What to Know ***Before*** *Analyzing the State Budget*

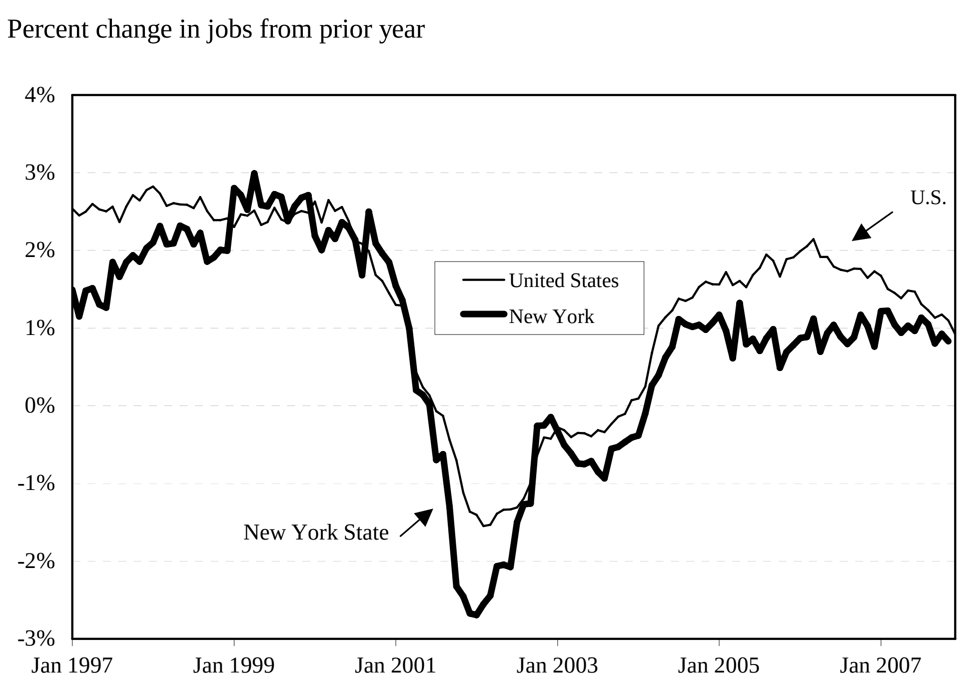
January 20, 2008

On Tuesday, January 22, 2008, Governor Eliot Spitzer will be releasing his proposed budget for the 2008-09 fiscal year. This brief, based on the Fiscal Policy Institute's recent presentation, New York State's Economic and Budget Outlook for 2008-2009, *provides information about the state's economy, its finances, and three policy issues that are sure to receive significant attention during this year's budget debates. It also reviews federal issues and concerns. For more detail, see the full version of FPI's outlook presentation at www.fiscalpolicy.org.*

What is New York up against?

It's becoming clearer every week. The current national economic slowdown and Wall Street turmoil could mean a recession. In fact, a recession may well already be underway and four years of moderate job and income growth in New York could be coming to an end.

Last September, in *The State of Working New York 2007*, the Fiscal Policy Institute documented the nature and magnitude of the four-year recovery and expansion that had been underway since mid-2003. Especially interesting were the positive developments in the upstate economy. Most upstate metro areas rose in national rankings of national income growth. Job growth continued to improve through the fall, with western and northern New York improving the most, and job growth was broadly distributed among the various industrial sectors of the economy.



