



NEW YORK STATE'S DEBT POLICY

A Need for Reform

FEBRUARY 2005

New York State
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Executive Summary

New York is the Empire State because, among other things, it has invested in our infrastructure. The construction of countless roads, bridges, canals, housing developments, hospitals, universities, mass transit and other government facilities has made New York a model state. There are two ways to pay for these improvements: cash or debt. No one can dispute that these public assets have improved the State's economic competitiveness. To pay for these projects the State and local governments have borrowed vast sums of money.

Debt is a tool that, when used prudently, helps governments plan and pay for large public works projects. Borrowing is essential when the cost of a necessary, worthwhile capital investment is prohibitive. Borrowing for the construction of a bridge is similar to buying a home. Like the State, most families are not equipped with enough cash on hand to pay for that property in one year. Instead, it is common practice to take out a mortgage to finance the purchase, allowing the buyer to pay for the investment over time. Where the State undertakes these types of financial obligations to fulfill needed improvements or expansions to the State's infrastructure, just as with one's personal finances, it is vital that great care be exercised to determine what the State borrows for, how much it borrows, for how long and when it borrows—all have critical importance to the State's overall economic health. Much like personal finances, debt should not be passed along to the next generation without an accompanying asset.

Thinking through these elements will help to answer the all-important question: Can the State afford this debt? Debt affordability can be described as a measure of debt relative to the ability to repay. The State's ability to support additional borrowing as a long-term obligation should not only be considered for today, but also for the future. If the debt is affordable today, will it be so tomorrow? Will our children and grandchildren be saddled with an unfair level of debt? To answer the long and short-term affordability concerns, it is necessary to assess the impact of both outstanding debt and debt service on the State's finances.

This report concludes that the State has misused its credit. It has increasingly used debt to pay for the operating expenses of State and local government. Some of these expenses were incurred almost 30 years ago and have not been paid for yet. The practice of borrowing for initiatives that provide no capital asset to the State is not only wasteful, it has the unintended consequence of chewing up debt capacity that would be better reserved for real capital needs. Currently, the State owes \$45.4 billion to

bondholders; fully \$7.7 billion was incurred since the Debt Reform Act of 2000 for operating expenses.¹ Furthermore, since 1997, the State has authorized \$2.8 billion for member initiatives and local economic development. And, rather than carefully planning how borrowed dollars are used, the State actually increased its debt levels during years of budget surpluses.

At the same time, the use of debt should support capital investment activity throughout a business cycle. Maintaining infrastructure and other capital projects should be a continuing process. During downturns in the economy when revenue collections fall, the use of debt allows these projects to continue and helps keep the economy from sliding further into recession. As the economy improves and revenue collections increase, the additional money should be used to pay down the existing debt. Paying down the debt during upswings in the economy enables the State to keep debt levels manageable.

Debt Reform Act of 2000 - Myth vs. Reality

Touted as the “Debt Reform Act of 2000,” Chapter 59 of the Laws of 2000 did little to curtail State borrowing. In fact, since its authorization, nearly every State debt indicator has moved in the wrong direction. When enacted, the Debt Reform Act was considered by many to be the final word in stemming the use of debt. What was not touted at the time were the massive loopholes in the law. Essentially, the legislation fell short of reform in that it lacked enforcement measures, mandates for transparency and provisions to actually reduce the State’s debt burden.

Furthermore, changes were merely statutory and not constitutional. This lack of permanency is a fundamental flaw that has allowed the Legislature and the Executive to circumvent the law with artful legislative language. Without constitutional changes, the “reforms” provided no guarantee of adherence and, in fact, the Legislature and the Executive have sidestepped the restraints each time that debt could be used to solve their budgetary troubles.

There are several myths about the Debt Reform Act of 2000, but the reality is the legislation failed to take on the borrow-and-spend culture.

Myth #1: The legislation capped outstanding debt at 4 percent of personal income, phased in over ten years.

Reality: The Act actually created an artificial measure of the State’s outstanding debt. The mandate in the legislation limiting outstanding debt to no more than 4 percent of personal income, only considered new, future debt and ignored the roughly \$35

¹ This report considers State-funded debt as bonds, notes and other bonded long-term obligations, reported on a cash basis and defined in the statutory and constitutional legislation associated with the Comptroller’s debt reform proposal. It will compare and contrast the statutory definitions for State-supported debt set forth in the Debt Reform Act of 2000 with the standard used for financial reporting.

billion in existing debt at the time of enactment—exceeding the law’s statutory cap.

Myth # 2: The law mandated that debt could only be used for capital works, not for operating expenses.

Reality: From the sale of future tobacco revenues to refinancing New York City’s Municipal Assistance Corporation (MAC) debt, the State has found loopholes around the limits. In fact since 2000, in just four years, new debt issuances inflated New York’s debt burden by roughly \$7.7 billion with *no* resulting capital assets for the State.

Myth #3: The law instituted future fiscal discipline.

Reality: The caps have not and will not have a meaningful impact on the issuance of new debt for the foreseeable future. As illustrated by the State’s current outstanding debt level of 6.5 percent of personal income, New York continues its practice of allowing excessive borrowing as usual. According to Moody’s, New York has the fourth highest debt as a percentage of personal income ratio in the nation.²

Myth #4: The Act was a complete package of reforms.

Reality: The law provided no monitoring or early warning system that would alert the public to instances of overspending or bad fiscal practices. The law did little to address the lack of voter approval in deciding the State’s debt policies. Instead, the law was not accompanied by a constitutional amendment. Absent these changes, public authority debt has soared, relegating voter approved debt to a minor part of the State portfolio.

Need for Real Reform

While debt is a useful tool, it should not be the sole mechanism to address the State’s infrastructure needs. In moderation debt is acceptable. The key word is moderation. New York’s debt has grown at an alarming rate. Since 1990, outstanding debt has skyrocketed from \$14.4 billion to \$45.4 billion in 2004, representing a 215 percent increase. From 1996 to 2001 when the State experienced unprecedented surpluses, ranging from \$445 million to \$3.6 billion, the State continued its addiction to borrowing. Rather than utilizing surplus dollars and responsibly paying for capital expenditures through more pay-as-you go (PAYGO) spending, the State, instead, opted to go deeper and deeper into debt. In fact, in 1985, the State financed over 75 percent

² Moody’s *State Debt Medians*, May 2004. Note that Moody’s measures tax-supported debt per capita as compared to the Office of the State Comptroller’s measure of State-funded debt of \$2,365 per capita. This report uses Moody’s measure for comparison purposes only.

of its non-federal capital program with cash. By 2001, only 40 percent of the non-federal share was financed with cash.

New Yorkers face one of the highest debt burdens in the country. Ranked number one through December 2003, New York now holds the dubious honor of being second to California for outstanding debt. According to Moody's 2004 State Debt Medians, New York is fourth highest in debt per capita just behind Connecticut, Massachusetts and Hawaii. New York's \$2,420 debt per capita is over two and one-half times the national average of \$944. If left unchecked, debt per capita could rise to almost \$12,000 by 2024. According to the Census, New York ranks second only to Alaska for state and local combined debt per capita.

Although the magnitude of New York's debt portfolio is a valuable indicator of the State's approach to debt management, other factors must also be considered when assessing the State's borrowing practices. Voter approval versus backdoor borrowing, the status of the State's overall revenue-to-expenditure ratio, the actual purpose of the debt (meaning capital purpose versus debt that does not result in a capital asset for the State), the long-term affordability of the debt and the transparency of the process are significant aspects that must not be overlooked. Real reform must turn the four myths of the Debt Reform Act of 2000 into reality.

Voter Approval vs. Public Authority, Backdoor Borrowing

Most of New York's debt indicators are moving in the wrong direction. The State Constitution requires that voters, through single purpose bond acts, approve all State debt. Moreover, there are no provisions in the Constitution authorizing State appropriation-backed debt issued by public authorities, commonly referred to as "backdoor borrowing." Backdoor borrowing is the most egregious method the State uses to accumulate debt because it is money frequently borrowed through public authorities, whose actions tend to be hidden from the public eye.

One of the objectives of public authorities is to finance, construct and operate revenue-producing facilities for the public benefit. Some of the benefits of public authorities include their ability to finance public improvements without increasing taxes and to assess fees on users to cover the costs of construction or operation.³ The absence of any direct prohibition or constitutional restrictions on this form of debt has led to the proliferation of non-voter approved debt.

As the numbers illustrate, backdoor borrowing has become the easy way to thrust additional borrowing upon taxpayers with few checks and balances. Voter approved debt, just 20 years ago, was 40 percent of the State's debt portfolio. Today, less than 10 percent of State debt is voter approved.

³ Office of the State Comptroller, *Study No. 4, Public Authorities in New York State: A Financial Study, Comptroller's Studies for the 1967 Constitutional Convention*, June 1967, citing the *Report of the Temporary State Commission on Coordination of State Activities*, 1956.

Conversely, public authority or backdoor borrowing has grown from 60 percent in 1985 to a troubling 92 percent of the State's debt today. ***Translation: Taxpayers were denied the opportunity to approve or reject \$40 billion in outstanding debt.***

Chapter 383 of the Laws of 2001 established revenue bond financing, which is debt backed by a percentage of personal income tax revenues. Although it is rated the same as General Obligation debt⁴ and may be designed to reduce borrowing costs through lower interest rates relative to other State appropriation credits, it is not voter approved. Lowering costs is a positive change in debt management practices, however, the use of this method also diminishes voter input. State policy and practice should be to obtain more voter participation. Conversely, when non-voter approved debt is used for a much-needed project, then transparency and affordability should be paramount and changes to enforce a more cost-effective, consolidated and transparent structure should be advocated.

Damaging Practices, Working to Destroy the State's Fiscal Health

New York's decisions on its overall finances and debt practices are interrelated. The State's practice of paying for recurring operating expenses with one-time funding sources exacerbates structural instability and feeds annual budget gaps along with the State's chronically poor credit rating. Furthermore, the State has recently turned to long-term debt again to fund a deficit with the issuance of \$4.6 billion in tobacco bonds.

In the view of bond rating agencies, if the State's revenues are matched to expenditures, structural balance exists: more PAYGO spending is utilized and debt practices will likely be sound, resulting in a favorable outlook. Conversely, as is the case in New York, if a state operates year after year with structural imbalances, turns to non-recurring resources to support long-term spending, delays payment to future fiscal years and uses debt as a means of masking increased spending, then it is certain its debt portfolio will be given a negative outlook by rating agencies and the public.

Some of the most egregious measures have included the State's sale of tobacco settlement revenues, borrowing for prior year school aid claims, bonding for the support of member initiatives and extending debt related to New York City's 1970's fiscal crisis, all of which provided no capital asset to the State⁵—not a building, not a bridge, not even a paved road that will last as long as this debt. Since the debt reforms, the State has issued \$7.7 billion in debt for operating expenses. Additionally, the State authorized another \$2.8 billion in debt for member initiatives and local economic development from fiscal year 1997 through fiscal year 2005.

⁴ Personal Income Tax Revenue Bonds are rated A1, AA and AA- by Moody's, Standard and Poor's, and Fitch, respectively.

⁵ As a means of funneling additional revenues to New York City, the 2003-04 enacted budget authorized the Sales Tax Asset Receivable Corporation to issue debt to refinance outstanding Municipal Assistance Corporation debt.

Tobacco Securitization Debt: \$4.6 Billion

The single, largest non-recurring resource, or one-shot, used to close the enormous 14-month gap facing the State during the last quarter of State fiscal year (SFY) 2002-03 and for 2003-04 was the sale of the revenues from the 1998 Tobacco Master Settlement Agreement. The State securitized its share of this future revenue stream initially estimated to be approximately \$25 billion over 25 years and instead used \$4.2 billion for one-time General Fund relief.⁶ In total, \$4.6 billion in bonds were issued—for a total cost of over \$6 billion paid over 12 years—while the proceeds were used to close a budget gap for a single year.

Refinancing of Municipal Assistance Corporation Debt: \$2.6 Billion

The 2003-04 enacted budget promised the City of New York \$170 million annually through the Local Government Assistance Corporation (LGAC), so the City was able to refinance outstanding Municipal Assistance Corporation (MAC) debt through a not-for-profit organization established specifically for this purpose (Sales Tax Asset Receivable Corporation - STARC).⁷ This debt, scheduled to be paid in full within five years, and dating back to New York City's near brush with financial disaster, was extended for another 30 years. Ironically, this fiscal gimmickry represents the same type of practice that led the City down a path of financial destruction and, if left unchecked, could lead the State down a similar path. In total, it will have taken 55 years and an additional \$5.1 billion in State taxpayer dollars to bring back the City from the brink of bankruptcy, forcing our grandchildren to pay for the errors of our parents.

Prior Year School Aid Claims Debt: \$511 million

The 2002-03 enacted budget authorized 19 school districts to initiate issuance of debt by the Municipal Bond Bank Agency for amounts owed them by the State for prior year claims. Prior year claims are the result of verified claims for State aid that are submitted after the last yearly scheduled payment as a result of revisions to local eligibility. The debt is issued by the Municipal Bond Bank Agency, a public authority and is backed by future education aid payments from New York State. Bond proceeds are provided to school districts.

The State pays the debt service from interception of its own State aid payments. The majority of the funding is for New York City and was used for salary increases. This circumstance not only transforms a budget liability of the State into debt, but also

⁶ The State's share of tobacco settlement funding is 51.76 percent. The remainder is divided between New York City and New York's counties.

⁷ The State Comptroller along with the Executive, both members of the Local Government Assistance Corporation Board, through a Board resolution opposed the legislation on grounds that it is bad public policy and could put existing LGAC bondholders at risk. The State Comptroller also commented that "[t]he MAC refinancing is a terrible deal for all the taxpayers of New York State, including those in the City. It would give the City \$2.5 billion in aid at a cost of about \$5.1 billion to the State."

gives New York City State-funded debt proceeds, a one-time occurrence, to fund recurring operating expenses.

Member Initiative Debt: \$2.8 Billion

Another example of the State's issuance of debt for goods and services that does not provide an asset to the State is borrowing to fund initiatives from both the Executive and Legislature that historically were funded with tax dollars. Some proposals, such as economic development and member initiatives, have long been funded in the State budget, but only recently financed with State-funded debt. Although such initiatives often support worthwhile purposes, the practice of replacing one-time expenditures with debt that requires yearly expenditures for an extended period has increased significantly since 1998. During this same timeframe, the State declared six years of budget surpluses ranging from \$445 million to \$3.6 billion. Between SFY 1997-98 and 2004-05, State debt was increased to support ten notable, but costly, initiatives:

- Community Enhancement Facilities Program,
- Strategic Investment Program,
- Empire Opportunity Fund,
- Centers for Excellence,
- Gen*NY*sis,
- Rebuilding the Empire State Through Opportunities in Regional Economies (RESTORE),
- Community Capital Assistance Program (CCAP),
- Multi-Modal transportation projects,
- Expansion of the Jacob Javits Convention Center, and
- Funding for economic development projects outside New York City.

The Added Cost of Debt Refinancing

The State has taken advantage of the low-interest rate environment to reduce its short-term debt service payments and to restructure its debt portfolio. The overall effect of these decisions in addition to the increased issuance of new debt, however, has actually increased its debt service costs into the future. In 1990, debt service was \$1.7 billion. However, by 2004 debt service climbed to \$3.6 billion, representing a 112 percent increase in just 15 years. Debt service payments are projected to rise even faster as payments that were deferred now come due.⁸

⁸ Many bonds refunded between 2002-03 and 2003-04 came with restructured debt service schedules that deferred principal payments to future years.

Attica Take Two - Earlier Error Compounded by a More Recent One

The sale of the Attica Correctional Facility in the early 1990s remains a symbol of bad debt policy. In 1990, the State financed the Attica Correctional Facility for \$200 million by “selling” it to the Urban Development Corporation. The associated debt was subsequently refunded in 1995. Although with the refunding the State was able to lower interest rates and claim savings, the State shortsightedly decided to take a pass on the next few principal payments, making a smaller one in 1996 and none from 1997 to 1999, some of our flush years in terms of State surpluses.

Since 1990, the State has paid \$242 million in debt service on the Attica debt, but due to refinancings, it still owes \$323 million in principal and interest. So the total cost of providing \$200 million in one-shot budget relief in 1990 will be at least \$565 million, assuming the debt is not refinanced again. On top of the State borrowing for immediate budgetary relief in 1991 without gaining a new capital asset, the savings generated by the refunding were all spent in our good years of 1996 to 1999 when one could argue that we not only could have afforded to make the regular payments, we could have increased payments in an attempt to wash this appalling debt from the State’s books.

Implementing Reform

The Debt Reform Act of 2000 was not reform. It “changed” some aspects of debt policy and management, but it did little to improve the State’s financial condition. Reform is a process that in the end results in an improved system. Webster’s dictionary defines reform as follows: *“to amend or improve by change of form or removal of faults or abuses.”*⁹ The objective of reform, which often is painful, is to put an end to a destructive practice.

Reform of New York’s debt practices will not be easy, but it will be the right thing to do for today’s taxpayers and future generations. The people of New York State face an enormous and ever-growing debt burden. The risk associated with this debt is mounting, and the management of debt policy is becoming less transparent and accountable from formulation to implementation. It is long past time for *effective* reform that will decrease the State’s propensity to utilize debt financing, recognize the value of pay-as-you-go spending and open the process to the public.

Successful reforms must implement debt management policy that balances need with capacity and intergenerational equity. The State plays an essential role in building infrastructure. For example, without mass transit, there would be no New York City. To be competitive with other states, New York must continue to make needed, affordable capital investments. This should be one of our government’s priorities. Yes, State leaders want to see a wide array of initiatives come to fruition, but not everything

⁹ Merriam-Webster Online Dictionary. 2005 Merriam-Webster, Incorporated. <<http://www.m-w.com/>>.

can be accomplished at once. Instituting discipline by choosing debt responsibly works hand in hand with prioritizing needs. It is a rare homeowner who can repair the roof, replace windows, update the kitchen and bathrooms, and install a new swimming pool in one year. Homeowners live within their means and prioritize need over desire. So too should the State.

The State must make every effort to improve its current abysmal dialogue with the public on its debt practices, reduce the present and future cost of debt, and ensure the most efficient debt structure by avoiding the issuance of long-term debt for short-term purposes. Furthermore, the management of debt and debt policy must be made more transparent. Merely increasing the use of competitive sales will create a more transparent environment with lower costs than the current environment dominated by negotiated, private sales. Taxpayers deserve better access to debt policy information, as well as more complete information about the current debt picture and future plans. Currently, data on the issuance, use and repayment of \$45 billion in State-funded debt is dispersed across a variety of entities, making it difficult for individuals to obtain a comprehensive accounting of the State's priorities.

To reach the level of reform that is necessary to address all the issues discussed in this report, the State must be willing to make sweeping changes, both constitutional and statutory. It must be willing to look into the future and realize that priorities need to be established and strict management changes are necessary.

Debt Guidelines and the Comptroller's Proactive Plan

In advance of proposing comprehensive legislative and constitutional debt reform, the Comptroller has taken steps to promote prudent debt management through the exercise of his responsibility to review the terms and conditions of the private or negotiated sale of debt. Many public authorities and certain local governments must obtain Office of the State Comptroller approval before selling bonds at private or negotiated sale. The purpose of the Comptroller's review is to protect the interests of taxpayers by ensuring that the total cost of the borrowing is reasonable and appropriate. With this goal of holding down the cost of issuance, the Office of the State Comptroller's review considers any factor that affects, or potentially affects, that cost.

Specifically, the Office of the State Comptroller review generally considers the following factors, taking into account the nature, size, structure and complexity of the transaction:

- The reasonableness of the underwriter's spread,
- The reasonableness of the costs of issuance,
- The reasonableness of the yields based on market conditions at the time of pricing,

- In the case of refundings, the reasonableness of the savings and savings structure with the goal of a structure that produces cash flow savings in every year, as well as net present value savings, and
- In the case of derivative transactions undertaken in connection with the sale, the reasonableness of the pricing and related costs of the transactions.

While the Comptroller's review of transactions may encourage issuers and underwriters to negotiate the best deal for the taxpayers, it is not a substitute for comprehensive constitutional and statutory debt reform.

Constitutional and Statutory Debt Reform Plan

Following a thorough analysis of the State's borrowing practices, this report recommends an additional package of major reforms that should be enacted by the Legislature, signed into law by the Executive and approved by the voters in an effort to restore accountability, limit debt to an affordable level and provide more transparency.

Recommendation: Constitutionally Define State-Funded Debt

As a result of the Debt Reform Act of 2000, the current limited statutory definition of State-supported debt allows for an arbitrary classification or exemption of what is considered to be a State-supported debt. This limited definition has exempted billions of dollars of debt from the State's debt cap. Establishing a new, all-inclusive definition of **State-funded debt** and amending the State's constitution to reflect this expansive term will prevent any picking and choosing of which debt will be counted in the calculation of the annual debt cap. By eliminating any discretion in what is to be considered State debt, a more comprehensive accounting of the State's debt portfolio will be possible and will, therefore, have the added benefit of providing the public a true picture of the State's debt burden.

Recommendation: Limit State-Funded Debt to 5 Percent of Personal Income

By applying the proposed State-funded debt definition to the current debt portfolio, taxpayers will be afforded a more transparent view of the State's debt burden. "State-funded debt" captures the complete picture of the State's obligations as a result of debt issuance—totaling \$45 billion at the end of State fiscal year 2003-2004 and growing by at least \$3 billion in the months since then. This more truthful classification of the various types of debt into one all-encompassing definition highlights the disappointing fact that even with the enactment of debt reform legislation in 2000, New Yorkers have experienced no relief from this costly habit. In fact, New York's current outstanding debt is equal to 6.5 percent of personal income.

With the lack of teeth in the Debt Reform Act of 2000 and its proven failure to keep debt to a responsible level, permanent caps must be implemented. All debt, currently outstanding and new, would be constitutionally limited to 5 percent of New York's personal income by April 1, 2014. Coupled with the constitutionally expanded definition of debt, this mandated cap eliminates any loopholes and exemptions.

Recommendation: Statutorily Limit Debt Issuance to 95 Percent of Previous Year Issuance

The State increased debt during times of prosperity. This was a costly mistake. As New York's outstanding debt is currently equal to 6.5 percent of personal income, steps will have to be taken to bring down the debt to 5 percent.

To force discipline and reach the proposed Constitutional debt cap of 5 percent, the legislation limits annual debt issuance to 95 percent of the previous year starting in the next fiscal year after passage of the legislation and continuing through March 31, 2015. It is clear that the State has to make some tough choices, requiring serious planning and clear identification of priorities.

Recommendation: Create a Debt Management Board and Annually Publish a Realistic Measure of Debt Affordability

New York State has to be held accountable for its actions regarding every State dollar, including those generated from debt. As illustrated by the rapid increase in debt over the last several years, New York currently lacks an effective oversight mechanism for new and refunded debt or for outstanding obligations.

The establishment of a debt management board would provide coordinated monitoring and reporting of all debt, including debt issued by public authorities. The three-person, debt management board made up of the State Comptroller, the Executive and a financial expert, selected jointly by the Executive and Comptroller, would be vested with the responsibility to issue an annual debt affordability study. With this construct, the State Comptroller, the fiscal watchdog for the State, would be an equal partner with the Executive in planning, implementing, reporting and managing the State's borrowing from beginning to end.

Many states with consistently high bond ratings produce annual affordability statements that are typically based on the ratio of debt to wealth and debt service to capacity. By October 31 of each year, New York's newly established Debt Management Board would produce a binding, comprehensive statement on debt affordability for the next State fiscal year and forecast the debt affordability level expected for the two succeeding fiscal years based on multi-year projections of State economic cycles, revenues and spending.¹⁰

¹⁰ Maryland, consistently rated highest among states, provides a debt affordability statement with an ongoing structure to reduce outstanding debt to affordable levels.

The Board would also be vested with the authority to unanimously adopt standards addressing the following:

- Structure for State-funded debt,
- Criteria for refunding, including extending debt, and use of savings,
- The use of credit enhancements and derivative instruments,
- Method of sale, and
- Debt policy standards for public authorities.

Recommendation: Require Voter Approval for Annual Issuances Exceeding \$1 Billion, Authorize Multiple Ballot Initiatives and Consolidate the Issuance of State-Funded Debt

To increase accountability and improve voter participation in fiscal decision-making, the reforms require that the voting public annually approve issuance of new debt when the amount issued exceeds 3 percent of the constitutional cap or \$1 billion, whichever is greater. By subjecting most annual debt issuance to public approval, the taxpaying public will have more influence on where their tax dollars are spent and how.

Furthermore, the State Comptroller would issue all State-funded debt. As with the Personal Income Tax Revenue Bond Financing Program established in 2001, the further consolidation of public authority debt issuances would consolidate debt statistics into one agency, thereby increasing the ease with which the public could obtain data. As a financial benefit, this change would reduce borrowing costs through lower issuance costs and possibly lower interest rates.

Although public authorities will still be authorized to issue debt for their own purposes and for private concerns, subject to caps imposed by the Legislature, the terms and conditions of all negotiated debt issued by these publicly created entities would be subject to the review of the State Comptroller.

Recommendation: Improve Accountability and Transparency with Expanded Oversight by the Public Authorities Control Board to Over 200 Public Authorities

Comptroller Hevesi's Public Authority Reform legislation establishes a new comprehensive definition of a public authority in New York State. The bill categorizes all public authorities into four classes: Class A: major public authorities with statewide or regional significance and their subsidies; Class B: entities affiliated with a State agency or created by the State that have limited jurisdiction, but a majority of board members appointed by the Executive or other State officials; Class C: entities with local jurisdiction; and Class D: entities with interstate or international jurisdiction.

The Public Authorities Control Board (PACB) was created in 1976 in response to the growing amount of public authority debt. The Board has the power and duty to receive applications for approval of the financing and construction of any project

proposed by any of the 11 State authorities subject to its review. This reform package provides for expanded oversight of State-funded debt issued by all Class A and Class B public authorities.

Recommendation: Mandate Intergenerational Equity and Present Efficiency with Standards and Guidelines

In the past two years, New York State has gone to great lengths in managing its debt portfolio to produce immediate savings, as well as savings that may be realized in the future. However, while efficiency is important and opportunities for responsible savings should always be a consideration, future risk and cost need to be weighed against current gains. For instance, extending debt, deferring principal payments or entering into derivative arrangements that may be overly dependent on current market conditions or bond ratings may provide immediate savings and budgetary relief, but if the risk is great enough, immediate fiscal relief may not be warranted and other options should be pursued.

For some time now, intergenerational equity has not been a consideration in managing debt. Financing the sale of New York State's future tobacco revenue stream and other forms of deficit financing, the deferral of payments and the lengthening of terms of existing debt add costs to future generations and administrations. In order to contain these costs, the following recommendations are made:

- Issue debt for capital purposes only. Pay-as-you-go financing should be the State's first choice, especially for capital with low periods of probable usefulness. Incurring debt for operating expenses should be avoided except in a strictly defined emergency.
- Advocate for competitive sales or provide justification for using negotiated deals.
- Call for non-recurring revenues, as defined by the Debt Management Board, to be used for pay-as-you-go capital spending or debt reduction only.
- When New York State realizes a surplus at the end of the fiscal year, deposit a percentage of such surplus in the Debt Reduction Reserve Fund to be used for pay-as-you-go spending or debt reduction.¹¹

Conclusion

There is a suitable time and an inappropriate time to utilize debt. There is a right purpose and a wrong purpose for debt. Since the Debt Reform Act of 2000, the State has shown little progress in reforming its destructive borrow-and-spend practices.

¹¹ Note that Maryland requires reserve deposits in their budget, not just as a result of surplus.

Debt has become a crutch for the State. It has been utilized all too often, for objectionable purposes, and has become an easy answer to solving the State's fiscal woes. The State faces hard choices and a difficult road with such a reform proposal. It is very important that those choices be the result of open, honest and informed discussion among policymakers and the public. Additionally, it is equally important to inform the public of decisions about and the status of debt management in the State. Debt is currently affordable only because the State is capable of providing enough funds to pay annual debt service. Simply having enough revenue does not mean that debt management is cost effective for current or subsequent taxpayers. The primary problem with the current structure is that too few really understand the depth of the problem, and even fewer have the inclination to institute change. The reform will be somewhat painful, but real reform is the right thing to do.

New York State's History of Debt

Debt is a necessary and effective fiscal management tool, used by governments throughout modern history to construct public works with benefits for future generations. Since the issuance of debt spreads the cost of a project over its useful life, those who benefit from the project, in theory, end up paying for it. However, the unchecked and irresponsible use of this mechanism burdens future taxpayers with the consequences of today's poor fiscal management.

