STATE OF NEW YORK
EXECUTIVE CHAMBER
ALBANY 12224

To: Agency Commissioners

From: Governor Eliot Spitzer

Re: State Budget

Date: September 20, 2007

For most of the last 12 years, the State has benefited from higher than expected revenues, largely driven by the strong performance of the financial services industry and the boom in real estate downstate. In good economic times, Wall Street accounts for up to 20% of our tax revenues.

Unfortunately, over the summer we witnessed a number of events that give us great concern about the rate of continued increases in revenues from these sources. The crisis in subprime mortgage lending and the cutbacks in the credit markets are already leading to major Wall Street firms reporting lower quarterly earnings and raising the prospect of layoffs. These changes in the credit markets also bode poorly for the continuation of very large commercial real estate transactions.

It is too soon to tell how much these factors will affect revenue this year and next. Because of our significant reserves, and the fact that most of these negative developments occurred mid-way through 2007, we remain on track with our forecasts with the State's financial position during the current fiscal year. But we must begin to turn away from the old mindset that if we wait long enough and delay the tough decisions, an 11th hour bailout from revenue increases will make our potential problems disappear.

In the Call Letter for Budget Requests that the State's Budget Director sent to state agencies last month, he noted that Agencies should prepare budget options that will prepare us for making hard decisions in the upcoming budget. I want to re-emphasize that directive and urge you to carefully scrutinize all hiring and other expenditures now. The Call Letter also emphasized that the goal is to carry out our top priorities effectively, while identifying lower-priority areas for savings – not to simply stand pat. We are better off making hard decisions now rather than making commitments that we might be unable to sustain once the budget is finalized.

I am committed to commencing our budgetmaking process as early as possible to ensure openness and transparency as we evaluate the hard choices ahead of us. I look forward to discussing all of these issues with you in more detail at next week's cabinet meeting. In addition, we will soon begin the process of reviewing with you the changes to current operations that may be necessary in the next budget year. It will be easier to make those changes if we have already adopted the mindset and discipline that greater austerity will require.

I appreciate your cooperation in this matter.

Remarks by Budget Director Paul Francis
CBC Conference on Reforming the NYS Budget Process
September 20, 2007

(As prepared for delivery)

Introduction

I want to thank the CBC for hosting this conference today and for your continuing efforts to shed light on the critical issues facing budgetmakers in New York State. I also want to commend you on your report on Options for further budget reform in New York State, with its recommendations to improve accountability and transparency, promote more effective use of State fiscal resources and manage local tax burdens. I can't say that the Division of Budget endorses every one of the recommendations, but we certainly are in agreement with the spirit behind many of them.

Governor Spitzer is committed to improving both the process by which we adopt the budget in New York and the fiscal principles that the CBC stands for. At the CBC's Annual Dinner in May of this year, Governor Spitzer spoke about the need to begin the budget process earlier to ensure an open and transparent budget process. He also talked about the need to have clear, long-term fiscal goals to guide our budgetmaking priorities.

This afternoon, I want to expand on those remarks and talk about three things: First, the "Early Budget" process that is now mandated by the Budget Reform Act of 2007; Second, the negative trends we see for revenue in the coming year, which will force us to make some tough and necessary choices for the 2008-09 budget; and, finally the fiscal principles that Governor Spitzer believes should guide New York's budgetary decisions not only in the difficult fiscal situation we currently face, but also in less challenging times.

The Early Budget Process

The budget is central to everything we do in New York government. During the budget process, we try to realistically determine the amount of resources available for spending and then debate the hard choices that need to be made in allocating limited resources among almost limitless needs. As we learned in last year's budget, it's difficult to adequately complete this process in the roughly ten week period between the introduction of the Executive Budget and the April 1st deadline for enacting a balanced budget.

We had little choice last year but to work within the short timeframe available, but one of Governor Spitzer's first achievements in office was to adopt measures that will effectively move up the starting line on the budget process. The Budget Reform Act that passed the legislature and was signed into law in January of this year established an important mechanism for ensuring that the Governor, the Legislature and the Comptroller all engage on the critical issues of estimating revenues and projecting current services disbursements in each of the major spending areas by the middle of November—almost six months before the budget must be adopted.

