

# Balancing the New York State Budget in an Economically Sensible Manner



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Like virtually all of the other states in the United States, New York continues to face its greatest revenue shortfalls since the Great Depression of the 1930s. State government revenues have literally fallen off a cliff. In January 2008, for example, the New York State Division of the Budget (DOB) was projecting that state income tax revenues during the 2010-2011 state fiscal year would be an estimated \$44.5 billion. In the Governor's January 19, 2010, Executive Budget, DOB's projection of income tax revenues for the 2010-2011 state fiscal year had fallen by \$7.3 billion to \$37.1 billion. But \$4.8 billion of that projected total was attributed by DOB to the temporary Personal Income Tax (PIT) rate increases that had been enacted last April for single individuals with taxable income above \$200,000 and married couples filing joint returns with taxable incomes over \$300,000.

If it were not for those temporary rate increases, projected PIT revenues for 2010-2011 would be only \$31.655 billion or \$12.8 billion less than what had been expected for this upcoming fiscal year just two years ago. That means that, in January 2010, DOB's economists believed that PIT revenues for the upcoming state fiscal year would be virtually 29 percent less than they thought just two years ago. The U.S. economy has literally changed in ways that were not conceivable two years ago.

While the situation is bad, it could get worse. On February 3, 2010, Governor Paterson announced that because of lower than expected personal income tax collections during January 2010, his budget experts were now projecting that "the overall net financial impact of these lower than anticipated personal income tax collections is expected to total \$550 million through the end of 2010-11." In response to that announcement by Governor Paterson, Assembly Speaker Sheldon Silver, with decades of experience on the front lines of state budget negotiations, indicated that the situation could be even worse: "These two-week revisions strongly suggest that the Governor's initial budget submission did not present an accurate picture of the state's finances. Furthermore, the revenue projections still do not accurately reflect the real shortfall in January receipts, or realistic expectations regarding revenues in February and March.

To meet the Governor's new estimates, revenues in February and March would need to grow by 37 percent over last year. This level of increase appears to be highly unlikely, as revenue growth in the first ten months of the 2009-2010 fiscal year has been flat or declined slightly in comparison to the previous year."

As a result of this incredible revenue fall-off, the 2010-2011 Executive Budget projected that New York State would face a \$7.4 billion current services budget gap during 2010-2011. According to the Executive Budget, \$692 million of that gap would be covered by the recurring value of savings actions that were included in the Deficit Reduction Plan (DRP) that the Governor and the Legislature agreed to in December 2009. After accounting for that \$682 million in savings, the Governor called for a \$6.7 billion gap-closing plan of which \$4.87 billion or 72.4 percent would come from cuts in state operations (\$1.2 billion) and local assistance (\$3.6 billion). In the Governor's January 19, 2010 plan, only \$1.070 billion

of the gap closing would come from revenue actions but about 20 percent of those revenue actions (\$216 million) would be in the form of increases in Medicaid Provider Assessments. The Governor's February 3, 2010, announcement indicated that the projected budget gap for 2010-2011 would grow from \$7.4 billion to \$8.2 billion.

On February 9, 2010, the Governor officially submitted his 21 Day Amendments. The financial plan that he submitted with the 21 Day Amendments increased the projected budget gap to the \$8.2 billion figure that he had cited on February 3, 2010. The additional gap closing actions included in the 21 Day Amendments relied almost entirely on the six-month extension (from December 31, 2010, to June 30, 2011) of the enhanced federal share of state Medicaid costs that President Obama had recommended in his FY 2011 federal budget. While the U.S. House of Representatives has included such a six-month extension in two different bills that it passed in 2009, the U.S. Senate has not yet adopted such an extension. This extension is important not only to New York but to all the states, and is therefore something that New York's labor, business, government and civic leaders should be urging the U.S. Senate to move on as soon as possible.

The Governor's 2010-2011 gap closing plan is very similar to (1) the budget balancing plans recommended by the Governor and adopted by the Legislature in the early 1990s; (2) the budget balancing plan submitted by Governor Pataki in 2003 but which, fortunately for the state's economy, was modified by the Legislature in ways that facilitated the economic recovery that began in May 2003; and (3) Governor Paterson's initial budget balancing plan for the current state fiscal year which also, fortunately for the state's economy, was modified by the Legislature to be more balanced and more economically sensible.

Governor Paterson attempts to justify his policy choices by asserting a relationship among taxes, government spending and the economy that is inconsistent with basic economic principles, and by presenting a mythical and incorrect rendition of New York State's economic history.

