New York City Independent Budget Office

Fiscal Brief

May 2013

Reestimating the Mayor's Plan:

An Analysis of the 2014 Executive Budget & Financial Plan Through 2017

Late last month, the U.S. Government Accountability Office issued a report presenting a gloomy picture of the near-term and long-term outlook for state and local budgets across the country. Just a few days later, Mayor Michael Bloomberg presented his Executive Budget for 2014 and Financial Plan through 2017 for New York City. Much like the federal agency's report, the Mayor's comments on the city's fiscal condition included a heavy dose of warnings about the city's ability to meet its expenses. Yet the budget documents themselves tell a somewhat different story.

IBO's latest economic forecast and reestimate of revenues and expenses under the Mayor's new budget plan presents a picture of a city that is in better fiscal condition than many other municipalities. Tax revenues are expected to grow at an average annual rate of nearly 5 percent, outpacing the anticipated growth in expenditures over the same period. IBO projects job growth of nearly 57,000 this calendar year, 72,000 next year, and average growth of 75,000 annually in 2015 through 2017.

Based on these and other factors, we project that under the Mayor's plan the city will end the current fiscal year with a surplus of $2.1 billion—about the same as estimated by the Bloomberg Administration. For 2014, IBO projects a surplus of $476 million. Our projection for 2015 is a relatively modest shortfall of $930 million, just 1.7 percent of city-generated revenue, an amount easily covered by routine end-of-year accounting adjustments.

Still, the budget documents do not tell the whole story of the fiscal issues confronting the city. The budget plan's balance rests on the assumption there will be no retroactive raises for municipal employees, many of whom have been working under contracts that expired three or more years ago. Under one plausible scenario presented by IBO in our report on the Mayor's Preliminary Budget for 2014, the cost of a settlement would add $4.5 billion to city expenses through the end of this fiscal year and it would increase annual costs in 2014 and beyond by $1.8 billion. The still unfolding consequences of federal cutbacks along with the still developing plans for how the city will protect itself from the effects of future storms like Sandy could also upend the city's fiscal balance.

The Economy and Taxes

Economic Overview. IBO's forecast for 2013 is for modest economic growth at the U.S. level, with little acceleration from last year. Stronger growth in gross domestic product (GDP) is expected in the following years, particularly 2014 and 2015. (Unless otherwise noted in this section on the economy,

Tables on IBO's Revenue and Expenditure Estimates @ www.ibo.nyc.ny.us

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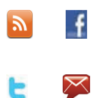

years refer to calendar years rather than fiscal years.) The expectation of weaker growth this year stems from anticipation that federal fiscal policy—tax increases that took effect in January following the fiscal cliff negotiations and federal spending cuts under the sequester—will be a drag on the economy.

Measured in terms of jobs, the local economy has bounced back strongly since the end of the Great Recession. Although we expect local employment growth to slow this year due in part to this fiscal drag, strong job gains are forecast to resume next year. However, growth in wages and earnings in the city have not kept pace with job growth as the composition of the city's work force shifts towards more lower paying industries. The securities industry—diminished but still central to the local economy—generated strong profits and bonuses in 2012, but these are expected to be smaller in 2013 through 2017.

U.S. Economy. U.S. economic growth picked up in the first quarter of 2013, though slower growth is expected later in the year. Real GDP grew 2.5 percent (initial estimate) in the first quarter, compared with 0.4 percent growth in the fourth quarter of 2012. (Unless otherwise noted, all monthly and quarterly figures are seasonally adjusted.) IBO expects that a combination of payroll tax increases and federal government spending cuts will restrain what was already expected to be only moderate real GDP growth for 2013 as a whole to 2.2 percent, the same rate as last year. With fiscal drag expected to abate by the end of the year, and barring any new shocks, conditions favorable for sustained private-sector growth are forecast to boost economic growth to 3.4 percent in 2014.

Although conditions favorable to sustained growth have been in place for some time, the economy has been slow to recover. Business profits and balance sheets are robust, the banking system has been recapitalized and is increasingly willing to extend credit, households have shed much of the debt built up during the boom years, interest rates remain near record lows, and there is considerable pent-up demand for everything from appliances to cars to homes. But annual growth of real GDP has just been about 2 percent in each of the past three years and real earnings growth has been minimal, constraining demand for output. Similarly, modest job growth in the private sector coupled with continued declines in public-sector employment have only resulted in a very gradual decline in the rate of unemployment, from 9.9 percent at the recession's trough (fourth quarter of 2009) to 7.7 percent in the first quarter of 2013.

One factor behind the slow pace of the recovery has been the prolonged slump in the market for housing. But over time the huge inventory of homes that was a legacy of the housing boom and subsequent recession has been slowly reduced. With increases in home sales and rising prices signaling that the market has turned around, IBO expects the pace of housing starts to accelerate in 2013 and 2014, fueling employment in construction and other sectors, such as manufacturing, trucking, and utilities.

