New York City's
Fiscal Outlook

January 1999

IBO's Forecast of City Revenues and Expenditures For Fiscal Years 1999 through 2002

New York City Independent Budget Office

Preface

January 1999

The New York City Charter directs the Independent Budget Office (IBO) to publish a report by February of each year giving our view of how much the city is going to collect in taxes and other revenues and how much it is going to spend. We have issued *New York City's Fiscal Outlook* well in advance of the deadline so that readers have this information before the 2000 budget adoption process gets underway.

We are not trying to predict future policy and budget decisions to be made by the Mayor and the City Council, nor are we recommending any particular course of action. Instead, we are providing a forecast of what the city's finances would look like if current spending policies and tax laws are allowed to run their course over the next few years. Such a forecast provides an objective starting point and serves as a benchmark for consideration of the Mayor's soon-to-be-released 2000 budget.

The report begins with an overview, is followed by our national and local economic outlook and a forecast of city revenues, and concludes with a discussion of our spending projections. As required by the Charter, we will follow this report up in March with an analysis of the Mayor's preliminary budget.

This report was completed under the supervision of Ronnie Lowenstein who directed the research underlying our projections and Frank Posillico who coordinated all spending and revenue projections. In addition to their programmatic responsibilities, Mark Schreiner and Kishan Putta helped prepare the report for publication.

Douglas A. Criscitello
Director

Chapter 1

Budget Outlook

Given continued strength in both the local and national economies and a prolonged bull market on Wall Street, New York City will end the current fiscal year with a surplus of about $1.1 billion. If the entire surplus is used to help balance next year's budget, the city will face a modest budget gap next year of $540 million - about 2 percent of city revenues.

Beyond 2000, serious fiscal challenges remain because a surplus cannot be counted on to occur every year and city spending is growing at a faster rate than revenues, resulting in projected budget gaps each year through 2002. Moreover, the projected gaps are still considerably larger—relative to city funds—than the gaps forecast at a comparable point during the 1980s expansion.

Key Findings:

The city's four-year budget outlook is brightening...

⇒ Given unexpectedly strong revenue growth, the city will end 1999 with a $1.1 billion surplus.
⇒ Assuming the surplus is used to prepay 2000 expenses, the city faces a modest budget gap next year of $540 million—about 2 percent of city revenues.
⇒ If existing tax laws and spending policies continue, future budget gaps will be substantially smaller than those included in the city's most recent financial plan.

...However, dark clouds remain.

⇒ Long-run revenue growth will be insufficient to sustain current spending policies. Spending will rise 5.1 percent annually compared with 2.4 percent revenue growth.
⇒ Revenues will grow sluggishly due to a cooling off of the local economy, already enacted tax cuts, and limits on property taxes.
⇒ Various policy initiatives under consideration (further tax reductions or construction of sports stadiums, for instance) would deteriorate the budget outlook if not accompanied with offsets to ensure budget neutrality.
⇒ Debt service costs are consuming an increasingly large portion of the budget.

The projections in this report assume that current spending policies and tax laws run their course over the next few years. This assumption implies that none of the pending policy initiatives in the city's most recent four-year financial plan - including proposed tax reductions, spending for new stadiums, and extension of a soon-to-expire property tax abatement - are put into effect. Under a continuation of current policies, the city's fiscal health can be expected to improve.

Our projections, reflecting IBO's generally more optimistic revenue forecast, result in budget gaps that are lower by $1.6 billion in 2000, $1.0 billion in 2001, and $0.6 billion in 2002 than those included in the city's latest financial plan.

Figure 1-1.
Lack of Surpluses Beyond 1999,
Combined With Greater Spending than Revenue Growth...

Dollars in millions

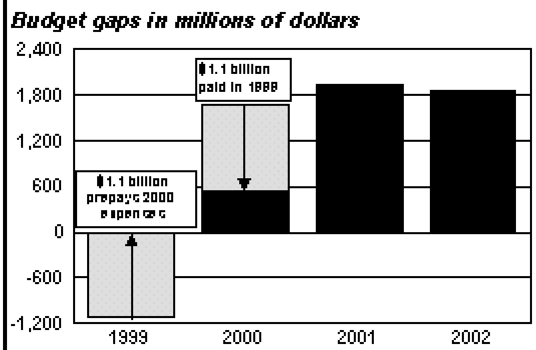
	1999	2000	2001	2002	Average Change
Revenues	35,363	35,862	36,630	37,945	2.4%
Expenditures					
Before 2000 prepayments	34,242	37,523	38,561	39,808	5.1%
Budget stabilization acct.	465	-465	---	---	
IBO estimated surplus	656	-656	---	---	
Subtotal	1,121	-1,121	---	---	
Total spending	35,363	36,402	38,561	39,808	4.0%
Gap	---	540	1,931	1,863	

SOURCE: Independent Budget Office.

Although the fiscal outlook is improving, it would brighten even further if the city targeted a substantial portion of this year's surplus toward providing long-term budgetary relief. Establishing a genuine rainy day fund for use only in the event of a significant economic downturn or revenue shortfall, or repaying a portion of the city's outstanding debt would help the city attain budget balance in the years ahead.

Given the city's practice over the past several years, however, we have assumed that the entire current year surplus will be used to prepay expenses that would otherwise be incurred next year—thereby lowering 2000 spending needs by $1.1 billion. The city also maintains a general reserve fund of $200 million to cover unanticipated current year expenses; any unspent funds would also likely be used to prepay 2000 expenses.

Figure 1-2.
...Leads To Sizable Out-Year Budget Gaps



SOURCE: Independent Budget Office.

Assuming current spending policies and tax laws continue, the city will face a deficit of $540 million in 2000. Without the benefit of surplus 1999 funds, the gap would be much larger, about $1.7 billion. As shown in Figure 1-1, projected spending will grow much faster than revenues from 1999 to 2002, resulting in sizable (though smaller than previously forecast) gaps for 2001 and 2002. IBO's projected gaps are illustrated in Figure 1-2.

Economic and Revenue Forecasts

Economic Forecast. City tax receipts fundamentally depend on the strength of the national and local economies. Defying expectations of a slowdown, the U.S. economy shrugged off last fall's financial market turmoil and expanded at an inflation-adjusted rate of 3.4 percent in 1998. We expect national economic growth to be only half as strong in 1999, however, primarily because of the impact of the Asian recession on U.S. trade and an expected increase in the personal savings rate (see Chapter 2). Our nation's longest economic expansion will continue in 2000 and beyond with moderately higher growth and slightly accelerated inflation.

The weaker national growth in 1999 and a more moderate year on Wall Street will be accompanied by a dip in personal income and employment growth in New York City as well. Personal income growth is expected to pick up again in 2000 and beyond, but payroll employment growth will remain modest following the record job gains of 1998.

Revenue Forecast. IBO's revenue forecast is discussed in Chapter 3. We project that total city revenues—the sum of taxes and non-tax receipts such as state and federal grants—will grow by an average of 2.4 percent per year over the 1999-2002 financial plan period. This modest revenue growth, just slightly greater than the rate of inflation, is the result of the weaker economic expansion, the cumulative impacts of recently enacted tax cuts, and constraints on growth in the real property tax.

Highlights of our tax revenue forecast include the following:

- Tax collections will rise 1.3 percent ($258 million) in 1999, but would have gone up 2.8 percent ($576 million) without the impact of recently adopted tax policy initiatives—primarily the elimination of a personal income tax surcharge and state tax relief. While the state's tax relief program will reduce the city's personal income and real property tax collections, *total* city revenues will not be affected because the state will reimburse the city for the loss.
- Reflecting weaker economic growth in the early part of the coming fiscal year, tax collections will grow 1.5 percent in 2000. If the changes in tax policy discussed above had not occurred and if a soon-to-expire coop/condo tax break is extended, our projection of revenue growth in 2000 would be 3.2 percent. Because inflation is higher in 2000, these growth rates are less substantial than those of the previous year.
- A rebounding local economy will produce another year of moderate tax revenue growth in 2001 (1.9 percent), followed by considerably stronger growth in 2002 (3.7 percent). If the tax initiatives discussed above had not been enacted, our forecast would be 2.8 percent and 4.4 percent in these two years.

Expenditure Forecast

Chapter 4 displays IBO's spending estimates assuming continuation of existing policies. We project overall spending will increase an average of 5.1 percent per year from 1999 through 2002. The rate would slow to 4 percent if the current year surplus is used to prepay expenses that would otherwise occur in 2000.

We have calculated future costs for most programs and agencies by adjusting current spending levels for both inflation and scheduled or anticipated pay raises for city workers. For programs with costs driven principally by factors beyond the immediate control of the city—such as public assistance (caseloads) and education (enrollment)—we have developed our own models to predict future costs.

Highlights of our spending projections include the following:

- Falling caseloads will cause public assistance costs to decrease over the next year, although the number of welfare recipients will stabilize from 2000 through 2002. Until 2001, the stable caseload will yield steady costs. After 2001, however, we expect the city's (and the state's) share of public assistance costs to rise as some recipients reach a five-year limit for federal assistance and begin to transfer to non-federally funded programs.
- Sanitation costs will rise sharply in 2002 with the closure of the Fresh Kills landfill and the need to export more garbage out of state.
- Board of Education spending will grow significantly due to rising labor costs and spending associated with two new state-sponsored initiatives: class size reduction and universal prekindergarten.
- Debt service costs will rise significantly over the next few years and absorb an increasing share of tax revenues. The trend of rapidly rising debt service costs has been obscured by: 1) the decision to move certain debt service costs off budget; and 2) the use of year-end surpluses to prepay portions of the upcoming fiscal year's scheduled debt service.
- Collective bargaining agreements contained no pay increases in the first two years (generally 1995 and 1996) but significant increases in each of the following three years. Consequently, city payroll costs are on the rise.

Chapter 2

Economic Outlook

National and local economic conditions affect New York City's revenues and expenditures, and thus play a major role in determining the city's fiscal outlook. After several years of strong economic performance, IBO expects growth in both the U.S. and the city to moderate over the next few years. Figure 2-1 summarizes IBO's economic forecast for calendar years 1999 through 2002. (Please note that all economic data in this chapter are presented on a calendar year basis.)

