IBO

New York City Independent Budget Office

Fiscal Brief

May 2002

Analysis of the Mayor's Executive Budget for 2003

Recently released by IBO...

Budget Options for New York City

...in print or on the Web.

New York City
Independent Budget Office
Ronnie Lowenstein, Director
110 William St., 14th floor
New York, NY 10038
Tel. (212) 442-0632
Fax (212) 442-0350
e-mail: ibo@ibo.nyc.ny.us
http://www.ibo.nyc.ny.us

OVERVIEW

New York City is facing its most serious fiscal challenge in recent memory. After enjoying five years of surpluses ranging from $1 billion to more than $3 billion, the city must now confront very large shortfalls—larger budget gaps over the next few years than the city faced during the recession in the early 1990s. These shortfalls result from a combination of factors: rising expenditures, a sluggish local economy, and the tragic events of September 11. The problem extends well beyond the upcoming fiscal year, and the choices the city makes in confronting the shortfall in 2003 will have considerable effect on the severity of the problems in 2004 and beyond.

Budget gaps. IBO's reestimate of the Mayor's Executive Budget and Financial Plan suggests that even if all the proposed gap-closing measures are adopted, a $785 million shortfall remains for 2003. This additional shortfall, coupled with the uncertainty of implementing a number of the proposed gap-closing measures, could render the Mayor's $500 million contingency plan insufficient. A significant portion of next year's gap stems from IBO's assumption that lower than expected tax revenues in the current year have erased a projected $322 million surplus that would have been applied to 2003. IBO's projected budget gap for 2004—assuming all the current gap-closing measure are adopted—is $3.6 billion, and the gaps in each of the next two years are expected to be over $4 billion.

Structural imbalance. One of the main reasons for these gaps is the fundamental imbalance between city revenues and expenditures. Over the past few years, ongoing operating expenditures grew faster than sustainable revenues. Extraordinary Wall Street profits helped fuel revenue surpluses that enabled the city to prepay some expenses for the next fiscal year, effectively masking the underlying imbalance. Now the surpluses are gone—city tax revenues are not expected to match their 2001 level until 2004—but the ongoing operating expenditures remain and continue to grow.

A multi-year problem. As IBO's projected budget gaps indicate, the city's fiscal difficulties are not confined to a single year. Even after local economic growth resumes, the city faces large shortfalls in 2004 and beyond, which will have to be addressed without the borrowing available in 2003. Some combination of deeper spending cuts, additional federal and state aid, and/or tax increases will be necessary to bring the city budget into long-term structural balance. IBO

ECONOMIC AND REVENUE FORECAST

Economic update. Recent months have brought fresh information showing just how dismal a year 2001 was for the local economy. The release of revised employment data in March revealed that the city had begun to lose jobs much earlier in 2001 than had previously been assumed. Between December 2000 and December 2001, the city lost 132,000 jobs, with a significant portion of the loss occurring prior to September 11. April brought news that payments from personal income tax (PIT) final returns were even weaker than expected, providing new evidence that incomes in 2001 were much lower than in 2000.

The new employment data and other economic indicators show that the local recession began at approximately the same time as the national recession. September 11 deepened the recession for both the local and national economies, but they have diverged since then. While the national economy began to recover in the fourth quarter—making this one of the shortest recessions on record—the local economy was plunging further. The divergence grew wider in the first quarter of this year. The US recovery has continued, although assessments of its strength are mixed, while the local economy has shown few signs of turnaround.

Economic outlook. IBO's forecasts for the national and local economies are similarly divergent. The national economy is expected to grow slowly for the balance of this calendar year, followed by a somewhat stronger expansion in 2003—4.0 percent in real gross domestic product (GDP) growth. In 2004 through 2006, US GDP growth is expected to slow to a more modest rate of about 3.1 percent per year. IBO projects payroll employment to fall slightly in 2002 before growing slowly in 2003 (1.8 percent growth) and somewhat faster in 2004 (2.2 percent). The outlook is for even slower growth in 2005 and 2006 (1.3 percent annually). Corporate profits are expected to follow a similar path. After falling by 16.3 percent in 2001 and 1.4 percent in 2002, IBO expects corporate profits to rebound in 2003, growing by 10.8 percent. Annual growth in corporate profits will slow to 5.2 percent on average from 2004 to 2006.

