



STATE OF NEW YORK

RICHARD RAVITCH
LIEUTENANT GOVERNOR

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Dear Governor Paterson:

I am very grateful for the opportunity to help you and the State of New York in this period of fiscal crisis.

You have quite properly raised this issue repeatedly for the last two years and I'm pleased to send you my recommendations for the revisions to the state budget system that are outlined in this attached document.

Sincerely,

Dick

cc: NYS Legislative Leaders

A FIVE-YEAR PLAN TO ADDRESS THE NEW YORK STATE BUDGET DEFICIT

The recession that began in 2007 caused a dramatic decline in the tax revenues of nearly all the states of the United States. This decline has been coupled with sharply increased state costs in Medicaid, education, employee benefits and other areas. The result has been a perfect storm of fiscal calamities that is straining state budgets and posing a serious challenge to the States' abilities to sustain vital services at a cost that taxpayers can afford. New York, while not standing alone in the face of these incredible fiscal headwinds, is facing a generational challenge that will test the durability and flexibility of its government.

But the current economic crisis did not cause New York's budget troubles; it merely exposed them. A long-term, unsustainable divergence between State revenues and expenditures has led directly to a large and growing structural budget deficit that is masked, year after year, through accounting techniques, borrowing, and one-time actions.

Many people in the State do not yet understand the severity of the structural deficit problem. This report seeks to increase this understanding and sets out recommendations intended to change State budgeting. Key to this approach is the recognition that budget-making is a critical function of State government. Current practices are not sustainable, and it is respectfully submitted that the State must enact and abide by strict statutory standards requiring the adoption and maintenance of balanced budgets.

The recommendations in this report, if adopted, would do the following:

- Lock the State into paying down its existing structural budget gap within five years;
- Require a quarterly assessment by an independent review board of the State's progress towards permanent budget balance;
- Authorize the Governor, if the independent review board finds that the budget is not projected to be in balance at year's end under current budget rules or has not made "adequate progress"--the standard applied to insure New York City's budget recovery in the 1970s--toward balance on the basis of GAAP as applied to governments, and the Governor and the Legislature cannot agree on gap-closing actions within a limited time-frame, to implement across the board *pro-rata* reductions, excepting the Legislative and Judicial branch budgets;
- Ameliorate the dispute between the Executive and Legislative branches over the inclusion of statutory language in Executive budget appropriations bills; and
- Allow the State to borrow within stringent limits to close existing budget gaps, but only if the independent review board finds that strict new financial controls have been met and only on the condition that debt service be repaid within a limited amount of time.

I. NEW YORK HAS A HUGE AND GROWING STRUCTURAL BUDGET DEFICIT.

The State's deficits are immense because its spending has grown faster than its revenues.

It is now generally understood that New York has a budget deficit of over \$9 billion for the forthcoming year. Depending on underlying assumptions and subsequent events, the figure could be considerably higher. Future deficits will depend on factors such as economic growth,

federal policy, and how much and by what means we cut this year's deficit. But we know that the out-year deficits will reflect the likely disappearance of federal stimulus funds and the State's rising health care expenditures. In short, our budget situation is going to get worse.

While it is true that revenue declines caused by the recession have contributed to the size of the deficit, it is also true that for at least a decade New York has had a chronic and growing structural budget imbalance. That is, spending growth has exceeded underlying revenue growth, even in periods of relative prosperity.

The State's current structural budget gap—the gap that will remain even if economic times improve—is estimated at more than \$13 billion. For 2010-2011, the Executive Budget states a gap of \$8.2 billion; but this number reflects almost \$10 billion in temporary revenue items such as tax increases and federal stimulus money. Once adjusted for these items, the gap totals around \$18 billion. Since the submission of the Executive Budget, the gap has widened by approximately an additional \$1 billion. Somewhere between \$5 billion and \$5.5 billion of the \$18 billion gap represents recession-related revenue declines and spending increases, which may be expected to abate with economic recovery. The remaining gap, estimated in excess of \$13 billion, gives the size of the present structural imbalance problem. Better economic times, in and of themselves, will not solve this problem.

