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New York City Independent Budget Office

Fiscal Outlook

December 2005

An Improving Fiscal Climate Presents New Challenges

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NEW YORK CITY'S FISCAL OUTLOOK has again brightened considerably. Much like the past two years, when tax revenue collections over the first few months of the fiscal year significantly outpaced estimates made in the spring, IBO projects the city will reap $2.2 billion more in tax revenue this year than anticipated last June when the current budget was adopted.

Largely on the strength of this tax revenue growth, IBO estimates the city will end the current year with a surplus of $1.9 billion. Assuming the surplus is used to remedy next year's shortfall, our projected budget gap for fiscal year 2007 is $1.8 billion—less than half of last June's estimate by the Mayor and $445 million less than his estimate in the November Financial Plan.

The 2008 outlook has also improved. IBO projects a 2008 shortfall of $3.3 billion, $1.1 billion less than last June's Mayoral estimate and $771 million less than his estimate last month.

While growing tax revenues—especially from the property transfer, business, and personal income taxes—play a lead role in the city's improved fiscal outlook, the limited growth in most city spending has also been a factor. IBO projects agency spending (excluding citywide costs and funds for future labor settlements) will average less than 1 percent a year growth through 2009.

Changes in the way the city calculates its contributions to city workers' pension funds, which is expected to be included in January's Preliminary Budget, could lower the 2007 shortfall to less than $1 billion. But these same changes would widen the gaps in 2008 and beyond.

Just a few years ago many worried that the city was approaching the fiscal brink. Today's fiscal climate has changed dramatically, though it brings a new set of potential challenges as public acceptance of the need for austerity may shift towards calls for tax cuts and increased spending.

Economic Outlook. IBO's forecast for the local economy is for continued growth. Local employment growth is expected to strengthen next year, although some other key indicators such as personal income and earnings are expected to show slower growth in calendar year 2006 than in 2005, and Wall Street profits are projected to actually decline. When the final data for 2005 are available, we expect they will show that the rapid appreciation in real estate prices has already begun to slow, a trend that will continue into next year.

Final 2005 data are also expected to show that the local economy added about 38,300 jobs, growth of 1.1 percent over 2004. Two sectors with accelerating employment growth this calendar year are also among those with the highest average wages: securities dealers and brokers, up 4.7 percent for a gain of 7,700 jobs in 2005 after growing by 2.0 percent in 2004, and professional and business services, up 1.4 percent for a gain of 7,400 jobs in 2005 after

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growing by only 0.1 percent in 2004. Other sectors with strong 2005 growth include education and health services (1.9 percent) and leisure and hospitality (2.9 percent). Employment gains in the leisure and hospitality sector reflect the resurgence of tourism in the city with measures such as hotel occupancy, airport passengers, and Broadway ticket sales all indicating strong recovery.

Total Revenue and Expenditure Projections

Dollars in millions

	2006	2007	2008	2009	Average Change
Revenues	$53,166	$53,073	$54,948	$57,127	2.4%
City-funded Revenues					
Taxes	31,742	31,896	33,554	35,432	3.7%
Other Revenues	6,305	5,902	5,909	6,049	-1.4%
Expenditures	$53,166	$54,878	$58,297	$59,522	3.8%
City-funded Expenditures	38,047	39,603	42,812	43,876	4.9%
IBO Surplus / (Gap) Projection	**$0**	**($1,805)**	**($3,349)**	**($2,395)**	

SOURCE: IBO.
NOTES: IBO projects a surplus of $1.9 billion for 2006, $135 million above the Bloombrg Administration's forecast. The surplus is used to prepay some 2007 expenditures, leaving 2006 with a balanced budget. Estimates exclude intra-city revenues and expenditures.

Employment gains in calendar year 2006 will be larger at 54,800 (growth of 1.5 percent) before slowing to 25,400 (growth of 0.7 percent) in 2007. Education and health services are expected to show the largest gains next year among the major sectors, up 20,200 jobs (3.0 percent). Securities firms are forecast to add 3,600 jobs (2.1 percent) over the course of next year, less than half the 2005 growth rate. Job growth in the professional and business services sector is expected to accelerate again next year with a gain of 12,000 jobs (2.2 percent). Slower 2007 job growth is expected across most sectors.

Personal income is expected to grow by 6.5 percent this calendar year and then slow to 5.2 percent growth in 2006 and then slow further to 3.3 percent growth in 2007. A similar pattern holds for earnings in some of the city's key industries such as professional and business services (up 10.7 percent this year with growth slowing to 5.2 percent in 2006), education and health (up 8.0 percent in 2005 but growing by only 2.5 in 2006), and leisure and hospitality (8.0 percent growth in 2005 and 2.4 percent in 2006).

