New York City Independent Budget Office Fiscal Outlook

December 2011

At A Fiscal Crossroads:

While Moderate Economic Growth Helps Shrink Budget Gaps, Reasons for Concern Remain

With little fanfare, the Bloomberg Administration last month issued its update of the budget for this fiscal year and financial plan for the ensuing years through 2015. The understated release reflects a budget plan that appears to leave the city idling at a fiscal crossroads as the Bloomberg Administration scans ahead, trying to discern where the roads may lead.

Given current economic and political uncertainties, it would not be hard to be thrown off course. The fragility of the U.S. and international economies and recent weakness in the city's financial sector are cause for concern. Other keys to the direction of the roads ahead lie in Washington and Albany and what will happen to the levels of state and federal aid for the city.

While waiting to see what develops on the horizon, the Mayor's November 2011 Financial Plan has proposed a $1.5 billion set of measures over two years to reduce city-funded spending. The budget plan also effectively zeroes out the Retiree Health Benefits Trust Fund with $1.0 billion allocations of its remaining assets in both 2013 and 2014. Even with these steps, the Mayor's budget plans for 2013-2015 show growing multibillion dollar shortfalls.

IBO's own economic forecast and tax revenue and spending projections map a different road. At the national level, IBO's forecast of moderate increases in inflation-adjusted gross domestic product (GDP), 2.5 percent in calendar year 2012 and 3.0 percent in 2013, are 0.7 percentage points above the Mayor's estimate for each year. Our projection for job growth in the city is another key difference, with IBO projecting the creation of about 89,000 jobs over the next two years, about 27,000 more than the Mayor estimates. Differences in the two economic forecasts drive differences in the forecast of tax revenues. IBO's tax revenue projections are a bit lower than the Mayor's for 2012 and play a large role in leaving a small deficit of $242 million that can be closed with the typical year-end budget and accounting adjustments. But our tax revenue projections for 2013 and beyond are increasingly stronger than those of the Bloomberg Administration and help narrow the projected shortfalls.

Based on IBO's tax and spending projections under the Bloomberg Administration's November 2011 Financial Plan, we estimate a budget shortfall of $1.2 billion in 2013, nearly $800 million less than the Mayor. For 2014, our gap projection is $2.2 billion, $1.7 billion less than the Mayor's; for 2015 our gap estimate is $1.9 billion, nearly $3 billion below the Mayor's.

Also available: **Additional Tables on Revenue, Expenditure and Economic Projections @ www.ibo.nyc.ny.us**

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Several factors could cast a pall over IBO's relatively modest gap estimates for the coming years. In addition to the economic uncertainties and the outlook for state and federal aid to the city, there is a crucial local fiscal issue: the potential cost of settling contracts with the city's unions—contracts with all the major unions have expired—still looms large with little in reserve for retroactive wage increases.

Taxes & Revenue

U.S. Economy. The U.S. economic recovery has been tenuous since it began in the first quarter of 2010. During the recovery the growth of the nation's output has been disturbingly slow and less than a quarter of the jobs lost during the 2008–2009 recession have been replaced. Weak economic growth has made the U.S. economy particularly vulnerable to looming threats, such as the worsening of the European debt crisis. IBO forecasts a gradual acceleration of real GDP growth in the next two years, to only 3.0 percent in 2013, but there are substantial risks to the continuation of even modest economic growth. (All years in this section refer to calendar years.)

Favorable conditions for an economic recovery, such as the recapitalization of the U.S. banking system and record corporate profits, have been in place for some time, but the U.S. economy has failed to gain momentum. Continued weakness in housing markets, high fuel prices, and the prolonged stalemate in Washington over the federal budget have all shaken consumer and business confidence this year and slowed consumer and investment spending.

The U.S. economy barely grew in the first quarter of this year and growth in the second and third quarters remained slow. Following first quarter growth of 0.4 percent, real GDP grew at an annual rate of 1.3 percent in the second quarter and 1.8 percent in the third quarter. These growth rates fell short of all but the most pessimistic forecasts made at the beginning of 2011.

The employment picture is starker. As of the third quarter of 2011, only 23.2 percent of all the jobs lost nationwide during the recession had been regained. Looking only at private-sector employment, the picture is only slightly better, with 28.3 percent of the jobs regained. On a seasonally adjusted basis, an average of 133,000 jobs has been added in each of the last 12 months; at this pace, it would take four years for U.S. employment to reach its pre-recession peak. The unemployment rate fell from 9.0 percent in October to 8.6 percent in November, though about half of the decline resulted from people leaving the labor force rather than an increase in the number of people employed.

Although key indicators show the U.S. economy still heading in the right direction, growth is sluggish. More troubling is the concern that one or more economic shocks will wash over an already weak economy, risking another U.S. recession. The two most problematic of these potential shocks are a further worsening of problems in the euro zone and its effects on banks, financial markets, and global trade; and a lack of political consensus on fiscal policy, including whether to extend fiscal stimulus in the near term and, longer term, how to reduce the U.S. government deficit. There are concerns as well about the underpinnings of China's economic growth, and fears of what a recession there would mean for the global economy.

IBO forecasts only a gradual acceleration of economic growth in the next two years, a much weaker economic recovery than we predicted in the spring. Projected real GDP growth in 2012 is 2.5 percent (compared with 3.5 percent growth predicted in May) and 3.0 percent in 2013.