The State of New York's history of debt is one of aggressive expansion of the type, use and purposes of debt. On at least one occasion, in the mid-1970s, the accumulated effect of the State's mounting use of public authority financing brought the State to the verge of financial disaster. An overview of the State's history shows that expanded use of debt is followed in turn by the enactment of reforms to control State borrowing practices. Reforms are effective, however, only until new mechanisms are devised to avoid their constraints. **The most recent example of "reform," the Debt Reform Act of 2000, was destined to be ineffective from the date of its enactment. Its limited definition of State-supported debt allowed the State to issue an additional \$7.7 billion in debt in the last three years—approximately 15 percent of the State's current debt burden. A reform in name only.**

State-funded debt has grown from \$38 million in 1846 to more than \$45 billion in 2004. Since 1990, State-funded debt ballooned by \$31 billion or 215 percent. If the historic trends of the last 15 years continue, State-funded debt could inflate to over \$111 billion by 2015.

History

State history provides insight into the evolution and expansion of State debt. The State Constitution adopted in 1777 did not place limits on debt issued, debt outstanding, the purpose of debt or for whom the State could borrow. Initially, State debt was incurred to pay for Revolutionary War expenses, which were later assumed by the federal government. In the early nineteenth century, State debt funded public improvements, such as the Erie Canal and railroads.

To ensure the repayment of canal debt, the Constitutional Convention of 1821 provided that toll schedules could not be reduced and required other revenues to be assigned to debt payments.¹² In 1836, the Legislature provided, in effect, a \$3 million loan to the New York and Erie Railroad. The State's lien on the rail beds was found to

¹² Quirk and Wein, "A Short Constitutional History of Entities Commonly Known as Authorities," *Cornell Law Review*, April 1971, p. 525.

be fundamentally worthless when the private rail company was unable to pay its debt.¹³ In 1842, the Comptroller stated that increasingly precarious financing was leading the State to “the very brink of dishonor and bankruptcy.”¹⁴

In response, the Constitutional Convention of 1846 passed the “People’s Resolution,” which required public approval for debt incurred by the State. By 1846, the State had approximately \$38 million in outstanding debt for “public improvements.”

As issuing State debt became more difficult, local governments issued more debt for public improvements, including railroads. By 1872, the outstanding debt of local governments totaled \$214.3 million, almost 13 percent of assessed property value.¹⁵ The 1884 Constitutional Convention limited outstanding debt for cities with over 100,000 residents to 10 percent of assessed property value.

In 1915, the Legislature created another tool for issuing debt for public improvement without the approval of the voting public or the restrictions of local debt limits. The State created river regulation districts controlled by boards appointed by the Executive, such as the Hudson River-Black River Regulating District that continues today. The statute authorizing the creation of these districts specifically stated that the debt incurred was not an obligation of the State.

However, one specific court case pressed the issue of liability as a moral obligation for debt issued by districts formed by the State. In 1910, the State Water Supply Commission issued \$200,000 in debt for water improvements. Although the debt was backed by assessments on the land, when the landowners fought the higher assessment and won, the bonds defaulted and bondholders sued. The Court of Claims subsequently ruled that the State was not liable because constitutional requirements for State debt were not met. The Legislature had authorized the Court of Claims to determine whether bonds might be a “moral obligation” of the State. Both the Court of Claims and an appellate court ruled against the bondholders. Bondholders appealed to the Court of Appeals, which overturned the Court of Claims decision and found the State liable.¹⁶ The court decision found the Commission to be acting under the State’s authority and that the Legislature had recognized its potential liability.¹⁷ This decision would have far-reaching consequences with the subsequent creation of public authorities.

Between 1915 and the Constitutional Convention of 1938, New York created 33 public authorities, largely led by the actions of Robert Moses, for various infrastructure projects in the New York City and Long Island area. After concerns were raised regarding the growth in the number of authorities, their role and, most importantly, the

¹³ Ibid. p. 527.

¹⁴ Ibid. p. 526.

¹⁵ Ibid. p. 550.

¹⁶ Ibid. pp. 559-560.

¹⁷ See *Williamsburgh Savings Bank v. State* 243 NY 231 (1926).

potential State liability for public authority debt, the 1938 Constitutional Convention took action to restrain public authorities.

With the Court of Appeals suggesting the State could recognize a moral obligation to pay debts incurred by districts in the *Williamsburgh* case, the final constitutional amendment (Article X, Section 5) required the Legislature to create each authority by a single act, required the Comptroller to supervise their accounts, and specifically stated that the debts of these authorities are not an obligation of the State or local governments.¹⁸

In 1943, the State changed the beginning of its fiscal year from July 1 to April 1. The change in the fiscal year had been under consideration since 1937.¹⁹ With the State's largest cities and its school districts following a July 1 fiscal year, this arrangement provided a one-quarter overlap that allowed the State to promise aid in one year and pay it in the next. Over the years, spending was concentrated in the State's first fiscal quarter, producing sizeable cash needs and an annual "spring borrowing."²⁰ This practice ended in 1995 after another public authority, the Local Government Assistance Corporation (LGAC), completed its mission of ending the practice of spring borrowing with the issuance of over \$5 billion in long-term debt.

In 1944, the State created the Dormitory Authority and entered into the State's first lease-purchase agreement in which the Dormitory Authority would issue bonds (for dormitories). The State would pay the debt service with an annual appropriation in the State budget. In a lease-purchase agreement, when the bonds are paid, the title to the property reverts to the State, usually for a nominal consideration.

Throughout the 1950s and early 1960s, the State increased its use of lease-purchase agreements, and voters approved additional State guarantees for housing and highway debt that were limited to specific dollar amounts.

Construction of the Thruway began in 1946 and its first segment was opened to traffic in May 1948. The desire to rapidly complete this project led to the creation of the Thruway Authority in 1950. The Governor's Thruway Committee, which included Comptroller Frank C. Moore, the State Budget Director and the State's Director of Public Works, stated that rapid completion of the Thruway was key to its success. According to the Committee, "Slow, piecemeal construction would string the work out over ten or more years and remove forever the possibility of making the project self-liquidating. Through the issuance of bonds, funds can become available to build the Thruway as fast as the construction industry can absorb contracts."²¹

¹⁸ Galie, Peter J., "The New York State Constitution: A Reference Guide," New York: Greenwood Press, 1991, pp. 226-228.

¹⁹ New York State Division of the Budget, *The Executive Budget in New York State, A Half-Century Perspective*, Albany, NY, NYSDOB, 1981, p. 79.

²⁰ *Ibid.* p. 181.

²¹ *Ibid.* p. 93.

In November 1951, a constitutional amendment guaranteeing \$500 million of the Thruway's Authority's bonds was approved by the voters. The Thruway was completed in 1960, but as of December 31, 2003, the Thruway Authority continues to hold approximately \$1.7 billion in outstanding debt supported by tolls.

A Rockefeller administration task force recommended the establishment of a new public authority, the Housing Finance Agency (HFA), to build middle income housing. John Mitchell, a lawyer specializing in municipal bonding (who later became U.S. Attorney General in the Nixon administration), was brought in to advise on the resulting legislation and proposed the idea that became "moral obligation bonding." HFA would be authorized to issue bonds, with specific revenues of the Agency dedicated for repayment. When the bonds were issued, HFA would be required to set aside a reserve fund equivalent to one year's debt service. In the event that revenues were insufficient for debt service, HFA would notify the Governor and the Division of the Budget of the amount needed to replenish the reserve fund. While not a legally enforceable obligation, these bonds were viewed as a "moral obligation" of the State.²² The creation of HFA was followed by the establishment of the State University Construction Fund and the Urban Development Corporation.

Throughout the 1960s, the use of moral obligation and lease-purchase agreements with authorities for revenue producing projects increased significantly. The State Comptroller warned of the use of lease-purchase agreements in reports throughout the decade. In 1964, the Comptroller noted that "[t]he State's long-term commitment to pay rent during the period of debt amortization has a fiscal effect little different than if the State had, in the first instance, issued its own bonds for such capital improvements."²³ The main reason for using authorities was, and still is, to avoid the public approval process prescribed in the Constitution.

Again in 1973, Comptroller Arthur Levitt warned of the use of the public authorities to finance State projects through lease-purchase or moral obligation debt:

All of these financing schemes have been adopted in the name of necessary public projects, but all of them are in derogation of the right of the people to vote upon indebtedness of the State of New York. Without the safeguard of control by the people, policy tends to be dictated by the needs of each passing year. Sound policy needs to be restored.²⁴

At the time of this comment, the State's non-voter approved debt commitments totaled \$5.6 billion.

²² New York State Division of the Budget, *The Executive Budget in New York State, A Half-Century Perspective*, Albany, NY, NYSDOB, 1981, pp. 121-123.

²³ Office of the State Comptroller, *Annual Report of the Comptroller*, 1964, p. 25.

²⁴ Debt-Like Commitments of the State of New York, New York State Comptroller's Studies on Issues in Public Finance No. 2, January 1973, p. 2.

The State's moral obligation came into play in 1975 when the Urban Development Corporation defaulted on \$105 million in bond anticipation notes. A Moreland Act Commission found that moral obligation debt was being created without action from either the Executive or the Legislature. The default played a significant role in the fiscal crisis faced by the State at that time but, more importantly, brought the investment community forward to encourage the State to change its practices. Spring borrowing had reached a level of nearly \$3 billion annually in 1975. Bankers and investors refused to market the State's short-term notes until the State capped the issuance of debt with moral obligation provisions. Furthermore, this crisis prompted the State to create the Public Authorities Control Board to review each new project proposed by certain public authorities, with the hopes of making New York's debt burden more accountable.

While various laws enacted in 1976 successfully halted the use of authority debt with moral obligation provisions, the State found other routes for circumventing the Constitution. In 1979, the State entered into the first contractual obligation with Triborough Bridge and Tunnel Authority to build the New York Convention Center (Javits Convention Center). "Contractual obligations" are an agreement between the State and an authority for a specific project or set of projects. The State agrees to pay a specified amount to the authority periodically that will cover debt service for the project. The payments to authorities are subject to appropriation in the annual State budget. Although the State does not have a moral obligation, it does have a contractual obligation to pay, subject to appropriation.

Prior to 2001 and the introduction of the Personal Income Tax (PIT) Revenue Bond program, this appropriation-backed debt issued by public authorities was rated below GO debt, thus generating higher borrowing costs.²⁵ The State began issuing PIT bonds in May 2002 and had approximately \$3.3 billion outstanding as of March 31, 2004. Because PIT bonds are rated the same as GO bonds, an additional incentive to continue the trend away from voter approved debt has emerged.

By 1985, over 60 percent of the State's outstanding debt was issued by authorities. Between 1985 and 2004, State-funded debt supported with State revenues and issued by authorities increased from \$5.7 billion to \$41.6 billion, representing an average annual increase of nearly 8 percent. In 2004, authority debt made up 92 percent of outstanding State debt. By 2004, there were over 700 public authorities across the State.

In 1995, an amendment to the State's Constitution, which would have provided for certain modifications and reforms to the State's debt practices, was rejected by the voters. The Constitutional amendment would have banned the use of "backdoor" borrowing for State capital or operating purposes. The ban, however, was not comprehensive and provided for several exceptions including natural disasters and

²⁵ Historically, obligations issued by the Local Government Assistance Corporation have been rated higher than other authority debt.

economic emergencies, large judgments and court facilities. A new category of non-voter approved revenue debt to be backed by a specific stream of revenues was also included as part of this Constitutional amendment. This new revenue debt, but not General Obligation debt, would have been capped at 4.4 percent of personal income. The amendment would also have limited the issuance of debt to capital purposes only. In an effort to facilitate the use of General Obligation bonds, the amendment would have authorized more than one bond issue to be placed on the ballot for consideration by the voters at any given time.

Reform

The State has reformed debt policies a number of times throughout history, generally to address issues relating to accountability and liability. In 1846, to address the growing concern regarding debt issued for canals and railroads under the credit of the State, a Constitutional Convention required both voter approval for State debt and new revenue to pay for the obligation. Furthermore, it prohibited the State from giving its credit to private organizations or individuals. In 1874, local governments were also barred from extending credit to private corporations or individuals as the trend of providing government credit for public improvements continued, even after the 1846 Constitutional Convention. To further address growing local debt, in 1884, the Constitution was amended to limit debt in certain cities to 10 percent of assessed land value.

The Constitutional Convention of 1938 provided the language that significantly shaped our current debt picture. The Convention adopted language that requires authorities to be created by the Legislature and specifically states that their debts are not obligations of the State. While this addressed the growing concern over the perceived moral obligation of the State, it set the stage for increased backdoor borrowing and the structure that has crowded out voter approved debt in this State.

Announcing agreement on the Debt Reform Act of 2000, discussed elsewhere in this report, Governor Pataki stated, "We've finally reached agreement on real and meaningful debt reform. That has been talked about for decades in this State, but it hasn't happened before."²⁶

Outstanding Debt

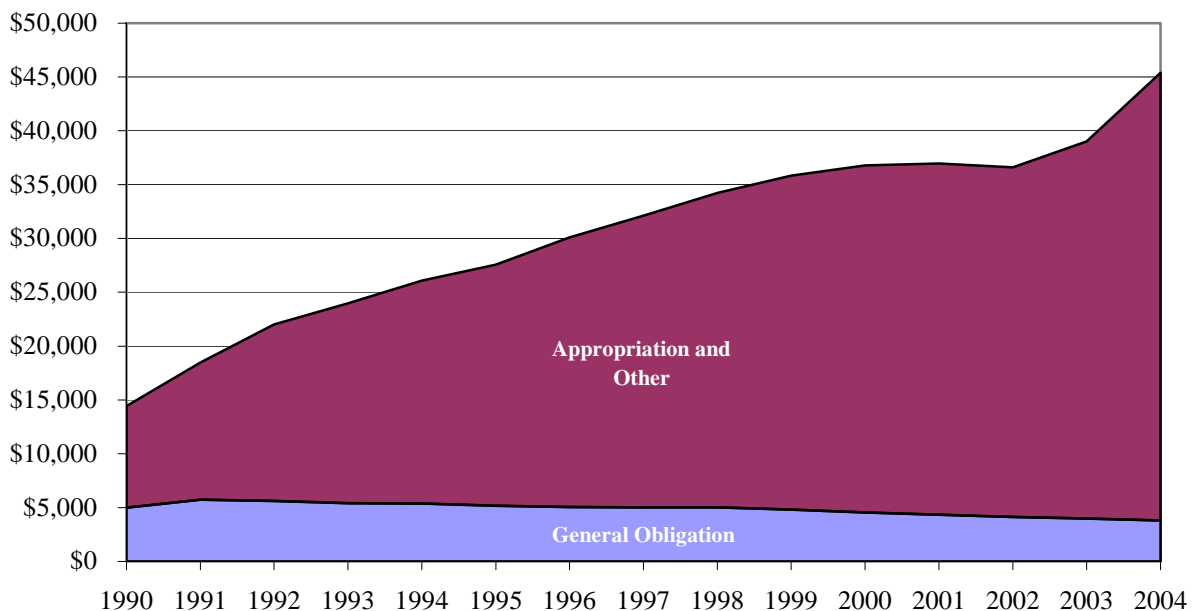
As of March 31, 2004, the State had over \$45 billion in outstanding State-funded debt, representing a 215 percent increase from 1990 when outstanding debt was only \$14 billion. This tremendous increase is not the result of voter approval. In fact, outstanding voter approved debt declined from \$5 billion to slightly under \$4 billion in the same period. State-supported authority debt increased from \$9 billion in 1990 to

²⁶ Perez-Pena, Richard, "For Debt in Albany, A Contrast in Words and Actions," [New York Times](#), May 4, 2000.

nearly \$37 billion at the end of the 2004 fiscal year, a 311 percent increase. During that same period, the State budget grew only 110 percent. In addition, the State's sale of its tobacco revenue and amortized prior year claim obligation further increased State-funded debt by \$5.1 billion. In the current fiscal year, the State added an additional \$2.6 billion when the Sales Tax Asset Receivable Corporation issued debt to refinance outstanding Municipal Assistance Corporation debt. Since 1990, State-funded debt per capita increased from \$802 per person to \$2,365 per person in 2004, an increase of 195 percent and an average annual increase of almost 13 percent. Debt as a percentage of personal income has increased from 3.7 percent in 1990 to 6.5 percent in 2004. Between 1998 and 2002, the State did enjoy declining debt as a percentage of personal income, but the decline was primarily due to personal income temporarily increasing faster than new debt.

Furthermore, from 1996 through 2001, the State enjoyed six consecutive years of surpluses. During this time, the State created the Debt Reduction Reserve Fund (DRRF), intended as a mechanism to reduce outstanding debt and increase cash financing in place of additional debt, but only deposited \$1.1 billion over three years. During those six years, the State experienced surpluses ranging from \$445 million to \$3.6 billion, outstanding debt increased 23 percent or 3.8 percent annually—almost double the average rate of inflation.

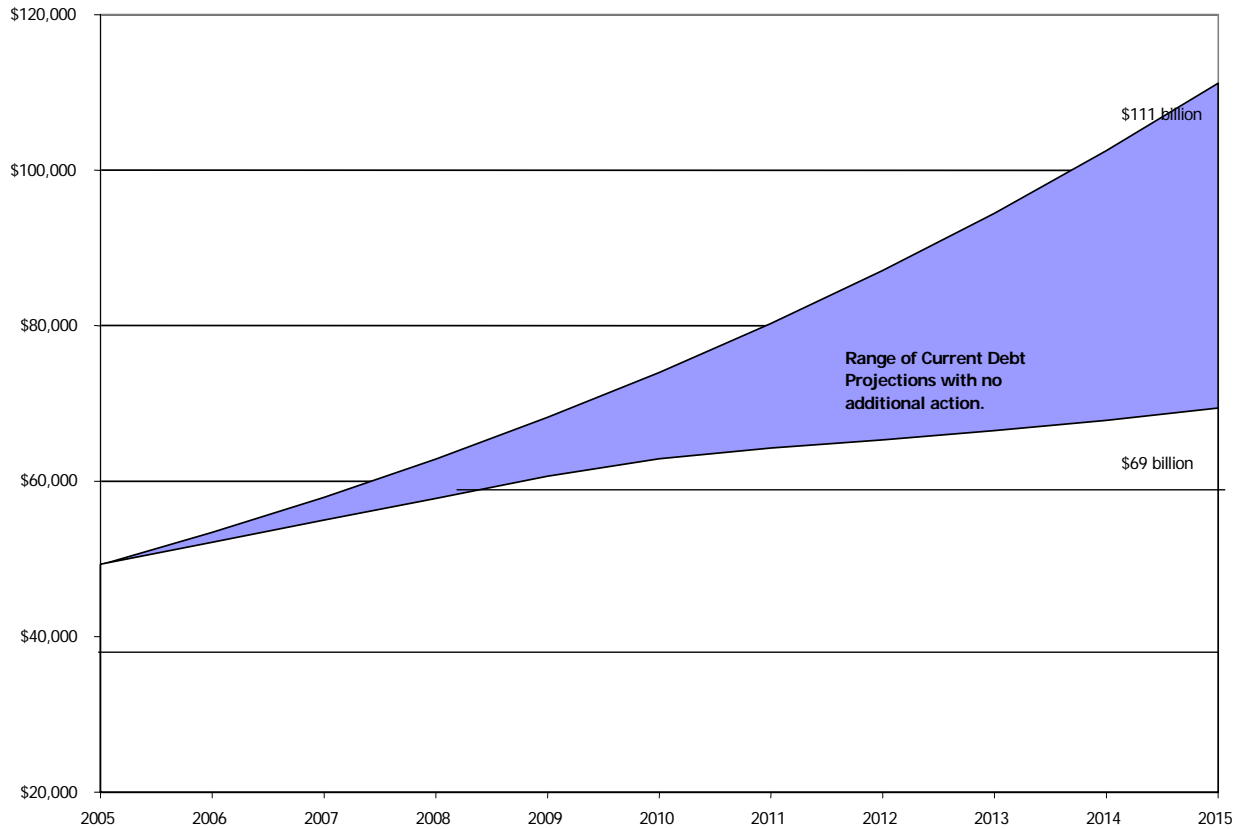
Growth of State-Funded Debt in New York State - 1990-2004²⁷
(\$ millions)



²⁷ The State enjoyed surpluses between \$445 million and \$3.6 billion annually between 1996 and 2001. During that period, State spending (all funds) increased at an average annual rate of 4.4 percent, whereas outstanding debt increased 5.1 percent. Inflation during that period averaged 2.6 percent.

As the graph below indicates, if the State continues to incur new debt at these historic rates, outstanding debt will be between \$69 billion and \$111 billion in 10 years. Debt caps established in the Debt Reform Act of 2000 have proved meaningless as the State has crafted new mechanisms to avoid them.

Projected Growth of Outstanding State-Funded Debt²⁸
(\$ millions)



²⁸ There are a number of growth indicators that could illustrate various scenarios, such as inflation or budget growth. The above chart uses various historic debt growth indicators to project possible future outstanding debt levels.

New York's Current Debt Picture

The current picture of New York State's outstanding debt stands in sharp contrast to the 1846 picture that alarmed lawmakers and voters enough to adopt a constitutional requirement for a public referendum on every debt issue.

In 1846, the \$38 million in outstanding State debt represented general obligation bonds issued by the Comptroller to support infrastructure such as canals and railroads.

Today, comparable General Obligation debt issued by the Comptroller comprises only about 8 percent of the \$45 billion in outstanding State-funded debt. The remaining debt, the vast majority of outstanding debt, was issued by one of six public authorities governed by boards of directors appointed largely by the Executive.²⁹ The framework of checks and balances that is laid out in the State Constitution does not apply to this "backdoor borrowing." Most of this authority debt was issued without the direct involvement of the State's elected chief fiscal officer, nor did the State's voters ever approve it, as was intended by the Constitutional Convention of 1846.

What's more, this debt is more likely to have been issued to provide short-term financial benefits to the State or local governments, or funding for local governments and not-for-profits, than to fund State public works. The types and purposes of State debt have evolved into a bewildering variety of debt and derivatives issued through complex relationships of public authorities and contractual agreements controlled largely by the Executive. The complexity and variety of these arrangements have the effect of reducing transparency and making effective oversight of debt more difficult.

In order to promote transparency and reform of State debt practices, this report introduces a new definition of debt that encompasses all debt where New York State pays principal and interest, directly or indirectly.

State-Funded Debt

State-funded debt includes all debt where debt service (principal and interest) is paid, directly or indirectly, by the State.³⁰ It includes General Obligation bonds and other State-supported debt as defined by Section 67-a of the State Finance Law, as well as obligations associated with the sale of the State tobacco revenue stream, amortized prior year school aid claims and debt issued by the Sales Tax Asset Receivable Corporation to refinance New York City's obligation from the 1975 fiscal crisis.

²⁹ The six authorities are the Local Government Assistance Corporation, Urban Development Corporation, Dormitory Authority of the State of New York, Tobacco Settlement Financing Corporation, Thruway Authority and Metropolitan Transportation Authority.

³⁰ This report considers State-funded debt as bonds, notes and other bonded long-term obligations, reported on a cash basis and defined in the statutory and constitutional legislation associated with the Comptroller's debt reform proposal. It will compare and contrast the statutory definitions for State-supported debt set forth in the Debt Reform Act of 2000 with the standard used for financial reporting.

The State makes payments for State-funded debt, either directly for General Obligation bonds or indirectly to a public authority, bank trustee or, on occasion, municipal issuer (lease-purchase or contractual obligation) to enable such issuer to make payments on its outstanding bonds. As of March 31, 2004, the State had approximately \$45 billion in State-funded debt outstanding.³¹ Public Authority debt issued for the State made up approximately 92 percent of this State-funded debt burden, or approximately \$42 billion, included in the table below. This includes \$5.1 billion for debt not counted as State-supported under Section 67-a.

Components of State Funded Debt
(in billions)

Component	Amount
State-Supported Authority (Public Authority and LGAC)	\$ 36.5
Tobacco Securitization	\$ 4.6
Prior Year School Aid Claims	\$ 0.5
Subtotal - Authority Debt	\$ 41.6
State-Supported General Obligation	\$ 3.8
State-Funded Debt - Cash Basis (as of 3/31/04)	\$ 45.4
Capital Lease Obligations	\$ 0.2
Unammortized Bond Premiums	\$ 0.9
Accumulated Accretion on Capital Appreciation Bonds	\$ 0.3
State-Funded Debt - GAAP Basis (as of 3/31/04)	\$ 46.8

General Obligation Debt

General Obligation (GO) debt is voter approved and constitutionally backed by the full faith and credit of the State. The State Comptroller is required to pay debt service even without a GO debt appropriation.

As of March 31, 2004, GO bonds made up 8.3 percent or \$3.8 billion of total State-funded debt. Of the \$14.5 billion in GO debt that is currently authorized by voters, \$13.5 billion has been issued and used for a variety of projects, leaving

³¹ Debt figures, except where noted, are the original issue par amount that remains outstanding. This does not include adjustments for premiums, discounts, accretions, deferred losses or outstanding actions from the Debt Reduction Reserve Fund.

approximately \$1.0 billion authorized, but not yet issued. With the increased utilization of non-voter approved debt, the use of GO debt has decreased significantly over the past 30 years.

State-Funded Public Authority Debt

To avoid the constitutional requirement for voter approval, the State has utilized various public benefit corporations to issue debt supported by lease-purchase agreements for capital assets or service contracts with the State. Lease or contract payments from the State to the authority cover related debt service requirements. This type of debt is often referred to as "backdoor borrowing" and has increased dramatically over the years. Public authorities are created by acts of the State Legislature with various missions, such as economic development, facilities financing, construction and operations, or highways and transportation financing. Authorities have even been used by the State to avoid the default of other public authorities. Others were created for specific financial purposes, such as the Local Government Assistance Corporation.

Local Government Assistance Corporation

The Local Government Assistance Corporation (LGAC) was created in 1990 to provide a means for the State to eliminate its annual reliance on intra-year short-term borrowing for cash flow purposes (also known as "spring borrowing") and reduce its accumulated operating deficit.³²

By 1990, the State's short-term borrowing increased to a high of \$4.3 billion. This borrowing was needed to provide the cash for payments to school districts and other municipalities; however, as the spring borrowing increased, it became more difficult and costly for the State to operate in this fashion.

Pursuant to Chapter 220 of the Laws of 1990, LGAC was authorized to issue up to \$4.7 billion in bonds and notes (plus amounts to fund a capital reserve fund, certain capitalized interest and costs of issuance), secured by a contractual obligation of the State, for the purpose of making certain payments to local governments and school districts. LGAC bonds are payable from revenues derived from the State sales and use tax equal to a 1 percent rate of taxation. A significant provision of this legislation is that as LGAC issued its bonds, the amount of intra-year short-term borrowing that could be undertaken by the State could not exceed a level defined as \$4.7 billion reduced by the net proceeds of the bonds and notes already issued by LGAC.

As a result of the 1990 Act, the State may now conduct intra-year short-term borrowing only if the Executive and the legislative leaders certify an emergency or other

³² See Article 10-b of the Public Authorities Law. An operating or GAAP deficit is an excess of expenditures over revenues at the end of the fiscal year.

extraordinary or unanticipated factors.³³ Should this type of emergency borrowing occur, it must be paid down within four years following the declaration of emergency.

LGAC issued its last authorized new money bonds during the State's 1995-96 fiscal year, thus eliminating spring borrowing. Since that time, LGAC only has issued bonds for refunding purposes, and there has been no State intra-year short-term borrowing since the State's 1993-94 fiscal year. As of March 31, 2004, there was \$4.6 billion in LGAC debt outstanding.

Certificates of Participation

Article 5-A of the State Finance Law authorized the issuance of Certificates of Participation (COPs) for financing real and personal property and equipment by State entities. For the period 1987 through 2001, the Office of the State Comptroller administered the issuance of 19 COPs, totaling approximately \$1.6 billion. As of March 31, 2004, \$116 million of such obligations were outstanding. In 2003, legislation enacted with the budget authorized certain public authorities to issue debt under the State's Personal Income Tax (PIT) Revenue Bond Program, replacing COPs as a borrowing vehicle.

