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Analysis of the Mayor's Preliminary Budget for 2003

Budget Overview and Revenues Forecast

IBO

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Overview

INTRODUCTION

As required by the New York City Charter, the Independent Budget Office (IBO) reviewed the Mayor's Preliminary Budget for 2003 and Financial Plan through 2006. IBO's analysis reflects its independent assessment of revenues, repricing of the Mayor's policy proposals, and reestimate of the cost of delivering existing services. Based on this comprehensive examination, IBO finds:

- A gap of $397 million remains for 2003 even if all the Preliminary Budget proposals are enacted. Gaps of more than $3.0 billion—or roughly 10 percent of city funded revenues—remain in each year from 2004 through 2006.
- Although the recession and events of September 11 worsened the city's fiscal difficulties, a large share of shortfalls for 2003 and beyond predate these events and result instead from long-term city spending rising faster than revenues.
- After tax revenues fall by a projected 5.7 percent in 2002, revenues will resume growing in 2003 and rise by 3.2 percent. Tax revenues are expected to continue rising through 2006, at an annual average rate of 5.0 percent during the 2002-2006 period.
- City debt service continues to rise at a fast pace, growing from $3.5 billion in 2003 to $5.2 billion in 2006, despite a 14.3 percent cut to the four-year capital plan.
- The Administration proposes using a total of $1.74 billion in borrowed funds to close the 2003 gap.
- The viability of $1.4 billion in cost-saving initiatives and a $441 million debt-refinancing proposal remain uncertain, and if not fully implemented could cause prospective budget shortfalls to rise.

Total Revenue and Expenditures

Dollars in millions

	2002	2003	2004	2005	2006	Average Change
Revenues	$ 41,954	$ 42,667	$ 42,157	$ 43,507	$ 45,080	1.8%
city funded revenues	*27,472*	*28,996*	*28,651*	*29,738*	*31,096*	3.1%
Expenditures:						
Before prepayments	$ 44,654	$ 43,308	$ 45,242	$ 46,771	$ 48,321	2.0%
city funded expenditures	*30,172*	*29,637*	*31,736*	*33,002*	*34,337*	3.3%
2001 prepayment	(2,944)	-	-	-	-	
2002 prepayment	244	(244)	-	-	-	
Subtotal	(2,700)	(244)	-	-	-	
Total expenditures	$ 41,954	$ 43,064	$ 45,242	$ 46,771	$ 48,321	3.6%
city funded expenditures	*27,472*	*29,393*	*31,736*	*33,002*	*34,337*	5.7%
Gap	**$ -**	**$ (397)**	**$ (3,085)**	**$ (3,264)**	**$ (3,241)**	

SOURCE: IBO.

NOTES:

Year 2002 includes a $244 million surplus, which is used to prepay 2003 expenditures.

City funded revenues and expenditures exclude State and Federal Categorical Grants.

Excludes intra-city revenues and expenditures.

BUDGET GAPS

The Bloomberg Administration estimates the projected budget gap for 2003 is $4.76 billion—17.9 percent of taxes and other city revenues. Unlike the past five years, in which the city ended each year with surpluses ranging from $1.0 billion to more than $3.0 billion, there will not be a significant surplus at the end of 2002 to help close next year's projected shortfall. IBO anticipates the city will end the current fiscal year with a surplus of $244 million.

If the spending and revenue changes proposed by the Mayor in the Preliminary Budget are enacted, IBO anticipates that a shortfall of $397 million still remains for 2003. IBO also projects the city will face budget gaps of $3.08 billion in 2004, $3.26 billion in 2005, and $3.24 billion in 2006.

These projected gaps assume the implementation of a number of proposals in the Preliminary Budget, including $800 million in anticipated new state and federal aid, $441 million in savings from debt refinancing and $500 million in savings from labor. The outcome of these proposals is uncertain and their failure—all or in part—could lead to substantially higher gaps.

While the recession and the terrorist attack of September 11 have exacerbated the city's fiscal difficulties, these events are not the only—and perhaps not even the largest—causes of the budget gaps. The shortfalls for 2003 and beyond mostly result from city expenditures growing faster than revenues. Over the past few years, spending growth has exceeded growth in revenues. The city was able to mask this structural imbalance by drawing down sizable surpluses that had accumulated during the boom years of the 1990s. These surpluses resulted from unsustainable sources of revenues, such as extraordinary Wall Street profits, and could not be counted on to support the growth of recurring expenditures. By using the surplus of one year to prepay certain expenses (primarily debt service) in the next, the underlying imbalance was simply pushed away for another year. Without the benefit of another large surplus, the city now must confront the structural imbalance and resulting budget shortfall.

REVENUE ESTIMATES

By early last spring New York City began to feel the effects of the economic slowdown. The recession, coupled with the September 11 attack, have led to the loss of 118,000 jobs in the city during calendar year 2001. Although IBO forecasts that the city will have some modest job growth in calendar year 2002 and stronger growth in 2003, the number of jobs will not return to the city's December 2000 peak—3.8 million—until the middle of 2005.

Based on this economic forecast, IBO anticipates that tax revenues in 2002 will be 5.7 percent—or $1.32 billion—less than in 2001. IBO expects revenues to resume growing in 2003, rising by 3.1 percent over 2002. Revenues are expected to continue rising through 2006, at an annual average rate of 5.0 percent during the 2002-2006 period.

Compared with the estimates in the budget adopted last June, tax revenues are expected to be $744 million lower in 2002 and $1.2 billion lower in 2003. The largest absolute shortfalls are in the cyclically sensitive sales tax, business income taxes, and personal income taxes. Revenues from the property tax and the property transfer-related taxes are now expected to exceed the levels projected last June.

