



Public Policy Forum

What the New Governor Will Face: A Fiscal Outlook

**Presented by
John Cape**

November 1, 2006

Brian Stenson

Good afternoon and welcome to the Rockefeller Institute of the Government of the State University of New York. I'm Brian Stenson and I'm deputy director of the Institute. Our policy forum series continues today with a presentation by John Cape, director of the State Budget Division. I don't know if anyone else feels this way, but I'm about ready for the campaign season to end. So to help divert our attention from the campaign ads and ethics charges, we thought it would be good to immerse ourselves in mind-numbing budget details. I guarantee you John won't do that today. As always, the fiscal condition of New York will be a major focus next year, especially with a new administration in Albany. This session is timed to coincide with the release of the midyear update to the state's financial plan. The update tracks the Budget Division's projections for the current year and the next two fiscal years. There are not a lot of people who will wade through the 123-page update that I have here. So I'm hoping that John help will give us his view with charts and graphs of the fiscal condition of New York and the outlook for the future.

In his role as budget director, John Cape serves as the governor's chief fiscal policy advisor. The budget director is responsible for the overall development and management of the state's fiscal policy, including overseeing and preparation of budget recommendations for all state agencies and programs, economic and revenue forecasting, tax policy, physical planning, capital financing and managing the state's debt portfolio, as well as pensions and employee benefits. John was appointed to the director's position on February 23, 2005,

after serving as acting director since the prior October. Prior to his appointment as acting director, John Cape served as first deputy budget director and, before that, he was deputy director of Budget for State Operations, where he oversaw budget and fiscal policies for the majority of state agencies and programs. He is a 31-year veteran of New York State government. This is his 24th year in the Budget Division. Mr. Cape is an expert in public finance, organizational analysis, and public pension financing. In 2003, he received the Charles Evans Hughes Award from the American Society of Public Administration. He has also been elected a fellow of the State Academy for Public Administration. Now it's my pleasure to introduce John Cape.

John Cape:

Thanks, Brian. Gee, I was just planning to read the budget update. Thank you for that introduction. Brian and I have worked together for a long time. He was kind enough to shorten up the introduction from the six-page narrative biography that was provided him by our ministry of propaganda, which usually people skip over. But, you know, I never mind hearing it again. But, luckily, in addition to the employees in the Budget Division, I have one person that always keeps my feet planted firmly on the ground, and that's my wife, Elaine.

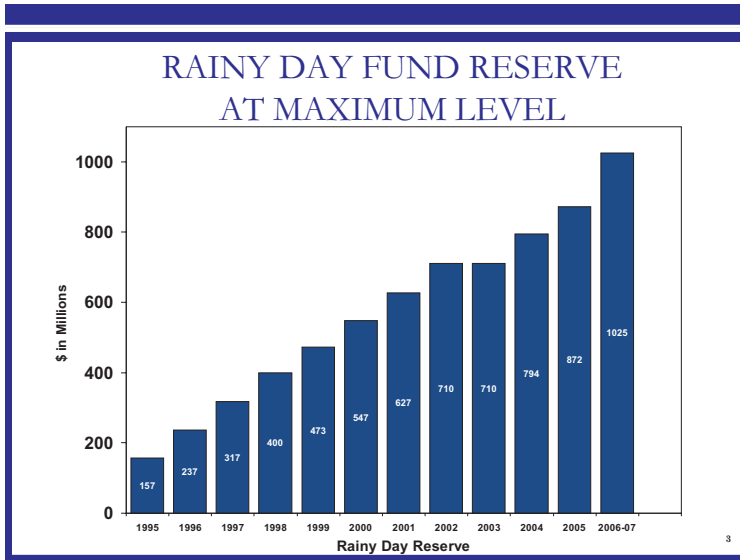
So with my feet firmly planted on the ground, what I thought I would do is go through a presentation of where we've come from and a little bit about where we're going in terms of the broad fiscal metrics that suggest some of the issues that the next administration will have to focus on. It's sort of a smattering of a number of different issues. I'm going to try to get through them relatively quickly so that we can spend most of the time engaging you and your thoughts and ideas about the material. So let's just dive right in.

GUIDING PRINCIPLES

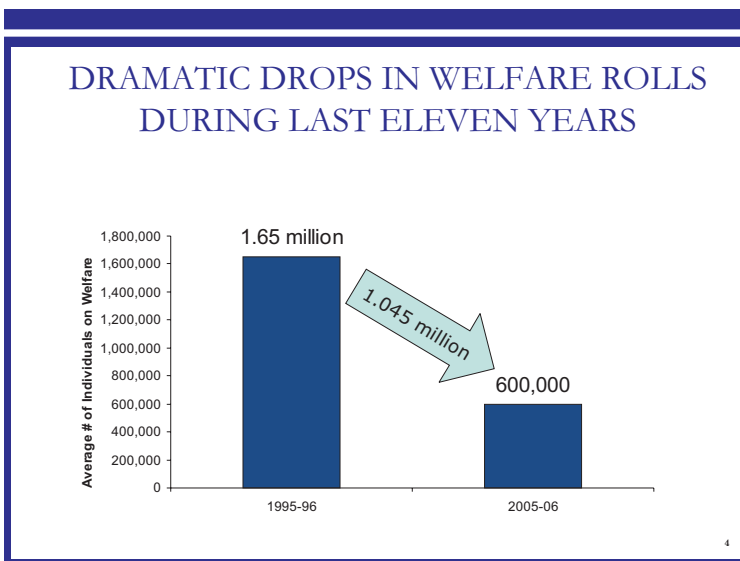
- Create Jobs and Improve Economic Climate.
- Build Up State's Fiscal Reserves.
- Cut taxes, restrain both spending and debt, and improve State's credit rating.
- Enact major programmatic changes including Medicaid reform, welfare reform and criminal justice reform.

2

The guiding principles of the Pataki administration, I think you're going to find, are the guiding principles of any next administration as well: create jobs and improve the economic climate; build up reserves; restrain spending; improve the state's credit; and reform Medicaid, welfare, and other major program areas. I think those goals ring true for both candidates as well as they do for the Pataki administration.

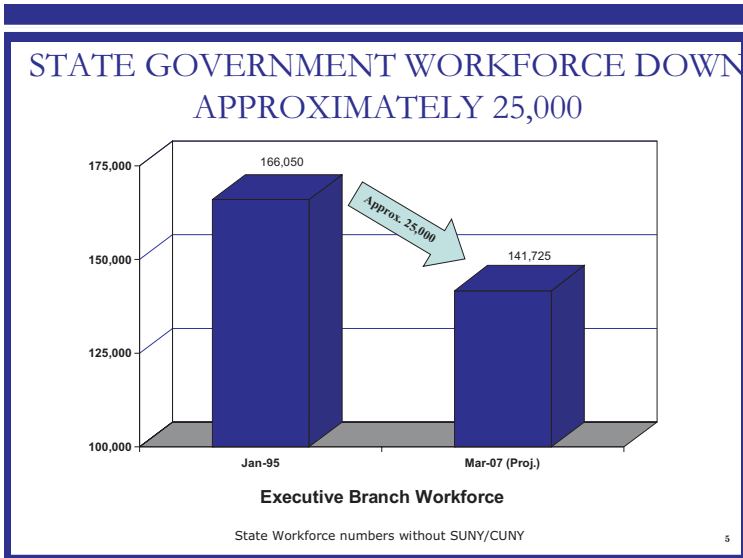


One of the things that this administration has done a good job of is building up our rainy day reserves. You can see at the last transition there was a whopping \$157 million in reserves. This is just the rainy day fund. It's going to be over \$1 billion by the end of the year. The total amount of reserves available to the state at the beginning of the 2007-08 budget year will be over \$3 billion.



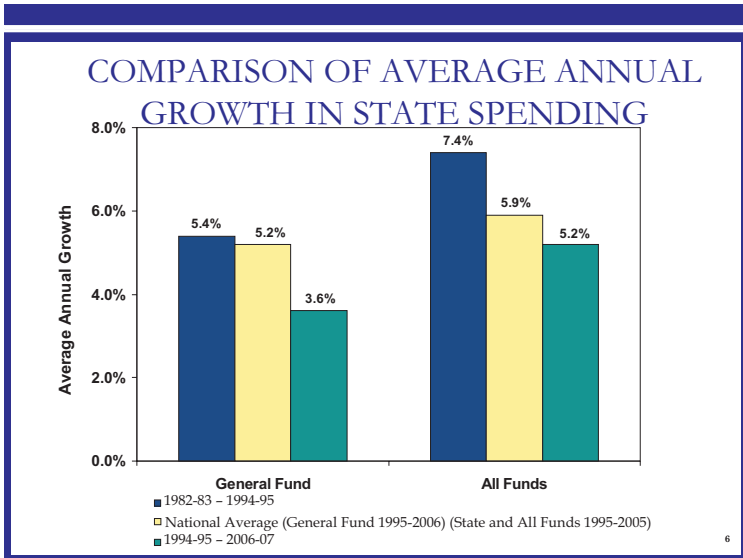
Welfare rolls are dramatically reduced and now relatively stable. The thing that's growing is the so-called safety net program. Those are individuals who don't qualify for TANF as well as individuals who reached the five-year limit for their TANF eligibility. So that is the one growth area in public assistance. But other than that,

caseloads overall, reflecting the stronger economy, are pretty much flat.