*Obligations of the State that are **Not** Counted Under the Debt Reform Act of 2000*

The General Obligation debt, State-funded authority debt and Certificates of Participation described above are counted as State-supported debt under Section 67-a of the State Finance Law. This definition was established by the Debt Reform Act of 2000 in order to establish statutory debt limits. But the State Finance Law defines State-supported debt so narrowly that certain types of debt, such as the recently issued tobacco bonds, fall outside its definition, but are nonetheless supported with State resources. **While such obligations are currently not statutorily required to be counted under the State's debt cap, they are classified as State-funded debt for the purposes of this report.**

Tobacco Securitization³⁴

Tobacco settlement securitization involves the sale of future revenue payments to be made by the four largest tobacco companies, subsequent companies electing to participate, to 46 of the 50 states and many counties and territories pursuant to a Master Settlement Agreement (MSA).³⁵ Recently, many states and counties have opted

³³ The Executive, Temporary President of the Senate and Speaker of the Assembly must issue a joint certificate describing the emergency or extraordinary factors unanticipated at the adoption of the budget for the fiscal year in which such borrowing is to be made that explain the need for additional short-term borrowing.

³⁴ Note that the term "securitization" holds different meanings for different situations. In its purest form, securitization is the process of converting financial interests into marketable securities.

³⁵ On November 23, 1998, the Master Settlement Agreement (MSA) was agreed to by the attorneys general of 46 states, several U.S. territories and the four largest tobacco manufacturers (Phillip Morris, R.J. Reynolds, Brown & Williamson and Lorillard Tobacco). Under the MSA, the tobacco manufacturers agreed to make payments to the

to issue debt secured by their future stream of tobacco settlement revenues as a means of immediate fiscal relief. The 2003-04 enacted State budget authorized New York State to sell its share from the 1998 MSA, initially estimated to be approximately \$25 billion over 25 years for New York State and its localities. The State securitized the revenue stream by establishing the Tobacco Settlement Financing Corporation (TSFC) and authorizing its issue of bonds, and selling to TSFC the State's right to any future tobacco revenues resulting from the MSA until such bonds are retired.

The State backs the bonds with a contingent contractual obligation, requiring that debt service be paid from additional State funds in the event that tobacco payments are insufficient. Structuring tobacco debt as a contingent contractual obligation prevents the debt from being included as State-supported debt under the definition in the State Finance Law. As of March 31, 2004, TSFC had issued \$4.55 billion in tobacco bonds, yielding approximately \$4.8 billion in gross proceeds for the State, of which \$4.2 billion was deposited into the General Fund, consistent with the enacted budget, while the remainder was used for costs associated with issuance.

Prior Year School Aid Claims Amortization

Recent financing structures created by the State are making identification of State-supported debt more difficult for both the State and other parties involved in the transactions. An example of this is a financing structure created in 2002 that allows certain school districts to obtain proceeds from debt issued by the Municipal Bond Bank Agency to pay prior year State aid claims (a State liability to the schools).³⁶ The only source of payment for these bonds is interception of future State aid payments from the State to the schools. It cannot be determined at issuance who in substance will ultimately be responsible for the repayment of the debt issued to fund an existing State liability should future education aid change significantly. A school district participating in this financing cannot be certain if the proceeds it receives are truly for prior year school aid claims or if it is borrowing on future school aid it would have received without any consideration of aid payments in arrears.

Municipal Assistance Corporation and the Sales Tax Asset Receivable Corporation

Legislation enacted with the 2003-04 budget provides the City of New York with an annual payment of \$170 million transferred from the Local Government Assistance Tax Fund through LGAC.³⁷ The legislative intent was to fund the refinancing of New York City's \$2.5 billion in Municipal Assistance Corporation (MAC) debt incurred in 1978 (in the wake of the City's fiscal crisis) and scheduled to be retired in 2008. The City created the Sales Tax Asset Receivable Corporation (STARC) to refinance MAC debt

settling states and territories in exchange for the release of all past, present and future claims related to the use of tobacco products.

³⁶ Prior year claims are the result of verified revisions to claims for State aid that happen after the last yearly scheduled payment.

³⁷ The tax fund was established with the Local Government Assistance Corporation. See Section 92-r of the State Finance Law.

through the issuance of \$2.6 billion in bonds to be repaid over 30 years. Provided there are no new refinancings, it will have taken 60 years to pay off costs incurred by the City of New York in the middle 1970s. The State, through the LGAC payments, will provide \$170 million per year to STARC to cover the debt service. In addition to the intergenerational inequity of this transaction, the funds provided by the State to New York City otherwise would have been used for State General Fund expenditures, and therefore the burden for the MAC debt has, in effect, been shifted from the City to the State.³⁸

Non-State Funded Debt

Public Authority - Revenue and Conduit

Non-State funded debt is issued by a number of different authorities for such purposes as highways, bridges and utilities. A portion of the outstanding debt in this category is supported by revenues derived from the facilities financed by the debt. For example, the New York State Thruway Authority, as of December 31, 2003, had approximately \$1.7 billion in revenue debt supported by Thruway tolls and concession revenue. Public authorities also often act as a lender for private entities, such as not-for-profits. This "conduit" debt is supported by contractual payments made to the authority from the private entity.

The State is under no obligation, moral or legal, to pay the debt service on these obligations. As of December 31, 2003, there was approximately \$74 billion in outstanding debt issued by various authorities that is not supported by payments made by the State or assignment of its revenues.

Contingent Contractual Obligation Debt

Historically, contingent contractual obligation debt has been used for distressed hospitals.³⁹ It is similar to "backdoor" borrowing, but the State only makes debt service payments if the hospital does not have sufficient revenues or reserve funds. The State has never been required to make a payment from this program. As of March 31, 2004, there was \$941 million in this category of debt outstanding.

Moral Obligation Debt

Historically, certain public authorities have been authorized to issue moral obligation debt, which carries a pledge by the State, subject to legislative appropriation, to make up deficiencies in the authority's debt service reserve fund, if necessary. The largest amount of moral obligation debt was issued by the MAC to help New York City

³⁸ The State Comptroller opposed such action because of the extension of the term of the debt and the shift of its cost to the State from the City.

³⁹ Between 1987 and 1995, the Dormitory Authority and the Medical Care Facilities Finance Agency (MCFFA) financed seven financially distressed hospitals through the Secured Hospital Program.

during the City's financial crisis in the 1970s. Although new moral obligation debt may no longer be issued, approximately \$377 million of various Housing Finance Agency (HFA) debt and debt issued for hospital and nursing home projects by the Medical Care Facilities Finance Agency (MCFFA) remained outstanding as of March 31, 2004.⁴⁰ Since 1987, the State has not been called upon to make payments on any outstanding moral obligation debt.⁴¹

State Guaranteed Debt

State guaranteed debt is an obligation authorized by the State Constitution where the State unconditionally guaranteed the payment of debt service for three authorities: the New York State Thruway Authority, the Job Development Authority, and the Port Authority of New York and New Jersey. The State makes payments on this debt only if the original borrower fails to do so. All of the State guaranteed debt of the New York State Thruway Authority and the Port Authority of New York and New Jersey has been retired, and the authorization by these two authorities to issue this type of debt has expired. As of March 31, 2004, the only debt remaining in this category was \$79 million for the Job Development Authority (JDA).⁴² The JDA can issue new debt up to \$750 million outstanding at any one time as approved by the Legislature. Note that the statutory limit is lower than the State guarantee of \$900 million, as authorized by constitutional amendment approved by the voters on November 5, 1991.⁴³ The State has never been called upon to make payments as per any such guarantee.

Other Debt Structures

In addition to the different debt programs available to the State, different debt structures are also available. This report will further discuss Personal Income Tax Revenue bonds, Variable Rate bonds and Interest Rate Exchange Agreements in the section titled "Recent Developments." Since 2001, the State has authorized different debt structures and debt management options for most of the debt described above including: (1) the issuance of revenue bonds that are backed by the State's largest revenue source—the Personal Income Tax, (2) variable rate exposure for the State and its public authorities, and (3) interest rate exchange agreements, known as swaps.

⁴⁰ The Medical Care Facilities Finance Agency (MCFFA) was consolidated with the New York State Dormitory Authority on September 1, 1995. Note also that moral obligation debt issued by the New York City Municipal Assistance Corporation was not fully retired, but refunded with new debt not carrying a moral obligation provision.

⁴¹ The State did make payments totaling \$162.8 million to Housing Finance Authority debt service funds in 1986-87 to make up deficiencies. At the same time, the State also had expenditures for the Project Finance Agency and Urban Development Corporation for moral obligation provisions. The State can no longer issue moral obligation debt, and it has not been called upon to make payments to debt service funds since 1987.

⁴² The principal purpose of the Job Development Authority, created by Chapter 443 of the Laws of 1961, was to provide loans to businesses in relation to acquisition, construction, rehabilitation or improvement of industrial or manufacturing facilities.

⁴³ The Legislature authorized only \$750 million as the statutory limit for the Job Development Authority in Chapter 389 of the Laws of 1992.

These additional tools, along with historically low interest rates, contributed to over \$13 billion in refinancing by the State and its public authorities over the past two years.

Constitutional and Statutory Framework

New York State's Constitution and statutes establish the framework for the use of debt as a financial management tool. The current framework reflects New York's historic cycles of expanding the use of debt, restricting that expansion through the adoption of reforms, and then developing new ways to circumvent the restrictions and further expand the use of debt.

The underlying framework provides a clear structure of checks and balances in the issuance of State debt. General Obligation (GO) debt must be authorized by the Legislature and, if not originally proposed by the Executive, the Executive must approve that authorization. Subsequently, the question of whether to issue debt for a particular purpose goes to the State's voters. After the voters approve and the Legislature authorizes issuance by appropriation from bond act proceeds, the Comptroller issues the debt through a public competitive sale and is responsible for management of the outstanding debt.

With the current picture dominated by the issuance of State appropriation-backed debt by public authorities, the checks and balances become less clear. Although the Legislature and Executive still must agree to authorize State-funded public authority debt, the question of issuing debt no longer goes to the State's voters. The debt is issued by public authorities governed by boards of directors appointed by the Executive and other public officials. The State-funded public authority debt is largely sold on a negotiated basis and is managed through the Division of the Budget's coordination of the activities of these individual public authorities. The projects and financing of 11 public authorities, including the issuance of State-funded debt, must be approved by the Public Authorities Control Board, an appointed body with five members representing the majority and minority of both houses of the Legislature and the Executive. Only three members, the representatives of the Executive and the two majorities, may vote. Finally, various provisions of law charge the Comptroller with review of the terms and conditions of the private or negotiated sale of bonds by many public authorities.

General Framework

State Constitution

Article VII of the State Constitution sets forth basic requirements for the issuance of State General Obligation (GO) debt.

In almost all cases, State GO debt must be submitted to the voters for approval. With the exception of housing bonds, only a single bond proposal can be put on the ballot at one time, and it must be for a single purpose (such as the environment, transportation or infrastructure). Requirements for bond refunding and limited

authorization for the issuance of short-term debt are also incorporated in the State Constitution.

There are no provisions in the Constitution for State appropriation-backed debt issued by authorities. The absence of any direct prohibition or constitutional restrictions on this form of debt has led to the proliferation of issuances designed to exploit this void. This type of bonding is often referred to as “backdoor borrowing.” Appropriation-backed debt is not required to be submitted to the voters, thereby avoiding one of the basic requirements of the Constitution for State debt. Each issue is clearly labeled “not a debt of the State,” though frequently falling within the definition of State-supported debt in the State Finance Law.

The primary vehicle for backdoor borrowing is public authorities. The State’s courts have determined that public authority debt backed by State appropriations is not debt of the State and, therefore, is not subject to constitutional restrictions. As a result, the State is in a position to finance almost any need without complying with the constitutional restrictions on long-term State debt.

Article VII, Section 16 of the Constitution directs the Comptroller to set aside revenues for, and pay debt service on, State General Obligation (GO) and certain guaranteed debt in the event the Legislature fails to appropriate money required for its payment.⁴⁴ In addition, the Comptroller is given custody of sinking funds and refunding escrow accounts for State GO debt.

Article VII - State Constitution (<i>State Debt Provisions</i>)
▪ State General Obligation debt, with very limited exceptions, must be approved by New York State voters.
▪ Debt service must be repaid in equal annual installments of principal or pursuant to a level debt service schedule.
▪ Bond refunding must achieve a present value savings and cannot extend beyond the maximum authorized term of the initial bonds.
▪ Except for housing debt, only one bond act may be submitted to voters per election, and it must be for a single purpose.
▪ Limited authorization is provided for the State to issue short-term debt.
▪ The Comptroller sets aside revenues for and pays debt service on State GO debt if the Legislature fails to appropriate any necessary monies.
▪ The Comptroller has custody of sinking funds for State GO debt.
▪ The Comptroller has custody of refunding escrow accounts for State GO debt.
▪ No provisions for State appropriation-backed debt exist. Absence of such provisions encourages backdoor borrowing.

⁴⁴ The only remaining State-guaranteed debt is \$79 million from the Job Development Authority, which is not specifically covered by Article VII, Section 16.

State Statute

Much of the statutory framework for State debt is found in Article 5 of the State Finance Law. The Comptroller is authorized to issue all forms of State GO debt. In addition, Article 5-B contains provisions that establish limitations on the amount of State-supported debt that may be issued by the Comptroller and all other issuers.

The power of various public authorities to issue State-supported revenue bonds backed by annual appropriations is not found in the State Constitution, but in the enabling acts of various authorities and in Article 5-C of the State Finance Law authorizing certain Personal Income Tax Revenue bonds (PIT bonds). The PIT bonds are backed by annual appropriations from a fund consisting of one-quarter of the State's personal income tax receipts.

It is important to note that by maintaining appropriation-backed debt authority in statute and not amending the Constitution to govern it, the Legislature and the Executive are afforded the ability to change the parameters of debt issuance for New York State without the direct input of the voters. The Comptroller must approve the "terms and conditions" of the private or negotiated sale of bonds by many public authorities.

State Finance Law (State Debt Provisions)
• Requires the Comptroller to issue all forms of State GO debt (Article 5).
• Provides limitations on the amount of State-supported debt that may be issued (Article 5-B).
• Authorizes various public authorities to issue State-supported revenue bonds backed by annual appropriations from funds consisting of one-quarter of the State's personal income tax receipts, up to \$6 billion annually (Article 5-C).
• Authorizes interest rate exchange agreements, swaps (Article 5-D).

Other Provisions Governing Debt
• Provides general authorization for public authorities to issue appropriation-backed debt (various enabling acts).
• Provides for Public Authorities Control Board review of the projects of selected public authorities.
• Creates the Local Government Assistance Corporation (LGAC). ⁴⁵
• Provides for sale of tobacco revenue. ⁴⁶
• Provides for the financing of State aid payments to schools. ⁴⁷

⁴⁵ The Local Government Assistance Corporation (LGAC) was created by Chapter 220 of the Laws of 1990.

⁴⁶ See Part D3 of Chapter 62 of the Laws of 2003.

⁴⁷ See Chapter 83 of the Laws of 2002.

- The Comptroller must approve the "terms and conditions" of the private or negotiated sale of bonds by many public authorities.

New York State's Five-Year Capital Plan

The Executive is required to submit a comprehensive, five-year estimate of capital program needs at the same time it submits the proposed State budget, normally in January. The plan is updated to reflect the enacted budget. The Capital Plan is meant to be a complete review of all State agency capital projects, as well as an analysis of the methods that will be used to finance those projects. The Capital Plan also outlines the anticipated mix of financing resources, including the total amount of pay-as-you-go disbursements, all projected bond-financed disbursements and the amount of anticipated federal support. The Capital Plan is then updated following adoption of the State budget to reflect legislative changes, if any, as well as more recent information on program costs and disbursements.⁴⁸

The Capital Plan covers State-supported debt as defined in Section 67-a of the State Finance Law and includes General Obligation (GO) debt and debt issued by public authorities when the State has a contractual obligation to pay the debt service. The plan does not cover such debt transactions as tobacco securitization, Prior Year Claims amortization or the refinancing of Municipal Assistance Corporation debt, which are included in this report's definition of State-funded debt.

Capital Spending and New Debt

The Division of the Budget (DOB) released an updated five-year Capital Plan on November 15, 2004 covering fiscal years 2004-05 through 2008-09. The following provides a brief overview of the enacted 2004-05 Capital and Financing Plan. According to DOB, outstanding State-supported debt will increase from \$40.3 billion in 2003-04 to \$44.0 billion in 2008-09, an increase of \$3.7 billion or 9.2 percent. This plan will cause an increase in outstanding debt of 22.7 percent from 1998-99 to 2008-09 (10 years) and 68.5 percent from 1993-94 to 2008-09 (15 years).

Annual debt service is planned to increase from \$3.4 billion in 2004-05 to \$5.1 billion in 2008-09, an increase of \$1.7 billion or 48.5 percent. The large increase is primarily the result of debt service restructuring for the MTA during the course of debt refunding in the 2002-03 and 2003-04 fiscal years. During that time, \$13.1 billion of State-supported debt was refunded, and much of the new debt was structured to require significantly lower principal payments in the near future (in some cases, no payments before 2010) and finance portions of accrued interest. These actions significantly lowered debt service paid in 2002-03 and 2003-04. However, these restructurings and refundings resulted in an estimated present value savings of \$895 million over 30 years with a cash flow loss of \$15 million.⁴⁹ Most of the savings were

⁴⁸ Section 22-c of the State Finance Law.

⁴⁹ The cash flow loss is a result of a 2002 \$1.7 billion Metropolitan Transit Authority refunding that produced nearly \$1 billion cash flow loss with a small (\$19 million) present value savings.

used in the immediate and near-term as fiscal relief, causing out-year debt service costs to grow significantly faster.

GO debt, as a percentage of total State-funded debt, will decrease from 4.0 percent in 2003-04 to 1.6 percent in 2008-09, continuing the trend of moving away from voter approved debt. Removing federal funding from the total (to better illustrate State cash funding), the share of State pay-as-you-go (PAYGO) will decrease from 28.3 percent in 2003-04 to 20.3 percent in 2008-09. In the past decade or so, this amount has held relatively steady between 35 and 40 percent. It had been as high as 75 percent (1985) and as low as 13.5 percent (1991). The share of State-funded authority debt as a share of total annual financing will increase from 48.1 percent in 2003-04 to 51.3 percent in 2008-09.

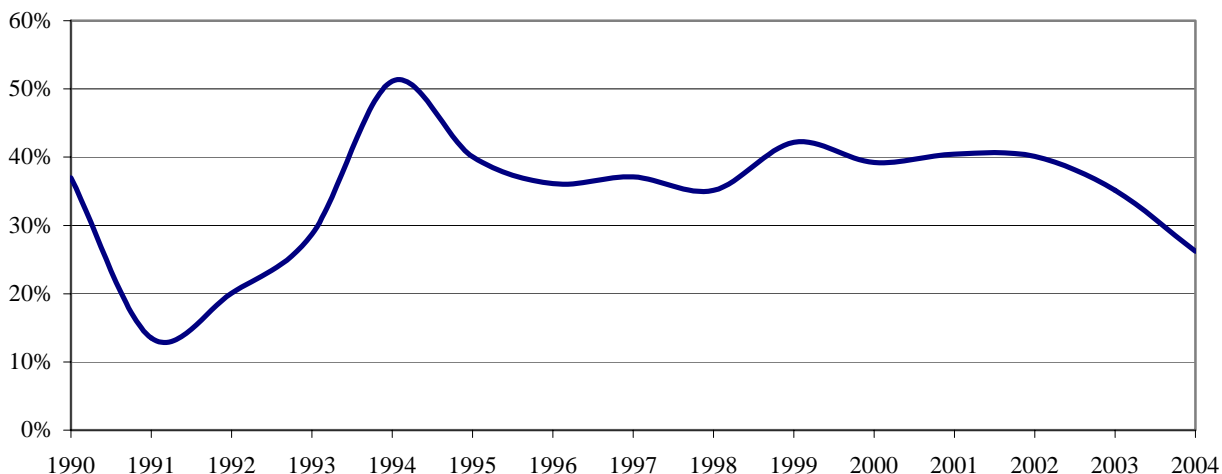
The majority of new financing continues to be for transportation and its share of the total increases from 59.6 percent of capital spending in 2003-04 to 62.9 percent in 2008-09. Capital spending for educational needs increases from 11.9 percent of the total to 12.9 percent over the same period. However, the November Capital Plan update does not include any additional capital spending that may be required as a result of the recommendations of the Campaign for Fiscal Equity court-appointed judicial referees.⁵⁰

The amount of cash used to finance capital needs can be indicative of fiscal health. When a state or municipality is financially healthy or has accumulated a surplus, it can be inferred that it has increased ability to pay cash, instead of issuing additional debt for capital purposes. Rating agencies view PAYGO very favorably.

New York's use of cash has varied greatly throughout its recent history. In 1985, the State financed over 75 percent of its non-federal capital program with cash, instead of incurring additional debt. In 1991, only 13.5 percent of the non-federal share was financed with cash. Between 1996 and 2001, the State enjoyed surpluses ranging from \$445 million to \$3.6 billion. While the State did utilize \$1.1 billion in Debt Reduction Reserve Funds for either debt retirement or PAYGO financing, the State, on average for those years, utilized cash for only 38 percent of its non-federal capital financing. As a result of the practice of increasing debt and underutilizing cash financing during its years of surplus, the State was saddled with higher debt service levels in times of need.

⁵⁰ On November 30, 2004 a court appointed panel recommended an additional \$9.3 billion in capital spending, phased in over five years, for education capital needs in New York City. This additional spending is not included in the latest Capital Plan. However, the court panel did not mandate this spending come from additional debt, nor did it mandate that it all is supported with State resources.

Cash Spending - Non-Federal Capital Spending - 1990-2004



Source: Office of the State Comptroller

* Note: The high point achieved in 1994 was the result of new, dedicated resources specifically collected for capital spending. Since that point, much of these funds are used for debt service in place of PAYGO.

Incomplete Scope of the State Capital and Financing Plan

There are three significant debt issues not covered in the Capital Plan and not counted as State-supported debt or considered in projected debt service requirements. First, the securitization of the State's tobacco settlement revenue creates what is, in effect, a long-term obligation for the State. The State is giving up a long-term revenue stream for health care spending to gain an immediate cash benefit needed to pay for current operating expenses unrelated to health care. The State is only obligated to appropriate additional amounts for debt service if there is a shortfall in the amount of anticipated future revenues that were sold.

Second, the Municipal Assistance Corporation (MAC) refinancing passed by the Legislature directly shifts New York City debt to the State via the required transfer of funds from the Local Government Assistance Corporation (LGAC) to the City. Last, the State Capital Plan does not include over \$500 million in prior year school aid bonds authorized in 2002. These three debt-producing actions, created in State budgets, are not accounted for in the Capital Plan because they are not considered State-supported debt under the definition of Section 67-a of the State Finance Law and will not be counted toward the debt limits established in the Debt Reform Act of 2000.⁵¹

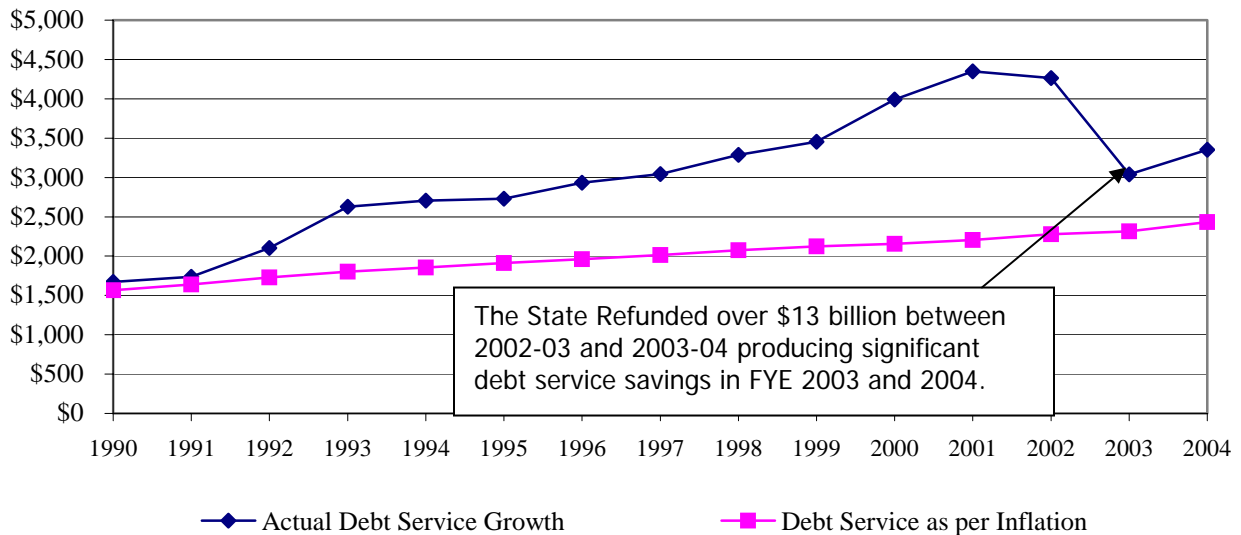
⁵¹ Section 67-b establishes limitations on the issuance of State-supported debt, which is based on an annually adjusted percentage of personal income of the State.

New York State Debt Service

In 2003-04, the State disbursed approximately \$3.4 billion in debt service on State-funded debt—representing approximately 3.4 percent of all governmental funds receipts. This represents an increase of approximately 26 percent from 1994 (\$2.7 billion) and 112 percent from 1990 (\$1.7 billion), but does not include current year debt service paid from funds disbursed to public authorities in prior years or paid from reserve fund earnings during the year.

Of this \$3.4 billion, approximately \$2.9 billion was needed for appropriation-backed authority bonds and \$510 million was for needed General Obligation (GO) debt. Absent the \$13 billion in refinancing actions taken by the State in 2002-03 and 2003-04, required debt service would have been significantly higher in both years. However, as a result of those refundings, debt service in subsequent years will be higher due to restructured amortization plans.

State-Funded Debt Service Growth - Actual and Inflationary - 1990-2004



Note: Actual debt service paid in fiscal years between 2000 and 2002 includes a total \$1.1 billion in additional funding from the debt reduction reserve fund to repay outstanding debt in advance or when due. In some instances, funds are being held by public authorities to make payments on regular payment dates. Thus, the State's budgetary basis debt service does not include payments on debt from funds transferred to a public authority in advance of the year that payments to bond holders are required or actually made.

Recent Developments

With mounting levels of State-funded debt in the 1990s and debt service costs consuming greater portions of the State budget, pressure built to reform State debt practices. This pressure resulted in the enactment of the Debt Reform Act of 2000 to establish statutory limitations on debt and, in subsequent years, the legislative authorization of Personal Income Tax Revenue bonds, variable rate financing and interest rate exchange agreements.

The municipal bond market—the market for debt issued by states, local governments and public authorities—is large and dynamic. New approaches are constantly being developed by market participants as they compete to meet the financing needs of State and local government. Budgetary pressures force government officials to rethink traditional financing methods and search for savings opportunities using less familiar debt financing and management tools.

In the last five years, the State has made significant changes to various debt practices, policies and management tools. The introduction of variable rate instruments and a low interest rate environment began a period of refinancing. The State established the Personal Income Tax Revenue Bond program and authorized certain authorities, as well as the State itself, to enter into interest rate exchange agreements under the management of the Division of the Budget.

The State refinanced over \$13 billion between 2002-03 and 2003-04, resulting in significant, near-term debt service savings. In the process, however, many debt service reserves were drained and principal payments deferred because of these refundings, thus contributing to the savings. The debt and its cost, albeit somewhat lower as a result of interest rates, will continue to be an obligation of the State. Furthermore, since some principal payments were restructured and deferred to later years, future debt service costs will increase above and beyond normal growth rates.

While the new management tools were instrumental in providing significant short-term debt service relief, they did not halt the overall accelerated growth of State-funded debt. The Debt Reform Act of 2000 was intended to do that. It was passed with a message to the taxpaying public that the restrictions it contained would change debt management forever.⁵² Instead, it established an inadequate definition of State-supported debt that would be subject to the new debt limits.

In just four years since the enactment of the Debt Reform Act, the Executive and the Legislature identified three different ways to issue debt outside its limits, increasing the State's outstanding debt by 17 percent. The Debt Reform Act of 2000 provided no

⁵² "This landmark reform will dramatically and permanently improve the State's long-term fiscal position, save billions of dollars in interest costs for taxpayers and prevent future generations of New Yorkers from being saddled with an insurmountable debt burden." Governor's Press Release, May 4, 2000.

real barrier to New York State's appetite for debt. Three transactions discussed in detail elsewhere in this report—tobacco securitization, the amortization of prior year school aid claims and the refinancing of Municipal Assistance Corporation debt for the City of New York—added almost \$8 billion in new debt.

