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New York City Independent Budget Office

Fiscal Outlook

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A Brighter Fiscal Picture, But Reasons for Caution

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SUMMARY

WHILE THE CITY'S FISCAL OUTLOOK has improved since last June, predominantly because of growing tax revenues, there are still reasons for caution. IBO projects the city will end the current fiscal year with a surplus of $1 billion that will be used to prepay some 2006 expenses. IBO estimates that the 2006 budget gap is now $2.2 billion. Despite IBO's forecast of continued tax revenue growth in the ensuing years, the projected budget gaps widen in 2007 and 2008 as several big-ticket city expenditures climb at a substantial pace.

Tax Revenues Grow. Moderate overall employment growth, strong—but far from record—profits from Wall Street, coupled with vigorous real estate markets result in growing tax revenues. IBO projects tax revenues for the current fiscal year will total $28.2 billion, 2.3 percent higher than the total for last fiscal year, and $1.3 billion higher than the forecast by the Mayor when the budget was adopted last June and over $500 million more than the Mayor's October projection. Although tax revenues are expected to rise from 2005 through 2008 at an average rate of over 3 percent annually, other revenues such as state and federal grants and fees and fines are expected to decline and bring the average growth rate each year for all city revenues down to less than 1 percent.

Spending Also Grows. IBO projects that total city spending will rise at an average rate of 2.3 percent annually from 2005 through 2008. After falling slightly in 2006, largely because of the prepayment of some 2006 expenditures, spending will rise by nearly $3.7 billion over the next two years and reach nearly $54.2 billion in 2008. Despite the growth in overall spending, expenditures for most programs and services, including state and federal aid, are projected to remain fairly flat over the next few years (although new labor contracts could drive costs up). Much as in the past two years, significant expenditure growth is projected in a few discrete portions of the budget that are largely outside the city's near-term control: debt service; pensions, health insurance and other employee benefits; and Medicaid.

Caution Ahead. Caution is warranted because of two very substantial costs on the horizon: resolution of the Campaign for Fiscal Equity lawsuit and settlements with the city's labor unions. Not only has the city still not come to agreements with teachers, police, and others whose contracts expired more than a year ago, but the contracts with the largest municipal union, District Council 37, and several other unions, expire at the end of the current fiscal year. Agreements on any or all of these issues could add significant costs to the city budget as soon as this year. IBO's spending estimates in this report do not include these likely costs.

A BRIGHTER OUTLOOK

IBO's Revenue and Expenditure Projections
Dollars in millions

	2005	2006	2007	2008	Average Change
Revenues					
Taxes	$ 28,228	$ 28,621	$ 29,355	$ 30,956	3.1%
Other Revenues	7,198	5,691	5,588	5,735	-7.3%
State / Federal Grants	15,113	13,943	14,129	14,323	-1.8%
Total Revenues	50,539	48,255	49,072	51,014	0.3%
Total Expenditures	50,539	50,432	53,146	54,163	2.3%
IBO Projected Gap	**$ -**	**$ (2,177)**	**$ (4,074)**	**$ (3,149)**	

SOURCE: IBO.
NOTES: IBO projects a surplus of $1.0 billion for 2005, $465 million above the Bloomberg Administration's forecast. The surplus is used to prepay some 2006 expenditures, leaving 2005 with a balanced budget. Estimates exclude intra-city revenues and expenditures.

Buoyed by stronger tax revenue growth than expected this year and next, New York City's fiscal picture for 2006 has brightened. This additional 2005 tax revenue is providing the city with a $1 billion surplus that will be used to prepay some 2006 expenses. IBO estimates that the budget gap for 2006 is now $2.2 billion, down considerably from the $3.7 billion projected by the Mayor's office when the current budget was adopted last June.

Economic Overview. IBO is projecting continued growth for the local economy, with some sectors only now showing signs of recovery from the local recession which began early in 2001 and then worsened after September 11. Overall employment growth has resumed, although it has been strongest in sectors with low and moderate wage levels. Employment in the securities sector, which has the city's highest compensation—for those still employed—has continued to decline. This pattern will continue to be a drag on the city's personal income growth. Indicators in sectors such as tourism point to more sustained recovery—hotel occupancy and room rates in October were both up over the previous year, according to city reports. Residential and commercial property markets both have continued to show strong appreciation this year.

After losing jobs for the last three years, New York City is expected to gain 23,100 jobs (0.7 percent) this calendar year, with continued growth in leisure and hospitality, education, and health and social services. Several sectors that experienced employment declines in recent years are expected to show increases this year, including professional and business services (2.3 percent), information (4.5 percent), and retail trade (1.4 percent).

Stronger job growth is expected in the city for calendar years 2005 and 2006, with the addition of 46,800 jobs (1.3 percent) next year and another 42,000 jobs (1.2 percent) in the following year. Professional, business, education, health and social services are expected to show the strongest gains. More moderate growth is expected thereafter.

