

# Tax Cuts and the Fiscal Management of New York State

Presently, debate over tax policy in New York State is beginning to go beyond the recurrent issue of whether and how much to cut tax rates when budget surpluses appear. Right now, cash surpluses are expected on average over the next several years, assuming stable expenditures, strong economic growth, and unchanged financial management. Recent experience, however, suggests that a tax reduction is not likely to be sustainable through a future recession if New York continues the fiscal management practices of the last several years. In particular, the question arises how tax reduction can be balanced with a policy to safeguard the fiscal health of the state. This article attempts to explore this question and offer some possible solutions.

State and local governments throughout the nation were unprepared for the back-to-back recessions of 1980-82. In order to recoup unexpected shortfalls, taxes were raised by over \$18 billion and expenditures were frozen or reduced in many states and localities. The overall economic effect of these fiscal policies was probably to worsen the 1982 recession. Moreover, these policy reversals disrupted private and public sector planning—only a few years earlier, expanding state and local budget surpluses had encouraged widespread tax cuts and expenditure increases.<sup>1</sup>

In New York State, the ability to maintain both tax reductions and strong expenditure increases also ended abruptly when growth in the state economy fell sharply and unexpectedly in late 1982. The resulting fiscal

stress lasted until reductions in the government work force and increases in several taxes restored cash balance by 1984.

Now the state is anticipating a cash surplus this year that is variously estimated at from one to three percent of budgeted expenditures. Tax cuts are possible once more, but the concern arises that they may again be reversed if an economic downturn should occur in the next several years. Alternative responses to the emerging surplus are short-term debt reduction or replenishment of reserve funds. The choice among responses will be difficult because each holds a strong claim on whatever surpluses become available.

In the case of taxes, New York is perceived to have relatively high rates of taxation which adversely affect the cost of living and doing business in the state. New York has one of the highest nominal rates of taxation on personal income, although more numerous exclusions, deductions, and credits bring effective rates more in line with other states. In addition, it has several business taxes whose rates are out of line with rates in other states but which are relatively minor sources of revenue for New York.<sup>2</sup>

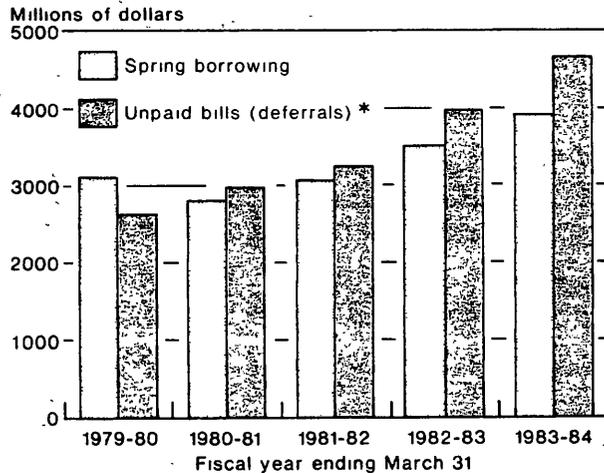
In 1978, a tax cut program was initiated to help arrest New York's below-average economic performance of the 1970s, and some observers credit that program with the state's above-average performance since then. Believing that cutting tax rates further may encourage business

Peter Skaperdas, "State and Local Governments: An Assessment of their Financial Position and Fiscal Policies" this *Quarterly Review*, Winter 1983-84, pages 1-13

<sup>2</sup>The New York Council on Fiscal and Economic Priorities has most recently studied New York's relatively high tax burden in their report entitled *Changes in New York State Taxes to Spur Economic Development*, November 16, 1984

Chart 1

**Spring Borrowing and Unpaid Bills**



\* Complete figures on earlier deferrals are not available.

Sources: State of New York, Annual Report of the Comptroller, Annual Budget Message, and Official Statement (various issues)

in New York and contribute to statewide growth into the future, many groups have offered proposals for further tax reductions.<sup>3</sup>

Nevertheless, the use of any cash surplus must be evaluated in light of New York's overall fiscal position and practice. While New York ended the fiscal year April 1, 1983 to March 31, 1984 (SFY1983-84) with a surplus on a cash basis—it took in \$51 million more than it paid out—it had a deficit on the modified accrual basis of generally accepted accounting principles (GAAP). Under GAAP, last year New York accrued over \$300 million more in liabilities than it accrued in assets. In simplistic terms the difference between the cash surplus and the GAAP deficit is the value of bills which the state had received but had not yet paid by the end of the fiscal year on March 31.<sup>4</sup>

Once each April, in the opening weeks of the fiscal year, the state issues enough tax and revenue antici-

<sup>3</sup>Among these groups are the Business Council of New York State, the New York City Partnership, the New York State Department of Commerce, the Finance Committee of the State Senate, and the Council on Fiscal and Economic Priorities

<sup>4</sup>New York began formulating its budget according to GAAP definitions in the fiscal year ending March 31, 1983. Because GAAP methodology is still evolving, some differences between the cash-

pation notes (TRANs) to pay those bills left from the previous year (Chart 1). In the following March, it stops paying bills until it has set aside enough revenue to repay the borrowing, and the cycle repeats itself a few weeks later.<sup>5</sup> The annual short-term borrowing is familiarly referred to as the "spring borrowing".

In April 1984, the spring borrowing was \$4.3 billion, equivalent to almost one-fourth of tax receipts the previous year. Next April the spring borrowing is expected to rise to \$4.5 billion—despite an anticipated cash surplus—because still more bills are planned for delayed payment. As a single borrowing, this TRAN issuance is surpassed in size only by the borrowings of the Federal government.

The size and persistence of the spring borrowing imposes several costs on the state. The interest cost in SFY1984-85 is \$245 million, or one percent of projected tax receipts. Moreover, the size of the debt, about equal to the combined short-term borrowing of the next nine largest state borrowers, has contributed importantly to New York's relatively low credit standing. This low rating costs New York an estimated 30 basis points in interest costs on its long-term debt.<sup>6</sup> Reducing this debt is the second major option to consider.

Furthermore, New York has inadequate reserve funds to provide for the routine errors of budget estimates. Budgeting is an error-prone activity in which revenue estimates were too high in some years as much as they were too low in other years. In the latter, revenue estimates in the closing months of the fiscal year, when final cash management decisions must be made, have been one to three percent lower than first estimated

Footnote 4, continued

and accrual-basis balances may be due to the incomplete identification of all accrued assets or liabilities. Other differences may be due to the arrival of bills after the fiscal year has ended. Since virtually all tax receipts are recorded in the General Fund under GAAP, cash or GAAP balances used in this study are for the General Fund as defined under GAAP. For an excellent discussion of the fund structure of GAAP accounting and the many public sources of information on the New York State budget, see Cynthia Green, "The State Budget Record Spending, Fiscal Imbalance", Citizens Budget Commission Quarterly, Spring 1984.