EXPENDITURES

IBO projects city-funded expenditures to reach $29.4 billion in 2003. This includes the Administration's proposals to reduce agency spending by $1.6 billion along with citywide cost-saving initiatives of $1.4 billion (state and federal actions, fringe benefit savings, and a severance program). Also included in IBO's projection are expenditure reestimates totaling $272 million in 2003. Among these reestimates are IBO's expectation that the city will spend $100 million more than budgeted for police overtime, $60 million more for public assistance than currently planned, and $57 million more for the public schools.

While the Preliminary Budget recognizes that Medicaid costs are growing more than previously forecast by the Mayor's Office of Management and Budget, IBO estimates Medicaid will require an additional $39 million in city funds. The Bloomberg Administration has acknowledged higher inpatient and pharmacy costs and somewhat larger Medicaid caseloads. Two recent legislative actions in Albany also have resulted in higher Medicaid costs for the city: The health bill enacted in January raised Medicaid payment rates and provided coverage for recent legal immigrants.

City debt service continues to grow at a fast pace. Debt service, including payments to the Transitional Finance Authority (TFA), will increase from $3.5 billion in 2003 to $5.2 billion in 2006—an annual average rise of 13.5 percent. IBO projects that paying off city debt will consume 19.4

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Pricing Differences Between IBO and the Administration

Items that Affect the Gap

Dollars in millions

	2002	2003	2004	2005	2006
Gaps as estimated by the Mayor	**$ -**	**$ -**	**$ (2,574)**	**$ (2,926)**	**$ (3,112)**
IBO Pricing Differences:					
Revenues:					
Taxes:					
Property	(36)	5	(37)	(56)	(128)
Personal Income	111	(148)	23	(12)	149
General Sales	(3)	253	304	347	360
General Corporation	(92)	(203)	(91)	(234)	(253)
Unincorporated Business	(36)	(14)	(40)	(18)	(29)
Banking Corporation	36	60	46	3	(14)
Real Property Transfer	25	60	78	94	124
Mortgage Recording	-	7	13	(5)	1
Utility	-	10	12	13	13
Hotel Occupancy	1	(12)	(16)	(10)	(11)
Commercial Rent	3	(20)	(17)	(18)	(29)
PILOTS	24	(20)	(19)	(18)	(17)
	33	(22)	256	86	166
STaR Reimbursement	-	72	(44)	54	(37)
Sale of OTB	-	-	(250)	-	-
Airport Rent	-	(175)	(320)	(285)	(40)
Total Revenues	33	(125)	(358)	(145)	89
Expenditures:					
Public Assistance	(7)	(60)	(11)	8	8
Medicaid	(14)	(39)	(21)	(79)	(103)
Board of Education	(28)	(57)	(6)	(22)	(23)
Overtime	-	(100)	(100)	(100)	(100)
Campaign Finance	-	-	(15)	-	-
Prepayment Adjustment	16	(16)	-	-	-
Total Expenditures	(33)	(272)	(153)	(193)	(218)
Total Pricing Differences	-	(397)	(511)	(338)	(129)
IBO Surplus/(Gap) Estimate	**$ -**	**$ (397)**	**$ (3,085)**	**$ (3,264)**	**$ (3,241)**

SOURCE: IBO.

NOTES:

Year 2002 includes a $244 million surplus, which is used to prepay 2003 expenditures.

Negative pricing differences (in parentheses) widen the gaps, while positive pricing differences narrow the gaps.

Pricing differences exclude intra-city revenues and expenditures.

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cents of each tax dollar by 2006, up from 16.3 cents in 2001.

This increase in debt service comes despite the Bloomberg Administration's proposed cut of 14.3 percent in authorized capital commitments from 2002-2005. This amounts to a $4.7 billion reduction in capital spending, which the Administration estimates will save a total of $390 million in debt service through 2006.

Almost every city agency shared in the cuts to the capital program, but the level of their cutbacks varied. Among the agencies that receive the largest capital commitments, the Board of Education's capital plan for 2002-2005 was cut by $1.0 billion, or 22 percent. The Department of Transportation, which after the board receives the largest amount of capital dollars, had its plan trimmed 14 percent. The Administration proposed reducing capital funds for housing development and preservation by 18 percent, mostly by curtailing planned new construction.

Despite cuts to these and other agency construction and maintenance programs, the city's capital commitments remain large. Planned capital commitments for 2002-2005 total $25.1 billion, an average of $6.3 billion a year. During the 1990s, capital commitments averaged about $4.5 billion annually. Last year, commitments jumped to $6.7 billion.

BORROWING TO CLOSE THE GAP

The Administration proposes using a total of $1.74 billion in borrowed funds to close the 2003 gap—$1.5 billion from the Transitional Finance Authority and a net $235 million from the reserves of the Municipal Assistance Corporation (MAC).

The legislature approved legislation on September 13, 2001—two days after the terrorist attack on the World Trade Center—authorizing the city to borrow through TFA an unlimited amount of short-term debt for all disaster-related costs, in anticipation of federal and state disaster relief aid. The law also allowed the city to borrow up to a total of $2.5 billion in long-term debt for disaster-related purposes. The legislation explicitly allowed long-term borrowing for non-capital operating expenses—a practice prohibited under the state Financial Emergency Act (FEA). It also exempted the short-term borrowing from the provisions of the FEA that would not normally allow the city to end the fiscal year with outstanding short-term debt.