Measured by the number of jobs, the city's full recovery from the last recession is still several years away. Private-sector employment in the city last peaked in 2000, at 3.15 million jobs. Employment then fell from 2001 through 2003 and began to rise this year. Because IBO expects only moderate job growth in the next few years, private-sector employment will not return to its 2000 level until 2008.

Wall Street remains an important driver of the city's economy. After Wall Street's profits surged last year to $16.7 billion, they are expected to fall to $13.3 billion this year. For 2005, IBO is projecting a rebound, with profits of $15.9 billion, followed by $15.8 billion in 2006. Securities industry employment is finally expected to start growing again next year, adding roughly 2,400 jobs annually, although after having shed around 40,000 jobs since employment peaked in 2000, the industry is not expected to regain its 2000 level during this decade.

Tax Revenue Forecast. Moderate overall employment growth, strong—but far from record—profits from Wall Street, coupled with vigorous real estate markets result in growing tax revenues. IBO projects tax revenues for the current fiscal year will total $28.2 billion, 2.3 percent higher than last year, and $1.3 billion higher than the forecast by the Mayor when the budget was adopted last June. IBO's tax revenue estimate is over $500 million above the Mayor's October projection.

A portion ($206 million) of the improved 2005 revenue outlook since last June results from the state's postponement of the sales tax exemption for clothing items under $110 until June 1, 2005. The balance is due to improving economic conditions, especially the continued strength of the city's property markets and mortgage refinancings, which have pushed the forecast for collections from the property transfer taxes up by $413 million (42 percent) since June.

With temporary increases in the personal income tax and sales tax scheduled to expire by December 2005, tax revenue growth is expected to slow to 1.4 percent in 2006 when tax revenues are projected to total $28.6 billion. Growth will then accelerate to 2.6 percent in 2007 and 5.5 percent in 2008, when tax revenues are projected to reach $31.0 billion. Over the entire period from 2005 through 2008, annual growth is expected to average 3.1 percent.

Excluding the effects of the expiring tax increases and the three year property tax abatement enacted this year, the projections for annual baseline tax revenue growth is more steady, ranging from 3.2 percent in 2005, 3.7 percent in 2006, 3.5 percent in 2007, to 4.6 percent in 2008.

The mortgage recording tax (MRT) and the real property transfer tax (RPTT), which have accounted for much of the tax revenue growth in recent years, are expected to decline somewhat in 2006, although they will remain far above the levels of a few years ago. The expected decline is due largely to IBO's forecast of a slowdown in property value appreciation and IBO's forecast of interest rates, which are expected to rise over the next two years, thereby reducing the demand for refinancing and also decreasing the number of real estate transactions. IBO estimates that the MRT will reach an all-time high of $858 million in 2005, decline slightly in 2006, and then resume growing. The RPTT, which peaked last year at $767 million, will yield the city $545 million in 2005 and $487 million in 2006.

The growth IBO expects in the real property tax is largely due to the extraordinary gains in market values over the last few years. Taxable values grew by over 11 percent annually, on average, from the 2001 assessment roll to the 2005 assessment roll, with growth in the last year topping 17 percent. Although IBO expects market values to continue to grow through 2008, the rate will be slower, averaging 4.9 percent annually.

Legal limits on assessment increases for buildings with 10 or fewer residential units mean that only about one-third of the market value appreciation between 2001 and 2005 will be directly translated into higher taxable assessments. And because most of the appreciation changes that the city *can* capture must be phased in over five years, there is a lag between when market values appreciate and when tax revenues actually increase. The pipeline of increases from the 2002-2005 period will sustain property tax revenue growth from 2006 to 2008, even as market value growth begins to diminish. Even if there were no changes at all in market values for the 2006 assessment roll, the pipeline would cause billable taxable assessments to grow by 4.2 percent from 2005 to 2006, accounting for much of the growth in billable taxable assessments forecast by IBO.

Compared to the Late 1990s. Although IBO's outlook for baseline tax revenue growth through 2008 exceeds that for recent years, it is still well below the growth the city experienced in the late 1990s. Adjusted for policy changes enacted from 1995 through 2001—for the most part tax cuts—tax revenues grew by an average of 7.3 percent annually. By comparison, projected tax revenue growth from 2005 to 2008, again adjusted for recent policy changes, is only 3.9 percent annually.

Another difference is that from 1995 to 2001, the primary source of tax revenue growth for the city was the personal income tax, followed by the business income taxes. Property tax revenue grew by only 1.5 percent per year over the earlier period, slower than the rate of inflation. By comparison, property tax revenue is expected to show the fastest growth among the major taxes in the coming years, averaging 5.3 percent annually from 2005 through 2008 (4.6 percent if we assume that the $400 property tax rebate is extended beyond 2007).

