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The New York State Fiscal Crisis and Special Legislative Session

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The economic crisis facing the country has had a profound impact on New York State's economy and on its government. We anticipate an extraordinarily difficult time ahead for New York State—with potentially very serious consequences for New Yorkers who depend on State support for important programs and services. We thought it might be helpful to summarize what is currently known about the status of New York State finances, the implications of the fiscal crisis for State governmental action and spending and the prospects for additional mid-year budgetary action during the special legislative session scheduled by the Governor for November 18th.

Background: We are all well aware of what has transpired nationally and internationally to bring us to this point: an overheated and under-regulated housing mortgage market, questionable investments by Wall Street, failures of leading investment banks, the federal takeover of Fannie Mae and Freddie Mac, an $85 billion loan to AIG (first assisted by New York State through approvals of AIG's efforts to raise $20 billion in cash liquidity) and a growing credit crisis. Congress responded by approving the $700 billion authorization to purchase distressed mortgages and the Federal Reserve joined the central banks of many other countries in reducing interest rates. Even with the extraordinary steps taken in the United States and elsewhere, Secretary of the Treasury Paulson has repeatedly stated that these actions will not immediately reverse the economic meltdown and the initial steps taken by the Treasury Department and the central banks do not appear to have stemmed the growing financial crisis.

The consequences for New York State have already been dramatic and may prove to be catastrophic: New York State's economy, which had already been in a steady decline over the past several months, has suffered disproportionately as a result of New York City's unique role as the capital for the world's financial markets. Given the State's heavy reliance on revenues derived from Wall Street and the State's financial services industry, the current fiscal instability has already resulted in a precipitous decline in State revenues.

In short, whatever action is taken in November during the special session called by the Governor, we should be prepared for deep spending cuts in the State Budgets over the next few years and assume that no element of state spending will be exempt. While the fiscal crisis may present some unique opportunities for overdue reforms in the manner in which New York State manages itself, the corresponding fiscal challenges presented by the fiscal crisis may be the greatest in a generation or more and may threaten many longstanding State commitments, particularly to the neediest New Yorkers.

Prior mid-year budgetary actions: Even before the most recent economic crisis materialized, Governor Paterson had summoned the Legislature to Albany in the middle of the summer to address the deterioration of the State's finances. The Legislature approved $427 million in cuts in its extraordinary August legislative session, which were principally the following:

Across the board reductions in local assistance spending: Most local assistance spending, affecting a broad swath of health and human services and related programs (other than school aid) and other programs had their unexpended balances reduced by six percent, saving close to $100 million in this fiscal year and potentially $160 million next year.

Reductions in new Executive and Legislative initiatives and Member items: Certain new program initiatives proposed by Governors Spitzer and Paterson were subject to a fifty percent reduction, while legislative "adds" were reduced by six percent, saving $34 million in this fiscal year, $21 million in 2009-10. So-called "member items" were also subject to a $50 million reduction.

Medicaid/Health Care Cost Containment: The Legislature agreed to $127 million in state share reductions, affecting hospitals, nursing homes, home care agencies, pharmaceutical companies and managed care.

Reduction in State Support for CUNY: To match reductions already suffered by the State University of New York, the City University of New York experienced a $51 million reduction in state support.

In addition to these budgetary reductions, the Paterson Administration had also achieved $1.3 billion in administrative savings—principally from a ten percent cut to State agency operations—which brought the overall reduction in spending in the current fiscal year to approximately $1.7 billion. With these reductions, it had been anticipated that the State would conclude the current fiscal year in balance.

Even with these extraordinary midyear reductions, it was acknowledged last August that the State would still experience very significant out-year deficits. Notwithstanding the fiscal restraint demonstrated by the Governor and the Legislature in August, the Division of the Budget projected a deficit of approximately ***$5.4 billion*** in SFY 2009-10 and a cumulative deficit of over ***$24.4 billion*** over the next three years. And then the economic picture actually went from bad to worse.

Latest fiscal projections: The Division of the Budget now estimates that, if no corrective action is taken, the State will experience at least a $1.2 billion budget shortfall for State Fiscal Year (SFY) 2008-09. According to the Division of the Budget[1], this current year deficit is chiefly due to actual and projected losses of revenue to the State in the third and fourth quarters of the fiscal year, as follows:

$950 Million Loss in Personal Income Tax Payments: The State estimates that the financial services sector accounts for twenty percent of State tax revenue during the year, with thirty percent (or $6 billion) of that revenue coming to the State in the fourth quarter of the fiscal year due to the timing of Wall Street bonuses. As a result of the heavy losses in the financial markets, it is expected that the State revenues derived from these fourth quarter bonuses will be substantially less than estimated earlier in the year. Coupled with losses in capital gains tax payments from the sale of real estate, stocks and other assets, the State estimates a net loss of $950 million in personal income tax revenue during the current fiscal year. Moreover, current projections are that Wall Street bonuses will be forty-three percent (or $20 billion) less than last year which will result in an even greater loss in personal income tax revenue in SFY 2009-10.