In October 2001, fearing extremely high disaster-related spending and a shortfall in revenues, the city used this authority to issue $1.0 billion in one-year notes, stating that the notes would either be repaid with federal or state aid at their term, or—as it now appears—refinanced with long-term bonds. Under the Mayor's Preliminary Budget, the city would issue another $1.0 billion in long-term "recovery bonds" in July 2002, for a total of $2 billion in TFA borrowing. The city will use $1.5 billion for general gap-closing purposes in 2003, and another $515 million, mostly in 2002, to pay for disaster-related spending already incurred but unlikely to be reimbursed by the federal government. The city projects that this borrowing will increase debt service costs $180 million annually for 20 years.

The Municipal Assistance Corporation, created in 1975, provided the city with access to capital markets in the wake of the fiscal crisis. The city makes annual payments to MAC for debt service. In essence, the city is proposing to lower its payment in 2003 by $250 million—to be repaid to MAC in 2008, the last planned year of its existence. To ensure repayment, the city will purchase a surety bond—essentially an insurance policy—for $15 million, for a net proceed of $235 million.

While this borrowing helps close the yawning budget gap in 2003, it does not address the shortfalls in the ensuing years. In fact, it is a one-time revenue that not only leaves the same gap to be addressed in 2004 and beyond but also increases the burden on future taxpayers. Given the depth of the shortfall for 2003 and the weakness in the local economy, the borrowing is understandable but should be kept to a minimum. The city's primary focus should be on spending cuts, state and federal assistance, and tax increases needed to restore structural budget balance.

UNCERTAINTIES

While all preliminary budgets present a number of trial balloons, giving mayors the opportunity to float a variety of proposals, this budget appears more preliminary than most. There are several major proposals that would provide the city with savings of $1.84 billion if enacted. IBO has included the full value of these measures in its reestimate of the Mayor's Preliminary Budget and Financial Plan. If these proposals fail, or are only partially adopted, the budget gaps for 2003 and beyond could grow steeply.

The city is counting on a total of $800 million in savings in 2003 through state and federal initiatives ($400 million each from state and federal sources), and a total of $500 million ($250 million each) in the out-years. The Preliminary Budget proposes to generate these savings from a larger menu of state and federal initiatives totaling $2.1 billion in 2003 and $1.5 billion in 2004-2006. IBO notes that some of theses menu items, such as those related to debt, pensions, severance, and the E-911 surcharge, are also included in other savings initiatives elsewhere in the budget. The intention behind counting savings in different parts of the budget is largely to maximize flexibility as the Administration works toward the Executive Budget. If these items are removed from the state and federal menu, however, the $800 million savings target for 2003 (and $500 million per year in 2004-2006) must be generated off a smaller menu of possible savings, totaling about $1.4 billion in 2003-2006.

The city also anticipates saving $500 million in 2003—rising to $575 million in 2006—by containing the growth in some fringe benefit costs for city workers. The Administration specifically proposes lengthening the phase-in of automatic cost-of-living adjustments for municipal employee pensions from 5 years to 10. This change requires the approval of the state legislature, which enacted the automatic adjustment in 2000. Stretching the phase-in over 10 years would save the city $275 million in 2003. Further containment of fringe benefit costs would come from unspecified measures. The Administration has asked the unions to identify actions that would achieve the additional savings needed to reach the targets for 2003 through 2006.

Another proposal in the Preliminary Budget anticipates saving $441 million in 2003 through a refinancing of existing debt. The Administration hopes to achieve nearly three-quarters of this savings by winning changes in Washington and Albany that will ease restrictions on municipal refinancing.

The viability of these as well as some other proposals, such as the plan for a severance program to save $100 million annually, should become clearer when the Mayor releases his Executive Budget in April.

Revenues

INTRODUCTION

IBO projects that revenues for 2002 will total $42.0 billion, 4.3 percent above the total for 2001. In 2003, revenues from all sources (taxes, miscellaneous city revenues, state and federal categorical aid, and other revenues including unrestricted aid) are forecast to grow at a much slower 1.7 percent rate to $42.7 billion. The slow growth is expected to continue through 2006 with growth averaging only 1.8 percent annually, bringing total revenues in the final year of the Financial Plan to $45.1 billion.

The bulk of this section is devoted to IBO's tax revenue forecast, which is built up from our forecasting models for 11 major tax sources. The section concludes with a brief discussion of IBO's projections for other-than-taxes revenues.

IBO Revenue Projections

Dollars in millions

	2002	2003	2004	2005	2006	Average Change
Tax Revenues						
Property	$ 8,500	$ 8,866	$ 9,253	$ 9,633	$ 9,977	4.1%
Personal Income	4,939	4,980	5,590	5,896	6,434	6.8%
General Sales	3,375	3,759	3,969	4,164	4,363	6.6%
General Corporation	1,316	1,217	1,443	1,405	1,503	3.4%
Unincorporated business	767	819	843	917	964	5.9%
Banking Corporation	349	403	456	438	447	6.4%
Real Property Transfer	429	464	510	561	630	10.1%
Mortgage Recording	401	373	389	398	434	2.0%
Utility	271	290	294	298	307	3.2%
Hotel Occupancy	181	194	212	233	247	8.1%
Commercial Rent	370	351	367	384	395	1.6%
PILOT's	168	87	93	96	98	-12.6%
Other Taxes and Tax Audits	714	681	681	683	686	-1.0%
Total taxes	21,780	22,484	24,100	25,106	26,485	5.0%
Other Revenues						
STaR reimbursement	632	717	650	765	723	3.4%
Miscellaneous revenues	3,186	2,971	2,625	2,610	2,625	-4.7%
Transitional Finance Authority - 9/11	-	1,500	-	-	-	n/a
All other	1,874	1,324	1,276	1,257	1,263	-9.4%
Total other revenues	5,692	6,512	4,551	4,632	4,611	-5.1%
State and Federal grants	14,482	13,671	13,506	13,769	13,984	-0.9%
Total Revenues	$ 41,954	$ 42,667	$ 42,157	$ 43,507	$ 45,080	1.8%

SOURCE: IBO.

