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# Analysis of the Mayor's Preliminary Budget for 2007

## *Overview*

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# Overview

IBO projects the city will end the 2006 fiscal year with a surplus of $3.1 billion. This surplus, which follows a $3.5 billion surplus in 2005, is being driven by better-than-expected tax revenues—$2.8 billion higher than the Bloomberg Administration's estimate last June, mostly from the income and property transfer taxes—along with two one-time accounting and actuarial changes that save the city $1.4 billion in 2006.

Although IBO's surplus projection for 2006 is slightly below the Mayor's and we anticipate a relatively small shortfall of $445 million in his 2007 budget, our gap projections are substantially less than the Bloomberg Administration's estimates for 2008, 2009, and 2010. And in a departure from from trends in most years, our gap estimates decline successively in each of these years.

The city's near-term fiscal strength has allowed the Mayor to propose two unusual measures in the Preliminary Budget. He plans to use $1 billion in 2006 and another $1 billion in 2007 to fund a retiree health insurance trust fund in anticipation of Government Accounting Standards Board rules that go into effect in two years. Although the rules do not require funding these liabilities, as must be done for pensions, credit rating agencies will likely look at these liabilities when judging the creditworthiness of the city and other state and local governments. The Mayor is also planning to delay the receipt of more than $350 million in tobacco revenues. Instead, the city would get the money in 2008, when the Bloomberg Administration anticipates a budget gap of more than $3 billion.

These steps underlie the inherent caution in the Mayor's budget plan and the temporary nature of a large portion of the revenue and savings creating the surplus. The accounting and actuarial changes helping to generate this year's surplus are plainly one-time events. The changes stem from two separate actions: proposals by the city's actuary on assumptions and timing of city pension contributions and an accounting windfall that results from the state's implementation of an annual cap on the growth in the city's share of Medicaid costs. (Detailed explanations of these changes follow in this report's sections on pensions and on Medicaid.) The pension changes will save the city an estimated $925 million in 2006 and $571 million in 2007, but will increase the city's costs in later years. The Bloomberg Administration estimates the Medicaid accounting switch will save $450 million in 2006.

Although the one-time nature of the pension- and Medicaid-related savings is clear, less clear is how much of the tax revenue that has exceeded expectations over the past couple of years is part of a new, higher baseline and how much is a short-term spike in collections.

With the assumption that much of these "surplus" revenues, as well as the savings, are fleeting, the 2007 Preliminary Budget and the Financial Plan through 2010 has little in the way of new spending on city services or on tax cuts. Nor, for that matter, does it contain many spending reductions. The Mayor's budget plan largely seeks to manage the use of the surplus in a way that does not commit the city to recurring expenditures or to tax reductions that could be difficult to sustain in future years.

Some key highlights of our analysis and reestimate of the

**Total Revenue and Expenditure Projections**

*Dollars in millions*

| | 2006 | 2007 | 2008 | 2009 | 2010 | Average Change |
|---|---|---|---|---|---|---|
| **Revenues** | $ 53,645 | $ 53,100 | $ 55,473 | $ 57,087 | $ 59,035 | 2.4% |
| *City-funded Revenues* | | | | | | |
| *Taxes* | *32,379* | *32,023* | *33,702* | *35,609* | *37,155* | 3.5% |
| *Other Revenues* | *6,257* | *6,121* | *6,582* | *6,041* | *6,257* | 0.0% |
| **Expenditures** | $ 53,645 | $ 53,545 | $ 57,956 | $ 59,498 | $ 60,738 | 3.2% |
| *City-funded Expenditures* | *38,636* | *38,589* | *42,767* | *44,061* | *45,115* | 4.0% |
| **IBO Surplus / (Gap) Projection** | **$ -** | **$ (445)** | **$ (2,483)** | **$ (2,411)** | **$ (1,703)** | |

SOURCE: IBO.
NOTES: IBO projects a surplus of $3.1 billion for 2006, $137 million below the Bloomberg 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.