Total Revenue and Expenditure Projections

Dollars in millions

	2012	2013	2014	2015	Average Change
Total Revenues	**$66,818**	**$69,511**	**$70,528**	**$73,608**	**3.3%**
Total Taxes	*41,046*	*43,620*	*45,567*	*48,574*	*5.8%*
Total Expenditures	**67,060**	**70,758**	**72,702**	**75,499**	**4.0%**
IBO Surplus /(Gap) Projections	**$(242)**	**$(1,247)**	**$(2,174)**	**$(1,892)**	
Adjusted for Prepayments:					
Total Expenditures	*$70,790*	*$70,770*	*$72,702*	*$75,499*	*2.2%*
City Funded Expenditures	*50,309*	*51,207*	*53,094*	*55,892*	*3.6%*

SOURCE: IBO

NOTES: IBO projects a deficit of $242 million for 2012, compared to the Bloomberg Administration's balanced budget forecast. Estimates excluded 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.

We expect real GDP growth to edge higher in 2014, to 3.5 percent. U.S. employment is not projected to reach its pre-recession peak until the second quarter of 2014, three quarters later than IBO expected in May. Although we are forecasting economic growth to gradually accelerate, as the economy improves, many who had become too discouraged by the bleak job market to continue looking for work are expected to reenter the labor force and be counted among the unemployed. As a result, we expect the unemployment rate to remain stubbornly high, averaging 8.9 percent in 2012, just below the average for 2011. The unemployment rate is expected to fall to 8.6 percent in 2013 and further thereafter, reaching 7.3 percent in 2015; the latter is 2.1 percentage points higher than the average rate during the last business cycle (Q1:2001 through Q4:2007).

IBO expects that excess capacity in the U.S. economy, particularly high levels of unemployment, will keep inflation in check over the next few years, even though our forecast assumes further monetary and fiscal stimulus. Inflation in 2012 and 2013 is expected to be 1.8 percent and 2.4 percent, respectively.

The U.S. housing market continues to defy forecasts of a turn-around. IBO now expects housing prices to decline through 2012 as foreclosure processing ramps up and distress sales increase as some of the legal and regulatory issues that have slowed the process are resolved. Significant recovery in the housing market is unlikely until consumers view prices as having hit bottom, banks ease mortgage lending requirements, and the huge inventory of properties available (including foreclosures) is absorbed. The U.S. has already experienced an increase in the number of multifamily housing starts. As inventory shrinks, single-family starts are expected to rise as well, which will lessen the drag the housing market has had on the economic recovery to this point.

With strong corporate profits, large nonfinancial businesses have solid balance sheets and the ability to finance their own investment. What they lack is confidence that economic growth and demand for their products are strong enough to warrant investment. Like major corporations, banks are also positioned to spur investment by expanding lending; their core capital ratio is the highest it has been in more than two decades. But with disappointingly slow economic growth and financial market uncertainties, banks have been hesitant to ease lending standards further, to the detriment of smaller businesses, which typically require access to loans to finance expansion.

Europe's difficulties present a significant downside risk to our U.S. forecast. Fiscal austerity policies, coupled with escalating sovereign debt problems, are likely to push Europe into at least a mild recession. European banks hold much of the debt at risk of default, and losses are all but inevitable, prompting the banks' trading partners to demand more collateral and sharply reducing liquidity in the European banking system. IBO's forecast assumes that European policymakers will move aggressively to restructure debt from insolvent countries and recapitalize the banking sector. Failure to do so could result in a steeper European downturn and potentially even a global recession.

IBO's outlook for U.S. economic growth is very similar to the recent real GDP forecast of the group of leading forecasters surveyed periodically by the Federal Reserve Bank of Philadelphia. Our GDP forecast is 0.1 percentage points below the median of the Philadelphia group for 2012 (2.5 percent v. 2.6 percent) and 0.1 percentage points above for 2013 (3.0 percent v. 2.9 percent). GDP forecasts of the Mayor's Office of Management and Budget (OMB)—1.8 percent growth in 2012 and 2.3 percent in 2013—are substantially lower than IBO's. Consistent with less growth, OMB also forecasts less inflation in these two years.

New York City Economy. As measured by employment and output, New York City's economy endured a shorter and less severe downturn than did the nation as a whole, and its recovery is now further along. IBO forecasts continued, if gradual, employment growth in spite of additional job losses in the government and financial sectors. However, problems within the euro zone pose a downside risk for IBO's local economic forecast, just as they do for our U.S. forecast.

New York City employment has grown by 1.9 percent since its recovery began, though 4 out of the past 6 months have actually seen employment declines. Compared with the U.S. overall, the city has recovered a much larger share of the jobs it lost during the recession (Q2:2008 through Q4:2009); as of the third quarter of 2011, the city has regained 57 percent of all jobs lost, including 69 percent of private-sector jobs. Real (inflation-adjusted) personal income, which fell by 12.4 percent from 2007 through 2009, has recovered more quickly and has already reached its pre-recession peak.

IBO forecasts steady but not particularly strong employment growth in New York City through 2015. Projected growth is 38,800 jobs next year, a few thousand more than in 2011, and 49,900 jobs in 2013. Employment growth in 2012 and 2013 is expected to be concentrated in three industries: health and education (an additional 33,200 jobs over the two years), leisure and hospitality (19,600 jobs), and professional and business services (19,200 jobs). However, we expect employment gains in these and most other private-sector industries will be partially offset by further job losses in the government and financial sectors. We project steady declines in the government sector, with the loss of 11,000 mainly local government jobs from the fourth quarter of 2011 through the third quarter of 2013 as budget pressures result in reduced headcounts. A combination of weak economic growth, new regulatory constraints and declining Wall Street profits leads IBO to forecast a decrease of over 5,200 financial-sector jobs in the second half of 2011 and the first half of 2012. After 2013, IBO projects that every major sector of the local economy except manufacturing will be adding jobs, with employment gains in 2014 and 2015 averaging 54,900 jobs annually.