NOTES:

Personal Income Tax includes Transitional Finance Authority (TFA) dedicated personal income tax.

All other non-tax revenues include unrestricted intergovernmental aid, other categorical grants, inter-fund revenues, and disallowances.

Miscellaneous revenues are net of intra-city revenues.

TAX REVENUE FORECAST

With the U.S. and local economies both still struggling to shake off the recession that began early last year and grew much worse after September 11, IBO is forecasting a decline in tax revenues in 2002, with only modest growth from 2003 through 2006.[1]

- IBO projects that total tax revenues in 2002 will be $21.8 billion, a decline of $1.3 billion (5.7 percent) from 2001.
- The forecast calls for revenues to resume growing and reach $22.5 billion in 2003—3.2 percent above the forecast for 2002.
- From 2004 through 2006, revenues will grow at an average annual rate of 4.8 percent, with total collections expected to reach $26.5 billion.
- IBO's current forecast for tax revenue in 2002 is $744 million below the amount in the Adopted Budget Financial Plan from last June. For 2003, the shortfall is $1.2 billion.
- IBO's and the Mayor's Office of Management and Budget's (OMB) tax revenue forecasts are strikingly similar for 2002 and 2003. Beginning in 2004 IBO's projections are slightly higher than OMB's. Much of the difference can be attributed to IBO's somewhat more optimistic economic outlook.

REAL PROPERTY TAX

With property values continuing to grow, albeit at a slower pace than in recent years, property tax revenues are projected to reach $8.9 billion in 2003, 4.3 percent above their 2002 level. From 2003 to 2006, growth in revenues will continue, although at the somewhat more moderate average pace of 4.1 annually. Much of the revenue growth in the latter years is attributable to a feature of the city's property tax system that phases-in market value appreciation over five years for apartment buildings and commercial properties. The run-up in market values in recent years has created a "pipeline" of assessment increases still being phased-in that will help sustain revenue growth even as current market conditions are slowing, and in some sectors declining.

Background. The amount of tax owed on real estate in New York City depends on the type of property, its value for tax purposes (as calculated by the city's Department of Finance from estimated market values), and the applicable tax rate.[2]

Under the property tax law, every parcel is assigned to one of four classes for tax purposes: class 1, consisting of one-, two-, and three-family homes; class 2, composed of apartment buildings, including cooperatives and condominiums; class 3, made up of the real property of utility companies; and class 4, composed of all other commercial and industrial property.

Because assessment rates (the share of market value actually subject to tax) and, to a lesser extent, tax rates vary from class to class, there are wide differences between each class share of total market value, assessed value, and tax burden (levy). On the 2002 assessment roll, class 1 homes account for 46.1 percent of market value in the city, but only 11.4 percent of assessed value for tax purposes and 13.5 percent of the tax levy. In contrast, the other three classes each account for greater shares of the assessed value than of market value, and therefore bear a disproportionately large share of the property tax burden.

Outlook for Assessments in 2003. In January, the Department of Finance released the tentative 2003 assessment roll. After taxpayer challenges and other department adjustments are processed, the values will be finalized in May and used for setting 2003 tax bills. IBO expects that final market values will show growth of 10 percent over the prior year, with class 1 showing the largest increase at 13.5 percent, followed by class 2 at 9.6 percent and class 4 at 2.4 percent. In each tax class, aggregate market value growth on the 2003 roll is slower than on the 2002 roll; the most marked slowdown occurred in class 4 where growth was less than half the prior year rate.

Much of the class 1 market value growth is attributable to the continuation of rapid appreciation through the first half of calendar year 2001. The available evidence indicates that the local economic contraction that began early last year and the shock of September 11 have stopped but not reversed the appreciation of class 1 values. Other property types that have continued to show market value growth, even as the local economy has been battered, include Manhattan rental apartment buildings, up 9.6 percent over 2002, and mid-town Manhattan office buildings.

Although Manhattan values showed continued growth overall, the September 11 attack has taken its toll on downtown market values. At the start of the current fiscal year the Port Authority was completing its sale of a 99-year lease of the World Trade Center, and the city removed the full exemption on the property. This added $2.8 billion of taxable market value to the assessment roll for 2002. After the destruction of the buildings, the city had to subtract most of this value from the assessment roll (only the land value at $485 million remains on the roll), which pulled down the market value growth rate. Values for many of the buildings surrounding ground zero have also had their values cut significantly.

IBO projects that total assessed value on the final 2003 tax roll will grow 3.2 percent over the 2002 roll, less than half the increase in market values. The required phase-in of assessment increases for classes 2 and 4 accounts for part of this difference. An additional constraint on growth is the 6 percent cap on annual assessment increases (or 20 percent over five years) for class 1 properties. While class 1 market values on the 2003 assessment roll grew by 13.5 percent, class 1 assessed value will show growth of only 5.6 percent, in large part because of the 6 percent limit on assessment increases. While the city eventually captures the phased-in assessment increases in classes 2 and 4, much of the value lost to the caps in class 1 is essentially lost to the city forever. When values are growing faster than the 6 percent permitted under the cap, assessments fall further and further short of the 8 percent target assessment rate for class 1. Even in weak real estate markets, values rarely fall so far that assessments "catch up" to the 8 percent target.

