IBO

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Tax Revenue Update: City Faces Significant Shortfalls from Adopted Budget

The outlook for New York City tax revenues has grown darker in the five months since the 2002 budget was adopted. The attack of September 11 delivered a strong shock to an already slowing U.S. economy. The length of the recession will depend on the military outcome of the war and how quickly Americans regain confidence in their domestic security. In addition to the nationwide downturn, New York City's economy has been directly impacted by the loss of life, destruction of property, relocation and closure of local businesses, and disruption of vital services. As the economy contracts, city tax revenues will fall as well. IBO's principle findings include:

• Assuming the downturn persists through the first half of the next calendar year, IBO projects that tax revenues for the city's current fiscal year will be $925 million less than anticipated in the Adopted Budget, a shortfall of 4.1 percent.

• The shortfall from the Adopted Budget will nearly double in the next fiscal year (beginning July 2002) to $1.8 billion or 7.7 percent. Shortfalls from the Adopted Budget persist through 2005.

• The projected tax revenue shortfalls for this year and next approach those of the early 1990s, the city's most difficult fiscal period since the 1970s fiscal crisis. The 2002 shortfall would be nearly as large as the 4.9 percent shortfall from the Adopted Budget in 1990, while the shortfall projected for 2003 is roughly two thirds of the 10.5 percent shortfall the city experienced in 1991.

• On a year-over-year basis, IBO projects that city tax revenues will fall by 7.1 percent from fiscal years 2001 to 2002. With recovery underway in calendar year 2002, tax revenues will grow just 1.3 percent in fiscal 2003.

• Among the city's major revenue sources, only the property tax will grow this year, while other key taxes will decline. For example, personal income tax revenues will be nearly $1.0 billion (17.2 percent) lower than last year, while receipts from the general corporation tax will decline $380 million (21.8 percent).

• If the U.S. downturn is shorter, local employment, retail activity, Wall Street profits, and property values will all recover more quickly. This would make the impact on city tax revenues smaller, but still substantial. Tax revenues would fall short of the Adopted Budget by $569 million (2.5 percent) this year and by $1 billion (4.3 percent) next year.

New York City
Independent Budget Office
Ronnie Lowenstein, Director
110 William St., 14th floor
New York, NY 10038
Tel. (212) 442-0632
Fax (212) 442-0350
e-mail: ibo@ibo.nyc.ny.us
http://www.ibo.nyc.ny.us

OVERVIEW

The outlook for city tax revenues has grown darker in the months since the 2002 budget was adopted, particularly in the aftermath of the September 11 attack on the World Trade Center. IBO now forecasts that revenues for the current fiscal year could be as much as $925 million less than projected in the Adopted Budget, and as much as $1.8 billion below the level projected for 2003.[1] Alternatively, if economic recovery at the national level begins earlier than we have assumed, the projected shortfalls would be smaller— $570 million below the plan for 2002 and $1 billion below for 2003.

After summarizing IBO's current economic forecast, this report will update our forecasts for each of the major tax revenue sources. The forecasts have used two alternative sets of economic assumptions; while both assume that a national recession had begun by last summer, they differ in the projected length and severity of the downturn. (See Economic Outlook.) The individual tax forecast discussions that follow focus on the results using the more conservative set of assumptions. The aggregate results obtained using the less pessimistic assumptions are presented in the tables.

The outlook last June. When the 2002 budget was adopted last June, it relied on a tax revenue forecast that was quite conservative, with collections expected to be $22.6 billion, a decline of 2.7 percent from their 2001 level.[2] Growth was expected to resume in 2003 with revenues totaling $23.7 billion. The city forecast that revenues would continue to grow at an average annual rate of 5 percent over the last years of the financial plan. IBO's tax revenue forecast last spring differed somewhat from the projections in the Adopted Budget, with revenues declining by a smaller amount in 2002 to $22.9 billion, and then growing by slower rates over the rest of the period. IBO projected revenues of $23.9 billion in 2003 and $26.0 billion in 2005.[3]

Suddenly last summer. Both the Adopted Budget forecast and the IBO forecast were predicated on growth in the U.S. economy slowing but remaining positive. It now appears that growth at the national level turned negative in the third quarter (July to September 2001) if not earlier. In the city, employment peaked in May and the local economy was losing jobs throughout the summer. Thus, even without the attack of September 11, the city's tax revenue forecasts—particularly for 2003 and beyond—were likely to have been reduced this winter and spring.[4] These problems were exacerbated when the state budget cut off a revenue stream compensating the city for the elimination of the stock transfer tax 20 years ago. This aid flow, which the city's financial documents classify with tax revenues, was budgeted to bring the city $114 million annually from 2002 through 2005.