In proposing a budget balancing plan that relies so heavily on cuts in essential public services, the Governor does not acknowledge the harm that his proposed budget cuts could do to the state's economy. Nor does he present any economic impact analysis whatsoever of his gap closing plan, let alone of alternate plans.

In proposing so little in revenue raising and in proposing no progressive revenue increases, the Governor says that we tried tax increases last year and they didn't work. That ignores the fact that the 2009-2010 gap closing plan, even after being made more balanced by the Legislature, still relied more heavily on spending cuts than on revenue increases. More importantly, his assertion also ignores the point that the state governments generally are experiencing a fiscal problem that is not of their own making and which they can not remedy on their own.

### **How should New York State balance its budget during the current recession?**

In reality, neither tax increases nor service cuts are desirable during a recession. Both take demand out of the economy—making recessions longer and deeper, and making recovery

more difficult. But New York, like most other states, is required to balance its budget in both good times and bad.

So the states face a real dilemma during economic downturns—having to figure out what mix of spending cuts and tax increases will do the least harm. Ideally, during such periods, the federal government, which is not required to run balanced budgets and which is responsible in our governmental system for overall macroeconomic management, will assist the states with some form of counter-cyclical financial assistance.

But what are the states to do during economic downturns absent federal aid or sufficient federal aid to avoid spending cuts and/or tax increases? Columbia University economist Joseph Stiglitz, a winner of the Nobel Prize in Economics, and Peter Orszag, then of the Brookings Institution and now the director of the U.S. Office of Management and Budget, co-authored a 2001 paper on this subject.<sup>1</sup> In this paper Stiglitz and Orszag concluded that a temporary increase in the tax on the portions of income over some relatively high level is the least damaging mechanism for balancing state budgets during recessions.

On the other hand, they conclude that basic economic reasoning indicates that reductions in government spending on goods and services that are produced locally (like education and healthcare) and reductions in transfer payments to lower-income families are most damaging to the economy since they come closest to taking dollar for dollar out of the local economy. Increases in consumption taxes and fees will take more demand out of the economy than tax increases on the tax on the portion of income over some relatively high level but less demand than cuts in locally-produced goods and services or transfer payments to lower-income families.

### **The federal government and state budgets during recessions**

In their 2001 paper, Stiglitz and Orszag also concluded that it made eminent sense for the federal government to help the states to balance their budgets during recessions.

The federal government is responsible for the overall macroeconomic management of the U.S. economy. This is why, during recessions (which, by definition, are periods during which consumer and business spending is low, thus slowing the economy and creating a downward economic spiral) the federal government works to stimulate the economy by increasing spending and cutting taxes. This requires deficit spending, which the federal government can engage in, and which it should engage in during recessions.

But state governments have to balance their budgets in both good times and bad. To balance their budgets during recessions, states almost have to cut spending and/or increase taxes, thus putting more drag on the economy rather than less. This means that, left to their own resources, states have to do things during recessions that will cancel out some of the positive effects of the actions that the federal government is taking to foster job creation and retention and to get the economy moving again.

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<sup>1</sup> *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?* Revised November 6, 2001. <http://www.fiscalpolicy.org/10-30-01sfp.pdf>.

Since the federal government is responsible for overall macroeconomic management, it makes sense for the federal government to provide fiscal relief to the states during recessions to reduce the amount of budget cutting and tax increasing necessary at the state level. If the federal government doesn't help the states during recessions, then state budget-balancing actions will cancel out a greater portion of the positive impact of federal stimulus efforts.

We have two recent and successful examples of such efforts by the federal government—one under President Bush in 2003, and the other under President Obama in 2009.

In the winter and early spring of 2003, even though the recession had officially ended in November 2001, state governments throughout the nation were facing substantial shortfalls as they were working to develop and adopt budgets for their 2003-2004 state fiscal years. The 15 months of state budget relief (for the period from April 1, 2003 through June 30, 2005), that President Bush signed into law in May 2003, allowed the states to get back on their feet with much less in budget cuts and tax increases than would have otherwise been necessary.