Recent Developments

After posting impressive 3.8 percent growth in 1997, U.S. real gross domestic product (GDP) remained strong in 1998; IBO estimates a growth rate of 3.4 percent for the year just concluded. In spite of strong economic growth, inflation as measured by the consumer price index (CPI) has slowed, from 3.2 percent in 1996 to 1.9 percent in 1997 and an expected 1.6 percent in 1998.

Figure 2-1.
IBO Economic Forecast

Percentage change from previous year (unless otherwise noted)

	Calendar Year				
	1998	**1999**	**2000**	**2001**	**2002**
United States					
Real GDP	3.4	1.7	2.8	2.6	2.5
Payroll employment	2.2	0.8	1.7	1.5	1.4
Unemployment rate (%)	4.5	4.9	5.2	5.0	5.2
Consumer price index	1.6	2.4	2.6	3.0	3.1
30-Year Treasury bond rate (%)	5.6	5.1	5.9	6.7	6.6
New York City					
Personal income	4.9	4.0	5.3	5.6	5.5
Payroll employment	2.8	0.9	1.0	1.0	0.8
Unemployment rate (%)	8.0	8.5	8.6	8.5	8.7
Consumer price index	1.6	2.1	2.4	2.9	3.0
Manhattan office asking rents ($ sf)	42.78	44.74	45.40	46.42	47.67

SOURCE: Independent Budget Office.
NOTE: The local consumer price index covers the metro New York/New Jersey region. Growth rates reflect fourth quarter to fourth quarter comparisons.

The New York City economy also performed well in 1998. City personal income, which shot up 8.0 percent in 1997, increased by an estimated 4.9 percent in 1998. Wages and salaries in the securities industry climbed an estimated 11.8 percent, to $33.7 billion, following a spectacular 1997 in which compensation in that sector grew by 18.2 percent.

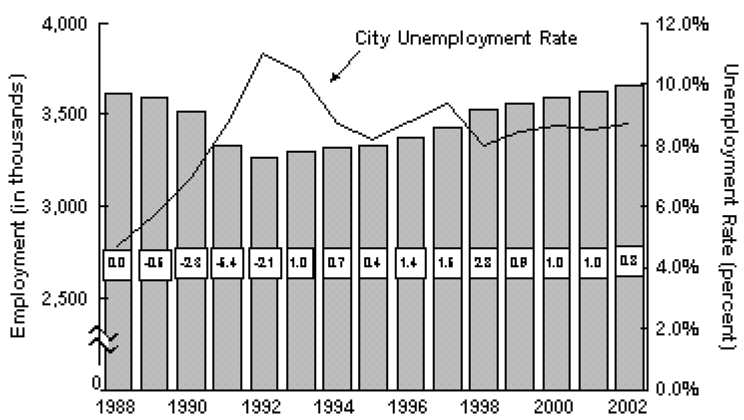
Employment in New York City rose a surprising 2.8 percent in 1998, the fastest growth rate in more than 20 years. Of the estimated 98,000 job increase posted between the fourth quarter of 1997 and the fourth quarter of 1998, 63,000 were created in the service sector, with business services (14,000 new jobs) the fastest growing industry. Other sectors contributing to strength in 1998 employment include retail, where a 17,000 job increase was realized, and manufacturing, where the number of jobs remained unchanged after losses averaging 5,400 jobs per year between 1992 and 1997.

The National Outlook

U.S. economic growth is expected to slow in 1999. IBO forecasts real GDP growth of 1.7 percent, somewhat lower than December's Blue Chip consensus forecast of 2.2 percent. This forecast of slower growth is primarily attributable to two factors. The continuing currency and financial crisis in Asia is expected to increase imports into the U.S. and cause exports from the U.S. to stagnate. In addition, consumption growth is expected to moderate following a surge in 1998 which saw personal savings dip to a very low 0.7 percent of disposable income for the year. A modest acceleration of growth is expected after 1999, when GDP is expected to expand by 2.8 percent in 2000, 2.6 percent in 2001, and 2.5 percent in 2002.

Figure 2-2.
Employment in NYC Continues Its Rise

Calendar years 1987 to 2001



SOURCE: Independent Budget Office.
NOTE: Figures inside bars show percentage change in employment.

Slow economic growth will mean minimal upward pressure on wages and prices over the next few years. IBO forecasts mild, slowly increasing inflation into the millennium: the CPI is expected to rise 2.4 percent in 1999, 2.6 percent in 2000, 3.0 percent in 2001, and 3.1 percent in 2002.

The City Outlook

Slower growth in the national economy and a leveling off of stock prices will result in slower growth in New York City. We expect total personal income to increase by 4.0 percent in 1999, following a rise of 4.9 percent in 1998. Growth in city wages and salaries is expected to decelerate more sharply, from an increase of 7.0 percent in 1998 to a more modest increase of 3.4 percent in 1999. Personal income growth will bounce back above 5 percent in the following three years, with growth averaging 5.5 percent per year. Total wages and salaries are projected to grow slightly faster during the 2000-2002 period than in 1999, with average annual growth of 4.2 percent.

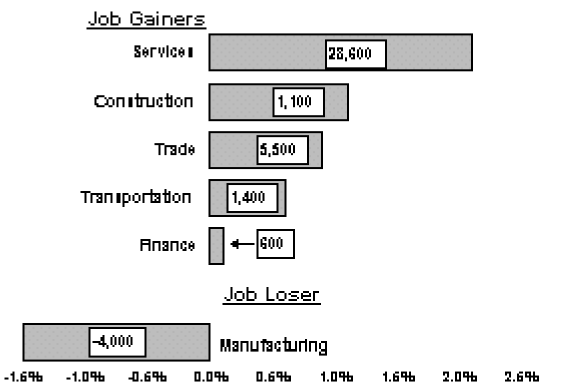
Employment Growth Moderates. In contrast to the remarkable 98,000 jobs the city gained in 1998, IBO expects the city to add a more modest 33,000 jobs in 1999. This slower employment growth, coupled with continued strong increases in the labor force, will cause the city's unemployment rate to climb from 8.0 percent in 1998 to 8.5 percent in 1999 (see Figure 2-2).

Over the longer 1999 to 2002 period, IBO expects employment growth to remain steady, with city employment increasing by 30,000 to 40,000 jobs per year, a growth rate of about 1 percent. Despite the job growth, we project that the city's unemployment rate will average 8.6 percent over the period.

Underlying these increases in total city employment are a variety of different growth rates for different industries. Figure 2-3 shows IBO's forecasts of both the absolute and percentage changes in city jobs by major sector over the next four years.

Figure 2-3.
Job Growth Varies By Sector

Average annual change in city jobs
From present to 2002



SOURCE: Independent Budget Office.
NOTE: Figures inside bars show change in number of jobs.

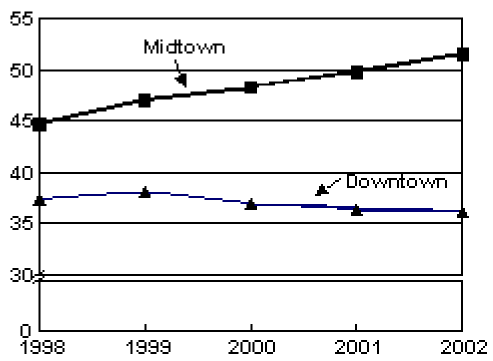
Service Sector Continues to Grow. The service sector will fuel city employment growth over the next four years. IBO expects service sector employment to rise a strong 2.1 percent per year through 2002, an average increase of 28,600 jobs per year. The service industry with the greatest growth is expected to be health services, which is forecast to gain 13,000 jobs per year.

Manufacturing Decline Slows. Although the number of manufacturing jobs in New York City stabilized in 1998, IBO expects the sector to resume its longer-term pattern of gradual employment declines in 1999. We project that the city will lose an average of 1.5 percent of its remaining manufacturing jobs each year through 2002, a loss of about 4,000 jobs per year.

Few New FIRE Sector Jobs. The finance, insurance, and real estate (FIRE) sector, which has experienced the sharpest growth in earnings, added just 5,900 jobs (1.2 percent) in 1998. The FIRE sector is expected to produce a net gain of 2,300 jobs over the forecast period.

Figure 2-4.
Midtown Office Rents Increase Steadily

Calendar years 1998 to 2002
Dollars per square foot



SOURCE: Independent Budget Office.
NOTE: Asking rental rates for primary office space.

Real Estate Remains Tight. IBO projects that midtown vacancy rates, which have steadily declined from 15.0 percent in 1991 to an estimated 5.6 percent in 1998, will stay in the low 5 percent range through 2002. In contrast, we expect a slight weakening in demand for office space downtown. The downtown vacancy rate, which fell sharply from 22.4 percent in 1995 to an estimated 10.3 percent in 1998, will hover between 12 and 13 percent over the next four years.

As shown in Figure 2-4, midtown rental rates are also expected to reflect the strong demand for office space throughout the forecast period. Midtown asking rents will rise from $44.61 per square foot in 1998 to $51.51 in 2002, an average annual increase of 3.7 percent. By contrast, a slight decline in rental rates is forecast for downtown.

Demographic Trends. New York City's population—up about 20,000 in 1998—will grow by a total of about 38,000 between now and 2002. Underlying this slow growth of 0.1 percent per year are two opposing trends: significant immigration, primarily from overseas, and significant out-migration, primarily to other American destinations.

Chapter 3

Revenue Forecast

In this chapter, IBO forecasts revenues from tax collections and other sources including aid from the federal and state governments. These revenues are used to fund the programs and agencies discussed in Chapter 4.

Our projections assume existing tax and intergovernmental aid policies continue through 2002. For the many city tax laws with fixed expiration dates, we have assumed extension of any law that has been renewed at least once in the past.

As shown in Figure 3-1, we project that revenues will increase by an average of 2.4 percent annually over the 1999-2002 period.

City Taxes by Source

Property and property-related taxes, personal and business income taxes, and general sales taxes account for over 90 percent of all city tax collections and about half of total revenues. More moderate local economic growth plus recent cuts in business, real property, and personal income taxes—including the elimination of the personal income tax surcharge (see below)—will result in tax revenues growing at a relatively slow pace of 1.5 percent in 2000, to $21.0 billion. Economic growth strengthens through the forecast period, but revenue growth will be constrained by the continued phasing in of the state's School Tax Relief (STaR) initiative. On balance, the average annual rate of tax revenue growth through 2002 is 2.4 percent. As shown at the bottom of Figure 3-1, without the elimination of the personal income tax surcharge in 1998, overall tax revenues would have grown an average of 2.9 percent from 1999 to 2002; without STaR, revenue growth would have been even higher.

