New York

Preliminary Analysis of Recent Budget Developments

Division of the Budget
October 3, 2008

Governor
David A. Paterson

Budget Director
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Introduction

On October 30, 2008, the Division of the Budget (DOB) will release the Mid-year Update to the 2008-09 Financial Plan (the "Mid-Year Financial Plan"). The Mid-Year Financial Plan will include revised multi-year revenue and spending forecasts based on a review of operating results through the second quarter of the fiscal year, a review of program trends, and an updated economic forecast.

Governor David Paterson has directed DOB to prepare a preliminary estimate concerning the impact of September's extraordinary economic events on the State's Financial Plan. This information is intended to give the public an initial assessment, in advance of the Mid-Year Financial Plan, of the budgetary risks resulting from the recent turmoil on Wall Street.

Overview

In the July 2008 First Quarterly Update to the State's Financial Plan, DOB said the economic downturn would have an adverse impact on State finances, noting that "the nation's economic troubles are severe and widespread [and] important financial institutions face a crisis of confidence among investors and the general public." A series of unprecedented economic shocks in September have further worsened the State's fiscal outlook.

DOB now expects annual General Fund tax receipts in the current year to fall $1.3 billion below the projections in the First Quarterly Update. In addition, adverse market conditions will likely delay both plans to convert GHI/HIP to a for-profit company and the sale of certain surplus State properties, adding another $300 million in expected costs to the current year. Current-year savings of $427 million from the August Legislative session will partially offset these costs.

The net impact of these changes is that the State must close a shortfall of approximately $1.2 billion in the current year. The budget gaps for 2009-10 and beyond will also increase. DOB is currently developing a revised forecast regarding the state's out-year budget deficits, which it will publish in the Mid-Year Update.

Economic Outlook

Credit market conditions have continued to deteriorate since the First Quarterly Update to the State's Financial Plan in July 2008. Financial institutions have become increasingly less willing to lend to each other, culminating in the largest bank failure in history (Washington Mutual), the bankruptcy of one major investment bank (Lehman Brothers), the wholesale Federal takeover of Fannie Mae and Freddie Mac, the bailout of a large insurer (AIG), and a Congressional bill to address under-performing assets.

The financial market terrain now looks very different from the way it did just a few months ago. The prime brokerage industry has been permanently altered with the wholesale disappearance of two investments banks, the purchase of two prime brokers by large banks, and the remaining two largest brokers reorganizing as bank holding companies.

These events appear to be taking their toll on the broader economy as well. In addition to tightening credit, labor market conditions have also deteriorated, with the unemployment rate exceeding 6 percent in August and initial claims for unemployment insurance reaching levels not seen since late 2001. Home prices continue to fall and equity markets remain in bear territory. Consequently, household spending has virtually stagnated since the Federal government rebate program ran its course. After adjusting for inflation, household spending for the third quarter of the calendar year is now projected to fall from the prior quarter, representing the first such decline since the fourth quarter of 1991.

DOB anticipates substantially weaker growth in both real household consumption and private sector investment through the end of 2009. In addition, in light of the global consequences of a weak U.S. financial system, the international economy is also expected to grow more slowly than anticipated, implying slower export growth over the coming 18 months.