<sup>5</sup>Most of the TRANs issued each April are due the following March. For example, \$3.0 billion out of \$4.3 billion of TRANs issued in April 1984 mature on March 29, 1985. By mid-March the Comptroller must postpone regular bill-paying and begin impoundment of all state revenues until enough funds are accumulated to repay the notes. Because of the postponement of bill-paying every March, the state can redeem the TRANs and close its books on March 31 with cash balance and no outstanding short-term debt. However, increasing amounts of TRANs are issued within two weeks and the proceeds are used primarily to pay the prior year's leftover bills. In spite of the two week gap, this practice has every appearance of rolling over past debt and borrowing more to finance new GAAP shortfalls.

<sup>6</sup>Office of the State Comptroller, "A Multi-Step Plan to Reduce the Spring Borrowing and the State's Accumulated Deficit", December 29, 1983.

when the budget was approved.<sup>7</sup> To minimize disruptions from such unanticipated revenue shortfalls, over twenty states set aside unexpected revenues in good years for use in years when revenues fall short. New York currently has only \$51 million in reserves, less than 0.2 percent of projected revenues for this fiscal year and less than half the smallest estimation error in the past eight years<sup>8</sup>

In addition to tax cuts and the two other uses of the cash surplus, the Governor's desire to balance next

<sup>7</sup>Initial budget estimates are reported in the State of New York *Official Statement*, April 11, 1984, and the closing estimates are reported in the State of New York *Annual Budget Message* (various years)

<sup>8</sup>Several states prefer to have larger funds that help them to weather not just routine forecast errors but also times when the economy turns sour. Six have funds equal to about 5 percent of expenditures. For New York's \$28 billion of SFY1983-84 spending, this would require reserves about fourteen times larger than the \$100 million the state plans to have in reserve by next April. A more precise method for calculating the uncertainty of revenue estimates is discussed in Robert Litterman and Thomas Supel, "Using Vector Autoregressions to Measure the Uncertainty in Minnesota's Revenue Forecasts", Federal Reserve Bank of Minneapolis *Quarterly Review* Spring 1983, pages 10-22. The reserve funds used by other states are discussed in Steven Gold, "Preparing for the Next Recession: Rainy Day Funds and Other Tools for States", National Conference of State Legislatures, Legislative Finance Paper No. 41, December 30, 1983.

year's budget on a GAAP basis will also require more cash. To maintain GAAP balance, payment of the planned increases in school aid will have to be accelerated so that current year cash will pay for it instead of the following year's spring borrowing. Similarly, more cash will have to be available to pay tax refunds before March 31. And these additional cash requirements come on top of the cash pressures from the salary increases that will be awarded in collective bargaining with state personnel next spring.

In evaluating state fiscal management, the analysis starts from the perspective that tax cuts and reductions in the overall tax burden can benefit the economic development of New York and that the economic development impact of any tax program is affected by three criteria. First, taxpayers place less value on tax reductions in the future. To be most effective, a tax program should have some emphasis on tax cuts in the early years of the program. Second, taxpayers are also cautious and dislike uncertainty. A program that is highly dependent on uncertain events—such as future economic growth, expanding budget surpluses, or fiscal reform—will probably have a small effect on economic development. Third, raising taxes and cutting expenditures during a recession is undesirable.

This study seeks to assess the impact of fiscal management on these three criteria by analyzing both New York's past practices and then alternative fiscal plans. It finds that financial practices contributed to the past reversal of state fiscal policy and imposed several costs on the state. By simulating another tax cut over a possible future recession, the study finds that the costs may be reduced, policy reversals avoided, and greater overall tax reduction achieved if fiscal management techniques are applied properly in the future.

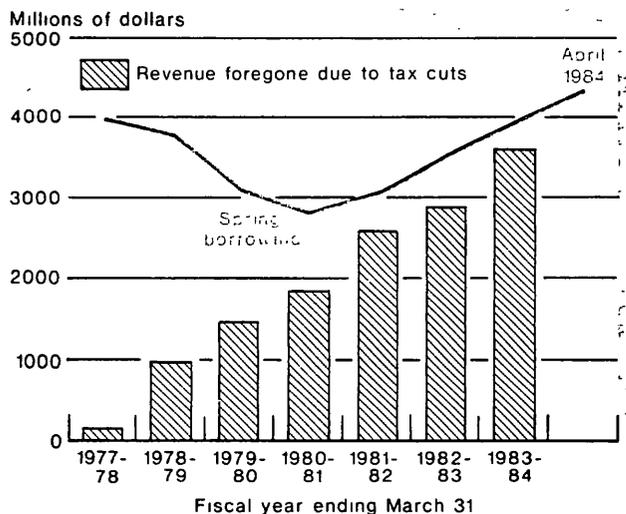
In particular, a balanced, controlled program of near-term debt reduction, tax cuts, and reserve accumulation may improve the chances of maintaining prudent tax reduction and expenditure growth through an economic downturn at some point in the next five years. The analysis begins with a diagnosis of how New York's tax cuts came to be partly reversed.

### Past practices

For years, financial managers in New York State have maintained steady cash balance, despite wide swings in the state's true financial condition. In the five years preceding SFY1982-83, the General Fund, which had billions of dollars of spending, had a cash balance that varied by only \$5 million (table). In contrast, short-term borrowing varied by almost \$1.2 billion, or from over 36 percent of tax revenues to less than 23 percent. Since modified accrual balances were first published in 1981, the General Fund has had a GAAP deficit of at least

Chart 2

### Tax Cuts and Spring Borrowing\*



\*The spring borrowing is related to the prior fiscal year's accelerations or deferrals of payments. Foregone revenues are cumulative, beginning with 1977-78.

Source: Federal Reserve Bank of New York Staff estimates based on data from the New York State Comptroller, Senate, and Assembly.

\$250 million yet on a cash basis it has been in surplus for all but one year

In addition, this cash balancing encompassed only part of total state spending. Before SFY1982-83, the state budget process and reporting covered transactions only of the General Fund, which includes less than two-thirds of total state spending. The effects on the state's financial health of the remaining third of spending, therefore, received little public scrutiny. In the last several years, however, legislation has required that all government spending be included in the budget. This more comprehensive measure of expenditures is now available for prior years as well (table).<sup>9</sup>

New York fiscal practice is closely related to the unusual overlap of the state fiscal year and the fiscal year of school districts and localities. The state fiscal year begins on April 1 and ends the following March

School districts and most localities receiving state aid begin their fiscal year three months later on July 1. This discrepancy means, for example, that state payments to localities in April, May, and June of 1984 occurred in state fiscal year 1984-85 but in local fiscal year 1983-84. In practice, the state can authorize SFY1983-84 local aid expenditures that do not require cash until SFY1984-85. Most importantly, this delayed funding enables the state to finance prior fiscal year expenditures with current fiscal year short-term borrowing every April (Chart 1).