Debt Reform Act of 2000

Chapter 59 of the Laws of 2000 added Article 5-B, Sections 67-a and 67-b, to the State Finance Law. These provisions establish statutory limitations, to be phased in beginning April 1, 2000, on State-supported debt and are commonly referred to as the Debt Reform Act of 2000.

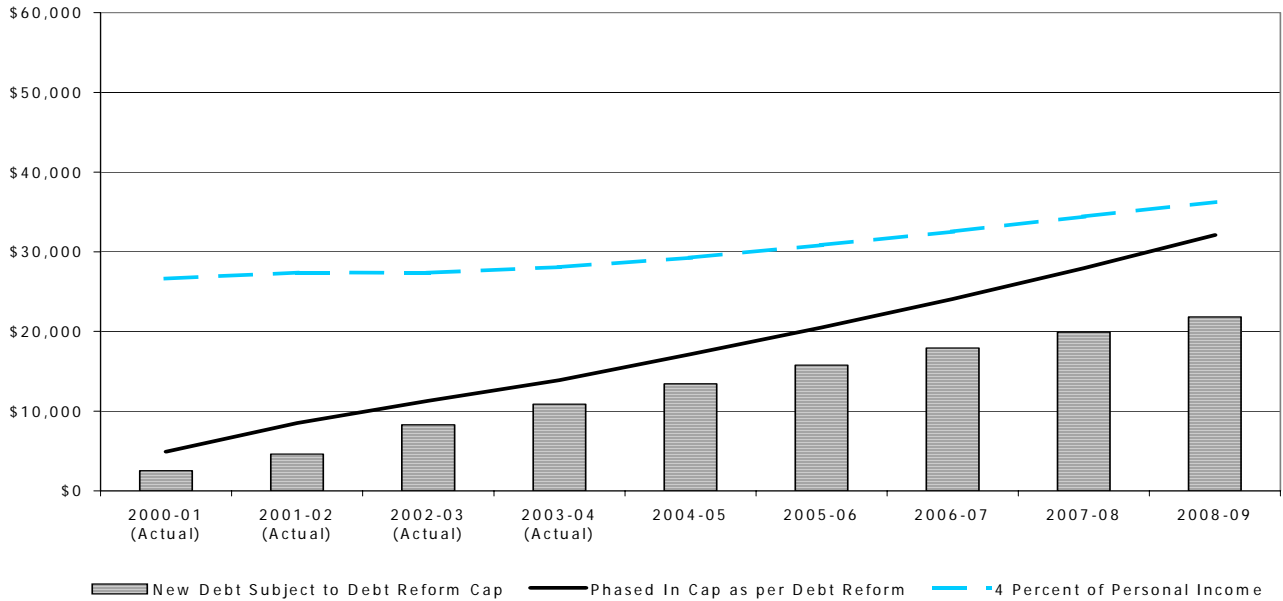
Unfortunately, the enacted Debt Reform package did little to provide fiscal discipline or ensure that future debt is affordable. The legislation made the following three statutory amendments:

- Cap new debt issued after April 1, 2000 at 4 percent of personal income. This cap is phased in over 10 years. New York's current debt outstanding is approximately 6.5 percent of personal income.
- Cap debt service on new debt issued after April 1, 2000 at 5 percent of all funds receipts. This cap is phased in over 13 years. New York's total current debt service costs, including pre-2000 debt, average approximately 4.5 to 5 percent of all governmental fund receipts.
- Provide that debt can only be used for capital works or purposes, and that State-supported debt cannot have a maturity longer than 30 years.

According to the Division of the Budget (DOB), the State remains well under the caps established in 2000.⁵³ However, the definition of State-supported debt counted under the caps does not count all borrowing that is funded with State resources. Furthermore, the law ignored the roughly \$35 billion in outstanding debt that existed at the time of its enactment. To get a true picture of the State's obligations, it is necessary to consider all State-funded debt as defined in this report. The graphs below compare the Debt Reform Act's measure of State-supported debt subject to its cap with this report's definition of State-funded debt, a true picture of the State's obligations. As the first graph below indicates, according to statutory definitions, the State is currently below the caps with room to spare throughout the next five years.

⁵³ The Division of the Budget reports on debt that is counted under the cap in annual Capital and Financing Plans and Annual Information Statements.

Current Debt Cap Projections as per Debt Reform Act of 2000
(\$ Millions)

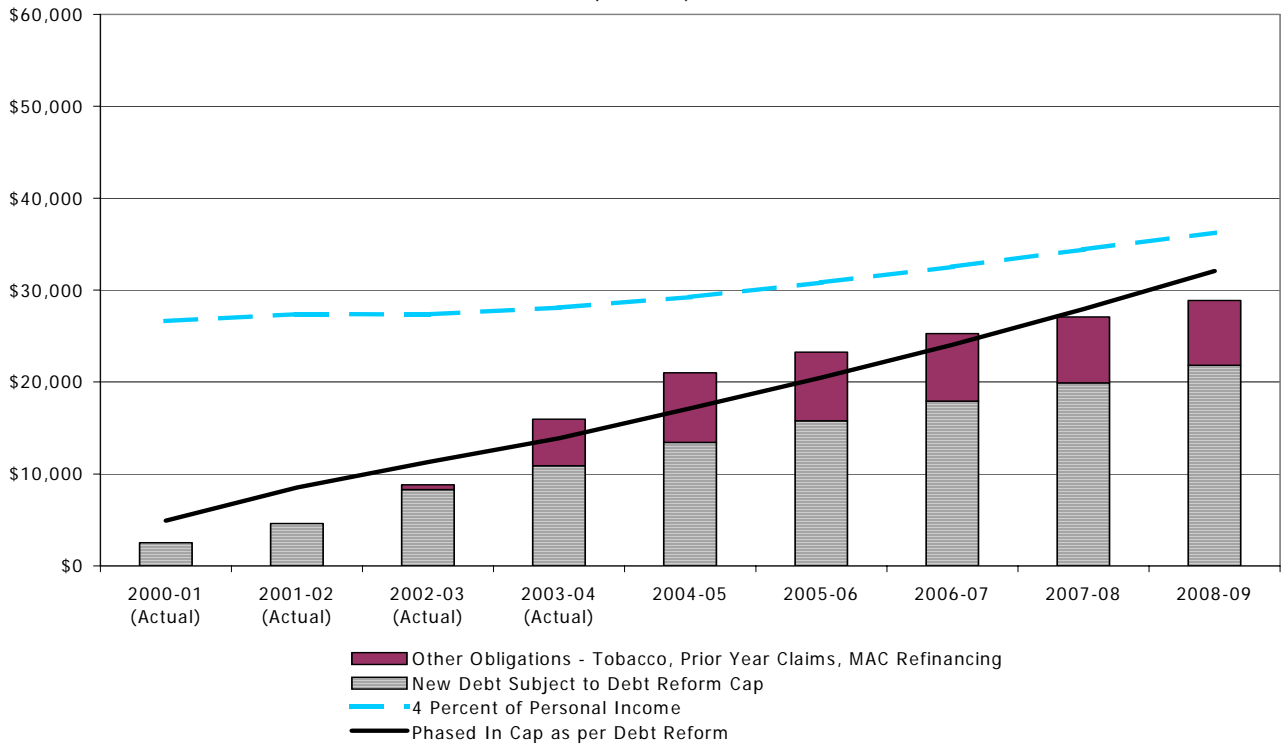


Note: New Debt Projections Subject to Debt Reform Cap as per Division of the Budget 2004-05 5 year Capital Plan

New York Personal Income projection by New York State Division of the Budget and Bureau of Economic Analysis.

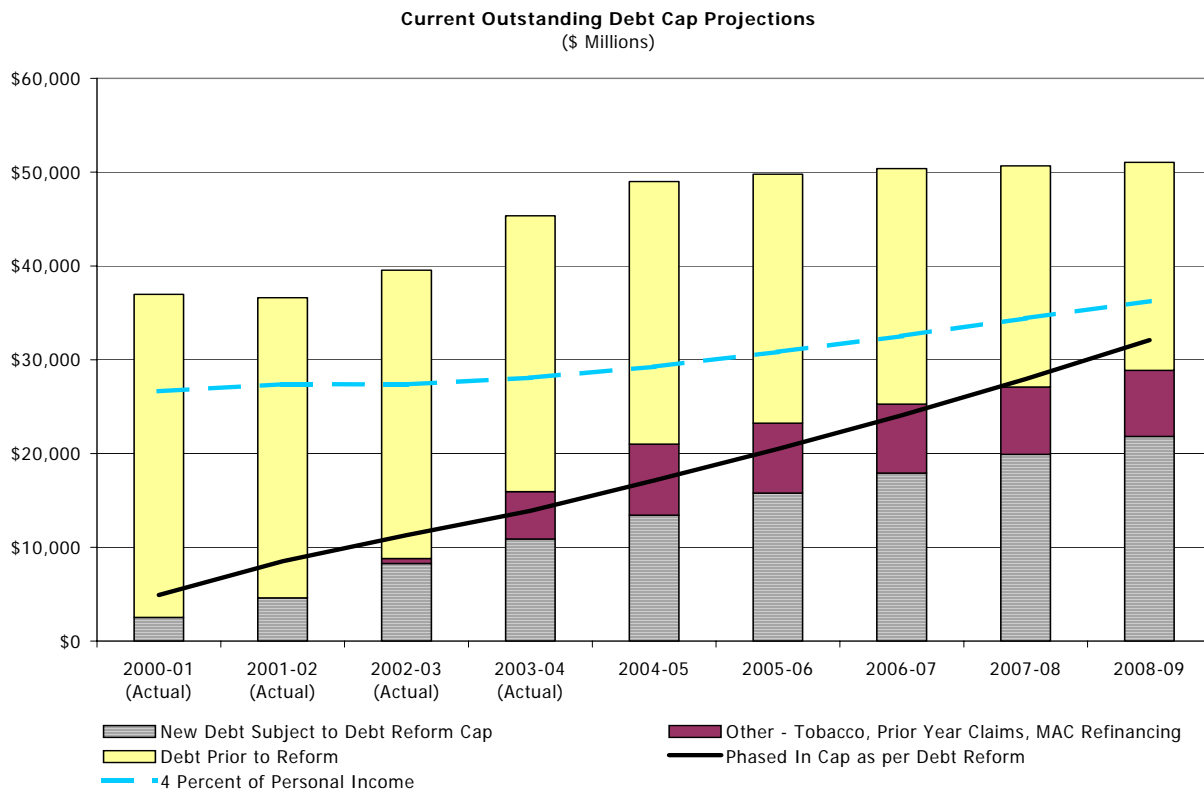
However, if tobacco, prior year claims and MAC refinancing were included, the State would exceed its debt caps from 2003-04 through 2007-08, at least.

Current Debt Cap Projections Including Tobacco, Prior Year Claims and MAC Refinancing
(\$ Millions)



Note: New Debt Projections Subject to Debt Reform Cap as per Division of the Budget 2004-05 5 year Capital Plan

Finally, if debt outstanding prior to April 1, 2000 is included, the debt caps established in the Debt Reform Act of 2000 are breached from the beginning.



Note: New Debt Projections Subject to Debt Reform Cap as per Division of the Budget 2004-05 5 year Capital Plan

The Debt Reform Act suffers from several weaknesses. First, the caps lack permanence since they are statutory and not constitutional. There is no guarantee of future adherence to these caps since the law could be repealed or "notwithstanding" at any time. In the face of budgetary pressures, State government has a history of undoing promises made in previous years' legislation, such as delaying the scheduled personal income tax reductions of the early 1990s and raiding various "locked box" funds, including the 1988 Infrastructure Trust Fund, which was created to reserve unexpected State revenues due to federal tax reform for housing and transportation capital facilities.

Next, the Debt Reform Act allows backdoor borrowing to continue. Subsequent debt management changes, such as the introduction of variable rate debt and PIT Revenue bonds, actually encourage the State to choose authority-issued over General Obligation (GO) debt, primarily because the lack of voter approval affords the State an easier way in which to borrow. PIT bonds are rated the same as GO bonds so additional costs associated with a lower rating are not there. Furthermore, the free use of variable rate instruments has provided managers with options and alternatives that were not available in the past. A centralized debt management environment has been created.

Furthermore, the definition of State-supported debt is inadequate and, due to its statutory nature, can be easily avoided. Based on past experience and current trends in borrowing, the caps are not projected to have a meaningful impact on the issuance of new debt for the foreseeable future. With the Executive and Legislature sidestepping the law with artful language, the Debt Reform Act of 2000 did nothing to impose fiscal discipline on State debt practices, but instead allowed borrowing to continue as usual.

New York's debt load of 6.5 percent of personal income required debt service payments of almost 3.5 percent of receipts in 2003-04 (\$3.4 billion in debt service and \$98 billion in receipts), even with a debt service level that remained artificially low due to refinancings. The outstanding debt cap of 4 percent of personal income and debt service cap of 5 percent of receipts encompass new debt issued after April 1, 2000. The caps will not have a meaningful impact until existing debt is retired or unless interest rates increase sharply and stay high for a sustained period of time.⁵⁴

The sale of the State share of tobacco settlement revenue illustrates the ineffectiveness of the Debt Reform Act's caps. The tobacco bonds, issued by a State created public authority, the Tobacco Settlement Financing Corporation, will be repaid with the diversion of tobacco settlement revenues originally destined to fund State health care needs. Although the tobacco securitization resulted in State-funded bonds issued after April 1, 2000, the limited legal definition established in the 2000 reform excluded this obligation from the debt caps.

If these bonds were counted as State-supported under the requirements of Section 67-a, the State would have exceeded its debt caps in 2003-04. Specifically, the caps are avoided in this instance with the establishment of a contingent contractual obligation and the following clause included in the enacted 2003-04 budget:

*Neither any bond nor any ancillary bond facility of the corporation shall constitute a debt or moral obligation of the state or a state supported obligation within the meaning of any constitutional or statutory provision (emphasis added) or a pledge of the faith and credit of the state or of the taxing power of the state, and the state shall not be liable to make any payments thereon nor shall any bond or any ancillary bond facility be payable out of any funds or assets other than pledged tobacco revenues and other assets, if any, sold to the corporation and other funds and assets of or available to the corporation pledged therefore, and the bonds and any ancillary bond facility of the corporation shall contain on the face thereof or other prominent place thereon a statement to the foregoing effect.*⁵⁵

⁵⁴ The calculation of outstanding debt subject to the caps is due October 31, 2001 and each subsequent year for debt outstanding on prior March 31.

⁵⁵ Unconsolidated Law - 2003. See Chapter 62 of the Laws of 2003, Section 7 of Part D3. Also note Section 6 (11)(ii) establishes a contingent contractual agreement, which also causes this debt to be exempt from the debt caps established in the Debt Reform Act of 2000.

In addition, the purpose of the tobacco securitization was to plug a gap in the State's budget. The State utilized an available revenue stream to pay for a debt that provided no public works or other tangible asset; yet, the Debt Reform Act states "[n]o state-supported debt shall be contracted except to finance capital works or purposes."⁵⁶

Personal Income Tax Revenue Bonds

Chapter 383 of the Laws of 2001 established the Revenue Bond Financing Program (Article 5-C of the State Finance Law) and the Revenue Bond Tax Fund (Section 92-z of the State Finance Law). The program is designed to reduce borrowing costs by issuing debt backed by a percentage of personal income tax revenues that will be pledged or earmarked for payment of debt service. This debt is rated the same as General Obligation (GO) debt and a notch higher than other appropriation-backed debt because it is backed by the State's largest revenue source, even though the pledged revenues are still subject to annual appropriation.⁵⁷ As of March 31, 2004, the State had issued approximately \$3.3 billion in Personal Income Tax (PIT) Revenue bonds.

Because rating agencies rate PIT Revenue bonds the same as GO bonds secured by the State's full faith and credit, there is an incentive for the State to issue PIT bonds over GO bonds. This form of backdoor borrowing has the potential to be less expensive for the State, and it does not require approval of the voters. The benefit of efficient debt issuance, however, must be balanced against other factors, such as accountability and fiscal responsibility. The fact that the voting public has been all but removed from the debt issuance process eliminates a layer of accountability, and it may result in more debt issuance with overall greater costs.

Variable Rate Obligations

Chapter 81 of the Laws of 2002 authorized the use of a limited State dollar volume of variable rate obligations. Consistent with rating agency guidelines, the legislation allows public authorities issuing bonds for the State to enter into variable rate debt instruments that result in a statewide maximum total net variable rate exposure of 15 percent of outstanding State-supported debt (as defined in Section 67-a of the State Finance Law). Variable rate bonds may be issued in various modes, including daily, weekly, monthly, multi-mode (less than one year), commercial paper mode, auction rate and extended rate.

At the time of issuance, variable rate debt provides a lower cost of funds to the issuer when compared to fixed rate debt obligations. Although this tool can provide

⁵⁶ See Section 67-b(3) of the State Finance Law.

⁵⁷ Personal Income Tax Revenue Bonds are rated A1, AA and AA- by Moody's, Standard and Poor's, and Fitch, respectively.

lower costs, variable rate debt also exposes the issuer to the possibility of higher costs should interest rates rise over time. At the same time, variable rate debt instruments also provide a natural hedge against interest rate fluctuations for State investments. As of March 31, 2004, the State had nearly \$2 billion in outstanding net variable rate debt.

Interest Rate Exchange Agreements (Swaps)

An interest rate exchange agreement swap is a contractual agreement between two parties who agree to exchange certain cash flows for a defined period of time. Generally, the cash flows to be swapped relate to interest to be paid or received with respect to some asset or liability. There is no principal exchanged in a swap, only interest payments based on the size of a swap also known as the "Notional Amount." When a swap agreement is executed, both parties agree to the notional amount, the rate or formula used to compute the amount paid to each party based on the notional amount, the dates on which the cash flows will be exchanged, and the term of the swap.

Three basic swap structures are:

- A Floating-to-Fixed Rate Swap (a "fixed rate swap") where the issuer pays a fixed rate to a counterparty, typically an investment banking firm, commercial bank or insurance company, and the counterparty in turn pays a floating rate (based on a floating index such as the BMA or LIBOR) to the issuer. The goal of this type of swap is to create, on a net basis, a synthetic fixed rate that is lower than a conventional fixed rate achieved through a traditional fixed rate bond sale. For this swap structure, the issuer issues variable rate bonds and swaps to a fixed rate.
- A Fixed-to-Floating Rate Swap (a "floating rate swap") where the issuer pays a floating rate to a counterparty (based on a floating rate index, such as BMA or LIBOR), and the counterparty in turn pays a fixed rate to the issuer. The goal is to create, on a net basis, a floating rate obligation as an alternative to issuing variable rate bonds in order to avoid incurring costs associated with issuing variable rate bonds, such as the cost of a liquidity provider and a remarketing agent. For this swap structure, the issuer issues fixed rate bonds and swaps to a variable rate.
- A Floating-to-Floating Rate Swap (a "basis swap") where the issuer pays a floating rate and also receives a floating rate. The basis swap allows the issuer to change the floating index that determines the payment it needs to make (change from a BMA to LIBOR or vice-versa). A basis swap may be used to reduce risk associated with potential changes in tax law, increase basis risk in return for upfront or potential on-going savings, or to move from one index to another.

State's Use of Floating-to-Fixed Rate Swaps

The State Division of the Budget (DOB) has coordinated the execution of swaps entered into by various State public authorities. As of March 31, 2004, public authorities had approximately \$5.5 billion in outstanding floating-to-fixed rate swap agreements with a negative fair market value of approximately \$132 million (amount State would have to pay to terminate the agreements). This fair market value fluctuates over time depending on market interest rates at the time of the valuation.

The floating-to-fixed rate swaps entered into by the various State public authorities produced synthetic fixed rates (ranging from 2.86 percent to 3.66 percent) in conjunction with public authority bond refundings resulting in significant debt service savings to the State. Pursuant to the swap agreements, in exchange for paying those synthetic fixed rates to the various counterparties, the public authority would receive variable rate payments equivalent to 65 percent of one month LIBOR. The interest rate on the underlying variable rate bonds are determined by remarketing agents responsible for marketing the bonds or, in the case of auction rate bonds, such rates are determined by the market through the use of a "Dutch Auction." The bonds and the related swap agreements have final maturities of July 31, 2031 and the swaps' total notional amount of \$5.5 billion matches the \$5.5 billion of variable rate bonds issued. The savings achieved by using swaps are calculated assuming that the variable rate paid to the State issuer on the swap will equal the variable rate paid by the State issuer on the variable rate bonds. To the extent there is a mismatch and the amount received under the swap is less than the amount paid on the bonds, the cost of the refunding will be higher than assumed.

According to Section 69-d (2) (c) of the State Finance Law, the notional amount, excluding excluded agreements, of the State's swaps may not exceed 15 percent of the total outstanding State-supported debt (as defined in Section 67-a of the State Finance Law) excluding excluded agreements. The execution of the approximately \$5.5 billion in floating-to-fixed rate swaps has brought the State very close to that limit. The following table summarizes the State's swap portfolio as of March 31, 2004 by public authority and notional amount:

Public Authority	Notional Amount of Swaps (Floating to Fixed) as of March 31, 2004 (in billions)
Dormitory Authority	\$2.3
Local Government Assistance Corporation (LGAC)	\$1.2
Empire State Development Corp (UDC)	\$1.0
Thruway Authority	\$0.5
Housing Finance Authority	\$0.4
Total *	\$5.5

* (Total may not add due to rounding)

State's Use of Fixed-to-Floating Rate Swaps

To date, the State has primarily used swaps to achieve refundings savings; however, DOB has now started coordinating the execution of fixed-to-floating rate swaps by certain public authorities. DOB has requested four authorities (Dormitory Authority, Urban Development Corporation, Thruway Authority and Housing Finance Agency) to bring the issue of fixed-to-floating rate swaps before their respective boards for approval, of which all four approved. Recently, the State through the Urban Development Corporation entered into several fixed-to-floating rate swaps and plans to execute additional fixed-to-floating rate swaps through the other three authorities to achieve the following goals:

- Reduce counterparty risk and termination risk of the State's current floating-to-fixed portfolio (such risks are described below).
- Increase the State's variable rate exposure. Historically, variable rate debt provides a lower cost of capital than fixed rate debt.
- Provide a mechanism for the State to better match its assets and liabilities, thereby hedging interest rate risks inherent in the State's short-term investments.

These fixed-to-floating rate swaps may not be counted against the statutory swap cap if they qualify as "excluded agreements" as defined in Section 69-a (7) of the State Finance Law. This excluded agreement provision applies when the swaps are being entered into for the purpose of reducing or eliminating a situation of risk or exposure under an existing swap. Since the floating rate swap reduces some risk or counterparty exposure from an existing fixed rate swap, then such floating rate swap will not count towards the statutory swap cap. Therefore, it is possible that the floating rate swaps contemplated to be executed to increase the State's variable rate exposure

may not count against the statutory cap. The State is treating the fixed-to-floating swaps undertaken by the Urban Development Corporation as excluded agreements.

The statutory limit for variable rate debt is 15 percent of State-supported debt outstanding and the current net variable rate exposure is approximately 5 percent (when variable rate debt is hedged by swapping to fixed, the variable rate debt does not count against the statutory limit, therefore it is possible to have 30 percent of State-supported debt issued as variable rate as long as 15 percent is swapped to a fixed rate). DOB has stated its intent to increase the State's overall net variable rate exposure by \$2 billion between 2004-05 and 2005-06. To do so, the State may issue additional variable rate debt and/or enter into fixed-to-floating rate swaps. According to DOB, the primary reasons for increasing variable rate exposure through the execution of fixed-to-floating rate swaps is to hedge the risk associated with the \$5.5 billion in floating-to-fixed rate swaps outstanding and to reduce debt service costs.

It should be noted that the State also has \$2.4 billion in convertible bonds that currently have a fixed rate, but will be converted at a later date to either variable or new fixed rates to be determined by current market conditions at the time of the conversion. Currently, DOB does not include these convertible bonds in its calculation of overall net variable rate exposure.

Swaps and Derivatives – Risk Assessment

Over the last few years, the potential savings from floating-to-fixed swaps based on a percentage of LIBOR have increased. The savings are based on technical factors affecting the swap market and the municipal bond market, primarily the compression of yields between the two markets along the curve.

Derivatives have been available for decades and are widely used in the corporate sector, but only recently has their use expanded into the public finance arena. Over the past couple of years, the increased use of swaps in the public sector has primarily been driven by the need to generate as much debt service savings as possible in refunding transactions, as well as being used as a tool to increase overall variable rate exposure. It is essential that such swap portfolios be managed with cautious oversight to assure that the inherent risks associated with swaps are reduced to the extent possible. The different types of risk associated with interest rate swap agreements are outlined below.

Basis Risk

Basis Risk is the mismatch between actual variable rate debt service and variable rate indices used to determine swap payments. When the State enters into a floating-to-fixed rate swap, it is subject to basis risk. Such risk is a mismatch between the floating rate payment that it receives from the counterparty and the floating rate it is required to pay on the underlying variable rate debt. Such mismatch is a result of the

impossibility of an index exactly matching the rates on variable rate bonds set by a remarketing agent or by an auction. Basis risk becomes more pronounced when tax-exempt variable rate bonds are hedged by a swap tied to an taxable index such as LIBOR.

Tax Risk

Tax risk is the risk of potential tax events that could affect rates paid on variable rate bonds. For example, if the marginal income tax rate decreases, then the rates that the State would pay on its tax-exempt variable rate bonds would increase relative to taxable rates. The tax advantage of holding tax-exempt bonds would be less. However, if the floating rates received by the State are based on a fixed percentage of a taxable index, for example 65 percent of LIBOR, these payments to be received by the State would not adjust.

Counterparty Risk

Counterparty risk is the possibility of the failure of the counterparty to make required payments. In the event of a non-payment, other default under the swap documents or downgrade of either party below a specified level, a termination event would be triggered. To the extent the market value of the swap is such that a termination payment would be owed the State, the ability to receive the payment could be in jeopardy due to a bankruptcy of a counterparty.

The State's swap agreements are structured to reduce counterparty risk by requiring that the counterparties meet minimum rating criteria in order to enter into a swap and require collateralization of a swap in the event of a downgrade. The swap agreements entered into by the various public authorities require that each counterparty have credit ratings from at least one nationally recognized statistical rating agency that is within the two highest investment grade categories. In addition, a credit rating within the three highest investment grade categories from any other nationally recognized statistical rating agency is also required for each counterparty. In the event a counterparty does not comply with such ratings requirement, the payment obligations of the counterparty shall be unconditionally guaranteed by an entity with such credit ratings. If the credit ratings of a counterparty fall below the ratings required, the swap agreements require that the obligations of the counterparty shall be fully and continuously collateralized by direct obligations of, or obligations, the principal of and interest on which are guaranteed by the United States of America (with a net market value of at least 102 percent of the net market value of the swap to the State). In this case, the collateral shall be deposited with the State or its agent.

In addition to protections in the documents, the State has entered into swaps with a diversified group of counterparties as shown below. Diversification reduces the counterparty exposure that the State has to any one firm.

Termination Risk

Termination risk is the possibility that there will be a need to terminate a transaction in a market that dictates a termination payment by the issuer. The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The schedule to the Master Agreement includes "additional termination events," providing that the swaps may be terminated if the credit rating of either the State or a counterparty falls below certain levels. The State or the counterparties may terminate the swap agreements if the other party fails to perform under the terms of the agreement. In the case of floating-to-fixed rate swaps, if one or more of the swap agreements is terminated, the related variable rate bonds would no longer be hedged (resulting in those bonds counting against the State's 15 percent variable rate cap) and the State would no longer be paying a synthetic fixed rate with respect to those bonds. In addition, if at the time of termination the swap has a negative fair market value, the State would incur a loss and would be required to settle with the counterparty at the swap's fair market value at time of termination. Assuming an involuntary termination is caused by the counterparty and not the State, the State may be able to enter into another swap with the same terms with a second counterparty. In this situation, the second counterparty would be willing to make a payment to the State approximately equal to the termination payment owed to the first counterparty.

Rollover Risk

Rollover Risk is the risk that the term of the swap agreement does not match the term of the related bonds being hedged. Upon the scheduled expiration of the swap, the interest rate risk will be unhedged unless a new swap is procured. The State's existing swaps all run co-terminus with the bonds, and therefore rollover risk does not currently exist.

Liquidity Risk

Liquidity Risk is the risk that the issuer will be unable to continue or renew a liquidity facility needed to support the variable rate bonds. In this situation, the variable rate bonds would have to be converted to either an auction rate mode (where a liquidity facility is not required) or to a fixed rate. If converted to a fixed rate, the bonds being hedged (the variable rate bonds) will no longer be outstanding, and therefore the swap portfolio would have to be adjusted accordingly (the swap would be terminated and a termination payment made by either the issuer or counterparty).

