



City's Fiscal Picture Continues To Brighten

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LAST MAY, MAYOR MICHAEL BLOOMBERG PRESENTED his budget for fiscal year 2007 with the warning: "This year's budget is strong and stable, but long-term financial problems persist and the out-year budget gaps loom large." He projected a shortfall of \$3.6 billion for fiscal year 2008, which begins this coming July. When the budget for the current year was adopted about six weeks later, the projected 2008 gap had grown to \$3.8 billion.

But the Mayor's warnings appear premature. Just five months after this year's budget was adopted the Bloomberg Administration presented a new four-year Financial Plan that showed the 2008 budget shortfall had all but washed away in a rain of better-than-expected tax revenues. This tax revenue took most forecasters, including IBO, by surprise. As a result, the Mayor increased his tax revenue projection for this year by \$2.2 billion and \$1.9 billion for next year. This is reminiscent of last year's budget cycle, when shortly after the 2006 budget was adopted the Bloomberg Administration increased its revenue forecast by \$2.0 billion for 2006—a year that ultimately resulted in a record surplus—and \$1.4 billion for the following year.

Based largely on IBO's latest tax revenue estimates, the city's short-term fiscal picture appears even brighter than the Mayor's most recent projection. We expect tax revenue to be more than \$250 million higher than projected by the Mayor's office in November for the current year and more than \$1 billion annually above their estimates for 2008-2010—even though we project tax revenue will grow more slowly than it has in the recent past.

When these tax estimates are coupled with our expenditure projections, which are a bit higher than the Mayor's, we anticipate a surplus of \$2.1 billion this year. Assuming this surplus is used to remedy next year's shortfall (projected by the Mayor to be \$510 million), we expect 2008 to end with a surplus of \$688 million. If this surplus is used to prepay some expenses for the following year, IBO's projected shortfall for 2009 drops to \$2.2 billion—nearly \$2 billion less than the Bloomberg Administration's estimate. IBO's estimate of the 2010 shortfall is nearly \$1 billion less than the Mayor's as well.

It would be easy to assume that the 2009 budget gap will be washed away, much as the 2008 gap has, in another wave of rising tax revenue estimates. But IBO's projection of a relatively modest U.S. economic slowdown, coupled with a protracted period of slow local growth, means that it is less likely a surplus will materialize to effortlessly eliminate the shortfall. Without a prior-year surplus to cover the shortfall the Mayor and City Council would face the prospect of tax increases and/or spending reductions to close the gap.

Tax Revenue Update and Outlook. The continued strength of the local economy has brightened IBO's outlook for tax revenues by \$2.5 billion (7.0 percent) in the current year and

Total Revenue and Expenditure Projections

Dollars in millions

	2007	2008	2009	2010	Average Change
Revenues	\$56,693	\$57,653	\$58,565	\$60,160	2.0%
<i>City-funded Revenues</i>					
Taxes	34,633	35,859	37,153	38,551	3.6%
Tax Reduction Program	-	(305)	(309)	(314)	
Other Revenues	6,663	6,768	6,316	6,390	-1.4%
Expenditures	\$56,693	\$56,965	\$61,423	\$62,818	3.5%
<i>City-funded Expenditures</i>	41,296	41,634	46,018	47,285	4.6%
IBO Surplus / (Gap) Projection	\$ -	\$688	\$(2,858)	\$(2,658)	n/a

SOURCE: IBO.

NOTES: IBO projects a surplus of \$2.1 billion for 2007, \$184 million above the Bloomberg Administration's forecast. The surplus is used to prepay some 2008 expenditures, leaving 2007 with a balanced budget. The tax reduction program includes proposals to extend the \$400 property tax rebate and a child care credit. Estimates exclude intra-city revenues and expenditures.

by \$2.8 billion (8.5 percent) for 2008, compared to forecasts made when this year's budget was adopted last June. IBO's current forecast for baseline tax revenues (not including proposed tax reductions) is \$34.6 billion in 2007 and \$35.9 billion in 2008. These estimates exceed the most recent forecast by the Mayor's Office of Management and Budget for 2007 and 2008 by \$250 million (0.7 percent), and \$1,073 million (3.1 percent), respectively.