In contrast, IBO expects that the local economy will see virtually no growth in calendar year 2002 and only weak growth in 2003 through 2006, with the strongest coming in 2004, a year after growth is expected to peak for the US as a whole. Most of the sectors critical to the city's economy will see lower employment levels in 2002 (measured on an average annual basis) than in 2001. Total employment in the city is expected to grow by only 32,500 jobs, or 0.9 percent, in 2003 and then by 43,700, or 1.2 percent, in 2004. The forecast for employment growth in 2005 and 2006 is even weaker, about 31,000 jobs, or 0.8 percent each year.

Total Revenues and Expenditures
Dollars in millions; fiscal years

	2002	2003	2004	2005	2006	Average Change
Total Revenues	$41,491	$43,116	$ 42,187	$ 43,343	$ 44,660	1.9%
city-funded revenues	*26,973*	*29,884*	*29,103*	*29,996*	*31,106*	3.6%
Expenditures						
Before prepayments	$44,502	$43,901	$ 45,781	$ 47,443	$ 49,181	2.5%
city-funded expenditures	*29,984*	*30,669*	*32,697*	*34,096*	*35,627*	4.4%
2001 prepayment	(2,944)	-	-	-	-	
Total Expenditures	$41,558	$43,901	$ 45,781	$ 47,443	$ 49,181	4.3%
city-funded expenditures	*27,040*	*30,669*	*32,697*	*34,096*	*35,627*	7.1%
Gap	**$ (67)**	**$ (785)**	**$ (3,594)**	**$ (4,100)**	**$ (4,521)**	

SOURCE: IBO.
NOTES: City-funded revenues and expenditures exclude state and federal categorical grants. Excludes intra-city revenues and expenditures.

Other measures of local economic activity show only modest growth as well. Personal income is forecast to grow by 2 percent in 2002 and slowly accelerate through 2004 (growth of 4.6 percent over 2003) before slowing to around 4.2 percent annually in 2005 and 2006. Growth over the five years will average 4.2 percent annually, compared with the 6.4 percent average annual growth during the 1997 to 2001 boom. Wages and salaries are expected to follow the same pattern, with a peak in 2004. Growth is expected to average 4.6 percent annually from 2002 through 2006. Office vacancy rates, which rose in 2001, despite the loss of over 20 million square feet of office space for at least some period of time, are expected to remain near their current levels, as are office asking rents, which have fallen by 15 percent from their peak in early 2001.

Tax Revenues. The April shortfall in PIT revenues is the most critical near-term factor in the revenue forecast. The shortfall is largely a reflection of the decline in income in 2001 rather than an indication of deepening problems in 2002; indeed, withholding for 2002 has remained steady through the first four months of the calendar year. The April "surprise" started with taxpayers who had large capital gains, bonuses, and other non-wage income in 2000 and had established estimated payment schedules for 2001 based on their 2000 liabilities. It now appears that for many such taxpayers their actual 2001 incomes were much lower than anticipated, so that when they filed their 2001 returns in April they owed little or no money. As a result, IBO now expects PIT revenues to end the fiscal year $285 million below the level assumed in the Executive Budget. IBO's forecast for other tax revenue sources is slightly lower than that of the Mayor's Office of Management and Budget (OMB), leaving projected total 2002 tax revenues $354 million below the estimate in the Executive Budget.