The projected near-term loss of 5,200 jobs in finance would be nearly half the financial jobs the city has regained following the recession's trough, but a much smaller fraction of the almost 45,000 financial jobs the sector lost during the recession itself. IBO projects that financial sector job growth, once it resumes in Q3:2012, will range from 1 percent to 2 percent a year over the remainder of the forecast period. At that pace, by the end of 2015 the city will have regained less than two-thirds of the finance jobs lost during the recession. IBO's forecast of declining Wall Street profits is one factor driving our forecast of weak employment growth in financial services. We expect profits of New York Stock Exchange member firms to total $15.4 billion this year and $13.2 billion in 2012, a sharp decline from the record profits of $61.4 billion and $27.6 billion in 2009 and 2010, respectively. (Note that IBO's forecast was completed before firms' aggregate third-quarter loss of $3.0 billion was announced, so total 2011 profits are likely to be lower than we have forecast.)

The fast-changing economic and financial dynamics of the euro zone sovereign debt crisis pose significant risks to IBO's forecasts of New York City's economy and tax revenues, beyond the general risks to the national and global economies. European banks have a major presence in New York's financial markets and some of our domestic banks have close connections to their European counterparts; defaults could generate significant losses for all of these institutions. Apart from investment risks, if economic conditions in Europe deteriorate, we expect European businesses to significantly reduce their demand for financial and other business services of many New York-based firms. In addition, the European downturn is likely to reduce business and tourist travel to the city, in turn reducing retail sales and hotel revenues.

IBO's local economic forecast is generally less optimistic than the forecast we made last May, when job growth was expected to average roughly 59,000 in both 2012 and 2013, compared with the average of 44,400 jobs annually we now forecast for the next two years. Our current forecast is also more optimistic than OMB's forecast in the November plan, particularly for employment in the near-term. OMB expects the city to add 62,000 jobs over the next two years, considerably less than the nearly 90,000 jobs we project. In part due to our expectation of more job growth, we also forecast faster personal income growth than OMB, particularly in 2012 (5.8 percent v. 2.6 percent for OMB) and 2013 (6.3 percent v. 2.7 percent). As with its forecast of inflation nationwide, OMB foresees less inflation in the local economy than IBO, particularly for 2012 and 2013, which also contributes to the difference between the two income forecasts.

Revenue Outlook. With the economic recovery proceeding at a relatively slow pace, IBO forecasts $41.0 billion in New York City tax revenue for the current year—a projected 3.6 percent increase over 2011 revenue. (Unless otherwise noted, all years in this and subsequent sections refer to New York City fiscal years.) This growth rate is far less than the 9.2 percent increase in tax collections last year, in part because a number of tax policy changes took effect last year which boosted 2011 revenue; controlling for these changes, baseline revenue growth was 7.2 percent in 2011. The 2012 growth rate is also the slowest of the four years in the IBO forecast. With the gradually accelerating economic growth expected for calendar year 2012, our forecast for total fiscal year 2013 tax revenue is $43.6 billion, 6.3 percent higher than this year. After 2013 the annual average rate of growth is 5.5 percent—modest in comparison with the 8.2 percent annual average increase in city tax revenue from 2002 through 2008, years of strong economic growth and an extraordinary bubble in the value of real estate and financial assets.

The projected $1.4 billion increase in tax revenue from 2011 to 2012 results from increases in collections of all the major taxes, with the exception of the volatile bank tax, from which we expect $349 million less revenue this year than last. IBO's 2012 forecast is $579 million lower than we projected last spring, when the nation's economic recovery was expected to be stronger and the extent of the difficulties facing the financial sector were less clear. With the exception of the property tax, the transfer taxes, and the hotel tax, IBO now expects revenue from all of the major taxes—especially the business income taxes—to be lower than we projected last spring. Only our estimates of the transfer and hotel taxes are now substantially greater. The transfer tax forecast has increased because the value of taxable commercial sales this year has been higher than expected. The increase in the hotel tax forecast is due to the recent extension of a higher tax rate that had been scheduled to expire last month.

With the exception of the property tax, whose 2013 revenue is largely determined by assessments that are now being finalized, the expected strengthening of the economy during calendar year 2012 will primarily boost revenue beginning in fiscal year 2013. We forecast substantial increases from 2012 to 2013 in revenue from all major taxes, especially (in percentage terms) the business and personal income taxes and the mortgage recording tax--taxes that are very sensitive to current economic conditions. IBO's 2013 forecast is $247 million greater than we projected last May.

IBO's forecast of total 2012 tax revenue is $235 million lower than OMB's forecast presented in the November plan, but our projections for 2013 and beyond are much higher. The lower IBO forecast for the current year is due primarily to our expectation of much lower bank and sales taxes relative to OMB; our forecasts for the personal income, unincorporated business, transfer, and hotel taxes are higher than OMB's. (OMB projects less hotel tax revenue than IBO because it generated its forecast before the extension of the higher tax rate was enacted into law.) After 2012, IBO's economic outlook is relatively more optimistic than OMB's, resulting in a growing difference in the tax forecasts.

Our forecast of total city tax revenue for 2013 is $841 million (2.0 percent) greater than OMB's. For all but the commercial rent tax, IBO's forecasts are higher than OMB's, with the business and personal income taxes, and the hotel tax accounting for most of the difference. With rates of income and employment growth exceeding OMB projections, the differences between IBO's and OMB's forecasts widens after 2013, especially for the economically sensitive business and personal income taxes.

Business Income Taxes. After a three-year decline, business income tax revenue rose by $794 million (17.6 percent) in 2011, with increased collections from each of the three business taxes. But IBO forecasts only modest growth of 2.2 percent in business tax collections in the current fiscal year, to $5.4 billion. Receipts of the general corporation tax (GCT) and the unincorporated business tax (UBT) are expected to increase from 2011 to 2012, by an estimated 13.5 percent and 9.6 percent, respectively. But the revenue gains from these taxes will be largely offset by a projected 26.0 percent decline in banking corporation tax (BCT) revenue. Double-digit growth of business tax revenue—14.3 percent—is expected to resume in 2013 when GCT and UBT growth continues and BCT collections reverse course and increase sharply. In total, IBO forecasts $6.2 billion of business tax collections in 2013.