Despite the momentum in the private sector from housing's revival, economic growth is expected to slow in the second and third quarters as the impact of fiscal austerity peaks. Although sequestration began in March, its impact on real GDP growth will increase through the third quarter because it takes time for these across-the-board cuts to actually affect government outlays. The 2 percentage point increase in payroll taxes that took effect on January 1st of this year has already contributed to an annualized 4.4 percent decline in disposable (after-tax) personal income in the first

Total Revenue and Expenditure Projections
Dollars in millions

	2013	2014	2015	2016	2017	Average Change
Total Revenues	**$71,771**	**$70,874**	**$74,499**	**$77,789**	**$80,788**	**3.0%**
Total Taxes	44,412	45,068	48,351	51,186	53,565	4.8%
Total Expenditures	**71,771**	**70,399**	**75,428**	**77,632**	**79,722**	**2.7%**
IBO Surplus/(Gap) Projections	**$-**	**$476**	**($930)**	**$157**	**$1,065**	
Adjusted for Prepayments:						
Total Expenditures	$72,109	$72,381	$75,570	$77,632	$79,722	2.5%
City-Funded Expenditures	$50,191	$52,393	$55,328	$56,941	$58,524	3.9%

NOTES: IBO projects a surplus of $2.093 billion for 2013, $68 million below the Bloomberg Administration's forecast. The surplus is used to prepay some 2014 expenditures, leaving 2013 with a balanced budget. Revenue and expenditures include $1.5 billion in Hurricane Sandy federal categorical funding in 2013. Estimates exclude intra-city revenues and expenditures. City-funded expenditures exclude state, federal, and other categorical grants, and interfund agreement amounts.Figures may not add due to rounding.

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quarter, though it will take several quarters for its impact on consumer spending to be fully realized.

Personal consumption spending rose 4.1 percent (annual basis) in the first quarter, fueled by a reduction in household savings and—to a lesser extent—by decreases in gas prices and the wealth effect of rising equity and housing markets. But given the decline in disposable income that results from elimination of the payroll tax cut, it is unlikely that this rate of consumer spending growth will be sustained.

Slow growth in consumption and cuts in government spending will constrain economic growth for the remainder of this year. For 2013 as a whole, IBO forecasts that real GDP will rise 2.2 percent, the same rate as 2012, and (nominal) personal income will increase 3.9 percent. We expect the U.S. to add 2 million jobs in 2013, about 200,000 less than in 2012. The slow pace of employment growth will barely nudge the unemployment rate down over the course of 2013; the unemployment rate is projected to average 7.6 percent for the year, slightly less than the rate in the last quarter of 2012. With a still-high unemployment rate and little inflation—projected to be 2.0 percent in 2013—the Federal Reserve is expected to maintain its accommodative policy of keeping interest rates low and expanding the money supply.

Economic growth is expected to accelerate in 2014 as the impact of tax increases and spending cuts diminishes. IBO forecasts real GDP growth of 3.4 percent in 2014, which would be the highest annual growth rate since 2004. Personal income growth will also pick up to a projected 6.5 percent. With the addition of 2.3 million new jobs in 2014, the unemployment rate will fall further, to an average of 7.0 percent.

IBO expects the solid economic growth of 2014 to continue into 2015, when real GDP is forecast to rise to 3.6 percent. Projected employment growth of 3.6 million jobs during the year should bring the unemployment rate below the Federal Reserve's 6.5 percent policy threshold, prompting the Fed to begin winding down its monetary stimulus. After 2015, economic growth will moderate but still be fast enough to reduce the unemployment rate further, from an average of 6.2 percent in 2015 to 5.8 percent in 2016 and 5.5 percent in 2017.

The Mayor's Office of Management and Budget's (OMB) forecast of U.S. economic growth is substantially below IBO's for both this year and next. OMB projects that real GDP growth will slow to 1.6 percent in 2013, well below IBO's forecast of 2.2 percent. The difference between the two GDP forecasts for 2014 is similar: 2.7 percent for OMB compared with 3.4 percent for IBO.

Two of the biggest risks to IBO's macroeconomic forecast continue to be economic problems in Europe and federal fiscal policy here in the United States. The European Union's sovereign debt problems have spread to yet another country (Cyprus) and most countries in the union—including the four largest economies—are either in recession or considered at risk for a recession. The political impasse over near-term federal fiscal policy also poses a major risk to the forecast. Another showdown in Congress over the federal debt limit, or over the budget itself, could undermine consumer and business confidence, similar to what happened when brinkmanship over the debt limit led to the downgrade of U.S. debt in 2011.

Finally, IBO's economic forecast is premised on there being no external shocks to the U.S. economy, such as a disruption in the supply of oil that would cause oil prices to spike.

Local Economy. After Hurricane Sandy brought New York City employment growth almost to a standstill in the fourth quarter of 2012, a large rebound was expected (especially in construction, trade, and leisure and hospitality) early in 2013. Instead, the city has had solid but not spectacular job growth so far this year, with employment increasing by 21,000 in the first quarter. That pace is expected to moderate over the course of the year due primarily to the lagged impacts of the recent federal tax increases and sequester on the local economy. As a result, IBO projects an employment gain of 56,900 (1.5 percent) in the city for 2013. This is almost unchanged from our previous forecast. Employment growth is expected to pick up speed again in 2014, however, with the city's own considerable momentum reinforced by increasing strength in the national economy. IBO forecasts city employment growth of 72,200 (1.8 percent) in 2014, followed by average growth of 75,000 (1.8 percent) per year in 2015 through 2017.