The upward revisions are due primarily to the continued strength of the city's real estate market and the profitability of businesses, both in the city's local securities and finance industry, and of firms in the broader national economy. Contrary to expectations that the city's real estate market would begin to cool over the summer, residential sales prices and volume have fallen only modestly. Since the spring, sales in the more volatile commercial sector, which includes rental apartment buildings, have been particularly strong, compensating for some of the relative weakness on the residential side. The effect of this unexpected strength is reflected in the city's property transfer taxes and to a lesser extent in the real property tax itself.

Profits of New York firms in the securities industry are expected to total over \$16 billion for calendar year 2006, a gain of \$7 billion over 2005, while U.S. corporate profits have been growing at double-digit rates for the past five years. Higher profits translate directly into business income tax revenues but they also contribute to personal income tax revenue through bonus payments to Wall Street employees and higher capital gains realizations as profits push up stock values.

More Tax Revenue, But Slower Growth. Even with the upward revisions in the outlook, IBO expects tax revenue growth in fiscal years 2007 through 2010 to be much slower than in recent

years, averaging 3.4 percent annually. By contrast, baseline growth in the four years after 2002—when the city's tax revenue plummeted in the wake of the 9/11 attack and a short-lived economic recession—averaged 10.2 percent annually, after removing the impact of the tax increases enacted in 2003.

The expected slowdown in tax revenue is due in part to IBO's forecast that growth in the local economy will slow sharply in the second half of calendar year 2007, with growth not expected to pick up until after 2008. Real growth in personal income, which is

expected to equal 5.6 percent for 2006, is forecast to slow to only 3.5 percent for 2007 and 1.7 percent for 2008. Growth in aggregate real wages and salaries, which was 4.9 percent in 2006, is projected to fall to 2.0 percent in 2007 and then 1.1 percent in the following year. Adjusted for inflation, wage gains averaged 3.2 percent in 2006, but are projected to be essentially flat in both 2007 and 2008. Employment, which grew by an estimated 57,000 in 2006, is expected to still be strong in 2007 when—fueled by gains in the construction and information industries—the city is forecast to add 62,800 jobs (1.7 percent). Employment growth will then slow to 30,200 jobs (0.8 percent) in 2008.

Transfer Taxes. The property transfer taxes, which have grown to unprecedented levels in recent years, have continued to confound forecasters, with revenues dropping far less than expected when this year's budget was adopted. Rather than declining by over one-third, as anticipated six months ago, IBO now expects that combined real property transfer tax (RPTT) and mortgage recording tax (MRT) revenues for 2007 will only be about 3 percent below last year's record. Instead, our current forecast for the two taxes this year is \$823 million (47.2 percent) above the amount projected when the budget was adopted last June.

The surprising strength in RPTT collections this year is due in part to some very large commercial transactions such as the recent purchase of the Stuyvesant Town development (purchases of rental apartment buildings are considered commercial deals for RPTT purposes). IBO projects that RPTT revenue for 2007 will be at or near the record level of 2006.

In the past year, RPTT revenue from commercial transactions has more than offset decreases in revenue from residential transactions. The decline in RPTT revenue projected by IBO

in 2008 is attributable to an outlook of fewer large commercial transactions, while residential RPTT revenue is expected to remain relatively stable at its 2007 level.

MRT revenue will weaken slightly in 2007, as mortgage refinancing activity declines in response to higher interest rates. The Mortgage Brokers Association projects that nationally, refinancing will represent just over 40 percent of the value of mortgage originations in 2007, compared with refinancing shares of well over half from 2001 through 2004.

