IBO

New York City Independent Budget Office

Fiscal Outlook

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New York City's Fiscal Outlook Fiscal Years 2002-2005

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New York City's fiscal outlook has dimmed considerably since last spring. While IBO projects the current recession—which we expect to last four quarters and result in the loss of 92,500 jobs in calendar year 2002—will not be as protracted or as steep as the recession of the early 1990s, the city faces considerable fiscal challenges in the years ahead.

The current shortfall. Despite the cautious tax revenue estimates underlying the budget adopted in June, earlier this month the Mayor estimated the city faces a $1.3 billion budget gap this year. In response, the Administration has proposed a combination of spending cuts, increased fee and fine collections, and additional federal assistance to close the current year gap and provide a surplus of $375 million that can be used towards next year. IBO estimates that the surplus created by these changes will equal $540 million. But only about one-third of the actions in the Administration's plan to address this year's gap provide recurring savings or revenues to help address the significantly larger shortfalls the city faces in 2003 and beyond.

Budget gap for next year. IBO projects a $3.9 billion gap in the budget for 2003, the fiscal year that begins July 1. Over the past few years, prospective budget gaps have been largely remedied by transferring a surplus—which amounted to more than $3 billion at its peak—from one year to the next. With a relatively modest surplus projected for the current fiscal year, however, the gap for 2003 will be particularly difficult to close. IBO's 2003 gap forecast is $329 million more than the Administration's. This results from our lower forecast for tax revenues and our expectation that spending on education and labor contracts will be higher than the Administration projects.

Perspective on next year's gap. The projected $3.9 billion shortfall for 2003 (the first full year of Mayor-elect Bloomberg's Administration) is 14.6 percent of city funds, twice as large in percentage terms as the gap that Mayor Dinkins closed in 1991 (his first full year). This is largely due to the fact that a roughly $3 billion gap was projected for 2003 even *before* the current recession began. If, as expected, the city's economy recovers along with the nation's by mid-year, the longer term budget deficits Bloomberg will face—17.5 percent in 2004 and 18.4 percent in 2005—will not be as great as the ones that Dinkins confronted as the city's tax base continued to contract in the early 1990s.

IBO finished this report as the City Council was completing its negotiations with the Mayor on his proposed budget modification and may not reflect all the changes. As in all IBO publications, a given year refers to the city fiscal year unless otherwise noted.

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TAX REVENUES

The national recession that began last March and grew more severe following the attacks of September 11 has taken a toll on the city's tax revenues. IBO projects that tax revenues in 2002 will be $584 million (2.6 percent) lower than anticipated when the budget was adopted last June. The shortfall is expected to be larger in 2003—$1.1 billion (4.7 percent) below the adopted budget's projections. IBO's tax revenue forecast assumes—consistent with current law—that the tax rate for the personal income tax surcharge will revert to 14 percent at the end of this month. If the reduction in the surcharge remains, however, the tax revenue shortfalls from the adopted budget would reach $757 million and $1.5 billion for 2002 and 2003, respectively.

Economic Outlook. The national economy entered a recession in March of this year, and the local economy followed shortly after, with local employment peaking in May. In the aftermath of September 11, the national economy has fallen into a deeper recession and the city's economy has been set back sharply. IBO's economic forecast assumes that the national recession will last through next June, with growth resuming slowly in the second half of the calendar year and then accelerating in 2003 and 2004. IBO expects the city economy, measured by inflation-adjusted gross city product, to contract this calendar year by 0.8 percent and then by 5 percent next year. As a result, job growth will be very slight in 2001, followed by a loss of 92,500 in 2002. Wage and salary growth in the city will slow in 2001 to 5.2 percent, less than half the rate for 2000, and then turn negative, declining by 1.1 percent in 2002. Wall Street profits and bonuses are also expected to fall to less than half the record levels set in 2000.

