New York City
Independent Budget Office

January 2001

New York City's Fiscal Outlook Fiscal Years 2001-2004

City will end current year with $1.4 billion surplus

New York City will end fiscal year 2001 with a substantial surplus, much as it has over the past five years. These surpluses have been used in prior years to close future budget shortfalls by prepaying expenses. IBO assumes that this year's $1.4 billion surplus will be used in the same way, reducing next year's prospective budget gap to $2.4 billion, or 6.1 percent of total revenues.

Slowing economy makes future gaps harder to close

Unlike recent years, however, rising gaps beginning in 2002 will be increasingly hard to close. The slowing economy makes it less likely that higher-than-expected tax collections will by themselves entirely eliminate the 2002 gap, much less turn it into a surplus. With no significant surpluses after the current fiscal year, gaps of $3.4 billion and $4.0 billion forecast for 2003 and 2004 will be even more difficult to close.

Modest revenue growth buoyed by property taxes

City revenues from all sources—including taxes, fees, fines, and state and federal aid—are projected to increase at an average annual rate of 2.2 percent over the 2001 to 2004 period. Tax revenues will be essentially flat from 2001 to 2002, as the slowing economy and the phase in of already enacted tax cuts reduce city personal and business income tax receipts. As the economy steadies and tax cuts are fully phased in, IBO expects tax revenue growth to resume in 2003 and 2004. In contrast to the weakness in cyclically sensitive income taxes, property taxes are expected to grow strongly and account for much of the increase in total tax revenues over the next four years.

Spending growth eclipses revenues

This revenue growth will not be sufficient to offset rising city spending. Assuming current expenditure policies remain unchanged, IBO projects that city spending will rise at an average rate of 3.8 percent a year, from $40.0 billion in 2001 to $46.7 billion in 2004. Several key factors are driving these increases:

Spending fueled by labor, education, Medicaid, & debt

- Labor settlements that increase wages at the rate of inflation would add $1.5 billion to city spending by 2004.
- Spending on education will increase by $1.3 billion over the four years. While this increase is substantial, it reflects average annual growth of 3.8 percent—well below the nearly 10 percent annual rate of 1997-2000.
- Medicaid spending, fueled by inpatient hospitalization and prescription drug costs, will increase $700 million between 2001 and 2004.
- Rising debt service will consume nearly 19 cents of every city tax dollar by 2004.

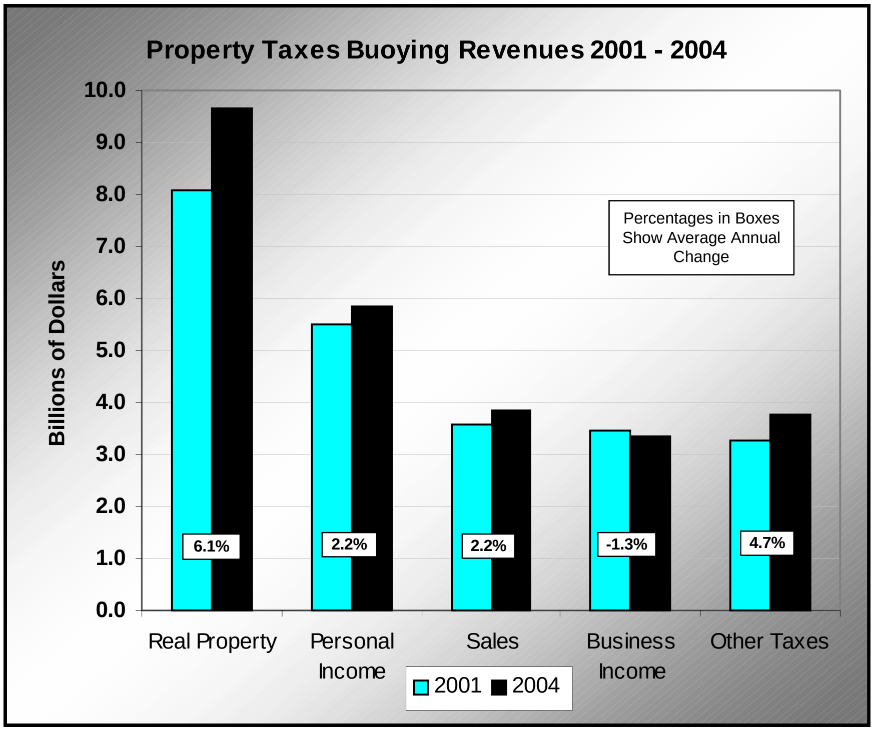
The forecast presented in this report reflects what the city's finances will look like if current spending policies and tax laws are allowed to run their course over the next few years. This provides an objective starting point and benchmark for considering the Mayor's upcoming preliminary budget. **IBO**

Additional tables detailing IBO's projections can be found on our Web site at www.ibo.nyc.ny.us or are available upon request.