Real property taxes are the city's largest revenue source. Collections will be $7.9 billion in 2000, 37 percent of total tax revenues. Beginning in 1999, the STaR exemption reduces property taxes for homeowners. Assuming that the co-op and condo tax abatement will expire as scheduled, however, total property tax revenues will still rise to $8.3 billion in 2002, with growth averaging 3.5 percent annually, over the 1999 to 2002 period.

Figure 3-1.
IBO Revenue Projections

Dollars in millions

	1999	2000	2001	2002	Average Change
Tax revenues					
Real property	7,505	7,850	8,076	8,313	3.5%
Property-related	1,091	1,015	1,090	1,174	2.5%
Personal income	4,803	4,535	4,540	4,574	-1.6%
General corporation	1,592	1,609	1,572	1,659	1.4%
Unincorporated business	640	660	710	762	6.0%
Banking corporation	367	461	361	461	7.9%
Sales	3,230	3,375	3,546	3,722	4.8%
Other taxes and tax audits	1,456	1,497	1,503	1,515	1.3%
Total tax revenues	20,683	21,002	21,399	22,181	2.4%
Other revenues					
STaR reimbursement	117	314	519	705	82.0%
Miscellaneous revenues	2,532	2,500	2,434	2,490	-0.6%
State and federal grants	10,879	10,931	11,174	11,467	1.8%
All other	1,152	1,115	1,104	1,102	-1.5%
Total other revenues	14,680	14,860	15,231	15,764	2.4%
Total revenues	**35,363**	**35,862**	**36,630**	**37,945**	**2.4%**
Newly enacted tax policy change					
PIT surcharge elimination	-179	-507	-525	-541	—
Total taxes less surcharge	20,862	21,509	21,924	22,722	2.9%

SOURCE: Independent Budget Office.

Property-related taxes include revenues from taxes on commercial rents, real property transfers, and mortgage recording. Collections will total $1.0 billion in 2000, rising to $1.2 billion in 2002. Larger exemptions and rate cuts in the tax on commercial rents will limit growth in property-related taxes to an average of 2.5 percent per year; without these changes, revenues would have been $77 million higher in 2002 and growth from 1999 to 2002 would have averaged 2.7 percent annually.

Personal income taxes are the city's second largest source of tax revenue. They will account for $4.5 billion in 2000, or 22 percent of tax collections. This amount is 5.6 percent *less* than in 1999, due to slower income growth, STaR tax cuts, and the 1998 elimination of one of two surcharges. Growth through 2002 will be flat because of the phase-in of additional cuts under STaR. PIT collections will be only $4.6 billion in 2002, for an average annual decline of 1.6 percent from 1999 to 2002. In the absence of StaR and the surcharge cut, PIT revenues would have grown to $5.7 billion by 2002—3.6 percent average annual growth.

Business income taxes include the general corporation tax, the banking corporation tax, and the unincorporated business tax. These three taxes will account for $2.7 billion or 13 percent of total tax revenues in 2000. Due to slower economic growth and cuts in the general corporation and unincorporated business taxes, growth through 2002 will average 3.5 percent—a much lower rate than in recent years.

Sales taxes apply to sales of goods and selected services. The 4 percent city tax will generate almost $3.4 billion in 2000, 16 percent of total tax revenues. By 2002, sales tax collections are projected to rise to $3.7 billion—average annual growth of 4.8 percent over the forecast period. If the state approves the elimination of taxes on the sale of clothing items costing under $110, as is expected, the growth of city sales tax collections will be significantly reduced in 2000 and 2001.

Real Property Tax

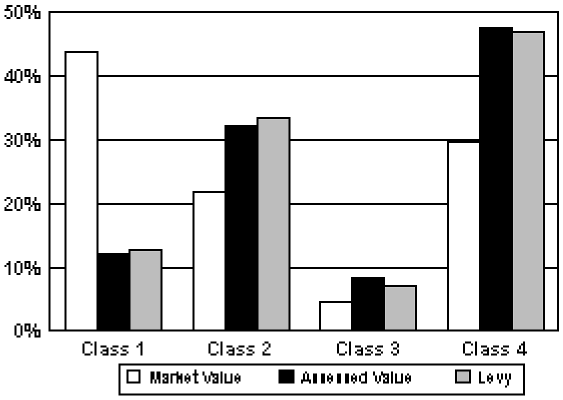
The amount of tax owed on real estate in New York City depends on the type of property, its value for tax purposes (as calculated by the city's Department of Finance on the annual assessment roll), and the applicable tax rate.[1]

Since 1983, the property tax has been based on four tax classes: Class 1, made up of one-, two-, and three-family homes; Class 2, composed of apartment buildings, including cooperatives and condominiums; Class 3, made up of the real property of utility companies; and Class 4, composed of all other commercial and industrial property.

Because assessment rates and, to a lesser extent, tax rates vary from class to class, there are wide differences between each class's share of total market value, assessed value actually subject to tax, and tax burden (levy). As shown in Figure 3-2, Class 1 homes account for 44 percent of market value in the city, but only 12 percent of assessed value and 13 percent of the tax levy. In contrast, the other three classes each account for greater shares of the assessed value than of market value, and therefore bear a disproportionately large share of the property tax burden.

Figure 3-2.
Market Values, Assessments and Tax Burdens Differ

Class share of total



SOURCE: Independent Budget Office.

Outlook for Assessments. IBO projects total assessed value on the 2000 roll will grow by 3.5 percent over 1999. Because of limits in the tax code that prevent the city from immediately taking into account all of the appreciation in property values, this assessment growth is slower than the increase in market values and expansion in the overall city economy.[2]

Assessment growth in both class 2 (3.7 percent) and class 4 (3.7 percent) will outpace the growth in class 1 (1.4 percent). Among apartment buildings, assessed value of Manhattan condos will show the largest increase. For prime office buildings, the pipeline of assessment cuts from the mid-1990s (which are usually phased in over five years) is finally running out. As a result, the 2000 assessment roll will show the first significant increase (up 3.1 percent) in billable value in nearly a decade for this group of properties. Assessed value growth for the rest of class 4 will be even higher (4.2 percent), fueled in part by the continued sharp increase in the value of hotels.

Revenue Forecast. While the total value on the assessment roll is the key determinant in predicting revenues, other factors include the cost of tax abatements (which reduce property tax liability without lowering the assessed value of affected parcels), delinquencies, collections from prior years, and refunds.

Several tax policy changes will affect property tax collections through 2002. First, our revenue estimate—following current law—assumes that the temporary three-year coop/condo tax relief program (1999 cost of $156 million) that is scheduled to expire at the end of this year will not be renewed.[3] Second, abatements under the downtown revitalization program are expected to reach $42 million in 2000—up from $27 million in 1999—and then $47 million and $49 million in 2001 and 2002. Third, the city expects that proceeds from the sale of tax liens, which had ballooned to $116 million in 1999, will be sharply lower in 2000 through 2002.

Property tax collections will also be affected by STaR, which reduces property taxes for homeowners statewide. We expect STaR to reduce city property tax receipts by $82 million in 2000, $135 million in 2001, and $192 million in 2002. The state will reimburse the city for these forgone receipts, however, so STaR has no impact on total city revenues.

After accounting for these factors, IBO projects that property tax revenues will be $7.9 billion in 2000, an increase of 4.6 percent over 1999. In 2001 and 2002, revenues will grow more slowly, increasing at an average annual rate of 2.9 percent.

Property-Related Taxes

Commercial Rent Tax. A series of tax policy changes in recent years have significantly altered the incidence of the commercial rent tax and reduced its revenues from over $700 million in 1994 to $351 million projected for 1999. The tax is now only assessed on commercial tenants with annual rents over $100,000 (with liability phased in for rents between $100,000 and $140,000) in Manhattan below 96th Street. In September 1998, the effective tax rate was reduced from 4.5 percent of the annual rent to 3.9 percent.

Because rents paid by tenants still subject to the tax have risen rapidly over the last three years, with rent increases averaging 5.1 percent annually, commercial rent tax collections have remained relatively stable despite the recent tax cuts. For 1999, while the cut in the effective tax rate will cost the city an additional $32 million, revenues will be only $7 million below their 1998 level. In 2000, even with the rate cut in effect for the full year, revenues will inch up to $355 million. In 2001 and 2002, growth in commercial rent tax revenues pick up, reaching $382 million in the last year.

Transfer and Mortgage Recording Taxes. Real property transfer and mortgage recording tax revenues, which historically have shown great volatility, have surged in the last two years, driven by the strength of the city's commercial and residential property markets and declines in long-term interest rates. While the continued growth in the city's economy forecast by IBO will sustain the property markets, a gradual rise in interest rates is expected to cut into receipts from these two taxes in 2000 and then result in slower growth through 2002.

For 1999, revenues from both taxes are soaring, far exceeding projections (including ours) made at the start of the fiscal year. The property transfer tax is projected to bring in $389 million (35 percent above the 1998 level) and the mortgage tax is expected to yield $351 million (51 percent over last year). In 2000, IBO expects revenues from the two taxes to fall to $364 million and $296 million, respectively. In 2001, each tax resumes growing—albeit at rates closer to their historical norms rather than the explosive rates seen in 1998 and 1999. By 2002, the transfer tax will reach $463 million and the mortgage tax will climb back to $330 million.

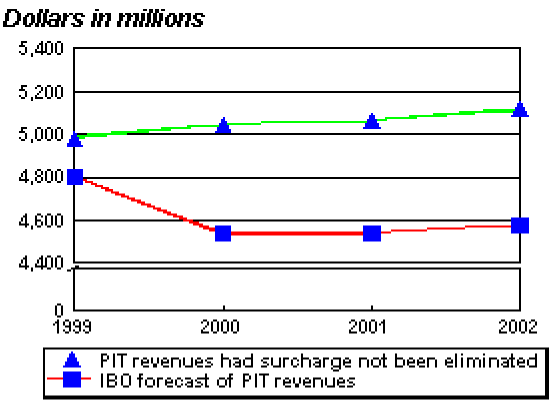
Personal Income Tax

New York City levies a personal income tax (PIT) on its residents and commuters. For resident individuals, estates, and trusts, the tax is progressive, with higher incomes taxed at higher rates—rates which reflect both a base rate schedule and one or two surcharges. Over the next few years, resident taxpayers' rates will fall due to both scheduled cuts in the base rate and the expiration of one of the surcharges.[4] Beginning this calendar year, the top marginal tax rate is 3.8 percent, which joint filers pay on taxable income above $90,000 per year. The top rate kicks in at lower income levels for single and head of household filers. The New York City earnings of non-resident commuters are also subject to the tax, at a rate of 0.45 percent on wage income and 0.65 percent on net income from self-employment.