New York's cash budgeting has enabled the State to avoid facing its structural budget imbalance.

Until recently, New York was able to avoid the consequences of its structural imbalance because of State budgeting practices, especially the use of cash budgeting. Under cash budgeting, the State can balance its budget in a technical sense by not paying its expenses in the

year in which they arise—or by accelerating future revenues into the present year. It has become common practice to roll current expenses into future years in this way and to use next year's cash to pay this year's bills.

In addition, though State law requires the enactment of a balanced budget for the General Fund, cash budgeting enables the State to circumvent this requirement by shifting cash into the General Fund and moving spending into other State funds. As a result, and not surprisingly, around a third of the State's non-federally funded spending is now outside the General Fund.

Cash budgeting has also allowed New York to make heavy use of “one-shots”—that is, non-recurring revenue sources or expenditure cuts that may show up in one year only to disappear in the next. In the past eight years the State has used more than \$20 billion in non-recurring revenues to make its budget numbers “balance.” In the short run, they do. But this kind of “balance” need only be temporary: There is no requirement in law that the State *maintain* balance or *end* its fiscal year with a balanced budget. Thus, the out-year gaps have grown. Even assuming that the State closes the coming year's budget gap primarily through recurring spending reductions, the Division of the Budget currently projects future year deficits at \$5.4 billion in 2011-2012, \$10.7 billion in 2012-2013, \$12.4 billion in 2013-2014, and \$14.5 billion in 2014-2015.

The State is coming to the end of its ability to avoid the consequences of its structural budget imbalance.

The pressures on state spending are accelerating, reflecting aging infrastructures, existing labor contracts, rising pension and health benefits for State retirees and, especially,

rising Medicaid costs. It is estimated that state and local Medicaid expenditures will rise around twice as fast as the gross domestic product over the next ten years.

In addition to the pressures faced by the states as a whole, New York faces particular economic uncertainties. New Yorkers have been in the habit of thinking that because of the State's underlying economic advantages, including its high per capita income and its status as the nation's financial capital, the State could readily afford higher spending and more generous programs than the rest of the country. But New York's advantages have been shrinking. In 1950, New York had about 10 percent of the nation's population; we are now at barely more than six percent. From 2000 through 2008, New York's population grew much more slowly than the national average; we ranked 41st among states in our population growth rate. During the same years, New York was the state with the highest amount of out-migration. A million and a half New Yorkers left for other states; Florida gained about a third of these former residents.

The structure of New York's economy—largely the downstate economy—has kept the State's per capita income relatively high, but the State's income growth is subject to a good deal of volatility.

Last year New York, like other states, relied on federal stimulus money to “balance” the budget. The aid was welcome but will likely prove short-lived. In fact, by enabling—and sometimes requiring—the State to continue spending State funds at current rates, stimulus aid raised the height of the fiscal cliff from which the State budget falls when the aid ends. Moreover, with federal policymakers increasingly focused on the huge federal deficit, we cannot count on future federal aid as a continuing source of budget relief.

One consequence of our situation is that the State's spending in areas such as higher education and infrastructure, has been badly impaired. These are precisely the areas of spending on which the State depends for its long-term economic well being.

Thus, while New York has managed to keep rolling its structural deficit from one year to the next, we have, as the farmers say, been eating our seed corn. Just as important, the State is coming to the end of its ability to continue pushing its deficits into the future.

II. THE RECOMMENDATIONS: FINANCIAL PLANNING, STRICT ACCOUNTING, ADEQUATE RESERVES, AND A NEW FISCAL YEAR.

While there is no budget system--public or private--that cannot be manipulated, strong budget rules can make it much more difficult to spend state resources imprudently. It is time for the State to establish such budget rules and practices. The following proposals are meant to provide incentives and penalties that can create a transition, over time, to a budgeting culture that values long-term balance. In order to do their job, these proposals must be treated as a package—an integrated whole, not a list of options. They stand as a piece; in order to work, they all must be put to work together.

The State needs a multi-year financial planning process directly linked to the annual budget process.

