comprehensive, government-wide inventory of activities that could be performed by the private sector. One model for this approach would be the 1998 Federal Activities Inventory Reform Act, which has identified more than 900,000 potential competition opportunities. The Governor could follow President George W. Bush, who has called on federal agencies to seek competitive bids for a minimum percentage of functions every year.[28]

Future tax cut priorities

For all the improvements wrought by Governor Pataki's tax cuts, New York's State's tax structure still represents a sizeable competitive disadvantage in many respects. This is especially true in the case of the state personal income tax. For all but low-income workers, New York's income tax burden remains significantly heavier than the average for all states and for neighboring states.

Of course, conventional wisdom in Albany would rule out any discussion of tax cuts in the face of budget deficits. But Pataki turned that wisdom on its head in 1995, when he responded to a $5 billion budget gap by cutting taxes as well as spending. His argument then—which applies with equal force today—was that the only way for the state to emerge securely from a budget crisis is to *grow* its way out, and that the best way to encourage growth is by lowering the burden of government on taxpayers.

Here are a series of priorities that will help prevent further economic erosion and promote a new era of growth for New York's economy:

Follow through on scheduled tax cuts.

The 2003-2004 stage of the multi-year tax cuts enacted in 1999 and 2000 is worth about $400 million, including the continuing phase-out of the state gross receipts tax on energy services, an increase in the standard deduction for married couples, a corporate tax rate cut for small businesses, and reductions in bank and insurance taxes.

Push the death tax back into its grave

As noted, the state has replaced its former estate and gift tax structure with a simplified tax calibrated to the credit on federal estate taxes. However, Congress threw New York and other states a curve in last year's federal tax cut package, which finances the gradual elimination of the federal estate tax by more phasing out the credit for state taxes over a four-year period, starting in 2002. This means that as the federal death tax disappears, a separate New York tax will rise to replace it (most other states will simply see their estate taxes automatically disappear).

The reasons cited by the Governor and legislative leaders for getting rid of the estate tax in 1997 are still valid: New York doesn't need to provide well-heeled residents with a yet another reason to flock to low-tax retirements heavens.

Pursue the unfinished 1995 agenda

Looking beyond those already scheduled changes, the most glaring piece of unfinished business on the state's economic growth agenda involves the personal income tax. As noted, Pataki's original plan called for reducing the top rate to 5.9 percent and raising the top tax bracket to $50,000; the enacted plan moved the marginal rate to 6.85 percent and left the top bracket at $40,000 for married taxpayers and $20,000 for singles.

Enacting the unfinished portions of the Governor's original income tax cut proposal—reducing the rate to 5.9 percent, broadening tax brackets—would create about 59,000 new jobs, according to the STAMP model.

By the same token, moving in the opposite direction by increasing the income tax would have the opposite effect on employment. The STAMP model indicates that raising the income tax by imposing $2.7 billion in surcharges, as proposed by a union-affiliated group, would cause the state to lose 46,000 private sector jobs.

Stop bracket creep

A further priority—one with a relatively small short-term budgetary impact—would be to annually update New York State's income tax brackets, exemptions and standard deductions to keep pace with the annual rate of inflation, as was done 20 years ago in the federal income tax code.

If such a change is not made, much of the value of the 1995-97 cut will be steadily eroded for middle-income families, even assuming continued low inflation. For example, a married couple with two dependent children and an income of $50,000 paid $1,652 in state income taxes in 1997. Assuming the couple's income has just kept pace with inflation, their tax bill in 2002 will be $1,933—5 percent higher after accounting for inflation, due solely to bracket creep. If inflation remains around the current national rate of 2 percent, bracket creep by 2007 will raise that same couple's tax bill by an additional 7 percent in real terms.

CONCLUSION

While the size of the next New York State budget gap is uncertain, it seems clear the gap will be large—very large. In fact, it may be even bigger than the one Pataki faced in 1995, both in absolute terms and in proportion to the overall budget.