The workforce is down dramatically. These are the general fund numbers. What is not in here are things like SUNY, where tuition revenue and the number of students enrolled drives changes. This is what I consider to be the parts of the workforce that best reflect the management actions of the state government. There are dogs

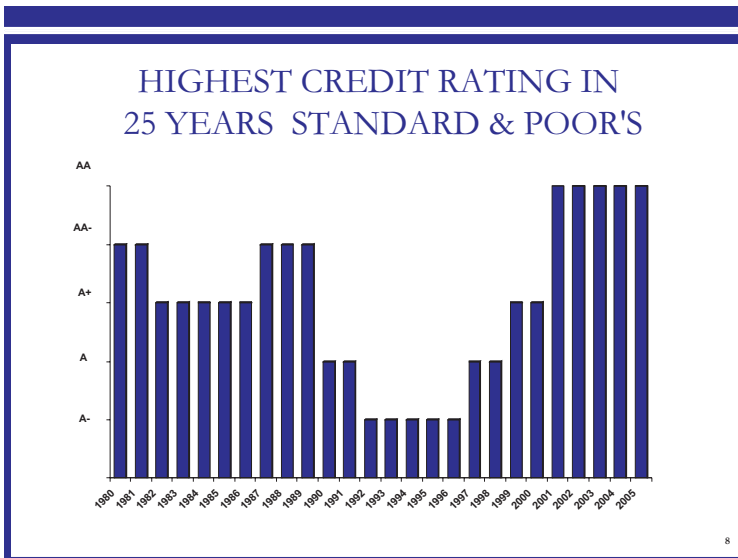
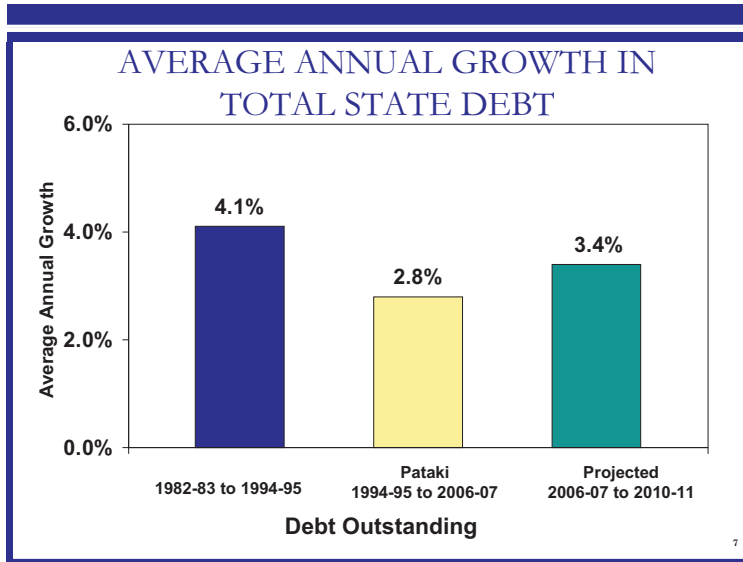
and cats on the periphery here. We don't include the Legislature or SUNY. Those are two big pieces that come out of there, but you can see the workforce is down by about 25,000 and depending on your point of view, that's either a good thing or not a good thing.



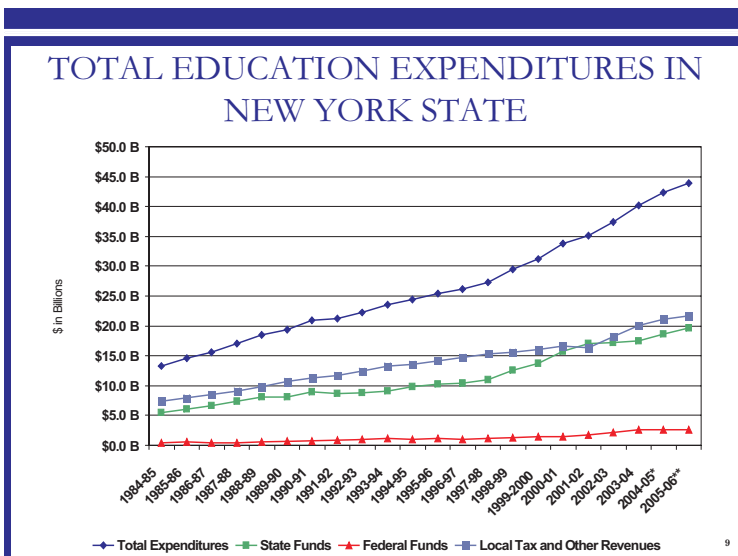
Average annual spending — I'm speaking to you today as the voice of the future about the failed policies of the past. Twelve years later, we're still talking about the prior period here, but you can see all fund spending really has been constrained somewhat. But when you look at an all funds basis, this is still healthy growth in spending every year compared to a number of

states around the country. And there have been years when that's a lot higher and there have been years when that's a lot lower. It averages out to a healthy growth in spending.

Debt is coming down in our five-year capital financing program. Going forward to 2010-11, the capital program and financing plan picks up a little bit, mostly in the areas of economic development and transportation. So there is some rising pressure on the debt levels that are going to confront the next administration.

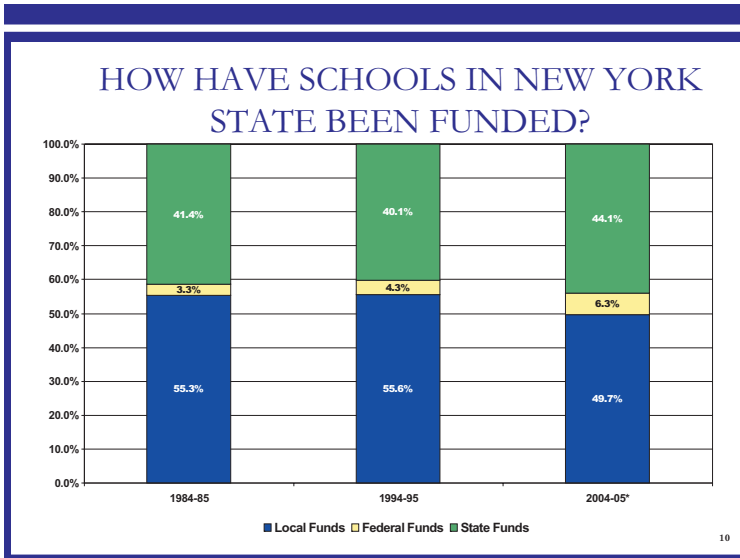


In terms of credit rating, there are a lot of metrics we just talked about: reserves, revenue growth, constraints, spending. Wall Street has reacted pretty well to these. As a matter of fact, for Standard and Poor's, our personal income-tax-backed bonds, which are the majority of the new bonds we issue today, are rated AAA by S&P.



This is going to be one of the areas that the next administration is going to have to tackle. This is total expenditures for education. Here we're talking about K-12. The blue line is local tax revenues, largely property tax revenues. The green line is state funds, largely school aid. And there's an intersection

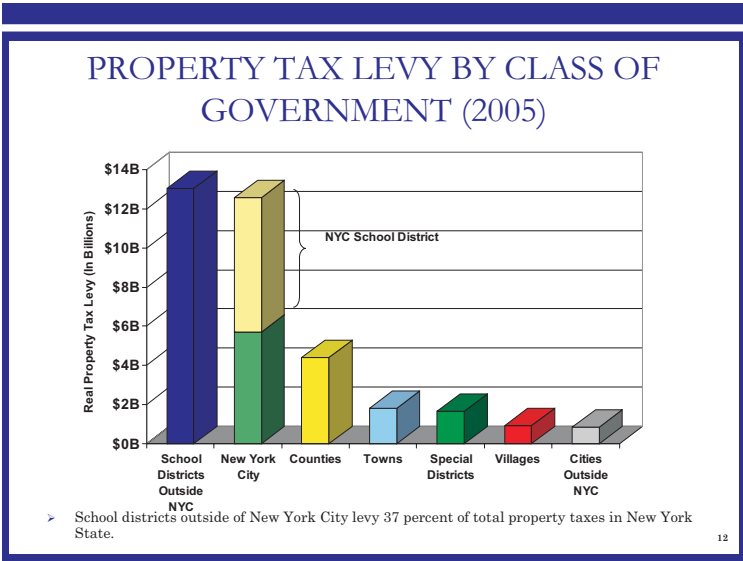
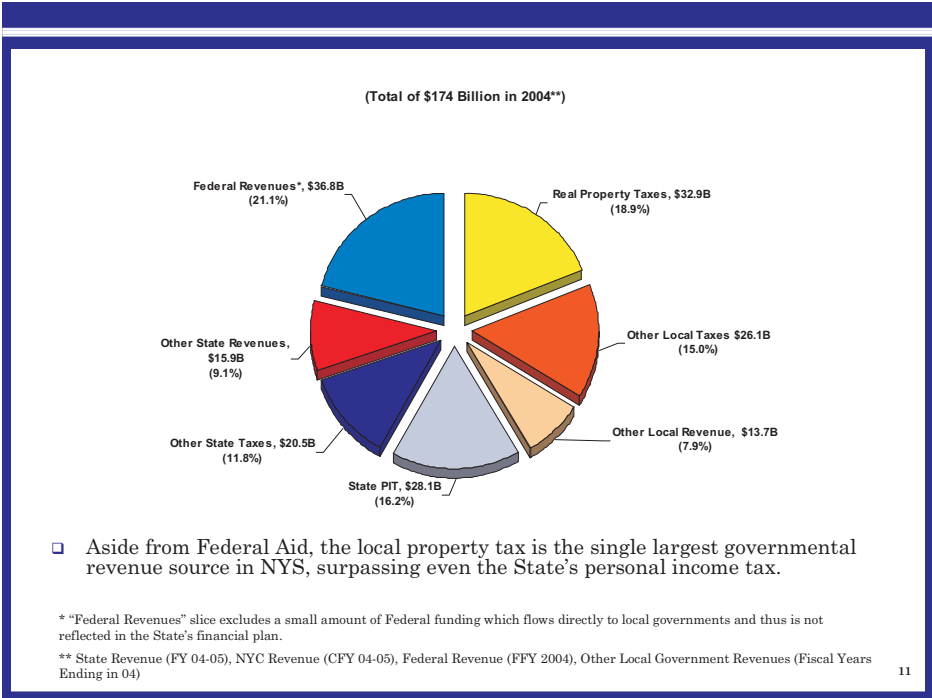
where we've got to a sort of stasis and then local property tax as a percentage has moved away from state aid in terms of supporting local aid. You can see, federal funds, which is pretty flat, pretty anemic, not a big player in New York education finance, picked up a little bit right at the end. That's mostly No Child Left Behind, which originally was supposed keep ramping up, but in recent years, it's flattened out and that looks to be the trend going forward.