$350 Million Loss in Business Taxes: The State estimates that the amount of taxes paid by sixteen of the State's largest banks will amount to one-third of what was paid just last year (or $111 million compared to $333 million in SFY 2007-08) and payments by the top twenty corporate taxpayers will be reduced by thirty-eight percent (or $82 million) from last year.

$300 Million Loss in Revenue Due to a Delay in Certain State Financial Transactions: The State projects that, due to adverse market conditions, it will not receive $200 million from the conversion of GHI/HIP to a for-profit company or $100 million from the sale of surplus State property.

In addition to the current year $1.2 billion deficit, the State anticipates that the very large future year deficits, noted above, have only grown very much larger. The Division of the Budget is still evaluating these projections and is not expected to announce a revised deficit amount until October 30, 2008: it has been speculated, however, that the $5.4 billion projected deficit for SFY 2009-2010 understates the deficit by at least two to three billion dollars. The revised Division of the Budget estimate will factor in the direct loss in revenues from Wall Street bonuses, but also the collateral effects of the crisis, including the projected loss of 40,000 financial sector jobs in New York and the elimination of many other jobs dependent upon a healthy State economy.

Governor Paterson's response to the fiscal crisis: As we had warned following enactment of the mid-year budget, there was a strong likelihood that the Governor might again call the State Legislature into special session during this calendar year to consider even more cost containment measures. In response to the dramatic further erosion of State revenues from the Wall Street crisis, Governor Paterson has summoned the Legislature to return on November 18th, presumably to take further action to reduce the current year and out-year budget deficits. He has also pledged to submit his 2009-10 Executive Budget to the Legislature by December 16, 2008—approximately one month before it is due—to encourage prompt action on the next year's fiscal plan.

While Governor Paterson has invited legislative leaders to propose budgetary savings of their own for consideration at the special November 18th session, it is generally anticipated that the agenda for that session will largely be set by the Governor. The Governor is reportedly hoping to enact sufficient cuts to eliminate the $1.2 billion current year deficit and to make a down payment on the budget reduction necessary to diminish the large subsequent year shortfalls. Whether such proposed cuts will be "across the board," as was the case with the Governor's mid-year budget proposal, or if they will be more selective, remains to be seen. To date, the Governor has indicated that no area of state spending will be exempt from his scrutiny, leading to speculation that even mid-year cuts to school aid may be on the table. The last time State Aid to Education was reduced mid-year was in the early 1990s—and the political repercussions from that reduction are still being felt in Albany.

At least for now, it appears that no tax increases will be proposed by the Governor or supported by the State Senate during the November special session.

The challenges faced by the Governor in achieving any meaningful reductions in the November special session include the following:

> With only a few months left in the fiscal year, reducing spending by over one billion dollars requires far more drastic cuts than would otherwise have been necessary earlier in the year. Since some of these cuts may require some time to implement, it is not altogether clear whether sufficient appropriation reductions can actually be implemented by April 1, 2009, the commencement of the next State fiscal year.
> The timing of the special session, just weeks after the biennial election for the New York State Legislature, provides very little time for serious legislative review or negotiation of any of the Governor's proposals. The Governor may, in fact, be reluctant to release any draconian budget proposals prior to the election for fear that it may impact on the election results—thereby leaving the Legislature with about a week and half to consider more than a billion dollars in cuts.
> With the Executive Budget for the next fiscal year scheduled to be released only one month after the special session, legislators may wonder whether the very difficult debate should await the release of the 2009-10 budget proposal. It is unlikely that the Division of the Budget will have very much more definitive information on the end-of-year revenue picture by mid-November.
> Perhaps most significantly, the Legislature that will be convened in November will be the lame duck Legislature of 2008—and will include those members who either chose not to run for re-election or who were defeated at the polls. If, as is possible, the Democrats pick up the necessary two seats on November 5th to assume control of the State Senate in January of 2009, the Governor would be placed in the awkward position of seeking the still Republican-led Senate to enact these budgetary changes.

Although neither House has yet expressed anything but support for the Governor's fiscal intentions, Senate and Assembly staff have expressed some skepticism over the Governor's prospects of achieving his objectives. While the Governor has requested the Senate and the Assembly to share their ideas regarding where additional reductions might be made, neither House appears likely to respond enthusiastically to that invitation and we anticipate that the Governor will begin fashioning his proposals for the November session very shortly.