Since September 11. The economic fallout from the September 11 attack has made the revenue situation much worse. The virtual shutdown of the city economy in the days immediately following September 11 reduced the taxable base for most revenue sources. More significantly, the sustained reduction in tourism, retail activity, Wall Street profits, and personal income, combined with the deeper job losses, will depress revenue growth for the peronal income tax, sales tax, and property transfer taxes throughout the rest of fiscal year 2002 and into 2003. The deeper national recession, which is now expected to last between six and twelve months, will mean sharply lower general corporation tax collections. Among the major revenue sources, only the property tax—with its structure of lagging assessment changes—will show growth this year, followed by much slower growth in 2003 and 2004.

IBO now projects that tax revenues will be $21.6 billion in 2002, a decline of 7.1 percent from 2001. This forecast is $925 million (4.1 percent) below the Adopted Budget and $1.3 billion (5.7 percent) less than IBO projected last spring. The Adopted Budget shortfall nearly doubles for 2003, reaching $1.8 billion (7.7 percent). Once again, the difference from IBO's earlier projection is greater, with our new outlook falling $2 billion (8.5) percent) below what was forecast last spring. Even after the economy once again begins to grow, the shortfalls from the revenue forecast in the Adopted Budget persist because the growth resumes off of a lower base. IBO projects that 2005 revenues will still be $1.9 billion (7.2 percent) below the level forecast in the current Adopted Budget.

These projections of the revenue shortfall are quite sensitive to the underlying economic assumptions used. If economic recovery at the national level occurs faster than we expect and growth resumes in the first quarter of calendar year 2002, the revenue shortfalls would be less. IBO has estimated tax revenues using an alternative set of less pessimistic assumptions, which cut the projected revenue shortfalls nearly in half. Using this less pessimistic assumption, IBO projects that 2002 revenues would be $22.0 billion, which is $570 million below the Adopted Budget forecast. In 2003, revenues would grow slowly to $22.7 billion, a shortfall of $1.0 billion.

ECONOMIC OUTLOOK

The September 11 attacks are influencing the New York City economy through two channels. First, the attacks and the ensuing uncertainty surrounding the U.S. response delivered a strong shock to an already slowing national economy, depressing consumer confidence, crippling tourism, sending stock prices tumbling, and raising security costs for businesses and communities. These impacts (along with the federal policy response) all affect the city economy as they do other areas of the nation, and their influence would be felt even if the terror attacks had occurred in another American city.

Second, there are additional impacts on the city economy specifically because the main attacks did in fact take place here and not elsewhere. The loss of life and destruction of property translate directly into lost income and output in New York, as does the disruption of services, temporary business closures, and temporary or longer-term relocations of businesses outside the city. The city economy is also directly affected by the insurance payments and federal aid flowing to firms and households devastated by the attacks.

There are uncertainties surrounding both these general and New York-specific impacts. If there is no quick resolution to the war in Afghanistan, or if further terror attacks take place, the national recession might persist well into next year. At the same time, regardless of when the national recovery begins, the city's economic recovery will be affected by the pace of the World Trade Center clean-up and restoration of downtown services, the timing of the flows of insurance and aid dollars, and the degree to which relocation decisions by displaced firms (particularly those in the finance sector) become permanent.