Under this forecast, total payroll employment in New York City would surpass the 4 million mark about midway through 2014. By the end of 2017, IBO expects the city economy to have added 580,000 jobs over an eight-year (32 quarter) stretch dating from the end of the recession in 2009. Moreover, the unemployment rate of city residents, which has remained stubbornly high, is projected to finally respond to the strong job growth. The unemployment rate, which

averaged 9.2 percent in 2012, is expected to fall to 8.5 percent in 2013, 7.3 percent in 2014, and 4.9 percent by 2017. This is a steeper decline than we forecast in March.

Better than half of the job growth over the 2013 through 2017 period will be supplied by professional and business services (19,300 jobs added per year, 27.3 percent of total growth) and education and health care services (17,200 jobs per year, 24.3 percent). Another quarter of the overall growth comes from leisure and hospitality (8,800 jobs per year) and trade (8,300 jobs)—both buoyed by the city's vibrant tourism industry. These four supersectors were also key contributors to the city's employment growth in the 2004 though 2008 period leading up to the recession.

But there are several notable differences in the composition of projected job growth as compared with the prerecession period. In particular, in the earlier expansion the securities sector added 4,800 jobs per year, accounting for 9.1 percent of net city job growth, while manufacturing lost 6,200 per year, offsetting 11.8 percent of the growth. In our current forecast for 2013 through 2017, the manufacturing decline abates to only 500 per year, offsetting 0.7 percent of job growth. But at the same time securities job growth weakens to 1,400 per year, good for only 2.0 percent of the local economy's projected aggregate employment growth through 2017.

The securities sector is also expected to contribute much less to aggregate real wage growth in the city over the 2013 through 2017 period (19.9 percent) than it did in the previous expansion (55.8 percent over 2004 through 2008). This is not just a function of the falloff in securities employment growth: average wages in securities are also growing more slowly. Following an 8.6 percent drop in 2012, real average securities wages are projected to grow 4.5 percent a year from 2013 through 2017. This is less than half the pace of the years before the eruption of the financial crisis. This reflects, in part, the increased use of deferred compensation in lieu of large cash bonuses in the industry.

As the securities sector's contribution to aggregate wage growth shrinks, the contributions from sectors such as education and health care, government, and trade are expected to expand in the forecast period. These sectors all have much lower average wages than securities. The result is that overall wage growth in the city, and also overall personal income growth, will be not be as strong as in past expansions. IBO's forecast calls for average personal income growth of 5.7 percent over the 2013 through 2017 period. This is 3.9 percent per year after adjusting for inflation, lower than the 4.6 percent average rate of real personal income growth in the 2004 through 2008 expansion.

Aggregate wage and personal income growth have also been constrained by the decline in average hours worked since the recession. While private-sector employment in New York City stood 4.3 percent higher in the first quarter of 2013 than in the first quarter of 2008, the average weekly hours of all private employees was 3.6 percent lower. Most of the drop occurred between 2008 and 2009, but there has been renewed downward pressure on the private-sector workweek in 2012 and 2013. As a result, aggregate private-sector hours worked in the city have barely advanced, up just 0.5 percent compared with five years ago.

Another factor affecting personal income growth in 2013 is the expiration of the payroll tax holiday in January. Contributions for social insurance, which are netted out of reported personal income, are expected to jump by $8.0 billion in New York City this year. This is nearly four times the normal annual increase in contributions.

The subdued employment and wage growth in securities reflect the constraints and uncertainties that continue to impact the industry in the aftermath of the financial crisis. With regulatory reform still very much a work in progress (to date fewer than half of the Dodd-Frank regulations have been finalized), we do not anticipate a return to the "old normal" on Wall Street any time soon. Another sign of the change is the post-crisis plunge in broker-dealer revenues of New York Stock Exchange (NYSE) member firms. Revenues as of 2012 ($161.5 billion) were still well under half of their 2007 peak ($352.0 billion). In IBO's forecast, it will be 2017 before revenues again exceed $200 billion.

On the other hand, broker-dealer profits were exceptionally strong last year ($23.9 billion). We expect profits to dip to $15.4 billion in 2013 and then to build incrementally to $17.4 billion by 2017. As we have discussed in prior forecasts, solid or even strong Wall Street profits despite substantially lower revenues are made possible by a steep decline in member firm interest expenses—which in turn has been made possible by the Federal Reserve's decision to keep interest rates at record-low levels.