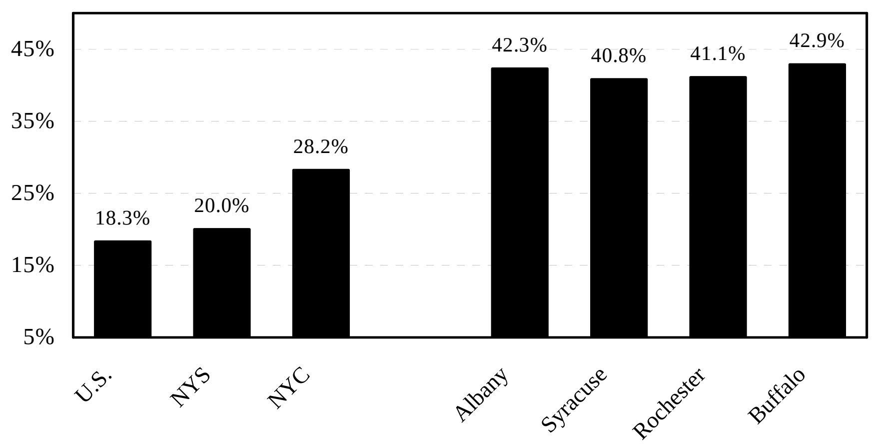
Source: BLS CES data.

But it now looks like New York's job growth is starting to slow. Indeed, manufacturing jobs never rebounded after the recession early this decade. And New York unemployment rates, along with the nation's, have been rising over the past year.

Looking back, these woes were predictable. Nationally, the four-year economic expansion was heavily fueled by debt, much of it related to an unsustainable housing bubble. Home mortgage debt doubled from 2001 to 2007, and residential construction was by far the fastest growing part of the economy. Corporate profits also doubled over the same time period. Now, the housing market has collapsed, and wages, which grew at only a third the rate of profits, are not keeping pace with consumption.

An even gloomier picture emerges when you look behind the statewide figures. Median wages (measured through the second quarter of 2007) are up, but income growth is concentrated among the top five percent. Poverty rates are much higher in the upstate cities than in the state and nation as a whole, and much higher than in New York City.

Upstate cities: a large proportion of children under 18 live below the poverty line



Source: American Community Survey.

Wall Street's turmoil also bodes ill for New York and the nation. The growth in capital gains and Wall Street wages accounted for half the growth in Adjusted Gross Income (the state's personal income tax base) from 2003 to 2007.

The real estate bubble, the explosion in household debt, and the surge in questionable financing activity on Wall Street are intertwined. Their unraveling, which will be painful and messy, should force a re-examination of what Wall Street does. CEOs have admitted they didn't understand their own "innovative" lending practices and investors have taken billions in losses.

A new report by Global Insight for the U.S. Conference of Mayors projects that mortgage foreclosure problems will worsen in New York, to the tune of $14.2 billion in 2008. And property values will decline by at least seven percent in 2008. On both measures, New York ranks as the fourth most troubled state.

What differences does state budget policy make?

Each year, the choices made by the governor and legislature during the budget process determine how much money will be raised in taxes, how much will be raised in other ways, and how much will be spent for particular state and state-funded programs.

Both taxes and spending are going up overall but the figures on trends in total spending fail to distinguish between the growth in the cost of existing state activities and increased spending that is attributable to important new commitments that have been taken on by the state government in recent years in order to reduce the pressure on local governments and local taxpayers. And the trends in total tax revenue do not reveal how much tax revenues would have gone up if it had not been for changes in tax bases (such as the elimination of the sales tax on items of clothing costing less than $110) and tax rates (such as the steady reductions in personal and corporate income tax rates).

A closer examination of changes in the state budget over the last 12 years shows that some agencies and programs have grown much more than overall spending, and that spending for some other components of the budget has either declined or grown much less than the average. The state agencies whose operating expenditures grew by more than 10 percent per year, on average, over this period were the Division of Military and Naval Affairs, the Insurance Department and the Department of Taxation and Finance. At the other end of the spectrum, the four agencies whose operating expenditures were less in 2006-07 than in 1994-95 (even without adjusting for inflation) were the Division of Housing and Community Renewal, the Department of Civil Service, the Division of Probation and the Department of Motor Vehicles.