Revenues

IBO projects that city tax revenues—which account for nearly 85 percent of city own-source receipts—will increase at an average annual rate of 3.3 percent over fiscal years 2001 to 2004. Tax collections will barely grow from 2001 to 2002 as the slowing local economy and the phase-in of tax cuts decrease receipts from the city's income taxes. Tax revenue growth will be more robust in the following two years, averaging 4.6 percent annually—slightly less than the 5.2 percent annual growth rate during 1996-2000.

Income tax revenues are forecast to decline from the fairly strong levels expected during the current year. Revenues from the tax on personal income will be lower in 2002 than in 2001 due to the slowing economy and already enacted tax cuts, particularly the state's School Tax Relief (STaR) program. (Under the STaR program, declines in city tax revenues are offset by increases in state aid.) After 2002, with STaR fully phased in and local economic growth picking up, personal income tax collections are expected to grow 5.4 percent annually. Business income tax receipts, which are sensitive to national as well as local economic conditions, are expected to decline in 2001 and decline again in 2002 before growing modestly in 2003 and 2004.



In contrast to the weakness in the economically sensitive income and sales taxes, property taxes are expected to grow strongly and account for much of the increase in total tax revenues over the next four years. IBO projects that property tax receipts will rise at an average annual rate of 6.1 percent from 2001 to 2004, outpacing growth in the local economy. Under the law governing the city's property tax, assessment increases for commercial properties—including apartment buildings—are phased in over five years. As a result, much of the projected increase in property tax receipts will stem from the run-up in values that occurred during the latter half of the nineties but is only just starting to be reflected in tax bills.

Over the next few years, these growth trends will reverse the longer-term pattern of city property taxes growing more slowly than most other taxes. This will result in the property tax's share of total tax revenues rising from 35.1 percent in 2000 to 38.5 percent in 2004. The increase is likely to be temporary and would still leave the property tax below the 39.2 percent share it accounted for as recently as 1996. **IBO**

Economic Growth Slows

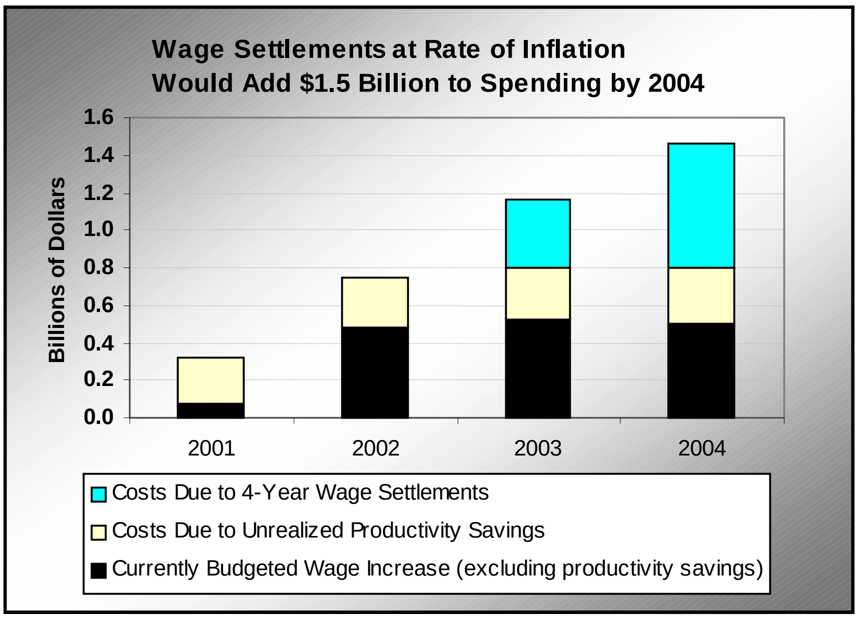
By the end of calendar year 2000, there were clear signs that the long national expansion had begun to wane. IBO forecasts that U.S. economic growth will slow considerably but remain positive in 2001; GDP growth will be a third slower than in 2000 and employment growth will be cut nearly in half. Slower U.S. growth coupled with an expected halving of Wall Street profits in 2001 will weaken the New York City economy. In spite of diversified city employment growth in recent years—in 2000, new jobs were concentrated in the construction, trade, and service sectors—the city's economy remains heavily dependent on Wall Street.