IBO Economic Forecasts, November 2001

	Calendar Years				
	2001	2002	2003	2004	2005
<u>National Economy</u>					
Real GDP Growth					
Longer Downturn	1.0	(0.3)	5.1	3.0	2.8
Shorter Downturn	1.2	1.4	4.2	2.9	2.9
Non-farm Employment Growth					
Longer Downturn	0.4	(0.8)	2.2	2.4	1.1
Shorter Downturn	0.4	0.1	2.2	1.6	1.2
Personal Income Growth					
Longer Downturn	5.1	2.3	5.1	5.4	4.7
Shorter Downturn	5.1	3.5	5.2	5.1	4.8
Federal Funds Rate					
Longer Downturn	4.0	2.7	5.2	5.5	5.3
Shorter Downturn	4.0	3.2	5.2	5.5	5.3
<u>New York City Economy</u>					
Real Gross City Product Growth					
Longer Downturn	(0.8)	(5.0)	4.9	2.9	2.9
Shorter Downturn	(0.6)	(1.8)	4.0	3.0	3.0
Employment (thousands)					
Longer Downturn	3,740.6	3,648.1	3,719.8	3,802.5	3,838.7
Shorter Downturn	3,748.5	3,710.1	3,779.9	3,828.4	3,863.7
Employment Change (thousands)					
Longer Downturn	20.3	-92.5	71.6	82.7	36.3
Shorter Downturn	28.1	-38.4	69.8	48.6	35.3
FIRE Sector Employment (thousands)					
Longer Downturn	481.4	445.0	450.6	461.4	465.0
Shorter Downturn	483.8	462.5	467.0	470.3	472.8
Business Services Employment (thousands)					
Longer Downturn	347.5	333.9	348.2	361.7	368.4
Shorter Downturn	348.8	341.4	357.3	367.4	374.0
Personal Income Growth					
Longer Downturn	4.4	0.4	4.7	4.9	4.5
Shorter Downturn	5.0	2.7	4.9	4.6	4.6

SOURCE: IBO.
NOTES: All growth rates reflect year-over-year percent changes.

Alternative economic scenarios. Because of these uncertainties, IBO has chosen to present revenue forecasts under two alternative economic scenarios. One scenario is premised on there being continued political and economic uncertainty that results in a prolonged national downturn, constraining travel, spending, and economic activity in general through the middle of calendar year 2002. Under this scenario, real GDP falls by 0.3 percent in 2002, in spite of an aggressive lowering of interest rates by the Fed, while employment falls by 0.8 percent. New York City's economic downturn would be far greater than the nation's. Real gross city product (GCP) is expected to decline by 0.8 in calendar year 2001 and by 5.0 percent in the following year. The city is expected to lose almost 93,000 jobs in 2002, many of which will be high-paying jobs in the FIRE and business services sector. As a result, personal income will grow by only 0.4 percent next year.

Because this scenario results in a more conservative revenue estimate, it is presented as IBO's baseline scenario. A more optimistic economic scenario, however, is plausible if there is a relatively quick resolution to the nation's military and security problems. Our forecast of such a scenario is one in which national economic growth resumes early next year, with real GDP growth equal to 1.4 percent in 2002 and no decline in U.S. employment. Such as scenario would mitigate (though not reverse) the gross city product decline to 0.6 percent this year and 1.8 percent in 2002; jobs losses in the city would be 38,000 in 2002, and personal income would expand by 2.7 percent.

PROPERTY TAX

Background. The property tax is the city's largest tax revenue source (2002 revenues are expected to be $8.5 billion) and one of its most stable. The limits on assessment changes built into the system mean that property tax revenues rarely have sharp year-to-year swings. Instead, changes in the upward or downward trend in assessments and revenues take hold slowly but then gain momentum over several years.

The outlook for 2002 has changed little since the budget was adopted with modest growth of 2.3 percent over 2001 still expected. This year's tax bills are based on assessments that were largely completed in January 2001, well before the slowdown in the local economy had set in. With taxpayers now facing greater economic pressures that will result in slower collections, IBO now expects revenues to be $8.4 billion, just $43 million lower than anticipated in the Adopted Budget.

Downturn has greater effect in 2003. The effects of this summer's downturn and September 11 on property tax revenues will be more apparent in 2003 and even more so in 2004 as newer—and in many cases lower—property assessments work their way through the system. A weaker economy lowers property values and ultimately property tax revenues in diverse ways. Commercial tenants, faced with less demand for the goods and services they produce need less space, resulting in lower rents. As office and retail rents decline, the value of commercial buildings stagnate or fall. With fewer residents working and less personal income, the boom in housing prices will also dissipate. Depending on the duration of the downturn, housing prices may actually begin to fall. In the lower Manhattan blocks closest to "ground zero," market values are expected to be particularly depressed, at least in the short term.

Last May, IBO projected that when the Department of Finance's assessors completed their valuations this coming January for the 2003 assessment roll, they would find market values still growing, although not at the brisk pace of the last three years. IBO now forecasts that the aggregate market values used for the 2003 assessments will fall in tax class two (apartment buildings including coops and condos) and tax class four (all commercial property except that of utility companies). A modest increase in class one (one-, two-, and three-family houses) will leave the total market value for all property virtually unchanged. With economic growth expected to remain negative for much of calendar year 2002, the market value slide will be more pronounced on the 2004 assessment roll. The roll is projected to fall by 3.9 percent, largely due to declines in tax class one.