The decline in transfer tax revenues that IBO had forecast to occur in 2007 is now expected to show up in 2008 as the heated local real estate market finally cools off, although the eventual fall-off in transfer tax revenues is now projected to be significantly smaller than had been anticipated earlier. For 2008, IBO projects that RPTT revenue will decline by 16 percent and MRT revenue is expected to fall by 21 percent from their 2007 levels and then remain relatively constant from 2008 through 2010.

Business Taxes. Net revenues from the city's three business income taxes—the general corporation tax, the unincorporated business tax, and the banking corporation tax—are expected to reach \$4.9 billion (exclusive of audits) in 2007. This is more than double the amount collected four years ago (\$2.3 billion in 2003).

The recent and current robust city business tax revenue growth reflects strong profitability both nationwide and in the city, especially on Wall Street. Following the 2001 recession U.S. corporate profits have been growing at an annual double-digit rate for five years, more than doubling in that period. After-tax profits have grown even faster, surging from \$504 billion in calendar year 2001 to an expected \$1.3 trillion in 2006.

IBO projects that net revenues for the current fiscal year will be \$518 million (11.9 percent) higher than in 2006. This forecast is also \$720 million (17.4 percent) higher than in the budget adopted last June. In just the first three months of collections credited to this fiscal year (September through November), business tax revenues are already \$286 million (32.5 percent) higher than the same period last year.

Our forecast anticipates sharply slower business tax revenue growth over the rest of the Financial Plan: 1.6 percent in 2008, 1.3 percent in 2009, and 5.0 percent in 2010. Moreover, IBO expects that profits of New York Stock Exchange firms will dip in 2007 and remain below their 2006 level through 2010.

Real Property Tax. The forecast for property tax revenue for the

current year is little changed since last June, and the outlook for revenue growth from 2007 through 2010 remains quite strong, averaging 7.2 percent annually. IBO's forecast anticipates that the continued strength of the local real estate market, including new construction, will produce growth in aggregate market value of 7.2 percent annually. This growth, combined with the pipeline of assessment increases for commercial properties and apartment buildings from prior years that are still being phased in as required by state law, will result in billable assessed value (the amount on which tax bills are based) of \$124.3 billion for 2008, an increase of 8 percent over 2007.

The pipeline of prior assessments will shrink a bit after 2008. With a smaller pipeline and the constraints on assessment growth for one-, two-, and three-family houses, growth in billable assessed value is expected to slow somewhat to 6.2 percent in 2009 and 6.1 percent in 2010.

Personal Income Tax. After growing by 31.7 percent from 2004 to 2006, even as the temporary increases in tax rates were being phased out, the outlook for net personal income tax (PIT) revenue is for much slower growth in 2007 and beyond. IBO's current forecast is for essentially no growth from 2006 to 2007 with an increase of 4.7 percent (\$340 million) in 2008. This forecast is \$92 million higher than Mayor's latest projection for 2007 and \$325 million higher for 2008. These projections are also substantially above the levels IBO forecast when the current budget was adopted last June.

In spite of strong personal income growth in calendar year 2006, an estimated 17 percent growth in securities industry bonus compensation and new records being set in many financial markets, the \$7.3 billion in PIT revenue forecast for the current year is \$9 million (0.12 percent) less than in 2006. There are several factors driving this forecast. In 2007, the amount of revenue generated by the 2003-2005 rate increases is negligible and \$386 million less than in 2006, constraining the growth of withholding receipts (by far the largest PIT component) to a projected 6.1 percent. Another factor affecting 2007 revenue is the near doubling of the per filer STaR credit, which is expected to reduce PIT revenue by \$200 million, mostly through a decrease in final returns payments and an increase in refunds. Additionally, IBO projects that last April's extraordinary surge in estimated payments by filers asking for extensions will not be repeated this year; as a result, we project a \$146 million (7.5 percent) decline in this PIT component for 2007.

With no changes in tax policy scheduled for next year, IBO expects PIT collections to resume growing in 2008, to \$7.6 billion. Slower employment and income growth beginning in

second half of calendar year 2007 is forecast, moderating PIT growth in 2008 and beyond. PIT revenue is expected to reach only \$7.7 billion by 2010.