Tax Policy Changes. Although collections are expected to reflect the strength of wage and non-wage income growth over the next few years, the 1998 surcharge elimination and other tax policy changes will greatly reduce PIT revenues. As illustrated in Figure 3-3, IBO estimates that the 1998 surcharge elimination will lower collections by $179 million in fiscal year 1999 and by roughly half a billion dollars a year starting in 2000, when the full effect of elimination is first felt.[5]

The STaR program will have almost as large an impact on city personal income tax receipts, although the program will not affect total city revenues. The personal income tax component of STaR combines a 10-percent rate reduction with a flat $125 per household ($62.50 for single filers) refundable tax credit; the scheduled phase in of these PIT cuts will be complete by calendar year 2001. IBO projects that STaR will reduce city personal income taxes by $85 million in 1999, $233 million in 2000, $384 million in 2001, and $514 million in 2002. Under the terms of the program, however, the city will be reimbursed by the state for these lost collections.

Figure 3-3.
Surcharge Elimination Reduces PIT Receipts



SOURCE: Independent Budget Office.

Finally, since calendar year 1997, city residents who are proprietors or partners in businesses paying the city's unincorporated business tax have been entitled to a partial credit against their PIT liability. As a result, city tax receipts will be $46 million less in fiscal year 1999 than they would have been without the credit, with the revenue loss increasing to $54 million by 2002.

Revenue Forecast. In the last two years, strong local economic growth, a booming stock market, and a sharp increase in capital gains (profits realized from the sale of assets) have led to double-digit percent increases in personal income tax collections. While these and other favorable economic conditions have mostly continued, PIT receipts so far this fiscal year suggest that growth of collections has slowed. In addition, many securities firms have announced plans to reduce year-end bonuses, which account for a particularly large component of compensation in this high-paying industry.[6] For the current fiscal year, once the STaR cuts and surcharge elimination have been taken into account, IBO projects that collections net of refunds will be $4.8 billion—$330 million or 6.4 percent less than in 1998.

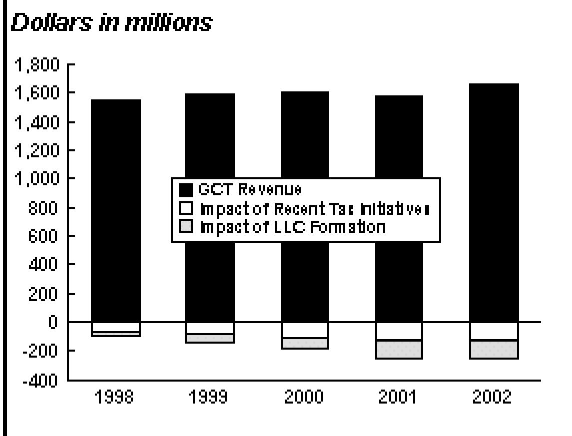
In addition to the 1998 surcharge elimination and STaR, slower expansion of local income and employment, a cooling off of Wall Street's bull market, and a reduction in realized capital gains in calendar year 1999 will dampen PIT collections even further in 2000. IBO's forecasts personal income tax revenues of $4.5 billion—a 5.6 percent decline from the previous year. If the surcharge had not been eliminated and STaR not been enacted, PIT collections would have increased 4.1 percent.

Though local economic conditions are expected to improve in the out-years of the forecast period, personal income tax collections will be flat because of the growing impact of STaR. We forecast collections will remain at $4.5 billion in 2001 and increase by less than one percent to $4.6 billion in 2002.

Business Income Taxes
General Corporation Tax

Most of the revenue collected from the general corporation tax (GCT) comes from a tax of 8.85 percent imposed on the portion of net income a corporation allocates to the city. The tax will account for $1.6 billion in 1999, or 8 percent of total tax revenues. The GCT also generates substantial revenue from audits, which are expected to bring in an additional $290 million in 1999.

Figure 3-4.
Tax Cuts and LLCs Reduce GCT Collections



SOURCE: Independent Budget Office.

Tax Policy Changes. Three 1997 changes in the general corporation tax are expected to reduce GCT collections by $107 million in 2000. Two of the initiatives allow corporations to reduce the portion of their income taxable by the city and are projected to reduce GCT collections by $50 million. A third initiative, which gradually eliminates compensation paid to a corporation's officers from one of the alternative bases of the tax, will cost $57 million in 2000.

Another change expected to reduce collections is the establishment in New York State of limited liability companies (LLCs), a form of business that offers some of the benefits of incorporation. As businesses make increasing use of this status, the number of corporations in the city will be reduced. The LLC form of business will reduce GCT collections by $52 million in 1999 and $122 million by 2002. Much of this lost GCT revenue will be offset, however, by the taxation of LLCs under the city's unincorporated business tax.

Revenue Forecast. After a dramatic 44 percent rise in GCT collections between 1995 and 1998, IBO forecasts much slower growth for 1999, with revenues rising just 2.6 percent to reach $1.6 billion. For 2000, GCT revenues are expected to increase by $17 million, or 1.1 percent. As shown in Figure 3-4, GCT collections in 1999 and the following three years will be significantly reduced by the growing impact of the tax cuts and the establishment of LLCs.

Two economic factors underlie this forecast and explain much of the recent growth in the corporation tax collections. Nationwide corporate profits doubled during the 1990s, but are forecast to grow by just 4 percent per year between 1998 and 2002. Earnings in the city's financial sector have also been strong; between 1995 and 1998, wages and salaries at securities and commodity brokerage firms rose 66 percent, or 18 percent per year on average. Between now and 2002, however, wages and salaries at these firms are expected to grow by 20 percent, or 5 percent per year.

Unincorporated Business Tax

New York City levies a 4 percent tax on the income of non-corporate business entities located in New York City, including sole proprietorships, partnerships, and limited liability companies. In 1998, partnerships accounted for 83 percent of unincorporated business tax (UBT) revenues, and in recent years over two-thirds of unincorporated business tax collections are from businesses in the legal, financial, and health services industries.

Tax Policy Changes. Over the past three years, many businesses have had their tax liabilities significantly reduced or even eliminated by several increases in the unincorporated business tax credit. The credit provides a tax break to those sole proprietors and partnerships with relatively small liabilities. (For example, sole proprietors with business income of $55,000 or less do not incur any unincorporated business tax liability.) As a result of the expansions in the tax credit from 1996 to 1998, annual collections are now roughly $40 million less than if the credit had not been increased. Also, a number of smaller reforms—including several that allow some firms to decrease the share of their income subject to the tax—have reduced annual UBT collections by approximately another $10 million.[7]

Since 1996, however, the city's UBT revenue has been boosted by New York State's establishment of limited liability companies (LLCs), a new form of business organization that offers some of the benefits of incorporation to non-corporate entities. The LLC option has induced some new companies to form as UBT-paying partnerships instead of forming as corporations paying the general corporation tax. In 1999, UBT collections will be $24 million greater due to LLCs. By 2001, LLC's boost to revenues ($56 million) will outweigh the loss of revenues due to the other recent UBT reforms and credit expansions.

Revenue Forecast. Sustained economic expansion and the bull market on Wall Street have fueled a 77 percent increase in unincorporated business tax payments in the last three years. While favorable conditions continued through the end of the calendar year, this extraordinary growth of tax receipts is not likely to continue. Collections to date in 1999 are no larger than last year, and IBO projects UBT receipts net of refunds will equal $640 million, 4.7 percent less than in 1998.

Personal income, employment, and business profits in New York City are all expected to increase slowly during calendar year 1999, causing UBT collections to rise modestly to $660 million in fiscal year 2000. With economic growth expected to pick up in the out-years of the forecast period, unincorporated business tax receipts will reach $710 million in 2001 and $762 million in 2002.

Banking Corporation Tax

The bank tax will generate $367 million in 1999, accounting for 1.8 percent of total tax revenues. Like the general corporation tax, the bank tax also yields a good deal of audit revenue - $80 million in 1999.

The bank tax has been an unstable and hard-to-predict revenue source. Over the last four years bank tax collections declined twice, by nearly 50 percent in 1995 and 0.3 percent in 1997, and followed those declines with very strong increases of 45 percent in 1996 and 43 percent in 1998. These sharp swings in collections result from the underlying volatility of bank profits, the fact that the bulk of the tax comes from a small number of payers, and the ability of payers to move income from one tax year to another.

Revenue Forecast. IBO expects a 29 percent decline in bank tax collections in 1999. The decline is partly explained by the fact that the high level of collections in 1998 reflected a build-up of tax liability based on income earned but not taxed in prior years. Another factor depressing 1999 collections is the small differential, or spread, currently found between the short-term interest rates at which banks borrow funds and the long-term rates at which they lend. Bank profits and therefore bank tax collections should increase as the spread returns to more typical levels. IBO forecasts bank tax collections of $461 million in 2000, $361 million in 2001, and $461 million in 2002.

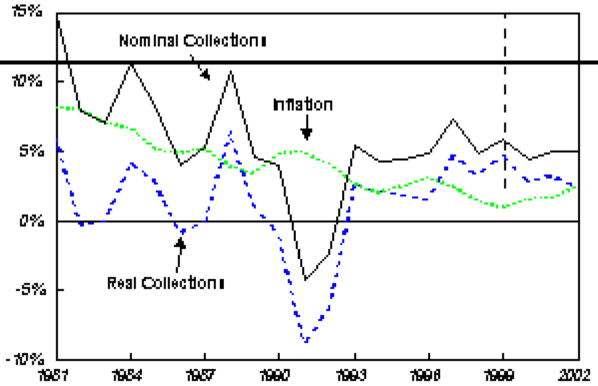
Sales Tax

The city's tax on sales of goods and services has remained unchanged since it was raised to 4 percent in July 1974. (The total combined 8.25 percent rate also includes a 4 percent state tax and a 0.25 percent public transportation surcharge.) The sales tax base exempts most food products, medical services and supplies, mortgage and rental payments, and interstate and international telephone services. Although most personal, professional, legal, business, and financial services are also exempt, services and utilities together still generate about 34 percent of total taxable sales in New York City. Retail sales generate about 45 percent.