Lingering problems in the domestic housing market, the European sovereign debt crisis, and persistent uncertainty surrounding the final form and function of the Dodd-Frank Act have contributed to tighter bank credit and a general reduction in the scale and scope of banks' trading and investment options, thereby constraining the growth of the city's financial service firms. The difficulties facing the city's financial sector are in turn constraining the growth of revenue in 2012 and 2013 from all three business income taxes.

The near-term employment decline in the financial sector and two years of substantial declines in the profits of New York Stock Exchange firms have particularly affected GCT collections. In the first quarter of this year, tax collections from the finance sector were off sharply from collections during the same period last year. Offsetting this, however, were strong increases in GCT payments from manufacturing, real estate, information, trade, and professional service firms. On balance, IBO forecasts just under $2.6 billion in GCT revenue in 2012, a 13.5 percent increase over 2011 collections. Driven largely by tax liabilities of nonfinancial sector firms, the GCT is expected to continue to grow in 2013 by 10.4 percent to reach $2.9 billion.

IBO forecasts an acceleration of UBT growth in the near term. Our projections are $1.8 billion for 2012 revenue (9.6 percent higher than in 2011) and receipts of $2.1 billion in 2013 (a 13.2 percent increase). Growth slows slightly in the following years but still averages 10.8 percent annually over the financial plan. This year, first-quarter collections of the UBT—largely from the professional services (including legal) and finance sector—are essentially flat, but we expect them to pick up in the rest of 2012 as national and local economic growth continues.

Revenue from the highly volatile BCT increased by almost 40 percent in 2011, but for 2012 IBO forecasts a sharp

26.0 percent ($349 million) decline to just under $1 billion. Positive and negative swings of this magnitude in the BCT are hardly unprecedented in recent years. The tough environment facing financial firms is evident in gross tax collections. October gross collections so far this year are down 47.5 percent, although we anticipate collections will pick up as the year progresses. For the full year, gross collections are expected to decline by 17.2 percent. Another factor contributing to the forecast decline in this year's BCT revenue is a projected 41.8 percent increase in refunds. In 2013, however, we forecast an upturn in collections with no increase in refunds, generating $1.3 billion of BCT revenue, 26.7 percent higher than our outlook for this year.

After 2013, IBO projects continued but more moderate growth of revenue from each of the business taxes. In 2014 and 2015, growth of the three taxes taken together will average 7.6 percent annually to generate $7.2 billion in revenue. For all but the current year, IBO's forecast of total business tax revenue is greater than OMB's, reflecting our forecast of relatively stronger economic growth. In the current year, however, IBO projects $304 million less revenue than does OMB, with almost the entire difference due to our BCT forecast, which is $301 million lower. In 2013, the difference is $366 million, with IBO's forecast higher for each of the three taxes, including $201 million more for the UBT.

Personal Income Tax. With the pace of the economic recovery more sluggish than anticipated, IBO's 2012 personal income tax (PIT) forecast—$8.1 billion—is $84 million less than our May projection. Still, the PIT forecast for the current year is 5.8 percent ($441 million) greater than 2011 collections. With income and employment growth expected to gradually accelerate in the coming calendar year, we forecast even faster revenue growth during the remainder of the forecast period. The 2013 PIT forecast is $8.7 billion, 7.2 percent more than PIT collections this year. By 2015, PIT revenue is projected to be just under $10.0 billion.

A little more than half of the PIT increase from 2011 to 2012 results from a large increase in projected state/city offset revenue--an accounting adjustment related to the state's administration and collection of the city's PIT that we do not project independently of OMB. Almost the entire balance of this year's increase is attributable to our forecast of withholding collections, which IBO expects to grow by 3.7 percent in 2012. Withholding receipts through November of this fiscal year are 4.6 percent greater than collected in the same period last year, but we expect sharp declines in Wall Street bonuses to reduce withholdings during the bonus period (typically December through February). With financial markets skittish, we forecast no increase in estimated payments, the second largest PIT component, over last year.

Withholdings and estimated payments growth are each expected to contribute to overall PIT growth of 7.2 percent in 2013. Personal income growth is expected to pick up early in calendar year 2012 followed by employment later in the year, fueling a projected 5.7 percent increase in withholding for fiscal year 2013. IBO also projects a 9.7 percent increase in estimated payments, due in large part to an expected surge of capital gains realizations at the end of calendar year 2012, when under current law preferential federal income tax rates on capital gains are scheduled to expire. For 2014 and 2015, we project that annual PIT revenue growth will average 7.4 percent, with more rapid growth in the latter year.

IBO's personal income tax forecasts exceed OMB's for every year in the November plan. Our current-year PIT forecast is $49 million more than OMB's—a relatively small difference of 0.6 percent. After 2012, the differences increase, the result of relatively higher income and employment growth in IBO's economic forecast. For 2013, IBO forecasts $168 million more PIT revenue that does OMB—a 2.0 percent difference. By 2015, IBO's PIT forecast is 8.5 percent greater than OMB's.

Real Property Tax. Because of long lags between changes in market values and when those changes are reflected in property tax bills, IBO projects relatively steady if modest increases in revenue from the real property tax (RPT) in the next several years even with slower market value growth and, in some areas, market value declines. IBO forecasts 4.6 percent growth in RPT collections for the current year followed by 3.9 percent growth next year, yielding $17.6 billion in 2012 and $18.3 billion in 2013. After 2013, RPT revenue is expected to increase at an average rate of 3.8 percent annually and reach $19.7 billion in 2015.