Who's paying for schools? This is a favorite chart I use. On the top are state funds, in the middle is federal, down at the bottom in purple is local. Back in 1985, 41.4 percent of total school spending was paid for by the state. It dropped down to about 40 percent by 1994-95, then up to 44.1 percent in 2004-05. Federal funds ballooned out a little bit; that's due to

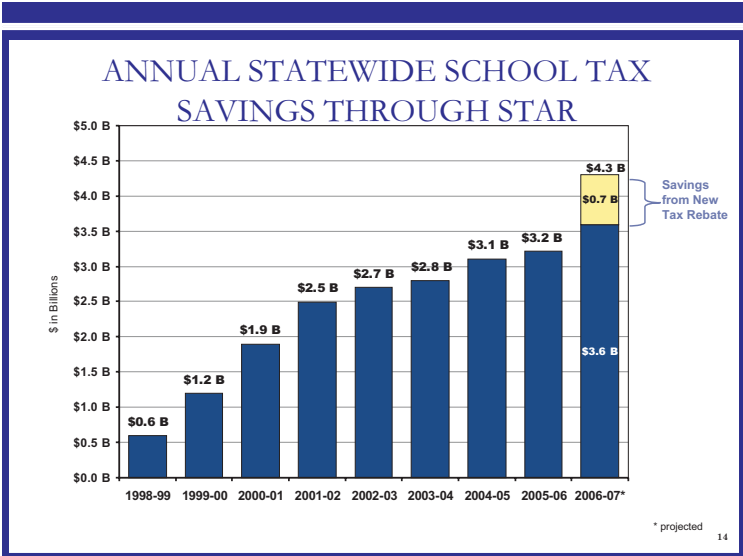
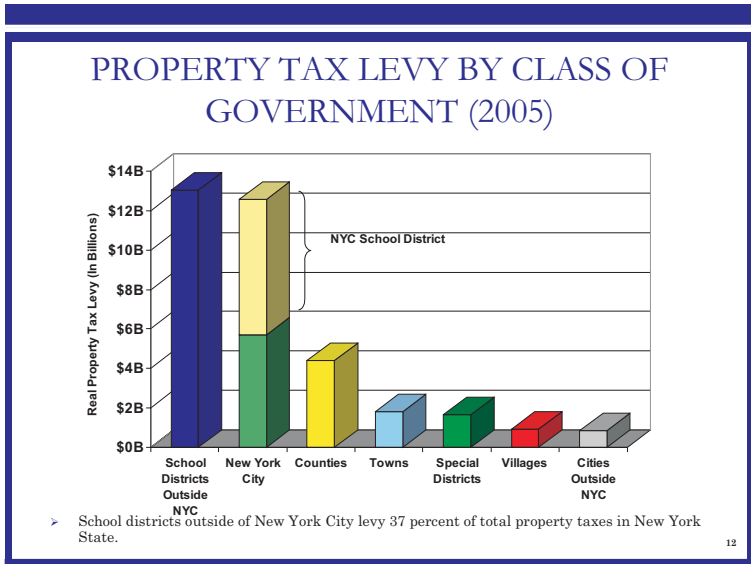
No Child Left Behind. What's really lagging, at least in part, is New York State's School Tax Relief (STAR) program in these numbers. So that, I think, is probably one of the things that's moving that percentage. Otherwise I would suspect that it would be a little better than 1984-85. But really the \$3 billion that we spend on STAR, we're going to talk about them in a minute, is what's moving the percentage of that number. Other than that, there's lots of debate, lots of talk about the property tax and school aid, and No Child Left Behind and sound basic education, and CFE. Over time, the percentages don't move dramatically.

While we're talking about the property tax, let me orient you to the chart (on the next page). The yellow is the property tax statewide. This is all property taxes in New York — about \$33 billion in property tax collections. This blue piece down at the bottom is the personal income tax, and that's the net number, which is \$28 billion. So the first thing you can see is that property taxes brings more money now in New York than the income tax. And you can see federal money, other state taxes, other local revenue, and other sales taxes. This is predominantly the sales tax, although this does include the income tax for New York City and Yonkers.

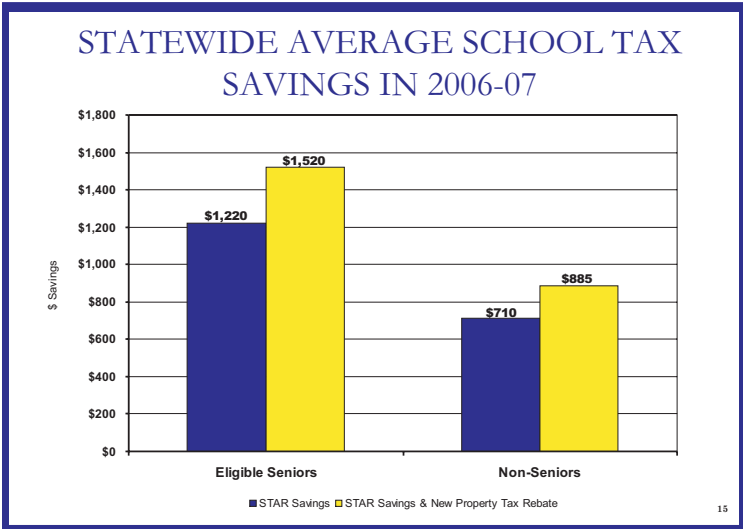


Who's paying property taxes? Property taxes are almost exclusively for schools. You can see from the two columns on the left, these are school districts outside New York City and this is the component of New York City property taxes. The top is the part that goes for schools. Counties are next, then everybody else tails off dramatically. So when people

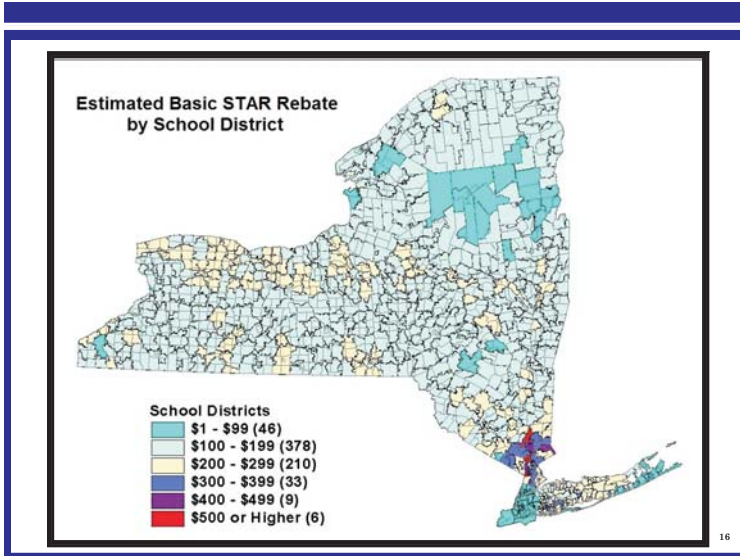
talk about the property tax, it's really all about schools. You can see what's happened with the growth in property tax for all classes. And the light color is other classes and municipalities, and the last column is school districts outside the City of New York. It doesn't matter who you think the culprit is. There's been dramatic growth in the property tax in all of those levels; property taxes for school districts increased up one-third from 1995 to 2005 (see chart on next page).



You can see STAR started out in 1998-99, and has ramped up to the current year, where the base program in STAR is now \$3.6 billion, and there's \$700 million that goes with the rebate checks that are added to the top of it, so the total amount that the state is investing in school property tax relief in the current year is \$4.3 billion.

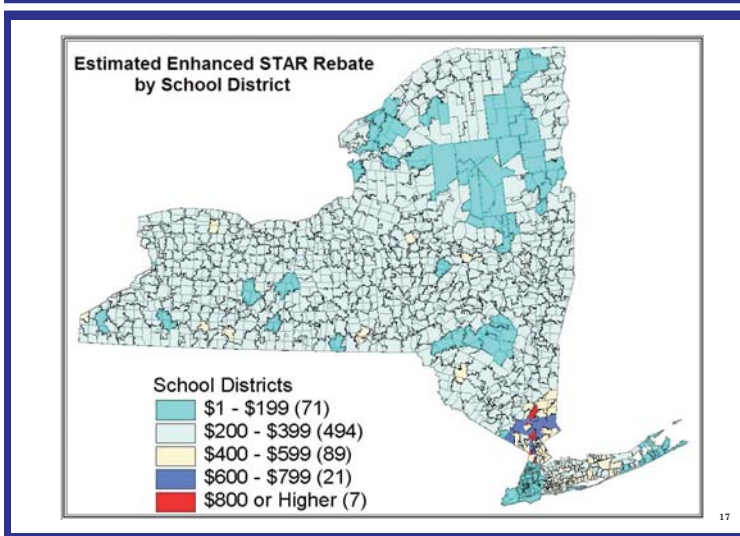


This is what it looks like on an individual taxpayer; the individual eligible senior savings is about \$1,500, the eligible nonsenior currently saving about \$885. The difference is that the purple is without the rebate checks; the yellow is with them.