The divergence in the growth patterns for these indicators and the outlook for employment, particularly for 2006, is due in part to shifts in the sources of employment growth from 2005 to 2006. While employment growth in the very high wage securities industry slows next year, it is expected to accelerate in the relatively lower wage education and health services sector. Even in the professional and business services sector, where employment growth is expected to accelerate next year, the subsector with the highest wages—management of companies and enterprises—is expected to show a decline in employment (down 0.2 percent), which is offset by growth in some of the other subsectors such as administrative and support services (up 2.1 percent).

Profits of Wall Street securities firms are a key variable in the city's revenue outlook. IBO projects that the profits of New York Stock Exchange member firms will be $15.8 billion in 2005, up from $13.7 billion in 2004. With member firms' revenues expected to decline in 2006, profits will fall back as well to $13.6 billion in 2006.

Tax Revenue Projections. Projections of a shrinking budget gap are mostly fueled by rising tax revenue estimates. IBO's tax revenue forecast for the current fiscal year is $31.7 billion, $2.2 billion higher (7.3 percent) than projected by the Mayor's office last June and $203 million more than their estimate in last month's Financial Plan. The increased revenue is attributable to continued strength in local real estate markets (boosting property transfer taxes this year as well as the property tax in subsequent years), steady performance by Wall Street firms, a jump in U.S. corporate profits in response to federal tax policy changes, and stronger than anticipated growth in capital gains realizations.

Likewise, IBO's tax revenue forecast for 2007 is also substantially higher than the Mayor's. We estimate tax revenues in 2007 will total $31.9 billion, $1.7 billion (5.8 percent) more than projected by the Mayor last June and $389 million more than last month's estimate.

Rising Revenue Sources. In this fiscal year, the largest percentage increases from prior estimates are in the property transfer taxes. Last spring forecasters assumed that rising interest rates would increase the cost of financing real estate purchases, reducing the number of sales and slowing—or perhaps reversing—the growth in property values. Higher interest rates were also expected to reduce the number of mortgage refinancings by current owners. These changes were expected to reduce revenues from the real property transfer tax (RPTT) and the mortgage recording tax (MRT).

Collections through the first four months of the fiscal year indicate that the rising rates have not yet resulted in lower revenues from these taxes. IBO's RPTT forecast is now 46.7 percent higher than the estimate in the 2006 Adopted Budget and the MRT forecast is 57.1 percent higher. Revenues from the two taxes in 2006 are now expected to be $1.1 billion for the RPTT and $1.2 billion for the MRT, both near the all-time highs reached in 2005.

With rising interest rates still expected to eventually cool off the city's real estate market, RPTT and MRT revenues are now projected to fall off sharply in 2007 (down 31.7 percent for the RPTT and 34.3 percent for the MRT), although collections will still be at levels that would have been unprecedented just two years ago.

Another key source of increased revenue for this year is the personal income tax (PIT). Our PIT forecast for 2006 is $6.8 billion, $819 million higher than last June's Adopted Budget estimate and $166 million above the Mayor's November estimate. Even with the temporary increase in the top tax rates set to expire half-way through the current fiscal year, revenue is expected to be 4.7 percent higher than in 2005. Unusually high capital gains and other non-wage income are mostly responsible for the increased PIT estimate for this year.

We expect PIT revenue to decline by $278 million in 2007 to $6.5 billion, the first full fiscal year since 2003 without the temporary rate increase on high-income earners. An expected return to more normal levels of capital gains realizations also contributes to the decline in 2007.

The forecast for business income tax revenues (particularly the general corporation tax) have also been revised sharply upwards for this year. IBO projects business income taxes will total $3.9 billion in 2006, up 4.4 percent from 2005 (growth for the general corporation tax is 11.2 percent). Revenue is expected to grow slowly in 2007 (2.1 percent) and 2008 (2.8 percent). Driving the increased business tax revenue estimates are strong corporate profits at the national level this year and solid results from the city's securities industry firms. National profits have swelled in part thanks to a federal tax code change allowing multinational firms a one-time opportunity to repatriate foreign source income and receive preferential tax treatment.

As is usually the case, the forecast for current year property tax revenue is little changed from the Adopted Budget and is now projected to be $12.4 billion. IBO's outlook for property tax revenue for 2007 through 2009 assumes continued strong growth, averaging 7.5 percent annually. Revenue is forecast to reach $15.4 billion by 2009.

Much of the growth anticipated by IBO comes from the "pipeline" of deferred assessment increases, which must be phased in over five years for commercial properties and apartment buildings with more than 10 units. With the surge in recent years in property values, a large backlog of assessment increases has accumulated. For example, IBO expects that of the projected $9.1 billion growth in billable assessments from 2006 to 2007, 59 percent will be due to prior year assessment increases still being phased in.

Spending Projections. The recent settlements between the city and the teachers, police, sanitation, and other uniformed services unions have not been more costly than budgeted by the Bloomberg Administration. In anticipation of contract settlements, the 2006 Adopted Budget included a reserve fund of over $650 million, enough to cover the cost of the agreements reached. While the raises for city workers were not entirely paid for by productivity increases, a bargaining position initially embraced by the Mayor, the agreements between the city and various unions contained enough concessions, such as lower starting salaries for new uniformed employees, and productivity measures, such as more scheduling flexibility, to meet the city's budget plan.