City sales tax revenues are largely a function of household spending, with expenditures by businesses, commuters, and tourists also playing an important role. Household spending, in turn, is determined by disposable income and the level of consumer confidence.

Figure 3-5.
Sales Tax Collections Growth Tops Inflation

Annual percentage change



SOURCE: Independent Budget Office.
NOTES: Nominal collections are in current dollars (not adjusted for inflation). Inflation is the rate of change in the Gross City Product price index. Real collections are in constant dollars (adjusted for inflation).

Revenue Forecast. The continuing economic expansion and high levels of consumer confidence will produce another year of strong sales tax revenue growth in 1999. Collections will surpass $3.2 billion for the year, a gain of $178 million over 1998. This 5.8 percent increase in a year when inflation is only running at only 1.0 percent is the third best real growth performance of the past two decades. (See Figure 3-5.)

Strong sales tax revenue growth is expected to continue over the next three years. Annual collections increases of 4.5 percent to 5.1 percent—2.4 percent to 3.3 percent above inflation—will raise sales tax revenues to over $3.7 billion by 2002.

Tax Policy Changes. Revenue growth would be still higher in 1999—6.6 percent—but for the impact of several new sales tax cuts, including a college text book exemption, a coop-condo parking exemption, and two tax-free clothing weeks.

New tax cuts may have a much more significant impact on sales tax revenues in 2000 and beyond. Pending legislative approval, sales of apparel and footwear priced under $110 would be permanently exempt from both city and state sales taxes and surcharges starting December 1, 1999. This would reduce city collections by about $163 million in 2000, $241 million in 2001, and $252 million in 2002. The relatively high part-year cost estimate for 2000 reflects both the typical seasonal distribution of clothing sales and the likely substantial postponement of sales from November to December 1999 to take advantage of the exemption. (The city would also reimburse the MTA for half of its public transit surcharge revenue losses from the clothing exemption, at a cost of $5 million in 2000 and $8 million in 2001 and 2002.)

The introduction of the permanent clothing sales exemption would cause overall city sales tax revenues to fall by 0.6 percent in 2000 and subsequently reduce collections growth to 2.9 percent in 2001 and 5.0 percent in 2002.[8]

Other Taxes

Other taxes will provide nearly $1.5 billion in annual revenues through 2002. These collections come from a variety of sources (such as taxes on hotel rooms, cigarettes, and utilities), payments in lieu of taxes, and revenues from tax audits. Most audit revenue is received from business taxpayers. Over two-thirds of each year's roughly $500 million in expected audit revenue comes from Department of Finance audits of corporate taxpayers of the general corporation and banking corporation taxes.

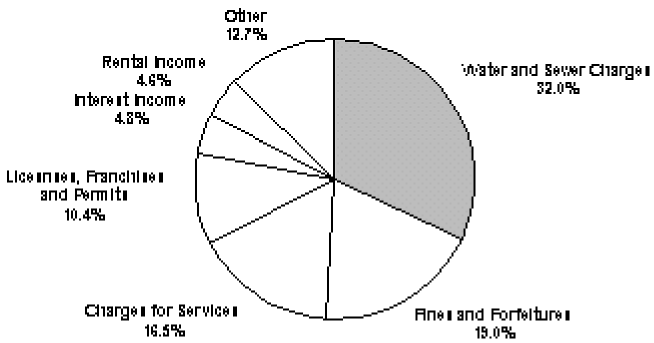
Non-Tax Revenues

Miscellaneous revenues consist of nearly 300 different non-tax sources. These sources may be either recurring (such as licenses, permits, and fines), or non-recurring (such as airport back rent from the Port Authority). IBO projects that miscellaneous revenues will total $2.5 billion in 2000, with little change from 1999, and remain relatively constant over the forecast period. As shown in Figure 3-6, nearly one-third, or $799 million, of all sources of miscellaneous revenues are attributable to water and sewer charges in 2000.

Based on our review of the largest miscellaneous revenue sources, the inclusion of back rent continues to be highly questionable. Airport rent consists of two factors: prior year rental income and anticipated current year rent receipts. The collection of airport rent has been under arbitration for quite some time and there is little evidence to suggest that this issue will be resolved in the city's favor. Accordingly, IBO's revenue forecast entirely excludes contested rental income from past years. Moreover, we estimate that airport rental income will be $35 million in 2000 and each year thereafter.

Figure 3-6.
Sources of Miscellaneous Revenues in 2000

Fiscal year 2000



SOURCE: Independent Budget Office.

State and federal categorical grants, monies received from the state or federal governments to fund specific expenditures, account for 30 percent of all funds spent by the city each year. IBO's projections of these categorical grants are based upon currently enacted legislation and historical trends. We expect categorical grants from the state and federal governments to total $6.7 billion and $4.3 billion, respectively, in 2000.

State grants are forecast to grow at an average annual rate of 3.3 percent through 2002. Four agencies—Board of Education (BOE), Department of Social Services (DSS), Administration for Children's Services (ACS), and Department of Mental

Health—account for almost 90 percent of all state categorical aid. By far the largest share, over two-thirds, will go to the BOE. State grants to the Board will grow at an average annual rate of 4.7 percent through 2002. This forecast reflects the continuation of growth in state educational formula aid, along with increased funding for universal pre-K and class size reduction. In contrast, state grants to DSS will decline slightly in 2000 and 2001 and grow modestly in 2002, due largely to reductions in welfare caseloads.

Unlike state categorical grants, IBO projects that federal grants will decline through 2002, at an average annual rate of 0.7 percent. Over 70 percent of all federal grants are received and spent by DSS, BOE and ACS. Grants to DSS will decline by 6.2 percent in 2000 and continue to decline, at a slower rate, through 2002 due to reductions in welfare caseloads. In contrast, the average annual increase in federal grants to both BOE and ACS will total 3.5 percent.

All other non-tax revenues will total $1.1 billion in 2000, changing little each year thereafter. The largest component of other non-tax revenues is unrestricted intergovernmental aid, which includes per capita state revenue sharing expected to total $327 million in 2000. Other non-tax revenue sources in 2000 are categorical (private) grants and inter-fund revenues, in the amounts of $294 million and $271 million, respectively.

The city will likely receive a substantial windfall as part of the settlement between the 50 states and the nation's tobacco companies. The tobacco companies have agreed to reimburse states and cities $246 billion, over the next 25 years, for health care expenditures they incurred due to smoking-related illnesses. The city can expect to receive a significant portion of the $25 billion that has been allocated to New York State. For example, a 30 percent city share would equal $300 million per year. It is unclear whether the city would receive these funds via categorical grants or unrestricted aid. IBO has not yet included tobacco settlement money in our revenue projections because of the tremendous uncertainty about the size and form of the anticipated payments.

Chapter 4

Spending Forecast

In this chapter, we forecast spending for all city programs by assuming that existing policies continue through 2002.

Figure 4-1.
IBO Spending Projections

Dollars in millions

	1999	2000	2001	2002	Average Change
Health/Social Services					
Social Services	5,236	5,141	5,213	5,364	0.8%
Children's Services	2,063	2,106	2,149	2,208	2.3%
Health	1,614	1,648	1,682	1,716	2.1%
Homeless Services	403	411	419	430	2.2%
All other	470	479	487	499	2.0%
Subtotal	9,786	9,785	9,950	10,217	1.4%
Education					
Board of Education	9,241	9,594	10,013	10,554	4.5%
CUNY	410	412	414	418	0.6%
Subtotal	9,651	10,006	10,427	10,972	4.4%
Uniformed Services					
Police	2,798	2,999	3,114	3,209	4.7%
Fire	1,013	1,065	1,087	1,120	3.4%
Correction	837	913	936	951	4.3%
Sanitation	742	812	843	1,058	12.6%
Subtotal	5,390	5,789	5,980	6,338	5.5%
Debt Service	2,513	2,562	3,964	4,178	18.5%
All Other	8,023	8,260	8,240	8,103	0.3%
Total Spending	**35,363**	**36,402**	**38,561**	**39,808**	**4.0%**

SOURCE: Independent Budget Office.
NOTE: Debt service projections and average growth rate include prepayment of debt; see text for details.

We have calculated future costs for most programs and agencies by adjusting current spending levels for inflation as well as for any pay raises currently scheduled or anticipated for city workers. For programs with costs driven principally by factors beyond the immediate control of the city—such as public assistance (caseloads) and education (enrollment)—we have developed our own models to predict future costs.

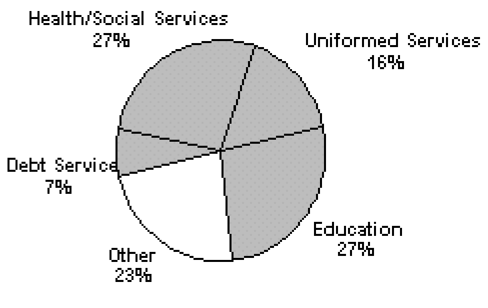
As illustrated in Figure 4-1, IBO projects that spending will increase by an average of 4.0 percent annually over the 1999-2002 period. If surplus funds from 1999 are not used to prepay 2000 debt service, spending growth would average 5.1 percent.

Spending by Program Area

As shown in Figure 4-2, over three-quarters of the city's budget is used to pay for health and social services, education, uniformed services, and debt service.

Figure 4-2.
Four Areas Account for Most Spending

Fiscal year 2000



SOURCE: Independent Budget Office.

Health and social services costs account for $9.8 billion, or 27 percent of our spending forecast for 2000. Continuing declines in public assistance caseloads and slower increases in the growth of Medicaid costs will contribute to a relatively modest average growth rate—1.4 percent annually—compared with total spending growth citywide.

- *Social Services*. The city's Department of Social Services provides cash and medical assistance to needy individuals and shelter and support services to victims of domestic violence, people with AIDS, and the elderly.
- *Children's Services*. Child welfare, child care, and child support enforcement services are the primary responsibilities of the Administration for Children's Services (ACS). Such care includes foster care, adoption, and protective services. The federally funded Head Start program is also administered within ACS.
- *Health.* The city provides funding to the Department of Health, the Department of Mental Health, and the Health and Hospitals Corporation. These agencies provide a variety of health services, including public health programs, mental health services, and comprehensive medical services through 11 city-operated acute care facilities.
- *Homeless Services.* The city provides food, shelter, clothing, and other services to homeless families and individuals. While the city still operates some facilities, homeless services are increasingly provided through not-for-profit organizations.