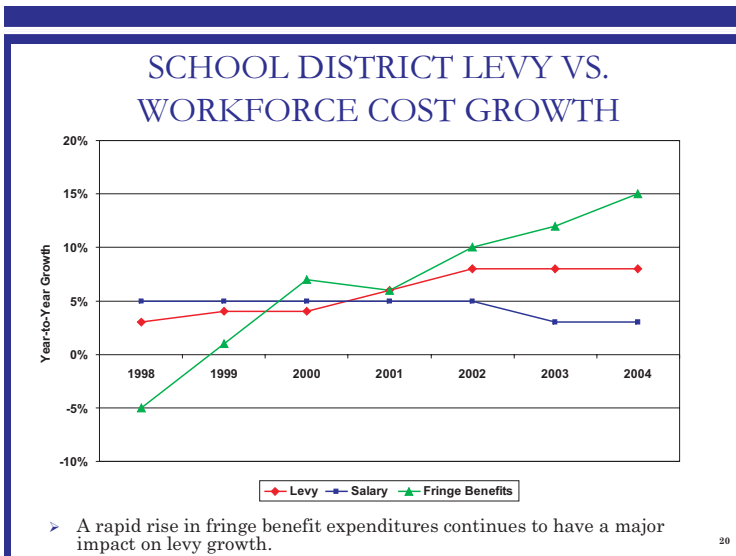
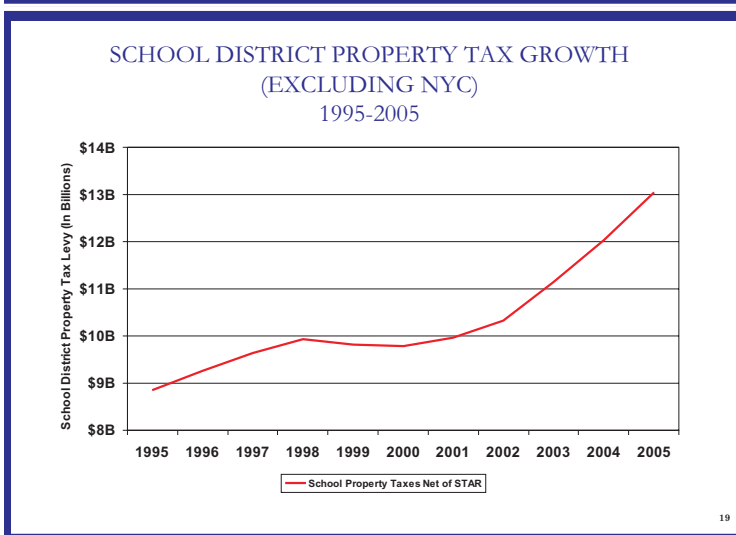
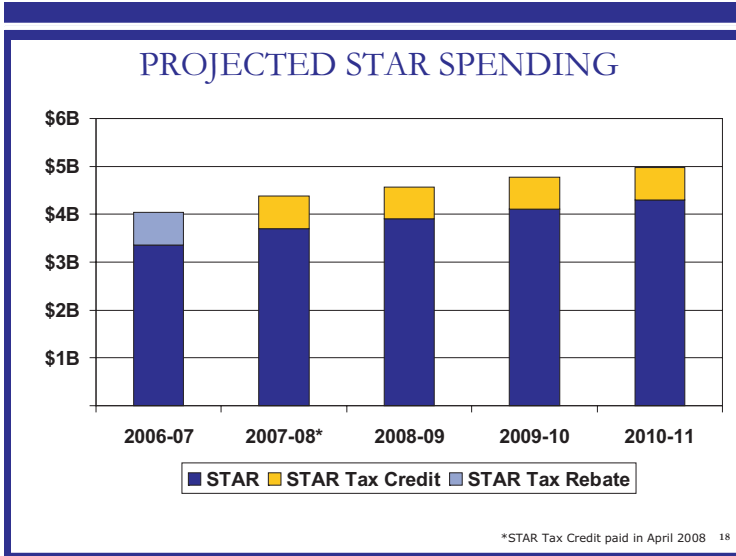
This is an interesting chart. This shows what the rebates looked like statewide. There's a little key down here at the bottom that you can see. The blue areas are where people got a rebate check of less than \$100. The red areas are where people got a check over \$500. It shows some interesting things here because the rebate is really a

measure of your tax rate. It's all done on full value. It all normalizes to account for whether you've got expensive homes or inexpensive homes. What you can see reflected here is in terms against the value of the property. You know, Long Island doesn't look much different than a lot of suburban areas in the upstate area. In property tax there's always this Thruway phenomenon that you see in a number of areas. And you can see, it's pretty sparse when you



get to some of the rural areas of the state. But down in the Long Island area, where there is so much talk and so much political activity around the property tax is where you can really see the rate impact, and that's what is driving the higher rebate checks. This is just the same thing when you add in the Enhanced STAR.

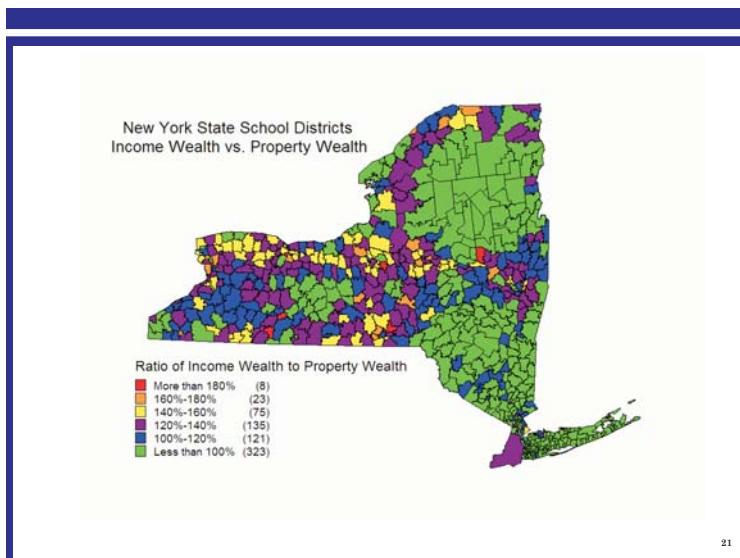
This is what STAR is going to look like going forward (see chart on next page). By the time we get to 2010-11, it's going to be a \$5 billion program. You can see that in 2007-08, the rebate checks change to a tax credit, and then continue to grow. So the future commitment to property tax before either of the candidates begins to work on this issue is really \$5 billion by the end of their first term. I like to call this a ski slope. This is property tax growth. And the reason I put this in here is because the blue chart shows how things look around the state in terms of the level of property taxation related to the value of your house.



Yes, your property taxes are going up, but so is the value of your house. That's not what people look at and feel. They feel the tax, because if your income hasn't gone up, if you live on Long Island and your income hasn't increased and you're an elderly person who's living on a fixed income, the fact that your house is worth three times what you paid for is cold comfort when you get your property tax bill. And so that's why, despite the fact that from an intellectual perspective there are only pockets of real stress on the property tax, this is what is driving a lot of the political concern.

What's driving costs in school districts? What's driving the increases in the property taxes aside from what's happening in state aid for schools? Some interesting things emerge over time. This is 1998. This is 2004, the last year we have data for. The red line in the middle is the tax levy. This is percent growth every year, this is zero. The blue line is the average annual increase in salaries, heavily

weighted by teachers' salaries, actually going down. The interesting line is the green line that is going nothing but up, and that's fringe benefits. What we think is happening here are a couple of things. One is, clearly, there have been cost pressures in both health insurance and in pensions, both ERS and TRS, over recent years. But the other thing may have to do with this phenomenon; salaries going down, benefits going up. There is some anecdotal evidence to suggest that people in unions in school districts are as interested in making sure that their co-pays don't go up, or that their benefits improve, or that vision and dental get added, and those are pre-tax kinds of dollars rather than adding an additional point to their salary increase. And so some of this you may be seeing is this benefit-sheltering impact of collective bargaining that compounds the problem for school districts when you look at their costs.



I just threw this chart in here. It would take the rest of the hour to really explain it. It's a complex chart, but I'm using it to make a simple point. What I've had the folks do is compare the value of your home to the value of your annual income. So people that say, "Let's just switch and have, like Yonkers does, an add-on to the income tax. Let's just put point one on

everybody's same income tax liability, and send it back to the school districts." That can change the way in which we do the property tax and dramatically lower it. The green areas are those where that is less than 100 percent. What that means is your property is worth more than your wages. The red and orange areas show where wages are worth more than property. The green areas are losers. The blue/orange areas are winners. We can debate this chart and what it means and I could take another half hour to really explain it, but the only point is changing to any other kind of basis of taxation is a simple answer for the property tax, which is fraught with as many winner and loser kinds of political issues as the property tax itself. All right, enough about the property tax.

STATE SOUND BASIC EDUCATION PLAN

Plan Submitted to the Court by the State in August 2004 Calls for a Five-Year Financing Plan

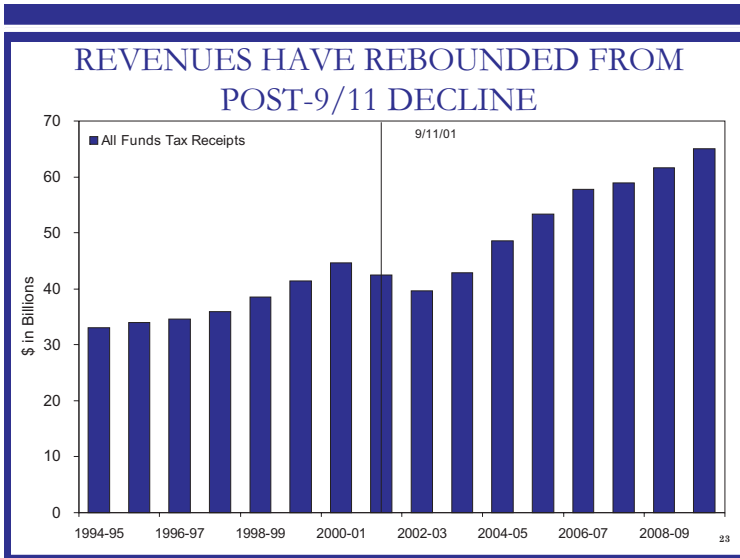
- ❑ **State Five-Year Sound Basic Education Plan:** Submitted to the Court in August 2004 based on Zarb Commission recommendations. The Commission proposed additional funding of \$2.5B-\$5.6B statewide to ensure an opportunity for a sound basic education.
- ❑ **State Financial Plan:** The State Financial Plan for 2007-08 — 2009-10 reflects increases in State Aid (SBE Aid and Traditional School Aid) in accordance with the plan submitted to the Court.
 - **Plan Amount:** Traditional School Aid will increase by \$2.5B Statewide over 5 years, and SBE Aid will increase by \$2.0B, for a total State contribution of \$4.5B. NYC would receive 40 percent of the Traditional School Aid increase (\$1.5B), and 60 percent of the SBE Aid increase (\$1.2B).
- ❑ **Federal Funds:** The Financial Plan also assumes Federal education aid to NYC to increase by \$2.0B over five years.
- ❑ **New York City Share:** Under the Plan, NYC is expected to share in 40 percent of the total costs, bringing the local share to a \$1.5B increase over five years.
- ❑ **VLT's:** Current Plan assumes significant growth in VLT's predicated in part on expansion.

	NYC	Rest of State	Total State
Sound Basic Education Aid	\$1.2B	\$800M	\$2.0B
Traditional School Aid	\$1.0B	\$1.5B	\$2.5B
Federal Aid	\$1.0B	\$1.0B	\$2.0B
Subtotal State/Federal Aid	\$3.2B	\$3.3B	\$6.5B
NYC Local Share	\$1.5B	\$0.0B	\$1.5B
Total Phased-in Increase	\$4.7B	\$3.3B	\$8.0B

- ❑ **Addressing Rest of State Needs:** While the Court decision only related to NYC, it is generally accepted that a final solution will include the Rest of State districts.
 - **Costing Out:** The resource gap for all other districts is much more difficult to determine given the absence of an agreed-upon methodology.
 - **Fiscal Capacity and Local Share:** While the State Plan provides that NYC will cover 40 percent of the costs, financial problems plaguing Buffalo, Rochester and other high need school districts may impact the availability of local funds to close the gap.