Spending. IBO projects that total city spending will rise at an average annual rate of 2.3 percent from 2005 through 2008. After falling slightly in 2006, largely because of the more than $1 billion surplus anticipated in 2005 that will be used to prepay some 2006 expenditures, spending is expected to rise steadily. IBO estimates spending will rise by $2.7 billion in 2007 to more than $53.1 billion and then increase by an additional $1 billion in 2008 to nearly $54.2 billion.

Despite the growth in overall spending, expenditures for most programs and services, including state and federal aid, are projected to remain fairly flat over the next few years—although new labor contracts could drive costs up. For example, IBO anticipates that spending by the Department of Homeless Services will grow at an average annual rate of less than 1 percent, from an estimated $691 million in 2005 to $703 million in 2008. Department of Health and Mental Health spending is projected to rise over the four-year period by $27 million to a total of $1.6 billion in 2008. Spending by the police department also is expected to see relatively little growth, rising from $3.5 billion in 2005 to $3.6 billion in 2008. Projected expenditures on children's services will decline at an average annual rate of 1.5 percent to $2.2 billion in 2008—a reduction of $104 million.

Much as in the recent past, significant expenditure growth is projected in a few discrete portions of the budget that together comprise about one-third of all city spending. This spending, which includes debt service; pensions, health insurance and other employee benefits; and Medicaid, is largely outside the city's control, at least in the near term.

Debt service is projected to escalate at an average annual rate of 11 percent, increasing from $3.9 billion in 2005 to $5.3 billion in 2008. Likewise, expenditures on pensions for the city's labor force also are expected to grow substantially, from $3.2 billion in 2005 to $4.4 billion through 2008, an average annual increase of over 10 percent. Barring any further investment losses or major benefit changes, pension fund contributions will finally level off beginning in 2008, removing one of the major drivers of spending growth.

The growth rates for Medicaid and health insurance and other benefits for city employees are more modest, but the additional costs remain substantial. IBO projects the city's share of Medicaid spending will grow from $4.7 billion in 2005 to just over $5.0 billion in 2008, with slower growth attributable to the phase in of the state takeover of Family Health Plus. Spending on health insurance and other fringe benefits (not including the education department) is projected to increase from nearly $3.0 billion in 2005 to $3.6 billion through 2008.

IBO's spending estimates do not include the likely costs to the city stemming from a resolution of the Campaign for Fiscal Equity (CFE) lawsuit or settlements with unions for the city's teachers, police, and other uniformed services that exceed the pattern set by the District Council 37 pact. This pact expires at the end of the current fiscal year, raising the likelihood of another source of additional labor costs.

Campaign for Fiscal Equity. The court-appointed panel in the CFE suit determined that spending on the city's schools should increase over four years so that it will be $5.6 billion higher (adjusted for inflation) than in the current year. For the school year that begins next September, the panel recommended an increase of $1.4 billion—but it did not say how much of this increase should come from the state and how much from the city. CFE has suggested that city funds should comprise 23 percent of new education spending due to the lawsuit. Under this scenario, city spending would increase by $330 million next year and total over $1.4 billion in the 2009-2010 school year. With further litigation of this case likely, it is very difficult to determine when and how much city spending may increase because of a settlement.

Labor. The other expense looming over next year's budget is the cost of settling labor contracts with the city's teachers and uniformed service workers. The city set aside enough money in the Financial Plan to fund raises on the same pattern as the agreement it reached with its other employees last year—a 3 percent raise in 2004, and a 2 percent raise in 2005. But the teachers' union and the unions representing uniformed police officers, firefighters, sanitation workers and corrections officers have all rejected a settlement on these terms. The teachers, whose contract expired in May 2003, have sought a 14 percent raise over three years (which would likely be funded in part with CFE–related dollars).

These contracts, once settled, are potentially quite costly. Each 1 percentage point above the pattern settlement would raise city-funded costs by roughly $150 million.

REASONS FOR CAUTION

While the city's fiscal outlook has improved since last June, predominantly because of growing tax revenues, there are still reasons for caution. The local economy is providing mixed signals. Although the city is beginning to experience job growth, many of the jobs the city lost over the past few years were in the high paying financial sector and many of the city's new jobs are in the relatively lower paying business and social services sectors. As a result, more of the revenue growth comes from real estate rather than personal income and business taxes than has been true in the recent past.

Even with IBO's projection of growing tax revenues, rising expenditures for debt service, pensions, health and fringe benefits, and Medicaid continue to strain the city's resources. Despite a projected $1 billion surplus in the current fiscal year that can be used to prepay some of next fiscal year's expenses, the city still faces a $2.2 billion shortfall in 2006. And without a surplus generated in 2006, the gap for 2007 will be harder to close.

Caution is further warranted because of two very substantial costs on the horizon: resolution of the CFE lawsuit and settlements with the city's labor unions. Not only has the city still not come to agreements with teachers, police, and others whose contracts expired more than a year ago, but the contracts with District Council 37 and several other unions expire at the end of the current fiscal year. Agreements on any or all of these issues could add significant costs to the city budget as soon as this year.