Education will account for $10 billion, or 27 percent of spending in 2000. Education spending will rise at an average annual rate of 4.4 percent, fueled by Board of Education spending including rising salaries and fringe benefits, modest enrollment growth, and expanded state support of early childhood programs.

- *Board of Education.* BOE operates the city's public school system, which educates nearly 1.1 million students in over 1,100 elementary and secondary schools. BOE also funds some transportation and special education costs for pupils enrolled in private and parochial schools.
- *City University of New York*. The city and state fund six community colleges and associate degree programs at four senior colleges. The rest of the CUNY system—four-year degree programs at 11 colleges, plus graduate, law, and medical schools—is almost entirely state-funded.

Uniformed services spending will account for $5.8 billion, or 16 percent of spending in 2000. Most of these costs are associated with salaries of police, fire, corrections, and sanitation workers. Spending for these activities will increase at an average annual rate of 5.5 percent through 2002, due primarily to rising labor costs. Costs related to the closure of the Fresh Kills landfill also play an important role.

Debt service (payments of principal and interest on money the city has borrowed primarily to fund capital projects) will be 7 percent of total spending in 2000, or $2.6 billion—a figure which excludes $1.1 billion scheduled for 2000 but prepaid in 1999. Costs are forecast to grow at an average annual rate of 18.5 percent through 2002, although without prepayments the rate of growth would be 8.3 percent.

All other costs make up the remaining $8.3 billion, or 23 percent of our 2000 spending forecast. One of the largest components of these costs is fringe benefits to city workers, which will cost $2.4 billion. (That figure excludes fringe benefits to Board of Education employees.) In addition, the city will contribute $1.3 billion to employee pensions. Lucrative investment earnings have led to pension savings, which will reduce the average annual growth in this category to 0.3 percent through 2002. Exclusive of pension costs, the average growth rate would be 3.6 percent.

In the remainder of this chapter, we discuss major budget-related issues in each program area.

Health and Social Services

Public Assistance

The city continues to implement local welfare reform initiatives within the context of new federal and state welfare laws. While driving the most radical restructuring of New York's welfare system in the last 60 years, the new laws have left the city with significant flexibility to develop its own reform efforts.

The new federal law replaces funding for a number of older welfare programs with a block grant known as Temporary Assistance for Needy Families (TANF). It also imposes a five-year lifetime limit on families receiving cash benefits and mandates increasingly ambitious work quotas for adult family heads.

The state's new welfare law, enacted in response to federal welfare reform, maintains a two-tiered system of public assistance that largely preserves prior benefit levels.

- Family Assistance is a cash benefit available to needy households with minor children. The program is funded with federal TANF funds and contributions from the state and city. Eligibility is limited in most cases to a cumulative total of five years.
- Safety Net Assistance is both a cash and non-cash benefit provided to needy individuals, families reaching the Family Assistance time limit, and others ineligible for Family Assistance. The state and the city evenly share the costs of the program.

In addition to implementing the new laws, the city has pursued its own welfare reform initiatives. These efforts began in 1995 with programs designed to tighten eligibility screening and expand work requirements. Together with continuing growth in the city's economy, these local reform initiatives have significantly reduced public assistance caseloads.

In July 1998, the Mayor announced a new phase in the city's welfare reform efforts. A critical aspect of the new plan is an increased emphasis on front-end diversion—the transformation of income maintenance centers into job centers, new job search requirements, and other mechanisms designed to greatly reduce the number of individuals who end up on the welfare rolls. Those deemed eligible for public assistance must work. Few recipients are exempt from a work requirement regardless of physical disabilities or other obstacles that until now have been recognized as serious barriers to employment.

***Caseload Projections*.** We have projected public assistance caseloads through 2002 as shown in Figure 4-3.

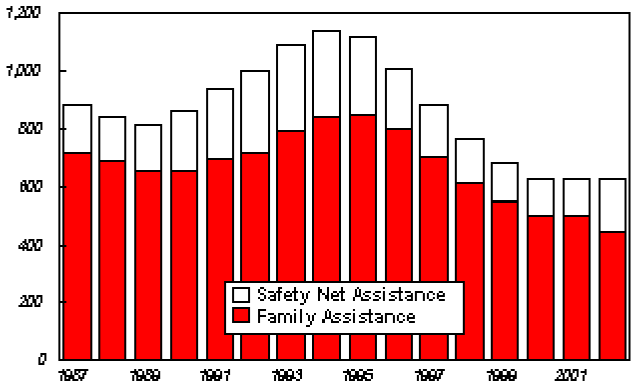
IBO expects that the new policy of front-end diversion will accelerate the recent decline in the Family Assistance caseload for the remainder of 1999 and well into 2000. The process of transforming income maintenance centers into job centers began in the summer of 1998 and is expected to be completed by February 1999. Results from the earliest job centers suggest that front-end diversion techniques have significantly reduced the number of new public assistance cases. Adding to this downward pressure on caseload is the federal prohibition against using TANF funds for assistance to immigrants arriving in this country after August 22, 1996. Beyond 2000, IBO expects the downward trend to moderate as the new policies result in a Family Assistance caseload that is smaller but increasingly needy and difficult to place in private employment.

IBO projects that the five-year limit on TANF assistance will cause 55,000 individuals to lose eligibility for Family Assistance in January 2002, even if the state exempts the maximum number of households based on hardship. If the state chooses not to do so, the number of recipients cut off from Family Assistance could total 155,000.

Caseload trends for Safety Net Assistance (SNA) will follow a similar course through 2000 but will diverge thereafter. As was the case for Family Assistance, the new policy of front-end diversion is expected to extend the downward trend in the Safety Net caseload through 1999 and into 2000. After that, however, downward pressures will be offset by the movement onto Safety Net Assistance of newer immigrant families who are ineligible for Family Assistance under the federal law. Moreover, the state- and city-funded Safety Net Assistance rolls will expand rapidly as families begin to reach the five-year limit on eligibility for Family Assistance and are shifted to SNA.

Figure 4-3.
Welfare Caseloads Stabilize

Caseloads in thousands



SOURCE: Independent Budget Office.
NOTE: Prior to 1998, Safety Net Assistance entries are for the Home Relief program and Family Assistance entries are for AFDC. All numbers are end of year amounts.

Spending Forecast. We forecast public assistance spending by New York City will decrease from $1.6 billion in 1999 to $1.4 billion in 2000 and will remain at that level through 2002. In later years, while the total cost of providing public assistance is expected to stabilize, the city's share of these costs will start to rise in 2002 as Family Assistance recipients begin to reach the five-year limit and transfer to the non-federally funded program.

Work Program Expansion. The cost projections discussed above include only expenditures for public assistance grants. Aside from grant costs, the city could face significant new costs for work program administration and child care if it fully implements the Mayor's planned universal work program. Under that program all family heads receiving assistance are required to participate in a full-time, 35-hour work week, usually including 20 hours of actual work and 15 hours of training or other activities. A recent analysis by IBO indicates that additional work program costs could reach more than $500 million annually by 2000.[9] Because increasing the size of the city's current work program for public assistance recipients is not required by either federal or state law, however, we have not included these costs in our spending forecast.

Medicaid

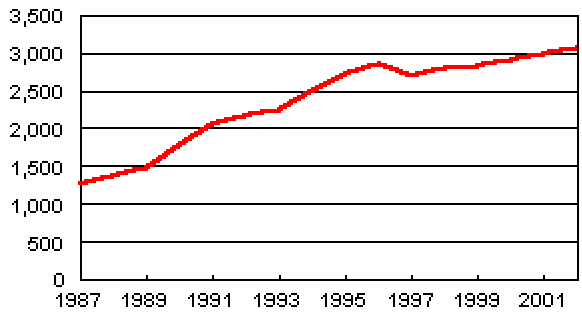
Despite major changes in the social services landscape, Medicaid remains the primary means to medical care for those unable to afford private care. Costs are shared by federal, state, and local governments, with the city's share totaling roughly 23 percent. Most individuals eligible for Medicaid also receive cash assistance through the Family Assistance, Safety Net Assistance, or federal Supplemental Security Income programs.

The Human Resources Administration (HRA) administers most of the Medicaid program and the city also provides funds to the Health and Hospitals Corporation (HHC) to cover the care of Medicaid recipients at public hospitals. About 78 percent of city Medicaid spending will take place through HRA in 1999.

Although managed care—which caps rates for services and focuses on outpatient care—has yet to be fully implemented, efforts to contain Medicaid costs have prevented growth rates from reaching the double digits of previous years. Welfare reform also will continue to be a factor in declining Medicaid costs as the pool of individuals enrolled in Medicaid declines along with welfare caseloads.

Figure 4-4.
Growth in Medicaid Spending Slows

Millions of dollars



SOURCES: IBO; Health and Hospitals Corporation.

IBO forecasts that city Medicaid spending at the HRA will be $2.3 billion in 2000, a 2.4 percent increase from 1999. Growth will continue over the financial plan period at an average of 3.0 percent annually reaching $2.4 billion in 2002. Our forecast reflects the assumption that while overall cost containment efforts will be successful, certain areas of spending will continue to grow albeit at slower rates than in the last decade.

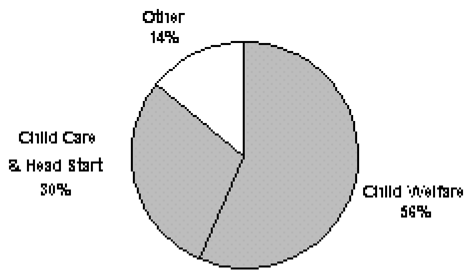
Figure 4-4 shows IBO's forecast for total city Medicaid spending through 2002, including spending at both HRA and HHC.

Children's Services

The Administration for Children's Services (ACS) is in the midst of implementing a major shift in the delivery of child welfare services and continues to struggle with trying to meet low-income parents' need for child care. As can be seen in Figure 4-5, spending on child welfare consumes a majority of the ACS budget. ACS administers child protective services, abuse and neglect prevention services, foster care, and adoption. Within ACS, the Agency for Child Development (ACD) administers most of the government-subsidized child care and the Office of Child Support Enforcement (OCSE) collects child support.

