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New York City Independent Budget Office

Fiscal Outlook

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Despite Property Tax Increase Large 2004 Budget Gap Remains

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Additional Gap and Revenue and Expenditure Tables

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SUMMARY

Despite recently enacting an 18.5 percent increase in the city's property tax rate and more than $800 million in spending cuts, bond refinancings, and fee increases, New York City still faces a formidable budget gap in 2004. IBO estimates that after the November 25 changes to the current budget, a $2.3 billion shortfall remains for 2004.

Property tax increase falls short of plan. The new Financial Plan presented by the Mayor on November 14 assumed a 25 percent property tax rate increase. The increase enacted was 18.5 percent, however, which will generate $296 million less than expected from the rate increase in 2003 and $608 million less in 2004. The lower property tax revenues leave a $904 million shortfall in the Mayor's plan (a revised Financial Plan will be issued in January).

Significant uncertainties remain. The November plan for 2004 rests on $2.2 billion in actions that will require considerable cooperation from labor and the state and federal governments. The $1.1 billion proposal to reduce personal income tax rates while extending the tax base to include income earned here by non-residents faces a reluctant state Legislature. The Mayor had linked this plan to easing the blow of the steep property tax increase.

The Mayor also is asking the municipal labor unions for $600 million in productivity "givebacks"—before he will negotiate any raises for city workers, which he says must be self-funded through more productivity gains. The plan contains no funding for pay increases for city workers. In addition, the Mayor proposed federal and state government actions that would save the city $200 million from each. Many of the items—particularly those that would cost money—are not likely to occur. The Mayor also anticipates a total of $200 million from new East River Bridge tolls and a Metropolitan Transportation Authority takeover of the private bus routes now subsidized by the city.

Tax revenues grow. IBO's relatively large gap estimate for 2004 comes despite a more optimistic outlook for tax revenues than forecast by the Bloomberg Administration. IBO projects $1.2 billion more in tax revenues next year than the city anticipates. Our forecast is higher for almost every tax source, but in particular from the personal income and general sales taxes.

Higher spending projected. In contrast, IBO's estimate of 2004 spending contributes to the gap. IBO projects $289 million in higher spending than the city currently anticipates, driven primarily by spending in the education department as well as higher Medicaid and police and fire department overtime costs.

INTRODUCTION

IBO projects city spending will total $44.3 billion in 2003, including $30.6 billion in city funds. Expenditures are projected to rise 6.4 percent from 2003 to 2004, to $47.2 billion, including $33.0 billion in city funds. City-funded spending will rise 7.8 percent. With the just-enacted property tax increase, IBO estimates that tax revenues will total $23.5 billion in 2003, an increase of 9.0 percent over the depressed 2002 level. Tax revenues will grow again in 2004 by another 10.5 percent to $26.0 billion.

CLOSING THE GAP

The Mayor's November Financial Plan anticipated a gap of $6.4 billion in 2004—24 percent of city funds. The Mayor's plan for closing the gap has five broad components: tax increases; using the 2003 surplus to prepay some 2004 costs; spending reductions and other savings; labor productivity gains; and state, federal, and other new initiatives.

IBO's Revenue and Expenditure Estimates

Dollars in millions

	2003	2004	2005	2006	Average Change
Revenues	$ 44,298	$ 44,811	$ 45,476	$ 46,777	1.8%
Expenditures	44,298	47,150	48,633	50,450	4.4%
IBO Projected Gap	**$ -**	**$ (2,339)**	**$ (3,157)**	**$ (3,673)**	

SOURCE: IBO.
NOTES: IBO estimates exclude intra-city revenues and expenditures. IBO's gap estimates assume that a number of actions we describe in the text as "uncertain" will not occur.

The November plan's initial outline of the 2004 gap-closing program relied heavily on tax increases—53 percent of the total, or $3.3 billion. The plan would have increased real property taxes by 25 percent and raised $2.3 billion. It also proposed changes in the personal income tax that would generate $1.1 billion.

The personal income tax reform requires state legislation and at present appears to have little political support outside the city. The City Council balked at the 25 percent property tax rate increase, but eventually the Mayor and Council agreed to an 18.5 percent increase. The smaller increase, however, opened up a $900 million hole in the Mayor's plan for 2004 through a combination of lower property taxes and a smaller than expected surplus for 2003. The property tax increase in 2003 will generate an estimated $500 million surplus that will be used to prepay some 2004 expenditures.

Baseline tax revenues. IBO released its tax revenue outlook last month and, with the exception of a change to the property tax forecast to account for the rate increase, our forecast is essentially unchanged.

Much of the overall baseline revenue growth in 2003 and 2004 comes from the personal income tax, which is expected to resume growing after plunging by 22 percent in 2002. Although IBO forecasts personal income tax revenue growth of 6.2 percent for 2003 and 12.4 percent for 2004, revenues will remain below their 2001 peak until 2005. Recovery of the business income taxes begins in 2004 and together with the personal income tax account for much of the additional growth in the latter years of the Financial Plan. Even with this growth, however, business tax revenues in 2006 are forecast to be below their 2001 levels. Adjusted for the rate increase, property as well as sales tax revenues grow slowly over the next four years.