Assessment Outlook for 2004-2006. Market values are expected to grow at an even slower pace over the later years of the Financial Plan. Growth will be slowest on the 2004 roll, which because of the timing of the assessment process, will be largely shaped by the economic conditions existing in calendar year 2002. IBO projects that class 1 market value growth will be negative for 2004, and then average 1.5 percent for the remaining two years. Annual market value growth in class 2 will average 2.0 percent in 2004 through 2006; in class 4 growth will average 0.7 percent annually.

With negative class 1 market value growth expected for 2004 though 2006, growth in assessments will also be anemic, with annual increases averaging 1.1 percent. The pipeline of previous growth will keep assessments in class 2 and 4 growing fairly briskly—and faster than market values—averaging 5.5 percent and 3.9 percent, respectively. Overall, assessment growth for all classes of property will average 4.1 percent annually.

Revenue Outlook. After the Department of Finance has completed the assessment roll, the actual property tax levy is determined by the City Council when it sets the tax rates for each class. Since 1992 the Council has observed an informal freeze in the average tax rate. IBO's property tax revenue forecast assumes that the freeze will be maintained, with the levy for 2003 and subsequent years equal to 10.366 percent of the aggregate assessed value for tax purposes on the assessment roll.

The amount of net property tax revenue in a fiscal year is determined not only by levy, but also by the delinquency rate, abatements granted, refunds for disputed assessments, and collections from prior years. IBO projects that net property tax revenue for 2002 will total $8.5 billion, 4.2 percent above revenues for 2001. For 2003, revenue will grow by 4.3 percent to $8.8 billion. For 2004 to 2006, growth will average 4 percent, with revenue totaling $10 billion by the last year of the plan period.

PROPERTY-RELATED TAXES

Commercial Rent Tax. Between 1994 and 2001, a series of tax policy changes significantly altered the incidence of the commercial rent tax (CRT) and reduced the revenues from over $700 million in 1994 to $367 million in 2001. In 2002, with the latest cut taking effect, revenues are expected to grow only slightly to $370 million. (Without the cut collections would have grown by 8.9 percent this year.) IBO expects that the continuing slump in the demand for office and retail space, particularly downtown, will result in lower CRT revenues in 2003; they are forecast to fall by 5.3 percent to $351 million. Revenues are projected to resume growing over the last three years of the plan at an annual average rate of 4 percent, reaching $395 million by 2006.

As of June 1, 2001, the tax is now only assessed on commercial tenants with annual rents over $250,000 (with liability phased in for rents between $250,000 and $300,000) in Manhattan below 96th Street. Liability is computed using an effective rate of 3.9 percent of the rent. The most recent change, which raised the liability threshold from $150,000 to $250,000, removed over 3,700 tenant-taxpayers with relatively modest rents, leaving roughly 6,700 still subject to the tax. IBO estimates that this reduction lowered CRT collections by $30 million in 2002.

Real Property Transfer Tax and Mortgage Recording Tax. Driven largely by the Federal Reserve Bank's 11 interest rate cuts in the last year, mortgage rates have been falling sharply. Lower mortgage rates account for much of the strength of current year collections from the real property transfer tax (RPTT) and the mortgage recording tax (MRT), even as the local economy has been contracting. IBO projects that 2002 revenues from these two sources will fall only slightly from their 2001 levels, show little growth in 2003, and then rebound strongly in 2004.

These two closely related revenue sources are collected at opposite ends of residential and commercial real estate transactions. The RPTT is levied directly on the sale price and is typically paid by the seller. The MRT is levied on the amount of the mortgage used to finance the purchase (usually the sale price less the down payment) and is paid by the buyer. While mortgage refinancing is often subject to the MRT, it is exempt from the RPTT, as no transfer of property is involved. Similarly, sales of coop apartments are subject to the RPTT but are exempt from the MRT because coop financing loans are not technically mortgages.

While sensitive to business cycle changes, the two transfer taxes are also influenced by mortgage rates, which have been decreasing steadily in recent months. The decrease in mortgage rates has sustained the number of home sales over the past several months, despite the economic slowdown. According to the National Association of Realtors, in January the number of existing home sales in the Northeast increased by 9.2 percent over the prior year.

IBO forecasts a decline in RPTT revenues of 11 percent to $429 million in fiscal year 2002, followed by renewed growth in 2003 through 2006. In 2003, IBO projects that RPTT revenues will reach $464 million (growth of 8.2 percent), as the local economy begins to recover. By 2004 RPTT revenues will surpass 2001 levels at $510 million.

The MRT is projected to decline 1 percent in fiscal year 2002 to $401 million. (IBO's MRT forecast reflects an expected $1.6 million annual savings in reimbursements for processing the tax from New York State.) The decrease is smaller than the 11 percent expected decline for the RPTT in 2002, and reflects recent increases in the number of mortgage refinancing transactions which have helped sustain MRT collections.

Interest rates are forecast to begin moving higher in the second half of this calendar year. The combination of higher mortgage rates and sluggish recovery in the local economy will result in a further decline in MRT revenues in 2003 to $373 million. With recovery more firmly underway during calendar year 2003, MRT revenues will resume growing in fiscal year 2004. IBO projects that revenues will reach $389 million in 2004 (a 4.3 percent increase). Growth will continue through 2006 when revenues reach $434 million, finally surpassing those of 2001.