IBO expects the growth rate of city employment to slow from 2.1 percent in 2000 to 1.1 percent in 2001, with slightly lower rates through 2004. Wall Street firms will share a portion of their record 2000 profits with their employees through bonuses paid at the beginning of 2001 and these bonuses will provide a boost to local personal income. Income growth is expected to moderate, however, in 2002 and 2003. IBO also projects that the city's red-hot real estate market will cool significantly in 2001—signs of this are already evident—with the rents asked for Manhattan office space declining through 2003. **IBO**

Expenditures

Total city spending over the fiscal year 2001 to 2004 period is projected to grow at an average annual rate of 3.8 percent after adjusting for prepayment of expenses. This growth in spending is driven by expected increases in the city's labor costs, as well as program-driven spending hikes in education, Medicaid, sanitation, and other areas, and rapid growth in debt service. IBO's projections assume that city spending policies remain unchanged over the next four years, with no new spending initiatives and no cuts in the current level of services. Models are used to forecast spending for programs with costs driven by factors beyond the immediate control of the city—such as public assistance (caseloads) and education (enrollment)—while other city spending is assumed to increase at the rate of inflation.

Labor. Labor contracts for most city employees have expired and the city and its unions are currently negotiating new contracts. In anticipation of a two-year labor settlement, the city has already budgeted $325 million in 2001, $750 million in 2002, and $800 million in both 2003 and 2004. The Administration expects that a significant share of these costs will be offset by increases in labor productivity of $250 million in 2001, $265 million in 2002, $280 million in 2003, and $300 million in 2004. Because the city has not provided any details regarding these productivity savings, IBO assumes that the savings will not be realized.



Moreover, city employees are likely to receive wage increases in each of the next four years. Assuming that any settlement covers the full four years of the city's financial plan and that wage increases equal the projected rate of inflation (as measured by the consumer price index), IBO estimates that an additional $324 million will be required in 2003 and $660 million in 2004. By the final year of the plan, four years of wage increases at the rate of inflation would cost the city a total of $1.5 billion a year, including funds already budgeted but excluding unspecified productivity savings.

It is, of course, impossible to predict the outcome of collective bargaining. If the agreements exceed the rate of inflation by one percentage point each year, city spending would be roughly $290 million higher by 2004. Conversely, if the agreements lag the rate of inflation by one percentage point, city spending would be reduced by a similar amount.

Education. IBO estimates that the Board of Education (BOE) will spend $11.6 billion in 2001—29 percent of total city spending—rising to $12.9 billion in 2004, a 3.8 percent average annual rate of growth. This spending growth is only modestly driven by increases in enrollment. More significant factors include rising labor costs, expansion of prekindergarten, hiring of teachers to reduce class size, additional resources devoted to implementing the new promotion policy, and the expansion of publicly funded charter schools. Our forecasts do not incorporate any impact from the recent court decision in the school financing case. If the decision is upheld, it is likely that additional resources will be made available to the Board.

The expected growth in BOE spending—while considerably above the rate of inflation—actually represents a slowdown from the past few years of particularly rapid increases that have been driven by the addition of thousands of teachers. From 1997 to 2000, BOE spending grew at an average annual rate of 9.9 percent with the pedagogic headcount rising by 12,000 positions. While state and federal education aid have increased steadily, the city contribution has climbed even more rapidly. The city-funded portion of the BOE budget has increased from roughly 40 percent in 1997 to over 43 percent in 2000.