IBO's tax revenue forecast is considerably less pessimistic than the Mayor's, particularly for 2004, when our forecast exceeds the Office of Management and Budget's (OMB) by $1.1 billion. Both IBO and OMB assume that the U.S. economy avoids falling back into recession (a "double dip") although national economic growth is expected to be somewhat anemic through the end of calendar year 2003.

There are greater differences in IBO's and OMB's outlook for the *local* economy, particularly for the second half of calendar year 2003 and through 2004. IBO expects local job growth to resume by late 2003, with employment growing by 24,000 jobs in 2003 and by 71,000 in 2004 (although high-paying securities industry jobs are expected to continue to decline through 2003 and remain flat in 2004). In contrast, OMB expects job losses to continue through most of 2003 with a decline for the year of 13,000 jobs and then expects a smaller recovery of 54,000 jobs for 2004. Significant differences also are apparent in the outlook for profits in the securities industry. The city expects lower profits and slower growth for each calendar year through 2006. IBO's higher forecasts for employment and profits result in higher tax revenue forecasts.

Mayor's tax proposals. The November plan included two major tax policy proposals: the first property tax rate increase since 1993 and reform of the personal income tax. The new property tax rates take effect on January 1, 2003 for the second half of this fiscal year. IBO forecasts that the higher rates will bring the city $865 million this year, $1.8 billion for 2004, and $2.1 billion by 2006.

The accompanying personal income tax proposal would make the city's tax treatment of earnings by non-residents conform to that of most states, including New York State, Connecticut, and New Jersey. The proposal is not just a re-instatement of the commuter tax—really a flat earnings tax—that was repealed in 1998. Under the Mayor's proposal non-residents would be subject to the city's personal income tax on the portion of their income earned in New York City.

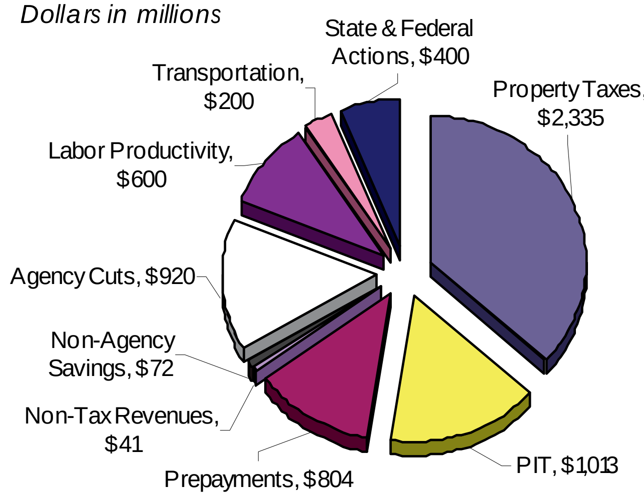
With the income of an estimated 815,000 non-residents added to the city's tax base, income tax rates could be cut while still generating new revenue for the city, at least initially. The Mayor proposes a 25 percent reduction in the city's income tax rates beginning July 1, 2003, with the reductions eventually growing to 40 percent in calendar year 2006. IBO estimates that the proposal would yield $830 million in new revenue for fiscal year 2004. Non-residents would pay $2.2 billion in new revenue, while city residents save $1.3 billion from the 25 percent rate cut. With the steeper reduction in rates, the amount of additional revenue declines in later years, leaving the city with a loss of $232 million by 2006. In that year, non-residents would pay $2.1 billion, while city residents save $2.3 billion.

Because the rate reductions would be across the board, the proposal does not change the distribution of income tax liability for city residents, although higher income taxpayers who currently pay the bulk of the tax would also get the bulk of the tax savings. However, the combination of the property tax increase and the income tax reductions for city residents would shift the combined burden of the two taxes from higher income households towards those with lower incomes. Many households with incomes under $40,000 would have a net increase in their tax burden. Their property tax increase—paid either directly as homeowners or indirectly as a portion of their rent—would exceed the size of their income tax reductions. But most households with incomes above $200,000 would see net savings because their income tax cut would be larger than their property tax rise.

Spending cuts and savings. The Mayor's plan for 2004 also relied on $1.1 billion in savings and cuts in city spending, as well as some small increases in fees and other revenues. The $920 million program to cut agency spending includes the elimination or reduction of programs and services, attrition, re-estimates of spending needs, and the substitution of non-city sources of funds for city money.

Mayor's 2004 Gap-Closing Program

Dollars in millions



$6.4 billion total

SOURCES: IBO; November Financial Plan.

IBO's analysis of the agency gap-closing program found that $388 million—over 40 percent of the total—would result from cutbacks to or elimination of city programs and services. These include such steps as $73.7 million in savings from reducing the police force by 1,900 officers; $90.7 million from the education department through elimination of the summer camp program and reductions to the summer school and teacher mentoring programs as well as cutting funding to the school districts; $37.6 million from reducing subsidies to the three library systems and to cultural programs and institutions; and $14.9 million through eliminating 2,500 child care slots and reducing foster care payments.