PERSONAL INCOME TAX

Background and Recent Changes. The personal income tax (PIT) is levied on the incomes of city residents. Resident PIT liability is made up of two components: a base and a surcharge. The base rate is progressive, with income in higher tax brackets taxed at higher rates; the tax rate for the lowest of the four brackets is 2.55 percent, compared with 3.2 percent for the highest bracket.[3] After a temporary reduction in calendar year 2001, the surcharge reverted to being equal to 14 percent of base rate liability.

By fiscal year 2001, a number of recent tax cuts and credits—including the elimination of the commuter tax, expiration of the 12.5 percent "criminal justice" surcharge, introduction of the STaR program's PIT credit and cut in base rates, and the temporary reduction of the current surcharge—together reduced collections by almost one-quarter of what they would have been in the absence of the cuts.[4] In spite of this substantial loss of revenue, PIT collections grew an average of 3.7 percent annually from 1998 to 2001, buoyed by a prolonged economic expansion that continually surpassed expectations.

Revenues in the Current Year. By the end of the last fiscal year, however, there already were several indications that PIT revenue would fall substantially from 2001 to 2002. The nation's economy weakened throughout the spring, while employment growth in New York City came to a halt and a break in Wall Street's bull market became evident. Starting in May 2001, monthly PIT revenues have generally been less than what they were in the same month of the prior year.

The attacks on the World Trade Center profoundly worsened the outlook for the local economy in general, and for Wall Street employment and profits in particular. As a result, fiscal year collections to date are 14.7 percent lower than for the same period in fiscal year 2001. With a sharp decline of capital gains realizations in both the current and last calendar year, quarterly estimated payments of the PIT have decreased in particular. Similarly, with profits in the securities industry roughly halved from calendar years 2000 to 2001, bonuses paid to securities industry professionals have been slashed, in turn reducing withholding payments made at the beginning of this calendar year. One factor bolstering PIT collections this year is the restoration of the 14 percent surcharge, which took effect on January 1, 2002.[5]

On balance, IBO expects net PIT revenue (after refunds) to decline by 13.3 percent in 2002 to $4.9 billion, about 22 percent of all city tax collections. (These and other collections figures reported in this section include PIT receipts dedicated to the Transitional Finance Authority.)[6] IBO's 2002 PIT forecast exceeds OMB's by $111 million—2.3 percent of the total.

The Forecast for 2003 and Beyond. IBO expects only a slight increase in PIT collections, to $5.0 billion, in 2003. With employment growth beginning to exceed 5,000 jobs per quarter by the second half of calendar year 2002, withholding collections are expected to increase by a healthy 8.6 percent from fiscal year 2002 to 2003. Estimated payments, however, are projected to grow only 2.8 percent, in large part because capital gains realizations are expected to fall from calendar years 2001 to 2002 and then remain the same for another year. The enacted tax cuts of recent years, however, will not dampen growth from 2002 to 2003 because for the first time in many years, the phasing in of already enacted cuts has been completed.

IBO's 2003 PIT forecast is $148 million less than OMB's, mostly due to differences in the forecasts of PIT refunds. Following the sharp decline in PIT liabilities during calendar year 2001, both IBO and OMB have projected a sharp increase in refunds from 2001 to 2002. But for 2003, IBO expects refunds to fall slightly while OMB expects them to drop by over 20 percent.

With both employment and income growth expected to accelerate in calendar year 2003 plus an increase in capital gains realizations by 2004, IBO forecasts 8.6 percent growth in PIT revenue from 2003 to 2004, to $5.6 billion. For the last two years of the Financial Plan, growth will average 6.3 percent, and PIT collections will reach $6.2 billion by 2006. IBO's projections of personal income of city residents are generally higher than OMB's throughout the forecast period, and our forecast of PIT withholding collections after 2003 is consistently higher. But for the out-years (2004 to 2006), IBO's total PIT forecasts exceed OMB's by an average of only $54 million per year, less than 1 percent of revenues from the tax.

BUSINESS INCOME TAXES

IBO projects total revenues from the city's three business income taxes to be essentially identical in 2002 and 2003 at $2,433 million and $2,439 million respectively. These forecasts are 18 percent below the total for the three taxes in 2001, with the largest decline coming in the general corporation tax. Revenue growth is expected to pickup in 2004 through 2006, with collections expected to total $2.9 billion in the latter year.

General Corporation Tax. One of the few localities in the United States to levy a tax on corporate income, New York City collected $1,735 million in general corporation taxes (GCT) in 2001, slightly below the peak $1,779 million in collected in 2000 when revenues grew by 25 percent.[6] IBO forecasts a sharp plunge (24.1 percent) in GCT collections in 2002 and a further, smaller decline in 2003. The collections forecast of $1,316 million in 2002 and $1,217 million in 2003 would make these the weakest years since 1996.

About three-quarters of GCT revenues come from a tax of 8.85 percent imposed on the portion of net income that corporations allocate to New York City. The rest comes from three alternative bases for calculating city corporate tax liability: (1) capital allocated to the city, (2) net income plus compensation paid to major shareholders who are also officers of the corporation, and (3) a minimum tax of $300. The alternative bases apply when they yield a higher liability than the net income base.

The projected slump in GCT revenue reflects the strong and lingering impact of the recession on corporate profits in general and securities industry profits in particular. U.S. corporate profits fell an estimated 16 percent in calendar year 2001 and are expected to slip a little further in 2002; it will be five years before they regain the peak reached in 2000. The drop in securities industry profits is even more precipitous: from an all-time peak of $21 billion in calendar year 2000, IBO expects them to fall to no more than $8.5 billion in 2001, and recover to only $10.5 billion the following year.