Tax Forecast. Tax revenues in 2013 have been very strong and by the end of the year are expected to total $44.4 billion, 7.5 percent higher than in 2012. Some of the increase is due to a shift in the timing of capital gains

realizations and bonus payments as taxpayers moved income into tax year 2012 when federal tax rates were lower. The shift means less revenue for subsequent years, particularly 2014 when $45.1 billion in tax revenue is expected, an increase of only 1.5 percent. IBO expects stronger tax revenue growth to resume in 2015, averaging 5.9 percent annually through 2017. IBO's tax forecast is slightly below OMB's for 2013, but thereafter, IBO's outlook exceeds OMB's with the difference widening each year from $664 million in 2014 to $2.7 billion in 2017.

Business Income Taxes. Following 2012, when combined revenue from the city's three business income taxes grew just 1.2 percent over the previous year, IBO forecasts business tax revenue growth of 4.4 percent this year, generating $5.6 billion. Revenue growth will be similar in 2014 (4.3 percent) but then accelerate to an annual average rate of 9.1 percent in the 2015-2017 period, with the fastest growth of each tax coming in 2015 or 2016—years in which IBO's forecasts of national and local economic growth are strongest. By 2017, combined revenue from the three taxes—the general corporation tax (GCT), the banking corporation tax (BCT), and the unincorporated business tax (UBT)—will reach $7.6 billion.

While the GCT generates the most revenue of the three taxes, it is projected to grow the slowest: 2.9 percent this year, to yield $2.5 billion. Annual growth will average 6.6 percent in the next four years, yielding $3.2 billion in 2017 revenue. Although total profits of NYSE-member firms reached their third highest annual total on record in calendar year 2012, the latest available data (through January 2013) on payments by industry indicates that GCT growth this year is being driven by the professional services and information sectors, rather than finance. Many financial corporations appear to have overpaid their calendar year 2011 liabilities, allowing them to reduce payments for 2012 liability. IBO is projecting faster growth for fiscal year 2014 as corporate profits continue to rise, with GCT revenue totaling $2.6 million. GCT revenue growth is expected to accelerate from 2014 through 2016 and continue into 2017 when our GCT forecast reaches $3.2 billion.

Though gross BCT payments are strong this year, especially those made by commercial banks, large refunds in recent months have lowered expected revenue growth in the current year. IBO's forecast for 2013 is $1.3 billion, 4.5 percent higher than in 2012. In 2014 we project a $60 million (3.0 percent) decline in BCT receipts, as banks' revenue potential is constrained by increased capital requirements, regulatory uncertainties, and the maintenance of tight lending standards. After 2014, BCT growth is expected to resume strongly as the regulatory environment becomes clearer and as faster economic growth takes hold. BCT revenue is expected to reach $1.8 billion in 2017.

UBT revenue growth has been the strongest among the three business income taxes so far in 2013. Revenue is expected to be $1.7 billion this year, 6.7 percent more than 2012 collections. IBO is expecting consistently fast—though hardly unprecedented—growth in subsequent years as strong earnings growth in the professional and business service, financial service, and information sectors is expected. UBT revenues in 2014 are forecast to be $1.9 billion—10.1 percent growth over 2013. They will then grow by an annual average of 9.6 percent during the 2015-2017 period, with UBT revenue reaching $2.5 billion in 2017.

There are only modest differences between IBO's and OMB's forecasts of the combined business income taxes in 2013 and 2014, with IBO predicting $164 million (2.8 percent) less than OMB for 2013 and $115 million (2.0 percent) more in 2014. After 2014, IBO's forecasts for each of the taxes are higher than OMB's, due to the faster growth in IBO's economic forecast. By 2017, the difference in projected revenue for the three taxes totals $1.1 billion.

Personal Income Taxes. A surge of estimated payments made in April by taxpayers filing for extensions has led IBO to increase its 2013 forecast of personal income tax (PIT) revenue by $522 million, to $9.2 billion—15.1 percent growth over 2012 collections. In 2014, however, PIT revenue will decline 5.7 percent, to $8.6 billion. This pattern of very strong revenue growth followed by revenue decline is due to a shift of capital gains realizations and year-end bonus compensation into calendar year 2012 in anticipation of increases in federal tax rates, boosting fiscal year 2013 revenue at the expense of 2014 and, to a lesser extent, subsequent years.

IBO's forecast for 2013 estimated payments, the component of PIT collections that includes most capital gains liability, is $2.9 billion, 36.8 percent greater than payments in 2012. Similarly, 2013 payments with final returns, which also reflect capital gains, are forecast to rise 18.0 percent. With a significant amount of gains that would have been realized in calendar year 2013 accelerated into 2012, there will be fewer realizations this year and next, resulting in a 23.4 percent fall-off in estimated payments for 2014. But the strength of the PIT this year is not simply the result of accelerated capital gains realizations fueling

estimated payments and payments with final returns. Based on strong collections to date in 2013—particularly during the winter months when bonuses are typically paid—we also expect a 6.5 percent increase in withholding, reflecting employment gains and personal income growth this past year. For 2014, we anticipate slower withholding growth of 4.2 percent, due to the impact of weaker U.S. growth on the city's economy and the likelihood that next year's bonus season will not be as strong.