Market values are only the first step in determining tax liabilities. Tax bills are based on assessed values, which are a percentage of the market value (the percentage varies by tax class). In tax classes two and four, year-to-year assessment changes are phased in over five years. For 2003, there is a backlog or pipeline of roughly $7.5 billion in assessment increases from the past four years remaining to be phased in. Thus, even when 2003 and 2004 assessments fall in response to market value declines, the pipeline of earlier increases will help keep the amount of assessments subject to tax (billable assessed value) growing, although at a diminished pace. In contrast to our May forecast, when we expected billable assessed value to grow by 5 percent annually from 2002 to 2005, IBO now expects growth of only 3.8 percent.

Total property tax revenues are determined by other factors in addition to the level of assessments, including: the current year delinquency rate, prior year collections, the level of tax policy abatements, refunds, and the ultimate tax rates set by the City Council. The 2002 Adopted Budget projected that after taking all these factors into account, property tax revenue would be $8.9 billion in 2003, $9.4 billion in 2004, and $9.8 billion in 2005. (IBO's estimates in May 2001 were quite similar.) With the slowdown in the local economy and the direct impacts of September 11, IBO now projects that property tax revenues will fall short of those in the Adopted Budget by $123 million in 2003, $290 million in 2004, and $364 million in 2005.

destruction of the buildings themselves. Under a long-standing agreement, however, the Port Authority makes an annual payment in lieu of taxes (PILOT) to the city to at least partially compensate New York for city services provided to the trade center. The PILOT is set each year using a formula based on assessments of pre-1970 buildings in downtown Manhattan. The formula produced a PILOT charge of $29 million in 2001, well below what the trade center's market value-based tax liability would have been.

IBO's Longer Downturn Revenue Forecast
(Dollars in Millions)

	2001	2002	2003	2004	2005	Average Annual Growth
Real property tax	$8,246	$8,435	$8,815	$9,072	$9,430	3.4%
Commercial rent tax	377	340	344	355	366	-0.7%
Real property transfer tax	473	410	437	532	578	5.1%
Mortgage recording tax	407	293	299	383	445	2.3%
Personal income tax	5,751	4,761	4,849	5,166	5,446	-1.4%
General corporation tax	1,735	1,356	1,101	1,351	1,464	-4.2%
Unincorporated business tax	820	765	803	869	890	2.1%
Banking corporation tax	424	396	378	441	424	0.0%
General sales tax	3,662	3,548	3,625	3,833	3,940	1.9%
Hotel occupancy tax	242	172	179	199	219	-2.4%
Other taxes, audits, and PILOTs	1,114	1,126	1,056	1,049	1,047	-1.5%
Total tax revenues	**$23,250**	**$21,602**	**$21,884**	**$23,250**	**$24,251**	**1.1%**
Memo: Alternative Forecasts						
IBO's shorter downturn	$23,250	$21,957	$22,688	$23,680	$24,617	1.4%
OMB Adopted Budget (6/01)	$23,250	$22,527	$23,705	$24,892	$26,121	3.0%
OMB (10/01)	$23,250	$21,527				
City Council (10/01)	$23,250	$21,841	$22,836	$23,943	$25,206	2.0%

SOURCE: IBO.
NOTES: Figures for 2001 are actuals. Personal income tax receipts include revenues dedicated to the Transitional Finance Authority.

Anticipated increase. In the summer of 2001, the port authority negotiated a deal to lease the trade center to a private operator. The terms of the agreement called for Larry Silverstein and his partners to pay $3.2 billion for a 99-year lease to operate the complex. The port authority and its lessee maintained that the deal did not change the tax exempt status of the trade center, leaving the existing PILOT formula in place. The city Administration countered that based on the terms of the lease a reasonable property tax bill would be over $100 million per year. The city unilaterally took steps to reduce the exemption on the World Trade Center. The Adopted Budget assumed that the PILOT would grow to $74 million in 2002 and $108 million in 2003. IBO's forecast of tax revenues (which includes PILOT payments) assumes that regardless of the merits of the city's argument, it is unlikely that the PILOT will be increased while the site is in ruins. Our forecast assumes that the existing PILOT will continue to be received.