I'm not sure how aware the public and press are of the importance of these provisions, so I'd like to review now the key milestone dates in this "Early Budget" process. By October 30 of this year, the Budget Office will release our mid-year update, which will include the Executive's updated estimates of revenues and spending.

On November 5, detailed separate "Quick Start" reports are due from the Division of Budget, the

Comptroller's office, the Senate and the Assembly. These reports must include, at a minimum, estimates of All Funds receipts (with detail on tax revenues) and disbursements (with detail on Medicaid, public assistance, and school aid) for the current year and ensuing fiscal years (at least 2008-09 and 2009-10), as well as underlying factors and data assumptions.

The Statute requires that after November 5, meetings will be held among all four groups to review the separate reports, and identify and evaluate differences.

By November 15, the statute requires a public meeting of the respective finance staffs to "discuss the economic outlook, revenue forecasts, projected spending, the impact of relevant state and federal statutory provisions, and any other matters deemed appropriate." The statute requires that the governor, the majority leader of the senate and the speaker of the assembly "jointly prepare and make available on their internet websites a report on the actual, estimated and projected state receipts and state disbursements for the prior, current and ensuing fiscal years, respectively, for all funds of the state."

In other words, if these parties comply with the statute, by November 15 we should have a clear consensus on the amount of the budget gap the State is likely to face in the upcoming fiscal year. The Governor hopes that this early consensus will stimulate a serious discussion of the choices we have available to close that gap. The Governor feels strongly that there be public input into that process. He will ensure that there are hearings around the state at which budget options can be reviewed and reacted to by the public.

Negative Revenue Trends

Given the size and scope of our state government, it is inevitable that budget negotiations will often prove difficult. The final enacted budget reflects difficult tradeoffs among many stakeholders about how to best use the state's limited financial resources.

In the 2008-2009 budget, we are going to have to make some tough but necessary choices. In many respects, the fact that we have the benefit of quick start negotiations this year is especially important. The sooner we face up to the potential fiscal difficulties that await us, the better position we'll be in to deal with them.

The truth is that for most of the last 12 years, the State has been bailed out of impending budget gaps by higher than expected revenues. In fact, except for the two fiscal years following September 11, 2001, revenues came in higher than forecast at the time of the Enacted Budget, by an average of almost $1.5 billion. And you can almost double the impact of that surplus, because higher revenues in a current year typically lead to an increase in the revenue estimate for the following year.

So it's no wonder that many in Albany have come to think of the Division of Budget as a kind of Chicken Little saying the sky is falling. And the windfall of added revenues has largely absolved the legislature from having to make hard decisions when it comes to the budget.

But all indications are that next year will be different.

At the time of our update for the quarter that ended June 30, we estimated that the State faced a budget gap of $3.6 billion in the 2008-09 year. However, we expect that when we reevaluate that number for our Mid-Year financial update in October, there is a significant risk that we will have to increase the expected gap.

In New York, our budget is uniquely sensitive to certain segments of the economy such as the financial services and real estate industries. In good years, Wall Street accounts for up to 20 percent of our revenues. Unfortunately, the summer saw a number of events that are very concerning in these very areas.

The crisis in subprime mortgage lending and the virtual shutdown of the market for highly leveraged financings has had a serious impact on the performance of some of our most important sectors in terms of tax revenue: financial services, private equity and hedge funds.

There has been talk of layoffs at major Wall Street firms and many firms have scaled back their searches for new employees after years of great expansion. Overall, investment banking stock prices have declined by 25% this year, reflecting poor industry performance. And firms such as Lehman Brothers and Morgan Stanley have already reported lower earnings for their third financial quarter.

Real Estate transactions have also slowed in great part due to the credit crunch we're currently facing. In particular, we are seeing fewer of the mega transactions that produced about $1 billion in revenue in recent years…double the roughly $500 million that had been the norm.

In addition, for the first time in years, economists are talking about the risks of recession. The headline in the New York Times last week read "Double Warning that a Recession May be on the Way" noting that the employment statistics and the bond market are combining to send out a warning of recession that has only rarely been wrong in the past.

The economists at DOB are not anticipating a recession, but they agree that there are uncertainties and risks. However, they are seeing a more pronounced softening than we anticipated in June and we are on watch for further signs of softening.