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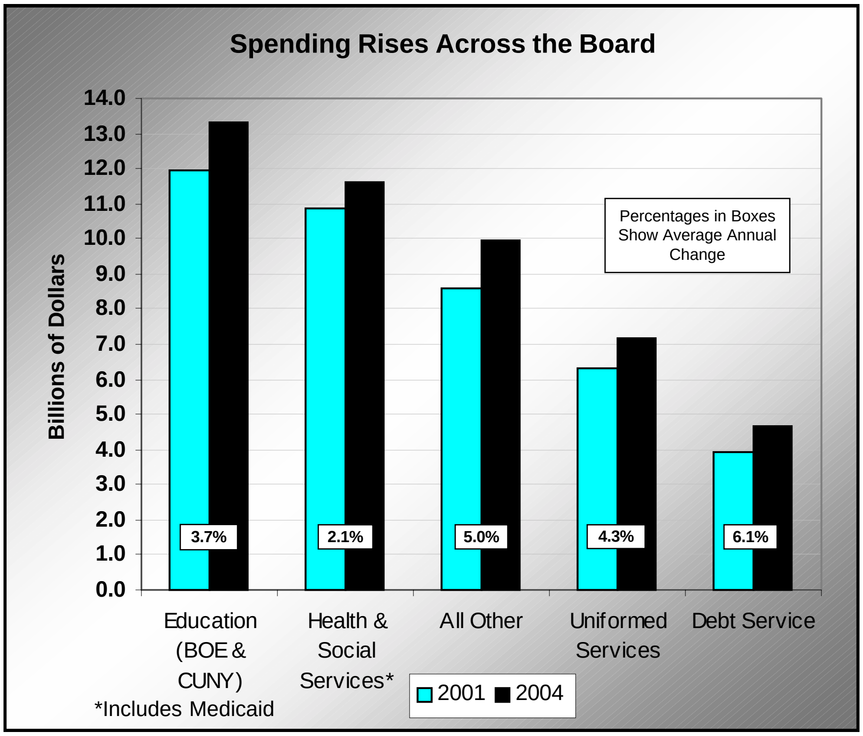
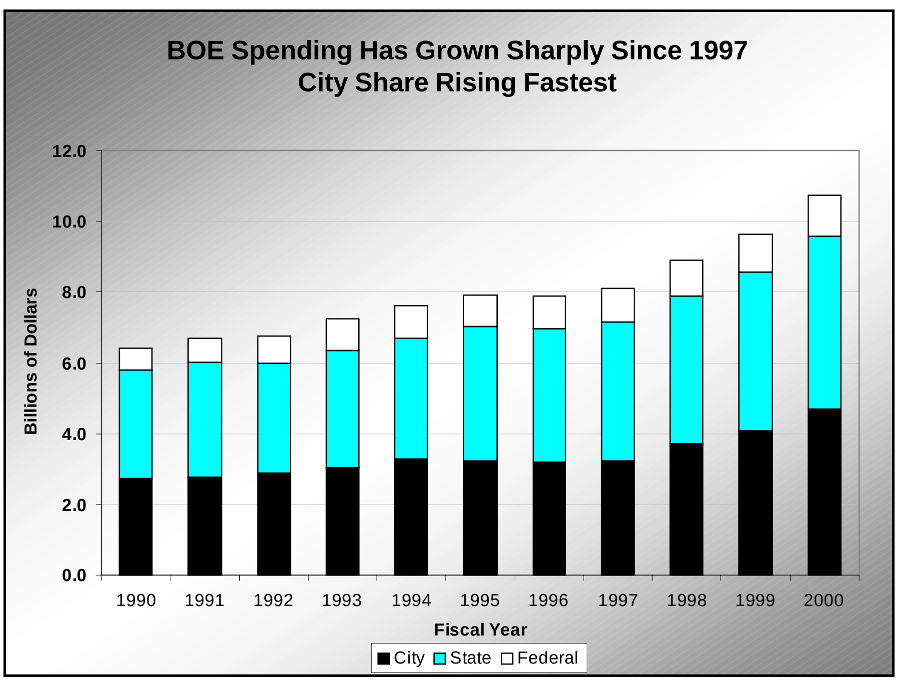
Medicaid. Spending for Medicaid, the federal health program for low-income individuals, continues to grow rapidly. IBO projects that the city will spend $3.3 billion on Medicaid in 2001, rising to $4.0 billion in 2004—an average annual increase of 6.1 percent. The primary factors driving these increases include higher-than-anticipated inpatient hospitalization costs and prescription drug costs that are projected to rise at a rate of 12 percent a year. Because the city's transition into mandatory managed care for Medicaid recipients has been slow, the IBO projects only modest cost savings from this initiative. In contrast, two additional initiatives—the city's HealthStat outreach program and the state Family Health Plus insurance program—could exert significant upward pressure on the city's future Medicaid spending by increasing overall Medicaid enrollment.



Uniformed Services. Combined spending on the uniformed services agencies—police, fire, correction, and sanitation—is projected to rise $841 million from 2001 to 2004, a 4.3 percent average annual rate. IBO's estimate includes $260 million annually in police overtime. Sanitation costs will rise particularly rapidly as exporting of the city's garbage to transfer and disposal sites outside the five boroughs is fully phased in by 2002.

Debt Service. The city has undertaken an extensive capital program in recent years in an attempt to catch up on a backlog of deferred maintenance. The resulting increase in borrowing has made debt service one of the fastest growing components of city spending. The surge in debt service is being exacerbated by the delayed impacts of debt refinancings undertaken in the late 1980s and early 1990s, which are adding almost $1.1 billion (8 percent) to the cost of debt service over the 2001-2004 period. After adjusting for the use of year-end budget surpluses to prepay debt service, IBO projects that debt service will increase at an average rate of 6.1 percent a year from 2001 to 2004. By 2004, servicing the city's outstanding debt will consume 18.7 percent of every city tax dollar. In comparison, debt service accounts for some 15.5 percent of city tax dollars in 2000.



Over the past few years, these rapid increases in debt service have received less attention than state constitutional limits on the city's ability to borrow. Due to a combination of appreciating city real estate values and administrative changes in Albany, IBO projects that the city's debt limit will rise enough to permit the city to finance its current commitment plan. **IBO**

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