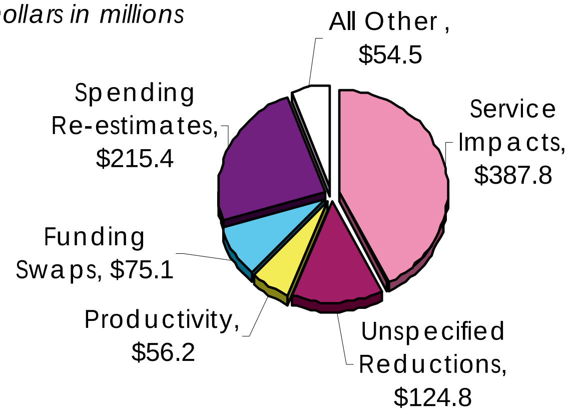
Another $125 million in savings comes from the expected reduction of almost 8,000 positions in the city workforce, due to a combination of this year's early retirement program and other attrition. Although the impact of these reductions cannot be directly tied to specific city programs and services, it will clearly affect some agencies' performance.

As it often does, the city plans to substitute federal and state aid or other revenues for city "tax-levy" funds, up to $75 million, including: $33 million from Medicaid for the city's share of certain Early Intervention Program services; other state and federal Medicaid and public assistance reimbursements; an increase in the express bus fare to $4; and shifting some expenses to the capital budget.

Reestimates of spending needs would save the city $215

Agency Spending Reductions for 2004

Dollars in millions



SOURCES: IBO; November 2002 Financial Plan.

million, according to IBO's analysis of the Mayor's plan. These include $50 million from a shorter average tenure of uniformed police officers, $84 million in savings at the Department of Correction from shutting down the Queens Detention Center and lower staffing needs, recouping overpayments to child care and foster care agencies, and reducing surplus funds in child care contracts.

Although a number of measures included elsewhere in our analysis could be considered to boost efficiency, the city made some specific productivity proposals in the November plan. For example, the plan eliminates the fifth post on 49 fire department engine companies and the Department of Sanitation will redraw its current collection routes with the goal of saving $42 million.

The plan also would raise or institute new fees, including higher parks permit and recreation center fees (to raise $3.9 million), higher parking meter and garage rates ($8.4 million), and charging non-profit groups for fire inspections currently performed for free ($3 million). New fee revenues would total $19.6 million in 2004. Other non-agency savings of $72 million include $41 million in lower debt service and changes in pension contributions.

Uncertainties. The combination of dramatic tax increases and significant reductions and savings in city programs would still leave the city short. To fill the remaining $1.2 billion gap, the Mayor has proposed:

Labor savings. The city would negotiate with the municipal labor unions to realize $600 million in labor productivity savings—equivalent to 12,000 city workers, or nearly 5 percent of the full-time workforce. Since the city has not budgeted any money for upcoming contract negotiations with its workforce—almost all of the current contracts will end by 2004—this savings must be achieved net of any pay increase. That is, any pay increases must pay for themselves, plus yield $600 million in productivity savings.

This is a significant target and may not be easy to accomplish. A recent study by the Citizens Budget Commission estimated that extending the workweek to 40 hours for about 70,000 city workers would yield $500 million annually. But the full value of the savings would only come about once the roughly 10,000 city workers this represents had left city service.

Buses and bridge tolls. The city also is hoping to gain $200 million through new transportation initiatives. These would include a takeover by the Metropolitan Transportation Authority (MTA) of private franchise buses that provide express and some local service, for which the city provides an annual $100 million subsidy. The MTA is unlikely to take over this service without a city contribution, however, so the total savings to the city may be less. The Mayor also proposes instituting tolls on the East River and Harlem River bridges to both reduce rush-hour congestion and raise revenues. A $6 toll on these bridges could ultimately raise over $600 million annually. The details of this proposal have yet to be worked out.

State and federal help. The Mayor has approached the state and federal governments with a menu of ways they could help the city, ranging from the doubtful (a complete state takeover of Medicaid) to items that are likely to be approved (an extension of the waiver on restrictions on the use of federal Community Development Block Grant funds). From the state, the city hopes to get tort reform to lower the annual $500 million cost of the city's legal settlements, and Medicaid cost containment measures, among other items.

Debt and pensions squeeze. Debt service and pension contributions consume a growing share of the city's budget. In 2004, they will together account for 27 cents of every city tax dollar. By 2006, largely because of growing pension costs, they will consume nearly one-third of city tax revenues.

CONCLUSION

The Financial Plan presented last month makes significant progress towards closing what had been a projected $6.4 billion shortfall in the 2004 budget. But parts of the plan rest on a considerable number of steps that are far from certain to be carried out. When combined with a property tax increase that will generate less revenue than expected in the November plan, the Mayor and City Council still face a serious challenge in closing the remaining 2004 budget gap.