The opportunity for fiscal management in New York is provided by the ease of adjustment provided by all these factors. New York has used principally four techniques to adjust recorded cash receipts and disbursements and thereby maintain cash balance. The techniques and how they affect cash balance are as follows:

- Deferring aid payments to school districts and localities until the following fiscal year;
- Deferring personal income tax refund payments until

<sup>9</sup>A lucid review of the shortcomings of state financial reporting and practice is contained in the Comptroller's Message in the 1978 *Annual Report of the Comptroller*. The legislation which mandated changes in reporting practices is explained in the State of New York *Official Statement*, April 11, 1984.

### The Fiscal Condition of New York State

In millions of dollars

Fiscal Year April 1 to March 31	Cash basis		Budget GAAP	Tax cut programs			TRANS	
	Disbursements* All Governmental Funds	Tax receipts	General Fund balance†	New cut	Total reduction	Issued in April	Other	
1977-78	17,846	10,491	4	‡	-184	-184	3,930	0
1978-79	19,404	11,005	5	‡	-791	-994	3,790	0
1979-80	20,412	12,320	0	‡	-346	-1,408	3,100	0
1980-81	22,307	13,485	0	-257	-307	-1,829	2,800	0
1981-82	24,778	15,129	3	-339	-545	-2,562	3,050	0
1982-83	26,460	15,976	-62	-1,076	-268	-2,882	3,500	500
1983-84	28,361	18,688	51	-345	-412§	-3,595§	3,900	0

Disbursements and tax receipts are reported on a cash basis for All Governmental Funds. As defined by GAAP, this includes the General, Special Revenue, Debt Service, and Capital Projects fund types. The cash- and accrual-basis General Fund balances follow the GAAP definition of General Fund for fiscal years beginning on or after April 1, 1980, and the former definition for earlier fiscal years. A comparison of the two definitions is presented in the February 1983 *Message of the Governor*. Calculation of the cumulative annual effect of tax reductions uses each incremental tax cut as an additional reduction in the tax base. The following year's tax revenues are calculated from the new tax base, the implicit income elasticities for each year, and the growth in New York State personal income. The Tax and Revenue Anticipation Notes (TRANS) issued in April are referred to as the spring borrowing and they mature before March 31. The other TRANS were issued in January 1983 and they matured in the following fiscal year.

\*Disbursements not funded by taxes and General Fund receipts are financed mostly by Federal grants. They are also funded by proceeds from general obligation bonds and notes and by fees charged by state educational and medical facilities.

†Surplus is positive, deficit is negative

‡Not available

§Excludes about \$800 million in tax increases

Sources: Federal Reserve Bank of New York staff estimates based on State of New York, *Official Statement*, April 11, 1984, *NYS Annual Report of the Comptroller* (various issues), *NYS Comptroller's Annual Report to the Legislature on State Funds Cash Basis of Accounting* (1984), *NYS Annual Budget Message* (various issues), and other information provided by the State of New York Senate Finance Committee, State of New York Assembly Ways and Means Committee, and State of New York Division of the Budget.

the following fiscal year;

- Depositing and withdrawing funds from the Personal Income Tax Refund Reserve; and
- Depositing, borrowing, and repaying funds to the Tax Stabilization Reserve Fund.

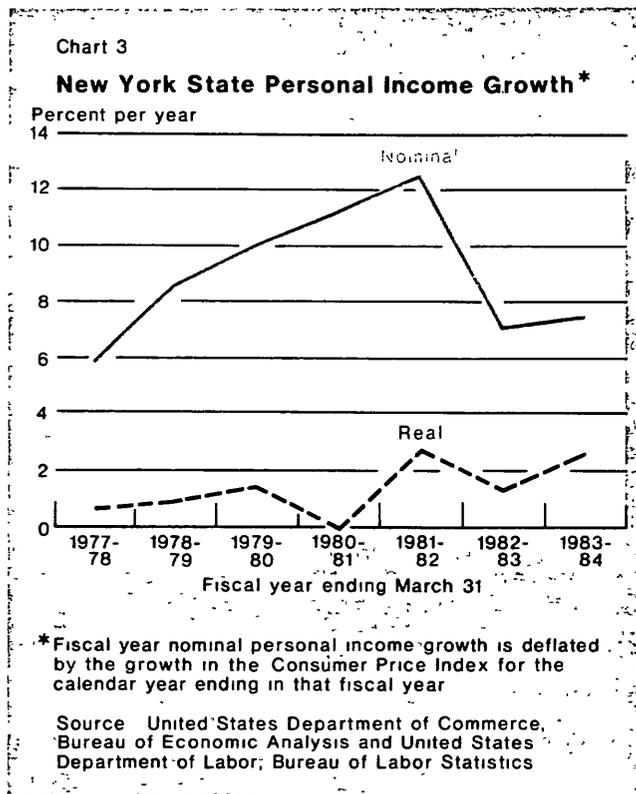
Local aid deferrals, which account for about 65 percent of adjustments to the cash budget, reduce recorded disbursements and thus cash deficits. Deferring tax refunds or withdrawing refund reserves, by way of contrast, increases recorded tax receipts, thereby lowering the recorded cash deficit for a given year. In addition, any cash deficits that have not been eliminated by these three techniques can be financed by the Tax Stabilization Reserve Fund at the end of the fiscal year. For the three years beginning with SFY1980-81, the state also supplemented its cash receipts with some one-time transfers from off-budget funds. By these means, state budget managers have substantial leeway to adjust the cash surplus or deficit at the end of the fiscal year.<sup>10</sup>

Deferrals are actively managed as a part of the budget process and their effect on the cash budget is predictable in advance. In that sense, the practice of deferring or accelerating payments goes beyond routine cash management and must be analyzed as an active instrument of fiscal policy.<sup>11</sup>

In this study, local aid deferrals are measured as GAAP liabilities to localities (*Annual Report of the Comptroller*). Tax refund deferrals are measured as personal income tax refunds paid after April 1 for the tax year ending the previous December (*State of New York Official Statement*). Tax Refund Reserve usage is reported in the *Annual Budget Message*. Stabilization Fund usage is reported in the *Annual Report of the Comptroller*, and one-time transfers are reported in the *State of New York Official Statement*, February 22, 1984.