Even before the Governor called for the special legislative session, the Assembly had announced a series of statewide public hearings to "gauge the fiscal impact of the national economic crisis on working families, businesses and communities throughout New York state."[2] We will be monitoring these hearings to gauge the Assembly's reaction to the economic crisis and would encourage interested parties to consider participating in these hearings to underscore the current and likely challenges faced by New Yorkers.

We will of course be closely monitoring budget-related developments leading up to November 18th and discussing with key decision-makers in the Governor's Office, State agencies, the Senate and the Assembly the prospects for budgetary actions and the consequences of another round of cuts to important programs and services.

2009-10 Budget Proposal: Regardless of the outcome of the November special legislative session, attention must also be paid to the Governor's commitment to submit his Executive Budget proposal for SFY 2009-10 to the Legislature by December 16, 2008. This self-imposed deadline is well over a month before the date the Governor is constitutionally required to submit his budget and is reportedly being done in the hope that it will enable the budget to be enacted well in advance of the April 1, 2009 deadline. We have been assured by the Governor's staff that the budget proposal will contain the more dramatic and severe reductions in state expenditures than have been seen in many decades and that no sector of State expenditures is immune from significant reduction.

We would anticipate that more serious consideration may be given to revenue enhancements in the 2009-10 budget submission than during the November special session—and that no sector of the New York State economy will be immune from the imposition of new or higher tax obligations, either.

Last August, Governor Paterson assembled a distinguished Council of Economic Advisors, which is also expected to make recommendations to the Governor this December on the steps that might be taken by New York State to confront its long-term economic challenges.[3] The Council is expected to be making recommendations to the Governor in December and those recommendations may be reflected in the fiscal plans submitted by the Governor over the next two years of his term.

Little is yet known for sure about the Governor's likely budget submission. For now, we would expect to see the following:

Drastic across-the-board cuts in virtually every area of State endeavor—including even the once sacrosanct school aid and certainly in the State's Medicaid program.
Some inclusion of targeted tax increases, including potentially a tax on high income New Yorkers as has been advanced by the Assembly and certain advocacy groups.
Perhaps some long overdue reforms of state practices, including pension reform, may accompany still further reductions in state operations—with a risk that state agencies will be incapable of meeting their regulatory, licensing and other essential governmental responsibilities.
With the advent of a new federal Administration, New York State may seek some assistance in meeting its fiscal challenges with a stronger partnership with the federal government—a prospect that may, for New York, be more promising if Senator Obama is elected, given the political alignment of New York.
Potentially significant reforms of the health care and education systems might accompany these drastic expenditure reductions. Certain long-postponed and difficult changes in state policy have a habit of emerging in the midst of a fiscal crisis: mandate relief for school districts, regulatory reform for regulated industry (including health care), perhaps even tort reform could emerge as necessary components of the State's response to the fiscal challenges.
"Public-private partnerships" may offer some short-term or longer-term fiscal relief. The Governor established a commission to study public-private partnerships (formally knows as the New York State Commission on State Asset Maximization) that will be examining how the value of certain State's assets might be maximized in the public interest—including assets in areas such as transportation, the State lottery, real property, intellectual property, and recreational facilities.[4] Potential development of other State resources, the privatization of other state functions and other creative financing opportunities are all likely on the table.

While the consequences of the economic crisis are still not completely known for New York State, any entity with an interest in New York State government—either as a recipient of state support, a taxpayer or a regulated entity—would ignore state policy-making over the next several years at their peril, as New York grapples with its most significant economic challenge since the Great Depression.

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If you have any questions or require any additional information, please feel free to contact Jim Lytle or other members of the Albany government relations team at (518) 431-6700 or Melinda Dutton or her colleagues in the New York City office at (212) 790-4500.

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[1] Division of the Budget, *New York: Preliminary Analysis of Recent Budget Developments*,

Oct. 3, 2008.

[2] NYS Assembly, *Silver Calls for Statewide Hearings on New York's Economy*, Sept. 29, 2008.

[3] NYS Executive Chamber, *Governor Paterson Announces Council of Economic Advisors*, August 18, 2008.

[4] NYS Executive Chamber, *Governor Paterson Establishes Commission to Study Public-Private Partnerships*, Sept. 30, 2008; Executive Order No. 11, *Establishing a Commission to Undertake a State Asset Analysis and Recommend Standards and Legislation to Maximize the Value and Use of Such Assets*, October 2, 2008.