2007 Preliminary Budget and Financial Plan through 2010 include:

- If the budget plan did not include money for starting the retiree health insurance trust fund and delay the receipt of tobacco revenues, this year's budget surplus would be $4.3 billion—$1.2 billion higher.
- IBO estimates that in 2008, 2009, and 2010 the city's budget shortfalls are roughly $1 billion a year less than the Bloomberg Administration has projected.
- IBO's lower budget gap estimates stem in part from our higher forecast of property tax revenues, which are $313 million higher than the Mayor's in 2007 and grow to $1.2 billion above his projection for 2010.
- Although city spending will rise by an average of 3.2 percent annually, expenditures by most city agencies will be relatively flat. As in recent years, spending growth is mostly in a few discrete areas of the budget over which the city has limited near-term control.
- The city's recent fiscal strength may make it difficult to keep future union settlements at the levels currently funded in the labor reserve. Wage increases at the rate of inflation—roughly twice the level currently budgeted—would cost about $300 million more than is in the reserve for 2007 and increase to $1 billion more for 2010.

## ECONOMIC AND REVENUE ESTIMATES

In spite of rising energy costs, interest rate hikes, and Hurricanes Katrina and Rita, the U.S. economy grew 3.7 percent in calendar year 2005 (adjusted for inflation), and it is now beginning its fifth year of expansion since the 2001 downturn. While consumer spending and the housing market appear to be softening, business investment remains strong, and steady economic growth is projected to continue through the third quarter of this year. Growth will then begin to slow, but the slowdown in the next few years is expected to be gradual and an economic recession is not forecast.

In the last couple of years, the city economy has benefited from the nation's economic growth, and more specifically from a renewal of Wall Street's good fortune, soaring real estate prices, and a record number of visitors. Local employment and income growth accelerated in calendar year 2005, and their strength is expected to continue in the coming months before moderating at the end of the year. The city's economy will grow a bit faster after calendar year 2007, but its growth rate through 2010 will be less than its current pace.

Based on this overall economic outlook, IBO projects city tax revenue to total $32.4 billion in fiscal year 2006, 5.9 percent above the 2005 total and $2.8 billion (9.5 percent) above what the Bloomberg Administration assumed when the 2006 budget was adopted last June. Because of the slowing economy in calendar year 2006 and the expiration of the last of the temporary tax increases that were enacted in 2003, IBO expects fiscal year 2007 tax revenues to be slightly lower than in 2006, totaling $32.0 billion (a decline of 1.1 percent). Tax revenue growth is expected to resume in 2008, with revenues growing at an average of 5.3 percent annually to reach $37.4 billion by 2010.

IBO's revenue forecast is slightly lower than the Bloomberg Administration's for 2006 and essentially equal for 2007. Beginning in 2008, the differences grow to over $1 billion each year. The sharp divergence is due to differences in economic forecasts. IBO expects growth in the local economy to slow late in calendar year 2006 and continue at a slower pace through 2008. The Mayor's budget office expects growth to slow somewhat later and the slowdown to be more pronounced. A second factor contributing to the differences in the revenue forecasts stem from changes to the 2007 property tax assessment roll subsequent to the release of the Preliminary Budget. IBO's forecast reflects these changes, which result in an additional $200 to $300 million dollars in property tax revenues each year from 2007 to 2010.

The outlook for most taxes shows an increase from the Adopted Budget for 2006, but the increases are most striking in the income taxes and the property related taxes. Fueled by higher than expected Wall Street bonus payments and capital gains, the personal income tax is now expected to yield $7.1 billion this year, 18 percent ($1.1 billion) above the forecast last June. Higher earnings by national and multinational firms with operations in the city and firms in the city's securities and business services industries are expected to push business income tax revenues up 14.9 percent ($519 million) from the levels expected last June to $4.0 billion.