With a few unions still working under contracts that expired several years ago and some others, such as the unions that are part of District Council 37, whose more recent settlements have already expired, the Mayor fully replenished the labor reserve fund for 2007 and beyond. These added funds were based on roughly the same terms assumed beginning in last May's Executive Budget of wage increases at one-half the rate of inflation. This increases the 2007 labor reserve to nearly $1.1 billion—after accounting for the cost of past settlements.

The November 2005 Financial Plan assumes that the state will fund a substantial share of the teachers' contract, $300 million including pension costs. These funds, which still await Albany's approval, would raise the city's share of state education aid beyond our traditional 38 percent unless aid is lifted commensurately statewide.

Agency Spending Remains Flat. Except for money added to their budgets from the city's labor reserve fund to cover the recent union settlements, spending by most city agencies has remained relatively flat over the past two years. There have been neither large spending initiatives nor major cuts.

The Mayor's November Financial Plan continues this trend. IBO projects agency spending (excluding Medicaid, debt service, funding for future labor settlements, and other citywide expenditures) will rise at an average annual rate of less than 1 percent from 2006 through 2009. If the funds in the labor reserve for future settlements with city unions are included, agency spending will grow by a still modest average of 1.6 percent a year over the 2006-2009 period.

Citywide Spending Growth. Despite very limited spending growth in most programs and services, the city's overall budget has been growing. A few escalating expenditures, which are largely outside the city's direct near-term control, have fueled this growth.

City spending on debt service for capital expenditures and health insurance and other fringe benefits for municipal employees is expected to continue to rise rapidly. After adjusting for the use of the projected 2006 surplus to pay some 2007 debt service, IBO estimates debt service costs will grow at an average annual rate of 11 percent through 2009, when the cost will total $5.8 billion. This increase results largely from the city's growing capital plan for school construction and other projects. Rising health insurance and other fringe benefit costs, will also grow rapidly, averaging over 6 percent annually and reach $3.9 billion in 2009.

Two years ago, Medicaid was one of the fastest-growing portions of the city budget. But with the state takeover of Family Health Plus and, beginning in 2007, a state-legislated cap on the growth in the local share of Medicaid spending, the spiral in Medicaid spending has eased. The implementation of the cap even affords the city $450 million in one-time savings this year because the state is changing the way it accounts for Medicaid spending. The city and other localities will no longer have to set aside funds for services that may be provided in one year but may not be billed until another year. Despite the slower growth rate of around 3 percent a year, Medicaid remains a large city expenditure and is projected to reach $5.5 billion by 2009.

Proposed changes in the way the city calculates its pension fund contributions could have a significant impact on spending and gaps. Contributions to city pension funds, driven largely by the need to make up for several years of poor investment returns, have more than doubled since 2002, growing to $3.3 billion in 2005. The current Financial Plan projects that pension contributions will level off and actually begin to decline in 2008. However, changes in how the city calculates its pension contributions, expected to be included in January's Preliminary Budget and Financial Plan, could alter this projection substantially. The changes would result in a deferral of contributions this year, producing savings of roughly $800 million, but would raise future contributions starting in 2008.

Campaign for Fiscal Equity. IBO's spending projections do not include the possible costs from the resolution of the Campaign for Fiscal Equity lawsuit. A court-appointed panel found that spending on city schools should increase by $5.6 billion, phased in over four years. The panel did not say how much of this increase should come from the city and how much from the state. The court decision is being appealed and it is unclear when the suit will be resolved.

A CHANGED FISCAL ENVIRONMENT

The city's fiscal outlook has markedly improved since 9/11 and the 2001-2002 recession. This improvement is the result of both fiscal design and economic fortune. The Bloomberg Administration and the City Council implemented a set of tax increases (some of which have already expired) while also limiting the increase in spending on many programs and services to a rate below inflation. At the same time, the local economy has rebounded, largely buoyed by an explosive increase in local real estate values, as well as by resurgent tourism and escalating Wall Street profits.

The combination of growing revenues and limited spending increases has moved the city towards a closer match between recurring revenues and recurring expenditures. The fast-shrinking gap for next year, and to a lesser extent 2008, is evidence of an improving fiscal environment.

Just a few years ago, the pressure on elected officials was to keep the city solvent in the face of a recession and unprecedented disaster. Today's comparatively small budget shortfall for the year ahead will likely lead to other kinds of pressure. Some may call for tax cuts in a city that has one of the highest tax burdens in the nation. Others may call for increased spending for programs that have stagnated in recent years or to start new programs to address unmet needs. How the Mayor and the City Council balance the new pressures of a changed fiscal environment will have a major effect on the city's budgetary outlook beyond 2007.