The good news is that the state's economy is in fundamentally better shape now than it was between 1989 and 1995, when New York's last serious fiscal crisis developed. On the other hand, there are even more uncertainties and uncontrollable factors affecting fiscal planning—not least of which is the possibility of another war with Iraq and the economic disruption it could bring, at least briefly, in the form of higher oil prices and reduced tourism. But this is all the more reason why the Governor next year needs to vigorously attack those factors that drive the cost of state government beyond New Yorkers' ability to pay for it.

Attempting to plug the upcoming budget gap with tax hikes and financial gimmicks, while minimizing politically tough decisions to reduce spending, will only make the problem worse—as New York's leaders have learned repeatedly in the past.

The surest way for New York to get out of its next budget hole is to *grow* its way out. And the blueprint for growth can be found in the policies and philosophy of George Pataki's first term.

Endnotes

1. Cash disbursements are reported three ways in New York State's budget. "All funds," the broadest category, includes spending supported by federal grants as well as state revenues, which totaled nearly $90 billion in fiscal 2002-03. The "general fund" is limited to spending supported by taxes and other non-federal revenues whose use is not otherwise restricted to specific purposes. The more inclusive "state funds" budget includes all spending supported by the state's non-federal tax and fee revenues, including revenues dedicated to specific purposes such as transportation and health care. In 2002–03, all funds spending is projected to reach $89.6 billion, general fund spending is projected at $40.2 billion, and state funds spending is projected at $59.4 billion. Unless otherwise specified, state spending in this report always refers to "state funds" spending, as reported in the annual New York State Executive Budget.

2. Senate Majority Leader Joseph Bruno has publicly speculated the budget gap may be as high as $8 billion to $10 billion.

3. This was the "out-year" disbursements projection in Governor Mario Cuomo's final Executive Budget.

4. Based on figures presented in the State Funds, Cash Disbursements by Function tables in the annual New York State Executive Budget.

5. Chris Atkins and William Eggers, "Show Me the Money: Budget-Cutting Strategies for Cash-Strapped States," American Legislative Exchange Council and Manhattan Institute for Policy Research, July 2002, p. 6.

6. This was the estimated value of the tax cut in 1995, the year of its enactment. Subsequent income and economic growth increased the tax cut's estimated annual value to more than $5 billon by 2000.

7. This figure is derived from estimates detailed on p. 141 of Appendix II of the 2001–02 New York State Executive Budget. STAR property tax relief and medical/provider assessments are excluded from the total.

8. However, since 1982, companies located in the Metropolitan Transportation Authority (MTA) region, which includes New York City, Long Island and five counties in the lower Hudson Valley, have been subject to a 17 percent corporate surcharge, which is dedicated to support mass transit spending. In cutting the main rate in 1998, the state raised the surcharge to 20 percent to ensure that the revenue from the mass transit tax would not be affected—arguably a tax *increase*. Moreover, since the entire MTA surcharge is imposed pursuant to a temporary law that "sunsets" every few years, the renewal of the surcharge – most recently, in 2000—also could be described as a tax increase.

9. The crucial first step in reducing business taxes was initiated in 1994, Cuomo's last year as governor, when the Legislature voted to repeal a 15 percent across-the-board tax surcharge. This cut, completed in the middle of Pataki's first term, is worth about $1 billion annually on the current tax base.

10. The New York State model was one of several state models commissioned from BHI by the Heritage Foundation. BHI also was commissioned by the Manhattan Institute in 2001 to develop a separate model to measure the effects of tax changes in New York City—NYC-STAMP. This model found that tax cuts implemented by the city in the late 1990s had been responsible for one-quarter of its job growth. For details, see "What New York Has Gained from Tax Cuts," Manhattan Institute Center for Civic Innovation, Civic Report 20, September 2001.

11. The program is by necessity structured differently in New York City—which has a large number of renters, extremely low property taxes on owner-occupied homes, and no separate school tax. STAR funds have been used to underwrite a reduction of two-tenths of a percent in the city's resident income tax, plus exemptions for single-family homes. Nonetheless, the city's share of overall STAR expenditures has been estimated at 23 to 26 percent of the total—well below its roughly 40 percent share of state tax revenue and population.

12. See, for example, the table on p. 73 of Appendix II of the 2002-03 New York State Executive Budget, in which STAR Property Tax Relief is listed among "Cash Disbursements" out of the State Fund.