Figure 4-5.
Most ACS Resources Directed to Child Welfare and Child Care

Fiscal year 1999



SOURCE: Independent Budget Office.
NOTE: Child welfare comprises protective services, preventive services, adoption, and foster care.

Two major changes designed to improve child welfare services are likely to have an impact on the agency's budget. First, ACS is moving toward a new, decentralized structure of foster care and family support services. The shift is designed to provide integrated services and foster care for children and their families in their neighborhoods. Request for proposals (RFPs) from nonprofit organizations in the Bronx have been submitted and contracts are planned to be funded by the end of the current fiscal year. No RFPs have been released yet for any other borough and a timeline is not available. The new system will be funded with current ACS child welfare dollars. We have assumed continuation of that funding in our out-year projections of ACS spending.

Second, the recent settlement of a lawsuit filed in 1995 requires ACS to submit to an assessment by an independent panel of experts charged with making suggestions for agency improvements. ACS also must undergo nine state audits and assign 41 workers to monitor compliance with state law. Funds to support the monitoring are not included in our projections because they have not yet been added to the budget.

Child care is another issue with the potential to significantly impact the budget outlook. While there continue to be tens of thousand of children on ACD waiting lists, some of the pressure on child care could be offset by children shifting from ACD to preschool in response to the implementation of universal prekindergarten.

IBO projects that ACS will spend $2.1 billion in fiscal year 2000, a 2 percent increase over 1999. Assuming the continuation of existing policies, we project that the agency's budget will grow to $2.2 billion by 2002.

Education

Board of Education

The Board of Education (BOE or Board) operates the largest public school system in the nation, providing general and special education instruction along with support services. Faced with state and local pressure to improve student performance, the Board is devoting more resources to instruction, especially early childhood programs.

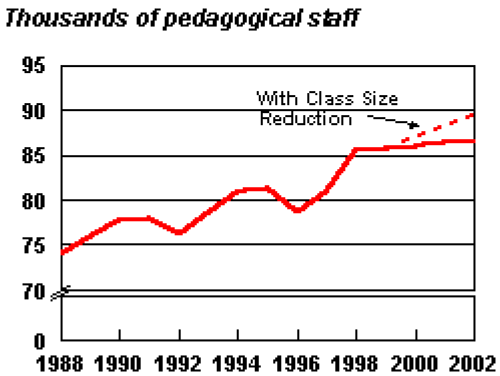
Enrollment Growth. Growth in total BOE enrollment—which increased by about 20,000 students per year from 1990 to 1997—has slowed recently. The Board expects general education enrollment to increase by less than 3,000 students (0.2 percent) per year through 2002, while full-time special education enrollment is anticipated to increase more rapidly over the same period, growing by more than 1,000 pupils (1.2 percent) per year. BOE spending averages more than three times as much, per pupil, on special education than on general education.

State Initiatives. Beginning in 2000, BOE will participate in a new state program that provides money to reduce class sizes to an average of 20 students in kindergarten through grade 3 over a three-year period.[10] Average class sizes in the city for those grades currently range from 24 to 26 students. IBO's spending forecast assumes that the Board will implement class size reduction in 75 percent of city schools by 2002.

The 75 percent rate is in line with BOE planning, based on expected levels of state and federal funding.

Implementing class size reduction will require building more classrooms (which would be funded from the city's capital budget) and hiring more teachers. We project that teaching staff will increase from about 85,500 in 1998 to about 89,500 in 2002, with more than three-quarters of the increase due to the needs arising from class size reduction initiatives (see Figure 4-6).

Figure 4-6.
Smaller Classes Require More Teachers



SOURCE: Independent Budget Office.
NOTE: Includes teachers, principals, assistant principals, guidance counselors, psychologists, social workers, and school secretaries.

BOE is currently participating in the first year of another state-funded program, which will make prekindergarten classes available to all 4-year olds in the city by 2002. Sufficient state funding to accomplish this goal, however, is uncertain. IBO's baseline projection assumes the Board maintains its current year contribution of $8 million. Depending upon state funding, BOE spending could easily exceed our projections. (See box on page 29 for more details.)

Spending Forecast. We estimate that BOE will spend $9.6 billion in 2000, an increase of 3.8 percent from 1999. Spending will continue to grow at an average annual rate of 4.5 percent, reaching $10.6 billion in 2002. Beyond class size reduction, universal prekindergarten, and enrollment growth, other factors are also boosting spending. The Board is facing rising labor costs while funding several programs to increase instructional time, including more summer sessions, evening high school programs, and after-school and weekend tutoring. The Board ended 1998 with a $300 million surplus—money it plans to use to pay 1999 bills. The Board is planning to use a portion of future surpluses to fund capital expenses, such as repairing existing school buildings and building new facilities.

City University of New York

CUNY is the largest urban university in the nation with over 200,000 students in degree programs. Over 60,000 of these students attend community colleges that receive significant city support.

Spending Forecast. IBO projects that spending by CUNY's community colleges will be relatively flat, rising at an estimated average annual rate of 0.6 percent over the 1999-2002 period. This forecast of slow spending growth is primarily attributable to the city's decision not to fund collective bargaining wage and salary increases for the community colleges. Accordingly, IBO's forecast does not include spending growth due to increased labor costs. The university, however, will somehow have to pay for salary increases already negotiated with its unionized employees. The impact of this spending constraint on staffing levels, course offerings, and class size is uncertain.

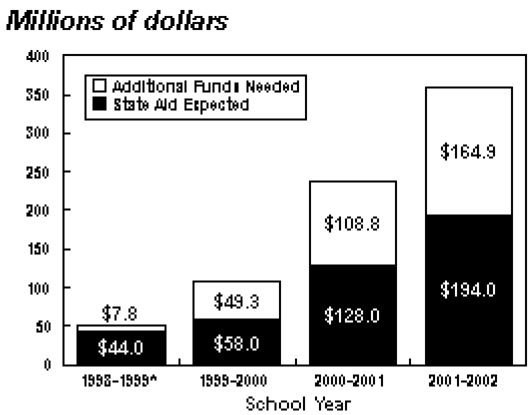
Universal Prekindergarten

This school year marks the beginning of a new state-sponsored program which, when fully phased in by the 2001-2002 school year, will make publicly funded prekindergarten classes available to all 4-year olds in the city. In its first year, universal pre-k is serving 14,000 New York City yearchildren. BOE expects this number to double to almost 29,000 next year and to reach 97,000 at full implementation.

During the current school year, New York State will cover most of the cost of universal pre-k, providing approximately $3,100 per pupil. In addition, BOE will contribute close to $600 per pupil. Using this year's expenditure of $3,700 per pupil as the benchmark cost of running the program and assuming the state maintains its current per pupil grant, BOE would have to double its pre-k contribution in the coming year, simply because the pre-k population is about to double. Instead of the state maintaining its current level of commitment, however, next year, state aid is scheduled to fall to $2,000 per New York City student.

Relying solely on this reduced state funding, it is unlikely the Board would deliver the same level of services offered this year. The Board does not have the option of making state money go further by serving fewer students since state funds are paid on a per pupil basis. If no steps are taken to make up the funding shortfall, the Board faces the choice of offering a scaled-back version of its current program or funding some (or all) of the gap itself.

Figure 4-7.
Expected Universal Pre-K Funding Leaves City Facing Growing Shortfall



* Actual

SOURCES: IBO; NYC Board of Education; NYS Education Department

NOTES: Funds needed are based on current expenditure of $3,700 per student. State aid commitment is assumed constant at the 1999-2000 school year level of $2,000 per pupil, the statutory minimum.

Scaling back the pre-k program would be difficult, however, given state regulations regarding teacher certification and maximum class size. Physical capacity constraints complicate the issue further. With a growing population to be served and limited classroom space, the Board expects to contract out more and more prekindergarten slots to private and nonprofit institutions. It is unclear how these community-based providers would scale back their services and unlikely they would be willing to provide a $3,700 service for $2,000.

Alternatively, the Board could cover the entire shortfall. Given the reduced state funding levels, the Board would need to contribute $49 million in the next school year, $109 million in the following year, and $165 million when the program is fully implemented in 2001-2002 (Figure 4-7). The Board would be matching 85 percent of state funding and, by the 2001-2002 school year, close to 2 percent of the Board's total budget would be committed to this state-sponsored program.

Uniformed Services

Police

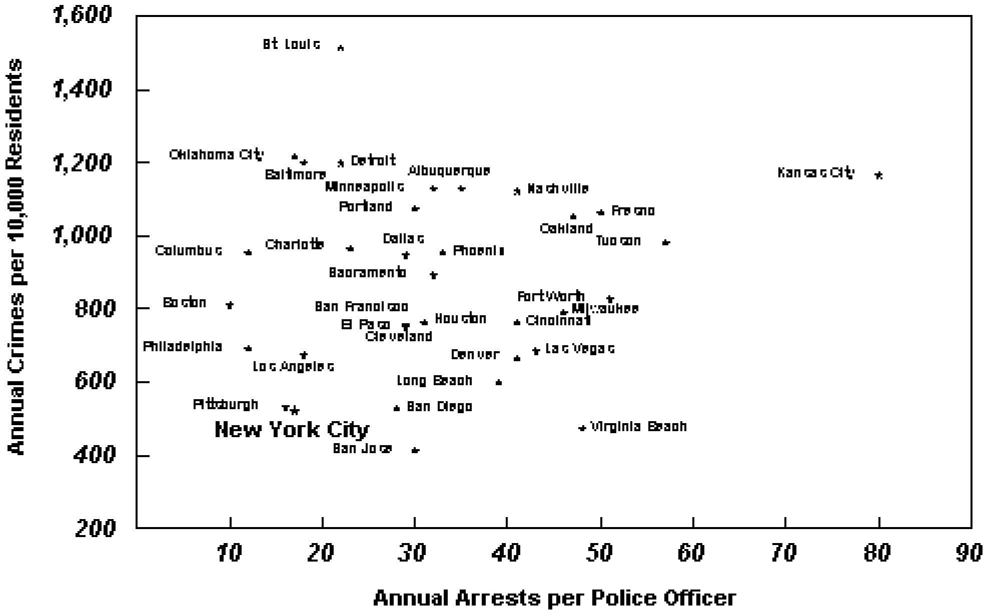
Earlier this year, the city increased police staffing to a record high of 40,210 uniformed personnel, fully 25 percent more than at the start of the decade. With 55 police officers per 10,000 residents, New York City now has a level of per capita police staffing about double the average of other large U.S. cities. Meanwhile, New York City's significant increase in police staffing since 1990 has been accompanied by an even more dramatic 50 percent decline in the rate of serious crime, with New York City now having one of the lowest crime rates of all major U.S. cities.