The Fed's rate cut and the related run-up in stock prices over the past two days is encouraging, but we do not believe this represents a silver bullet that fixes all our problems.

To make matters worse from a revenue perspective, a number of risks we've previously cited in our financial plan are coming home to roost, including lower and later revenues from Video Lottery Terminals.

It is too soon to tell how much these factors will cut into revenue this year and next. Because of our significant reserves, and the fact that most of these negative developments occurred mid-way through 2007, we remain on track with our forecasts with the State's financial position during the current fiscal year. But we must begin to turn away from the old mindset that if we wait long enough and delay the tough decisions, an 11th hour bailout from revenue increases will make our problems disappear.

The Governor's Response

Despite the budget gap, we expect that the budget Governor Spitzer will propose in January will reflect the priorities he embarked on this year to reform education, health care and provide property tax relief.

Every budget is a blueprint for action. It reflects hard choices among competing priorities. Given the current economic situation, we expect the choices this year to be especially difficult.

Earlier this summer, we told agency commissioners that the 2008-09 Executive Budget should continue support for the major structural reforms that the Governor and the Legislature set in motion this year, while at the same time exercising fiscal discipline and closing the expected

2008-2009 General Fund budget gap without raising taxes.

We told agency heads that, when developing their budget requests, they should understand that most agencies will need to reduce spending below base-level growth or so-called 'current services' levels to both maintain the Governor's core priorities and achieve a balanced budget. We sought their ideas on how to deploy limited resources more effectively. And we are continuing to work with them and their staffs to explore ways to provide services more cost-effectively. The end product will reflect a collaborative effort that moves New York State forward on these reforms, and provides a responsible spending plan that reflects the need to set priorities among many worthy but competing needs.

This morning, the Governor sent a letter to all State Agency and Department heads reinforcing that message and urging them to carefully scrutinize all hiring and other expenditures now. As the Governor noted, we are better off making hard decisions now than making commitments that we might be unable to sustain once the budget is finalized.

Fiscal Principles

In his remarks to the CBC in May, Governor Spitzer set forth his goal to hold the rate of growth in operating spending to the rate of growth in personal income. In the current fiscal year, we expect the rate of personal income growth to be about 5.3%. We expect that state operating spending will grow this year by about 7.0%, down from about 10.6% in the last year of the Pataki administration.

We were criticized by some after the last budget for not holding total growth in state spending to the rate of inflation. But this criticism fails to acknowledge two fundamental characteristics of New York's budget. First, New York has not historically distinguished between capital spending, which typically uses debt to fund long-term investments, from operating spending, which is spending that is consumed in the current year. New York City and most other states have recognized that this method of accounting doesn't present a true picture of the priorities reflected in the budget, and we feel strongly that New York State should adopt the same approach.

Second, 70 percent of New York's budget is dedicated to payments to local governments. Unless the costs of municipalities and school districts are held to the rate of inflation, holding state spending to the rate of inflation will just push the tax burden down to localities, which have fewer and more regressive revenue sources than the state.

Over the ten years through 2006-07, State operating spending grew at an average annual rate of 6.2%, nearly 1% higher than our target growth rate. If our spending cap had been in force during this period, 2006-07 spending would have been roughly $6 billion less than actual results.

Conclusion

It's perhaps fortunate that the first year with a formal Early Budget process will be a year when hard budget decisions will have to be made. Governor Spitzer knows that this process will not be easy, and that painful choices will be necessary. So he is especially committed to ensuring that the public understands the tradeoffs involved. And that to the maximum extent possible, we make those hard choices after full public deliberation, with a process that is as transparent as possible to ensure that the public understands the tradeoffs involved. He also will seek assistance and input from the legislature, for they will need to play an active and collaborative role if New York is to achieve both its fiscal and programmatic goals.

In doing so, we will adhere to the long-term fiscal principles that I described earlier. It's always better to fix the roof in good times—as President Kennedy once said. But this administration is committed to getting our fiscal house in order in good times or bad.

We expect the CBC will be an important ally in that process. And we hope that many of you will join with us as well in working to make the best out of what promises to be an unusually difficult budget year.