IBO projects that baseline tax revenues will grow by 4.2 percent in 2003, only partially reversing the 6.1 percent decline in 2002. The PIT and general sales tax account for much of the increase, spurred, in part, by the slow resumption in employment growth in the second half of calendar year 2002 and early 2003 and faster growth in personal income. Revenue increases from these sources will be partly offset by continued declines in the general corporation tax, weighed down by the continued fall in corporate profits during calendar year 2002, and the mortgage recording tax, which will shrink as refinancing activity diminishes following anticipated Federal Reserve action to raise interest rates. IBO's forecast for 2003 is $208 million lower than OMB's Executive Budget plan.

Tax revenues are expected to pick up further in 2004, growing by 6.4 percent from their 2003 level to $24 billion. With calendar year 2004 expected to mark the strongest period of expansion for this business cycle, IBO is projecting growth from all tax sources in 2004, led by the PIT (growing by 10 percent or $502 million), the business income taxes (9.9 percent or $246 million), and the real property tax (4.8 percent or $429 million). IBO's forecast for 2004 is lower than OMB's Executive Budget projection by $155 million.

For 2005 and 2006, IBO expects tax revenues to continue growing, although at a slower pace than in 2004, consistent with IBO's forecast of diminished economic growth in calendar years 2005 and 2006. Tax revenue growth will average 4.2 percent for the last two years of the financial plan, with baseline tax revenues reaching $26 billion in 2006. With OMB's somewhat more optimistic economic forecast for the later years, the Executive Budget projects faster tax revenue growth for 2005 and 2006. As a result, there is a bigger gap between IBO's forecast and OMB's, with IBO $521 million lower in 2005 and $618 million lower in 2006.

Federal depreciation changes. In March, the President signed an economic stimulus bill containing provisions designed to spur investment by allowing faster depreciation on certain types of investments. A general benefit is available for qualifying investments made by the end of 2003 anywhere in the country. A separate benefit is available for qualifying investments made in Manhattan below Canal Street. This benefit, which is available for investments made through the end of 2006, is aimed specifically at helping New York recover from the World Trade Center attacks. Although the legislation affected federal tax law, because the city income taxes are linked to the corresponding federal taxes, these provisions will result in lower city tax revenues. IBO's tax forecasts reflect the impact of these changes, which result in lost revenue of over $200 million a year from 2003 through 2005.

The Executive Budget includes a proposal to sever the link between the city and federal tax code (decouple) when accounting for depreciation for the three business income taxes. Because IBO's estimate of the impact of the federal changes is larger than OMB's, our estimate of what the city would save if the business income taxes were decoupled also exceeds OMB's. The difference is $59 million in 2003 and $97 million in 2004.

If the state legislature and the Governor approved the city's decoupling proposal, tax revenues would be about $200 million higher each year for 2003 through 2005. Revenues would be $23 billion in 2003 (growth of 5.1 percent) and $24 billion in 2004 (6.5 percent growth).

EXPENDITURES AND GAP CLOSING

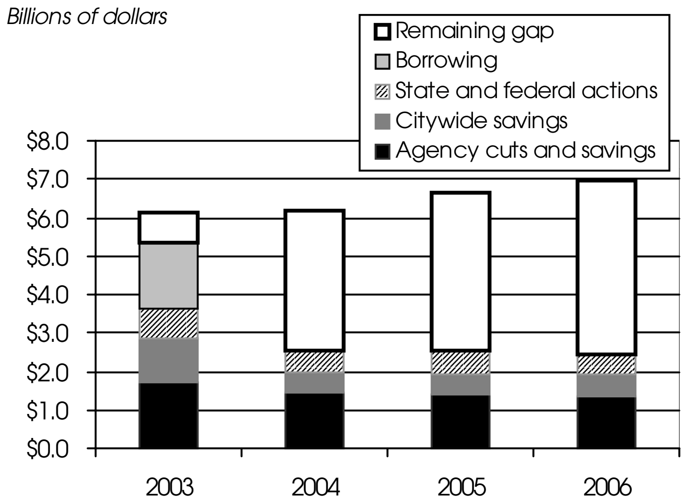
IBO's reestimate of the Mayor's Executive Budget and Financial Plan suggests that even if all the Mayor's hoped-for gap-closing proposals materialize, the city will still face a $785 million shortfall in 2003. If some of the measures, particularly aid from the federal and state governments, are not achieved, the city will have to do much more as early as possible to bring 2003 into balance. The Mayor's $500 million contingency plan for cuts may by itself be insufficient to address such a large shortfall.