The real estate market appears to be cooling off somewhat, but it was still stronger during the second half of calendar year 2005 than had been anticipated. Rather than falling significantly from their all-time highs in 2005, the tax

**Pricing Differences Between IBO and the Administration**

Items that Affect the Gap

*Dollars in millions*

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| **Gaps as Estimated by the Mayor** | **$ -** | **$ -** | **$ (3,447)** | **$ (3,500)** | **$ (2,711)** |
| **IBO Pricing Differences** | | | | | |
| Revenues | | | | | |
| Taxes | | | | | |
| Property | (25) | 313 | 693 | 923 | 1,179 |
| Personal Income | 88 | (127) | 285 | 214 | (167) |
| General Sales | (1) | (33) | 62 | 41 | 14 |
| General Corporation | 49 | (142) | (40) | 43 | 39 |
| Unincorporated Business | (23) | (46) | 44 | 32 | 24 |
| Banking Corporation | (11) | 8 | 30 | 2 | (58) |
| Real Property Transfer | (121) | (13) | (45) | (4) | 6 |
| Mortgage Recording | 27 | 36 | (36) | (60) | (73) |
| Hotel Occupancy | 4 | 2 | 25 | 53 | 87 |
| Commercial Rent | 7 | - | (1) | (1) | (2) |
| Cigarette | 2 | 2 | 1 | - | 1 |
| | (4) | - | 1,018 | 1,243 | 1,050 |
| Tax Program | - | - | (12) | (17) | (22) |
| STaR Reimbursement | (2) | (85) | 76 | (92) | 74 |
| **Total Revenues** | **(6)** | **(85)** | **1,082** | **1,134** | **1,102** |
| Expenditures | | | | | |
| Public Assistance | 8 | 28 | 33 | 33 | 33 |
| Department of Education | (114) | (173) | (73) | - | - |
| Police Overtime | (25) | (75) | (75) | (75) | (75) |
| Campaign Finance | - | - | - | - | (49) |
| Buildings | - | (3) | (3) | (3) | (3) |
| **Total Expenditures** | **(131)** | **(223)** | **(118)** | **(45)** | **(94)** |
| **Total IBO Pricing Differences** | **(137)** | **(308)** | **964** | **1,089** | **1,008** |
| Prepayment Adjustment | 137 | (137) | - | - | - |
| **IBO Surplus/(Gap) Projection** | **$ -** | **$ (445)** | **$ (2,483)** | **$ (2,411)** | **$ (1,703)** |

SOURCE: IBO.
NOTE: Negative pricing differences (in parentheses) widen the gaps, while positive pricing differences narrow the gaps.

revenues generated from the sale and financing of real property are now expected by IBO to total $2.3 billion. Although this is virtually unchanged from last year's total, it is $878 million (60.5 percent) above the revenue anticipated last June when the current budget was adopted.

Looking ahead, property tax revenue is expected to continue growing briskly, averaging 6.9 percent annually from 2007 to 2010. The increases are attributable to IBO's projection of continued growth in property values, although at a bit more moderate pace than in the recent past, combined with the large pipeline of recent assessment increases that are still being gradually phased in. Growth in the income taxes is expected to be more moderate, while revenues from the property transfer taxes are expected to be 37.6 percent below their 2006 level in 2010.

## SPENDING TRENDS

IBO projects that under the Mayor's current Financial Plan total city spending will rise by an average of 3.2 percent annually, growing from $53.6 billion in 2006 to $60.7 billion in 2010. Despite this increase of more than $7 billion over five years, spending by most agencies is relatively flat (in part because agency budgets do not include funds for any future wage increases). For example, IBO projects Department of Education spending to increase by an average of 1.3 percent annually—roughly half the rate of inflation. Similarly, sanitation spending would rise at an even lower rate, growing from $1.1 billion in 2006 to $1.2 billion in 2010. Spending by the Administration for Children's Services would *fall* at an average rate of nearly 1 percent annually, decreasing from $2.2 billion in 2006 to $2.1 billion in 2010.

Much as in recent years, the growth in overall spending is in a few discrete portions of the budget over which the city has limited near-term control. Based on the January 2006 Financial Plan, the fastest growing of these items is debt service, which is projected to rise by an average of 10 percent annually (adjusted for the use of some of the 2006 surplus to prepay a portion of 2007 debt service). These principal and interest payments on the money the city borrows for capital projects will grow from $4.5 billion in 2006 to $6.2 billion in 2010. The Mayor's use of $200 million annually in pay-as-you-go capital in 2006 through 2010 slightly eases the growth in debt service (although in past years the Bloomberg Administration has also budgeted pay-as-you-go capital funds but then used them for other purposes).