The State's structural budget gap cannot be solved in a single year without unacceptably hurtful dislocations. Therefore, this report calls for a multi-year financial planning process under

which the State can achieve *structural balance within five years*. The process will help State budget-makers rein in the universal human preference for short-term expedients, because it will make unavoidably visible the future-year consequences of current policy decisions.

The multi-year planning process should produce an annual plan that identifies present and future structural budget gaps, requires proposed actions to close the gaps, and is adjusted periodically to take account of changed conditions.

The five-year plan, which will be submitted with each Executive Budget, will begin by explicitly identifying plausible assumptions about the economy and other relevant conditions in the coming five years. The plan will project recurring State revenues and expenditures—within the meaning of GAAP as applied to governments, which will be described in the next section of this report—over the five years under current laws and policies and realistic assumptions. The plan will identify the structural gaps, if any, that the recurring revenues and expenditures would produce.

The initial plan will lay out options for policy initiatives to close these structural gaps over the course of the five years. In laying out the options, the plan will employ a number of standard budgeting tools. For example, the plan will make contingency plans against the possibility that some expected events may not occur. Similarly, the plan may make use of “one-shots” or non-recurring revenues, but only to meet temporary costs and only as part of a process that will bring the budget into eventual balance on the basis of revenues that are *recurring* in nature. The plan will calculate each year’s savings from the policy initiatives, net of any up-front expenditures that must be made to achieve the savings. Further, the plan must be adjusted periodically within each year to take account of the inevitable intervening changes. The

adjustment will require quarterly reviews of the differences between initial plan forecasts and actual budget results, and corrective action when necessary.

Thus, the planning process will affect the current budget year by requiring that steps be taken to re-balance current-year budgets on the basis of the quarterly results. The process will also affect future years of the plan by adjusting for current results and requiring further consideration of the future consequences of current policies and proposals.

The Division of the Budget, in addition to producing the information required to fulfill State law budget requirements, already does the work of projecting the budget deficits that are expected to occur in future years if current laws continue and current policies are carried out. The information in these projections will be critical to a continuous multi-year planning process aimed at achieving and maintaining structural budget balance. The information is not presently used for this purpose, because the State has no budget rules that require officials to take steps to close the projected future year gaps; but the projections will give the State invaluable aid in moving to a multi-year system.

The multi-year plan should be balanced not just for the General Fund but for all non-federally funded State spending, and not on a cash basis but on a basis that gives a more rigorous and realistic account of the State's expenses and revenues.

The State Constitution, as commonly interpreted, requires that the Governor propose a balanced budget for the State's General Fund. However, about a third of the non-federal State spending on operations each year comes from outside the General Fund. It is not possible to give an accurate picture of State operations and the measures required to control the budget for these operations unless the new budget rules apply to all non-federally funded State spending.

Further, the State should be required to balance the budget according to Generally Accepted Accounting Principles (GAAP), which are applied to governments by the Governmental Accounting Standards Board (GASB).

The State currently budgets on a cash basis, recognizing “receipts” *when* funds are received and “disbursements” *when* funds are paid out. This system allows considerable manipulation of *timing*. It is common practice in New York to use next year’s receipts to pay for this year’s disbursements, and to balance this year’s budget by rolling expenses into the next year.

GAAP, in contrast, requires revenues to be recognized when they are actually *earned*, and expenditures to be recognized when the *liability is incurred*. GAAP has become the standard for accurate financial reporting in both the public and private sectors.

A number of governments, including New York City, use versions of GAAP that take account of the particular circumstances of governments. For example, a government may set a yearly target for an accumulated surplus and make a part of that surplus available for achieving end-of-year balance. Or, a government might make provision for replenishing a shortfall in the accumulated surplus over the course of a number of years. GAAP rules are not meant to be a straitjacket. They are not immutable and may be modified to allow for emergencies.

GAAP is not a budget panacea. Under GAAP, as under cash budgeting, bad judgments will be bad judgments; overly rosy forecasts may not materialize. But it can be expected that budgeting under GAAP rules will improve the quality of the financial data on which decisions are based and that these rules will provide a tighter and more stringent standard for budgeting than the State’s current system.