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act (ARRA) into law. Of this package's total estimated cost of \$787 billion over several years, \$135 billion was explicitly for state fiscal relief in the form of (1) a temporary increase (until December 31, 2010) in the federal government's share of Medicaid costs (referred to as the Federal Medicaid Assistance Percentage or FMAP), and (2) a State Fiscal Stabilization Fund comprised primarily of federal aid designed to forestall a significant portion of the education budget cuts that were otherwise likely to occur throughout the nation. This state fiscal relief played a major role in allowing New York and the other states to balance their 2008-2009 and 2009-2010 budgets with fewer service cuts and fewer tax increases than would have been necessary otherwise. In New York's case, the Division of the Budget has estimated that this aid package provided New York State with \$6.15 billion of gap closing aid as the state worked to balance its 2008-2009 and 2009-2010 budgets by the beginning of April 2009. Given the continuing nature of the state governments' fiscal problems during the current Great Recession, it is essential that the President and Congress provide for an extension of the ARRA's state fiscal relief components so that the phase-out of this aid will dovetail more closely with the recovery of the 50 states' economies and finances.

### **Learning from experience: The Legislature's better choices (2003 and 2009)**

In May 2003, the legislature passed the Governor's budget bills but with significant changes from what the Governor had originally proposed. By then, the two-year budget gap had grown to \$12.6 billion, due to revenue and spending re-estimates. Despite the growth in the size of the gap, the Legislature adopted a much more balanced approach to balancing the state budget, relying more heavily on revenue increases than the Governor had originally recommended and reducing many of the spending cuts that had been recommended by the Governor.

Ten days after the original legislative passage of its budget package, the Governor vetoed the Legislature's bill to raise state taxes, authorize transitional borrowing and allocate school aid

and line-item vetoed 118 spending additions. Within 20 hours, the Legislature overrode every one of the Governor's vetoes on a bipartisan basis. The veto override votes were virtually unanimous in the Senate and overwhelming in the Assembly.

The Governor originally argued that the revenue increases enacted by the legislature would not cover all of its spending restorations. But, shortly thereafter, the Congress and President Bush adopted the significant but temporary “state fiscal relief package” discussed above. With this infusion of federal “budget balancing” aid, the Governor concluded that the 2003-2004 state budget, as adopted, was credibly balanced.

The budget package adopted by the Legislature in May 2003 avoided the extremes that had characterized the budget balancing packages of the early 1990s and the plan proposed by Governor Pataki in January 2003. The same happened in March and April of 2009 when the Legislature modified Governor Paterson’s budget plan to make it more economically sensible.

### **Does New York State have a spending problem or a revenue problem?**

Some critics like to say that New York State’s budget gap is proof that New York State has a “spending” problem and that state spending is growing faster than state revenues. Their implication is that New York State agencies are not managed well and that spending is out of control. But a careful analysis of changes in the state revenues and expenditures over the last 15 years shows that revenues would have grown faster than expenditures if the state had not enacted multi-year, back-loaded tax cuts plans annually from 1994 to 2000, and then again in 2006; and if the important new spending commitments that have been made since 1997—from the original STAR exemptions enacted in 1997 to the statewide solution to the court decisions in the Campaign for Fiscal Equity lawsuit—were accompanied by new revenues.

Important new commitments were made in the last several years. As these commitments are phased in over time, their costs will increase. Among the most important of these new commitments are the following.

- The state takeover of the full cost of the non-federal share of Family Health Plus and the capping of the growth in the counties’ share of Medicaid costs will cost almost \$1 billion during the current fiscal year, an estimated \$1.35 billion in the fiscal year that begins on April 1, 2008, and more than \$2.5 billion in 2010-2011.
- The STAR program which began a decade ago cost \$582 million in the first year (1998-1999) of its implementation, \$2.5 billion in the first year in which it was fully phased-in (2001-2002), and is expected to cost \$3.4 billion next year (or, \$3.2 billion if several changes proposed as part of the 2010-2011 Executive Budget are adopted.
- In 2007, Governor Spitzer proposed, and the Legislature adopted with a few modifications, a legitimate statewide solution to the court decisions in the Campaign for Fiscal Equity lawsuit. These reforms replaced approximately 30 individual aid

programs (under which \$12.5 billion was distributed in 2006-2007) with a “foundation” formula that bases districts’ aid on a calculation of the amount necessary to provide all pupils with a sound basic education. As enacted, the 2007 reforms called for a four-year phase-in that would increase this general operating aid in four annual steps to \$18 billion in 2010-2011; and required districts receiving substantial aid increases to enter into Contracts for Excellence with the State Education Department to ensure that these new resources are used effectively to increase student performance. Another part of this initiative increased funding for the state’s Universal Pre-Kindergarten program by 50 percent. In 2009, Governor Paterson proposed freezing the phase-in of foundation aid for two years and then stretching out the phase-in from four years to eight. The legislature agreed to the freeze and to an extension of the phase-in to seven years. This year the Governor is proposing to extend the phase-in from seven years to ten years along with a Gap Elimination Assessment that will turn the foundation aid freeze into a substantial reduction in this aid.