The city's pension contributions for city employees are also continuing to rise at a fast pace over the Financial Plan period, in part because of the savings in 2006 and 2007. Rising at an average annual rate of nearly 10 percent, the city's pension contributions are expected to grow from $3.9 billion in 2006 and level off at $5.6 billion in 2010. Likewise, the cost of health care and other fringe benefits for the municipal workforce also continues to climb, rising from $5.5 billion in 2006 (not including the $1 billion earmarked for the retiree health insurance trust fund) to $6.7 billion in 2010.

Medicaid also continues to be a significant cost for the city, although the recent state takeover of Family Health Plus and Albany's new cap on the annual growth in the local share of Medicaid spending means the burden has eased somewhat. Total city spending on Medicaid, based on projections by the Mayor's budget office, is expected to grow from $4.5 billion in 2006 to $5.4 billion in 2010.

The budget plan also recognizes some significant new and anticipated costs. With the labor contract with the city's biggest union, District Council 37, already expired and others to end soon as well, the Mayor has set aside $310 million in 2006 growing to $1.3 billion in 2010 to cover wage increases at roughly half the rate of inflation. Due to the sharp rise in energy costs, the budget also includes spending of roughly $100 million more than previously anticipated in 2006 and 2007 for utilities and fuel.

The Preliminary Budget for 2007 contains a relatively small plan of $262 million for agency-based gap closing initiatives. About half these measures would come from generating new revenues from measures such as increasing the city's efforts to issue tickets for violating parking rules; completing a new franchise agreement for public toilets, bus shelters, newsstands and other "street furniture"; and charging fees at more city recreation centers and raising the admission cost at zoos. Most of the rest of the gap-closing plan includes cost reestimates and supplanting city funds with federal or state dollars as well as a small number of spending reductions, including cuts in the subsidies to libraries and cultural organizations and programs for youth and seniors. Based on similar spending reduction proposals in recent years, these funds are likely to be restored.

## UNCERTAINTIES

There are a number of issues that could substantially affect the city's budgetary picture, ranging from expectations of state and federal assistance to budget shortfalls in the city's public hospital system. Among the major issues:

***Education.*** Several different factors could alter spending projections for the city's schools. The Preliminary Budget assumes about $300 million more in state education aid than the Governor included in his budget proposal. President Bush's budget plan for the upcoming federal fiscal year could result in less aid for the city's schools. Over the past few years Title 1, the main source of federal education aid, has increased for the city. But his recent budget proposal would reverse that trend and cut Title 1 aid to the city.

The recent decision to cancel $1.8 billion in school construction and repair projects because the state has not provided funds the city sought for its five-year school construction plan may prove hard to maintain. Last year, when the state failed to provide the requested funds, the city "advanced" $1.3 billion of its $6.5 billion share of the $13 billion school construction plan.

Resolution of the Campaign for Fiscal Equity lawsuit, while not apparently imminent, could occur during the Financial Plan period. Based on comments by a state Supreme Court judge as well as some of the proposed solutions, in addition to more state aid the city would likely have to increase its spending on schools as well.

***Labor.*** The Mayor has provided enough funds in the city's labor reserve to cover future wage increases with municipal labor unions at roughly half the rate of inflation. Given the pattern of recent settlements with city unions and the city's current fiscal strength, the funding in the reserve may prove to be insufficient to cover future contract agreements. If the Bloomberg Administration and the unions were to reach settlements at roughly the rate of inflation, the cost would be about $300 million more than is in the labor reserve for 2007 and $1 billion more than is in the reserve for 2010, barring any significant productivity givebacks.

***Health and Hospitals Corporation.*** The city's public hospital system is projecting a budget shortfall of more than $500 million in 2007 that grows to nearly $900 million in 2010. The hospital corporation's plan to close this shortfall includes more than $380 million in federal and state aid in 2007, increasing to more than $640 million by 2010. If the Health and Hospitals Corporation is unable to obtain this aid or substitute other measures, there will be increasing pressure on the city to help close the hospital system's budget gap.

***State and Federal Actions.*** The Preliminary Budget includes $350 million in gap-closing assistance from the state and federal governments. Last year's Preliminary Budget anticipated $750 million in similar aid, but in the Mayor's subsequent Executive Budget the expectation was cut in half. The city's large surplus last year and nearly as large surplus anticipated for this year may make it hard to leverage assistance from Washington and Albany.