22

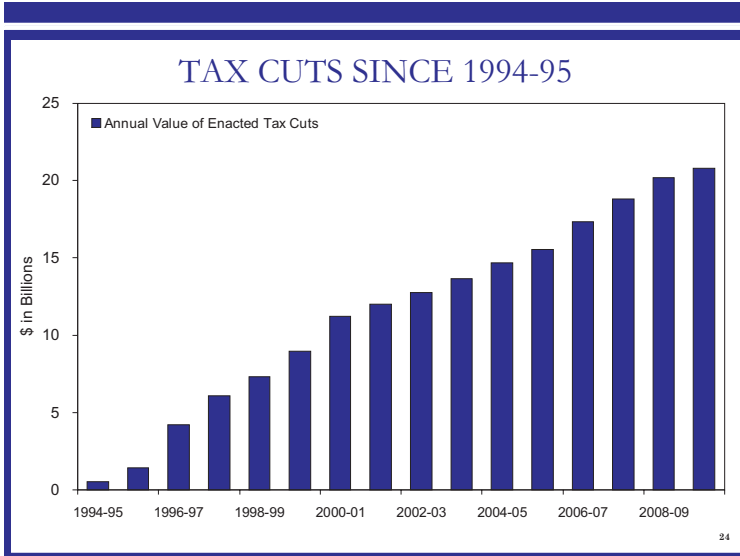
This is the Governor Pataki's current plan for a sound, basic education focused primarily on New York City: \$4.7 billion for New York City, and the rest of the state \$3.3 billion — a total of an \$8 billion plan. It relies on \$2 billion from video lottery terminals (VLTs) when the plan is fully phased in. To get the \$2 billion, aside from finally getting Aqueduct moving, the plan contemplates expansion of the number of existing video lottery terminal plans. So if we think these numbers are inadequate, we haven't yet come up with a device to make this number work. This \$2.5 billion is simply \$500 million worth of school aid increases a year. Those are reflected in the out years of the state's financial plan. And just a comment about VLTs. In the plan, we now believe we won't have revenue in 2007-08 from Aqueduct. And so at the midyear, what we've done, because it is the governor's commitment to fund sound basic education, we have put about \$250 million of general fund money behind the sound basic education plan to make sure that it's fully financed at about \$1 billion in 2007-08. Federal money is \$2 billion. As you saw in the earlier chart, No Child Left Behind is really flat. We're not seeing the growth that was envisioned when this program was presented. No matter what you think about sound basic education, even this program that Governor Pataki has proposed and is in the process of implementing still has some financial stress before it fully matures, and some political stress in terms of things like expanding VLTs. The good news is the money is coming in.



You can see through our forecast period, we're looking for some steady growth in the state's revenues. We've seen this sort of dramatic increase. Some of this increase is the temporary income tax. You can see that the growth plateaus out a little bit as that phases out. But you can see our view is that the economy is going to slow down, but as is

usual, there is a disconnect between the state's economy and the state's revenue. Many of you in this room have heard this statistic before, that four-tenths of one percent of the state's taxpayers provide us with anywhere from 20 to 33 percent of our income tax revenue. That's 45,000 of our 5.8 million taxpayers who, in really good years, account for a third of all the money we take in. I could make an argument that if you wanted to do effective modeling of revenue in New York, it would be this model, the top one percent of taxpayers, and you'd probably come pretty close. So there are a lot of issues, a lot of moving pieces, a lot of vulnerability in that number. What's happening in the current year, reflected in the media report, is we've got about a \$300 million increase in the income tax. That's because our estimated tax payments — and we have three of the four estimated tax payments for the year already in the door — are running stronger than we anticipated. That reflects nonwage income. So property and stock market capital gains, other kinds of nonwage income, seem to be pretty strong. For next year, we believe that some of that strength will be reflected and will be called the income tax settlement, which is the April 15 tax payments. That number will also increase by about \$250 million, so we've moved that base forward. So what the midyear is saying about the income tax is about \$300 million more this year, about \$550 million in each of the out years basically because of capital gains and other nonwage income strength.

Tax cuts continue to phase in (see chart on the next page). There were a number of new tax cuts enacted last year, or in the current year, that are going to phase-in in the out years. This puts a marked damper on revenue growth and will be an issue in terms of a new administration's desire to use baseline revenue growth to finance a change in directions on the program side. You're going to have to confront the fact that \$700 million worth of



childcare credit is already on the books and phases in starting January 1, etc. On our website, we've got a list of all the taxes that are phasing in.

We've got a chart in here that's probably better to illustrate that. You can see what's phasing in. There's the increase in STAR. What's happening here is that STAR

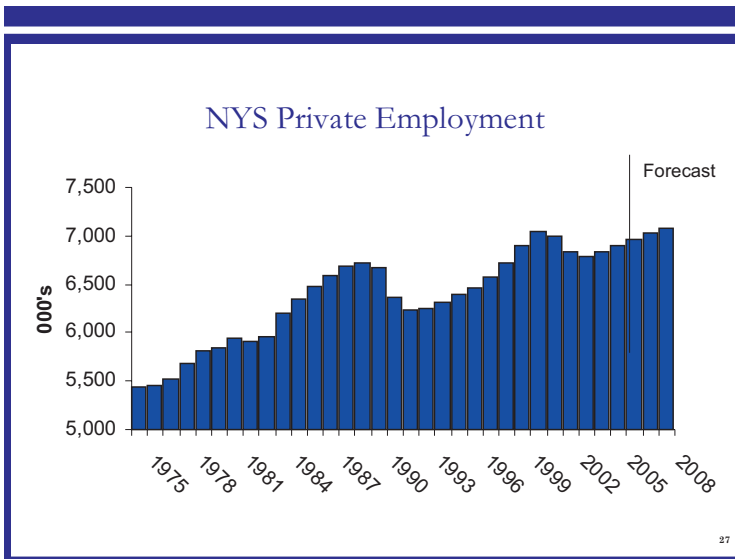
changes from a rebate check and drops up into this category of a tax credit. And there is this year-skipping phenomenon in the current STAR rebate. This year we pay it as a rebate, so it's a current year disbursement. Starting next year, it's a tax credit. Most of that tax credit comes out of revenue in April 15, so it really affects the income tax settlement in the 2008-09 year. There's piece of enhancement for New York City that kicks in next year. But most of the cost of the STAR rebate program skips from here to here and doesn't really land anywhere next year. The other big metrics that you can see: sales tax on clothing kicked in this year; child credit, as I said, 625 and levels off at 600; the cap on the tax on gasoline

NET TAX ACTIONS PASSED IN 2006-07

(Millions of Dollars)

State Fiscal Year	2006-07	2007-08	2008-09
Personal Income Tax	(76)	(720)	(1,403)
- Child Credit	(75)	(625)	(600)
- Property Tax Credit	0	0	(675)
- All Other PIT	(1)	(95)	(129)
STAR	(745)	(293)	(293)
- Rebate	(675)	0	0
- NYC STAR	2	(213)	(213)
- All Other STAR	(72)	(80)	(80)
User Taxes & Fees	(756)	(207)	(207)
- Sales Tax on Clothing	(608)	0	0
- Cap on Tax of Gasoline	(108)	(127)	(127)
- All Other User	(40)	(80)	(80)
Business Taxes	(90)	(113)	(134)
- S-Corporation Differential Rate	(40)	(40)	(40)
- Empire Zones Significant Capital Investment	0	0	(33)
- Film Production Credit	(35)	(35)	(35)
- All Other Business	(15)	(38)	(26)
Other Taxes	(4)	(2)	(2)
TOTAL	(1,671)	(1,334)	(2,038)

going across. There are a variety of other moving pieces. Here's the New York City STAR piece that I spoke of: about \$213 million. By the time you get out to 2008-09, you've got \$300 million plus nominally \$700 million — about \$1 billion in new STAR enhancements. That's what you saw on that earlier chart.



In terms of employment, we carried this out a little bit. I think this is only out to 2008-09. You can see that we have recovered the pre-9/11 peak in employment. Other states, like Ohio and Michigan, are not so lucky. We continue to see employment growth in New York from between three-quarters of a percent and one percent employment growth

per year, and personal income growth in the range of between 5 and 6.5 percent per year. So for New York, this is reasonably healthy economic growth, but certainly not gangbusters that you find in some of the other areas of the country. Here's just something that shows a little bit more about New York City private employment. You can see in our forecast period, that those sort of steady, nominally one percent growth per year numbers. You can see right in here is where we've recovered pre-9/11 peak.

CURRENT YEAR RESULTS ARE FAVORABLE . . .

- ❑ Surplus of \$1 billion projected for current year.
- ❑ Fourth consecutive surplus following emergence from 9/11.
- ❑ If projections hold, general reserves will total \$3.1 billion (6 percent of spending) at the end of 2006-07.
 - \$1.0 billion surplus in 2006-07.
 - \$1.0 billion rainy day reserve (after \$81 million deposit in 2006-07).
 - \$.8 billion in reserves carried forward from 2005-06.
 - \$.3 billion for prior legislative/gubernatorial initiatives.
- ❑ Revenues may further exceed expectations -- but "upside potential" must be balanced against immediate risks.
 - Payment agreement with New York City (\$450 million annually).
 - Federal School Supportive Health Services audits (\$500 million).

In terms of the current year, things are not looking too bad. We have a billion dollar surplus, the fourth year in a row we've had a surplus since 9/11. Reserves are at \$3.1 billion. You can see here how the reserves lay out. There is some upside potential in the numbers. There's also vulnerability in the numbers.

... BUT THE STRUCTURAL IMBALANCE PERSISTS

- ❑ Before application of any reserves, gaps would total \$3.5 billion in 2007-08 growing to \$4.7 billion in 2008-09.
- ❑ For planning purposes, current Financial Plan shows a total of \$1.3 billion in general reserves used for budget-balancing purposes.
 - \$1 billion in 2007-08, leaving a gap of \$2.5 billion.
 - \$255 million in 2008-09, leaving a gap of \$4.5 billion.
- ❑ One of the first key choices for a new administration is how much in reserves to hold as a hedge against risks and how much, if any, should be used to close the gaps.