Since the housing bubble collapsed in 2008, the total market value of class 1 properties (one-, two-, and three-family homes) has fallen by close to 10 percent. IBO expects a further decline of 0.5 percent for class 1 properties for 2013, followed by little change during the next two years. But we also forecast continued growth of class 1 assessed value for tax purposes—a 3.1 percent increase for 2013 and annual average growth of 2.6 percent in 2014 and 2015. During the housing market boom of the last decade statutory limits on annual assessment increases left many class 1 properties under-assessed with respect to the 6.0 target assessment ratio (assessed value over market value). As market values have fallen in recent years, class 1 assessment ratios have risen; the median class 1 assessment ratio has increased from a low of 3.7 percent in 2008 to 5.1 percent in 2012. But as long as a property is below the 6.0 percent target ratio, the assessment on that property will continue to rise, subject to the limit on annual increases, even if the market value declines. Thus, total taxable assessed value for tax purposes in class 1 will increase despite the lack of growth in aggregate market value, which is likely to result in higher tax bills for some homeowners in 2013.

In contrast to class 1, the total market value for other types of property is expected to rise for 2013: 4.9 percent for class 2 properties (apartment buildings); 5.7 percent for class 3 (property of utility companies); and 2.3 percent for class 4 (all other commercial and industrial property).

For class 2 properties IBO forecasts total assessed value for tax purposes will increase in 2013, with annual growth rising to 4.4 percent for 2015. A caveat to our projections, however, is that methodological changes in assessing class 2 led the Department of Finance to institute a cap on growth for certain properties last year, and it is unclear how these properties will be treated in the 2013 tentative roll due next month. For class 4, IBO projects steady increases in assessed value for tax purposes of about 3.7 percent each year.

Changes in market values for properties in classes 2 and 4 are phased in over five years, so changes in assessed values are less volatile than changes in market value. The value in the pipeline—assessment increases still being phased-in—is now estimated at $10.9 billion, and some portion of it will add to the assessed value of properties in 2013. A year ago IBO projected that the pipeline would be largely exhausted by 2013. But new additions to the pipeline in 2012 were greater than we anticipated, and IBO now expects the pipeline to grow during the forecast period. One factor behind the growth in the pipeline was the city's use of lower capitalization rates, which increased class 4 market value by 9.0 percent in 2012, thereby increasing the value in the class 4 pipeline.

IBO's current year RPT revenue forecast is almost the same as we projected last May, and the forecast for 2013 is just $28 million less, largely the result of adjustments to the property tax reserve. Though IBO's and OMB's 2012 forecasts differ little, our 2013 forecast is $96 million more than OMB's. This difference increases greatly in the out-years, reaching $647 million by 2015.

Real Estate Transfer Taxes. Last year a turn-around in the city's real estate markets reversed a three-year decline in revenue from the real property transfer tax (RPTT) and mortgage recording tax (MRT). The recovery continues, and a sharp increase in the value of commercial property sales in the first quarter of the new fiscal year has led IBO to significantly increase its 2012 forecasts of the two taxes. IBO now forecasts $896 million in RPTT revenues, 12.8 percent more than in 2011. For the MRT, the forecast is $532 million, 22.5 percent more than 2011 revenue. In comparison with many quarters after the collapse of the real estate market, credit is now more available, bolstering revenue from both taxes. But the MRT is expected to grow faster than the RPTT in 2012 because of increased refinancing activity.

So far in 2012 the recovery in real estate sales has been limited to the commercial market, where the total value of taxable sales recorded during the first quarter—$9.7 billion—was more than double the amount during the same quarter one year earlier. However, three very large transactions in the first quarter—involving the Starrett-Lehigh Building on West 26th Street, 75 Ninth Avenue, and 200 Fifth Avenue—accounted for about a fourth of the aggregate value of commercial sales, and IBO does not expect market activity to continue at the same pace during the remainder of this fiscal year.

In contrast to the commercial market, first-quarter taxable sales of residential real estate ($8.9 billion) were slightly below the amount recorded one year earlier. Mortgage rates continue at historically low levels, but lending standards are tight in comparison with those during the real estate boom of the previous decade. The limited availabilty of credit combined with stagnant prices in much of the residential market (particularly outside Manhattan) have combined to depress the value of residential sales.

IBO expects continued gains in transfer tax revenue during the rest of the forecast period, though at more moderate rates of growth than projected for this year. In 2013, the RPTT will generate $954 million (6.5 percent growth) while the MRT is expected to increase 10.2 percent, to $586 million. Mortgage rates will continue to be relatively low, while the median price of single-family homes outside Manhattan (a proxy for a large part of the city's residential real estate market) will be essentially flat. Steady growth in both taxes is anticipated during the following two years. By 2015, roughly $1.9 billion in transfer tax revenue is forecast—a sum twice the amount of 2010 collections but still far below the $3.3 billion peak of transfer tax collections in 2007.

General Sales Tax. IBO projects that the city's general sales tax revenue will reach $5.8 billion in 2012, a 3.5 percent increase over 2011. In spite of the sluggish pace of the economy and depressed levels of consumer confidence, demand for taxable goods and services has been surprisingly resilient. Consumer spending in the city has grown at a steady, if modest, pace in recent months. The projected revenue increase is consistent with the moderate year-over-year increase in nationwide consumer spending for the third quarter (July to September) and advance estimates of retail spending in October and November.

For 2013, IBO projects sales tax revenue to increase by $315 million—growth of 5.4 percent over our forecast for 2012. We expect consumer spending to rise significantly as fears of a double-dip recession recede, hiring in national and local job markets slowly picks up, and personal income growth accelerates. IBO projects still faster revenue growth after 2013 as consumer confidence moves closer to pre-recession levels, bringing the annual average rate to 6.3 percent in 2014 and 2015.