There will need to be adjustments to certain GAAP rules to take account of New York's specific circumstances; and it will take some time for the Division of the Budget to build GAAP into its budget preparation, controls, and reconciliation. Ultimately, the Division of the Budget and the Office of the State Comptroller will have to work together to ensure that the State's financial management system can function in real time, throughout the fiscal year, with a system of GAAP accounts that mesh for their different needs. Some necessary adjustments to State practice can be identified now. Appropriations language will likely need certain changes. Similarly, cash manipulations have effectively enabled the State to borrow from its localities and employees through lagged reimbursements and payrolls—and, on the other hand, have sometimes resulted in loans by the State. These “accrual lags” will need to be unwound. Eliminating them and other such behavior may entail one-time costs.

But GAAP is not an unknown quantity to the Division of the Budget. New York already reports its financial statements on a GAAP basis, and the Division of the Budget provides an accounting “cross-walk” from the cash budget to the GAAP financial statements at year's end.

When the State imposed strict GAAP requirements on New York City in the 1970s, the City did not employ any version of GAAP accounting—or, indeed, have any properly functioning financial management system. Yet the City achieved an independently audited financial statement and a balanced budget under GAAP within three years, a year earlier than required by State law. There is every reason to expect that New York State can meet such an implementation timeline, especially given the State's talented pool of budget and financial personnel.

The State must adopt means of enforcing compliance with the multi-year plan.

The elements of the compliance process should include the following:

- Each year's five-year plan and each quarterly update of the plan, together with any current-year actions that the Governor proposes to take to close structural gaps, will be submitted to an independent Financial Review Board composed of highly respected private citizens with knowledge of the State's economic and fiscal conditions and expertise in budgeting, accounting, and public finance.
- In the first five years of the plan, the board will determine whether the plan or update has made adequate progress toward balance under GAAP rules, as applicable to governments, by the end of the fifth year.
- If the board finds that the current year budget is not projected to be in balance at year's end under current budget rules or has not made adequate progress toward balance under GAAP, as applied to governments, the board will so inform the Governor and the Legislature. If the Governor and the Legislature do not agree within a limited time on actions to close the gap found by the board, the Governor will have authority to make *pro rata* spending reductions, excepting the Legislative and Judicial branch budgets.
- The State may borrow a *limited amount* of funds (amortized over the shortest practicable period) to help close the current year's budget gap, but only if the board finds that the plan or update is projected to achieve or maintain balance at the end of the fifth year of the plan.

A fuller description of the enforcement process is appended to this report.

Finally, in order to make it possible for the Governor and the Legislature to play responsible roles in this process, it is necessary to ameliorate the current dispute between the two

branches over the relationship between substantive legislation and appropriations bills. We propose a recognition, by statute or agreement, that the Governor will not insert language into Executive budget appropriations bills that is more than incidentally legislative and that the Legislature may strike, though not replace, language that is more than incidentally legislative.

The State must make provision for adequate reserves.

Experts on state finance generally recommend reserves in the neighborhood of 10-15 percent of revenues. Moreover, as the State moves to budgeting on the basis of GAAP, as applied to governments, reserves will become even more important. In fiscal terms, State government is largely a pass-through entity: it collects and redistributes revenues and reimbursements. Under GAAP, the State will need to set aside resources that are adequate to insure against volatility in these reimbursements and payments.

The State will have to determine the appropriate size of its reserves and the rules for their use and replenishment. It will take time to build up the reserves to a prudent level, since it is unrealistic to think that we can make large contributions to such reserves in our present financial and economic circumstances.

The State should change to a July 1 fiscal year.

Forty-six of the 50 states currently budget for a fiscal year that begins on July 1. A change in New York's fiscal year to July 1 would address a number of problems in the present system by making revenue forecasts more accurate and decreasing the chance that there will not be a timely budget. Even under the current cash budgeting system, State officials must engage in

complex operations to manage the task of forecasting and budgeting for a fiscal year that begins April 1 while the State's highly volatile income tax receipts do not appear until after April 15.