Current-Year Operating Results

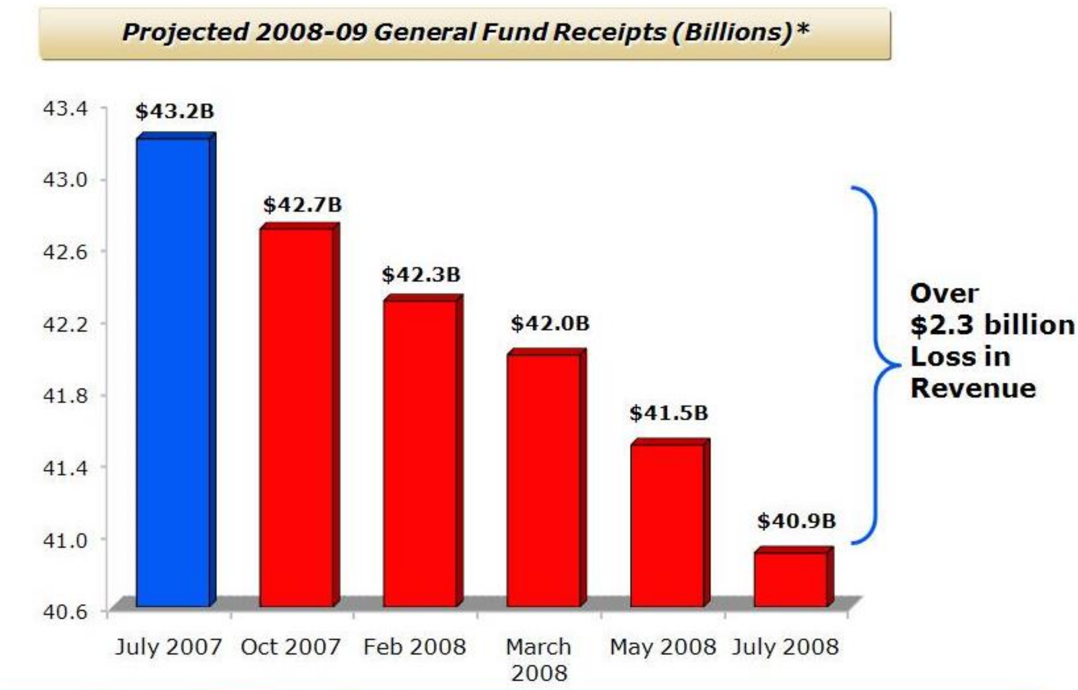
For the period from April 1, 2008 through September 30, 2008, General Fund receipts, including transfers from other funds, were roughly $175 million higher than projected in the First Quarterly Update. General Fund disbursements, including transfers to other funds, are projected to be about $220 million below planned levels.

However, DOB does not believe these results are indicative of future results. Receipts have benefited from continuing strength in personal income tax collections (up by $302 million versus plan). By comparison, business taxes, which are more responsive to current economic trends, especially the continuing weakness in the banking sector, are down by $184 million through the first six months of the fiscal year versus the cash-flow forecast. In the coming months, DOB expects that the economic downturn will begin to have a substantial impact on tax collections, when the impact of lower bonus payments and capital gains realizations will be felt.

Spending results reflect, in large part, the timing of payments for public schools, which will be paid out by the end of the fiscal year, and federally-required changes to Medicaid systems that temporarily slowed payment processing. It is expected that these timing-related variances will disappear as we move through the fiscal year.

Budget-Balancing Actions and Reestimates to Date

The State had already recognized a significant amount of revenue risk in its financial plan prior to today's report. DOB has revised its General Fund revenue projections downward for the 2008-09 fiscal year by a total of $2.3 billion since July 2007.



*Excludes Changes to Law

When Governor Paterson came into office in March 2008, he expressed immediate concern about the state of the economy and its impact on revenues. He has accordingly taken significant and consistent action to reduce spending, implementing savings measures totaling nearly $1.8 billion in just the last six months. This includes $427 million in current-year spending reductions adopted in partnership with the Legislature at a special emergency economic session in August 2008.

	2008-09 (millions)
April 2008 -- 3.35 percent Agency Reduction, 2 Percent Local Assistance Reduction	710
July 2008 -- 7 percent Agency Reduction, Hard Hiring Freeze	630
August 2008 -- Special Session	427
Total	**1,767**

Absent the recent turmoil on Wall Street, DOB believes that the 2008-09 fiscal year would have ended the year in balance without further action. The $427 million in savings measures implemented at the August special emergency economic session created a potential surplus designed to guard against additional revenue deterioration.

Extraordinary Events Lead to Projected Current-year Gap

DOB believes that September's extraordinary economic events will have a materially adverse impact on General Fund receipts in the current fiscal year. DOB now projects that the State must close a current- year shortfall of at least $1.2 billion.