The impossibility of knowing whether a delayed payment was due to late arrival of a bill or due to a policy decision to defer payment can lead to disagreement over the proper measure of deferrals. GAAP can distinguish between what was eventually paid and what was actually paid prior to April 1. And refinements of GAAP procedures have made these estimates of accrued liabilities more comprehensive over the past several years. GAAP figures exaggerate the true extent of policy decisions to defer payments because not all deferrals are controllable. Under GAAP, some deferred liabilities such as Medicaid, pensions, and vouchers payable grow irrespective of policy actions. Similarly, the amount of accrued tax refund liabilities is partly due to policy decisions to postpone refund payments and partly due to how many taxpayers file their returns after the end of the fiscal year on March 31.

The size of the spring borrowing is an alternate proxy for the extent of cash adjustment in New York. The amount of TRANs issued each spring is closely related to the amount of local aid and tax refund payments left over from the previous fiscal year (Chart 1). Efficient management of state cash flows will always include some issuance of TRANs since taxes are not necessarily received at the same time that the state's bills are due. However, as they are used in New York, TRANs are a means for financing fundamental budget imbalances.



### Cash budgeting and the 1978-84 tax cut program

In SFY1977-78, New York initiated a series of cuts in personal, business, sales, and estate taxes. The first year's cuts reduced tax revenues by \$180 million or about two percent (table). Annual cuts of \$250 million or more continued for the next six years. By the end of the program, tax revenues were almost \$4 billion or about 17 percent less than they otherwise would have been. The revenues foregone in the last year of the program would have been enough to eliminate the GAAP deficit, to cancel most of the spring borrowing, or to finance a reserve fund large enough to have prevented the need for state tax increases and spending reductions in SFY1983-84. In seeking instead the economic development benefits from slower growth in tax revenues, the state did not equally slow the growth of spending. Resolution of the fiscal conflict this created was delayed by the fiscal management of New York's cash budget.

In the first two years of the tax program, growth in the state economy and surpluses from prior years were still sufficient to finance both current spending and tax cuts as well as to accelerate enough payments to reduce spring borrowing needs by almost \$900 million (Charts 2 and 3). The recovery of the state economy

provided an opportunity to catch up on the backlog of bills this represented, increasing the future availability of deferrals and short-term borrowing in financially more difficult years.

More rapid nominal growth of the state economy in SFY1979-80 and SFY1980-81 (Chart 3) enabled tax receipts to rise even as the value of the tax cut program was reaching \$1.5 billion. In addition, spending growth and debt reduction were continued over both years—spending grew by about fifteen percent and short-term borrowing fell by one-fourth. Nevertheless, the emergence of a conflict between tax and spending policies was reflected by fiscal adjustments to create a more positive cash position. Income in each year was raised by about \$400 million by virtually emptying the Personal Income Tax Refund Reserve, slowing tax refund payments, and transferring cash from off-budget funds into the General Fund. The cash position was further enhanced through a freeze on revenue sharing with local governments and through late payment of over \$2.5 billion of school aid and personal income tax refunds.

In SFY1981-82 and SFY1982-83, the use of fiscal management techniques increased substantially. Policy decisions reduced or cancelled current payment of tax refunds, continued to seek one-time revenue sources, and deferred payment of substantial amounts of bills.

By permitting the state to maintain cash balance, these actions made it possible to budget accelerating expenditures at the same time the state's GAAP deficit was expanding. Press coverage of the fiscal debates at the time reveals these widely differing assessments of the state's fiscal health.<sup>12</sup> Without consensus on the state's fiscal position, there was little basis for agreement on the need for compromise between tax and spending priorities. The outlook was further complicated by the fact that, while the nation was reentering a recession in 1982, the above-average growth of the state economy was sustaining strong revenue growth; some hoped continued growth would pull the state through to fiscal health.

Midway through SFY1982-83, however, these ambiguities evaporated. The recession had entered the service industries for the first time, seriously affecting the New York economy. Moreover, a sharp slowdown in inflation cut deeply into the growth of the tax base (Chart 3).

There was a dramatic slowdown in growth of net tax receipts to less than six percent in SFY1982-83 from an annual average of about eleven percent over the previous three years. Nevertheless, state spending growth exceeded this by almost \$1 billion.

<sup>12</sup>For examples see articles and/or editorials in *The New York Times* on January 20, April 14, May 7, June 6, and November 11, 1982.

New York had already tapped all the techniques available to allow it to certify that the proposed budget was balanced. No current tax refunds were planned, and all refund payments were deferred into the next year. Use of one-time revenue sources peaked at over \$500 million. Continued delayed payment of local aid was pushing the spring borrowing back to its April 1977 peak. This was not enough and the state issued an extraordinary TRAN of \$500 million in January 1983 that was carried into the next fiscal year. The total increase in debt and fiscal adjustments necessary to finance the expenditure program replaced almost one-half of the SFY1982-83 revenues foregone through the tax cut program.

As the budget was being formulated for SFY1983-84, the revenue shortfall remained severe and the state economy weak. There were virtually no further fiscal adjustments to utilize and the special borrowing of the previous year had to be repaid. In this setting, consensus was reached that tax and expenditure policies were out of line. As a result, consumption taxes, selective business taxes, and various fees were increased by an estimated \$800 million and work force reductions saved another \$200 million.

The reversal of over 20 percent of the progress in reducing the state tax burden could have been avoided in the middle of a recession if tax and spending policies had been kept in line when the economy was expanding. One obvious way to have facilitated this would have been agreement on some measure of the fiscal condition of the state. Alternatively, there could have been agreement that increased spring borrowing or any of the fiscal adjustment techniques could not be used when the economy was expanding. Or that tax cuts or expenditure increases were contingent on a zero GAAP balance or a steady or falling spring borrowing.

