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New York City Independent Budget Office

Fiscal Outlook

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Despite Economic Upturn, City Still Faces Budget Shortfalls

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SUMMARY

An improving local economy will generate significantly more tax revenue in fiscal years 2004 and 2005 than was anticipated last spring when the current budget was adopted. Despite this revenue—totaling nearly $1 billion over the two years—it is not enough to keep pace with rising expenditures. IBO projects the city still faces a $1.7 billion gap in 2005. The city's fiscal difficulties become more pronounced in 2006 and 2007 as expenditure growth eclipses revenue growth. The projected budget gap doubles in 2006 to $3.4 billion and jumps to $3.9 billion in 2007.

Spending Grows Sharply. Under the Mayor's most recent financial plan, expenditures for most city programs and services will rise at less than the rate of inflation. But rapid increases in a few big-ticket items—Medicaid, pensions and fringe benefits for city workers, and debt service—will continue to propel overall city spending upwards. IBO projects city spending will total $45.8 billion in 2004. We expect expenditures to rise by $1.9 billion in 2005 and total $47.7 billion. Spending will continue to climb and total $51.1 billion by 2007.

Revenue Growth Slows. Improving local economic conditions, coupled with recently enacted tax increases, is leading to substantial growth in revenue in 2004. IBO projects that tax collections in fiscal year 2004 will be 13.2 percent higher than in 2003. IBO's outlook for 2005 through 2007 is for much slower tax revenue growth largely because of the expiration of the sales and personal income tax increases. Total revenues (tax collections, fees and fines, and state and federal aid) in 2005 will grow by only 0.6 percent over 2004 and will pick up only gradually in the later years. IBO projects revenues to rise from $45.8 billion in 2004 to $47.2 billion in 2007.

Uncertainties Remain. A number of unresolved issues present risks to the 2005 budget and could quickly erase the projected revenue gains from the improving economy and widen the city's budget gap. Among the uncertainties: the anticipated state takeover of the payments on the city's Municipal Assistance Corporation debt, the stalled effort to have the Metropolitan Transportation Authority assume responsibility for the private bus franchises, contract settlements with the city's municipal labor unions, and the state's own fiscal difficulties.

SPENDING OUTPACES REVENUE GROWTH

IBO's Revenue and Expenditure Estimates
Dollars in millions

	2004	2005	2006	2007	Average Change
Revenues	$ 45,782	$ 46,012	$ 46,285	$ 47,226	1.0%
Expenditures	45,782	47,686	49,649	51,082	3.7%
IBO Projected Gap	**$ -**	**$ (1,674)**	**$ (3,364)**	**$ (3,856)**	

SOURCE: IBO.
NOTE: Estimates exclude intra-city revenues and expenditures.

With the local economy continuing to improve in calendar year 2004, IBO's forecast for city revenues also is brightening. We anticipate tax revenue to be $26.3 billion in the current fiscal year—$789 million above the amount projected when the current budget was adopted and $321 million more than the Mayor's most recent projection. We also expect tax revenue to total $26.5 billion in 2005—$91 million more than the Mayor's estimate. IBO's expectation of a bigger surplus in 2004 and slightly higher revenues in 2005, along with estimates of some higher spending, leave a $1.7 billion shortfall for the upcoming year. With expenditures growing much faster in the future than revenues, IBO's estimated budget gaps spiral upwards in the ensuing years: $3.4 billion in 2006 and $3.9 billion in 2007.

Economic Overview. Although it appears that the local economic recession is finally coming to an end, the city has badly lagged the national economic recovery and is expected to continue doing so over the next few years. The lingering effects of September 11, the steep decline in the financial sector in the years following the burst of the dot.com bubble and the continuing revelations about corporate mismanagement have contributed to a nearly two-year gap between the end of the national recession and the start of the city's economic upturn.

The resumption of local job growth appears to be underway, with modest increases in private-sector employment in recent months. As compared to our last forecast, IBO now projects stronger recovery in the second half of calendar year 2004 and in 2005. In spite of recent private-sector jobs growth, for calendar year 2003 as a whole IBO expects that employment levels will still be below last year's by about 44,200 or -1.2 percent. We estimate the economy will add 19,400 jobs in 2004, a less than 1 percent increase, and 49,000 in 2005 and 50,100 in 2006, increases of 1.4 percent each year.