Standard & Poor's Debt Derivative Profile

On September 29, 2004, Standard and Poor's (S&P) unveiled a new aspect of its public finance rating process with the release of its Debt Derivative Profile (DDP) criteria for municipal issuers. S&P's objective with this initiative is to provide the public finance

market with a simple measure of the complexities of municipal debt-related derivatives by translating derivative related exposure into an easily understandable measurement of risk. The increasing use of derivatives among municipal issuers and the introduction of risks associated with such products, led S&P to develop a framework within which to understand how those risks can affect credit. S&P views each issuer's DDP as a credit consideration taken into account in the rating process and not as an add-on to the rating itself.

Every issuer rated by S&P that is involved in debt derivative products will get a DDP score. The issuer's DDP score is based on four equally weighted components: (1) Risk of termination or having to post collateral to derivative counterparties, (2) Counterparty credit quality and related termination risk, (3) Economic viability of the derivative portfolio, and (4) Management policies and procedures relating to derivative contracts. S&P determines a score in each category on a scale of 1 to 5 with a score of "1" indicating "low risk" and a score of "5" indicating a "high risk." Each of these four categories will be scored individually with the DDP calculated as the weighted average of these individual scores. Factors that will be considered in incorporating the DDP into an issuer's rating include the following: (1) Issuer rating and outlook, which are indicative of tolerance for a high DDP score, (2) Derivative exposure as a percentage of total debt, (3) Value at risk relative to available reserve levels, and (4) Net variable rate exposure.

DDP scores of 1 and 2 reflect a manageable impact of derivatives on an issuer's financial profile and are considered a neutral credit factor. A DDP score of 3 indicates a moderate credit risk. Scores of 4 and 5 indicate greater risk relating to an issuer's debt derivatives portfolio. S&P has stated that depending on other credit fundamentals, DDP scores of 3, 4 and 5 may influence the issuer's rating. Currently, the State has a DDP score of "2."

Swap Reporting

As swaps have become an integral part of public finance, it is essential that the use of swaps be properly and adequately reported for the investment community, as well as taxpayers. The Financial Accounting Standards Board (FASB) requires derivative instruments to be reported as an asset or liability at fair market value in annual financial statements. The Governmental Accounting Standards Board (GASB) currently requires note disclosure only.

The National Federation of Municipal Analysts suggests in their *White Paper on Disclosure for Swaps* issued in February 2004 that the following points are necessary for complete swap disclosure:

- Overview of issuer risk management policies and process by which swap contracts are evaluated, approved and monitored,
- Overview of issuer debt profile,

- Swap summary including a detailed listing of individual swap transactions, and
- Other issues including details regarding the authorization to enter into swap transactions, details regarding default and early termination, source of payments for termination payments and disclosure regarding default and early termination payments.

Currently, the financial statements issued by the Office of the State Comptroller provide some detail about swaps, including an overview of the various risks and a brief explanation of outstanding swaps and mark-to-market cost. The State's Annual Information Statement and Capital Plan issued by DOB provide some general information about the swap program.

Swap Management Plan

Article 5-D of the State Finance Law requires authorized issuers to adopt swap guidelines. It requires a compiled report of outstanding agreements from authorized authorities to DOB, the Legislature and the Office of the State Comptroller (issued on a monthly basis); however, the statute does not require any publicly detailed planning or detailed disclosure for the general public.

As such, the actual planning for variable rate and swap management has remained solely within DOB. Currently, the Annual Information Statement and Capital Plan provide very little detail on what is actually planned, other than to indicate that the State is considering increasing its variable rate exposure. The required monthly report does summarize the details of every swap transaction after it has been completed; however, there is minimal input from outside of DOB, leaving DOB exclusively responsible for planning and managing the swap portfolio, along with its inherent risks.

The Need for Real Reform

Perhaps the most disturbing aspect of debt use in New York is the startling amount of debt issued for operating purposes or budgetary relief. Basic financial logic tells us that a 30-year mortgage should not be used to finance groceries. Not only has the State used debt for such purposes, its use is increasing. Furthermore, the State is increasingly issuing debt that does not result in a highway, a building, or any other sort of tangible asset owned by the State, although taxpayers across the State will pay the bill.

Many of the programs discussed in this section may be worthy of funding from the State. Some of them may well provide the State and local governments with additional tax revenue due to the economic development they provide. Some may not provide the State anything but future costs. When considering the bonding out of spring borrowing through LGAC, the refinancing of the Empire State Plaza, the sale and lease-back of Attica Correctional Facility, the tobacco securitization and the issuance of Municipal Bond Bank Agency (MBBA) Special Purpose School Aid Bonds, the State has \$24 billion of debt outstanding that does not finance a State capital asset. This "asset-free" debt represents 52 percent of total State-funded debt and is projected to drop only slightly to \$23 billion (46 percent of State-funded debt) by 2009.

Debt That Does Not Produce a State Capital Asset

Debt that is paid with State resources, but does not produce a State asset, results from financing expenditures that are normally paid for with cash of the government. This type of debt is used to pay for expenditures that would not normally be financed and do not provide long-term benefits to the issuer. This type of debt includes deficit financing, long-term financing of projects that may not produce a physical asset and the financing of projects that will produce a local asset.

Years of cash based budgeting and the deferral of payments resulted in inadequate cash-flow in the first quarter of the State's fiscal year. Every spring, the State issued tax and revenue anticipation notes to provide needed cash. Beginning in 1990 with the creation of the Local Government Assistance Corporation (LGAC) and ending in 1997, the State utilized \$4.7 billion in long-term bond proceeds to fund certain payments due early in its fiscal year. As a result, the State was able to end its reliance on spring borrowing in 1995.

However, as the result of more recent declines in the State's financial condition, the State once again resorted to deferral of payments during its 2003 fiscal year that were planned to be paid from receipts that failed to materialize that year. This time the State arranged \$4.2 billion in long-term deficit financing by securitizing its tobacco

settlement revenues. Tobacco settlement revenues became part of the State's operating income when they were created by contractual rights established in 1998.

State Tobacco Securitization

In the 2003-04 budget proposal released in February 2003, the Executive proposed creating the Tobacco Settlement Financing Corporation (TSFC), a public benefit corporation, that would be a subsidiary of the Municipal Bond Bank Agency (MBBA) to sell the State's share of future tobacco settlement receipts resulting from the Master Settlement Agreement (MSA) payments.⁵⁸ The sale of the tobacco revenues provided an up-front payment of \$4.2 billion to the State from the proceeds of bonds issued by the Corporation.

The enacted budget authorized the creation of the TSFC as a subsidiary of the MBBA. The bonds were structured with a term of 20 years, but included a turbo provision in which all available revenue from the settlement would go toward debt service, thus lowering the expected life of the bonds from 20 to 13 years. Section 6 (11)(i) of the legislation authorized a contingent contractual obligation between the State and the TSFC in the event tobacco settlement revenues were not sufficient to cover required debt service. The contingent contractual obligation requires the State to make up any deficiencies in tobacco revenues with its own resources should a tobacco revenue shortfall occur. It is this contingent contractual obligation and the statement made in Section 7 of the TSFC Act specifically excluding this debt as a State-supported debt obligation that keeps this debt outside the realm of the Debt Reform Act of 2000.

In March 2003, the largest contributor to the Tobacco Settlement, Altria Corporation (parent company of Philip Morris), faced a judgment of \$10 billion in a class action lawsuit in the State of Illinois involving light cigarettes. Illinois law requires that a defendant post a bond for the amount of the judgment prior to appealing a judgment. The judgment and the necessary posting of a \$12 billion bond (the \$10 billion judgment plus related costs) caused two immediate repercussions: the tobacco payment due to states on April 15, 2003 was in jeopardy, and there was a threat of bankruptcy of the largest tobacco manufacturer.⁵⁹

The bond market responded immediately by downgrading \$18 billion in outstanding tobacco bonds. Numerous tobacco securitization deals were put on hold as a result of costs and yields skyrocketed. At one point, tobacco bond buyers were realizing yields of 8.25 percent, nearly 300 basis points over other municipal bonds.

The Illinois courts eventually allowed Philip Morris to secure a bond with \$800 million in four quarterly payments and a pre-existing bond of \$6 billion placed in escrow. This effectively allowed Philip Morris to make its share of the April 15, 2003

⁵⁸ The Municipal Bond Bank Agency was created by Chapter 902 of the Laws of 1972 in order to provide localities with an alternate vehicle for selling their General Obligation bonds.

⁵⁹ Altria Corporation is the largest manufacturer of cigarette products in the United States. Philip Morris, a subsidiary of Altria, was responsible for 51 percent of the April 15, 2003 payment.

payment, approximately \$172 million for the State of New York alone (excluding the amount shared with local governments). In the meantime, Moody's, Fitch, and Standard and Poor's downgraded over \$19 billion in outstanding tobacco bonds to just above non-investment grade.

In 1999, the Justice Department filed suit in Federal District Court accusing tobacco companies of racketeering and deceptive marketing practices that ultimately led to health problems for 30 million Americans who started smoking as teenagers since 1954. This is the latest step in actions started by then Attorney General Janet Reno on behalf of the Clinton administration. The Justice Department is asking the court to consider action against tobacco manufacturers to recoup \$279 billion in health related costs due to the effects of smoking under the Racketeer, Influenced and Corrupt Organizations Act of 1970 (RICO). Reports estimate that manufacturers would have to increase prices by approximately \$0.50 per pack if the Justice Department were to prevail in this litigation. Opening arguments began September 21, 2004 and are expected to last into 2005.

In April 2002, Freedom Holdings Inc., an importer of foreign cigarettes, joined with a number of other importing firms to sue the State alleging violations of the Sherman Anti-Trust Act. The suit claimed that the State's "Contraband" statutes that were passed shortly after the Master Settlement Agreement (MSA) and "Escrow" or "Model" statutes of 1998 established a State supported cartel.⁶⁰ The Escrow statutes require all non-participating manufacturers (NPMs), those who have not signed onto the MSA and are not making payments to states, to make payments equal to the amount that they would have had to pay to an escrow account for 25 years for the purposes of protecting against possible future litigation.⁶¹ The Contraband statutes require all cigarette manufacturers that sell cigarettes in New York State to prove either their compliance with the MSA or with Model statutes prior to receiving stamps required for sale. Those manufacturers that are not in compliance are essentially selling contraband; thus, the State is authorized to seize their product and fine the company.

In September 2004, a U.S. District Court upheld the validity of the MSA, as well as the escrow laws, but ruled that tobacco manufacturers could not be forced to pay into escrow funds of states where they do not sell cigarettes.

Largely as a result of various litigation, the market for tobacco bonds remains volatile. Cigarette sales (those sales used for determining manufacturer payments) are declining faster than initial projections and tobacco payments are declining. This decline, along with ongoing litigation issues and bond rating downgrades, could

⁶⁰ The "Contraband" statute was passed in 2001 to support enforcement of the "Escrow" statutes. See Sections 480-481 and 1846 of the Tax Law. The State's "Escrow" statute is the codified version of the "Model Statute" actually included in the Master Settlement Agreement (MSA)—see Article 13-G of the Public Health Law.

⁶¹ The MSA initially involved four manufacturers that held approximately 97 percent of the market share of cigarette sales in the United States. It gave other manufacturers the option of signing onto the MSA and exempt themselves from additional lawsuits from states. At this time, 37 manufacturers with 99 percent of the market share have signed onto the MSA and make annual payments to 46 states.

continue to negatively affect the market for tobacco bonds, although industry analysts have stated that tobacco bonds will be safe due to the nature of the MSA and significant required debt service reserves built into many deals.

New York State's 2003-04 enacted budget seemingly addressed market conditions by providing payment from State resources if tobacco settlement revenue is insufficient. In June 2003, the TSFC in New York State issued \$2.3 billion (par amount) in tobacco bonds. In light of the volatile market for tobacco debt at that time, the bonds were received well, with yields in the range of 4 percent (as compared to yields upward of 8.25 percent for tobacco bonds without additional security backing them).⁶² New York State's TSFC issued an additional \$2.24 billion of tobacco bonds in December 2003. While New York's tobacco bonds have not been downgraded because of the State's contingent backing, the ongoing litigation and uncertain future for the tobacco industry poses a risk to the State's financial plan.

Bonding for Support of Member Items

While the State continues to issue debt for goods and services that do not provide an asset to the State, another similar trend is the use of debt to fund initiatives from both the Executive and Legislature that historically were funded with annual appropriations. Although often for worthwhile purposes, those initiatives, such as economic development and State subsidies for local projects, have recently been increasingly financed with State debt. The practice of replacing one-time expenditures with debt that requires recurring payments has increased significantly since 1998. Between State fiscal year (SFY) 1997-98 and 2004-05 State debt was increased to support six notable, but costly, initiatives: the Community Enhancement Facilities Program, Strategic Investment Program, Empire Opportunity Fund, Centers for Excellence and Gen*NY*sis, Rebuilding the Empire State Through Opportunities in Regional Economies, and the Javits Center Renovation among other smaller programs. During this same timeframe, the State declared six years of budget surpluses ranging from \$445 million to \$3.6 billion.

Currently, certain public authorities are authorized to issue up to a total of \$2.8 billion for these programs. However, the funds are distributed according to a memorandum of understanding between legislative leaders and the Executive. The appropriations for most of these programs are vague at best, grouping individual programs together under one appropriation. Furthermore, individual financings that are required to go to the Public Authorities Control Board may consist of many projects covering various economic development programs covered by a single bond authorization.

⁶² New York State tobacco bonds also have \$449 million in a debt service reserve along with insurance. Together with the State contingent contractual obligation, New York State's tobacco bonds are a significantly better security than most tobacco bonds to date that do not provide such a structure.

Economic Development Programs
(\$ millions)

Program	Appropriation
<i>Chapter 55 Laws of 1997</i>	
CEFAP	425.0
Total Authorized in 1997-98	425.0
 <i>Chapter 55 Laws of 2000</i>	
SIP	225.0
Total Authorized in 2000-01	225.0
 <i>Chapter 55 Laws of 2002</i>	
Centers for Excellence/Empire Opportunity Fund	520.0
Gen*NY*sis/Transportation projects/CCAP	340.0
RESTORE/Transportation projects/CCAP	340.0
Total Authorized in 2002-03	1,200.0
 <i>Chapter 55 Laws of 2004</i>	
Empire Opportunity Fund	125.0
RESTORE/CCAP	62.5
CCAP	62.5
 <i>Chapter 3 Laws of 2005</i>	
Javits Restoration - State Share	350.0
Economic Development Outside NYC	350.0
Total Authorized in 2004-05	950.0
 Total Member Item Capital Spending Programs	 2,800.0

- Strategic Investment Program (SIP)
- Community Enhancement Facilities Program (CEFAP)
- Multi-Modal (Transportation Capital Projects)
- Community Capital Assistance Program (CCAP)
- Rebuilding the Empire State Through Opportunities In Regional Economies (RESTORE)

Community Enhancement Facilities Program

The 1997-98 enacted budget provided \$425 million in additional borrowing authority to the Community Enhancement Facilities Program (CEFAP). Chapter 432 of the Laws of 1997 defines community enhancement facilities as the following:

An existing or proposed facility and other property real and personal, and other appurtenances thereto to be utilized for arts, cultural, educational, athletic, housing, child-care, recreation, transportation, port or economic development purposes or other purposes incidental to the improvement of communities within the State.

The funds are distributed based on a memorandum of understanding between the Executive and the two legislative majority leaders, thus removing the public from

the process. The provisions of the statute allow funds to be used for virtually any purpose, including operating expenses.

Strategic Investment Program

Much like the CEFAP, the Strategic Investment Program (SIP), created in 2000, provides \$225 million in funding to legislative members and the Executive for local projects over \$250,000. While a project cannot be funded entirely with SIP funds (limited to 10 percent of the total cost), the debt that is supported by the State results in no additional State asset. Again, the funds are distributed outside of the normal capital plan process with little or no public information available.

Empire Opportunity Fund

The Empire Opportunity Fund was established in the 2002-03 enacted budget and provided \$100 million over two years for economic development projects ranging from waterfront development to brownfield cleanup.

*Centers for Excellence and Gen*NY*sis*

Also created in the 2002-03 enacted budget, this initiative uses State-funded debt to create and upgrade research facilities around New York State. The program is aimed at generating a private-public funding ratio of 3:1. Gen*NY*sis uses State-funded debt for research and development initiatives.

Rebuilding the Empire State Through Opportunities in Regional Economies RESTORE NY

This is another initiative created in the 2002-03 budget, increasing State-funded debt for project financing or assistance for the development and/or improvement of community and civic facilities that offer training, economic development and/or educational benefits.

Javits Center Expansion

On December 7, 2004, the Legislature passed and the Executive signed legislation authorizing the expansion of the Javits Convention Center in New York City. The cost of the project is estimated at \$1.2 billion, with \$350 million from the State, \$350 million from the City and \$500 million covered by additional hotel fees. In an effort to provide equal funding for upstate needs, the bill also includes another \$350 million for economic development needs for any economic development project outside of New York City. Funding for the Empire Opportunity Fund and RESTORE, along with two smaller initiatives, also increased by \$250 million in the 2004-05 enacted budget.⁶³

⁶³ Chapter 3 of the Laws of 2004.

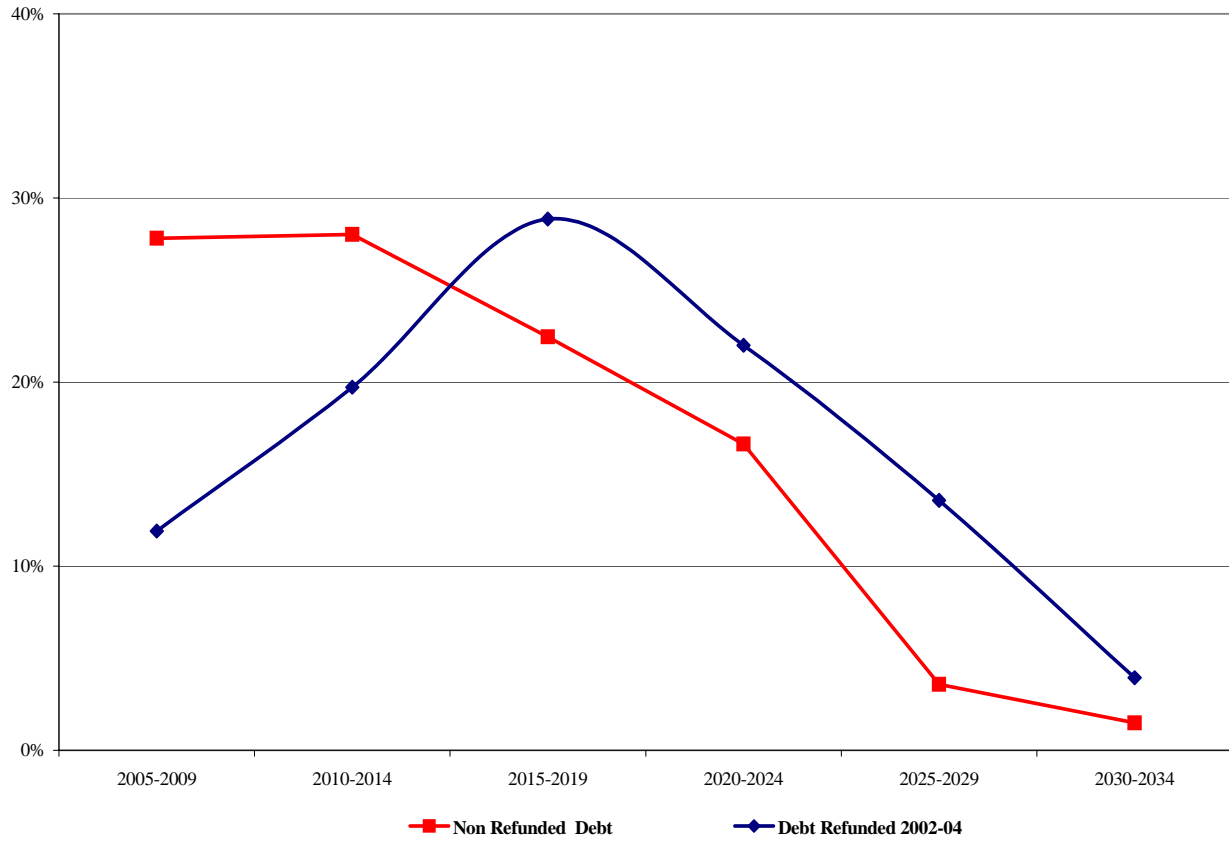
The State carries debt related to a number of programs that do not provide a State asset, but instead provide economic development opportunities. In many circumstances, it is in the best interest of the State to support this debt so important local projects are completed. For example, the Rebuild Schools to Uphold Education (RESCUE) program provides funding to local school districts for school construction and renovation. Although the proceeds will not provide a State asset, it is the responsibility of government to provide adequate facilities for public education. Similarly, funds are available for environmental protection projects throughout the State. Bond proceeds for these types of initiatives will not provide a physical asset to the State, but since the projects may not happen without State assistance, it is in the best interest of the State to contribute.

Saving Money and Restructuring Payments

During fiscal year ending 2004, the State's public authorities with outstanding State-supported debt entered into a series of bond refunding transactions, which sought to take advantage of lower market interest rates. In 2003-04, the State issued a total of \$5.6 billion of refunding bonds on State-supported debt, for a total of \$13.1 billion over 2002-03 and 2003-04. While each of these transactions should save the State money on an estimated present value basis, dependent on future variable interest rates and swap agreement performance, they did not result in a combined net aggregate future cash flow savings to the State.

Overall, the transactions resulted in a long-term cash flow loss, as the result of the June 2002 Metropolitan Transit Authority (MTA) refunding, which produced a nearly \$1 billion cash flow loss with a small present value savings. Combined, all these refundings, which were in the form of an unannounced financial restructuring for which no master plan was presented, resulted in a cash flow loss over two years of \$15 million and an estimated present value savings of \$895 million. Excluding the MTA transaction, present value savings would have been \$877 million with cash flow savings of \$954 million. Because the early principal payments were deferred, much of the savings were essentially spent up front in the immediate and near future. Some of this principal will be paid for with higher debt service costs in years well into the future. The graph below shows the rapidity of repayment—how fast principal is retired—of the \$13.1 billion of 2003 and 2004 refunding bonds, compared with the rest of the State's portfolio, illustrating how the majority of the principal repayment will not occur until the period between 2015 and 2024.

Rapidity of Repayment of Debt As a percentage of outstanding debt



Source: New York State Office of the State Comptroller

**Summary - State-Supported Refunding Issues
Fiscal Years 2002-03 and 2003-04**

Authority	Refunding Amount	Refunded Amount	Cash Flow Gain (Loss)	Present Value Gain
Dormitory Authority *	\$ 4,179,645	\$ 3,971,396	\$ 380,737	\$ 377,839
Housing Finance Agency	713,090	692,337	74,375	53,093
Environmental Facilities Corporation	9,691	10,370	527	490
Local Government Assistance Corporation Metropolitan	1,573,000	1,506,660	241,318	223,906
Transportation Authority	1,715,755	1,578,157	(968,715)	18,704
Thruway Authority	2,032,175	2,086,575	75,191	52,208
Urban Development Corporation	2,493,045	2,361,685	161,976	157,152
General Obligation	362,905	345,320	19,736	11,997
Totals	\$ 13,079,306	\$ 12,552,500	\$ (14,855)	\$ 895,389
Totals Without MTA	\$ 11,363,551	\$ 10,974,343	\$ 953,860	\$ 876,685

* Includes portions related to SUNY and CUNY Senior Colleges and State Share of CUNY Community Colleges.

Perhaps the most egregious example of stretching out debt is the refinancing of outstanding Municipal Assistance Corporation (MAC) debt. The debt initially provided the City of New York with fiscal relief in 1975, while providing no tangible asset. The annual debt service obligation from the City was paid with various revenues that were intercepted by the State and dedicated to those payments. The debt was scheduled to be paid off in 2008. In an act to provide the City with fiscal relief, the State authorized the creation of the Sales Tax Asset Receivable Corporation (STARC) and an annual payment of \$170 million from State sales tax revenues to the City with the intention of the City using this funding to pay STARC. STARC issued 30 year bonds totaling \$2.6 billion, thus extending the obligation by 26 years, from four years remaining to another 30 years. The obligation was also transferred to the State as State revenue is used to pay for debt service. The final result is an additional \$2.6 billion (\$5.1 billion with interest over the life of the bonds) obligation for State taxpayers that provides no asset whatsoever. Furthermore, the original 30 year deficit financing will cover nearly 55 years, thus effectively transferring the fiscal mistakes from one generation to many generations in the future.

Debt-Related Fees Charged by Public Authorities

During the 1989 legislative session in the midst of the last State fiscal crisis, Governor Cuomo proposed and the Legislature enacted dozens of fees for the purpose of offsetting General Fund expenditures. Included in the 1989 Article VII bill were new fees levied by debt-issuing public authorities, including bond issuance charges, cost recovery fees and two kinds of Department of Health fees.

The bond issuance charges and the cost recovery fees were created in an amended Article 9 of the Public Authorities Law. Fees charged for hospital and other health facility construction and financing were included in statutes that amended the Public Health Law (PHL) and the Medical Care Facilities Finance Agency Act. These statutes allow the Commissioner of Health to levy fees on applicants for Certificate of Need (CON) approvals and federally aided mortgages made by the Medical Care Facilities Finance Agency (MCFFA).⁶⁴

Bond Issuance Charges

Authorization for bond issuance charges is found in Section 2976 of the Public Authorities Law (PAL). The statute requires public benefit corporations that issue debt to pay the State a bond issuance charge when the debt is issued. In 2002, a previously enacted amendment excluding the Dormitory Authority of the State of New York (DASNY) was again amended to require DASNY to collect this fee. In addition, Industrial Development Agencies (IDAs) were required to collect the fees. The maximum fee charged is for issuances over \$20 million (70 basis points or 0.7 percent of bonds issued).

In one year (between 2001-02 and 2002-03) collections from this fee increased from \$20.4 million to \$152 million, due to the massive refinancing of Metropolitan Transit Authority debt, the inclusion of DASNY and the IDAs, and large issuances of Personal Income Tax bonds, as well as the record-setting volume of bond refundings in the last year due to low interest rates. In 2003-04, the State collected \$128 million from these fees.

Indirect Cost Recoveries

Indirect cost recovery from State public benefit corporations was also first authorized in 1989 and is found in Section 2975 of PAL. It authorizes the State to recapture the costs of services provided to public authorities, at least three of whose members are appointed by the Executive. Costs recovered are based on actual costs for each authority. The Director of the Budget is required to consult with the Comptroller over the total amount of State expenses incurred or to be incurred on behalf of covered public benefit corporations during the State's fiscal year. The Budget Director must then apportion the lesser of those total costs or a capped amount found in the statute to each State authority on or about November 1 of each year.

The amount of cost recovery from this source, originally capped at \$17.5 million, was raised to \$20 million in 1992 and is now capped at \$40 million. The State Treasurer is charged with collecting these assessments from the authorities by March 31 following the imposition of the assessments. The State collected nearly \$20 million from this fee in 2003-04.

⁶⁴ Note that the Medical Care Facilities Finance Agency was consolidated with the Dormitory Authority in 1995.

*Certificate of Need Account*⁶⁵

The CON fee was also added in 1989 to assess fees against health care facilities seeking a Certificate of Need approval from the Commissioner of Health. According to the Public Health Law (PHL), the Commissioner must assess a fee of \$1,250 on all applications approved for a Certificate of Need and must assess a fee on all capital project applications requiring approval from the State Hospital Review and Planning Council. Current law requires an assessment of 45 basis points upon the total capital costs of these projects. In 2003-04, the Department of Health received nearly \$6.3 million in revenues from this source and disbursed \$3.2 million on staff and other expenses of the Department.

Department of Health Fees

In addition to the CON fees, the Department of Health collects fees from DASNY and the IDAs when they provide mortgages to health care facilities. This fee, currently either 90 basis points for new money financings or 50 basis points for refinancings, is levied on the recipient of the mortgage and is paid to a Health Department's Special Revenue Fund. In 2003-04, this account (which collects both mortgage-based fees, as well as other regulatory fees) received \$13.2 million in fees on mortgages provided to health care facilities.

Who Spends the Fees?

The Health Department spends its fees for personal service costs of staff associated with CON and mortgage approval activities. Excess fees in those accounts are swept into the General Fund. Portions of the bond issuance and cost recovery receipts are paid to the Division of the Budget (DOB) to support staff and non-personal service (NPS) costs. Over the last ten years, DOB has spent \$27.2 million for those purposes from this account.⁶⁶

The 2003-2004 receipts in these funds totaled \$175.9 million, most of which was either spent directly on State staff and associated costs or was swept directly into the General Fund for general State purposes spending.