If this had been done, one could have seen at least two signals by 1981 that some restraint of tax cuts or expenditure growth was necessary. The first was that, in closing the books in March 1980, the state spent virtually all that remained in its two reserve funds combined. The second was that the March 1981 balancing effort forced up deferrals of tax refunds and local aid at a faster rate than the economy was growing.<sup>13</sup>

### **Costs of past practices**

As Chart 2 shows, since 1978, New York State has indeed benefited from a substantially reduced tax

<sup>13</sup>The key to recognizing these signals is to combine the effect on the budget of all four adjustment techniques. In any given year, some techniques are used more than others. Focusing on any single technique over this period would not have revealed a picture of rapidly and continuously expanding use of fiscal management techniques.

burden, even given the reversals of SFY1983-84. Moreover, deferrals are an indirect way to borrow interest-free. And TRAns are a much less expensive way to fund a deficit than are long-term bonds. But the fiscal management practices—deferrals, reserve fund withdrawals, and increased short-term borrowing—have also had undesirable effects on the state, including

- An increased fiscal adjustment burden on localities faced with volatile and unpredictable aid flows,
- High direct debt-servicing costs and deteriorated credit standing because of budgetary reliance on continual and expanding access to short-term, tax-exempt credit markets;
- An unpredictable long-term tax environment in which businesses and individuals may find it difficult to plan for the future composition or size of their tax liabilities, and
- A procyclical worsening of the economy in a downturn because all alternatives to tax boosts or spending cuts were exploited in more prosperous years

Because aid to local governments and school districts is more than 60 percent of state spending, one would expect occasional disruption to aid payments when the state encounters fiscal difficulties. However, school districts and cities routinely face an uncertain budget environment and an erratic cash flow from year to year because of the constant and extensive adjustments to local aid. For example, each year since SFY1979-80, the legislature has reimposed a cap on state revenue sharing to localities. As a result, each year local governments have had to limit expenditures or find alternative revenues for the \$80 to \$150 million in increased revenue sharing they were otherwise scheduled to receive.

Unpredictable year-to-year cash flows undermine the value of state assistance and may have additional adverse effects on the ability of localities to implement long-range spending plans. Furthermore, within each fiscal year, many school districts and counties must borrow until the closing weeks of their fiscal years when state payments finally arrive, creating an additional local short-term financing burden on New York taxpayers. For example, the particularly late payments for SFY1980-81 were estimated to have imposed extra financing costs on localities and school districts of about \$22 million.<sup>14</sup>

The extensive use of deferrals brings the state to the short-term credit market with regularity. The financial

costs are substantial. New York pays over \$200 million in interest every year on the spring borrowing. The risk that the state will be shut out of the market, and be caught short by billions of dollars, is small—high state taxes and the growing popularity of tax-exempt money market funds probably ensure strong and continuing demand for New York paper. But New York's reliance on debt for operating funds contributes to the state's relatively low credit rating. This penalty has already raised New York's infrastructure repair bill by an estimated \$60 million over the next decade or so.

A less quantifiable, but potentially more harmful, consequence of New York's recent fiscal experience is the effect it may have on popular perceptions of the future tax burden in New York. Decisions of businesses to invest in New York, or of skilled individuals to take jobs in New York, are influenced by their expectations concerning the tax consequences of their decisions over a period of many years. The trend toward reduced taxes was halted and partially reversed in SFY1983-84. If New York embarks on a new tax cut program that again results in tax increases a few years down the line, future tax cuts may have little effect on expectations.

The last consequence of past fiscal practices was that, by exhausting most of its management techniques in relatively good years, the state had little maneuvering room during bad years. As a result, the state was left with no alternatives to raising taxes and reducing the state work force in a recession, when the state economy most needed income and jobs.

### **Alternative fiscal plans for New York**

The most effective use of fiscal management techniques is to help maintain and not reverse tax and expenditure plans during an unexpected recession. For example, a reserve fund system can collect funds in years of economic expansion for use in declining years to maintain desired tax and spending programs, including tax cuts. Deferrals can also be managed so that they stabilize state fiscal policy over business cycles—the state can reduce deferrals and the spring borrowing in expansions, and increase them in recessions.

The remainder of the paper examines how effective management of deferrals or reserve funds can preserve tax cuts and expenditure growth over a hypothetical economic downturn. To make tax reduction feasible, a combination of reasonable state economic expansion and controlled expenditure growth has been chosen that provides periods of both cash-basis and GAAP budget

*Footnote 14, continued*

impact of delayed payments, particularly on the most distressed localities. In SFY1983-84, the state increased its share of direct Medicaid payments to providers. Delayed state reimbursements for localities' direct payments had been an important source of local aid deferrals.

<sup>14</sup>E. J. Dionne, Jr. "Albany's Delay on New Budget is Called Costly", *The New York Times*, July 18, 1981, page 25. It should be noted, however, that special efforts have always been made to reduce the

surpluses now and in the future (illustrated by the two shaded areas in Chart 4). The bold line represents a target for tax receipts and expenditures over the next few years which would allow state spending, including aid to school districts and localities, to grow steadily without interruption at about the same long-term rate as the economy.<sup>15</sup> The dashed line represents the tax receipts that could be generated with constant tax rates at the same rate of long-term economic growth, with the exception of a downturn in year four.<sup>16</sup>

The state has three choices of how to respond to changing fiscal circumstances once a prudent expenditure objective is chosen.<sup>17</sup>

- Adjust tax rates as needed.
- Manage deferrals
- Manage reserve funds.

Each choice will be examined in isolation. The consequences of each choice become clear during and after the fourth year when the state is hypothesized to have an economic downturn that results in a cash shortfall of about the same magnitude as in SFY1982-83 and SFY1983-84. In the fifth year, a recovery is assumed that is sufficient to restore budgetary balance and provide growing surpluses in later years. The assumption of rapid growth of excess receipts is common to many fiscal analysts' projections of New York finances over the medium term.<sup>18</sup>

<sup>15</sup>The state has other sources of revenue such as Federal grants, long-term bonds, and educational and medical fees. These are excluded for the purposes of this exercise and it is assumed that all activities now financed by these non-tax revenues will continue to be financed that way.

<sup>16</sup>Personal income is assumed to increase at eight percent per year, which allows for moderate inflation and real growth at least as strong as any of the past 15 years. Tax receipts are estimated using elasticity estimates that represent a consensus of state legislative and executive budget analysts: 1.5 for personal income taxes, 0.9 for sales and use taxes, 1.1 for business taxes, and 0.6 for other taxes and fees. In addition, it is assumed that the 16 percent SFY1983-84 refund rate on gross personal income tax collections is maintained in the future so that any changes in gross collections will be accompanied by proportional changes in refunds and net collections.

<sup>17</sup>The pressures on the spending side of the budget process can be substantial, and government leaders may decide that important needs warrant using some of the surplus to finance more rapid expenditure growth. If so, and tax reduction and expenditure growth become incompatible, fiscal management can at best delay an eventual policy reversal.

<sup>18</sup>However, none of the existing state projections incorporate any national economic downturn over the next five years even though there has been a downturn, on average, once every 19 quarters in the post-war period. It has been 12 quarters since the last downturn.