Although gains in the larger economy are expected to take some time, the turnaround has come much more quickly in the securities industry. Wall Street profits are now expected to total $16.5 billion in calendar year 2003, more than twice what IBO projected last spring. Wall Street profits are expected to grow slightly in 2004 to $17.2 billion before falling off to $16.2 billion in 2005 and $13.7 billion in 2006. The outlook for securities industry profits has been tempered somewhat since the early fall, when some were forecasting consecutive years of all-time highs. IBO's current outlook includes less robust data from the third quarter of this year. Securities employment is expected to grow slowly, adding 8,700 or about 5 percent by 2008.

Tax Revenue Growth. Although the upturn in the local economy is pushing tax revenue up, the rise is not sufficient to keep pace with the city's increase in total spending. IBO estimates that tax collections in fiscal year 2004 will be 13.2 percent higher than in 2003. About two-thirds of this rise results from the property, personal income, and sales tax increases.

The balance of the tax revenue increase is largely the result of a stronger local economy, particularly in the securities sector. A gradual recovery in hiring, substantial increases in Wall Street bonus compensation, and a resumption of growth in capital gains realizations will all contribute to a surge in personal income tax revenue to $5.5 billion in fiscal year 2004. Excluding the impact of the tax increase, personal income tax revenue will grow by 5.5 percent from 2003 to 2004, although revenue will still be below its 2001 peak—indeed, IBO's projections through 2007 remain below the 2001 level.

Business income taxes, which were not increased, are expected to grow by 12.4 percent from 2003 to 2004, when they will total $2.6 billion, although they will still be below the peak level reached in 2000. Property tax revenue also is growing, fueled largely by continued appreciation in home values, and the continued phase-in of commercial and apartment building assessment increases from prior years. Property tax revenue is expected to total $11.4 billion in 2004. Excluding the 18.5 percent rate increase, this represents baseline growth of 4.6 percent.

IBO's outlook for 2005 through 2007 is for much slower tax revenue growth. Total revenues in 2005 will grow by only 0.6 percent over 2004 and will pick up only gradually in the later years, with annual growth averaging 2.4 percent over the two years.

The phase out of the sales and personal income taxes are a key reason for this limited 2005 growth. Baseline personal income tax revenue growth of 5.5 percent in 2005 will be almost entirely offset by the revenue loss from the phasing out of last spring's tax increases on upper-income filers. With the pipeline of assessment increases from earlier in the decade largely exhausted, property tax revenue growth will slow to about 2.9 percent, putting 2005 revenues at $11.7 billion.

Spending. The city is facing significant budget gaps despite the financial plan's projection of relatively flat spending for most programs and services in 2004 through 2007. For example, spending on health and social services will rise at a very modest annual average rate of 1.8 percent—from $11.8 billion in 2004 to $12.5 billion in 2007. Department of Education spending will rise at an annual average rate of just 1.3 percent, with spending increasing from $12.7 billion in 2004 to $13.2 billion in 2007. Spending by the city's uniformed services—the police, fire, correction, and sanitation departments—is projected to dip by $96 million, falling from $6.5 billion in 2004 to $6.4 billion in 2007.

But several items—Medicaid, pensions and fringe benefits for city employees, debt service, and overtime—continue to propel overall city spending upwards. Driven primarily by these needs, total spending will rise at an average annual rate of 3.7 percent from 2004 through 2007.

Medicaid. The city's share of Medicaid spending continues to grow rapidly. The city's Medicaid expenditures are estimated to rise from nearly $4 billion this year to $4.5 billion in 2005. The recent growth in Medicaid spending has been spurred by the creation of the Family Health Plus program, which began in January 2002; according to the most recent data available, the program now has 167,900 city residents enrolled. IBO projects that by 2007 local Medicaid expenditures will total nearly $4.9 billion, roughly $900 million more than in 2004.

Pension and Fringe Benefits. Expenditures on pension and fringe benefits for the municipal workforce will continue to rise, consuming an increasing portion of the city budget. The city's contribution to the five pension funds will grow by $610 million in 2005 and total just over $3 billion. By 2007 the city's pension spending is expected to reach $4.2 billion, an annual average growth rate of 20.2 percent from 2004 through 2007, driven largely by the need to cover prior-years losses as well as cost-of-living increases required by the state.

Spending on fringe benefits for city workers also is expected to grow sharply. Health insurance rates are driving much of this increase. Expenditures on fringe benefits are projected to rise by $603 million from 2004 through 2007, with spending growing from more than $3 billion to nearly $3.6 billion (not including benefits for education department employees).