With personal income growth in the city expected to double after calendar year 2013 and an average annual gain of 77,000 jobs forecast for calendar years 2014 and 2015, IBO forecasts $9.8 billion of PIT revenue in 2015—13.2 percent greater than in 2014. In 2016 and 2017, IBO projects slower revenue growth at an annual average rate of 3.1 percent, with revenues reaching $10.4 billion in 2017.

IBO's 2013 PIT forecast is only $36 million (0.4 percent) higher than OMB's. The difference between the two forecasts grows to $464 million in 2014, the result of faster income and employment growth in IBO's economic outlook and of OMB forecasting a much sharper drop in estimated payments. The differences in the economic forecasts continue to widen the divergence between the PIT projections, to $725 million in 2015 and roughly comparable amounts thereafter.

Real Property Tax. IBO has made only minor changes to its forecast of real property tax revenue since March. Our 2013 forecast has been increased by $100 million to $18.6 billion—3.4 percent greater than collections in 2012. The revision to our forecast for 2014 is even smaller, a decline of $11 million, with all of the changes in various components of the reserve (prior year collections, cancellations, refunds, delinquencies, and revenue from the lien sale); our levy forecast is unchanged. IBO now expects property tax revenues of $19.5 billion next year, up 4.9 percent from 2013. As in March, our forecast assumes a larger than usual tentative to final roll change, due to expected assessment reductions for properties damaged during Hurricane Sandy. There are also minor changes to our levy and reserve forecasts for 2015 and 2016, resulting in very small changes in the property tax revenue forecast for each year.

For 2014 through 2017, IBO projects that assessed value for tax purposes will grow at an annual rate of 2.8 percent for Class 1, 4.2 percent for Classes 2 and 3, and 6.4 percent for Class 4. The pipeline of assessed value of Class 2 and 4 properties waiting to be phased in is expected to increase throughout the forecast period, from $16.2 billion after the 2014 roll to $20.1 billion after 2017. After 2014, increases in property tax revenue will average 5.1 percent a year, rising from $19.5 billion in 2014 to $20.3 billion in 2015 and reach $22.6 billion in 2017.

IBO's and OMB's forecasts of 2013 property tax revenue are virtually the same. For 2014, the forecasts are also very similar: IBO's revenue forecast is $21 million lower. IBO's forecast of a lower 2014 tax levy than OMB projects is partly offset by our expectation that the coop and condo abatement will cost the city less in foregone tax revenue. For the remainder of the period, IBO's forecast of property tax revenues is higher than OMB's, by a small amount in 2015 ($18 million) and by larger amounts in 2016 ($207 million) and 2017 ($537 million). The growing divergence between the forecasts is attributable to IBO's projection of faster growth in the assessed value of properties for tax purposes.

Transfer Taxes. The city's real estate markets continue to recover after bottoming out in 2010. IBO forecasts an 18.7 percent increase in real property transfer tax (RPTT) receipts in 2013, to almost $1.1 billion, and a 33.8 percent increase in mortgage recording tax (MRT) receipts, to $718 million.

MRT revenues have increased at a faster rate than either taxable real estate sales or the RPTT this year. Both commercial mortgages, which are taxed at a higher rate than residential mortgages, and mortgage refinancing, which generates MRT revenue without a corresponding sale, have been strong. Though New York City-specific data are not available, national data from the Mortgage Bankers Association indicate that from July 2012 through March 2013, refinancing accounted for around three-fourths of the value of residential mortgage originations.

The growth in RPTT revenue this fiscal year has come primarily through commercial real estate transactions—33 percent higher through March than during the equivalent period in 2012. RPTT revenue from residential sales was up 18 percent. In anticipation of higher capital gains tax rates effective January 1, 2013, sales of both commercial and—to a lesser extent—residential properties surged at the end of calendar year 2012. Many transactions that took place late in calendar year 2012 were not recorded until January 2013, including the two largest taxable sales of commercial properties so far in 2013, each greater than $1 billion. The increase in capital gains taxes shifted the timing of some real estate transactions that otherwise would have occurred in fiscal year 2014. As a result, slower revenue growth in

2014 is projected for each tax. IBO forecasts $1.1 billion in RPTT collections—2.4 percent growth—and $746 million in MRT receipts, an increase of 3.9 percent. IBO projects faster revenue growth for the 2015 through 2017 period, at average annual rates of 11.1 percent for the RPTT and 9.8 percent for the MRT. RPTT increases will be fueled by both residential and commercial sales, and mortgage activity will remain strong. IBO expects that mortgage rates will begin to climb in 2015 but will remain low enough by historical standards to encourage mortgage activity. By 2017, RPTT revenue is forecast to reach $1.5 billion and MRT revenue $988 million, for a total of around $2.5 billion—still well below the 2007 peak of $3.3 billion. In general, IBO's forecast for the transfer taxes are slightly higher than OMB's but follow a similar trajectory; IBO's forecast of combined RPTT and MRT revenues over the entire 2013 through 2017 period is 1.3 percent above OMB's.