One widely accepted way of evaluating the level of state spending is by comparing it to the size of the economy, using total state personal income (as estimated by the U. S. Bureau of Economic Analysis) as a proxy for the size of the economy. Using this yardstick we find that during the second half of the 1990s, when the economy grew strongly, state spending declined as a percentage of state personal income. During the current decade, overall state spending relative to the size of the economy has returned to traditional levels. But it turns out that most of the recent spending growth has been attributable to the state government taking on new commitments rather than to the cost of existing programs and services growing at rapid rates.

New commitments made in recent years are costing more as they are phased in:

- The state takeover of the full cost of the local share of Family Health Plus and the capping of the growth in the counties' Medicaid costs.
- The creation and expansion of the STAR program.
- The adoption of a statewide solution to the court decisions in the Campaign for Fiscal Equity lawsuit.

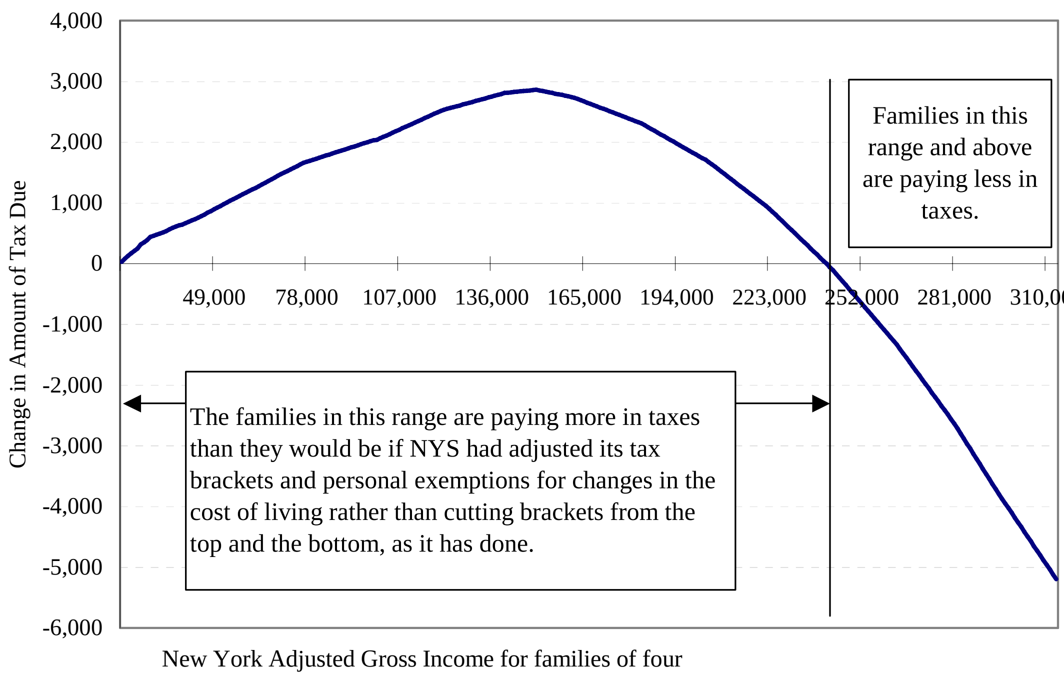
Program (billions)	FY 07-08	FY 08-09	FY 10-11
FHP & Medicaid	0.974	1.35	2.5
STAR Tax Relief	4.73	5.36	6.14
CFE Foundation Aid	1.1	2.3	5.5
	over 6.8	**over 9**	**over 14**

One kind of spending left behind is the amount that the state spends on its workforce. Since 1990 (in constant 2007 dollars) employee wages and salaries have declined by more than half a billion dollars, almost 5 percent.

What else is going down? The multi-year tax cuts enacted in 1994 through 2000 are reducing state revenues this year by over $16 billion. Even with these tax cuts, state revenues are growing as fast as state expenditures for existing programs, but not fast enough to cover the new commitments of recent years as well.