Spending Projections. Continuing the pattern of the past few years, spending projections for city services over the Financial Plan period are relatively flat. There are neither significant program expansions nor cuts. For example, from 2007 through 2010 IBO expects police department expenditures to grow at an average rate of just 0.1 percent annually (excluding funds for debt service, pensions, future labor settlements, and other costs budgeted on a citywide basis). Sanitation department expenditures are expected to be essentially the same from 2007 through 2010, while spending by the Administration for Children's Services is expected to decline by an annual average of 0.3 percent over the same period.

Despite the continued flatness in program spending, IBO projects total city spending to rise from \$56.7 billion in 2007 to \$62.8 billion in 2010—an average increase of 3.5 percent a year. Much as in past years, this growth is driven by a few discrete areas of the budget.

Debt Service. Debt service for capital expenditures is the fastest rising major cost over the 2007-2010 period. After adjusting for the use of budget surplus in 2007 to prepay some of this cost, IBO expects debt service to grow at an average annual rate of 8.2 percent. Debt service is now projected to cost just over \$6 billion by 2010, although the Bloomberg Administration is considering the delay or cancellation of some capital projects that would result in lower annual debt service spending.

Pensions. The cost of providing pension contributions for city workers also continues to climb faster than most other city spending. Pension costs are expected to rise from \$4.7 billion in 2007 to \$5.8 billion in 2010, an annual average increase of 7.2 percent. Although pension costs are now expected to level off after 2009, this could change based on recommendations from the independent, biennial actuarial audits presented to the city's Chief Actuary. Depending upon which (if any) of the recommendations are adopted, the amount of the city's annual pension contribution could rise.

Health and Other Fringe Benefits. The costs of health insurance and other benefits for city workers are also expected to continue to rise at a fast pace. Driven primarily by the rising cost of health insurance, fringe benefit spending (excluding education department employees) is expected to rise from \$3.5 billion in 2007 to \$4.2 billion in 2010, an average increase of 6.7 percent a year. In addition, the education department budget includes

\$2.4 billion in 2007 for health and other fringe benefits and \$2.5 billion in 2008.

Judgments and Claims. Though not nearly as high in terms of actual dollars, the cost of settling lawsuits against the city is also one of the fastest growing expenses. Spending to settle these suits is expected to increase from \$602 million in 2007 to \$748 million in 2010, an average increase of 7.5 percent a year.

Labor and Medicaid. While not growing as fast in percentage terms as these other portions of the budget, the sheer size of the increases in labor and Medicaid costs makes them important. In anticipation of extending the cost of last July's pact with District Council 37 to all city employees, the Bloomberg Administration has added \$256 million to the labor reserve fund for 2007, an amount that grows to \$930 million in 2010.

A few years ago Medicaid was also one of the city's fastest growing expenses. This is no longer the case because the state enacted a cap that now limits annual growth in the city's share of Medicaid costs to about 3 percent. But Medicaid still represents a substantial cost for the city and is expected to increase from roughly \$4.9 billion in 2007 to \$5.4 billion in 2010.

Mind the Gap. The out-year gaps we are projecting now are smaller in dollar terms and as a share of city-generated tax and other revenues than the gaps of a few years ago. This has occurred in part because the Mayor and City Council raised the property tax rate in 2003 and have continued to limit the growth in spending in many areas of the budget.

But the city's budget balance has also been aided by a string of remarkably good years for the local economy that resulted in surprisingly strong tax collections. The surplus revenue has been used to prepay expenditures in upcoming years—a practice that masks the underlying shortfalls. If IBO's forecast of an economic slowdown proves correct, there may not be a surplus available to bridge even the more modest out-year gaps we currently project. Absent a surplus, the Mayor and Council would face difficult choices on tax increases and spending reductions in order to bring the 2009 and 2010 budgets into balance.

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