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Market Volatility and Budget Uncertainty

By RONNIE LOWENSTEIN

A collapse in stock prices is roiling America. But nowhere are the effects likely to be felt as deeply as in New York City, where even residents who do not own a single share of stock may well suffer from a thrashing of the municipal budget brought on by the bear market. The current slump should serve as a reminder that the city needs to budget and plan for the long term, taking steps during the boom years to cushion its budget from the inevitable busts.

New York is certainly not a one-industry town, but it is heavily reliant on the tax revenue generated by the financial sector, and securities firms in particular. The securities industry directly generates 15 percent of the city's revenue from major business and personal taxes. With the industry responsible for such a significant share of city tax revenues—about $3.4 billion annually—rumblings on Wall Street can cause an already fragile city budget to teeter ever more precariously.

Securities firms employ a relatively small share of the work force—in 2001, they accounted for 5 percent of the city's 3.6 million jobs. But they are well-paying jobs, and this is one reason Wall Street is so critical to the city's tax base. The average compensation for a Wall Street worker was $248,500 in 2000, according to State Department of Labor statistics—10 times more than the average pay of someone employed in the retail industry. In fact, workers in the securities industry account for 21 percent of total pay in the city. These well-paid workers generate additional jobs and tax revenue with their spending on housing, cars, clothes, restaurants and other services. There is a similar spillover effect from the securities firms themselves.

The slide in stock prices is also taking a toll on how much revenue the city garners from its richest residents in all lines of work. While millionaires are less than 0.5 percent of the city's tax filers, they are expected to account for nearly 30 percent of the personal income tax revenues the city will collect this year. A large share of that revenue comes from taxing the capital gains from the sale of stocks. As their capital gains shrink because of the declining market, the city's income tax receipts will also fall.

At the same time Wall Street's troubles are threatening to crimp New York's tax receipts, the fall in stock prices is creating a significant new expenditure for the city: the city's pension funds for the municipal work force and retirees are heavily invested in the market. How much the city must directly contribute to the pension funds each year is based on the funds' investment returns. By law, the city anticipates an 8 percent return. In fact, last fiscal year the funds lost more than 8 percent. The city will make up the difference between the expected gain and the actual loss over five years—at a cost of $4.6 billion.

While there is not much the city can do to ensure that Wall Street generates expected profits for pension funds or investors, it can take steps to minimize the effects of the bear market on the city's ability to provide essential services. As others have suggested, when Wall Street-related tax revenues are strong, the city can pay upfront for some of its capital needs rather than taking on costly new long-term debt. New York City also could establish a true rainy-day fund, requiring that a share of any surplus be saved—instead of the city's current practice of using surpluses to prepay some of the next year's expenses. The fund could be tapped only to address a short-term emergency, like a recession, that would be defined by law.

Another way of protecting the city is to take a careful look at our largest and most stable revenue source: the property tax. Some of the limits built into the city's property tax structure have contributed to our growing dependence on volatile personal and business income taxes. We need to consider why the property tax system fails to keep pace when property values grow.

Even more so than most cities, New York cannot avoid the effects of a volatile market. But it can, and should, take steps to be better prepared to weather future Wall Street storms.

Ronnie Lowenstein is director of the New York City Independent Budget Office.