There has also been a change in the distribution of the tax burden as New York has cut its top personal income tax rate by more than 50 percent over the past 30 years (from 15.375% to 7.85%), thus making the income tax less progressive than it used to be, and putting greater pressure on local property and sales tax bases. New York families with incomes above $250,000 have come to bear much less of the burden, while lower-income families are paying more in taxes than they would be paying if the state had simply indexed the state's 1972 tax brackets and personal exemptions for inflation, rather than eliminating brackets from the top and bottom of the rate structure and eliminating the personal exemption.

Tax policy choices have increased the burden of lower and middle class families, while decreasing the burden for those with high incomes.



In 2003, the Senate and Assembly, over Governor Pataki's veto, enacted a three-year temporary top income tax rate (7.7 percent on taxable incomes over $500,000) in order to balance the state's budget. During the ensuing three years, the state suffered none of the dire effects predicted by the governor when he vetoed the legislation. In fact, the number of high-income returns grew significantly during the three years of the surcharge.

Notably, New York State's top personal income tax rate (6.85 percent) is now at an historical low relative to New Jersey (8.97 percent) and Connecticut (5 percent)..

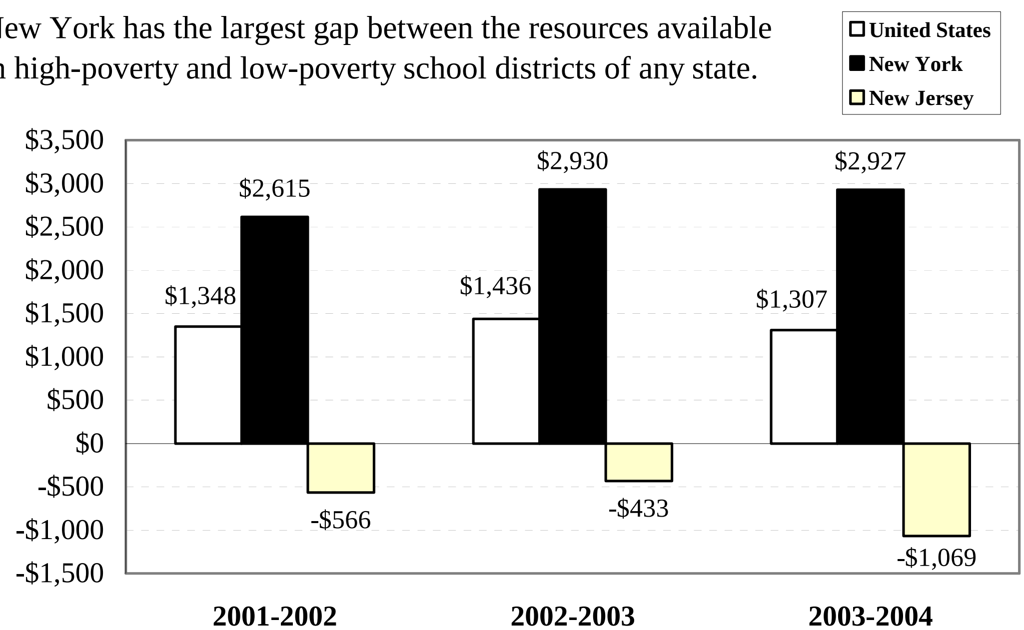
Key policy issues for 2008-09

Property taxes

State policy choices—with respect to how important public services like education and health care are financed—have placed great pressure on local property and sales tax bases. For example, basing each county's share of Medicaid costs on the mix of services provided rather than on its "ability to pay" imposes a greater burden on communities with weak tax bases relative to their concentrations of needy individuals. Capping the growth in counties' Medicaid costs is institutionalizing and exacerbating those inequities.

The Fiscal Policy Institute's analysis of school district finance data from 1992 through 2006 shows that in years when state aid goes up by a reasonable percentage, property tax increases are small, and vice versa. Moreover, across-the-board caps on school budgets or school property taxes are inappropriate in a state with huge disparities in terms of resources relative to needs.

New York has the largest gap between the resources available in high-poverty and low-poverty school districts of any state.