IBO's estimate of PILOT revenues also assumes a reduction in payments from the World Financial Center and Battery Park City of $30 million per year. These properties, which are owned by the state-chartered Battery Park City Authority and thus fully tax exempt, make payments that approximate their tax liability if they were conventionally assessed. The projected reduction in the Battery Park PILOT reflects IBO's estimate of the near-term impact of the September 11 attack on market values of the two complexes.

Shorter downturn. If the economy were to begin recovering quicker, demand for housing, office and retail space would all grow faster, resulting in higher property values and assessments. In turn, the revenue shortfall would be smaller, with revenues $246 million below the current plan for 2004 and $317 million lower for 2005.

PAYMENTS IN LIEU OF TAXES (PILOTS)

Background. The World Trade Center was owned by the Port Authority of New York and New Jersey. Because it is a state agency (in this case an agency of two states), property owned by the port authority is exempt from property taxation by the city. Thus, there is no direct property tax loss to the city from the

COMMERCIAL RENT TAX

Background. The commercial rent tax (CRT) is paid by commercial tenants leasing space south of 96th Street in Manhattan. Since 1995, the CRT has been cut back sharply both in terms of the number of firms subject to the tax as well as in the burden for those businesses still paying the tax. The most recent change—enacted for 2002—raises the liability threshold so that only firms paying more than $250,000 per year in rent owe any tax. With this latest change reducing revenues by an estimated $25 million per year, the Adopted Budget assumed that collections would be $356 million in 2002, $11 million below 2001, and then grow to $389 million in 2003 and $406 million in 2005. (IBO's estimates in May 2001 were similar.)

Lower demand, lower revenues. The economic slowdown, with lower demand for office and retail space in Manhattan, will reduce CRT revenues somewhat in the next two years, although long-term leases, particularly for office space, should minimize the decline. IBO now projects that the 2002 decline in CRT revenues will be sharper than projected earlier with little rebound for 2003 and only modest growth through 2005. Revenues will be $340 million in 2002 and $344 million in 2003, growing only to $366 million by 2005. These forecasts are below those in the Adopted Budget by $16 million in 2002 and $45 million in 2003. With the slow growth in the later years of the forecast, 2005 collections remain $40 million below the Adopted Budget level.

TRANSFER TAXES

Background. The real property transfer tax (RPTT) is levied on the sale price of properties when they are sold. The mortgage recording tax (MRT) is levied on mortgages used to finance the purchase of real property, as well as many refinancing transactions. Financing for residential cooperative sales is exempt from the MRT. Because real estate markets tend to be highly sensitive to economic conditions, these two revenue sources—which have been quite volatile in the past—are again expected to react quickly to the local and national downturn.

Modest declines. IBO's updated 2002 forecast calls for RPTT revenues to total $410 million (down 13.3 percent from 2001) and MRT revenues of $293 million (a decline of 28 percent). The Adopted Budget projected sharp declines in transfer tax revenues in 2002, with RPTT forecast to fall by 11.1 percent and MRT down 14.1 percent. Because the city's estimates last spring were so conservative, the *additional* losses of transfer tax revenues for this year due to the recession are expected to be relatively modest.[5]

RPTT and MRT revenues began a slow decline in the third quarter of calendar 2001, before the World Trade Center disaster. The bulk of the additional drop will occur in the months directly following the attack. By the beginning of calendar year 2002, IBO expects revenues will begin to stabilize and then recover in the second half of the year. IBO's forecast of a fairly quick rebound of RPTT and MRT revenues assumes that real estate transactions, including mortgage refinancing, will increase in response to the continuing decline in interest rates.[6] By 2004, RPTT revenues will have recovered their 2001 levels, while MRT revenues will have nearly done so.

Differences Between IBO's Longer Downturn Forecast and Adopted Budget
(Dollars in Millions)

	2002	2003	2004	2005
Real property tax	($43)	($123)	($290)	($364)
Commercial rent tax	(16)	(45)	(29)	(40)
Real property transfer tax	(8)	(6)	66	77
Mortgage recording tax	(47)	(51)	20	57
Personal income tax	(256)	(509)	(564)	(700)
General corporation tax	(119)	(412)	(304)	(285)
Unincorporated business tax	(37)	(53)	(58)	(97)
Banking corporation tax	37	(31)	14	(28)
General sales tax	(162)	(274)	(198)	(204)
Hotel occupancy tax	(74)	(77)	(66)	(55)
Other taxes, audits, and PILOTs	(200)	(239)	(233)	(233)
Total differences	**($925)**	**($1,820)**	**($1,643)**	**($1,871)**
Percent shortfall	**-4.1%**	**-7.7%**	**-6.6%**	**-7.2%**
Memo: Difference between Shorter Downturn Forecast and Adopted Budget				
Total differences	($569)	($1,017)	($1,212)	($1,504)
Percent shortfall	-2.5%	-4.3%	-4.9%	-5.8%

SOURCE: IBO.
NOTE: Personal income tax receipts include revenues dedicated to the Transitional Finance Authority.