Sales Tax. In recent months sales tax collections have been strong, and IBO has increased its forecast of sales tax revenue to $6.1 billion in 2013, 4.8 percent over last year's collections. Through March sales tax revenue is up 5.2 percent over the same period last year—an increase that is greater than expected given the expiration of the payroll tax holiday at the start of the calendar year. But revenue growth in the remainder of fiscal year 2013 and in 2014 is expected to slow, as the economic effects of the payroll tax increase and sequestration become more broadly felt. IBO's forecast of sales tax revenue for 2014 is $6.3 billion, 4.2 percent greater than projected for 2013.

Sales tax receipts have grown strongly in part because the flow into the city of record numbers of tourists has continued, even through January and February—months when the number of tourist visits typically fall off. (Tourists not only pay sales taxes on their purchases in stores and restaurants, they also pay sales tax on hotel rooms, in addition to a separate tax on hotel occupancy.) Sales tax receipts in recent months were also likely bolstered by households rebuilding and replacing property and goods lost to Hurricane Sandy.

With the expectation that income and employment growth will accelerate by the end of this calendar year as fiscal drag abates, IBO projects $6.7 billion in sales tax receipts in fiscal year 2015—strong but hardly unprecedented growth of 5.3 percent over the previous year. Increases in sales tax revenues are expected to average 4.8 percent a year over the remainder of the forecast period, with collections reaching $7.3 billion in 2017.

IBO's sales tax forecasts for 2013 and 2014 are only 0.3 percent greater than OMB's, by $20 million and $22 million, respectively. Because differences between OMB's and IBO's projections of employment and income increase over the forecast period, the difference between IBO's and OMB's sale tax forecasts also widens, from $93 million in 2015 to $246 million in 2017.

Expenditures

Based on our latest projections, annual increases in tax collections will outpace IBO's estimate of growth in spending under the Mayor's budget plan. IBO projects that spending in 2014 will total $70.4 billion from all revenue sources, over $600 million more than projected by the Mayor. When we adjust our 2014 estimate to account for the use of the expected 2013 surplus to prepay some of next year's expenses, total spending to meet 2014 needs is $72.4 billion, an increase of 0.4 percent. Looking just at city-funded spending, which excludes the one-time federal funds in the wake of Sandy, expenditures are projected to grow from $50.2 billion this year to $52.4 billion in 2014, an increase of 4.4 percent.

IBO's higher expenditure estimate in 2014 includes our projection that city agencies will need to spend about $120 million more than budgeted under the Bloomberg Administration's plan. This additional spending is in a number of areas such as $71 million for health insurance for city employees, $20 million for a likely runoff election following this September's primaries, $15 million in overtime for correction officers, and $14 million for homeless shelters for single adults and families.

Where Costs Are Rising. While spending for most city functions remains flat under the Mayor's budget plan, there are several expenditure categories that continue to rise. One of the largest and fastest growing city expenditures is the cost of health care insurance and other fringe benefits for city employees. Health and related benefit costs are expected to increase by $136 million in 2014 and total just over $5.0 billion (including the use of the last $1.0 billion left in the Retiree Health Benefits Trust fund). Health costs are expected to climb an additional $403 million in 2015 and total nearly $5.5 billion. By 2017, health care and related benefit costs are projected to reach $6.4 billion—an increase of $1.5 billion from this year—rising at an average annual rate of 6.9 percent.

Rapid growth in health care costs is not unique to New York City. Last month's Government Accountability Office report

on state and local budgets cited rising health care costs as the primary long-term fiscal challenge faced by statehouses and city halls nationwide. The report also notes that the effect of the Patient Protection and Affordable Care Act on the growth rate of health care costs for governments remains uncertain.

Another large and fast-growing cost is debt service on the money the city borrows for its capital projects such as building or expanding schools, fixing roads and bridges, and buying sanitation trucks or police cars. The Mayor's plan projects debt service spending to rise by $253 million in 2014 and total $6.2 billion after adjusting for the use of the 2013 surplus to prepay some of the next year's costs. Debt service is expected to increase by an additional $933 million in 2015 and reach nearly $7.2 billion. By 2017, the last year of the financial plan, debt service is projected to reach $7.7 billion—a $1.7 billion increase from this year—rising at an average annual rate of 6.6 percent.

Although low-interest rates over the past few years have enabled the city to borrow at lower-than-expected costs and refinance some existing debt to reduce future costs, debt service spending is projected to continue to rise because of the city's many, and in some cases very costly, capital projects. The Bloomberg Administration's latest Capital Commitment Plan for 2013-2017 spends $44.5 billion on projects, with $34.3 billion of the funds coming from the city. Among the initiatives in the plan are $10.6 billion in school construction projects, $547 million for the design and reconstruction of a new detention center on Rikers Island, and $151 million for the planned renovation of the New York Public Library's central branch on 42nd Street.

While not growing as fast in percentage terms as some other parts of the city's operating budget, spending by the Department of Education is rising sharply in dollar terms. Education spending is expected to rise by $711 million and total nearly $19.9 billion in 2014 and then increase by another $592 million in 2015 when it is expected to reach almost $20.5 billion. By 2017, education spending is expected to reach $21.7 billion—a $2.6 billion increase—rising at an average annual rate of 3.2 percent.