***Medicaid.*** Unlike the issues cited above, Medicaid may prove to be somewhat less costly for the city than as projected in the Preliminary Budget. Technical details for the implementation of the new cap on the local share of Medicaid expenditures are still being worked out. But IBO estimates that the city's share of Medicaid costs will be upwards of $100 million *below* the projection of the Bloomberg Administration for 2007.

## CONCLUSION

The 2007 Preliminary Budget and Financial Plan through 2010 take a cautious approach to the city's current budget surplus. With the assumption that much of the surplus is from temporary revenue spikes and one-time savings actions, the budget plan largely seeks to use the surplus in ways that do not commit the city to recurring expenditures or tax reductions that could be difficult to sustain in the future.

In doing this, the Bloomberg Administration has sought to take money "off the table" through steps such as the creation of the retiree health insurance trust fund and the deferral of tobacco revenues. These are steps that manage the use of the surplus prudently and can help to reduce the burden of rising health insurance costs or cyclical declines in the local economy in future years.

But these are not the only means for achieving those goals. For example, using more of the surplus for pay-as-you-go capital would not commit the city to recurring expenditures. But it could help meet the need for housing, schools, transportation, and other capital investments while also reducing the growing cost of debt service in future years. How the Mayor and the City Council determine to best use the surplus while remaining fiscally prudent will have effects beyond the city budget for years to come.

**IBO Revenue Projections**

*Dollars in millions*

| | 2006 | 2007 | 2008 | 2009 | 2010 | Average Change |
|---|---|---|---|---|---|---|
| **Tax Revenue** | | | | | | |
| Property | $ 12,409 | $ 13,093 | $ 14,379 | $ 15,284 | $ 16,218 | 6.9% |
| Personal Income | 7,071 | 6,765 | 7,248 | 7,677 | 7,704 | 2.2% |
| General Sales | 4,356 | 4,443 | 4,622 | 4,864 | 5,120 | 4.1% |
| General Corporation | 2,192 | 2,122 | 2,233 | 2,436 | 2,614 | 4.5% |
| Unincorporated Business | 1,221 | 1,253 | 1,310 | 1,381 | 1,465 | 4.7% |
| Banking Corporation | 587 | 533 | 538 | 539 | 508 | -3.5% |
| Real Property Transfer | 1,106 | 810 | 725 | 756 | 787 | -8.2% |
| Mortgage Recording | 1,224 | 811 | 691 | 660 | 667 | -14.1% |
| Utility | 387 | 348 | 343 | 342 | 331 | -3.8% |
| Hotel Occupancy | 302 | 311 | 342 | 383 | 429 | 9.2% |
| Commercial Rent | 480 | 497 | 514 | 530 | 546 | 3.3% |
| Cigarette | 123 | 120 | 116 | 112 | 111 | -2.5% |
| Other Taxes and Tax Audits | 921 | 917 | 909 | 918 | 933 | 0.3% |
| Total Taxes Before Proposal | 32,379 | 32,023 | 33,970 | 35,882 | 37,433 | 3.7% |
| Property Tax Rebate | - | - | (268) | (273) | (278) | n/a |
| Total Taxes After Proposal | 32,379 | 32,023 | 33,702 | 35,609 | 37,155 | 3.5% |
| | | | | | | |
| **Other Revenue** | | | | | | |
| STaR Reimbursement | 855 | 751 | 932 | 788 | 981 | 3.5% |
| Miscellaneous Revenues | 3,606 | 3,362 | 3,749 | 3,337 | 3,356 | -1.8% |
| Unrestricted Intergovernmental Aid | 490 | 340 | 340 | 340 | 340 | -8.7% |
| Other Categorical Aid | 948 | 968 | 980 | 995 | 999 | 1.3% |
| Anticipated Federal and State Aid | - | 350 | 250 | 250 | 250 | n/a |
| Inter-fund Revenues | 373 | 365 | 346 | 346 | 346 | -1.9% |
| Disallowances | (15) | (15) | (15) | (15) | (15) | n/a |
| **Total City Funded Revenue** | 38,636 | 38,144 | 40,284 | 41,650 | 43,412 | 3.0% |
| | | | | | | |
| State Grants | 9,408 | 9,634 | 9,872 | 10,123 | 10,306 | 2.3% |
| Federal Grants | 5,601 | 5,322 | 5,317 | 5,314 | 5,317 | -1.3% |
| | | | | | | |
| **Total Revenues** | **$ 53,645** | **$ 53,100** | **$ 55,473** | **$ 57,087** | **$ 59,035** | 2.4% |

SOURCE: IBO.