New York City Economic Forecast
Calendar years

	2001	2002	2003	2004	2005
Real Gross City Product Growth (%)	(0.8)	(5.0)	4.9	2.9	2.9
Employment (thousands)	3,740.6	3,648.1	3,719.8	3,802.5	3,838.7
Employment Change (thousands)	20.3	-92.5	71.6	82.7	36.3
FIRE Sector Employment (thousands)	481.4	445.0	450.6	461.4	465.0
Business Services Employment (thousands)	347.5	333.9	348.2	361.7	368.4
Wage and Salary Growth (%)	5.2	(1.1)	4.7	6.3	4.7

SOURCE: IBO.

Tax Revenue Outlook. IBO projects that 2002 tax revenues will be $21.8 billion, $1.3 billion (5.7 percent) less than 2001. All but $112 million of this decline is attributable to the deteriorated economic climate. With economic growth resuming in mid-calendar year 2002, tax revenues will begin to rise in *fiscal* year 2003 and grow by 2.5 percent to $22.4 billion. The weak growth in 2003 will still leave tax revenues $776 million below their 2001 level. Stronger growth will resume in 2004 and 2005, raising total tax revenues in the latter year to $24.9 billion. The largest declines will occur in the city taxes that are most sensitive to the business cycle: the personal and business income taxes, those related to real property transactions, and the sales and hotel taxes.

Business income taxes. Collections from business income taxes (the general corporation, unincorporated, and banking corporation) are driven not only by local conditions—primarily Wall Street profits—but also by the strength of business profits in the national economy. With Wall Street profits well off 2000's all-time record and pessimistic profit expectations for many national firms, IBO expects the city's business income tax revenues to fall by $461 million (15.5 percent) in 2002. Revenues in 2003 are expected to decline a further $236 million (9.4 percent). Although strong growth resumes in 2004 and 2005, pushing business income tax revenues to $2.9 billion, collections still will be slightly below their 2001 level.

Personal income tax. Personal income tax (PIT) collections tend to closely track changes in employment and wages and salaries. Another critical determinant is Wall Street bonuses. The outlook for each of these indicators is negative. Combined with the impact of a small tax rate cut that took effect last July ($85 million), personal income tax revenues are expected to be $4.9 billion in 2002, a decline of $821 million (14.3 percent) from 2001. IBO projects PIT revenues will resume modest growth in 2003. Despite the growth, collections will be $557 million less than in 2001. Stronger growth in 2004 and 2005 will yield revenues of $5.6 billion in the latter year.

Sales and hotel taxes. Sales tax revenues depend on spending by local residents and businesses, as well as by tourists. IBO projects a very modest decline for the sales tax, with revenues falling to $3.6 billion in 2002, a decline of only $23 million (0.6 percent) from 2001. Revenues are expected to grow by 3 percent in 2003 to $3.7 billion. Despite the economic downturn, local consumer spending has remained relatively strong. Growth will continue through 2005, when revenues are projected to reach $4.1 billion. The hotel occupancy tax is particularly dependent on spending by business travelers and tourists. Both groups have cut back sharply, resulting in lower occupancy rates and discounted room rates. As a result, hotel tax revenues in 2002 will fall by $73 million (30.1 percent) to $169 million. Revenues will slowly resume growing and reach $219 million by 2005, although this is still 10 percent below the 2001 level.

Property transfer taxes. The property transfer taxes (mortgage recording tax and real property transfer tax) depend on the strength of local property markets and less directly on mortgage rates. Prices for both residential and commercial properties have begun to fall and are expected to continue falling in the coming months. Low mortgage rates will partially offset the downward pressure on prices. Revenues from these two taxes will total $697 million in 2002, a decline of $183 million (20.8 percent) from the previous year. With property markets responding quickly to resumed economic growth and the expected continuation of low mortgage rates, these taxes will rapidly grow by 9 percent in 2003 to $760 million and reach nearly $1.1 billion by 2005.

Real property tax. The property tax is expected to bring in $8.4 billion (38.6 percent of all tax revenues) this year, an increase of 3.3 percent over 2001. The structure of the city's property tax produces a delayed response to changes in underlying property market values. As a result, property tax revenue growth is expected to continue at an average annual rate of 3.8 percent through 2005, when revenues will reach $9.4 billion.