Source: The Education Trust, "The Funding Gap 2006: How the Federal Government Makes Rich States Richer," December 20, 2006.

STAR as currently structured doesn't deliver on its promise to protect homeowners "who are literally being taxed out of their homes" —because it is inadequately targeted. Every homeowner gets some aid but those who are truly overburdened are not getting anything near the aid necessary to prevent them from being taxed out of their homes.

A middle-class circuit breaker is the way to do the job. A circuit breaker bases the amount of relief on a household's property taxes relative to its income. The Middle Class

STAR program enacted last year moves in the right direction by taking household income into consideration, but because it does not consider the size of a household's property tax bills relative to income, it still steers hundreds of millions of dollars in aid to those with reasonable property tax bills relative to their incomes, while failing to provide enough aid to the truly overburdened.

A middle class circuit breaker like the one proposed by Assemblywoman Sandra Galef and Senator Elizabeth Little would get much closer to this goal by basing relief on the amount by which a household's property taxes exceed a percentage of its income with that percentage being higher for higher income households. A circuit breaker can also be designed to address the impact of property taxes on renters, another glaring inequity of the STAR program as currently structured.

The property tax crisis can and should be addressed with both short- and long-term policy responses. In the short run, relief can be delivered much more effectively and efficiently by replacing the Middle Class STAR rebate check program with a middle class circuit breaker. In the long run, New York State needs a multi-year strategy that will reduce fiscal disparities and reduce the pressure on the local property tax base by:

- Restoring New York State's commitment to "revenue sharing" with its local governments through a transparent needs-based formula that is honored over time.
- Fully implementing the statewide solution to the Campaign for Fiscal Equity lawsuit, as scheduled over four years in the 2007-08 budget, and then gradually increasing the state share of each district's foundation amount.
- Gradually increasing the state share of Medicaid costs in a way that bases each county's share of those costs on objective measures of its relative "ability to pay."

Economic development

The executive budget will undoubtedly include proposals for strengthening the state's economy. In evaluating these proposals, the following concepts and ideas can serve as a useful checklist.

- Recognize that productivity—the output generated per dollar of inputs—matters more than costs.
- Increase the effectiveness and accountability of government economic development programs and work to diversify the state's economy.
- Recognize that manufacturing still matters and implement a manufacturing strategy that reaches beyond "high tech."
- Recognize that we can't have a middle class without middle-class jobs.
- Level the playing field among businesses by establishing higher wage standards and enforcing labor standards and compliance with workers' compensation and unemployment insurance.
- Make economic development tax breaks work or invest the money directly in infrastructure; reform IDAs and the Investment Tax Credit so that they do a better job of creating and retaining jobs; the Empire Zone program is so severely flawed it should be scrapped.