While average consumer spending appears to be growing in the near-term, expected layoffs on Wall Street and a projected 20 percent to 30 percent decline in bonus compensation relative to 2010 levels are likely to constrain spending by those in the industry, who are among the most affluent residents and commuters in the city. A decline in financial-sector bonuses would have the greatest effect on taxable sales in the city's luxury retail, leisure and hospitality, and food services sectors.

International tourism, one of the most significant drivers of taxable sales in New York City, is expected to continue to contribute strongly to the city's economy in calendar year 2012, but not at the record levels of recent years. New York City has already welcomed a record number of visitors this year, surpassing the 2010 total of 48.8 million. Looking ahead, foreign travel to the city is expected to decline due to the economic problems in Europe and elsewhere, ultimately bringing the number of international visitors to the city down from its current peak.

IBO's 2012 sales tax forecast is $86 million less than OMB's—a 1.5 percent difference. After 2012, however, our projections of faster employment and income growth relative to OMB results in IBO forecasting more sales tax revenue than does OMB. Our 2013 forecast is only $28 million greater, but in the out-years the difference rises sharply, reaching $358 million in 2015.

Hotel Occupancy Tax. IBO projects $452 million in hotel occupancy tax revenue in 2012, a 7.1 percent increase from 2011. Our forecast incorporates the recent two-year extension of an increase in the hotel tax rate from 5.0 percent to 5.875 percent. Had the tax rate extension not been enacted, IBO projects that revenue would have fallen to $420 million.

The city's hotel industry held up well in the first quarter of this fiscal year even as attendance at tourist attractions and business travel volume declined from the previous year due to the travel disruptions of Hurricane Irene in August. Hotel room occupancy rates declined a modest 1.2 percent in August, but that was against the backdrop of adding hotel rooms to the city's inventory—4.9 percent more rooms than in August 2010. Despite the increase in supply, the average daily room rate posted solid growth of 7.7 percent.

Year-to-date trends suggest that demand for New York City hotel rooms is still robust, but the growth of tourist spending is expected to slow in the coming year. For calendar year 2012, the World Trade Council, an industry-sponsored reasearch group, forecasts 1.1 percent growth in tourist spending in the U.S., compared with an estimated 4.6 percent in the current year. In particular, visits from European travelers, who account for over a third of the city's international tourism, are expected to decline due to the euro zone's debt crisis. However, as the U.S. economy recovers, growth in domestic tourist volume and non-European international visitors should offset losses from this group.

For 2013, IBO forecasts a 7.5 percent increase in hotel tax revenue to $486 million. The faster growth is due to improved economic conditions and continued growth in the city's hotel room inventory, which is expected to add nearly 6,000 new hotel rooms in the next 30 months—a 6.7 percent increase. While an increase in hotel room supply is likely to reduce room rates, we expect the increase in the number of tourists to more than offset the effect of lower room rates on hotel tax receipts as the availability of cheaper hotel rooms draws business and leisure travelers to Gotham who previously found hotels in the city too expensive.

IBO projects a 1.8 percent decline in hotel tax receipts in 2014, to $477 million. The decline is due to the scheduled expiration on November 30, 2014 of the 0.875 percent tax rate increase that was just extended for three years. Hotel tax revenue is expected to grow modestly to $480 million in 2015. IBO's forecasts are significantly above OMB's projections for all years in the forecast period, in part because OMB's forecasts were made assuming that the hotel tax rate would revert to 5.0 percent at the end of November.

Spending & Savings

In a departure from the pattern of recent years, IBO expects that tax revenue growth will outpace spending growth in 2012 through 2015. This results in part from a series of agency spending reductions and revenue initiatives over the past few years, combined with additional measures totaling $470 million this year and $1.0 billion next year. Based on the November 2011 Financial Plan and adjusting for the use of last year's surplus to pay some of this year's expenses, IBO estimates total spending, including state and federal dollars, will reach $70.8 billion in 2012. Spending is expected to remain relatively flat in 2013 and then rise to $75.5 billion by 2015. Over the 2012-2015 period, total spending growth is expected to average 2.2 percent a year.

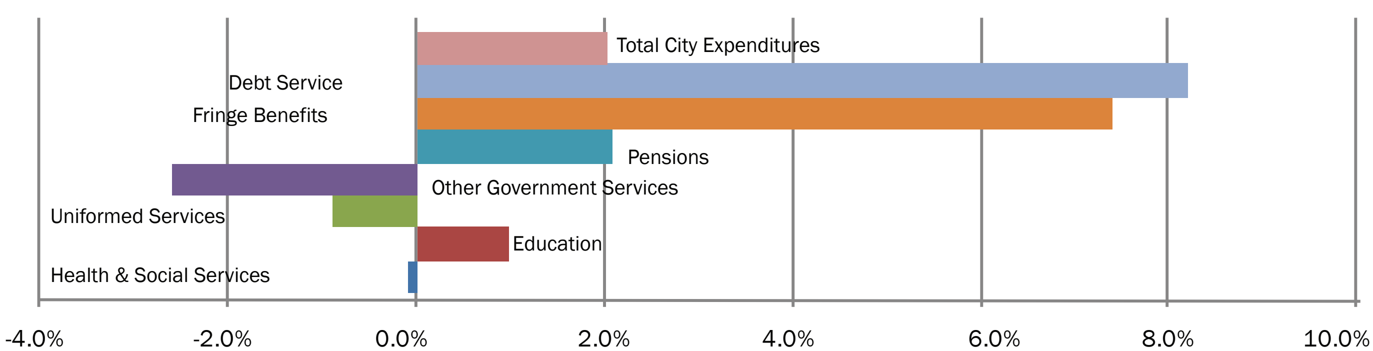
Looking just at city-funded expenditures and again adjusting for the use of the 2011 surplus to cover some 2012 expenses, spending growth is projected to be a bit less than tax revenue growth and rise from $50.3 billion this year to $51.2 billion in 2013 and reach $55.9 billion by 2015—an average annual increase of 3.6 percent, still below our projected rate of tax revenue growth of 5.8 percent over the same period.