The three alternatives discussed here can all finance a possible future shortfall. Equally important, they can also leave room for a tax reduction which is assumed to take the form of a two-stage, eight-year program, while maintaining expenditure growth equal to the long-term growth of the state economy. The alternatives primarily differ in whether or not they can prevent a reversal of the first-stage tax cuts and what effect that has on the second stage of tax cuts. To simplify the analysis, the tax changes will be only in the personal income tax and the first-stage cuts will take place all in fiscal year one.<sup>19</sup>

#### *Tax cuts with no fiscal management*

The first option is to institute a program of tax cuts now that is intended to eliminate much of the \$2 billion surplus that would otherwise accumulate over the first three fiscal years. The size of possible tax changes is illustrated in Chart 5. An immediate tax cut is followed by a tax boost in year four to finance a revenue shortfall and then by a resumption of tax cuts once surpluses reappear. The exact magnitudes will vary, depending how and which taxes are changed. Nonetheless, in the absence of expenditure cuts or the use of deferrals or reserves, an economic downturn will result in a roller coaster pattern of overall tax policy.

A gross tax cut of \$450 million in the first year will lower tax revenues over the first three years by about \$1 billion after refunds, and it will increase the shortfall in year four by half.<sup>20</sup> If other adjustments, such as deferrals and expenditure cuts, are to be avoided and if no reserve funds are available, a revenue shortfall must be avoided by substantial increases in taxes during the economic downturn. The gross tax increase necessary to finance the shortfall in Chart 4 is about \$1.5 billion.

Because the effect of a tax change increases each year, the tax boost necessary to eliminate the revenue shortfall in the fourth year will produce expanding surpluses in subsequent years. To eliminate the surpluses, taxes would have to be cut in the fifth year to offset the temporary boost and then again the next year as part of the second stage of the tax reduction program.

This fiscal management technique has the advantage of minimizing tax burdens until economic events force

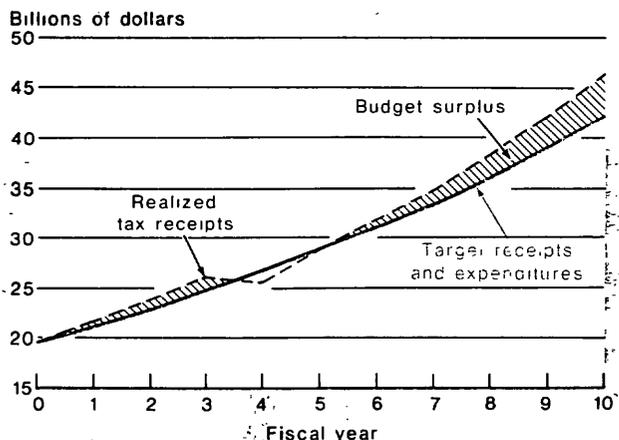
<sup>19</sup>A program that gradually phases in cuts in several taxes over several years would allow additional cuts but it would also create a larger fourth year shortfall.

<sup>20</sup>The scheduled sunset of temporary taxes in SFY1985-86 could have a similar and perhaps larger effect. Any cuts beyond this sunset will further reduce future surpluses and possibly increase any future shortfall. The excess receipts remaining after the tax cut are assumed to be used for one-time expenditures. Saving leftover funds for later years through accelerating payments or raising reserve funds is discussed later on in the article.

Chart 4

**New York State General Fund Tax Receipts and Related Expenditures**

Hypothetical business cycle



Source Federal Reserve Bank of New York staff estimates

an upward adjustment. It also has the virtues of being publicly visible, easily monitored, and under the direct control of elected government officials

But this approach is not without difficulties. A policy requiring tax boosts in an economic slowdown reduces some incentives to business investment from the initial tax cut. To some degree, this effect can be limited by lowering only those taxes which are most likely to affect business decisions and raising only those taxes which are least likely to do this. Nevertheless, even when tax changes are selective, fiscal adjustment via the tax system places severe strains on individual and business taxpayers—their tax burden is raised when they are least able to pay, yet lowered when their financial situation is eased

Moreover, tax changes are not easy to manage. The legislative process and tax collection procedures result in long lead times between the proposal of a tax change and the actual change in receipts. Recent experience in New York also suggests that this timing problem can be exacerbated by pressures to cut taxes as soon as surpluses appear yet boost taxes only as a last resort.

*Managed use of deferrals*

Deferring payments or drawing on reserve funds may ease a cash shortage enough so that tax increases may not be necessary. When properly managed, both methods accumulate funds in years of economic expansion and disburse the funds in economic down-

turns or years of unexpected fiscal stress. The deferral method prepares for difficult years by reducing deferrals and the spring borrowing while the reserve method does so by increasing reserve fund balances. The principal distinction between the two is timing and discipline. Reserve management is useful only if sufficient reserves are accumulated before the shortfall occurs, whereas effective deferral management can reduce deferrals and debt throughout the business cycle. Also, deferral management has few formal guidelines whereas use of reserves is governed by statutory rules.

Simulation of tax receipts and properly managed deferrals over the hypothesized business cycle shows a possible pattern of tax cuts and short-term borrowing as follows (Chart 5). In the first year, taxes would still be cut as before. In addition, jointly with the tax reduction, some bills would be prepaid to increase the proportion of current funding until the spring borrowing early in fiscal year four is about \$1.3 billion lower.

As the economy turns down in the fourth year, the cash budget would be balanced, not by raising taxes, but instead by reducing current fiscal year cash requirements through deferrals of local aid and/or personal income tax refunds. In the following year, the spring borrowing would increase by about \$1.5 billion to provide the funds for the postponed aid and refund payments.

Subsequent catch-up spending to repay interest and principal necessarily reduces the scope for the second stage of tax cuts. In the present example, because of the costs of the earlier tax cut and the new short-term debt, deferrals continue to grow modestly through the fifth and sixth years. As a consequence, the resumption of the tax cut program must be scaled down to \$300 million and postponed until the eighth year in order to leave enough revenues to repay the debt. Full repayment allows the program to resume the full schedule of cuts in the ninth year.

A deferral-based method of balancing the budget has several advantages, which may account for its popularity in New York. Most importantly, many deferral decisions can be made in the closing weeks of the fiscal year. This characteristic leaves maximum flexibility to state officials in planning the precise timing and magnitude of the budget-balancing effort—an advantage notably absent when tax changes are used to replace lost revenues. Furthermore, the Federal tax exemption on state debt indirectly subsidizes New York's use of the spring borrowing to balance the state books.

But, as the example illustrates, postponing payment of obligations places an increased financial burden on the future that can be limited only by debt reduction prior to an economic downturn. The economy in succeeding years may not have enough strength to produce

sufficient tax revenues for both debt servicing and current expenditure programs. Even when future cash surpluses do become large enough, reduction of deferrals and short-term borrowing may be unpopular alternatives to tax cuts or expenditure increases. Thus, deferrals can easily continue for years after the revenue shortfall is over—two years in the present example but potentially indefinitely.