As we move to budgeting under GAAP, as applied to governments, the problem would become still more pressing, because the State would be required to set aside large reserves to protect against possible inaccuracies in its revenue forecasts. Changing to a State fiscal year beginning July 1 would make this issue less pressing, by enabling the State to have its April 15 personal income tax receipts in hand when forecasting revenues for the coming year.

It will not be a small matter to change the starting date of the State fiscal year. Among other things, the change will require at least one fiscal year that does not consist of 12 months. Further, many localities and others are accustomed to the present State calendar. A single transitional fiscal year of 15 months is likely to be the least disruptive option and would allow extra time for the necessary adjustments. In the Division of the Budget and the Office of the State Comptroller, the State is fortunate to have professionals who are more than capable of effecting the transition.

III. ASSESSING THE RISKS

If we do nothing about our current budget system, the system will continue to impose large and increasing risks on the State. We cannot count on national economic recovery to lift us out of our budget crisis, and we have reached the limits of our ability to postpone action. The status quo means erosion of the vital services upon which New Yorkers depend. In contrast, while the changes we have proposed will entail considerable costs, the ultimate result will be far more beneficial in the long term to the citizens of the State.

In the 1970s, New York City faced a grave fiscal crisis. In response, the State put in place new financial rules for the City, not unlike the some of the rules that this report proposes for the State itself. These new rules are one reason for the remarkable recovery that the City has made and for the fact that it has had a GAAP balanced budget for every one of the past 30 years.

In the New York City emergency, the State showed that it was capable of recognizing what it takes to bring a government back from chronic fiscal incapacity. What we did for New York City we can do for ourselves.

The recommendations in this report reflect the belief that the difficult and often unpleasant burdens of the discipline described here are the only way to begin the regeneration of the New York economy. The report is also based on the deeper conviction that the State of New York will rise to the occasion of the present budget crisis and set in place a foundation for future years of growth and prosperity.

ACHIEVING AND MAINTAINING LONG-TERM STRUCTURAL BALANCE

The following revisions to the State budget process will be established by legislation prior to the enactment of the fiscal year 2010-11 budget in order to achieve and maintain a balanced budget for all non-federally funded State spending.

The Planning and Budgeting Process

- The legislation will impose on the Governor the obligation to achieve and maintain, for all non-federally funded State spending, Balance pursuant to the Plan, both as described below.
- The Governor will submit to the Legislature a five-year financial plan for all non-federally funded State spending, including the General Fund (the "Plan"), as follows:
 - By May 1, 2010, the Governor will submit the initial Plan to the Legislature.
 - Thereafter, when the Executive Budget is submitted to the Legislature on or before February 1, the Governor will submit a revised Plan to the Legislature.
- The Plan will project operating expenditures and revenues for all non-federally funded State spending for the coming fiscal year and the four following years.
 - The Plan will begin with provisional projections of revenues and expenditures, based on revenue estimates prepared by the Executive and on the continuation of current State commitments and policies. The Plan will state the underlying assumptions and risks in the projections.
 - In the first five years of the existence of the Plan, the Plan's provisional projections will be followed by a statement of the revenue and expenditure initiatives that the Governor proposes to achieve balance between recurring operating expenditures and recurring revenues ("Balance") under GAAP as applicable to governments, as defined in the legislation, no later than the end of the fifth year of the Plan. At the end of the Plan's fifth year and at the end of each fiscal year thereafter, the Plan will be in Balance.

- By June 1, the Legislature will enact the budget, embodying the first year of the Plan, and, on a non-binding basis, will adopt the following years of the Plan.
 - There will be recognition, by statute or agreement, that the Governor will not insert language into Executive budget appropriations bills that is more than incidentally legislative and that the Legislature may strike, though not replace, language that is more than incidentally legislative.
- After the Legislature adopts the Plan, the Governor will promptly submit the Plan to the Financial Review Board, described below.
- Within 30 days of the end of each quarter within a fiscal year, the Governor will submit an updated Plan (“Quarterly Update”) to the board, stating (i) any differences between projected and actual revenues and expenditures; (ii) the reasons for the differences, including legislative and administrative actions, variations between expected and actual performance, and changes in economic or other external conditions; (iii) revised projections; and (iv) any other changes that the Governor proposes in order achieve balance at the end of the fifth year of the plan.