29

In terms of revenue, there is some modest upside potential in the income tax. In terms of business taxes, there's some modest downside potential in the current year. I think the risks balance each other out. Going forward, I think we should watch the personal income tax and what happens in the broader economy, what happens to capital gains and

those 45,000 who are not rich; they're wealthy. The wealthy people — what happens to them and what happens to corporate profits; what happens to corporate audit revenue; what happens to real estate transfer tax. It used to be a \$200 million item for us. It's currently \$850 in the current year and in the base going forward. As the real estate market starts to cool, does that pose a vulnerability? But the gaps are still a lot better than we thought. The state comptroller likes to look at these rates and forget about the reserves. They can be used on a one-time basis to balance the budget. You're still looking at gaps of \$3.5 billion and \$4.7 billion in the financial plan. For planning purposes, the financial plan shows using \$1.3 billion of the \$3.1 in reserves for budget balance next year, clearly a policy choice for the incoming governor. That will be one of the things; how much do you want to hold in reserve, how much of the reserve do you want to use, and what do you think your revenue and spending vulnerabilities are going forward? In addition, there are a couple of things that

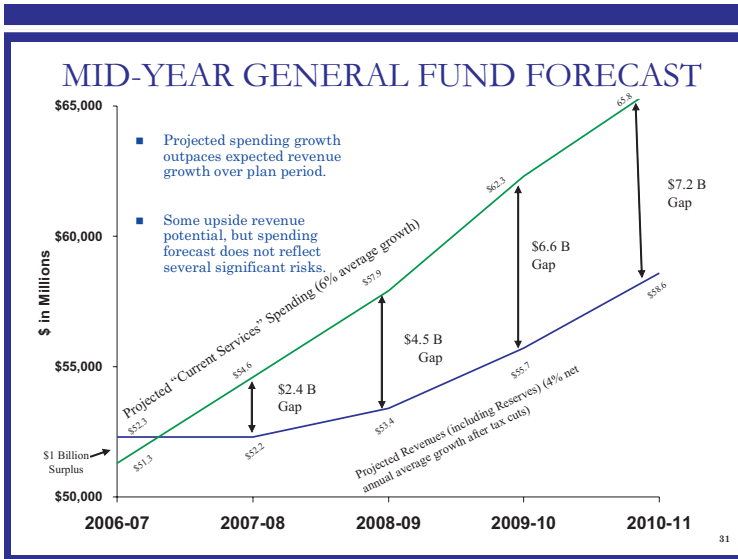
2007-08 PROJECTIONS

- ❑ Revenues from 2006-07 to 2007-08 are projected to remain flat.
 - Healthy "constant law" growth is fully offset by growth in tax reductions, phase-out of PIT surcharge, increase in debt service, and loss of one-time resources.
 - Any upside potential must be weighed against long-term risks, including an economic slowdown, Federal aid reductions, and transaction risks.
- ❑ General Fund disbursements are projected to grow by \$3.3 billion.
 - Over 95 percent of the growth is in local assistance – which consists of direct aid to schools and localities, and payments to individuals and providers.
 - Medicaid and School Aid alone account for over 70 percent of the annual growth (they comprise roughly 50 percent of total General Fund spending).
 - State Operations is up by \$254 million, reflecting personal service growth (\$90 million) and NPS growth (\$164 million).
- ❑ Gaps do not include HCRA shortfalls, new labor contracts, initiatives of the new administration, or a range of budgetary risks.

30

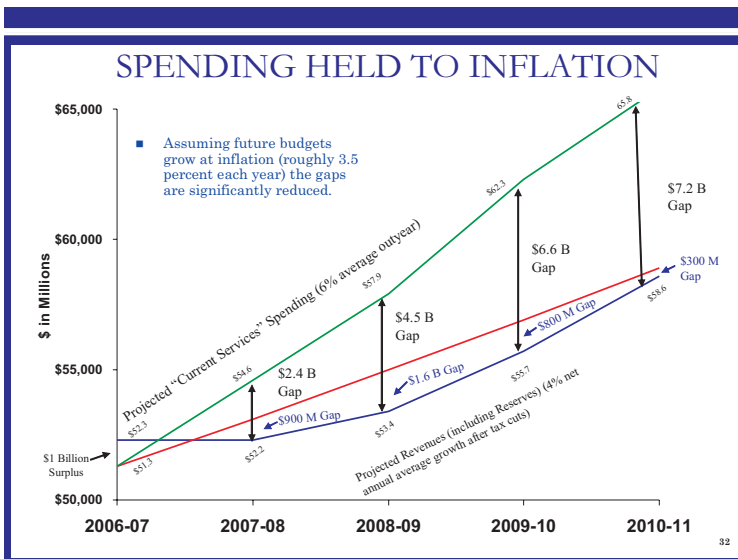
aren't on this chart. There's over a \$400 million shortfall in HCRA (Health Care Reform Act) next year. It gets worse in the out years. HCRA is about a billion dollars out of balance. It spends a billion dollars a year more than it takes in. The way that HCRA has continued to function is because it had a huge surplus that we've been incrementally

running down. At some point next year, we'll cross over into a deficit condition in HCRA of about \$400 million. But then it just keeps going down.



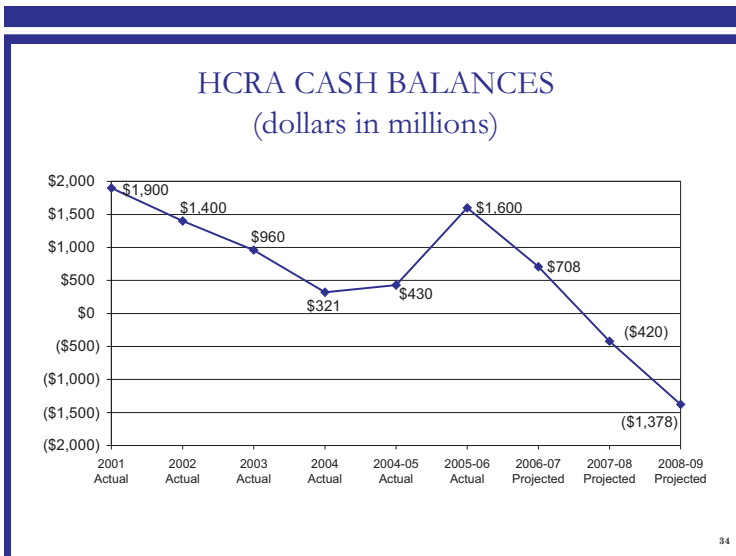
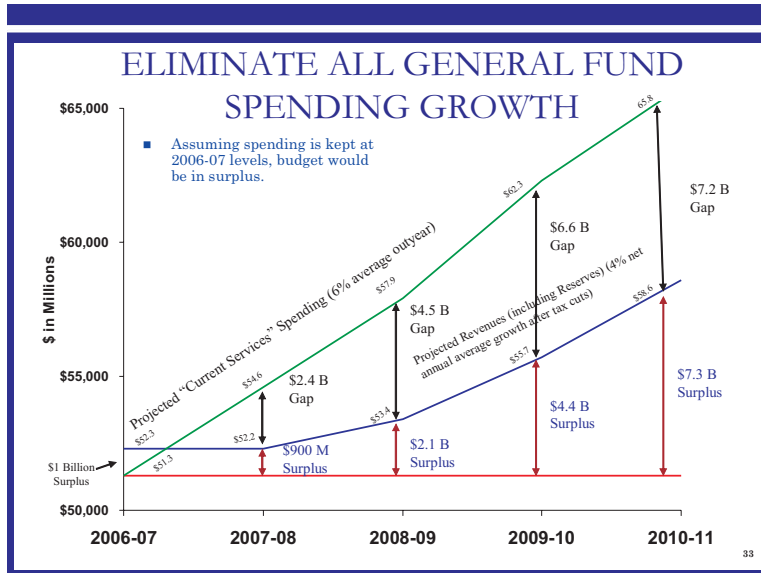
We call these the “Jaws charts.” This is what causes the gaps, and this is what the gaps look like up to 2010-11; \$7.2 billion. The green line is current services spending, which runs between 6 and 7 percent. That’s what’s in our baseline assumptions. The blue line is our projected revenue growth, which is about, after the tax cut stays in,

4 percent. So it’s real simple math. There’s about a 2 to 3 percent structural imbalance here that moves up.



What happens if we hold spending at the rate of inflation. That’s the red line. Not so bad. Sounds good, unless you’re one of the people that’s funded up here. Do you want to volunteer to give up half a billion dollars on behalf of the home-care industry? No? Thought I’d ask. So that’s the problem. Spending restraint can do a lot.

It’s easy for us to say, and I say it all the time, but the devil’s in the details and there are a whole lot of details in this white space. We’d be rolling in money with a \$7.3 billion surplus if we didn’t spend a penny more for the next four years than we’re spending in the current year (see chart on the next page). The likelihood that this will happen? Not gonna happen.