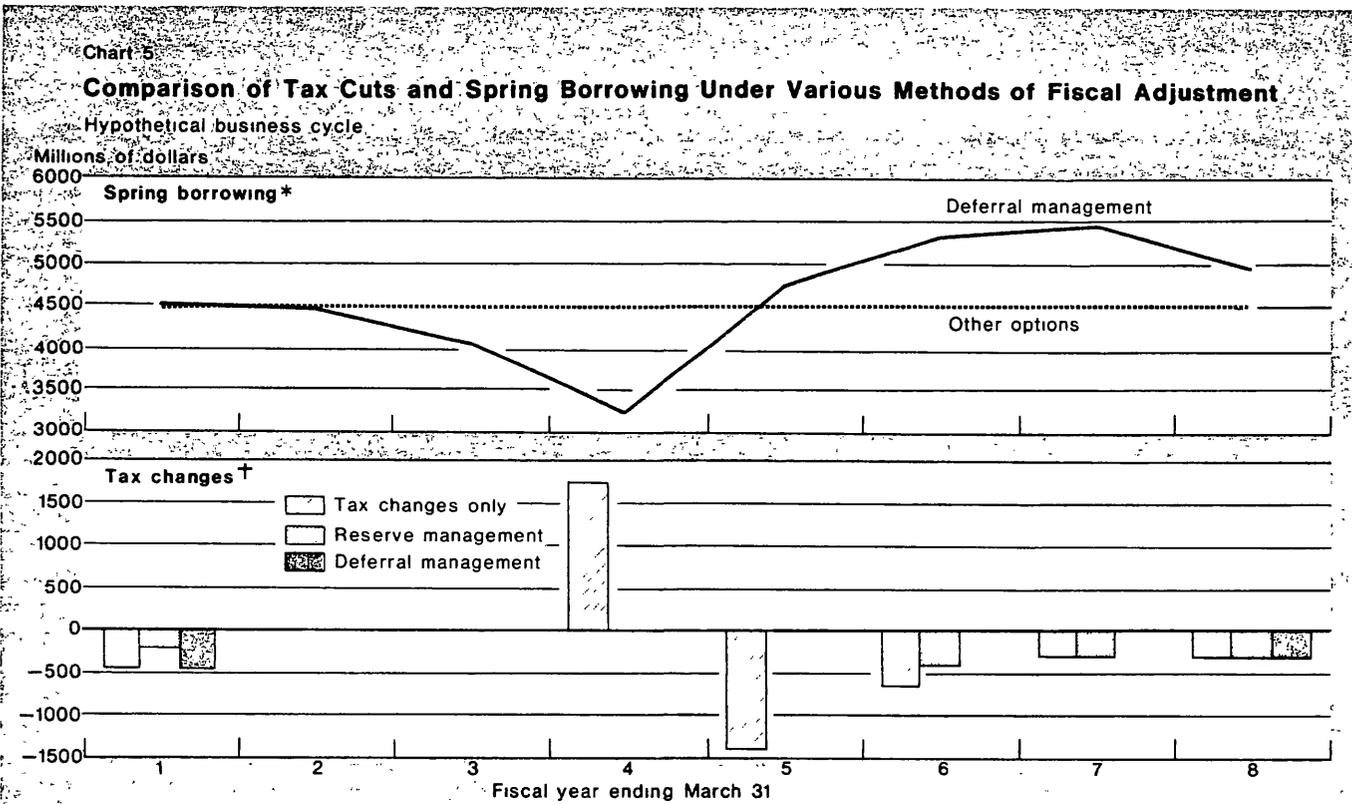
For a successful deferral system to rely on expanded deferrals and short-term borrowing in difficult years, there must be some reduction of deferrals and the spring borrowing in good years. Reduction and increase of deferrals will probably require continued constitutional and statutory authority to budget both GAAP surpluses and deficits, respectively. Given the fiscal pressures already on state officials when there is a cash surplus, budgeting a more stringent GAAP surplus is likely to be difficult. Another issue, closely related to this incremental adjustment of short-term debt, is how to manage

the spring borrowing that remains. An assessment of the costs and benefits of continued annual short-term funding deserves considerable attention but lies beyond the scope of this study.

#### Greater use of reserve funds

Financing revenue shortfalls with a reserve fund can avoid all of the disadvantages of a deferral-based system of funding. Reserve funds, like deferrals, allow maximum flexibility in managing the exact amount and timing of deficit elimination efforts. Because deficits are funded entirely by previous, known surpluses, reserve funds can potentially be the most stabilizing deficit-funding technique. Furthermore, reserve balances earn interest income, and their existence is likely to improve New York's credit standing and thereby reduce debt-servicing costs.

There are, however, serious disadvantages to a reserve fund and few states have completely exploited



\*Spring borrowing based on expected 1985 level

† These are the first-year effects on gross tax receipts. Net receipts will not change by as much because of proportional changes in refunds. The multi-year effect of a tax change will be larger, depending on the growth of the state economy.

Source: Federal Reserve Bank of New York staff estimates.

its potential. The principal difficulty lies in establishing rules for depositing and withdrawing funds from the reserve. Deposits are often too small to accumulate to a significant balance and withdrawals are frequently made before an economic downturn occurs. For example, New York's combined reserves were virtually exhausted three years before the cash shortfall of SFY1982-83. Reserve funds also require legislators to set aside funds years before fiscal problems become apparent—a difficult task when immediate demands appear to be more pressing.

With a well-designed fund, an immediate tax cut can be accommodated and still permit sufficient reserve accumulation to avoid tax increases during the hypothetical economic downturn in the fourth year. A first-stage tax cut of \$200 million in the first year would limit the amount available for the reserve fund in the example to one percent of receipts or just over \$200 million. To compensate, the contribution rate in later years must be increased, say, to 2.5 percent. The lower revenue path created by the first-stage tax cuts would prolong the withdrawal of reserves into the fifth year and limit the initial second-stage tax reduction to \$400 million. However, subsequent cuts of the tax program could remain on schedule (Chart 5).

Financing a shortfall of this magnitude, or of the magnitude of SFY1982-83 or SFY1983-84, without recourse to deferrals or tax increases requires reserves of about \$1 billion. Setting aside this amount, while at the same time limiting the size of tax cuts and expenditure growth, may be impractical for New York. If so, the best system may be more strict control and oversight of a compromise among several approaches.