⁶⁵ The Certificate of Need (CON) process governs the establishment and construction of health care facilities in New York State. CON applications are required for all health care facilities that propose construction, acquisition of major medical equipment, changes in ownership and the addition of services.

⁶⁶ In 2003-2004, DOB had \$12 million in appropriations to spend from this account and spent \$5.9 million. The monies is transferred into the General Fund and used for non-specific general State purposes. In 2004-2005, DOB had \$12 million in appropriations.

FEE RECEIPTS	Fund Name	2003-04	YTD to December 31
Bond Issuance Charges	339-CR	\$127.6 million	\$78.7 million
Indirect Cost Recoveries ⁶⁷	339-CR	\$28.8 million	\$2.3 million
Certificate of Need Account	339-26	\$6.3 million	\$2.0 million
Hospital and Nursing Home Mgt ⁶⁸	339-44	\$13.2 million	\$14.5 million
Total		\$175.9 million	\$97.5 million

Authority Fee Collections

Authorities build these fees into their bond issuances, which inflate the cost of debt for the beneficiaries of the borrowing. In fiscal year 2003-04, as noted in the chart above, \$175.9 million in fees was collected from the public authorities and IDAs and deposited in the State's accounts. This does not reflect the amount actually collected by the authorities to pay for their own costs, in addition to the State's assessment. For example, the Urban Development Corporation assesses an "ESDC/UDC" fee on its bonds, including Personal Income Tax (PIT) Bonds, of 50 basis points (0.5 percent) on the par amount of its bonds. (UDC does not get appropriations in the State budget to support its operations so fees must cover its costs.) A recent bond sale of \$500 million resulted in an "ESDC/UDC" fee of nearly \$2.7 million in addition to the Bond Issuance Fee of \$3.4 million.

The Personal Income Tax, used as security on PIT Bonds, is the source of the debt service payments; increasing debt payments will reduce the amount of PIT revenue available to support the State budget, potentially decreasing General Fund resources. On top of the cost recovery charges, UDC paid over \$3.4 million in bond issuance charges to the State for all of its PIT Bond sales. These are being used to offset the annual costs of general State expenses, but the source of these revenues is bond funds that are being borrowed for seven to ten years.

These fees inflate the size of the PIT Bond sale and increase the cost to the State taxpayer. The Environmental Facilities Corporation, in its subsidized revolving fund programs, assesses the bond issuance fee on the municipal government to which it is loaning money, thereby raising the municipality's costs of borrowing. Entities that want to borrow through the State's public authorities are generally not-for-profit corporations seeking to keep their borrowing costs as low as possible. These issuance-related fees inflate the costs of borrowing so that the increased costs are merely passed on to users of the facilities, such as hospital patients, students in dormitories and the aged in nursing homes.

Though now producing significant revenues for the State, the assessment of these fees on State-funded debt, in the long-run, unnecessarily increases debt service costs. This, in turn, ultimately increases demands on the State's Personal Income Tax

⁶⁷ Indirect costs are levied November 1 by the Budget Director and captured by the State Treasurer by March 31.

⁶⁸ Receipt amounts reflect fees resulting from bonding activities. Other regulatory fees are deposited into this account for the purposes of supporting State staff that audit, inspect and regulate health care facilities.

revenues to pay the very same fees that were designed to bring relief to the General Fund.

Statutory References for Bond Fees

Type of Fee	Enacted	Statutory Reference	Amendments
Bond Issuance Charges	L. 1989, Chapter 62, § 67	PAL, Sec. 2976	1991, 1999, 2002
Indirect Cost Recoveries	L. 1989, Chapter 62, § 67	PA,L Sec. 2975	1992, 1999, 2002
CON Fees	L. 1989, Chapter 61, § 256	PHL, Sec 2802, subd. 7	2002
DOH Fees on mortgages	L. 1989, Chapter 61, § 90 (Federally-aided [FHA] mortgages) L. 1991, Chapter 166, § 239 (non-FHA mortgages)	McKinney's Unconsolidated Laws, § 7415-a, (Federally-aided [FHA] mortgages) PAL 2976-a (non-FHA mortgages) (formerly Sec. 1678-a, enacted in 1991)	PAL amended in 1999 to temporarily exempt DASNY. Amended again in 2002 to restore DASNY and include IDAs.

Debt Level Comparisons

New Yorkers face one of the highest debt burdens in the country. Comparing New York State's debt picture to that of other states clearly illustrates the need for reform.

Although state debt levels are growing throughout the country, ***New York State is currently second only to California for outstanding debt, and only because of California's \$11 billion in deficit financing issued in mid-2004.*** Ranked number one in the country through December 31, 2003, New York State had 24 percent more outstanding tax supported debt than California.⁶⁹

According to the National Conference of State Legislatures, at least 33 states addressed shortfalls while budgeting for fiscal year 2005.⁷⁰ Many of these states resorted to debt to address an aggregate \$78.4 billion gap at the end of fiscal year 2003. The Government Accounting Office (GAO) states that six states turned to tobacco securitization totaling \$12.7 billion to partially address shortfalls.⁷¹ States also implemented revenue increases and spending cuts, as well as utilized non-recurring resources to close budget gaps in 2004.

Dollars in Millions

Rank (2003)	State	1998	1999	2000	2001	2002	2003
1	New York	36,097	36,924	38,336	38,805	40,130	46,437
2	California	22,181	21,690	24,838	26,920	28,441	37,609
3	Illinois	8,710	9,136	10,119	11,282	13,101	24,591
4	Massachusetts	14,974	16,129	18,772	20,741	21,199	21,443
5	New Jersey	13,469	14,691	16,281	17,383	18,123	20,145
6	Florida	12,872	13,087	14,117	15,333	16,456	17,403
7	Connecticut	10,251	10,016	10,344	11,034	11,905	12,394
8	Washington	6,744	7,351	7,754	8,151	9,144	9,691
9	Ohio	7,270	7,518	7,921	8,507	8,571	9,217
10	Pennsylvania	6,977	7,203	7,405	8,243	8,544	8,798

Source: Moody's State Debt Medians 1999-2004

According to Moody's *2004 State Debt Medians*, New York State ranks among the top five of all states in two measures of tax-supported debt burden. First, New York is

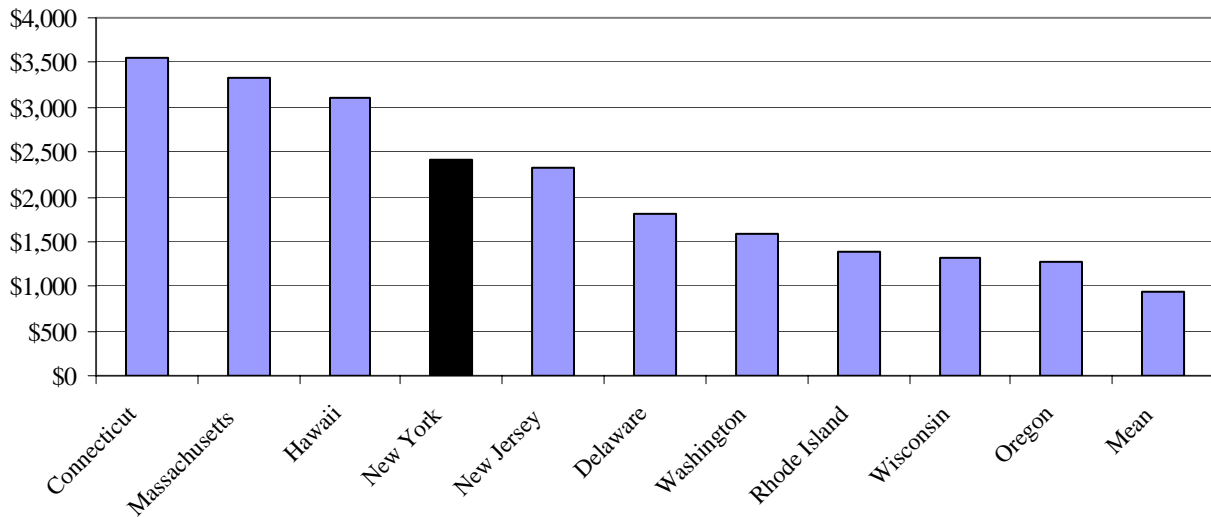
⁶⁹ Moody's measures debt as "net tax supported debt." This is similar to State-funded debt as used throughout this report. However, net tax-supported debt includes some moral obligation debt and contingent contractual obligations that are still outstanding, which the Office of the State Comptroller does not include in its State-funded debt totals. Additionally, Moody's uses calendar year figures for all states, whereas this report utilizes State fiscal year data (April-March). The report utilizes Moody's data only for its comparability with other states.

⁷⁰ National Conference of State Legislatures, *State Budget Update: April 2004*.

⁷¹ Government Accounting Office, *Tobacco Settlement – States' Allocations of Fiscal Year 2003 and Expected Fiscal Year 2004 Payments*, March 2004.

fourth highest in tax-supported debt per capita, with Connecticut, Massachusetts and Hawaii as the three states with heavier debt loads per person. New York State's per capita tax-supported debt of \$2,420 is over two and one-half times the national average of \$944. This does not include local debt paid through local taxes. Furthermore, per capita figures do not account for differences in ability to pay for debt among the states. Per capita data provides a reference of individual obligation that can be compared to other individual measures, such as wages or individual debt.

Tax-Supported Debt Per Capita - 2003
Top 10 States



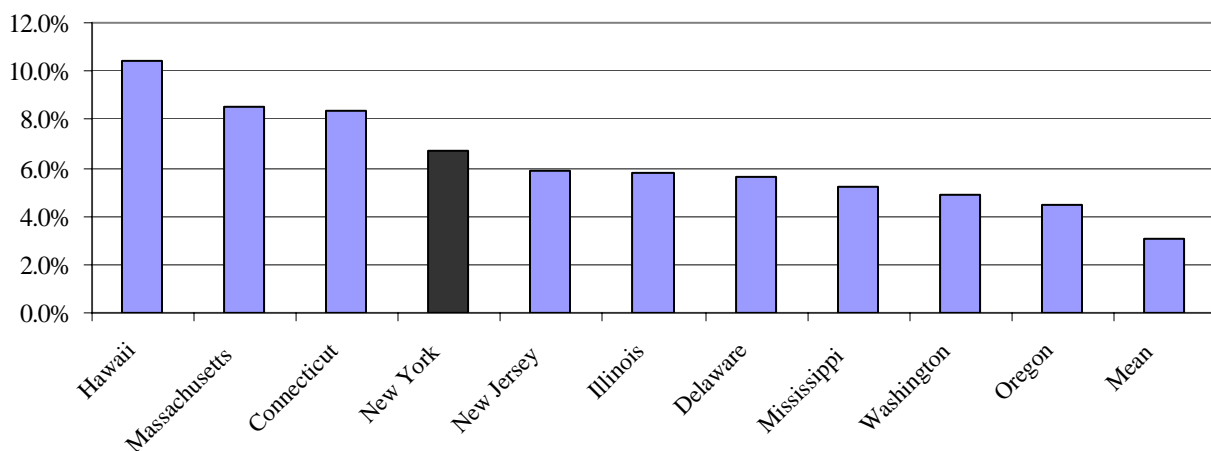
Source: Moody's Investors Service

A more precise measure relates debt to the total income of state residents. According to Moody's, New York State also ranks fourth in tax-supported debt as a percentage of personal income, with only Hawaii, Massachusetts and Connecticut having higher burdens. New York State's high debt burden of 6.7 percent of personal income was over three times the average level of all states.⁷²

New York State's debt as a percentage of personal income declined between 1996 and 2003, primarily due to increases in personal income related to the surging economy. In 2004, debt as a percentage of personal income increased significantly as outstanding debt (including \$4.6 billion in tobacco bonds) grew faster than personal income for that particular year.

⁷² Moody's Investor Service, *2004 State Debt: Medians*. April 2004.

Tax-Supported Debt as Percentage of Personal Income - 2003 Top 10 States



Source: Moody's Investors Service

State Bond Ratings and Rating Implications

There are three major bond-rating agencies that regularly rate debt for countries, states, municipalities, corporations and any other entity issuing securities. They are Moody's Investors Service, Standard and Poor's, and Fitch Ratings, Ltd.

Higher investment-grade ratings provide greater confidence to the investment community that the issuing entity is willing and able to meet the financial commitments on its obligations. Higher ratings may allow issuers to issue debt at lower interest rates, thereby lowering debt service costs. Low credit ratings reflect higher risk and generally result in issuers paying a higher rate of interest on debt. If ratings fall low enough ("junk" or non-investment grade), the issuer may effectively be prohibited from obtaining access to the credit market. Rating agencies consistently reevaluate outstanding debt for which they previously issued a credit rating. If circumstances change, ratings may change. See the Appendices for ratings definitions for each agency.

While a number of indicators affect issuance cost, including bond insurance and the market's ability to absorb the dollar amount of debt issued, bond ratings can have a significant impact on cost. A downgrade before issuance will naturally increase both debt issuance and debt administration costs. If an issuer is a party to a number of swaps, a bond rating downgrade could cause counterparties to terminate, leaving the downgraded issuer with potential costs. Issuers of variable rate debt supported by Letters of Credit (LOC) or liquidity facilities may find the costs of credit or liquidity support to be higher after a downgrade.

Furthermore, each rating agency may have a different perception that could affect individual ratings. For instance, Standard and Poor's rates New York State General Obligation (GO) debt at AA, which is somewhat in the middle of the range among states. However, Moody's ranks New York State GO bonds at A1, which is second lowest in the country among states. Rating reports from each agency illustrate a different view of New York's financial circumstances. However, recent reports from Moody's and Standard and Poor's indicate that the two ratings could be converging in the future. In a rating report from November 2004, Moody's states the following:

New York State's upgrade reflects a trend of recovery in its economy, tax revenues, and liquidity position from last year, indicating that the worst of the recent period of fiscal stress has ended.

However, Moody's does illustrate continued financial concern:

The methodology-based review also confirms the New York State's relatively weak profile among the states, as indicated by the still relatively low rating of A1. Principal weaknesses include a highly cyclical state economy and revenue structure; chronic structural imbalance resulting from a very difficult political process; and the uncertainty and potentially high costs associated with a school funding court order (*Campaign for Fiscal Equity v. State of New York*).⁷³

A Standard and Poor's report from September 2004 provides the following analysis:

New York appears to be emerging from the pressures of the recession, both economically and financially. The State's financial position in the most recent fiscal year benefited from additional federal aid received and increased taxes and closed with a surplus of about \$300 million. The success of financial management will continue to be measured by the achievement of annual balance and reduction of the out-year gaps forecasted.

Standard and Poor's also underscores the importance of the budget process on the rating:

The state's rating is capped at 'AA' as a result of its high service/high cost nature and consistent failure to implement meaningful spending restraint or permanent revenue enhancements in the face of budget imbalance. Although budgeting and forecasting results are strong, the political process surrounding the budget and its adoption are totally inconsistent with a higher rating.⁷⁴

⁷³ *Moody's Analysis – New York (State of)*, November 9, 2004.

⁷⁴ *Standard and Poor's Rating Report*. September 21, 2004.

Both viewpoints illustrate what the financial markets analyze when considering which credits to purchase. A solid budget and capital planning process, a healthy economy, a reasonable and affordable debt level, and strong financial and debt management are generally viewed favorably by the markets and will typically go far in providing a solid bond rating.

Moody's Investors Services

Moody's recently upgraded New York State General Obligation debt to A1, still second lowest in the country. The newly issued Personal Income Tax revenue bonds also hold a rating of A1, whereas appropriation backed authority debt is A2 (Local Government Assistance Corporation debt is A1).

Standard and Poor's

Standard and Poor's upgraded the State's General Obligation debt from A+ to AA in December 2000, the last of three upgrades since 1997. Personal Income Tax Revenue bonds are rated AA and other appropriation-backed authority debt is rated AA-. The agency has a stable rating watch for the State as of September 21, 2004.

Fitch Ratings Ltd.

Fitch currently rates New York State's General Obligation debt at AA-, the same rating held by Personal Income Tax Revenue bonds. The Agency rates LGAC and other appropriation bonds at A+.

Tobacco Bonds (Tobacco Settlement Financing Corporation)

Tobacco bonds are enhanced by a contingent-contractual obligation of the State and are rated AA- by Standard and Poor's and A+ by Fitch. Moody's has rated the bonds at A3.

Although New York's General Obligation and appropriation debt currently has a "stable" outlook with Standard and Poor's and a "positive" outlook from Moody's, New York State still has one of the lowest credit ratings in the nation among states.

Fitch Ratings of State General Obligation Bonds
(as of June 2004)

AAA	AA+	AA	AA-	A+	A	BBB
Delaware	Maine	Alabama	Hawaii	Louisiana		California
Georgia	Michigan	Alaska	Massachusetts	Oregon		
Maryland	Nevada	Connecticut	New York			
Minnesota	Ohio	Florida	West Virginia			
Missouri	Texas	Illinois	Wisconsin			
North Carolina	Vermont	Iowa (implied)				
South Carolina		Mississippi				
Utah		New Hampshire				
Virginia		New Jersey				
		Oklahoma				
		Pennsylvania				
		Rhode Island				
		Tennessee				
		Washington				

Source: Fitch Ratings Ltd.

Moody's Ratings of State General Obligation Bonds
(as of January 2005)

Aaa	Aa1	Aa2	Aa3	A1	A2	A3
Delaware	Indiana	Alaska	Alabama	Louisiana		California
Georgia	Iowa	Arkansas	Connecticut	New York		
Maryland	Kansas	Florida	Hawaii			
Missouri	Minnesota	Kentucky	Idaho			
South Carolina	New Mexico	Maine	Illinois			
Utah	North Carolina	Massachusetts	Mississippi			
Virginia	Ohio	Michigan	Montana			
	Texas	Nevada	New Jersey			
	Vermont	New Hampshire	North Dakota			
	Washington	Pennsylvania	Oklahoma			
		Tennessee	Oregon			
			Rhode Island			
			West Virginia			
			Wisconsin			

Source: Moody's Investors Service

Standard and Poor's Ratings of State General Obligation Bonds
(as of September 2004)

AAA	AA+	AA	AA-	A+	A	A-	BBB
Delaware	Florida	Alabama	Colorado	Louisiana	California		
Georgia	Iowa	Alaska	Hawaii				
Maryland	Kansas	Arizona	Idaho				
Minnesota	Michigan	Arkansas	Kentucky				
Missouri	New Mexico	Connecticut	Massachusetts				
North Carolina	Ohio	Illinois	Montana				
South Carolina	Vermont	Indiana	New Jersey				
Utah		Maine	North Dakota				
Virginia		Mississippi	Oregon				
		Nevada	Rhode Island				
		New Hampshire	West Virginia				
		New York	Wisconsin				
		Oklahoma					
		Pennsylvania					
		Tennessee					
		Texas					
		Washington					
		Wyoming					

Source: Standard and Poor's

Debt Affordability, Accountability and Transparency

Debt affordability can be described as a measure of debt relative to the ability to repay. Since debt is a long-term obligation and debt service is an immediate expenditure, typically outstanding debt is measured against wealth and debt service is measured against available resources.

On a larger scale, state and local governments utilize a variety of tools to measure debt affordability. In some states, debt affordability measures are incorporated in the debt management plan as a guide or limit to additional debt issuance. For instance, in the State of Maryland (a "AAA" rated State) a Capital Debt Affordability Committee annually advises the Executive and General Assembly of prudent General Obligation debt issuance using such measures as outstanding debt as a percentage of personal income and debt service as a percentage of general fund and property tax revenues. In New York, the Debt Reform Act of 2000 included caps on both outstanding State-supported debt and debt service, although the caps were set at levels that will probably never restrict borrowing.⁷⁵ These and other similar indicators are more useful in debt management when they realistically measure actual resources and debt levels. The use of borrowing limits or affordability measures that may or may not be realistic often provides more effective political advertising than effective debt management.

There are a number of measures that are useful in quantifying affordable debt levels. The most popular measures of affordability are debt per capita and a comparison of outstanding debt or obligation to a measure of wealth (personal income or full value of taxable property) and debt service or expense to a measure of capacity or ability to pay (receipts).

New York State's highest debt burden of 6.5 percent of personal income in March 2004 was over two times the average level of all states. In recent years, the percentage of debt to personal income had declined primarily due to increasing incomes rather than declining debt levels. New York's State-funded debt per capita steadily increased between 1985 and 2001, at which point it declined for two years. This decline reflects the single year (2002) in which outstanding debt dropped.

Accountability and Transparency

The Governmental Accounting Standards Board (GASB) defines accountability as the "cornerstone of financial reporting in government." According to the GASB,

⁷⁵ The fact that policymakers can notwithstanding statute or simply define certain debt as non-State supported also limits the effectiveness of any debt affordability program.

"[G]overnmental accountability is based on the belief that the citizenry has a 'right to know,' a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives."⁷⁶

Accountability for the State's debt is dependent on its financial reporting and disclosure practices. Governments disclose their financial condition when they publish their annual financial statements or Comprehensive Annual Financial Reports (CAFRs) and when they prepare and publish official statements for bond offerings. While complete and transparent financial disclosure has been a "best practice" for many years, the Securities and Exchange Commission promulgated its rule for secondary market disclosure when it amended Rule 15c2-12 in 1994.⁷⁷ According to Rule 15c2-12, primary debt issuers must regularly submit financial information to national repositories of this information, as well as disclose certain "material events," such as a failure to make a debt service payment or a rating change.

The State's financial disclosure provides citizens, taxpayers, lawmakers, rating agencies and the financial marketplace with an extensive amount of information on the State's financial condition, debt issuance practices and debt load. Disclosure documents take many forms because of the complexity of the State's finances. Because the State was a frequent issuer of debt, its financial information was readily available in the secondary market.

The State revised its disclosure process following promulgation of Rule 15c2-12's 1994 amendment. The principal means of disclosure of State financial information for debt offerings is the State's Annual Information Statement (AIS). The AIS is issued by the Division of the Budget after the passage of the legislative budget, or within 120 days of the State's fiscal year end if a budget is not enacted by then, and updated quarterly. In addition, AIS supplements are issued at other times when notable events or State-related bond sales require additional disclosure. The Comptroller's GAAP Financial Statements are also part of the State's financial disclosure and are issued in July. Other documents, such as the Capital Program and Financing Plan and the Executive budget, are often incorporated by reference in the AIS and become part of the disclosed information.

Cash Basis vs. GAAP Reporting for Debt

The Executive prepares the State's financial plan, including the Capital Program and Financing Plan, on a cash basis. Although cash basis reporting is often easier to understand than GAAP basis debt reporting, the Comptroller accounts for the State's debt on a GAAP basis in the State's audited annual financial statements. This is the

⁷⁶ Concepts Statement Number 1 of the Governmental Accounting Standards Board Objectives of Financial Reporting, Issued May 1987.

⁷⁷ At the time, the municipal bond market was concerned with the growing percentage of municipal bonds that were in the hands of individual and mutual fund investors. These small investors were particularly susceptible to the lack of updated information available from municipal issuers. Though information is available in official statements in the primary market, the lack of consistency and regularity of reporting by municipal issuers in the secondary market made it difficult for small investors to get current information.

method preferred by the financial marketplace because the financial statements are prepared using nationally accepted accounting standards that clearly account for and report out-year debt obligations and the resources necessary to pay them. Nevertheless, often the most current information available to the financial markets on the State's debt activities is reported on a cash or budgetary basis.

Unfortunately, the State's cash basis presentation of debt does not give the full picture of debt outstanding. For example, cash basis presentations of future debt service show principal and interest aggregated as a single column. This presentation does not allow an analysis of the rapidity of debt repayment, a significant factor in determining future debt capacity. In addition, the debt service tables in the Capital Program and Financing Plan now include payments related to interest rate swap agreements, but they make no attempt to separately show the amount of estimated payments under the swap agreements. These amounts have been blended with interest and principal into the same type of presentation used before interest rate swaps were widely used by the State and its authorities.

The State's cash basis presentations also do not report the billions of dollars in State resources held in reserves by the public authorities, which are funded from the proceeds of bonds issued for that purpose, or other unspent proceeds and investment earnings. During the last year, a significant number of public authority refundings of State-supported debt have taken place that includes a release of funds from debt service reserves of the refunded bonds. The release of debt service reserves for issues that are State supported provides a one-time cash savings to the State for debt service. Presenting up-to-date information on debt service reserve funds on a GAAP cash basis (which the Comptroller's annual financial statements do) would provide analysts with the ability to identify absolute growth in spending on bonded debt service.

Moving Bonding and Spending Off-Budget

The State has used financing obtained through its public authorities for decades for spending on State capital programs and for operating purposes. However, over the last several years, the State has increasingly authorized public authorities to also retain custody of the proceeds of bond issuances and to pay recipients directly for certain capital expenditures, aid to local governments, grants to businesses and legislative and executive member items. This decision to allow authorities to make direct disbursements of bond proceeds moves the spending off-budget and, perhaps more importantly, off the State's accounting and expenditure pre-audit system. In the past, most proceeds from authority borrowings were remitted to the State Treasury to reimburse the State for payments that were made through the State Comptroller's office, subject to the Comptroller's audit authority. The disbursements were included in reported spending on a both budgetary and GAAP basis of accounting.

When authorities disburse these proceeds directly for projects, they are not required to account for the transactions in their own financial statements. In this case, the receipt, disbursement and administration of bond proceeds are not required to be

pre-audited or even reported by the authority. As a result, the State discloses only limited information about them in the cash-basis reports. Furthermore, when bond proceeds are used to directly finance projects outside the State's budgeting and central accounting system, they are not reported as a part of cash basis spending, though they are captured in the GAAP financial statements. The growing practice of authorizing public authorities to make direct disbursements for State expenditures from bond proceeds has the illusory effect of containing reported growth in State spending while completely removing these disbursements from cash basis reporting.

Accountability for State debt involves the complete and transparent accounting and reporting of the State's administration, recent activities and strategic plans for managing resources generated from borrowing and borrowing as a resource itself. The value of increased transparency is increased accountability, which also has a favorable effect on the cost of borrowing. However, the inconsistencies between the Executive presentation on debt and the Comptroller's GAAP financial statements diminish the usefulness of the available information.

Public Authorities Control Board

The Public Authorities Control Board (PACB) was established by Chapter 38 of the Laws of 1976 as a temporary response to the fiscal crisis involving the Urban Development Corporation's default on \$105 million in moral obligation bonds. The State was facing a credit crisis and the investment banking community demanded additional accountability from four troublesome authorities and a cap on moral obligation debt in return for the purchase of \$2.76 billion in notes that made up the State's annual "spring borrowing."⁷⁸ The Board was made permanent in 1978. As of December 31, 2003, the 11 authorities under the oversight of PACB held \$20 billion of State-funded debt (over half of the State's total outstanding State-funded debt).

The PACB has five members representing the majority and minority of both houses of the Legislature and the Executive. The representatives of the Executive and the two majorities are voting members, while the minority representatives can publicly comment, but are non-voting members. The Executive designates one of the voting members to serve as the chair (currently the Director of the Budget). The State Comptroller only has the opportunity to comment. The voting members must unanimously approve all projects.

According to Section 51(1) of the Public Authorities Law, "[the] public authorities control board shall have the power and it shall be its duty to receive applications for approval of the financing and construction of any project proposed by any of the following State public benefit corporations:

- ♦ New York State Environmental Facilities Corporation

⁷⁸ See Chapter 39 of the Laws of 1976.

- ◆ New York State Housing Finance Agency
- ◆ New York State Medical Care Facilities Finance Agency⁷⁹
- ◆ Dormitory Authority
- ◆ New York State Urban Development Corporation (ESDC)
- ◆ Job Development Authority
- ◆ Battery Park City Authority
- ◆ New York State Project Finance Agency
- ◆ State of New York Mortgage Agency
- ◆ New York State Energy Research and Development Authority
- ◆ Long Island Power Authority

“Any application made concerning a project shall include the terms, conditions and dates of the repayment of state appropriations authorized by law pursuant to a repayment agreement. Any subsidiary of, or corporation with the same members or directors as, a public benefit corporation subject to the provisions of this section shall also be subject to the provisions of this section. All applications and submissions to the board required to be made by a subsidiary shall be made on behalf of such subsidiary by the public benefit corporation, which created the subsidiary. No public benefit corporation subject to the provisions of this section shall make any commitment, enter into any agreement or incur any indebtedness for the purpose of acquiring, constructing, or financing any project unless prior approval has been received from the board by such public benefit corporation as provided herein.”