PERSONAL INCOME TAX

Background. The personal income tax (PIT) is levied on the incomes of city residents. A series of tax cuts in recent years have left PIT collections 25 percent less than what they would have been in the absence of the cuts. Even with the cuts, revenue grew by an average of 6.2 percent annually from 1998 to 2001, buoyed by a prolonged local economic expansion that continually surpassed expectations. In general, PIT collections are sensitive to local economic conditions, reflecting changes in the employment and incomes of city residents relatively quickly. In particular, Wall Street's bull market and the accompanying profitability of the securities industry have swelled PIT revenues in the last few years. This is because high-income city residents account for a large share of local income. Many of them work in the securities industry and have received large year-end bonuses and may also have realized substantial capital gains in recent years.

Revenues in the current year. Even before the events of September 11, slower economic growth spelled a decline in PIT collections from 2001 to 2002. Since then, the outlook has steadily worsened. IBO projects that PIT revenue will be $4.76 billion in 2002, 17.2 percent less than the $5.8 billion collected in 2001.[7] Our 2002 forecast is $256 million less than the projection in the Adopted Budget, and $554 million lower than what IBO had forecast in May, before the extent of the slowdown in the local economy had become evident.

The forecast for 2003 and beyond. The current downturn will shrink the city's employment and income tax base, as well as depress capital gains realizations, to an even greater degree in calendar year 2002 than in the current year, particularly if it persists for four quarters. As a result, the recession will continue to affect PIT revenues throughout the forecast period, lowering growth from 2002 to 2003 in particular. PIT revenue is projected to grow only 1.8 percent—to $4.85 billion in 2003. This estimate is $509 million less than the Adopted Budget projection and $675 million less than our May forecast. PIT growth is expected to pick up after 2003, although the revised revenue estimates are far below previous forecasts because the income base in the city will likely be lower than foreseen last spring. IBO estimates that PIT revenues will grow by 6.5 percent in 2004 to reach $5.2 billion and by 5.4 percent in 2005 to reach $5.4 billion—forecasts that on average are $632 million less than the Adopted Budget estimates.

Shorter downturn. Even if it turns out that the recession does not last beyond the current calendar year, the impact on PIT collections during the forecast period will still be substantial. Net PIT revenue would decline by an estimated 15.1 percent in 2002, to $4.9 billion—an amount that is $132 million less than the Adopted Budget target. In 2003, PIT collections would reach $5.1 billion under this alternative scenario—3.8 percent growth over 2002 yet still $285 million less than the Adopted Budget forecast. Growth after 2003 is expected to generate $5.4 billion and $5.7 billion in PIT revenues in 2004 and 2005, respectively.

BUSINESS INCOME TAXES

Background. New York City's business income taxes are highly sensitive to securities industry profits, both as a direct source of taxable income and as an indirect source of economic stimulus for related business sectors. Because of the plunge in share values that began earlier this year, securities industry profits were expected to drop sharply from the record $21.0 billion level of calendar year 2000 even before the September 11 attacks. The Securities Industry Association (SIA) now projects industry profits of $4.3 billion over the last two quarters of 2001 and $11.3 billion for the year as a whole.

General corporation tax falls hardest. If the national recession persists through the first two quarters of calendar year 2002, however, there will be further slippage in SIA profits, and city business income taxes will fall sharply in 2002 and 2003. The general corporation tax (GCT) will be hit hardest, with IBO forecasting a 22 percent drop in GCT collections between 2001 and 2002 followed by a further 19 percent drop in 2003. IBO's 2002 GCT forecast of $1.4 billion is $119 million (8.1 percent) below the very conservative forecast in the Adopted Budget, while our forecast for 2003, $1.1 billion, is $412 million (27.2 percent) below the Adopted Budget projection. While IBO expects both SIA profits and GCT growth to sharply rebound in 2004, collections are forecast to remain $304 million (18.4 percent) below the Adopted Budget level in 2004 and $285 million (16.3 percent) below in 2005.