Despite tax revenue growth outpacing spending growth, year-to-year budget shortfalls remain. Under IBO's forecasts of expenditure and revenue growth, we expect budget gaps to peak at $2.2 billion in 2013 and then gradually decline.

A Change of Pace on Pension Spending. Under the November plan many agency budgets will remain flat or decrease slightly. As in past years growth is largely confined to a few areas of the budget, but even here there is a marked change from the recent past: Although the city's pension contributions remain at historically high levels, they are no longer projected to increase at a rate far outpacing most other spending.

City pension spending is expected to grow from $8.3 billion in 2012 to $8.6 billion in 2015, assuming the Mayor's proposals to alter pension rules for new civilian employees (such as increasing the retirement age to 65 and requiring worker contributions throughout their years of employment) take effect in 2014. With these changes, city pension spending would grow at an average annual rate of 1.1 percent; even if these changes are not implemented, pension spending would rise at an annual rate of 2.1 percent. It is unclear if the city Actuary's just announced recommendation to lower the assumed rate of return on pension investments from 8.0 percent to 7.0 percent will affect the size of the city's projected

Debt Service and Fringe Benefits Costs Lead Spending Growth, Average Annual Change, 2012-2015



SOURCE: IBO
NOTES: Debt service and other government services adjusted for use of 2011 surplus; pension contributions do not include Bloomberg Administration's cost-saving proposals; fringe benefit costs adjusted for the use of the Retiree Health Benefits Trust Fund; all estimates exclude intra-city expenses.

contributions since $1 billion was already added in anticipation of this change.

Cost Centers: Debt Service and Fringe Benefit. One area of spending that continues to rise sharply, as it has in the recent past, is debt service, the interest and principal the city pays on the money it borrows for capital projects such as building schools or buying sanitation trucks. Although the November financial plan anticipates savings of $228.8 million in 2013 in city funds on debt service through refinancing existing debt and lower-than-expected interest rates, these payments are still projected to rise substantially next year. Debt service is expected to increase from $5.7 billion this year (adjusted for the use of the 2011 surplus to prepay some of this year's obligations) to $6.4 billion in 2013. By 2015, debt service is projected to reach $7.2 billion for an average annual growth rate of 8.2 percent over the course of the financial plan. The increase in debt service costs largely results from capital spending and financing decisions made in the recent past.

Another portion of city spending that continues to rise at a pace far outstripping other expenses is fringe benefits for city workers. The cost of health insurance and other benefits for city employees (excluding the education department and adjusting for the use of the Health Benefits Trust Fund to cover a portion of these costs) is projected to grow from $4.5 billion this year to $5.6 billion in 2015—an average annual increase of 7.4 percent.

More Dollars for Overtime. The November plan also includes nearly $500 million in new spending needs annually in 2012 and 2013 (and slightly more in the following years). Much of this additional spending is concentrated in the uniformed services, and much of that within the police and fire departments. The police department budget includes $217 million in new funds for 2012 and $172 million for next year to cover increased overtime spending as well as the fact that fewer officers have been retiring than expected, so higher salaried veterans cannot be replaced by less costly new hires.

Overtime spending is also driving the need for additional funds in the fire department, although the underlying causes are different. The fire department budget now includes $238 million for overtime this year, 48 percent more than was initially planned for 2012. The additional overtime is needed because the fire department has 300 fewer firefighters on staff than authorized in its budget due to continued legal challenges to the agency's hiring practices.

The November plan contains other spending additions, including funding restorations and new needs for the Department of Sanitation that exceed the value of the agency's proposed cost-saving measures this year. A total of $37 million in city funds was added this year and $33 million next year for a variety of reasons, such as $12 million annually to cover annual salary "step" increases for uniformed sanitation workers and $16.7 million this year and $19.8 million in 2013 for previously planned but unmet sanitation department budget savings initiatives. The parks department is another agency that has also had money added to its budget because it could not meet a prior savings plan. The November plan includes $16 million in 2012 for parks since planned layoffs of parks workers did not a occur and a proposed attrition plan was delayed, as well as to cover costs related to Hurricane Irene and the snow storm in October. The budget plan also restores $23 million to the fire department's budget for this year and $30 million next year, as a variety of savings initiatives are being being dropped. One savings assumption that remains in the budget is the planned elimination of 20 fire companies beginning next year. Another addition to spending is $21 million in 2013 for the Mayor's Young Men's Initiative.

Along with the funds included in the November plan due to the costs of failed PEGs and other needs, IBO anticipates that spending by the Department of Homeless Services will be higher than budgeted–by about $9.0 million this year and $17.0 million next year. One reason for IBO's expectation of rising homeless services costs is growth in the shelter population. With no replacement for the Advantage rental assistance program, families are remaining in shelters for longer stays. IBO also expects that ongoing challenges in implementing proposals to divert single adults from the shelter system and to pair families with children in shared housing will mean less in savings than projected under the budget plan.

Gap-Closing Measures. Since January 2008, the Bloomberg Administration has initiated measures under the rubric of the Program to Eliminate the Gap, or PEGs, which by the Mayor's estimate has reduced city-funded spending by about $5 billion in 2012. This October, city agencies were told to present proposals to reduce their city-funded spending in 2012 by 2.0 percent and 6.0 percent in 2013 for a total of $2.0 billion in new savings over the two years.