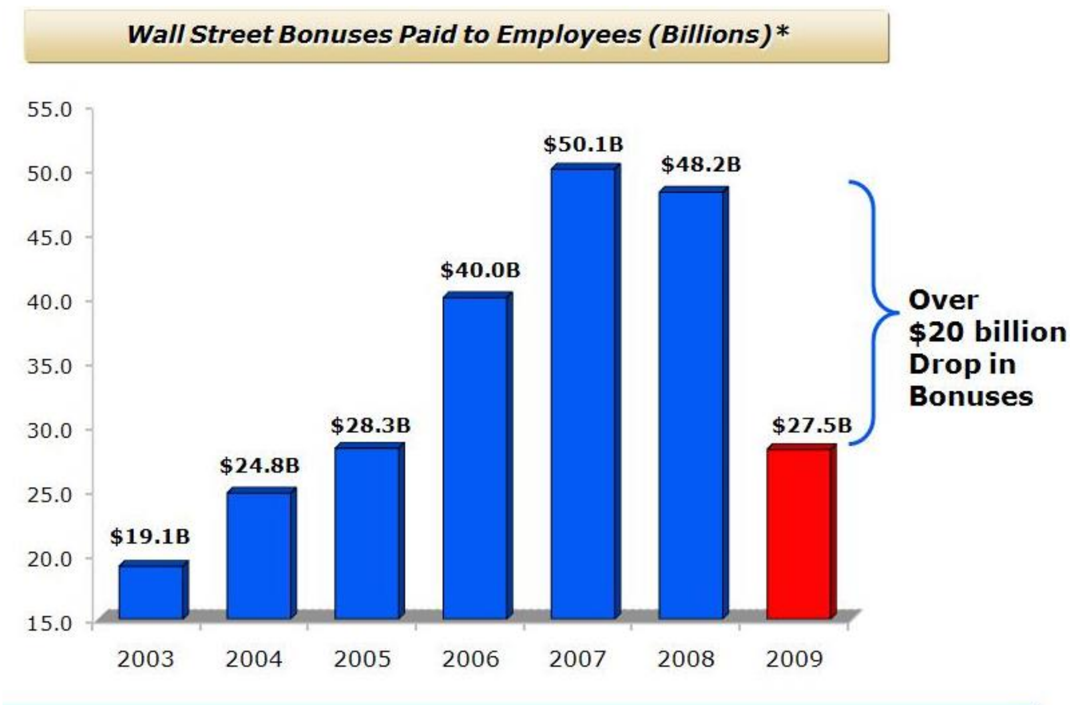
	2008-09 (millions)
Special Session Surplus	**427**
Personal Income Taxes	(950)
Business Taxes	(350)
Other	(300)
New Surplus/Deficit	**(1,172)**

Personal Income Taxes

On September 15, quarterly tax payments were due to the Department of Taxation and Finance. Those results demonstrated that DOB's forecast for personal income tax collections was generally consistent with collections through that date. The day these payments were due, however, Lehman Brothers filed for bankruptcy, marking the beginning of a fundamental restructuring of the financial services industry. The rapid deterioration seen in the financial market in the days and weeks following that event was not yet reflected in the payments received.

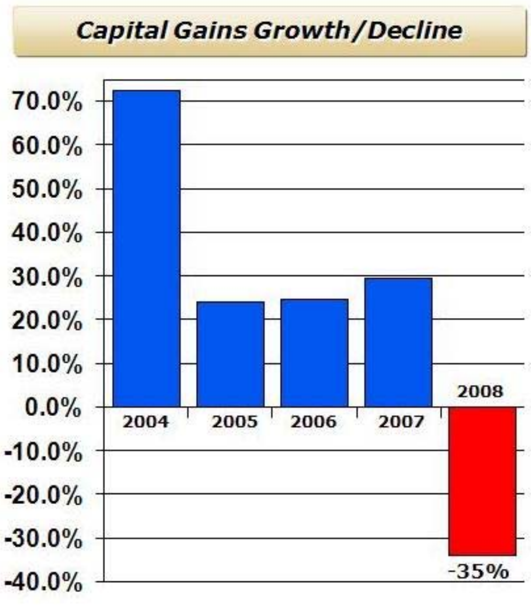
The impact of the fundamental restructuring of Wall Street will begin to manifest itself most acutely in the fourth quarter of the State's fiscal year, which is a critical time for revenue collections. Nearly a third of the State's tax revenue or nearly $18 billion is paid during the final quarter of the fiscal year – more than any other quarter. Part of the reason for this is that January, February, and March overlap with the timing of bonus payments on Wall Street. The financial services sector accounts for 20 percent of overall state tax revenue during the year. But in the fourth quarter, it typically accounts for over 30 percent of tax revenue or an estimated $6 billion.