Unincorporated business and banking tax. The unincorporated business tax (UBT) will not be immediately affected as severely by the attack and recession. Collections are expected to fall about 6.7 percent between 2001 and 2002. IBO's $765 million UBT forecast for 2002 is $37 million (4.6 percent) below the figure in Adopted Budget. And while the UBT is expected to resume growth in 2003 and maintain it through the next several years, that growth will be persistently weaker than forecast for the Adopted Budget last June. As a result, UBT collections are projected to lag the financial plan forecast by $53 million (6.2 percent) in 2003, $58 million (6.3 percent) in 2004, and $97 million (9.8 percent) in 2005.

As with the UBT, the banking corporation tax (BCT) is not expected to show a sharp immediate impact, with collections in 2002 projected to fall by only 6.6 percent from their 2001 level. IBO forecasts an additional 4.5 percent fall in BCT collections in 2003, followed by a sharp recovery in 2004. However, the bank tax is notoriously volatile, with collections in any given year depending much less on current economic activity and more on large settlements and late payments driven by prior years' activity than is the case with other taxes. It is thus not surprising to find IBO's forecast of BCT revenues to range sometimes above and sometimes below the projections in the Adopted Budget, which tend to smooth out the lumpiness in BCT collections.

If the recession ends more quickly than IBO now assumes in its forecasts, the successive declines in GCT revenues from 2001 levels would be much shallower in 2002 and 2003—only 14.6 percent and 6.7 percent, respectively. Our 2002 forecast in this scenario ($1.48 billion) would actually be no worse than that of the Adopted Budget, while our 2003 forecast would be $131 million (8.7 percent) below adoption. However, in 2004 and 2005, GCT growth would remain weak even in our short recession scenario, and by the latter year collections would be only $14 million higher than in our long recession scenario—and thus $271 million (15.5 percent) below adoption.

Shorter downturn. The short recession scenario would add about $40 million (5.0 percent) to UBT revenues in both 2002 and 2003, and have little effect on the forecast thereafter. BCT losses would also be trimmed.

GENERAL SALES TAX

Background. Sales tax collections growth had already been weakening in the months before the World Trade Center attack, as New York City began to feel the effects of the stock market declines and the nationwide slowdown in investment. The attack and its aftermath have further depressed taxable sales—both retail and business-related—in four ways: disrupting economic activity downtown, stifling tourism, exacerbating the national recession, and precipitating a plunge in consumer confidence.

Falling collections in 2002. Back in May, IBO forecast sales tax revenue growth of 3.8 percent in 2002, a slowdown from previous years after the impact of recently enacted sales tax cuts—particularly the phase-in of the clothing tax cut in 2000 and 2001—are factored in. Our forecast now calls for a 3.1 percent *fall* in sales tax collections in 2002. Revenues are expected to total $3.5 billion for the fiscal year. This is $162 million (4.4 percent) below the relatively conservative Adopted Budget forecast in June (and $326 million, or 8.4 percent, below what IBO forecast in May).

Resumed growth. IBO expects sales tax revenue growth to resume in 2003 and strengthen over the out-years of the financial plan. The projected 2.2 percent growth in 2003 is actually below the expected rate of inflation and lags the 5.0 percent growth projected both by IBO in May and by the Administration when the budget was adopted in June. As a result, the gap between IBO's current forecast and the pre-trade center attack projections grows even wider in 2003. Our current $3.6 billion forecast for 2003 is $274 million (7.0 percent) below what was included in the Adopted Budget and $443 million (10.9 percent) below what IBO projected in May.

For 2004 and beyond, IBO forecasts a return to roughly the same sales tax growth rates as were projected last spring. However, the growth will come off of 2003's smaller base, and the gaps between our earlier projections and our current projections for collections will only shrink slightly after 2003.

Shorter downturn. In the event of a swifter national recovery, the projected drop in sales tax revenues would be less marked in 2002, and the recovery would be stronger in 2003. However, the picture does not improve that much: collections would still fall 2.4 percent in 2002 and be $134 million below the Adopted Budget figure (and almost $300 million below IBO's May forecast) for the current fiscal year. In 2003, there would still be a nearly $200 million shortfall from the Adopted Budget and a $367 million drop-off relative to IBO's May forecast.