A substantial share of the growth in education spending is largely funded by an expected rise in state aid. This includes the restoration of $250 million in state assistance for 2014 the city lost this year because of the impasse in developing a plan for teacher evaluations. With the state education commissioner now responsible for ensuring the city has an evaluation plan in place for next year, the city will avoid a second penalty of $213 million in aid for 2014. The Mayor's plan also includes an increase of $121 million of state foundation aid in 2014.

Rise in Pension & Medicaid Costs Ease. Although the costs of pensions for municipal employees and the city's Medicaid expenditures continue to be substantial costs in dollar terms, their rate of growth has slowed considerably from past years. The Mayor's financial plan projects the city's pension contributions will grow from about $8.1 billion this year to nearly $8.7 billion in 2017, an annual average increase of 1.8 percent. With pension fund investments earning a return of roughly 12.0 percent this fiscal year to date, well above the current assumption of 7.0 percent, it is likely the city's pension costs will be reestimated downward in 2015 and beyond as the benefit of this year's good returns begin to be phased in.

While the city's budget for Medicaid spending is also substantial, it is no longer growing rapidly. This is largely due to the cap enacted by Albany several years ago to ease the pressure of then fast-rising Medicaid costs on local budgets. Medicaid spending is projected to grow from $6.5 billion this year to just under $6.6 billion in 2017, an average annual increase of 0.3 percent.

Spending Cuts. The budget plan for 2014 includes a $1.0 billion set of proposals to reduce city-funded spending and bring in additional revenue. Much of the Program to Eliminate the Gap (PEGs) remains the same as when first proposed in the November 2012 Financial Plan. The PEG program includes $940 million in reductions of city-funded expenditures and $109 million in new revenue through increases to various fees and fines.

There are several measures previously announced by the Bloomberg Administration and that drew considerable public attention that have been reversed or scaled back in the most recent budget plan. One such measure is the plan to charge large nonprofit organizations for garbage collection. This plan, which has been eliminated, was expected to raise $17 million in 2013 and beyond. The parks department initiative to sell naming rights to dog runs and basketball courts and market other sponsorships has not succeeded. Initially expected to raise $13 million this year, it has brought in no revenue and the projection for 2014 and beyond has been reduced to $7.0 million a year. The expected savings of $2.0 million from the planned implementation of a new eligibility review for single adults

Sandy's Aftermath and Federal Aid

The Mayor's budget plan includes $4.5 billion in federal aid to the city in the aftermath of Hurricane Sandy. Of these funds, $1.5 billion is in the city's operating budget and will virtually all be spent in the current fiscal year. The other $3.0 billion is in the city's capital budget and is expected to be spent over fiscal years 2013 through 2015. Nearly $1.8 billion in additional funding was recently approved by Washington for New York City. These funds, which will come through the federal Community Development Block Grant program, have not yet been recognized in the city's budget.

The $1.5 billion largely comes to the city through the Federal Emergency Management Agency and is intended to reimburse the city for emergency relief, cleanup, and repairs. This includes $192 million in overtime, holiday pay, and other Sandy-related personnel costs for city agencies; two agencies, the police department ($87 million) and the sanitation department ($63 million), account for the majority of these costs. The city had initially received $500 million for its Rapid Repairs program, which made free emergency repairs such as restoring heat or electricity so that residents could stay in their homes while waiting for longer-term repairs. The city has now received $77 million more to cover additional costs incurred under this program.

The capital funds will be used for a range of longer-term infrastructure repair and rebuilding projects. This includes repairs to roads and bridges, schools, hospitals, beaches, boardwalks, and parks as well as housing and other buildings. The largest change since the Mayor's January plan is the redistribution of $477 million that had been allocated for undefined purposes in the city's housing department. These funds have been removed from the housing department and reallocated for other Sandy-related needs. For example, capital funding for beach and boardwalk repairs has been increased by $211 million, various parks repairs by $30 million, and playground repairs by $16 million, bringing total parks department capital funding for Sandy-related repairs to $785 million. The other largest planned areas of spending are $775 million for road and bridge repair and $712 million for hospital repairs.

A substantial portion of the community development funds will be used for housing aid such as providing grants to owners of Sandy-damaged homes, and a combination of grants and loans to renovate apartment buildings and to purchase emergency generators for public housing developments. Some of the community development funds will also be used to aid business recovery efforts.

seeking entry to the city's homeless shelters has also been eliminated for 2013. The City Council challenged and won its case against the new eligibility review, but the Bloomberg Administration may file an appeal and has still budgeted the savings in 2014 and later years.

The budget plan also reveals some early indications of the effects of recent federal cutbacks, the so-called sequestration. The Bloomberg Administration intends to cover the loss of $63 million in federal school aid with the additional funding the city expects from the state. The Bloomberg Administration also has a partial—and temporary–fix for the expected loss of $36 million in federal funding for Section 8 housing vouchers in 2014. The housing department intends to tap a reserve fund for the program next year, but this is a one-time measure that would cover only about half of the expected loss of funding and would mean the city will not be able to issue any new vouchers for rental assistance.