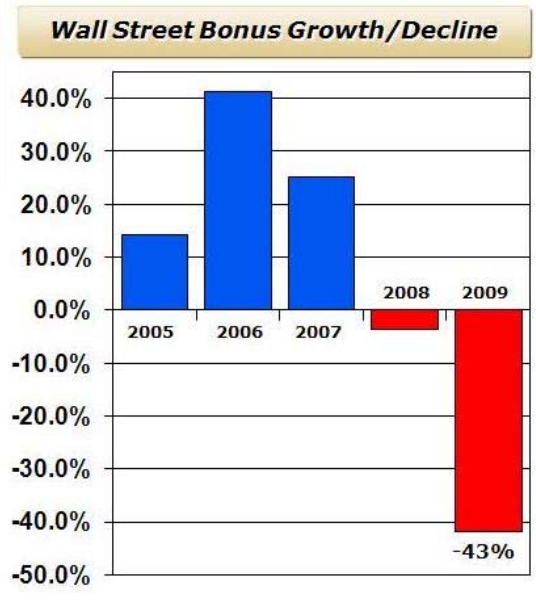
In light of the recent turmoil in the financial markets, the Division of the Budget has revised its forecast downward for Wall Street bonuses. DOB is now projecting a 43 percent ($20.7 billion) year-over-year decline in financial sector bonuses, more than double the 20 percent decline initially projected in July.



*2009 Projection by NYS Division of the Budget

Capital gains tax collections on profits derived from the sale of stock, real estate, or other assets are also now forecast to decline by 35 percent, a significant change from the Division of the Budget's previous estimate of a 24 percent decline. DOB also believes more than 40,000 financial services jobs will be lost during this downturn.

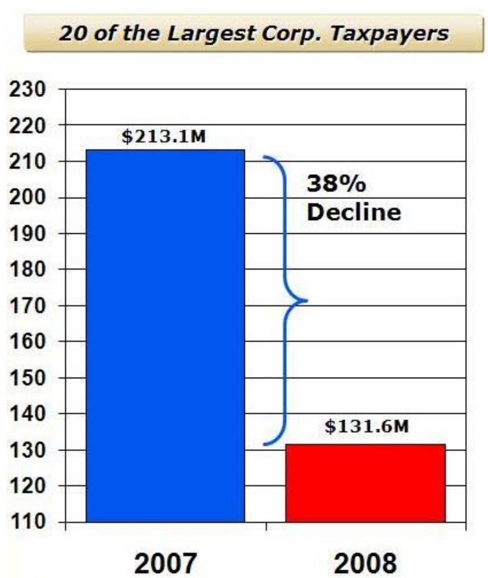


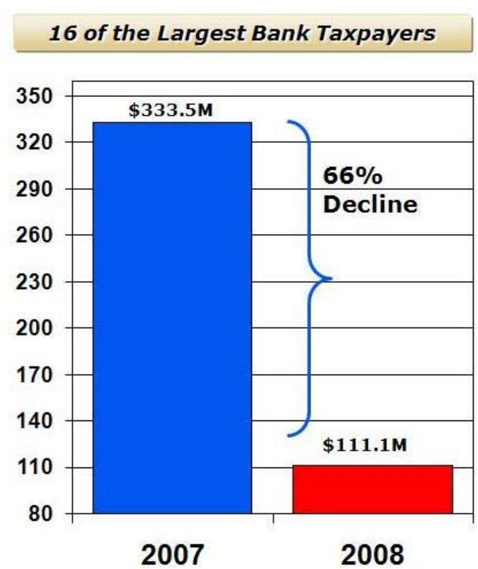


Combined, these changes and other revisions to our forecast are expected to result in a net loss of at least $950 million in personal income tax revenue during the current fiscal year.

Business Taxes

Tax filings through September 15 demonstrated some concerning signs in the area of business taxes.





Through the first two quarters of the fiscal year, the amount of taxes paid by sixteen of the state's largest banks was down nearly two-thirds compared to one year ago from $333 million to $111 million. The amount paid by the top 20 largest corporate taxpayers dropped by 38 percent ($82 million) compared to last year.

Overall, DOB has revised its forecast downward for business tax collections by a total of $350 million for the current fiscal year from its previous projections.

Other Issues

Other financial transactions that were expected to provide the state with $300 million in additional revenue – the conversion of GHI/HIP to a for-profit company ($200 million) and the sale of certain surplus state properties ($100 million) – are no longer expected to occur during the current fiscal year because of adverse market conditions.

While spending to-date has thus far been slightly lower than DOB's initial projections, significant revenue declines are expected to outweigh any positive impact this may have on the State Financial Plan. Moreover, given the weakened state of the economy, the state could experience increased enrollment in entitlement programs such as Medicaid in the future, driving higher costs and further widening our budget deficit. These issues will be evaluated as part of our Mid-year Update to the state financial plan when final spending data for the second quarter is available.