The Financial Review Board

- The Financial Review Board will consist of five members who will not be officers or employees of the State and will not have business with the State. Two members will be appointed by the Governor and one member will be appointed by each of the Comptroller, the Assembly, and the Senate.
 - Each board member will be a person with knowledge of the State’s economic and financial conditions and expertise in the fields of budgeting, accounting, and finance. Each member will serve for a renewable term of five years, will be removable only for cause, and will receive no compensation but will be entitled to reimbursement for actual and necessary expenses incurred in the performance of official duties.
 - The board may act only by a majority vote of the entire board then in office.
 - The board will have an Executive Director who is authorized to hire additional staff. The board will have an initial budget of \$[XXX], which amount shall not be reduced.
- Within seven days of receiving a Plan or Quarterly Update, the board will meet and issue a finding as to whether the Plan or Quarterly Update (a) before the end of the fifth year of the Plan, is projected to be in balance at the end of the year

under current budget rules and has made “adequate progress,” as described in the draft Five-Year Plan of which this Appendix is a part, toward Balance by the end of the fifth year of the Plan and (b) at the end of the fifth year of the Plan and for any period thereafter, is projected to be in Balance by the end of the year. For purposes of this finding, “Balance” will mean balance within \$0.5 billion.

--If the board finds that the Plan or Update is not projected to achieve or maintain Balance, as described above, without joint action by the Governor and the Legislature, the board will so inform the Governor and the Legislature. If the Governor and the Legislature do not agree within 15 days on action that enables the board to find that the Plan or Update is projected to achieve or maintain Balance, the Governor may reduce current-year appropriations *pro rata* on a permanent basis, only to the extent necessary to achieve or maintain Balance; but there will be no reduction in appropriations to pay debt service or meet binding contractual obligations or for the Legislative or Judicial branch.

Fiscal Year

- The current fiscal year (FY 2009-2010) will be extended through June 30, 2010. The 15-month fiscal year will allow the State to know the size of its 2009 revenue collections when deliberating on the FY 2010-2011 budget; have greater clarity on anticipated federal actions and economic recovery; better assess and develop consensus about the size of current budget problems; and set in place a series of financial, accounting and budget reforms to begin a multi-year financial planning process designed to achieve structural budget balance within five years. Subsequent fiscal years, beginning with FY 2010-2011, will run from July 1 to June 30.
- A three-month spending bill will be enacted in conjunction with the extension of FY 2009-2010.

Borrowing

- The legislation will authorize transitional borrowing secured by personal income tax receipts, in an amount limited by the legislation, for the purpose of achieving Balance in any year of the Plan (“Transition Bonds”). No borrowing other than the Transition Bonds may be used for this purpose or for the purpose of otherwise financing State operating deficits during the five years of the Plan.
- Transition Bonds and other State-supported debt will include covenants by the State to issue future State-supported debt only if the board has found that the Plan or Quarterly Update, as of the end of the immediately preceding fiscal quarter, is

projected to be in balance under current budget rules at the end of the year and has made “adequate progress” toward Balance by the end of the fifth year of the Plan.

- There will be strict limits on any borrowing for deficit purposes. Borrowing for the five-year period of the plan should amount to no more than ten percent of the five-year cumulative deficit, currently estimated to be \$60 billion. The term of this borrowing should be the shortest period practicable. In any given year, deficit borrowing should not exceed \$2 billion; and no additional borrowing should be allowed after the third year of the five-year plan. Any unplanned surplus that occurs over the five-year plan must be used for debt reduction. The remaining 90 percent of the deficit closing measures should be comprised of recurring actions that reduce the structural gap on a permanent basis. Spending reductions need to be the driving force.