A forecast 38 percent jump in securities industry profits and 11 percent increase in U.S. corporate profits in calendar year 2003 will be reflected in a projected 18.6 percent increase in GCT collections in 2004. A slight fall-off in collections in 2005 (resulting from projected slippage in securities industries profits) followed by modest growth will bring GCT collections to $1.5 billion in 2006.

Unincorporated Business Tax. New York City levies a 4 percent unincorporated businesses tax (UBT) on the income of sole proprietorships, partnerships, and (since 1994) limited liability companies. Until recently, sole proprietorships constituted more than three-quarters of UBT payers, while over 80 percent of UBT revenue has come from partnerships. Increases in UBT credits (raised from $800 to $1,800 in 1998), however, have completely eliminated UBT liabilities for many smaller businesses (predominantly sole proprietorships), while the share of total UBT revenues accounted for by limited liability companies has been growing. Most UBT revenue comes from partnerships in the legal services and financial sectors.

UBT revenues more than doubled between 1994 ($379 million) and 2001 ($820 million). The recession and the additional shocks to the local economy are expected to deliver only a relatively glancing blow to the UBT. Collections are projected to fall 6.4 percent, to $767 million, in 2002, and then recover to $819 million in 2003. Projected steady growth throughout the rest of the plan period will bring collections to $964 million by 2006.[8]

This solid performance reflects that while one of the principal determinants of UBT revenue growth trends—security industry profits—declined steeply in calendar year 2001, the other principal determinant—legal services earnings—registered strong growth in 2001. Legal services earnings is expected to continue to grow (albeit more slowly than previously anticipated) over the next five years.

Banking Corporation Tax. New York City imposes a separate tax on banking corporations doing business in the city. Like the GCT, the banking corporation tax (BCT) requires three alternative calculations, including a 9 percent tax on net income allocated to the city. BCT revenues have always shown a pattern of sharp year-to-year jumps and declines. This pattern has continued in recent years, with a 50 percent ($247 million) plunge in 1994 followed by a 45 percent ($111 million) increase in 1995, and a 46 percent ($154 million) increase in 1998 followed by drops of 25 percent ($126 million) and 11 percent ($41 million) in 1999 and 2000. This volatility stems from overpayments and underpayments based on losses or gains experienced in some years but not recognized until a year or two later. Other contributing factors are the underlying volatility of bank profits in this rapidly restructuring industry, and the relatively small number of payers accounting for the majority of BCT liabilities.

IBO expects this pattern to continue through 2003, albeit muted by the current slowdown affecting all the business taxes. After growing 22.3 percent ($77 million) in 2001, BCT revenues are expected to decline 17.7 percent ($75 million) in the current year, to $349 million. Relatively mild double-digit growth is projected for the coming year (15.5 percent, $54 million). The forecast for 2004 shows the pattern breaking down with a second consecutive year of modest double-digit growth (13.2 percent, $53 million). This will bring collections up to $403 million in 2003 and $456 million in 2004. Little change is forecast for the final two years of the Financial Plan. As of 2006, BCT revenues will still be well below the 199 peak of $514 million.[9]

General Sales Tax. IBO projects that sales tax revenues will be $3.8 billion in 2003, the result of a strong rebound from 2002, which has been depressed by the general recession and the aftermath of the September 11 attacks. Collections in the current year (2002) are now expected to be only $3.4 billion, a decline of 7.8 percent from the prior year.

Consumers in New York City pay an 8.25 percent tax on the sales of most goods and services. The tax is composed of a 4 percent city tax, a 4 percent state tax, and a 0.25 percent public transportation surcharge to the Metropolitan Transit Authority. The sales tax base exempts most food products, medical services and supplies, mortgage and rental payments, interstate and international telephone services, and, beginning in March 2000, all clothing priced under $110. City sales tax revenues are a function of household spending of city residents along with consumption expenditures by businesses, commuters, and tourists. Household spending, in turn, is primarily determined by disposable income and the level of consumer confidence.

A year ago, when there were already signs of a slowdown in the U.S. economy, IBO forecast sales tax revenue growth of 1.8 percent in 2001 and 1.2 percent in 2002, much weaker than the growth rates of recent years. In December, amidst a deepening recession and the economic aftershocks of the World Trade Center attack, IBO projected a 0.6 percent drop in sales tax collections in 2002. It is now evident that the near-term aftershocks of September 11 were stronger than previously thought, and that the underlying economic picture has been bleaker. Over the last three quarters of calendar year 2001 year-over-year sales tax collections growth was -6.4 percent, -3.6 percent, and -6.8 percent, respectively. IBO now forecasts -7.8 percent growth in sales tax revenues for fiscal year 2002 overall. IBO's current 2002 projection of $3.4 billion is $265 million less our December forecast.

In contrast, IBO's new 2003 forecast of $3.8 billion is almost unchanged from December (and from last March). This reflects our view that the factors contributing to the plunge in sales tax collections in 2002 will snap back sharply as the nation emerges from the recession and the city recovers from the September 11 attack. Revenues are expected to jump 11.4 percent in 2003. Brisk but not booming sales tax revenue growth—averaging 5.1 percent per year—is projected for the out-years of the Financial Plan.