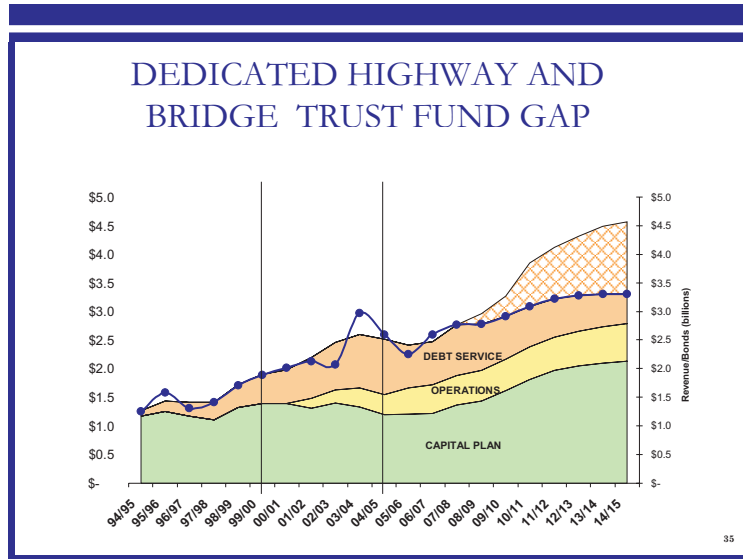


This is the HCRA cash balance chart. HCRA is out of balance by about \$2 billion by the end of the next administration's first term. Basically, it has a structural imbalance of about \$1 billion. What causes that structural imbalance? There is about \$1 billion worth of "vanilla" Medicaid that is currently financed by HCRA. There's another billion dollars of

erstwhile state programs (Child Health Plus, Family Health Plus, Epic) that are paid for in HCRA. So in a 70,000-foot level view for the next administration, this is really part of your general fund gap that you're going to have to deal with in some way or another, and it's really simple. This is why you don't have to be really smart to be budget director. You can either raise the bridge or lower the river. You can either raise more money or you can cut spending, or you can move programs back to the general fund and then have a bigger problem there and a lesser problem here. In my point of view it doesn't matter. Editorial note: this is just me talking, I don't know that HCRA makes any sense any more. Having these three-year reauthorizations ... HCRA is up for authorization next July. I've got to be a little bit careful because I don't want to get fired prematurely. HCRA is just another special

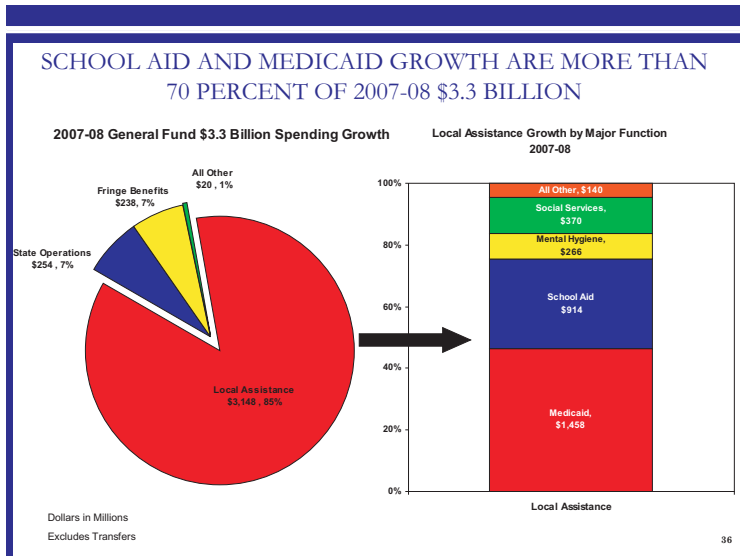
revenue account, like the Environmental Protection Fund and a bunch of others. I don't know that about this whole "let's just pretend it only lasts for three years." It's on budget now, who are we kidding? And I would hope that the next administration would see it that way, plug it into the budget, plug it into their fiscal metrics, and say, "This is what we're paying for health care and this is how we're going to fund it." That's my speech on HCRA.

Here's another interesting challenge coming up: highways. This is a phenomenon going on nationwide and I won't get sidetracked by talking a little bit about what's happening in the federal highway trust fund. It's coming up to a cash crunch. Congress just cannot manage to do anything about it. As you know, in Washington there are pros and cons; *progress* and *Congress*. Okay, so stand-up comedian is not going to be working out as my new theme for me.



This is the funding gap that the next administration is going to have to deal with. Why? It goes way beyond them, but you can see some of this gap is opening up. In the next plan that they have to do, there is going to be some need for additional revenues as the debt service and the projected program levels for highways, roads, and bridges outstrip the ability of the current set of dedicated taxes to finance them. Part of this metric occurs because of the high price of gasoline. Unlike the sales tax that was the subject of much debate this year capping the rate, most highway taxes are on a per-gallon basis. We've got price elasticity. As the price rises, consumption falls. All things being equal, if we didn't have a cap, that would be sales-tax positive for us. On the dedicated highway funds that are charged per gallon, you've seen some of those revenues drop off. And you can see these revenues flattening out in here, and part of that is part of the reason.

So \$3.3 billion, let's just cut that (see chart on the next page). Not so bad. We're all set. Next governor, John Faso, Eliot Spitzer. Piece of cake. Here's the problem. This big orange thing that was purple yesterday and I said I thought orange would look better and now you



can't read it; it says "local assistance." It's the majority of it. This blue slice is state operations. This yellow slice is fringe benefits. Somebody asked Willie Sutton once why he robbed banks, and he said, "That's where the money is." This is where the money is. Medicaid: a billion and a half in growth, school aid: \$914 million, mental health: \$266

million. Social services, that's mostly Office of Temporary & Disability Assistance (OTBA) and Office of Children & Family Services (OCFS) programs and other things and stuff: 140 million. The majority of this is in our meat and potatoes, human services entitlement programs. Very difficult to cut the growth, that level of growth, where it lies. So that means whoever becomes governor is likely to have to employ a broader strategy to look at the government overall. "Surplus Mirage" was ripped from the headlines of today's *Times Union*. It quotes E.J. McMahon making the point that having a surplus going into a

Surplus mirage

New York's budget might look healthy, but there's an urgent need for reforms

First published: Times Union Editorial - Wednesday, November 1, 2006

Oh, no, not a surplus. Not now, not when a new governor is about to take office and could seize upon a time of public good will to make the reforms that remain critically necessary.

It's fortunate, of course, that the state's fiscal health isn't worse. A surplus of \$1.1 billion, which the Pataki administration reported on Monday, is obviously better than a 10-figure deficit. The danger is that come January, the governor and the Legislature might be lulled into a sense of complacency. It's happened more than once before.

The warning of E.J. McMahon of the Manhattan Institute's Empire Center for New York State Policy is well worth remembering. "Big change happens in this state when there is a crisis, or the perception of a crisis," he says. "It will be harder now for the next governor to convince the public there is a crisis."

It helps, surely, that both Eliot Spitzer and John Faso insist they can see well beyond what at first looks like a quite promising state budget picture. Next year's forecast is for a \$2.4 billion deficit. A \$4.5 billion deficit is anticipated for the year after that.

Whether it's Mr. Spitzer or Mr. Faso who's governor next January, the pressing challenge will be to get spending under control. For too long, the yearly increases in the state budget have been considerably higher than the annual rate of inflation. In just 12 years, the overall state budget has increased by about two-thirds.

Even more urgent will be the need to reduce New York's alarmingly high level of debt. The Citizens Budget Commission, a Manhattan-based watchdog group, estimates that a 20 percent reduction -- from just under \$50 billion to about \$40 billion -- is necessary just to get New York out of the crisis stage.

It's telling that the Pataki administration says the projected deficits for the next two years are modest ones. They'll also be the problems of a new state government. It's not very hard for state budget officials to suggest the deficits can be eliminated, or at least controlled, through sound fiscal management, rather than substantial budget cuts or layoffs.

It's also very telling that the Pataki administration makes a point of saying New York's finances are better off than they were when it took office 12 years ago. The truth is that's not saying so much. The next administration has to do even better, and might start by seeing the surplus, for now, as something closer to a mirage.

37

changing season is probably not a good thing. I would agree with E.J., but with the following caveat, which is a surplus is either a blessing or a curse depending on how you use it. A surplus gives you time. It's a blessing because it gives you the time to ramp in changes in government direction. You don't have to do the "we need to do this immediately; it has to start fully effective on April 1st in order for us to get the kind of money we need to balance the financial plan." A surplus can give you a little bit of a cushion. The curse is that a surplus can give you a great excuse to avoid the hard work you have to do to effect reforms and fiscal restraint over the long term. So whether it's a blessing or a curse is in how the surplus is perceived and used, not in the surplus itself.

Let me close with a quick story. Half a decade ago, Oliver Brown had a problem. His daughter went to the all-black segregated school in the Kansas town where he lived, but that wasn't the problem. That was just the way things were. The problem was that the school was on the other side of a wide set of railroad tracks in the town, and every morning Oliver watched in horror as his little daughter picked her way across those railroad tracks with freight trains moving in each direction. So he went to the school board and he said, "Can I get a bus to take my daughter to the all-black school? There's not a bridge that she can walk over for a mile in either direction." The school board said no. So as he's walking home, dejected, Oliver walks by a storefront legal services operation that's set up in an abandoned dime store downtown. He goes in and tells his plight to a young civil rights attorney, who has to tell him, "No, I'm sorry. The school board is within its rights to deny you a school bus." And Oliver Brown is dejected. But then the young lawyer says, "But if you were to sue the school district, demanding that your daughter be allowed to go to the all-white school that's on your side of the railroad tracks, maybe they'd settle for a bus." Oliver's desperate. He's willing to try anything. He agrees. On an old Olivetti typewriter that the local newspaper threw out, the complaint is drawn up. He signs it. He feels a lot better. He goes home to his daughter, and the rest, as they say, is history. Because the little Kansas town that he lived in was Topeka, and that young civil rights attorney was Thurgood Marshall. We all know the end of this story. Oliver Brown never got his school bus, but four years later in the case of *Brown v. The Topeka Board of Education*, Oliver Brown changed the course of American history forever and for the better. And that happened for one reason; because Thurgood Marshall knew one thing that the next administration needs to know. The opportunity to change the human condition, the opportunity to change the course of government for the better is where you find it. It's not in big speeches, flashy campaigns, big halls filled with bunting; it's where you find it every single day and make the most of those opportunities. Whichever government takes over next week and on January 1st, if

they adhere to that one principle, New York State will be in much better condition when they leave it than it is today, the same way it's in much better condition now than when Governor Cuomo left it to us 12 years ago. Thank you.

John Cape:

Questions? I should have read the midyear. Any questions? Bless you, Sandra.

Sandra Shapard:

I really want to ask you about the Berger Commission on hospitals. Will you update us on where that is and the possibility or probability is of the state being able to access the federal money for restructuring the two and a half billion that's potentially available?

John Cape:

It's \$1.5 billion over five years. It's a good question. I don't know a lot about that. Sandra's question is what's happening with the Berger Commission, the Commission on Health Care in the 21st Century set up by the governor and the Legislature that is going to report by the end of November on hospital and nursing home closures and restructuring. It's a base-closing style commission. The Legislature gets one vote up or down on the whole package. They can either accept it or reject it in its entirety. If the Legislature doesn't vote, it goes into effect. I haven't been directly involved. The Budget Division hasn't been directly involved, other than providing some technical assistance on how to cost out the costs and savings from the Berger Commission, so I don't know a lot of the specifics about what they're going to recommend. The out year of the state's financial plan currently doesn't contemplate any savings from hospital restructuring. There clearly will be savings, but until the Berger Commission comes out and we see how the Legislature deals with it, it doesn't meet our standards for being able to book savings against that. So it will be one of the potential positives or negatives, depending on whether the initial effort at restructuring is a cost or a savings. That will go into the financial plan once those decisions are made.