Subdivision 2 of Section 51 of the Public Authorities law provides that “[t]he Board may require as part of such application such information as it deems necessary and shall act upon such application within a reasonable time.”

The charge of the Board is to provide additional oversight for the 11 authorities listed above in the form of a statutory debt approval process. However, the fact that only three members control the Board limits the effectiveness and the accountability in that the voices of the minority and Comptroller are not included in the final vote. While the Board oversees the borrowing of 11 authorities, there are numerous other authorities or public benefit corporations with the ability to spend public dollars and/or borrow public dollars with no review at all by the PACB.⁸⁰

In 1976, the PACB was an important creation for restoring access to the municipal finance market for the State, its public authorities and municipalities. However, its role is limited to approving projects for the 11 authorities and does not require a detailed review of every facet of the actual financings.

⁷⁹Note that the New York State Medical Facilities Finance Agency was consolidated with the New York State Dormitory Authority on September 1, 1995 and the Urban Development Corporation does business as the Empire State Development Corporation..

⁸⁰There are over 200 such public benefit corporations within the State and local authorities.

Capacity

Deficit Financing - When Is It Appropriate?

There are rare and extreme circumstances in which the government might wish to incur additional debt that does not provide a physical asset but closes a gap in an operating budget. Governments can face funding emergencies, such as an unanticipated reduction of a large portion of recurring revenue (for example factory closings or power plant ownership transfers) or a large judgment in the case of a municipality. Generally, however, deficits tend to be structural and the result of budgeting practices and economic conditions that are not properly addressed in a timely manner. The State does not allow local governments to finance deficits without State approval and, generally, when the State approves such financing, various levels of oversight are applied that may include additional reporting requirements to the State or State control of local finances.

While there is a need for the State to retain the flexibility to deal with extraordinary deficits, the ability to undertake any deficit financing should be difficult at best. The process should be as public as possible and exhaust every other funding possibility, including additional revenue raising actions and spending cuts. Such action, if necessary, should include the full participation of the Executive, Legislature and Comptroller, along with public hearings. The sale of future tobacco settlement revenue to cover \$4.2 billion of State budget deficits occurring in SFY 2003-04 and 2004-05 was not only shortsighted policy, but tremendously unfair to future generations of the State's taxpayers.

Debt and the Economy

Using debt as a policy tool should be structured to support capital investment activity throughout a business cycle. Maintaining infrastructure and other capital projects should be a continuing process. During downturns in the economy when revenue collections fall the State has the responsibility to ensure the continuation of these projects.

Besides allowing these projects to continue during downturns in the economy, the use of debt also helps keep the economy from sliding further into recession as: 1) workers remain employed, and 2) the State spends money purchasing goods and services from the private sector. This spending provides income to businesses, which in turn allows them to maintain a stable workforce during the recession. The continued employment and business income allows for higher levels of spending on other goods and services which in turn builds the foundation for recovery.

As the economy improves and revenue collections increase, the additional money should be used to pay down the existing debt or to pay for capital projects. Paying down the debt during upswings in the economy enables the State to keep debt levels manageable. Failure to pay down the debt during these times makes it more difficult to

use this stabilizing tool in the future because the debt servicing costs will continue to grow, resulting in increased borrowing costs that have the potential to lower the State's credit worthiness in bad economic times.

Projection of Debt Capacity

As previously noted, the State Constitution provides limitations on the issuance of certain debt; statutes and bond covenants place additional limits on the amount of short-term intra-year borrowings in which the State can engage. The Debt Reform Act of 2000 further limits debt issuance if the repayment is appropriated as debt service to capital projects, but not necessarily State-owned projects.

To gauge the future capacity of the State to issue debt as a single category is not very useful. Through March 31, 2004, the State essentially reported its debt as a single portfolio broken down by purpose, issuer and program. However, segments of that single portfolio were issued for unique purposes that warrant individual consideration.

The table in the next section illustrates outstanding State-funded debt as of March 31, 2004 and projected balances derived from the Capital Program and Financing Plan and debt associated with tobacco securitization and prior year school aid claims. Since the debt issued for MAC refinancing happened within the 2004-05 fiscal year, it is included in the out-year column as "issued for other purposes." The out-years of this plan are subject to revision and future legislative changes.

The table below illustrates how much of the State's debt capacity is used for projects that do not provide a State asset. For instance, debt issued for deficit financing has increased from nothing in 1990 (although the State was still issuing short-term notes for its annual spring borrowing), to nearly \$10 billion in just 15 years. Deficit financing represents over 20 percent of outstanding State-funded debt. In 1990, the State had issued approximately \$3.4 billion for projects that would not provide a State asset (which would include debt issued for environmental and local development projects, member items and the State's share of local transportation needs). In 2004, that total increased fourfold to nearly \$14 billion. These types of projects are ideally suited for pay-as-you-go financing. However, history indicates that the State is increasingly using debt over cash and the State's increasing dependence on debt is yielding fewer long-term assets for the State.

Of course, the State continues to use debt for new and ongoing capital projects. Currently, the State has over \$21 billion in debt associated with capital (State asset producing) needs. This represents an increase of almost \$11 billion from 1990 but only takes up less than half of the current outstanding State-funded debt portfolio.

Capital Asset Refinancing

In 1989, the State issued \$123 million in bonds to refinance the subsequent four semi-annual rental payments on the Empire State Plaza. In 1990, the State financed the Attica Correctional Facility for \$200 million by "selling" it to the Urban Development Corporation. The associated debt was subsequently refunded twice. Because of political limitations, rather than legal limitations, the closest the State has come recently to utilizing this type of debt capacity is to defer immediate and near-term payments to the future as part of a refunding. Such actions modestly add to debt balances, and lower interest rates do help contain future debt service. Based on current market conditions, there are additional opportunities to refinance capital assets but such actions have been heavily utilized in the past two years. As this sort of capacity is dependent on market conditions, future refinancing capacity is unknown.

State of New York State-Funded Indebtedness

Authorized, Authorized But Unissued, and Outstanding, and Projected to be Outstanding

November 2004

amounts in millions of dollars

Type	March 31, 2004		March 31, 1990	March 31, 1995	March 31, 2004	Projected March 31, 2009
	Authorized (1)	Authorized but unissued (1)				
Tax Revenue Anticipation Notes	(2)	(2)	-	-	-	-
Deficit Notes	(3)	(3)	775	-	-	-
Bond Anticipation Notes	(4)	(4)	-	-	-	-
"Spring Borrowing - net of deficit notes"			3,325	-	-	-
General Obligation Bonds						
Issued for State Capital Assets	8,900	157	2,736	3,686	1,663	1,247
Issued for other purposes	5,635	994	1,492	1,494	2,140	1,605
Other Financing Arrangements						
Issued for State Capital Assets	(5)	(5)	7,597	13,186	20,145	26,127
Issued for Long-term Deficit Financing (6)	9,411	-	-	4,752	9,630	8,474
Refinanced for Budgetary Relief (7)	333	10	123	356	276	189
Issued for other purposes	(5)	(5)	1,905	4,695	11,521	13,213
Total/Projected Debt			17,953	28,169	45,375	50,855
Summary						
Debt Invested In Capital Assets			10,333	16,872	21,808	27,374
Debt Issued for Non-Capital Asset Spending			3,397	6,189	13,661	14,818
Debt Issued for Long-term deficit financing			-	4,752	9,630	8,474
Debt Issued for Budgetary Relief			4,223	356	276	189
Total/Projected Debt			17,953	28,169	45,375	50,855

Note:

- Amounts issued may exceed the stated amount authorized by premiums received, by amounts used to pay for the cost of issuance, by amounts used for funding reserve fund requirements and, in certain circumstances, borrowing additional amounts to refund bonds previously issued.
- Limited to declaration of Emergency Need by covenant with LGAC bondholders.
- May be issued but must be repaid within subsequent year's budget.
- May be issued for any purpose bonds have been authorized.
- Certain financing programs have limits expressed as annual debt service or payments to be financed - the total can not be quantified.
- Authorization for deficit financing includes: \$4.7 billion for LGAC, \$4.2 billion for TSFC, and \$511 million for MBBA Prior Year Claims issued for school aid payments in arrears.
- Budgetary Relief Debt Authorization includes \$200 million to Refinance Attica and \$133 million to Refinance the South Mall.

Source: Annual Information Statement (September 2004), Office of the State Comptroller, Public Authorities, and Capital Program and Financing Plan (November 2004) and Official Bond Statements for STAR Corporation.

Promoting the Responsible Use of Debt

Traditional checks and balances on government debt issuance in New York have shifted with the explosion of debt issued by public authorities. Though the Comptroller once issued all debt for the State in the form of General Obligation bonds and notes, today nearly all State-funded debt issuance has been shifted to issuance by public authorities. The locus of State debt management has shifted, from a responsibility shared by the Legislature, Executive and Comptroller with specific restrictions and oversight responsibilities articulated both in statute and the Constitution, to a program that is largely managed by the Division of the Budget through public authorities controlled by the Executive and subject to fewer restrictions and oversight mechanisms.

Meanwhile, the municipal bond industry has continued to develop and market new debt instruments and derivatives intended to finance public purposes at lower cost, but which carry new risks. Fiscal constraints on State and local governments and public authorities have pressured officials to turn to these instruments for short-term budgetary relief.

Role of the Office of the State Comptroller

With its varied and wide-ranging fiscal responsibilities, the Office of the State Comptroller has a unique vantage point on these developments in New York State. As chief fiscal officer, the Comptroller must make legal, business and policy judgments about debt every day. The duties of his office include:

- Approving and issuing General Obligation debt,
- Reviewing and approving the negotiated sales of debt of certain local governments and local and State public authorities,
- Participating in the work of public authorities as a member of the board of the Local Government Assistance Corporation and through representatives on the boards of the Dormitory Authority and the State of New York Mortgage Agency,
- Monitoring the finances of State and local governments, including New York City,
- Auditing State and local government finances, and
- Approving the contracts of State agencies and some public authorities.

In the exercise of these duties, Comptroller Hevesi has drawn the public's attention to the irresponsible use of debt to achieve short-term savings at the price of future budget and policy choices:

- In 2003, Comptroller Hevesi joined Governor Pataki in going to court in an unsuccessful attempt to stop the use of State sales tax revenues paid through the Local Government Assistance Corporation to refinance \$2.5 billion in Municipal Assistance Corporation debt from New York City's fiscal crisis in the 1970's.
- In November 2004, the Comptroller released an audit of the Erie County Medical Center that described the creation of a new independent hospital authority that was supposed to put the Erie County Medical Center on a solid financial footing. Instead, Erie County sold the Medical Center to the new public authority in a manner that provided \$60 million in short term cash to help solve a one-year budget problem for the County. As a result, taxpayers will pay \$214 million in principal and interest for Erie County Medical Center, a public hospital they already owned.
- In the fall of 2004, the Comptroller pointed out the impact of debt levels on the MTA. The MTA implemented a debt restructuring initiative in 2002 that produced short-term savings, but increased future costs by \$8.6 billion. Due to the record surplus in the 1990s, the State and City capital subsidies dropped to zero, providing no pay-as-you-go capital. As a result, the MTA is locked into a very high level of debt through 2031 and is faced with tight budgets, outyear gaps and the need to borrow even more for future capital programs.
- In February 2003 in his report on the Executive proposed budget, the Comptroller warned of shifting costs associated with the securitization of the State's share of tobacco settlement revenue to future generations along with the use of the bond proceeds as a non-recurring resource for budget relief. In a June 2003 report on the enacted budget, the Comptroller again warns of intergenerational inequity, the use of bond proceeds as a non-recurring resource for budget relief and the improper accounting treatment of the debt itself with regards to the Debt Reform Act of 2000.

In each of these examples, public authorities issued debt to provide immediate operating budget relief by incurring greater future costs.

The responsible use of debt is one measure of a government's fiscal integrity. Comptroller Hevesi has directed his staff, in carrying out the responsibilities of the Office of the State Comptroller, to promote the prudent and fiscally responsible use of debt for infrastructure and other purposes that serve the common good. Except under dire circumstances, it is irresponsible to use long term debt to pay for operating costs, directly or indirectly. Debt should be structured to share the costs of infrastructure and capital improvements in an equitable manner with future taxpayers, not to limit future choices or to burden them with disproportionate costs. Debt issuance costs should be minimized through the use of cost-benefit analyses and competitive procurement methods, such as Requests for Proposals.

In addition, as a relatively new and complex development in the municipal market, special attention should be paid to swaps, hedges and other derivatives. Though swaps are available only to certain public authorities and local governments in New York, it is important to make sure that their use is authorized by law, that their conditions and risks are understood and disclosed by the governing board of the public authority or local government through the issuance of formally approved swap policies and guidelines, and that they are priced fairly.

Comptroller's Review of Negotiated and Private Sales

The Comptroller has had approval authority over the manner in which public authorities sell debt for at least 50 years. Chapter 516 of the Laws of 1954 amended Section 365(2) of the Public Authorities Law to provide that notes of the Thruway Authority "shall be sold by the comptroller, as agent of the authority, in such manner as the authority, with the approval of the comptroller, shall determine." Subsequently, over 70 statutes have been enacted that subject private or negotiated sales to the Comptroller's approval.

In addition, Section 112(2)(a) of the State Finance Law requires the Comptroller to approve most contracts "made for or by any state agency" before any such contract may be executed or take effect. When a public authority issues State-supported debt, generally, a State agency and the public authority enter into a service contract or other financing agreement, which obligates the State to make payments to the authority in amounts sufficient to defray debt service payments, as well as all costs associated with issuing the debt. Because these contracts and agreements are made by a State agency, they are subject to the Comptroller's approval under Section 112.

The Comptroller's approval of private or negotiated bond sales was discussed in a *Staff Report on Public Authorities in New York State* (Hults Commission Report) issued in 1956 by the Temporary State Commission on Coordination of State Activities, chaired by Senator William S. Hults.⁸¹

The Hults Commission Report recommended that every public authority have "... the right to sell its bonds at private sale ... if upon proper application by the authority such private sale ... and the terms thereof are approved in writing by the State Comptroller".⁸² In formulating this recommendation, the Hults Commission Report noted that while "[p]rivate sale[s] may raise questions of collusion or favoritism," they may also be advantageous under certain circumstances.⁸³ The Hults Commission Report balanced these competing concerns by recommending that private sales be approved by the Comptroller:

⁸¹ Staff Report on Public Authorities in New York State (1956 Legislative Document No. 46).

⁸² *Ibid.* p. 339.

⁸³ *Ibid.* pp. 337-338

Private placement of bonds may prove advantageous to authorities, and they should be able to have recourse to such private sale. However, private sale should be subject to such controls as may be necessary to protect the best interests of the State and the public. It would appear desirable to require an authority to obtain approval of a proposed private bond sale. ... If an authority could sell its bonds privately to local buyers, it could with approval do so if it could show that such private sale would be less costly and more favorable than public sale. ...

Such approval power over private sale of authority bonds should logically be placed in the hands of the State Comptroller. He is the State's financial officer, and as such he's in close and constant contact with the bond market. ... He has an experienced staff and is well equipped to consider the conditions of the bond market and to judge the advantages of any private bond sale negotiated by an authority. His contact with the bond market is more complete than that of any local official, and he would be in the best position to judge the merits of any private bond sale proposed by a local public authority.⁸⁴

Since the Hults Commission Report, dozens of statutes have made private or negotiated "sales," the "terms and conditions" of such sales, or the underwriting and private sale "arrangements" subject to the Comptroller's approval. The language and history of these statutes make it clear that the Comptroller's approval function, among other things, is intended to protect the State and the public from collusion, favoritism, and improvidence through an independent evaluation of the reasonableness of the factors affecting the total cost of the borrowing. This independent check is not in any way inconsistent with statutes that authorize the public authority to determine those factors, in the first instance or to procure goods and services.

In recent years, negotiated sales have eclipsed competitive sales as the preferred method to issue bonds in the municipal market. As an example, in the calendar of planned sales for the first quarter of 2005 issued by the Comptroller as chair of the Securities Coordinating Committee, only 1 in 23 new money sales will be competitive. Some municipal finance experts believe that negotiated sales may be more cost-effective than competitive sales for some large and complex debt issues, especially in volatile markets. In light of these larger and more complex transactions presented to the Office of the State Comptroller, it is more apparent than ever that the Comptroller's approval function includes review of more than just a comparison of the prices and interest rates in "comparable" public sales. It also includes a review of any matter that

⁸⁴ Ibid. pp. 338-339.

affects, or has the potential of affecting, the total cost of borrowing to the issuer, or the State's credit rating or other interests.

When considering whether to approve a private or negotiated sale, the Comptroller is entitled to assess the reasonableness of the issuer's expenses, including fees of bond counsel, rating agencies, and financial advisors, printing costs, and the cost of insurance, because these factors affect the total cost of the borrowing to the issuer. Similarly, the Comptroller is also entitled to assess the reasonableness of underwriters' expenses, including counsel fees, because those expenses affect the total cost of borrowing to the issuer through either the rate of interest on the obligations, the price the issuer receives for the obligations, or both.

Moreover, to the extent that a private or negotiated sale of debt contemplates a swap transaction, and the swap affects, or has the potential of affecting, the effective interest rate of the borrowing or the size of the issue, then the swap affects the issuer's total cost of borrowing.⁸⁵ Under these circumstances, the Comptroller is entitled to consider the effect of the swap, the reasonableness of the pricing of the swap, as well as the reasonableness of any costs relating to the swap transaction.

Debt Issuance Approval Policy

The Comptroller recently issued a Policy Statement and Guidelines for Debt Issuance Approvals in order to provide clear guidance to public authorities and local governments, ensure that all factors contributing to the cost of an issuance are considered in the review of negotiated or private sales, and streamline and improve the Office of the State Comptroller's oversight process.

In 2003, the Office of the State Comptroller's Bureau of Debt Management began to conduct a more rigorous review of negotiated bond sales, consistent with the Comptroller's direction of promoting the responsible use of debt. Over a recent 18-month period, the Bureau reviewed and approved 335 issues totaling \$41.2 billion. The Bureau's workload spans a wide variety of issues and issuers, from large public authorities who frequently access the municipal market to small local governments with infrequent borrowing needs.

In reviewing a negotiated or private sale, the Bureau now takes into account the nature, size, structure and complexity of the transaction and generally considers the following factors:

- The reasonableness of the underwriter's spread,
- The reasonableness of the costs of issuance,

⁸⁵ The same reasoning would, of course, apply to other "derivative" and "hedge" products.

- The reasonableness of the yields based on market conditions at the time of pricing,
- In the case of refundings, the reasonableness of the savings and savings structure with the goal of a structure that produces cash flow savings in every year, as well as net present value savings, and
- In the case of derivative transactions undertaken in connection with the sale, the reasonableness of the pricing and related costs of the transactions.

At the request of the public authority and local government issuers who present their negotiated bond sales for review, the Office of the State Comptroller developed a new Debt Issuance Approval Policy Statement and accompanying Approval Request Form to clarify the process, describe the information requirements in detail and allow for the collection of all needed information as early in the approval process as possible. These materials were released as drafts for comment on July 22, 2004. A dozen sets of comments were received, and many suggestions were incorporated into a revised Policy Statement, dated November 12, 2004, and a revised Approval Form. Subsequent meetings and conference calls with public authorities and local governments allowed for further discussion about the current approval process and the adjustments that would be put in place as a result of the Policy Statement.

During the comment and discussion period, the Office of the State Comptroller continued to systematically review negotiated deals, considering the reasonableness of the underwriters' spread, expenses, costs of issuance, the savings and savings structure related to refundings, and the pricing and costs related to the derivatives and hedge transactions—the approach that will be maintained with the recently issued Policy Statement and Guidelines, as well as the Approval Request Form.

Use of the new form, which specifies all information requirements up front and encourages electronic submission, will expedite the Office of the State Comptroller's review of financings. Issuers are asked to submit an Approval Form no later than five business days prior to the planned date of sale of the bonds or notes with all information (except certain pricing information) submitted no later than one business day prior to pricing; the Office of the State Comptroller's determination will be made as soon as possible after a fully completed Approval Form is submitted following bond pricing, frequently within three hours.

The Policy Statement and Guidelines demonstrate the Office of the State Comptroller's commitment to review all factors to hold down costs. To ensure that the total cost of borrowing is reasonable and appropriate, a multitude of expenses and factors must be considered. The Office of the State Comptroller reviews costs such as insurance, bond counsel and advisors fees, and swaps and other hedge transactions, as well as price, yield and underwriters' compensation. The Office of the State Comptroller also looks at the structure of refundings for present value savings and optimally for cash flow savings as well.

Detailed data collection will allow the Office of the State Comptroller to compare a financing under review against similar financings and other publicly available benchmarks. The Office of the State Comptroller will work toward making more benchmarking data available, with the goal of providing public authority and local government issuers with information to assist them in holding down costs. This benchmarking can be particularly helpful to government entities that do not regularly issue debt. With the Office of the State Comptroller's support and information, they may be able to negotiate better financing terms with underwriters and advisors.

As the municipal market continues to develop and expand the use of new products, such as derivatives, the Office of the State Comptroller will collect data on their use and review terms and costs, as appropriate, in the course of reviewing negotiated sales. Although the number of government issuers in New York that are authorized to use them is limited, derivatives are a rapidly growing factor in municipal financings. Total derivatives in the municipal market have been estimated at \$300 billion to \$600 billion. While the municipal bond market is subject to the regulation of the Municipal Securities Rulemaking Board and the Securities and Exchange Commission, the marketing of derivatives is not similarly regulated. Recommended practices for the management and disclosure of derivatives continue to be refined by industry and government finance experts.

Through this review process, the Office of the State Comptroller acts as a gatekeeper on specific debt transactions. With the Debt Issuance Policy Statement and Approval Guidelines as a framework for this review, the Office of the State Comptroller seeks to promote the prudent and fiscally responsible use of debt. Use of the new Approval Request Form will streamline the review process, ensure that all factors in a debt issuance are considered and improve the Office of the State Comptroller's oversight and monitoring. But even though the Office of the State Comptroller's review of negotiated transactions may encourage public authorities and local governments to negotiate the best deal for the taxpayers, it is not a substitute for comprehensive constitutional and statutory reform. Increasingly, the individual debt issues that are brought to the Office of the State Comptroller represent trends and problems of a larger, structural nature that demand additional controls and reforms. The Comptroller's comprehensive reform package of constitutional debt caps, a new Debt Management Board and increased oversight of public authority debt will provide the disciplined controls to address these problems on a structural basis.

Reforming New York State Debt Practices

The people of New York State face an enormous and ever-growing debt burden. Unfortunately, State debt was inappropriately increased during times of prosperity as well as during fiscal crisis, and seems to have become a popular and convenient, yet costly, option in managing New York's finances. The risk associated with this debt is increasing, and the management of debt policy is increasingly irresponsible from formulation to implementation. The State needs effective reform that will decrease its propensity to utilize debt financing, recognize the value of pay-as-you-go spending and open the process to the public.

In order for a debt management policy to be successful, it must balance need with capacity and intergenerational equity. Debt level targets should be manageable to avoid consuming other State spending priorities. Next, a debt management policy should incorporate accountability. The Governmental Accounting Standards Board (GASB) defines accountability as the "cornerstone of financial reporting in government." GASB notes that accountability creates an obligation for governments to explain their actions and justify what they have done.⁸⁶

To accomplish meaningful debt reform, New York State should tackle the problem from a variety of directions, including constitutional amendments complemented by statutory changes. As the State has experienced with the Debt Reform Act of 2000, statutory reform that can easily be circumvented with "notwithstanding" language, or in the case of tobacco securitization and other examples discussed in this report, by adding a clause exempting the transaction from debt limit calculations, is not true reform that will accomplish the legislation's intended goal of limiting the State's dependency on debt.⁸⁷ While there will be required statutory amendments, amending the Constitution should be the focus of debt reform in New York State.

First and foremost, an effective policy should start with affordability. Affordability, accountability, and transparency are three broad categories that will define reform. As an ongoing process, the State should improve its dialogue with the public, minimize the present and future cost of debt and ensure the most efficient debt structure by avoiding the issuance of long-term debt for short-term purposes. Furthermore, managing debt and debt policy should be made accountable by spreading that responsibility beyond the Executive and the Division of the Budget. Taxpayers

⁸⁶ Concepts Statement Number 1 of the Governmental Accounting Standards Board Objectives of Financial Reporting, Issued May 1987.

⁸⁷ Part D3 of Chapter 62 of the Laws of 2003 defines tobacco securitization as a contingent contractual obligation. The Debt Reform Act of 2000 exempts contingent contractual obligations from being considered State-supported debt and, therefore, it does not count toward the net debt caps. Furthermore, Section 7 of Part D3 provides that, "Neither any bond nor ancillary bond facility of corporation shall constitute a debt or moral obligation of the State or a State-supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State..."

deserve access to debt policy information, as well as complete information about outstanding debt and future plans, so they know they are affordable.

To reach the level of reform that is necessary to address all the issues discussed in this report, the State must be willing to make sweeping changes, both constitutional and statutory. It must be willing to look into the future and realize that some things cannot happen today—strict management changes are necessary first.

Constitutional change is broad in that it cannot simply be notwithstanding or avoided with other convenient mechanisms. The Constitution should be amended to make the broad and unbendable, but very necessary changes that can only be changed with bipartisan and public support. The Constitution should define State-funded debt and limit it to five percent of personal income. It should require a debt management board to produce an annual public debt affordability study. It should end backdoor borrowing permanently.

Statutory changes should be mechanical and adjustable, if necessary. Statutory changes should include how a debt management board would work. Statutes should be changed to reflect what a debt affordability statement should include and how it should be used. Statutes should mandate how the State should prepare for the constitutional debt caps that will take time to reach.

Implementing Reform

Clearly, the State faces hard choices and a difficult road with such a reform proposal. It is very important that those choices be the result of open, honest and informed discussion among policymakers and the public. Additionally, it is equally important to inform the public of decisions about and the status of debt management in the State. For too long, the Executive and the Division of Budget have tightly controlled debt management, with minimal information available to the public or the policymaking community. Debt is currently affordable only because the State is capable of providing enough funds to pay annual debt service. Simply having enough revenue does not mean that debt management is cost effective for current or subsequent taxpayers. The primary problem with the current structure is that too few really understand the depth of the problem, and even fewer have the inclination to institute change.

Recommendation:

Constitutionally Define State-Funded Debt

The Constitution should provide an unbending definition that includes all obligations that require State resources for debt service needs. By eliminating any discretion in what is to be considered State debt, a more comprehensive accounting of the State's debt portfolio will be calculated and will, therefore, have the added benefit of providing the public a true accounting of the State's debt burden.

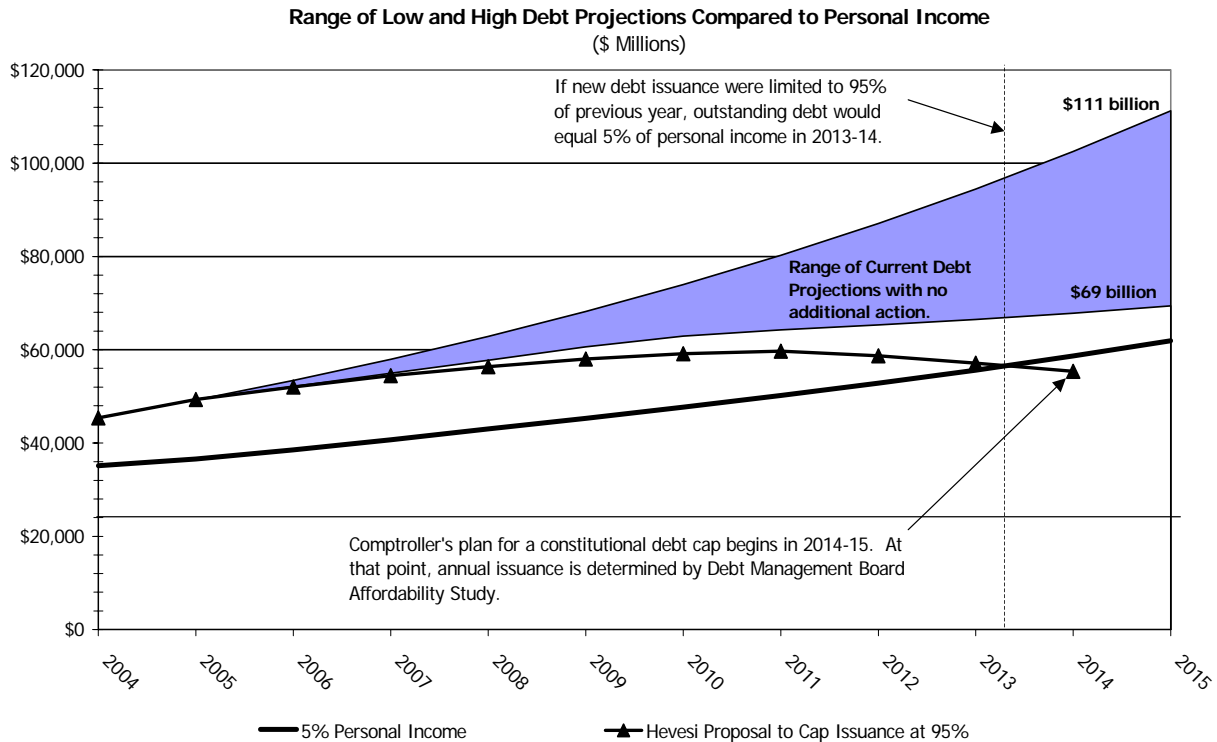
Constitutionally Limit State-Funded Debt to Five Percent of Personal Income

By applying the proposed State-funded debt definition to the current debt portfolio, taxpayers will be afforded a more transparent view of the State's debt burden. "State-funded debt" captures the complete picture of the State's obligations as a result of debt issuance—totaling \$45 billion at the end of State fiscal year 2003-2004 and growing by at least \$3 billion in the months since then. This more truthful classification of the various types of debt into one all-encompassing definition highlights the disappointing fact that even with the enactment of debt reform legislation in 2000, New Yorkers have experienced no relief from this costly habit.