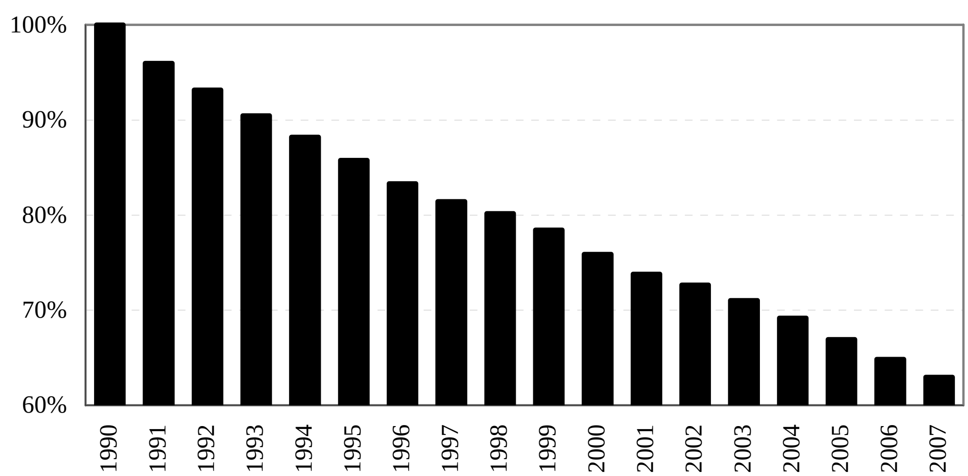
Economic security

In August 2007, Governor Spitzer announced the formation of an Economic Security Cabinet to provide a focus on the needs of working families. In reviewing the executive budget from this perspective, it will be important to determine what the governor proposes in regard to the key economic security safety nets: the minimum wage, the unemployment insurance system and aid to needy families. In addition, the executive budget is likely to offer proposals for strengthening and expanding the middle class by creating better “up ramps” into the middle class. These proposals are likely to include (a) improving higher education quality, access and affordability, and (b) building more effective labor markets and better career ladders. An example of an initiative of this type that was taken during 2007 was the Spitzer administration’s effort to improve the enforcement of basic labor standards.

Unemployment insurance benefits are the state’s main response to economic downturns. When the program works, it boosts communities and families and empowers the redeployment of New York’s workforce into good jobs. During the last recession, state unemployment benefits increased by $2.6 billion, accounting for one-sixth the change in total personal income between 2000 and 2002. But because of major shortcomings, New York is getting a badly diminished economic charge out of the unemployment insurance program. Among other things, the maximum benefit has not kept pace with wage growth. The program should be fixed now to temper the looming downturn.

For public assistance recipients, New York should make sure that work “pays” for low income New Yorkers by increasing the earned income disregard. All families dependent on cash assistance, particularly those unable to work, need an increase in the basic cash assistance grant. The basic allowance has not been increased since 1990; it has lost more than a third of its purchasing power since then.

Inflation adjusted Basic Allowance for a three person family, as a percent of 1990 Basic Allowance.



Federal issues and concerns

Since states must balance their budgets in both good times and bad, the federal government has a special obligation to provide fiscal stimulus when the economy falls into a recession. Done properly, federal stimulus can make it easier for states to balance their budgets in a recession. In the past, states were able to rely on automatic stabilizers such as Aid to Families with Dependent Children, food stamps and unemployment insurance. These programs used to automatically increase when the economy slowed down. Now, with many federal programs converted to block grants, there is less automatic stabilization.

Poorly designed fiscal stimulus packages can actually make it harder to balance state budgets. To be effective, stimulus packages must be timely, targeted and temporary.

- Timely measures, once implemented, stimulate new spending quickly.
- Targeted measures are aimed at individuals and entities that will spend quickly—that is, low- and moderate-income consumers and unemployed workers. Fiscal relief for state governments is another well-targeted form of stimulus; it enables states to balance their budgets with fewer service cuts and/or tax increases than would otherwise be necessary
- Temporary measures expire once the economy improves, so the country is not stuck permanently with deficit-increasing tax cuts or spending increases.

The centerpiece of President Bush's new stimulus plan (a rebate provided by temporarily eliminating the 10 percent income tax bracket) fails the effectiveness test since it is poorly targeted—flouting advice from Ben Bernanke, chairman of the Federal Reserve Bank. The Center on Budget and Policy Priorities has pointed out that the plan would bypass altogether, or provide only partial help to, the more than 40 percent of tax filers (over 50 million filers) with the most modest incomes. Families of four below $40,950 would get partial help or nothing at all. Also, the plan's business tax component would provide at best only modest stimulus.

During the last downturn in the economy, a $20 billion stimulus package enacted in May 2003 included a temporary (15 month) increase in the federal matching rate for the Medicaid program and a $10 billion program of direct, flexible grants to states. This package was very effective in allowing New York and other states to balance their budgets in ways that took less demand out of the economy than would have otherwise been the case.

The Fiscal Policy Institute (FPI) is a nonpartisan research and education organization that focuses on tax, budget, and economic issues that affect the quality of life and the economic well being of New York State residents.

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