The PEG program included in the November plan ultimately contained about $1.5 billion in proposed savings. While some services are routinely targets for reductions such as the subsidy for libraries or support for cultural programs, noticeably absent this time was senior services. The Department for the Aging had no new budget reductions planned for 2013. Likewise, programs in the HIV/AIDS Services Administration, which had also been repeatedly targeted for budget savings in recent years, were also exempted in the current round (although an unrelated delay in finishing a supportive housing project is providing some small savings in staffing costs).

The proposed savings in the November plan are not as focused on job reductions as in some recent plans. Last May, the Mayor's Executive Budget proposed the elimination of more than 9,000 jobs, including more than 5,600 layoffs in 2012; the November plan proposes a comparatively modest 249 layoffs this year and 317 next year.

Although it makes no practical difference to the individuals and families potentially affected, many of the proposed layoffs would be of employees in the libraries and cultural organizations supported by the city, not direct municipal workers. The largest numbers of layoffs of city employees would occur at the Departments of Transportation and Health and Mental Hygiene. The layoff of 62 transportation department staff members in 2013, along with additional attrition, is related to the conversion of 51,000 single-space parking meters to Muni-Meters, which require fewer staff for collection and maintenance. The health department job reductions are largely centered in the medical examiner's office and most of them may be among staff responsible for DNA analysis. Previous staffing cuts have caused the average time to complete a DNA analysis to rise by 9 percent in 2011.

Fewer Dollars to Classrooms. Department of Education spending would grow very modestly under the November plan—$14.0 million above the budget adopted in June for 2012, and $77.0 million in 2013. Still, expenditures on classroom instruction and principals and assistant principals are budgeted to decline by $304.5 million, or 3.3 percent. Conversely, several areas of school spending are expected to rise. The cost of special education pre-kindergarten contracts with private schools is projected to rise by $108.5 million, or 10.0 percent, next year. Fringe benefit costs for education department staff are expected to increase by $68.0 million (2.5 percent), and payments to charter schools are budgeted to grow by $42.5 million (5.8 percent).

The budget plan also includes several measures to save on city-funded spending by the education department. A series of changes aimed at reducing special education costs would save $62.4 million. The changes include cutting back on the use of certain contracted services for special education students, slowing the rise in the cost of contracts for pre-kindergarten special education, and reducing transportation costs for these students. At the same time, the Bloomberg Administration has increased its estimate of how much money the city will be reimbursed by the state for special education pre-kindergarten, reducing city spending by $37.6 million this year and $62.3 million annually through 2015. The Bloomberg Administration also expects the education department to increase its ability to be reimbursed by Medicaid for certain student services, saving $50 million annually beginning in 2013.

Billion Dollar Fixes. Given the size of the projected budget shortfalls in the November plan and the assumption of only a minor surplus, the Mayor has chosen to draw on $2.0 billion in nonrecurring sources of funds to help reduce the 2013 budget gap and an additional $1.0 billion for 2014.

The budget plan gets two-thirds of these gap-closing funds from the Retiree Health Benefits Trust Fund, which was created several years ago when the city was running large surpluses. The trust's stated purpose when it was created was to help cover the city's unfunded liabilities for providing health insurance for its retirees. But in recent years the trust has in effect been used to help close budget shortfalls. The current year's budget includes $672.0 million from the trust. The Mayor proposes using $1.0 billion from the trust fund in 2013 and $1.0 billion in 2014, effectively wiping out its remaining resources.

The other $1.0 billion for 2013 is expected to come from the sale of new taxi medallions in conjunction with the proposal that will allow car services to pick up "street hails" in upper Manhattan and throughout the other boroughs. After raising some concerns, the Governer has now agreed to sign legislation allowing the city to proceed.

The Road Ahead

The fiscal road for the coming years as mapped under IBO's revenue and spending projections poses challenges that are considerably less daunting than the city has faced over the past few years. Our budget gap estimate for next year of $1.2 billion is nearly $800 million less than the Mayor's. The usual year-end budget and accounting adjustments would erase a considerable share of IBO's projected shortfall for 2013. But there are ample reasons to be wary of possible detours that could take us far off course.

One potential detour is the risks posed to our economic forecast by worsening problems in the euro zone. While debt crises abroad could lead to bank and financial market instability and push the U.S. economy into another recession, the risks are not all offshore. Lack of consensus in Washington on how to handle the fiscal and monetary challenges facing the U.S. could also weaken the national economy and undermine IBO's forecast of gradually strengthening U.S. economic growth.

Another factor that could send IBO's projections off course is ongoing negotiations with the city's labor unions. Contracts with the city's largest unions have expired, some many months or even several years ago--the teachers' contract in October 2009 and the Council of Supervisors and Administrators and District Council 37 in March 2010. The budget contains no money to cover settlements with teachers and principals for the period that other unions received 4.0 percent wage increases. For all unions, the Bloomberg Administration has assumed a wage freeze in 2011 and 2012, while including some funds in the labor reserve to support salary increases of 1.25 percent in 2013-2015. The Mayor is counting on productivity to offset the cost of any raises for years in which no funds have been set aside, a position that has proven hard to hold onto in the past, particularly when productivity would have to be achieved retroactively. Each 1 percent increase in salary not paid for with labor savings would cost the city about $290 million, including additional pension costs.

Continued declines in state and federal aid also pose risks to city budget balance. The loss of this aid does not itself directly affect the gap. But budget gaps will widen if the Mayor and City Council choose to replace lost state or federal dollars with city resources, just as they did with $850 million in federal stimulus aid for schools this year.

As Washington struggles to meet its deficit reduction goals, it remains unclear how much aid the city may lose in the future. And although Albany's budget shortfall is not nearly as steep as last year, the city could still receive less than expected levels of aid.

As city resources are squeezed, the ability to maintain current levels of services slips. Balancing fiscal resources with the public's expectations for municipal service needs may be the biggest challenge on the road ahead.

Additional Tables on Revenue, Expenditure and Economic Projections

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