In fact, New York's current outstanding debt is equal to 6.5 percent of personal income. With the lack of teeth in the Debt Reform Act of 2000 and its proven failure to keep debt to a responsible level, permanent caps must be implemented. All debt, currently outstanding and new, would be constitutionally limited to 5 percent of New York's personal income by April 1, 2014. Coupled with the constitutionally expanded definition of debt, this mandated cap eliminates any loopholes and exemptions.

Statutorily Limit Debt Issuance to 95 Percent of Prior Year Issuance Until Cap is Reached

As New York's outstanding debt is currently equal to 6.5 percent of personal income, steps will have to be taken to bring down the debt to 5 percent. Policymakers should be statutorily limited to issuing additional debt no greater than 95 percent of the previous year starting in the next fiscal year after passage of the legislation and continuing through March 31, 2015. From April 1, 2014 forward, annual issuance would be limited to what is deemed affordable in the annual debt affordability statement, as well as the constitutional cap. If debt issued in 2005-06 was limited to 95 percent of what was issued in the previous year, the State would be limited to issuing \$2.75 billion. It is estimated that the outstanding State-funded debt burden will reach 5 percent of personal income by the 2013-14 fiscal year if this limit is followed.



Recommendation:

Create a Debt Management Board

Clearly, New York State has to be held accountable for its actions regarding every State dollar, including those gained as a result of debt. In order for this to take place, New York State should establish an effective oversight mechanism for new and refunded debt, as well as outstanding obligations. Over time, the voting public has been virtually excluded from managing the amount, the timing and the purpose of borrowed *public* dollars. The taxpaying public should have an understanding and a voice in the process.

Currently, the Division of the Budget and the Executive control a substantial portion of the process. The establishment of a debt management board would provide coordinated monitoring and reporting of all debt, including debt issued by public authorities. The State Comptroller, the fiscal watchdog for the State, should be as active in planning, implementing, reporting and managing the State's borrowing from beginning to end, as the Executive. Furthermore, a qualified representative of the general public, knowledgeable and experienced in public finance, accounting or economics, should provide a voice outside of the budget-making process.

Many states have established boards to oversee debt management and policy on a number of different levels. The Maryland Capital Debt Affordability Committee provides a yearly affordability study to legislative leaders with a recommended level of

new debt based on long-term projections and economic conditions. The committee is made up of a member from the Executive's Budget and Management Division, the Treasury, the Transportation Department, the State Comptroller and a member of the public. It provides a comprehensive and independent yearly review of debt condition before the capital planning process begins. The Texas Bond Review Board provides a comprehensive semi-annual report to policymakers regarding debt conditions, including overviews of the costs or savings associated with refinancing or refunding debt. Furthermore, the Board oversees debt after the capital planning process, but before the debt issuance process. Required information from agencies issuing debt includes detailed plans for administration and disbursement of bond proceeds. The Board is charged with providing the Legislature detailed information on bond issuances throughout the previous year.

To increase accountability, complete and transparent information regarding debt practices and plans must be readily available to all New Yorkers. The creation of a debt management board made up of the State Comptroller, the Executive and the public would be responsible for the assessment of Executive and legislative proposals and would be prepared to balance oversight with risk management practices.

The Debt Management Board would establish overall debt policy and regularly monitor and report on the State's debt affordability level. It also would have the authority to adopt guidelines and standards addressing the issuance of bonds and the management of bond proceeds and establishing guidelines for refinancing.

Establish and Annually Publish a Realistic Measure of Debt Affordability

Reports indicate that New York State has, for at least the last five years, been at or near the top of nationally accepted rankings in affordability measures. Moody's indicates that New York State holds the fourth greatest debt per capita, as well as fourth highest debt as a percentage of personal income. The Citizen's Budget Commission has reported that New York State is significantly into the "danger zone" when considering debt level to capacity. However, the debt caps established in the Debt Reform Act of 2000 conflict with these established measures and indicate that New York State is well below the levels designated by the State itself as "too much."

A number of states produce annual affordability statements that are typically based on the measures discussed in this report: debt/wealth and debt service/capacity ratios. Many of those states with consistently high bond ratings not only produce an affordability statement, but also use such statements when considering capital planning decisions. The Debt Management Board should produce an annual, comprehensive statement on debt affordability, utilizing a number of measurements, which are available to the general public and policymakers. The findings of the report should be incorporated in the decision-making process of capital planning and debt management.

There is a need for the public and policymakers to understand debt in terms of capacity. The debt caps established in the Debt Reform Act do not adequately illustrate

how much additional debt the State can effectively absorb. A public analysis of debt affordability issued on a yearly basis by the Debt Management Board, along with strict and effective debt caps, will curb the State's appetite for borrowing. Such a document should be designed to be reader-friendly and should be constitutionally authorized to limit outstanding debt to an affordable level.

Recommendation:

End Backdoor Borrowing and Increase Accountability

In addition to creating a debt management board, all State-funded debt should be issued by the State Comptroller, thus ending the decades old habit of backdoor borrowing.

Authorities will still be authorized to issue debt for their own or private concerns, although the terms and conditions of all negotiated debt issued by these publicly created entities will be subject to the review of the State Comptroller.

By concentrating the issuance of State-funded debt to one entity, disclosure and accountability will increase as all debt will be subject to accounting standards in one organization. By subjecting a portion of annual debt to public approval, the taxpaying public will have more influence on where their tax dollars are spent and how. The introduction of the centrally funded Personal Income Tax Revenue Bond program is a good example of how centrally managed issuance will benefit the State.

Require Voter Approval for Debt over \$1 Billion and Allow Multiple Annual Initiatives

The voting public should annually approve issuance of new debt in any amount greater than three percent of the constitutional debt cap or \$1 billion, whichever is greater, and annual referendums should be allowed to offer up to five borrowing proposals.

Mandate Intergenerational Equity and Present Efficiency with Standards and Guidelines

Considering that New York State spends between \$3 billion and \$4 billion annually on debt service, it should be assumed that fiscal efficiency should play a significant role in managing debt. In the past two years, New York State has gone to great lengths to produce immediate savings, as well as savings that may be realized in the future. However, while efficiency is important and opportunities for responsible savings should always be a consideration, future risk and cost should be weighed against current gains. For instance, extending debt, deferring principal payments or entering into derivative arrangements that may be overly dependent on current market conditions or bond ratings may provide immediate savings and budgetary relief, but if

the risk of significant losses is great enough, immediate fiscal relief may not be warranted and other options should be pursued.

For some time now, intergenerational equity has not been a consideration in managing debt. The sale of New York State's future tobacco revenue stream and other forms of deficit financing, the deferment of payments and lengthening of terms of existing debt add costs to future generations and administrations. In order to contain these costs, the following should be addressed:

1. Issue debt for capital purposes only. Pay-as-you-go financing should be the State's first choice, especially for capital with low Periods of Probable Usefulness (PPU). Incurring debt for operating expenses should be avoided except in a strictly defined emergency,
2. Advocate for competitive sales or provide justification for using negotiated deals.
3. Call for non-recurring revenues, as defined by the Debt Management Board, to be used for pay-as-you-go capital spending or debt reduction only, and
4. When New York State realizes a surplus at the end of the fiscal year, deposit a percentage of such surplus in the Debt Reduction Reserve Fund to be used for pay-as-you-go spending or debt reduction.

Guidelines and standards should be issued by the Debt Management Board that include the following:

1. Structure for State-funded debt,
2. Criteria for refunding including extending debt, savings structure and use of savings,
3. The use of credit enhancements and derivative instruments,
4. Method of sale, and
5. Debt policy standards for public authorities.

Even before the effective date of a constitutional debt limit, the Debt Management Board will serve the critical function of setting the direction for State debt policy in an open and accountable forum. The Board will weigh the risks and rewards afforded by new developments in the municipal bond market and provide clear guidance for the public authorities, Office of the State Comptroller and Division of Budget in managing and issuing State-funded debt.

The most common debt management offenses occur because the following principles are not followed. The Comptroller endorses these general principles regardless of the outcome of any debt reform changes that may or may not take place.

General Principles of State Debt Management

- ➔ **Do Not Use Refinancing to Extend Debt Maturity**
 - Ensure present value and cash flow savings in every year
 - Maximize the economic benefits of debt refunding

- ➔ **Integrate the Capital and Financial Planning Process**
 - Update both plans quarterly and provide realistic four-year projections

- ➔ **Maximize the Use of Pay-As-You-Go Financing**
 - Target projects with low periods of probable usefulness

- ➔ **Maximize the Use of Surplus Revenues to Retire Older and Expensive Debt**
 - Use non-recurring revenues for capital spending/debt reduction

- ➔ **Long-Term Debt Should Be Issued for Capital Purposes Only**
 - Issue no debt for operating expenses
 - Issue debt for capitalized interest only in extraordinary circumstances, such as pending construction of a revenue producing facility

- ➔ **Keep Debt to an Affordable Level**
 - Limit outstanding debt and debt issuance
 - Minimize the costs of debt issuance

- ➔ **Limit the Term of Debt to Maximize Intergenerational Equity**
 - No debt issued beyond Period of Probable Usefulness

- ➔ **Provide Comprehensive and Clear Debt Reporting**
 - Continually strive toward superior disclosure practices.

- ➔ **Use of Competitive Sales over Negotiated**

Commonly Used Acronyms

AIS – Annual Information Statement

CEFAP – Community Enhancement Facilities Program

COPs – Certificates of Participation

DA – Dormitory Authority

DOB – New York State Division of the Budget

ESDC – Empire State Development Corporation (see also UDC)

GAAP – Generally Accepted Accounting Principles

GASB – Governmental Accounting Standards Board

GO – General Obligation (backed by pledge of faith and credit)

LGAC – Local Government Assistance Corporation

LIBOR – London Interbank Offered Rate

MAC – Municipal Assistance Corporation

MBBA – Municipal Bond Bank Agency

MSA – Master Tobacco Settlement Agreement of 1998

MTA – Metropolitan Transportation Authority

NPV – Net Present Value

OGS – New York State Office of General Services

PACB – Public Authorities Control Board

PAYGO – Pay-As-You-Go

PI – Personal Income

PIT – Personal Income Tax

PPU – Period of Probable Usefulness

RESCUE – Rebuilding Schools to Uphold Education

RESTORE – Rebuilding the Empire State Through Opportunities in Regional Economies

SCC – Securities Coordinating Committee

SIP – Strategic Investment Program

TFA – Transitional Finance Authority

TSASC – Tobacco Settlement Asset Securitization Corporation

TSFC – Tobacco Settlement Financing Corporation

UDC – Urban Development Corporation (see also ESDC)

General Definitions

Annual Information Statement (AIS) - New York State's principal means for disclosing financial information that is required to meet its legal obligations under the federal securities law and constitutes the official form of such financial disclosure information (Division of the Budget definition).

Basis Point - Smallest measure used in quoting yields on bonds and notes. One basis point is 0.01 percent of yield. For example, a bond's yield that changed from 6.52 percent to 7.19 percent would be said to have moved 67 basis points.

Bond Anticipation Note (BAN) - A note issued in anticipation of later issuance of bonds, usually payable from the proceeds of the sale of the bonds or of renewal notes.

Bond - Generally, an evidence of the issuer's obligation to repay a specified principal amount, together with interest, with a maturity of greater than one year.

Bond Market Association (BMA) - International trade association of banks and broker/dealers in U.S. government and federal agency securities, municipal securities, mortgage backed securities and money market securities. The BMA index is a tax-exempt index used for swaps.

Bond Rating - Designation used by ratings services to give relative indication of credit quality.

Cash Flow Savings/Loss The difference between cash flows required to service the old debt and the cash flows required to secure the new debt as a result of a refunding.

Conduit Debt - Debt issued by an issuer for a third party for which the issuer has no obligation to repay beyond resources provided by that third party.

Contingent Contractual Obligation - Contingent contractual obligation financing is an arrangement pursuant to which the State agrees to make periodic payments only in the event that the expected sources of payment of debt service on bonds issued by a public authority or other entity is insufficient to make payments to bondholders. The primary source of payment may include resources that would otherwise have been available to the State if not previously sold or assigned to meet required debt service payments. Obligations that are classified as contingent obligations under State law, may include obligations that are not considered "contingent" obligations under Generally Accepted Accounting Principles. Contingent-contractual-obligation financing contracts generally have a term not less than the amortization period of debt obligations issued by the public benefit corporation or other entity in connection with the contract. As a general rule, the State does not expect to make payments beyond any resources it may have already arranged to provide. Contingent payments made by the State, if necessary, are used to pay debt service on the obligations and are subject

to annual appropriation by the Legislature and the availability of moneys to the State for the purposes of making legally contingent contractual obligation payments.

Counterparty - One of two entities in a traditional interest rate swap. In the municipal market, from the issuer's perspective, this is typically an investment banking firm, commercial bank or insurance company.

Credit Enhancement - Bond insurance, letters of credit, pledges of revenue and other facilities intended to strengthen the credit of the issuer.

Debt or Indebtedness - General term for amounts owed and payable on specified dates or on demand, generally evidenced by bonds, notes or other instruments.

Debt Service - Principal and interest paid on debt.

Debt Reduction Reserve Fund - Established in 1998 to accumulate surplus revenues to pay debt service costs on State-supported bonds, to retire or defease such bonds and to finance capital projects (Division of the Budget definition).

Debt Service Reserve Fund - The fund into which are paid monies required by a trust agreement or indenture as a reserve against a temporary interruption in the receipt of the revenues or other amounts which are pledged for the payment of the bonds. A common deposit requirement for a "debt service reserve fund" is six months or one year's debt service on the bonds. The "debt service reserve fund" may be initially funded out of bond proceeds or over a period of time from revenues or by a combination of both.

Defeasance - Termination of the rights and interests of the bondholders in accordance with the terms and conditions of the bond contract.

Derivative - A financial product that derives its value from an underlying security. In the tax-exempt market, there are primary and secondary derivative products.

Face Value - The par value of a security, as distinct from its market value.

Financial Accounting Standards Board (FASB) - Independent board responsible for establishing and interpreting generally accepted accounting principles. It was formed in 1973 to succeed and continue the activities of the Accounting Principles Board.

Fixed Rate Bond - A long-term bond that pays a single "fixed" rate of interest until its maturity.

General Obligation Bond (GO) - A governmental bond secured by the pledge of the issuer's faith and credit.

Generally Accepted Accounting Principles (GAAP) - Conventions, rules and procedures that define accepted accounting practice, including broad guidelines as well as detailed procedures. The basic doctrine was set forth by the Accounting Principles Board of the American Institute of Certified Public Accountants, which was superseded in 1973 by the Financial Accounting Standards Board (FASB), an independent self-regulatory organization.

Governmental Accounting Standards Board (GASB) - Organized in 1984 by the Financial Accounting Foundation (FAF) to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities. The Foundation is responsible for selecting the members of the GASB and its Advisory Council, funding their activities and exercising general oversight—with the exception of the GASB's resolution of technical issues (GASB definition).

Interest Rate Swap – A contractual agreement between two parties who agree to exchange certain cash flows, calculated at different interest rates, for a defined period of time.

Interest - The compensation paid or to be paid for the use of borrowed money, usually expressed as an annual percentage rate.

London Interbank Offered Rate (LIBOR) - The rate banks charge each other for short-term Eurodollar loans. LIBOR is commonly used as the index for the floating leg of a swap. The British Bankers' Association sets the rates daily.

Mark to Market – reflects the difference between initial agreement and current market value for an investment including swaps and other derivatives.

Moral Obligation Bond - A bond, which in addition to its primary source of security, possesses a structure whereby a state agrees to consider restoration of a debt service reserve fund, subject to legislative appropriation. There is no legal obligation for the state to make such a payment, but market participants recognize that failure to honor the "moral" pledge would have negative consequences for the state's own creditworthiness.

Net Present Value (NPV) - Compares the value of a dollar today versus the value of that same dollar in the future, after taking inflation and return into account.

Notional Amount - A stated dollar amount in an interest rate swap used as the basis to determine the amount of swap interest payments.

Par Amount - The principal amount of a bond or note due at maturity as stated on the face of the obligation. Also known as par value.

Premium - The amount by which the price of a security exceeds its principal amount.

Prior Year Claims for State Aid - Valid claims for school aid received prior to expiration of a statute of limitations for filing such claims that are eligible for deferred payment by the State.

Refunding - A financing structure under which new bonds are issued to retire or defease all or a portion of an outstanding bond issue.

Securitization - The process of converting financial interests into marketable securities.

State-Funded Debt - Any debt or obligation that is supported in whole or in part by any financing arrangement whereby the state agrees or has in the past agreed, whether by law, contract, or otherwise, to make payments which will be used, directly or indirectly, for the payment of principal, interest, or related payments on indebtedness incurred or contracted by the state itself for any purpose, or by any state agency, municipality, individual, public or private corporation or any other entity for state capital or operating purposes or to finance grants, loans or other assistance payments made or to be made by or on behalf of the state for any purpose. If the state agrees to make future revenues from a specific state source available for the purpose of supporting debt of any municipality, individual, public or private corporation or any other entity, such debt shall be considered to be a debt for the purpose of financing a state grant, loan or other assistance payment. This term applies to all debt or obligations for which the state agrees, or has in the past agreed, to make payments (i) whether or not the obligation of the state to make payments is subject to appropriation or is otherwise contingent, or (ii) whether or not debt service is to be paid from a revenue stream transferred by the state to another party that is responsible for making such payments. State-funded debt does not include short-term debt incurred in accordance with section 9 of article 7 of the constitution, emergency debt incurred in accordance with section 10 of article 7 of the constitution, and refunding debt incurred in accordance with section 13 of article 7 of the constitution.

State-Supported Debt (statutory definition) - "State-supported debt" shall mean any bonds or notes, including bonds or notes issued to fund reserve funds and costs of issuance, issued by the state or a state public corporation for which the state is constitutionally obligated to pay debt service or is contractually obligated to pay debt service subject to an appropriation, except where the state has a contingent contractual obligation (Section 67-a of the State Finance Law statutory definition).

State-Related Debt - Includes all State-supported debt and types of debt that are not direct obligations of the State, including contingent contractual-obligation debt, moral obligation debt, State guaranteed debt and non-State supported debt of State issuers.

State-Guaranteed Debt - Debt whereby New York State unconditionally guarantees the payment for three authorities: the New York State Thruway Authority, the Job Development Authority (JDA) and the Port Authority of New York and New Jersey. Only

the JDA has this type of debt outstanding or can issue new debt of this type. The State makes payments on this debt only if the original borrower fails to do so.

Taxable Bond - A municipal bond whose interest is not excluded from the gross income of its owners for income tax purposes.

Tax-Exempt Bond - A bond for which the interest is excluded from the gross income of its owners for income tax purposes. Municipal bonds that are exempt from state and local as well as federal income taxes, are said to have triple tax exemption.

Variable Rate - Interest rate on a loan or debt that rises and falls based on market conditions, a formula or procedure sometimes tied to the movement of an underlying index of interest rates, an auction or some other predetermined method for setting floating rates.

Yield - The net annual percentage rate of return earned on a security.

Bond Rating Definitions

Standard and Poor's	
Credit Rating	Definition (Shaded area denotes speculative grade)
AAA	An obligation rated 'AAA' has the highest rating assigned by Standard and Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA	An obligation rated 'AA' differs from the highest-rated obligations only in a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions that affect obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.
CC	An obligation rated 'CC' is currently highly vulnerable to nonpayment.
C	The 'C' rating may be used to cover a situation where a bankruptcy petition has been filed or similar action had been taken, but payments on this obligation are being continued.
D	An obligation rated 'D' is in payment default. The 'D' rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard and Poor's believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.

Note: Plus (+) or minus (-): Ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

Moody's	
Credit Rating	Definition (Shaded area denotes speculative grade)
Aaa	Obligations rated Aaa are judged to be the highest quality, with minimal credit risk.
Aa	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
A	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
Baa	Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
Ba	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
B	Obligations rated B are considered speculative and are subject to high credit risk.
Caa	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
Ca	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
C	Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.

Note: Moody's appends numerical modifiers 1, 2 and 3 to each generic rating category from Aa through Caa. The modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category, the modifier 2 indicates a mid-range ranking, and the modifier 3 indicates a ranking in the lower end of that generic rating category.

Fitch	
Credit Rating	Definition (Shaded area denotes speculative grade)
AAA	Highest credit quality. AAA ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality. AA ratings denote a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A	High credit quality. A ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB	Good credit quality. BBB ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.
BB	Speculative. BB ratings indicate that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.
B	Highly speculative. B ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC, CC, C	High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. A CC rating indicates that default of some kind appears probable. C ratings signal imminent default.
DDD, DD, D	Default. Securities are not meeting current obligations and are extremely speculative. DDD designates the highest potential for recovery of amounts outstanding on any securities involved. For U.S. corporations, for example, DD indicates expected recovery of 50 percent - 90 percent of such outstanding debt, and D indicates the lowest recovery potential, i.e. below 50 percent.

Note: "+" or "-" may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the 'AAA' category or categories below 'CCC.'

State Debt Timeline

YEAR	EVENT
1777	State Constitution adopted, creating a Legislature not limited by borrowing constraints.
1790	Federal government assumes all State's debts (which were mostly related to Revolutionary War).
1817	Legislature authorizes Canal Commissioners to borrow on State's credit at rate not to exceed 6 percent. Comptroller directed to issue "transferable certificates of stock" to evidence such loans.
1821	Constitutional Convention results in limitation on use of Canal revenue to repay Canal debts.
1836	Legislature authorizes issuance of \$3 million of "State Stock" backed by "full faith and credit of the people of this state" to the New York & Erie Railroad to be sold at public auction. State believed railroad would pay interest and retire the debt. State took as collateral lien on land used for railroad bed.
1841	State finds railroad beds to be nearly worthless and sells two for 3 percent of the amount of the lien.
1842	State Comptroller reports the State is pressed "to very brink of dishonor and bankruptcy." Legislature defeats "people's resolution" requiring voter approval of State debt with limited exceptions.
1846	Constitutional Convention results in enactment of "People's Resolution" requiring, with limited exception, voter approval of State debt for a single specified work or object, with enactment of a tax to pay for it, and requiring such debt be retired within 18 years. State was \$38 million in debt.
1851	Legislature directs Comptroller to issue \$9 million in "Canal Certificates" to be repaid from a Special Canal Surplus Fund over 21 years at 6 percent. Certificates expressly denied they were a debt of the State. Issuance challenged in court as violation of constitutional limitation on State debt issuance. Appeals courts ultimately found the statute directing their issuance violated constitutional provisions regarding use of Canal revenues and future improvements required to be paid on a "pay as you go basis." Chief judge was not impressed by the disclaimer and noted "sooner or later a claim would prevail that could not be effectually resisted."
1851	The State begins shifting burden of financing public improvements to local government in a series of "town bonding acts," requiring local governments to borrow and invest the proceeds in a public improvement—often by buying railroad company stock.
1855	The appeals court establishes the "Law of Moral Obligation," allowing for payment of claims based upon "equity and justice" where no binding obligation to pay is present.
1858	Referendum calling for a constitutional convention based on petition seeking to replace Executive and Legislature with the management of the New York Central Railroad narrowly defeated at general election.
1872	Local government debt in New York reaches \$214 million—almost 13 percent of aggregate assessed valuation.
1874	Constitutional amendment prohibits local governments from owning stock in any corporation and giving or loaning its credit to an individual or corporation, and it prohibits the State from giving or loaning its money to or in aid of any corporation or private undertaking.
1884	Constitution amended to prohibit debt in excess of 10 percent of assessed value for cities with population of 100,000 or more.
1915	First public authorities created under a law authorizing river regulation districts, which provided they were to be public corporations, with the boards to be appointed by the Executive and bonds that were not a debt of the State.
1918	Constitutional provision requiring enactment of a tax to retire debt within 18 years removed.

1935	Appeals court ruled in two cases that the Legislature could create an entity known as an "authority" that was unbound by constitutional provisions that restrain the government itself.
1938	Constitutional Convention limits creation of public corporations to special acts of the Legislature and provides the State shall not be liable for their obligations.
1943	State moves start of fiscal year from July 1 to April 1, allowing an extra nine months to raise cash to pay bills due by June 30th. Leads to eventual "spring borrowing."
1944	State enters into lease-purchase contract with the Dormitory Authority for dormitory facilities.
1951	Voters approve constitutional provision to allow the State to guarantee repayment of \$500 million of bonds to be issued by the Thruway Authority.
1960	HFA statute provides for indirect State guarantee of its housing loan bonds under Mitchell Lama Program.
1963	State Comptroller reports he "is convinced the State is making excessive use of lease-purchase financing."
1964	State Comptroller begins to report on "debt-like commitments" known as "lease-purchase agreements."
1965	State contracts with Albany County to finance Empire State Plaza. Cost estimated at \$480 million, ultimate cost approximates \$1 billion, and agreement with Albany County provides for issuance of \$985 million in bonds.
1975	The New York State Urban Development Corporation defaults on its Moral Obligation backed bonds. Total debt backed by a State moral obligation provision approaches \$6 billion.
1976	A group of bankers led by Morgan Guarantee Trust Company conditions its purchase of the State's \$2.76 billion annual spring borrowing on the enactment of legislation capping moral obligation debt and creating a temporary oversight board for the issuers. Moral obligation debt is capped and the Public Authorities Control Board is created.
1979	State enters into its first contractual obligation financing arrangement, known as a "service contract."
1986	State issues first series of negotiable Certificates of Participation (COPs) through a bank trustee.
1990	State creates Local Government Assistance Corporation to provide \$4.7 billion in long-term financing to eliminate the need for annual "spring borrowing." State enacts legislation placing limits on the circumstances under which it can engage in future short-term, intra-year borrowing. No limitation is imposed on short-term deficit financing.
2000	Debt Reform Act of 2000 limits debt to be repaid as State appropriated debt service to capital projects and provides for phased in limits on the amount of such debt that can be subsequently issued.
2001	Executive assigns annually recurring revenue to the New York City Local Government Development Corporation to pay for the State share of a new building for the New York Stock Exchange. Revenue assignment is not subject to Debt Reform Act of 2000 limitation. Later in the year, planned building development stalls and revenues revert back to the State.
2002	State authorizes eligible school districts owed State aid for unpaid claims from prior years to obtain bond proceeds from a public authority it created in exchange for relinquishing the claims against the State. Sole source of debt service is interception of future appropriations for State aid. Repayment is not appropriated as debt service and not subject to limitations of Debt Reform Act of 2000.
2003	State authorizes sale of all its future tobacco settlement revenues to a public authority in exchange for \$4.2 billion in General Fund proceeds to the State from the sale of bonds secured by the tobacco settlement revenues and the State's contractual promise to appropriate necessary amounts if tobacco settlement revenues are insufficient to repay bondholders. The sale is termed "securitization" and is not subject to limitations imposed by Debt Reform Act of 2000.

2004	The Sales Tax Asset Receivable Corporation (STARC) issues \$2.6 billion in debt to refinance and extend for an additional 26 years remaining Municipal Assistance Corporation debt for the City of New York. The Debt service is paid with State sales tax revenue.
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