HOTEL OCCUPANCY TAX

Background. The hotel occupancy tax has been one of the city's fasting growing sources of tax revenues. Hotel tax receipts grew by an average of 15 percent annually from 1995 to 2001 and last year reached $243 million. This revenue growth was fueled by the nation's prolonged economic expansion and growth in other countries that generally invigorated travel, and by factors such as the well-publicized drop in New York City's crime rate and several tax cuts that made New York a relatively more attractive destination for tourists. The hotel occupancy tax is roughly proportional to room rent and is levied in addition to City and State general sales taxes.

Outlook for tourism and hotel tax revenue. In the spring, when the U.S. economy was slowing and business-related travel was beginning to decline, little growth in hotel tax collections over the next few years was forecasted. Now, with national economy in recession and the unsettling events of September 11 making many people apprehensive about travel, there has been a sharp decline in tourism nationwide. Tourism and business travel to New York have especially suffered, and local hotels are slashing room rates in an effort to attract visitors, which in turn is further depressing hotel tax receipts. Even if the recession is relatively short, the number of visitors to New York in calendar year 2002 is not expected to return to last year's levels because of travel fears and shaken consumer confidence.

IBO projects hotel tax revenues will equal $172 million in 2002 and $179 million in 2003—roughly one-fourth less than tax collections in the last two years and about $75 million less per year than Adopted Budget estimates. Economic growth and the tourism it generates are expected to result in substantial increases in hotel tax collections after 2003. However, these forecasts—$199 million in 2004 and $219 million in 2005—are below 2000 and 2001 receipts and on average are $61 million less than the Adopted Budget estimates.

Shorter downturn. In the case of a shorter recession hotel tax revenues would fall to estimated $185 million in 2002, with a rebound to $204 million in 2003 and even higher levels in later years. Even if this more optimistic scenario unfolds, however, hotel tax collections in each year of the forecast period would remain below revenue in 2001.

CONCLUSION

IBO's estimate of a current year tax revenue shortfall of $925 million—4.1 percent—presents a particular challenge due to the limited time and policy alternatives available to address it. The shortfall in 2003 will nearly double to $1.8 billion—or 7.7 percent of projected tax revenue. If the national downturn is shorter, the affect on the ciy budget would be less, although still significant: $569 million in 2002 and $1.0 billion in 2003.

For this year and next, the projected tax revenue gaps in a longer downturn would be comparable to those of of the early 1990s. IBO's projected 4.1 percent revenue shortfall for this year is nearly as large as the 4.9 percent gap from the Adopted Budget in 1990. Similarly, our estimated 7.7 percent shortfall in 2003 approaches the 1991 gap, which would have been rough;y 10.5 percent without the tax increases enacted subsequent to adopting that year's budget.

Over the longer term, the tax revenue gaps we are facing now do not appear to be as daunting as those encountered in the 1990s. Even in IBO's longer downturn scenario, the revenue shortfalls persist after 2003 but do not grow larger. IBO's projected shortfalls in 2004 and 2005 are 6.6 percent and 7.2 percent respectively. These are less than half the revenue shortfalls that the city would have confronted in 1992 and 1993 absent the post-1990 tax increases. But today's challenges are nonetheless very real and will take significant measures to address.

This report was prepared by George Sweeting, deputy director;
David Belkin and Michael Jacobs, senior economists; and Elizabeth Zeldin, budget and policy analyst.

END NOTES

[1] Throughout this report, the term "Adopted Budget" includes not only the revenue estimates in the Adopted Budget for fiscal year 2002 but also the city's revenue estimates for fiscal years 2003 through 2005 included in the financial plan that accompanied the budget.

[2] The Adopted Budget revenue forecast as presented in this report ignores an unspecified tax cut of $100 million budgeted for 2002 and $200 million for the remaining years that was included in the Adopted Budget. No legislation has been enacted to implement such a cut. The effects of other tax policy changes that were identified in the Adopted Budget and which have been enacted are reflected.

[3] The IBO forecasts from last spring presented in this report are those shown in our May 2001 report on the Executive Budget updated to take into account the tax policy actions included in the Adopted Budget.

[4] The Adopted Budget's conservative forecast for 2002 revenues might have obviated the need for such action in the current year.

[5] The projected declines in property transfer taxes for 2002 are not unprecedented. Between fiscal years 1990 and 1991, for example, RPTT revenues dropped 34 percent. Similarly, MRT revenues fell by 28 percent from 1989 to 1990.

[6] The larger decline in the MRT stems from a projected sharp fall off in transactions involving large commercial mortgages.

[7] These and other collection figures reported in this section are net of refunds and include PIT revenue dedicated to the Transitional Finance Authority.