#### **Determining the best combination of fiscal management approaches**

No single approach to fiscal management seems ideal for New York. The simulations under each approach reveal a tax program over the business cycle that contradicts one of the three criteria for a tax cut program to help promote economic development.

- Reserve fund management reduces the scope for near-term tax cuts.
- Deferral management may limit future tax cuts.
- Tax changes without fiscal management could repeat the procyclical fiscal experiences of SFY1982-83 and SFY1983-84.

The first criterion is that the tax cuts should come soon to have the greatest value to taxpayers. The most immediate tax relief is facilitated by a system of tax adjustment or spending deferrals because state officials

need make no provisions for revenue shortfalls in advance.

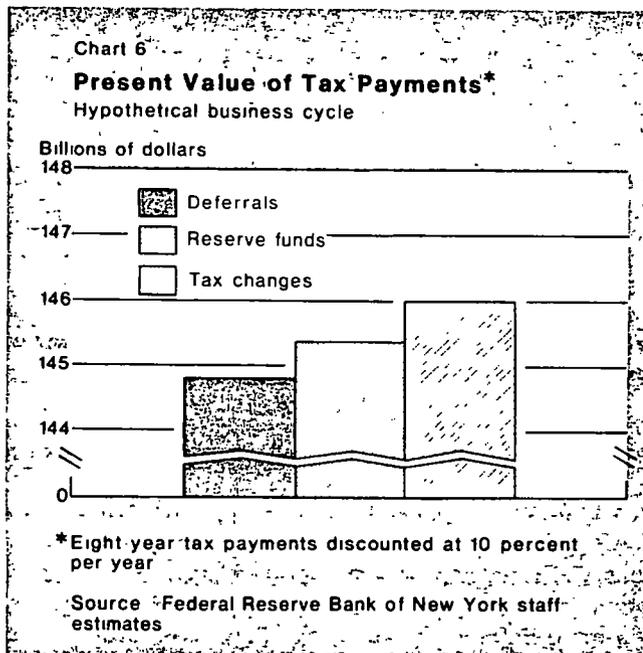
A common measure of the value of the stream of payments over several years is its net present value. The present value of tax payments acknowledges the value of future tax changes at the same time that it places more emphasis on the level of taxes in the early years of the program. While the eventual tax burden depends on tax changes, reserve accumulation, debt service, and economic growth in an uncertain environment, the tax burdens in this simple setting suggest which methods of fiscal management are most capable of facilitating permanent tax reduction.

Chart 6 shows the present value of tax collections under each management approach to financing target expenditures over the business cycle. The present values of tax collections vary across alternatives because of the consequences of each approach on the timing and duration of tax cuts over all stages of the cycle. Each management system achieves tax reductions of roughly ten percent or more from what taxes would otherwise have been. Reductions could be greater if lower expenditure growth was targeted.

These calculations suggest that careful management of deferrals could save taxpayers an additional \$1 billion through lower taxes over the course of a business cycle compared with a management system that relies on tax increases to avoid revenue shortfalls. The additional savings is about \$500 million if reserve funds are used instead of tax changes.

The second criterion is that the tax cut program must have a reasonable probability of being carried through to completion. Without that, it may have a limited effect on New York economic development. Use of a reserve fund provides the greatest probability that the full long-term tax cut program will be completed. By preparing for fiscal difficulties in advance, a reserve system relies much less on uncertain future economic events or budget surpluses for its effectiveness. Adjustment through tax changes also has a high probability of meeting the long-term tax cut targets; however, in the meantime the tax environment may be erratic and thus hurt economic development. In contrast, increased post-recession debt repayment relies heavily on uncertain future economic growth to finance both deferrals from prior years and continued tax reductions. For that reason, a deferral system provides the least assurance that planned tax cuts will be carried out.

In terms of the last criterion, both a deferral and a reserve system can provide assurance that tax increases over the medium term are unlikely, even if the state encounters a revenue shortfall. The key to that assurance is the ability to accumulate in advance a pool of reserves or unused deferrals. The more rapidly



reserves are set aside or deferrals and short-term borrowing are reduced, the greater will be the future pool of emergency resources. A system relying only on tax adjustment obviously provides little assurance that future tax increases can be avoided, because it makes no provision for contingencies.

Thus, tax cuts must be accompanied by the use of deferrals or reserve funds in order to satisfy all three criteria. Use of reserves or deferrals, however, does not guarantee these objectives will be achieved, as New York's past experiences have shown. Their achievement requires that reserves and deferrals must be properly managed so that sufficient resources are always available for use only when an unexpected economic downturn produces a revenue shortfall. The difficulty lies in how New York State can use its existing reserve funds and well-established deferral system to greater advantage than it has in the past.

One way to address this problem is to incorporate into deferral management some of the strengths of a reserve system. Such a combination might provide good overall tax-reduction characteristics while limiting adjustment burdens on local government and reducing uncertainty

concerning the future tax reduction. Such a hybrid approach may be possible with the tools already available to New York fiscal managers. The current techniques used in New York, taken as a whole, should be able to provide several ways to implement a controlled system of management incorporating the best characteristics of deferrals and reserve funds. One direction to take could be the following:

New York's ability to defer local aid payments and income tax refunds, and to finance them with short-term debt, can be viewed as an adjustment potential to be tapped when unexpected economic developments lead to a cash shortfall. During periods of economic expansion, this range of flexibility can be enlarged by reducing deferrals and the spring borrowing. This reduction is analogous to a buildup of reserves because it increases the amount of adjustment possible should a downturn occur.

To facilitate the managed reduction of deferrals of tax refunds, New York's Personal Income Tax Refund Reserve could be used each year to set aside enough cash for current estimated tax refund liabilities. Total refunds have remained steady over the past nine years, at 16 to 17 percent of gross collections. A set-aside of this amount will reduce and possibly eliminate the financing of tax refunds through the spring borrowing.

In addition, New York's Tax Stabilization Reserve Fund could be incorporated into fiscal planning. The cash balance of the fund is presently scheduled to grow annually by about \$50 million for the next two years and by \$16 million for three more years to a total of \$200 million. If left untapped until an economic downturn occurs, it will lessen the need for deferrals and thereby limit the burden on local aid.

#### Future policy

The effects of an economic downturn need to be considered in planning a tax cut program. A multi-year plan combining modest tax cuts and prudent management of deferrals and reserves can provide state residents with even greater tax reduction over the business cycle than a program that simply cuts taxes without any contingency planning. Moreover, the effectiveness of tax reduction and of local aid may also be enhanced. The key to achieving these benefits is more comprehensive overview and control of the fiscal management of New York State.

Allen J. Proctor