Comparison with Mayor's Financial Plan. In the revised financial plan, the Mayor's Office of Management and Budget (OMB) updated its revenue forecast and adjusted its projections to reflect deteriorating economic conditions. With the revisions, OMB's projection of tax revenues are somewhat lower than IBO's for each year of the plan, with the greatest difference in 2002 ($445 million). As a result, OMB is forecasting greater shortfalls from the adopted budget's revenue estimates ($1.0 billion in 2002 and $1.4 billion in 2003). These differences are due to differing economic assumptions (OMB is forecasting a more severe local downturn in calendar year 2002 than IBO, and a slower recovery in 2003 and beyond) and differing assumptions about the PIT surcharge rate cut.

PIT surcharge cut. IBO has assumed that the City Council will not extend the cut, while OMB assumed that it will. This results in IBO projecting more revenue and a smaller shortfall from the adopted budget than OMB. Therefore, IBO assumes that next January 1 the city will begin collecting additional PIT revenues totaling $173 million in 2002 and $347 million in 2003.

EXPENDITURES

IBO projects city spending of $41.9 billion in 2002, including $27.3 billion in city funds. Due in part to lower revenues and the city's emergency spending that resulted from September 11, expenditures will rise just 0.4 percent from 2002 to 2003 (adjusted for prepayments). Although the Mayor proposed a gap-closing program of $1.3 billion for 2002, roughly two-thirds of the savings do not recur in 2003 and beyond, leaving large gaps to still be addressed.

Closing the Gap This Year and Next. Many of the actions the city anticipates taking to close the gap in 2002 will not result in ongoing savings in future years. The Mayor's revised financial plan showed the city facing a budget gap of $1.3 billion for this year, rising to $4.3 billion in 2003. The Mayor proposed eliminating the gap in the current year through a combination of agency spending cuts and savings, federal aid, and miscellaneous revenue enhancements. Many of the proposed changes for 2002 would not provide recurring savings or revenues. Because of this, IBO estimates a gap of $3.9 billion remains for next year.

The financial plan proposes spending cuts and savings totaling $766 million in 2002, $641 million in 2003, and $384 million in 2004. An early retirement and severance program—still in negotiation with city unions—would save the city $50 million in 2002 and $100 million annually thereafter. Other savings include lower-than-budgeted staffing as the result of a hiring freeze ordered by the Mayor in October and the elimination of many City Council initiatives as well as several new programs proposed by the Administration.

One-time measures. The city is also relying on several one-time measures to help close the budget gap in 2002 and 2003. Most notably, the city anticipates receiving $399 million in unrestricted aid from the Federal Emergency Management Agency (FEMA) for the current year on the basis of spending needs arising from September 11. The city also would receive smaller amounts of federal aid in 2003 and 2004: $39 million and $27 million, respectively. The funds would help pay both payroll costs and replacement of lost or damaged capital equipment. If the city does not receive the full amount from FEMA, it will instead use the proceeds of $1 billion in short-term notes issued in October under special authority granted by the state, which allows the city to borrow for disaster-related costs through the Transitional Finance Authority.

The city is also anticipating the acceleration (or "spin-up") of a $73 million payment from the state general revenue-sharing program this year. This would move the semi-annual payment up from next March to this month. This has no effect in future years since all successive payments would move up one period.

Additionally, to help close the gap in 2003 the Administration is counting on a one-time loan of $250 million from the debt service reserve fund of the Municipal Assistance Corporation (MAC). The city will seek to obtain a surety bond guaranteeing repayment of the loan, which would begin after 2005.

Miscellaneous revenues. The city also plans to increase certain miscellaneous revenues. Components include private sponsorship of city parks, increased cable franchise revenues, and payment of parking fines by foreign diplomatic missions. The value of recurring revenue initiatives is $12.8 million in 2003, rising to $14.6 million in 2005.

Debt and Debt Service Rising. Debt service—principal and interest payments on the city's outstanding long-term debt—would grow at an average annual rate of 7.2 percent (adjusted for prepayments), rising to $4.8 billion in 2005, or nearly 20 cents on each tax dollar the city collects. The city plans to generate savings of $156 million in 2002 and similar amounts in 2003 and 2004 from refinancing part of its outstanding debt and from delays in some projects—including the New York Stock Exchange. Savings would fall to $108 million in 2005.