Other losses in federal aid may not be reversed even temporarily. The city expects to lose about $14 million in federal aid from the Child Development Fund, which is used to support child care, child welfare, and related programs. Cuts to federal health funding will cost the city $8.7 million in 2014; nearly $7.0 million of these funds are for AIDS/HIV-related services and the rest for tuberculosis, sexually transmitted diseases, immunization, and other programs. Additionally, the city will also lose $2.0 million in Workforce Investment Act funds in 2014 on top of a previously anticipated reduction of $5.1 million.

Besides the federal cutbacks, the budget plan for 2014 also does not include about $400 million in City Council restorations and initiatives funded just for 2013. Some of these are among the most controversial cuts embedded in the Executive Budget for 2014. One example is the loss of $102 million in subsidies for the city's library systems in 2014—a combination of restorations funded for just the current year as well as cuts proposed in November for next year—which could lead libraries to reduce services by as much as two days a week. An underlying $51 million cut to the city's largest after-school program, Out-of-School Time, coupled with a

new reduction of $10 million proposed for 2014, would reduce the number of slots in the program from 56,000 this year to 21,500 next year. The Executive Budget would also eliminate 20 fire companies, a reduction that has been proposed and rejected in each of the past three years—restored last year at a stated cost of $44 million.

Challenges on the Horizon? While the city's overall budget picture looks relatively bright as presented in the Executive Budget for 2014 and Financial Plan through 2017, the picture could darken quickly. The largest fiscal challenge facing the city is a settlement of the expired contracts with New York's municipal labor unions. All of the city's labor contracts have expired—three of the city's largest unions have been working under expired contracts for more than three years—and there is virtually no money set aside for raises prior to 2013. The Mayor's latest financial plan continues to assume there will be no retroactive raises unless they are paid for with productivity gains, something that is particularly difficult to do retroactively. The financial plan is placing a fiscal bet that may be hard to win.

To better understand the potential cost to the city from new contract agreements, earlier this year IBO developed a plausible scenario for a settlement with the unions (the terms are detailed in our Analysis of the Mayor's Preliminary Budget released in March). Under this scenario, a settlement would cost the city $4.5 billion by the end of this fiscal year. This scenario would also add $1.8 billion annually to the city's personnel costs in 2014 and in future years.

Another potential challenge, though comparatively modest in scale, is the Mayor's plan to generate revenue through the sale of 2,000 new taxi medallions. Four separate lawsuits have put the plan on hold and the Mayor has repeatedly changed projections of when the city would receive the expected total of $1.5 billion from the sale. The Bloomberg Administration now expects the city to net $300 million from the sale in 2014 (down $300 million from the estimate in the January 2013 plan) and $400 million in 2015 (down $97 million since January), with the balance coming in 2016 and 2017. Given the history of this plan, these expectations seem far from certain.

Another challenge could come from still emerging plans for increasing the city's resilience to Sandy-like storms in the future. Suggestions such as building sea walls are hugely expensive and it remains unclear how much Washington or Albany are willing to invest in helping the city prepare. Additionally, the mounting cost of providing health care for retired city workers will consume an increasingly substantial portion of the city's annual budget and potentially crowd out other spending needs.

There are economic uncertainties abroad and at home that could also lead to increased fiscal challenges locally. Ongoing economic problems in the European Union, with most countries in recession or at risk of recession, could have reverberations here. In Washington, another showdown over the debt limit or federal spending could undermine consumer and business confidence, effecting growth in the national and local economies. Federal regulatory changes for the financial sector, which are still a work in progress, could result in slower job and wage growth on Wall Street than IBO has forecast—and less tax revenues for the city.

A Mixed Message. Mayor Bloomberg has said that one goal of his administration was to not leave the next Mayor facing the level of fiscal duress he inherited. On paper the Mayor's budget plan accomplishes that goal. IBO projects a surplus approaching $500 million in the budget plan for 2014 and our projected shortfall for 2015 amounts to a very modest 1.7 percent of city-generated revenue, a sum easily covered by routine end-of-year accounting actions.

Yet the Mayor's presentation of his last Executive Budget struck a somewhat discordant note. Although he trumpeted such factors as the city's strong job growth, the number of tourists visiting the city hitting a record-high last year, and the city's rising level of housing construction, the Mayor placed even greater emphasis on the city's rising expenses. In particular, he pointed to rising labor costs, including the cost of pensions and health benefits—even absent a settlement of the expired contracts.

Reaching settlements with city unions may require an approach other than simply saying no to retroactive raises. That does not mean the level of raises in our scenario are a given—the high cost underscores just how difficult it would be fiscally. But zeroes for those past years without a new contract may be equally impractical. At the same time, balancing the city's budget largely through spending reductions as has been the practice over the past few years may not be tenable in the future, particularly if federal cutbacks continue to mount. New York City may well be in better fiscal condition that many other cities around the country, but that does not mean the next Mayor and City Council will be free of budget challenges.

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