Sandra referred to what we like to call F sharp, which is a federal matching program that will provide essentially 50 percent match for new restructuring efforts going forward. So while it's a spend-to-get kind of program, where you have to spend a new dollar to get a new federal dollar, it doesn't present, in and of itself, savings opportunities. What it does do

is present a booster rocket for new healthcare initiatives aimed at restructuring and downsizing and making a more efficient healthcare system. How all of that gets integrated into the next budget is going to be a major challenge for both the governor-elect and the new governor and one that's going to really heavily depend on how the Legislature deals with the Berger Commission. So that's one where we have to stay tuned.

Brian Stenson:

In the past couple of years, New York and many of the states have seen rapid increases in Medicaid, which was on everybody's hot priority list. But now in the past year, we've seen a slowing of the growth rate. It's not a decline, but slower growth. I'm just curious about your thoughts about whether that's going to set the stage or the tone for the next several years or is it just temporary?

John Cape:

The answer is it is doing that. After about 20 years, we're finally getting a break in Medicaid. In New York, we're assuming that the underlying Medicaid program grows by about 3.8 percent this year. That's a very low number. And here are the reasons why: There's savings in the plan for Medicaid at midyear. Those savings come from three components, but really one. What's driving savings in the financial plan for Medicaid is the fact that now that all of the numbers are in and crunched, the base year for the Medicaid cap, which is county fiscal year, that is calendar year 2005, was lower than we had expected. So all of the numbers for the Medicaid cap, both at the county level, depending on the numbers they budgeted, and at the state level come down. The rate of growth hasn't changed, but those numbers come down and that's the principal thing that's driving savings in the Medicaid program in the out years as well as in the current year.

In addition, we had expected to see an acceleration in enrollment for Family Health Plus. With the state takeover of Family Health Plus now complete, I was concerned that local governments, no longer having a fiscal stake in it, would aggressively market this program. We haven't seen that. As a matter of fact, Family Health Plus is relatively flat. That accounts for about \$100 million worth of savings this year and a little bit in the out years.

The third area in the current year that migrates a little bit into the out years is drugs. As you know, Medicare Part B phased in nationally on January 1st of last year. New York is the only state in the nation that has a wraparound, which means if the federal government under Medicare Part B won't pay for a drug and you are what is known as a dual eligible, which means by virtue of your age you're eligible for Medicare, and by virtue of your income level, you're eligible for Medicaid, you can get Medicaid to pay for that drug. Under the budget enacted this year, that program changes January 1, 2007. We were pretty conservative about how many people would continue to rely upon the wraparound and have been pleasantly surprised. There have been more drug costs that have migrated off of state Medicaid this year than we thought, and that's because while the dual eligible population is only a component of the Medicaid population, it's a component that is a high user of prescription drugs, especially high-end multiple-type prescription drugs. There are certain things that remain to be funded under a wraparound: organ transplant, antiretrovirals as they're known, atypical antipsychotics, which I'm certainly going to go on sooner or later, and other kinds of drugs like that remain in the wraparound. But for the most part, we've seen a decent migration from Medicaid to Medicare, and that's generating some savings in the current year. Nothing in the out years because the wraparound ends on January 1st.

Overall, this is a national phenomenon. As I talk to my fellow state budget directors, Medicaid is flat or actually in decline in most states around the nation, and it has to do with a variety of factors. In New York, it's probably the maturing of the managed-care system in New York. Managed care has peaked in New York with about 2 million individuals currently covered by managed care. We are starting to penetrate some of what are known as carve-out populations. When we implemented managed care about eight years ago, there were a couple of restrictions in it. There were major groups that were carved out of it; people on SSI, HIV/AIDS individuals, seriously and persistently mentally ill individuals, etc. Those are some of the big populations. We're starting to make some inroads into those populations in terms of managed care on a voluntary basis. We're starting to make some inroads into those populations on a mandatory basis as a result of actions that were taken this year. We're starting to move SSI people into managed care, and we're also moving the seriously and persistently mentally ill individuals into managed care for healthcare services. We're not instituting managed care for their mental health services, and that is going to be a question whether the next administration likes this direction and wants to continue going there or not. A policy issue that's got to develop in this area is the old problem that we always have in Medicaid, which is how much you pay the provider versus if you don't increase payments to the provider, they'll drop out of the program and you

won't have enough coverage. In the years going forward, there's going to be that same paradox but it's going to revolve around the managed care companies. We've all heard, "Oh, my God, there are managed care companies in New York City that are ripping off the state and making a big profit." There are managed care companies that are struggling and threatening to drop out of the program in other parts of the state. How we look to the managed care sector and its increasing cost as a component of the Medicaid delivery system in the future is going to be a balancing act for the next administration and one that, because of the dramatic improvement in costs, the managed care that's broadest is one that has to be dealt with delicately.

Don Boyd:

Do you think the disclosure of retiring healthcare costs is going to create real pressure to either fund the costs or use benefits, or is New York more likely to just ignore it?

John Cape:

I'm tempted to say it depends on who's comptroller. And for New York, depending on the actuarial assumptions you use, it's anywhere from \$47 to \$54 billion. That's a big number. It means that the general state charges, the portion of our budget that pays for the fringe benefits of current and retired employees, is going to do nothing but go up. Right now, the state works on a cash basis of accounting. We work on a cash budget. We provide pay-as-you-go for these services, and that means that some of the general state charges for retired employees are going to continue to increase every year for as far as the eye can see. If you pay on a pay-as-you-go basis, we can continue to meet that obligation. Exactly how the next administration chooses to treat that is going to be their policy choice. Right now, we don't have anything other than the normal pay-as-you-go costs built into the out years of the state's financial plan.

Robert Ward:

Getting back to Medicaid, from an uninformed outsider's perspective, it seems that relatively little is being done in terms of data mining. At one point, there was some excitement and discussion about some action that had been taken, but we can all agree that there is the possibility for significantly more savings to be accomplished with that and what, if anything, do you see happening?

John Cape:

The answer to that is yes. As you know, this year we established the Office of the Medicaid Inspector General. There's always a slowdown while we get an organization together. We have a new system. A few years ago, we replaced the NMIS system with something called eMedNY that is a very powerful data mining tool, and we're already starting to use it. The inspector general is starting to use it. Our current audit target for Medicaid has gone from \$150 million last year to \$300 million this year. Next year, it goes to about \$400 million. The year after that it goes to in excess of \$500 million. So we are counting on the data mining ability of eMedNY and the enforcement ability of a Medicaid inspector general to generate significant cost containment over the next few years.

Robert Ward:

Although actually I didn't mention it, I was kind of pointing the finger at localities as much as the state. Should the counties and New York City be doing that?

John Cape:

Right. I think New York City does a good job with this. The state is the payer on Medicaid, but that doesn't mean that there isn't an administrative role for counties. And I would say the best county out there right now is Chemung. Chemung County and their county executive have a number of very powerful data mining tools that they're using to do some really exciting things down there. It's clearly the wave of the future. It's what managed-care companies and health insurance companies live or die by now, and it's what the state needs to do more of, and Bob, I think you make a good point that localities certainly have a role in that. And how you integrate all of that is going to be an issue for the next administration.

Another issue related to that is whether or not the state will take over the local administration of Medicaid in 2008. In 2008, the Medicaid cap program matures at the 3 percent level. Localities have an opportunity to pledge their sales tax in that amount or to stay at the 3 percent cap level. It is the year when the state has the ability to take over the local administration of Medicaid, so that's going to be an issue that doesn't turn on a dime. It's going to take a good year of planning to get ready for. So that's going to be a long-lead policy issue that whoever the next administration is needs to look at starting this year.

Richard Nathan:

As we look at managing the budget process and the fiscal process procedures in the state, there is a lot of talk about debt reform. What about authority debt reform and what about authorities? What can you say to us about what you think could happen or is needed in both those areas?

John Cape:

I think both of them are going to be subjects for the next administration. There is a debt reform statute in place. Governor Pataki has proposed a constitutional amendment on debt reform a couple of times and has not been able to achieve that. We'll see what the next administration thinks about that. As you saw, our debt profile is kicking up a little bit. It's still obviously under the debt cap, which means one of two things — either the debt growth isn't so bad or the debt cap is too high, and that's a matter for people to make judgments. I personally believe we need a good, solid debt reform constitutional amendment that straightens out a lot of our debt practices.

The second part of Dick's question has to do with public authorities and public authority oversight. That's an area that I think is going to be fertile for some action this year. There is, as a result of legislation passed two years ago, an authority budget office that is in place. It is for housekeeping purposes under the Budget Division, but it's a separate office, a separate organization. It's in a separate building. It is just starting to ramp up. It has been buffeted by the political winds from all sides. There is a commission headed by Ira Millstein that reported on a lot of public authority oversight reforms that they felt they wanted to achieve, and that the public authority budget office needed to be strengthened to do that. Comptroller Hevesi has had a lot of concerns and is doing a lot in his own right about public authorities and the management and fiscal integrity of those organizations. Each house of the Legislature has its own particular point of view about public authorities. This is not only state public authorities, but local public authorities, where there are two things on every street corner: an IDA and a Mobil gas station. I'm wondering whether we've got more local development corporations than we do McDonald's in this state. So there's a proliferation of debt-issuing kinds of organizations out there that need some organization, management, oversight, and direction, and probably some consolidation. How exactly the next governor chooses to approach that, I don't know, and I think the two candidates would have very different philosophies about it. What the relationship between the new executive and the

comptroller will be, I think it remains to be seen, and how the Legislature reacts to whatever initiative is put forward is also a wild card at this point. It's something I think both the governor and the Legislature realize had to be done and started to do, but then there hasn't been the normal carry-through that needs to be done, and so it's sort of unfinished business that I think should be on the next administration's first-year agenda.

Is there anything else? If not, I'd just like to thank you all for coming and take this one last opportunity to thank the 350 men and women of the Budget Division. They are incredibly talented and conscientious and care deeply about all of these issues and are the reason why I can stand up here and look like I know what I'm talking about. They're terrific people. There are none better and they are people I'm going to miss. So thank you very much. I appreciate it.