Total Revenue and Expenditures
Dollars in millions

	2002	2003	2004	2005	Average Change
Revenues	**$41,911**	**$39,930**	**$41,188**	**$42,395**	**0.4%**
City-funded revenues	*27,334*	*26,810*	*27,952*	*28,901*	*1.9%*
Expenditures					
Before prepayments	$44,315	$44,378	$46,072	$47,717	2.5%
City-funded expenditures	*29,738*	*31,258*	*32,836*	*34,223*	*4.8%*
2001 prepayment	(2,944)	0	0	0	
2002 prepayment	540	(540)	0	0	
Subtotal	(2,404)	(540)	0	0	
Total expenditures	**$41,911**	**$43,838**	**$46,072**	**$47,717**	**4.4%**
City-funded expenditures	*27,334*	*30,718*	*32,836*	*34,223*	*7.8%*
Gap	**$0**	**($3,908)**	**($4,884)**	**($5,322)**	

SOURCE: IBO.

NOTES: Year 2002 includes the $375 million surplus estimated by the Mayor and an additional $165 million estimated by IBO, for a total 2002 surplus of $540 million.
The $540 million is used to prepay 2003 expenditures, leaving 2002 with a balanced budget.
City funded revenues and expenditures exclude State and Federal Categorical Grants.
Excludes intra-city revenues and expenditures.

Scaling back the capital plan, resulting in lower debt service costs in future years, may be one source of expense budget savings to which the city will look. Any cuts are likely to fall on parts of the plan viewed as "discretionary": they are not required by law or court order, or considered necessary to protect the health and safety, or financed by another source (such as the water and sewer system debt, backed by user charges). Savings from cutting the capital program are not immediate, since the first principal payment typically comes 18 months after the bonds are sold.

Funding for Labor Settlements. The city's labor reserve does not include funds for wage increases beginning in 2003, when most city workers' contracts will expire. If all city employees were to negotiate settlements with wage increases equal to the projected rate of inflation beginning in 2003, city-funded labor costs would increase by an additional $22 million in 2002, $146 million in 2003, $537 million in 2004, and $967 million in 2005. Our projections assume that both the Patrolmen's Benevolent Association and the United Federation of Teachers will settle for wage increases through 2002 in line with the Uniformed Forces Coalition settlement.

Other Expenditure Re-estimates. IBO estimates that the Board of Education (BOE) will spend $12.0 billion in 2002, rising to $13.2 billion in 2005, a 3.2 percent rate of annual growth. The projected growth is primarily attributable to rising labor costs and anticipated increases in federal aid. IBO assumes that the city will return to BOE all the education funds currently held in escrow: $80 million in 2002 and $98 million in 2003 and beyond.

Public assistance and Medicaid. IBO's public assistance caseload projections vary significantly from those in the revised financial plan, although the differences have only a modest impact on city spending. The economic downturn will result in rising caseloads, with the number of individuals receiving either Family or Safety Net Assistance growing from its low point of 464,000 in September 2001 to 530,000 in September 2002. Caseload decreases then will resume as economic recovery results in job growth. Last summer's larger than expected caseload decreases will result in enough savings to cover the added grant costs for the remainder of 2002. For 2003, grant costs will exceed the Mayor's financial plan by $40 million in city funds.

For Medicaid, higher growth rates, especially for pharmacy costs, will result in the need for $29 million in additional city funds in 2003. This projection assumes that the city will succeed in its efforts to have the federal government to cover a higher proportion of its Medicaid costs. If this effort fails, the shortfall in city funds in 2003 would increase to $95 million.

New Borrowing Options. Immediately following September 11, the state authorized additional city borrowing through the Transitional Finance Authority (TFA) to meet disaster-related spending needs. Recognizing that there could be considerable lags between city spending needs and FEMA reimbursements, the state allowed the city to borrow an unlimited amount in short-term (one year) notes. Although normally the city is barred from having short-term debt outstanding at the end of a fiscal year, the legislation permits this. While the city also can convert up to $2.5 billion of this short-term borrowing into long-term TFA debt, it would increase the city's debt service costs.