Debt Service. Interest and principal payments for the city-backed debt, including bonds issued by the Transitional Finance Authority, will grow from $3.4 billion in 2004 to $4.0 billion in 2005. Debt service will continue to rise steeply to $4.9 billion in 2007, an annual average growth rate of nearly 9 percent (after adjusting for the use of this year's anticipated surplus to prepay some 2005 debt service).

Overtime. Despite efforts to limit overtime expenditures, overtime spending continues to grow. In 2000, the city spent $615.4 million on overtime and projects spending $664 million for overtime this year. The police department spends the most on overtime and routinely exceeds its budget. The city has budgeted $235 million for police overtime in 2004. IBO estimates that uniformed police overtime will cost an additional $125 million in 2004 and that the city will have to spend $125 million more than now budgeted for police overtime in 2005 as well.

Uncertainties. A number of unresolved issues present risks to the 2005 budget and could quickly erase the projected revenue gains from the improving economy and widen the city's budget gap.

State Takeover of MAC Debt. The financial plan assumes a savings of $490 million annually in 2004 through 2007 from the state taking over the payment of the city's debt service on Municipal Assistance Corporation bonds. The takeover plan, which was passed by the state Legislature but opposed by the Governor, is currently tied up in court. If the court upholds the Governor's challenge, the city could face having to restore this substantial expenditure to its annual budget.

MTA and the Private Bus Lines. The city had been seeking to have the Metropolitan Transportation Authority take control of the seven private bus franchises operating here and relieve the city of its $145 million annual subsidy of these lines. An agreement has not yet been reached and given the authority's own budget problems it is unlikely the transportation agency will take over the bus service without some continued city contribution.

Labor Contracts. The contracts of nearly all the municipal labor unions have expired. The Mayor has repeatedly insisted that there will be no wage increases without concessions from the unions that cover the cost of any pay raises; reflecting this position, the 2005 budget and financial plan do not include any funding for prospective pay increases. The Mayor's vow that future raises must be funded by labor productivity savings may be difficult to keep. Each 1 percent increase in wages for the city work force costs $206 million; settlements at the rate of inflation would cost the city $463 million in 2005 and roughly $1.6 billion by 2007.

State Aid. The Governor's budget office projects a state shortfall of roughly $6 billion in the coming fiscal year. The state closed a large gap in its current fiscal year by borrowing $4.5 billion and tax increases, which begin to phase out next month. The Governor and state Senate and Assembly leaders say there will be no tax increases for the coming year. Because aid to localities is a large share of state spending, Albany could choose to lessen its shortfall by reducing aid to the city and other counties and municipalities.

Education Lawsuit. The state's highest court has ordered the Legislature to develop a new education financing system to resolve the lawsuit brought by the Campaign for Fiscal Equity. Since the suit seeks to ensure that the city has adequate resources for its schools, many have assumed the settlement would solely involve more state aid. In fact, a new financing arrangement could require the city to spend more than the $5 billion it already allocates for the public schools.

Airport Rent. Earlier this year the Mayor and Governor announced that the Port Authority of New York and New Jersey would pay the city $690 million in back rent for the city's airports and would sign a new lease, settling a longtime dispute. The city's current budget anticipates receiving the funds in 2005. But the port authority's board has not approved the terms of the new lease and has not yet set a date to address the issue.

CONCLUSION

A fairly strong economic recovery in calendar year 2004—strong by historical standards but not the kind of booming economy seen in the late 1990s—will generate a combined $412 million more in tax revenue in fiscal years 2004 and 2005 than projected in November by the Mayor. But this revenue growth will not be sufficient to keep up with growing costs. Although spending increases for most city programs and services will not keep pace with inflation, several key items will drive expenditures up: Medicaid, health insurance and fringe benefits for the municipal workforce, and debt service.

Depending on a number of uncertain or unresolved issues such as the state takeover of Municipal Assistance Corporation debt and a contract settlement with the municipal unions, the $1.7 million shortfall in 2005 could grow even more. Conversely, resources such as the general reserve of $300 million and an accounting adjustment for prior year expenses and revenues can help close the gap.

The city's fiscal difficulties become more pronounced in 2006 and 2007 as expenditure growth eclipses revenue growth. IBO estimates that expenditures will grow at annual average rate roughly three times faster than revenues in 2004 through 2007. This structural imbalance will lead to spiraling budget shortfalls in 2006 and 2007.