OTHER REVENUES AND CATEGORICAL GRANTS

Other Revenues. IBO's estimate of revenue from sources other than taxes for 2003 totals $5.8 billion, $95 million lower than projected in the Preliminary Budget. The differences between the IBO and Administration forecasts vary for the out-years of the plan, with IBO $605 million below the Administration in 2004, $222 million below in 2005, and $68 million below in 2006.

Other revenues include funds from unrestricted intergovernmental aid, STaR reimbursement, private grants, inter-fund capital transfers, and miscellaneous revenues from recurring and nonrecurring sources. For 2003, the $1.5 billion in proceeds from TFA borrowing are included in the other revenues category. Other items of note follow.

Airport Rent. The Preliminary Budget anticipates receiving rental income from the Port Authority for JFK and LaGuardia airports of $185 million in fiscal year 2003, $330 million in 2004, $295 million in 2005 and $50 million in 2006. These projections include annual base rent of $50 million and anticipated payments of prior-year rental income that the city asserts it is owed based on its interpretation of what income should be included when calculating rent. The collection of airport back-rent has been under arbitration for over six years and there is no indication that the city will prevail in its claims. For this reason, IBO's revenue forecast entirely excludes contested back rental income. Additionally, we forecast that the city will receive approximately $10 million annually in airport base rent, reflecting the decline in revenues collected by the airports resulting from the trade center attack.

OTB Sale. In the Preliminary Budget Financial Plan the city once again postponed receipt of $250 million in revenue from the proposed sale of the Off-Track Betting Corporation (OTB). The plan now assumes that the proceeds will be realized in 2004 rather than in 2003. The new Administration, however, has deferred the OTB sale and has decided to wait and see if OTB continues to generate profits for New York City. (The city has not identified any alternative revenue source for 2004 if the sale were to be postponed again or cancelled.) There remain significant obstacles to selling OTB. The deal is not entirely within the city's control, as it requires state legislative approval. In addition, the city is facing strong opposition from the union representing OTB workers, which has filed a lawsuit to block the sale. In projecting miscellaneous revenues, IBO has assumed that there will be no revenue generated from the sale of OTB over the term of the Financial Plan.

Categorical Grants. Categorical grants received from the state or federal government to fund specific programs account for approximately 30 percent of all funds spent by the city each year. IBO projects that state and federal categorical grants will total $8.4 billion and $5.2 billion, respectively, in 2003. For some types of categorical aid, such as education and welfare, IBO has developed forecasts based on changes in programs and caseloads. IBO's forecast of categorical aid in other parts of the budget is based on a methodology that takes the grant level in the current year, adjusts for historical trends and programmatic changes, and applies growth factors on an agency-by-agency basis.

IBO's forecast of state categorical grants is $61 million higher than the estimate provided in the Preliminary Budget for 2003, primarily due to a temporary increase in public assistance caseload projections. Beginning in 2004, IBO's forecast of state categorical grants exceeds the Preliminary Budget by $161 million, growing to $414 million in 2006 largely due to modest projected growth in school district operating aid.

IBO's forecast of federal categorical grants is $621 million higher in 2003, growing to $791 million in 2006. IBO's estimates of education, social services, and housing aid—which together account for close to 60 percent of all federal grants—are significantly greater than the Preliminary Budget's. IBO's higher projections are mainly attributable to an increase in housing rental subsidies and social service aid consistent with past years, along with an analysis of education funding increases included in federal appropriations enacted for school years 2001/2002 and 2002/03 and proposed by the President for 2003/04.

END NOTES

[1] IBO's revenue forecasts were completed prior to the release of the Department of Labor's revision to the 2001 employment data in early March, which changed the picture of when job losses began. IBO forecast that the city lost 123,000 jobs from the fourth quarter of 2000 to the fourth quarter of 2001, while the new revised figures show a loss of 118,000 jobs over the same period.

[2] When we refer to market values and assessments, we are including only taxable property. The assessed value for tax purposes reflects the required phase-in of assessment changes for apartment, commercial, and industrial buildings.

[3] For example, for married couple filing jointly, the lowest bracket ends at $21,600 of taxable income and the highest bracket begins at $90,000. For other types of filers, the income thresholds are lower.

[4] A separate PIT surcharge equal to roughly 12.5 percent of base liability, was instituted in 1990 but allowed to expire at the end of 1998. For much of its history, revenue from this second surcharge had been dedicated to criminal justice spending.

[5] The PIT surcharge rate had been reduced for calendar year 2001 through two separate initatives. However, under the state law authorizing the city to adjust the surcharge rate, the rate reverts to the full 14 percent unless legislation to continue the lower rates is adopted. Because such legislation has not been enacted, the Preliminary Budget is premised on the surcharge rate returning to 14 percent. IBO estimates that the reversion to the full rate has added $177 million to PIT revenues in 2002 and $344 million in 2003.

[6] Also included in the 2002 PIT total is a $153 million accrual revenue that will actually be received during 2003. The city plans to make this accounting adjustment because a delay in updating withholding tables to reflect the restoration of the full 14 percent surcharge rate will cause many employers to withhold less in city taxes than they should from January to May of this year, with taxpayers making up what they owe when they file their final returns for calendar year 2002 in city fiscal year 2003.

[7] The city also collects a significant amount of audit revenues from the GCT. Audits are expected to bring in $268 million in 2002, and over $250 million per year over the rest of the financial plan. Audit receipts are segregated from their individual taxes and shown as a separate tax revenue source in city budget documents.

[8] These projections are exclusive of audit revenues, which are expected to run around $34 million in 2002 and $32 million per year over the rest of the Financial Plan period.

[9] Annual BCT audit revenues of $40 million to $45 million are expected in the 2002-2006 plan period.