NOTES: Personal Income Tax includes Transitional Finance Authority (TFA) dedicated personal income tax revenue. Estimates exclude intra-city revenues.

**IBO Expenditure Projections**

*Dollars in millions*

| | 2006 | 2007 | 2008 | 2009 | 2010 | Average Change |
|---|---|---|---|---|---|---|
| **Health & Social Services** | | | | | | |
| Social Services | $ 6,760 | $ 7,158 | $ 7,301 | $ 7,448 | $ 7,583 | 2.9% |
| HHC | 728 | 955 | 938 | 924 | 942 | 6.7% |
| Health | 1,558 | 1,483 | 1,496 | 1,510 | 1,509 | -0.8% |
| Children Services | 2,220 | 2,149 | 2,148 | 2,148 | 2,148 | -0.8% |
| Homeless | 737 | 697 | 692 | 682 | 672 | -2.3% |
| Other Related Services | 557 | 458 | 457 | 457 | 457 | -4.8% |
| *Subtotal* | 12,560 | 12,900 | 13,032 | 13,169 | 13,311 | 1.5% |
| **Education** | | | | | | |
| DOE (excluding labor reserve) | 14,696 | 14,912 | 15,022 | 15,281 | 15,491 | 1.3% |
| CUNY | 554 | 494 | 493 | 493 | 493 | -2.9% |
| *Subtotal* | 15,250 | 15,406 | 15,515 | 15,774 | 15,984 | 1.2% |
| **Uniformed Services** | | | | | | |
| Police | 3,767 | 3,860 | 3,854 | 3,835 | 3,810 | 0.3% |
| Fire | 1,354 | 1,312 | 1,311 | 1,304 | 1,297 | -1.1% |
| Correction | 886 | 852 | 846 | 843 | 839 | -1.4% |
| Sanitation | 1,136 | 1,176 | 1,187 | 1,183 | 1,179 | 0.9% |
| *Subtotal* | 7,143 | 7,200 | 7,198 | 7,165 | 7,125 | -0.1% |
| **All Other Agencies** | 5,259 | 5,373 | 5,387 | 5,406 | 5,497 | 1.1% |
| **Other Expenditures** | | | | | | |
| Fringe Benefits (excluding DOE) | 3,254 | 3,440 | 3,675 | 3,920 | 4,182 | 6.5% |
| Retiree Health Benefits Trust Fund | 1,000 | 1,000 | - | - | - | n/a |
| Debt Service | 4,463 | 1,594 | 5,444 | 5,826 | 6,166 | 8.4% |
| Pensions | 3,881 | 4,750 | 5,474 | 5,710 | 5,576 | 9.5% |
| Judgments and Claims | 601 | 647 | 690 | 743 | 793 | 7.2% |
| General Reserve | 100 | 300 | 300 | 300 | 300 | n/a |
| Labor Reserve: | | | | | | |
| Education | 24 | 24 | 24 | 24 | 24 | n/a |
| All Other Agencies | 310 | 572 | 829 | 1,010 | 1,254 | n/a |
| Pay-As-You-Go Capital | 200 | 200 | 200 | 200 | 200 | n/a |
| Expenditure Adjustments | (400) | 139 | 188 | 251 | 326 | n/a |
| **Total Expenditures** | $ 53,645 | $ 53,545 | $ 57,956 | $ 59,498 | $ 60,738 | 3.2% |

SOURCE: IBO.

NOTES: Debt service expenditures, if adjusted for prepayments, would grow at an annual average rate of 10 percent. Debt service includes Transitional Finance Authority (TFA) debt service expenditures. Expenditure adjustments include energy, lease, prior year payable adjustments, and non-labor inflation estimates. Estimates exclude intra-city expenses.