Rising gap in 2003. While IBO expects that the city will need to address a small shortfall to end the current fiscal year (2002) in balance, lower than expected income tax receipts will wipe out the $322 million surplus projected in the Mayor's Executive Budget. As a result, no 2002 surplus will be available to help close next year's gap. In addition to a larger gap than estimated by the city for 2003, IBO also projects bigger shortfalls in future years. The differences stem from a slightly more pessimistic revenue estimate than the Mayor's, higher spending needs for public assistance and Medicaid, a teachers' union settlement along the lines recommended by a state board, and our continuing skepticism that the Port Authority will agree to the city's formula for back airport rental payments. The proposed teacher's settlement, for example, will cost the city $78 million more than planned in the Executive Budget (even with some $200 million in potential salary aid from the state) and $226 million more in 2004.

The Mayor's proposals to close the 2003 gap rely on $2.3 billion in nonrecurring actions, including borrowing ($1.75 billion), nonrecurring federal and state aid, and federal reimbursements for World Trade Center-related capital items for which the city will issue debt and take the reimbursement as current operating revenue. The remaining $2.7 billion in gap-closing measures includes $727 million in citywide savings initiatives (debt refinancing, fringe benefit cost containment, an early retirement program, and procurement efficiencies), another $458 million in federal and state actions (including the decoupling of city business taxes), and $210 million in agency revenue initiatives. Finally, agency cuts and savings total $1.3 billion.

Even if Executive Budget Proposals Are All Adopted, Out-year Gaps Remain Very Large

Billions of dollars



SOURCES: IBO; Executive Budget Fiscal Year 2003.

Out-year gap closing. The reliance on one-time actions to close nearly half of next year's budget gap leaves a substantial hole still to be addressed in 2004 and beyond. Even after local economic growth resumes, the city will still face large operating gaps in 2004 and beyond—shortfalls that will have to be remedied without the borrowing available in 2003. It will take a combination of deeper spending cuts, additional federal and state aid, and/or tax increases to bring the city budget into long-term structural balance.

The expectation of large and continuing gaps despite the resumption of local economic growth exposes the underlying structural gap—masked during the late 1990s by large surpluses. Absent policy changes, the gaps in 2004 and beyond are as large or larger than the coming year's. And even with optimistic assumptions about the Mayor's success in having his proposals for help from Washington, Albany, and the unions adopted, over half the gaps in future years still remain unresolved.

The Mayor's financial plan lays out an out-year gap-closing program that relies on cuts, savings, and revenues of roughly $1.9 billion annually (more than doubling the recurring savings and revenues from 2003). The plan also includes another $500 million in federal and state help, as well as unspecified measures in the areas of transportation, sanitation, and management and procurement efficiencies for savings that would rise from $200 million in 2004 to $1 billion in 2006.

Despite a 10.4 percent cut to the city's four-year capital plan, a sharp rise in debt service contributes to the large budget gaps over the next few years. Debt service grows by nearly $1 billion between 2003 and 2004—from $3.7 billion to $4.6 billion—and continues to rise to $5.2 billion by 2006.

A further challenge, not reflected in IBO's gap estimates, is that of future labor settlements. The city's contracts with all its workers will begin expiring on the first day of fiscal year 2003. There is currently no provision in the financial plan for wage increases as contracts expire. IBO

For tables providing details of IBO's revenue and expenditure estimates, see our Web site at www.ibo.nyc.ny.us.