13. In fact, the rate of state funds spending growth originally proposed by the Governor in 1998–99 was even larger than the end result—8.5 percent.

14. State of New York, Annual Information Statement, June 3, 2002, Table 23, p. 52.

15. State-supported debt includes both voter-approved general obligation debt and public authority debts that are paid out of the state budget under "lease-purchase" deals and other contractual arrangements. Debt rose much more quickly in Pataki's first term (an average rate of 6 percent a year) than in his second term (just over 2 percent a year). Major borrowing in Pataki's first term included the voter-approved $1.75 billion Environmental Bond Act of 1996 and the $3 billion State University and City University capital construction program.

16. State of New York, Annual Information Statement, June 3, 2002, Table 24, p. 53.

17. Unless otherwise specified, references to the state budget and state spending throughout this report are on a "state funds" basis, including all activities supported by state taxes and fees, but excluding federal grants.

18. The 1987 tax cut is much less significant than it appears on the surface because it was enacted in response to 1986 federal tax reforms that had significantly broadened the taxable income base at both the federal and state level. Thus, some of the 1987 rate relief was necessary simply to prevent the state from reaping a windfall of new tax revenues as a result of Washington's action.

19. Because nearly all the new revenue generated by economic growth was plowed back into new spending during Cuomo's first two terms, there was nothing left to finance the long-overdue elimination of a rolling annual cash shortfall that required the state to issue more than $4 billion in short-term tax anticipation notes every spring. It was not until Cuomo's last term that the so-called spring borrowing was finally eliminated. It was accomplished in typical New York-style—not with real fiscal discipline, but through the use of long-term bonds issued by a public authority created expressly for that purpose, the Local Government Assistance Corp. (LGAC). In effect, the state carried a credit card balance for 30 years, and then took out a second mortgage to pay it off.

20. Examples of agencies that employed more people as of July 2002 than they in mid-1983 include the State Comptroller's Office, the Attorney General's Office, the Division of the Budget, Office of Employee Relations, Workers' Compensation Board, and the Departments of State, Environmental Conservation, Taxation and Finance, Banking, Insurance and Motor Vehicles.

21. In mid-1983, the state Department of Social Services (DSS), Department of Health, and Division for Youth (DFY) employed 13,486 people. As of July 2002, the Department of Health (which assumed most of DSS' former Medicaid administration responsibilities), the Office of Temporary Disability Services (which assumed DSS' welfare administration function), and the Office of Children and Families (which assumed DFY's institutional responsibilities for youthful offenders) employed about 13,000 people. Both figures are full-time equivalent (FTE) headcounts based on periodic payroll reports from the State Comptroller's Office.

22. Estimate based on average biweekly salary of $1,937 for all state government employees, as reported by the state Comptroller's office as of June 2002, plus average benefit load of 34 percent.

23. Estimate based on average biweekly salary of $1,377 for all legislative employees other than elected members, as derived by figures reported by the state Comptroller's office as of June 2002, plus average benefit load of 34 percent. A 40 percent reduction would match the legislative staff cut that California voters madated as part of their term limits law in 1990.

24. Estimate based on average biweekly pay of $1,937 for all state government employees, as reported by the State Comptroller's Office as of June 2002, plus average benefit load of 34 percent. The average weighted biweekly salary for judiciary employees is higher than this figure, but includes more highly paid elected and appointed judgeships established by statute, which would not be eliminated under this proposal.

25. These figures are derived from state funds cash disbursements for payments to Medicaid providers as reported in Executive Budgets for 2000–01 and 2001–02, including updated projections issued at the end of the 30-day budget amendment period in February. Due to classification and timing differences, the state Comptroller's annual financial reports provide different figures in the "Medical Assistance" category, but the overall pattern of spending increases has been roughly the same.

26. Over the past four years, as the consumer price index rose about 12 percent, most state employees have received base salary increases totaling nearly 14 percent, plus $500 bonuses. Thousands of state workers received an additional 3 percent salary raise when the Governor and Legislature agreed in 2000 to eliminate pension fund contributions for state employees with more than 10 years of service.

27. Atkins and Eggers, "Show Me the Money," p. 10.

28. Ibid., p. 7.

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