- In finalizing the 2006-2007 state budget, the Legislature put into place a solution, called Excel, to the school facilities part of the Campaign for Fiscal Equity law suit. The costs of honoring this important commitment grow each year.

There may well have been better ways of designing some of these new commitments. For example, the money now going to the STAR program could have funded a real property tax circuit breaker that would have provided property tax relief in a much more effective and efficient manner. Still, it is clear that all of these new commitments addressed important priorities. But by adding these important new commitments to the state budget without adding revenue to pay for them, the state will have structural deficits—unless current revenues grow fast enough to both cover both the ordinary growth in the cost of existing programs and these new commitments. As this year’s budget indicates, such rapid growth is not likely to be sustained.

## **Establishing a fair, adequate and economically sensible state-local tax system**

A failure on the part of state policymakers to invest in the state's future will exact a heavy price in terms of the state's human and physical infrastructure. Instead, policymakers should reestablish a fair, adequate and economically sensible tax system. To address unmet needs identified, and to avoid the costs savings proposals advanced by the Governor most likely to have negative effects on the state's economy or on the health of New York residents, state policymakers should consider steps that would make the tax system fairer while raising the revenue necessary to balance the budget in an economically sensible manner.

The most important steps in this direction would be for New York to reform its personal and corporate income tax structures. In regard to the personal income tax, New York should consider approaches that will ensure that the wealthiest New Yorkers pay their fair share in state and local taxes, and which will allow the state to reduce the pressure that it is currently placing on local property and sales tax bases.

New York State should balance its budget during the current economic downturn in ways that will not make economic conditions worse. The Governor and members of the State Legislature should carefully analyze the budget balancing strategies of the early 1990s and those of 2003 and 2009, and should make policy choices that will take the least amount of demand possible out of the state economy.

1. Rather than cutting essential services, the Legislature should consider additional revenue-raising options such as the following.
  - a. Closing some of the litany of corporate tax loopholes spelled out in the state's annual Tax Expenditure Report,
  - b. Adopting one or more of the following temporary measures designed to have Wall Street (which is now realizing unprecedented levels of profit) despite the economic challenges facing families and other businesses) help Main Street get through the current economic downturn:
    - i. a temporary and modest reduction in the stock transfer tax rebates,
    - ii. a temporary tax on bonuses over some reasonable level,
    - iii. an excess profits tax, on firms with profit margins above some reasonable level, or
    - iv. a temporary suspension of the ability of large firms to reduce their current net income levels through the carryover of losses incurred in the past (Note this is referred to as the "carry forward" of Net Operating Losses [NOLs] and is akin to "income averaging," a benefit that was taken away from individual taxpayers many years ago.
  - c. Adopting a temporary increase in the top income tax rate on taxpayers with incomes above \$1 million (Note: in 2009, the Legislature and the Governor adopted a temporary rate of 8.97 percent on taxpayers with taxable incomes above \$500,000).

2. New York's government, labor, business and civic leaders should work with their counterparts in other states and at the national level to secure a much needed extension of the state fiscal relief parts of the American Recovery and Reinvestment Act (ARRA) as discussed above, in greater detail.
3. New York leaders should work for the repeal of the federal law (P.L. 86-272) that prohibits the states from taxing the income of corporations that have sales but no property or employees in a state. As more states, including New York, move to apportioning income solely on the basis of the portion of a firm's sales in the state (i.e., the Single Sales Factor proposal which was adopted by New York in 2005 and whose implementation was accelerated in 2007), P.L. 86-272 (an outdated 1959 law which was supposed to be temporary) has the affect of making an increasing portion of the U.S. income of multi-state and multi-national firms not subject to taxation by any state. At the present time, many of the same corporations that have lobbied for the Single Sales Factor at the state level are working to expand P.L. 86-272 to make even less corporate income subject to taxation by the states.
4. Until P.L. 86-272 is repealed or substantially reformed, New York State should adopt a "throwback rule" to stop the loss of corporate income tax revenues due to the interaction of Single Sales Factor apportionment and this outdated federal law.

*The Fiscal Policy Institute ([www.fiscalpolicy.org](http://www.fiscalpolicy.org)) is an independent, nonpartisan, nonprofit research and education organization committed to improving public policies and private practices to better the economic and social conditions of all New Yorkers.*

*For more information, contact Frank Mauro at [mauro@fiscalpolicy.org](mailto:mauro@fiscalpolicy.org) or 518-786-3156.*