The same pattern of simultaneous increases in police staffing and decreases in crime New York has experienced over much of the 1990s has also generally been the case in other large cities. It is noteworthy, however, that some cities have enjoyed significant declines in crime with no increases or even *decreases* in per capita police staffing. For example, San Diego was one of a few major American cities (besides New York) to enjoy a drop in its crime rate of more than 40 percent between 1990 and 1997, but that city accomplished its crime reduction with virtually no increase in per capita police staffing. Meanwhile, the rate of serious crime has fallen by 40 percent and 25 percent in Dallas and Denver, respectively, although per capita police staffing in both of those cities actually declined by 3 percent.

As impressive as New York City's drop in crime has been, these trends have led IBO to consider whether productivity differences exist between police agencies in major American cities. For example, as displayed in Figure 4-8, cities such as San Diego, San Jose, and Virginia Beach have crime rates nearly as low or lower than New York City, yet on average police officers in the former three cities make significantly more arrests per year than do their New York City counterparts. More precisely, police officers in San Diego, San Jose, and Virginia Beach made 28, 30, and 48 arrests in 1996, respectively, as compared to 17 arrests per officer in New York City. The only other major city with both crime and arrest rates similar to New York's is Pittsburgh. (A total of 38 of the 50 largest U.S. cities reported arrest data to the FBI in 1996, with 30 the median number of arrests per police officer.)

Figure 4-8.
NYC Stands Out with Low Crime and Arrest per Officer Rates

Largest American cities, 1996



SOURCE: Independent Budget Office, utilizing data disseminated by FBI.
NOTE: Incomplete data for 15 of the nation's 50 largest cities (Atlanta, Austin, Chicago, Honolulu, Indianapolis, Jacksonville, Memphis, Mesa, Miami, New Orleans, Omaha, San Antonio, Seattle, Tulsa and Washington D.C.) prevent their inclusion in the figure.

While it is reasonable to assume that New York's growing police force has played a significant role in the city's declining crime rate, the precise relationship between police staffing levels and crime levels is not well established. Therefore, New York City could consider the option of downsizing police staffing in the future while simultaneously seeking ways to more efficiently deploy remaining police personnel. The goal in doing so would be to free up city resources for the purpose of meeting other pressing public needs without compromising public safety.

Spending Forecast. Assuming no change in current force size, we estimate that NYPD spending will increase by an average of 4.7 percent annually, rising from $2.8 billion in 1999 to about $3.2 billion in 2002. Salary increases stemming from collective bargaining agreements account for most of the expected growth, with police officers already scheduled to receive a 6 percent increase in pay as of June 1, 1999.

Department of Sanitation

The closure of the Fresh Kills landfill in Staten Island on January 1, 2002, will pose serious logistical and budgetary problems in coming years for the Department of Sanitation (DOS). The closure will force the city to develop ways to export nearly all of its refuse and to come up with significant funds to cover those new costs.

Waste Export Plan. The city currently disposes of most of its waste by loading barges at marine transfer stations and towing them to Fresh Kills. The city spent roughly $38 per ton (including indirect costs such as overhead) on the cost of marine transport, unloading, and landfilling in 1997, the latest year for which comprehensive data are available.

In the plan released in December by DOS, the city will continue to load barges with refuse at its marine transfer stations in Manhattan, Queens, and Brooklyn. As of 2002, however, instead of towing the barges to Fresh Kills, the waste will be towed to unloading facilities to be located in New Jersey and Brooklyn where it will be unloaded and transferred to ocean-going barges or trains for export. Waste from Staten Island and the Bronx will be exported through barge or rail facilities that will be located in their respective boroughs. IBO projects that exporting all of the city's trash by barge or rail in 2002 will cost roughly $70 per ton.

On an interim basis, through 2001, the city intends to export some waste by transferring it to tractor-trailer trucks utilizing existing transfer stations (currently used for commercial waste) and transporting it to landfills outside the city. IBO projects that truck export will cost the city about $55 per ton.

Despite the lower cost of transporting garbage by truck, the city has decided to use barges and trains to export its waste after Fresh Kills is closed. There is considerable opposition to truck transport because trucks are a major source of traffic congestion, air pollution, and noise pollution. Moreover, barge transport has the advantage of using existing marine transfer stations that are distributed throughout the city, which limits the distance collection trucks need to travel before unloading.

Figure 4-9.
NYC Becomes Major Exporter of Trash

Year	Fresh Kills	Exported	Recycled
1996	12,433	0	1,457
1997	12,211	0	1,563
1998	9,923	1,900	1,906
1999	7,749	4,023	1,936
2000	5,283	6,069	2,321
2001	2,509	8,512	2,652
2002	0	10,690	2,983

SOURCES: IBO; Department of Sanitation Solid Waste Management Plan Draft Modification.
NOTE: All numbers are tons of refuse per day.

Exporting and Recycling. As shown in Figure 4-9, the DOS plan for closing Fresh Kills calls for sharp increases in the volume of trash exported and recycled over the next four years. DOS projects that garbage exports will increase more than fivefold, rising from 1,900 tons per day in 1998 to 10,690 tons per day in 2002. Recycling is projected to increase an average of more than 14 percent per year over the same period—considerably faster than in recent years and a goal that may be difficult to attain.

Paradoxically, because the per ton cost of recycling within city limits currently exceeds the cost of any form of out-of-city disposal, the more recycling and less exporting the city achieves, the greater will be the total cost of closing Fresh Kills.

Our cost estimates assume that the DOS plan for exporting and recycling trash will proceed on schedule.

Spending Forecast. The cost of exporting refuse will far exceed the current cost of landfilling material at Fresh Kills. IBO estimates the city will need to spend roughly $230 million in 2002 to export waste. Any estimate, however is highly uncertain because spending will ultimately depend on a number of unknowns, including the amount of waste generated, the amount recycled, and the final export costs negotiated by the city.

The city presently spends about $110 million on waste disposal—a comparatively low number given the present availability and use of Fresh Kills.

Debt Service/Capital Commitments

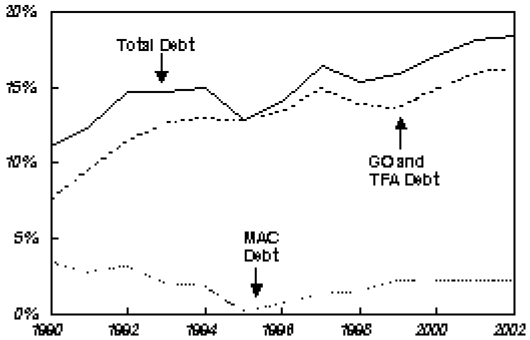
The city borrows money by issuing bonds to pay for new construction and the physical improvement of schools, roads, and other public facilities. Debt service is the repayment of the borrowed funds.

The city's debt service payments support three types of city debt: General Obligation (GO), Municipal Assistance Corporation (MAC), and Transitional Finance Authority (TFA). GO debt is financed by the broad taxing powers of the city government. MAC debt, backed by dedicated sales tax collections, was used to meet city borrowing needs when its access to capital markets was curtailed in the aftermath of the fiscal crisis of the 1970s. TFA was created in 1997 in response to the impending exhaustion of GO borrowing authority; it issues bonds backed by a dedicated stream of city personal income tax revenues.

The city excludes TFA debt service (and the personal income tax revenues that fund it) from the operating budget. Such treatment provides an incomplete picture of the allocation of public resources and makes it difficult to evaluate changes in the city's debt burden. Accordingly, IBO will continue to include TFA debt in its analysis of debt service.

Figure 4-10.
Debt Service Rising

Debt service as a percentage of tax revenues



SOURCE: Independent Budget Office.

Spending Forecast. Total debt service payments have been absorbing an increasing share of city tax revenues since 1990, and are projected to continue growing faster than taxes through 2002. In recent years this trend has been somewhat obscured by the use of year-end budget surpluses to prepay portions of the upcoming fiscal year's scheduled debt service. For example, IBO assumes that the expected 1999 surplus will be used to prepay $1.1 billion in debt service otherwise due in 2000. Prepayments move debt burdens between fiscal years, lowering net borrowing costs in some years and raising them in others. These impacts have been reversed in Figure 4-10, which shows prepaid debt service in its originally scheduled year.

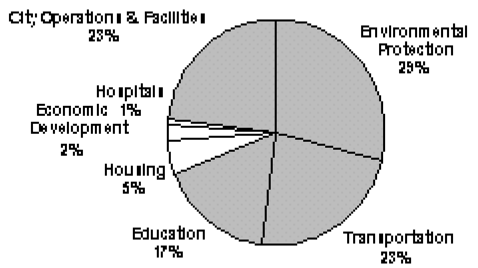
The rising ratio of debt service to tax revenues—from 11.0 percent in 1990 to a projected 15.9 percent in 1999 and 18.4 percent in 2002—can be attributed to several factors. On the spending side, new borrowing rose from an average of $1.1 billion per year during the 1980s to $2.7 billion per year in the 1990s, increasing almost 75 percent even after adjusting for inflation. In addition, refinancings of existing debt that initially saved the city an average of $170 million per year over the 1987-95 period have raised average debt service by $200 million per year from 1996 through 2007. At the same time, city revenue growth has been and will continue to be constrained by the failure of some taxes (especially the property tax) to keep pace with the economy as well as by the cumulative impact of tax cuts.

Debt Limit. The state constitution currently limits the general debt-incurring power of the city to 10 percent of the average market value of taxable real estate. The precipitous fall in borrowing capacity—from $55 billion in 1994 to barely over $30 billion in 1998—led to both the creation of the Transitional Finance Authority (which allows the city to borrow up to $7.5 billion beyond its statutory limit) and to calls for permanently raising the constitutional debt limit to better reflect the city’s ability to raise revenues from a broader array of taxes.

There has been less attention, however, to the fact that the $25 billion decline in borrowing capacity between 1994 and 1998 was preceded by a $25 billion jump in capacity between 1990 and 1994. Even in inflation-adjusted dollars, the city’s current and projected debt limit remains higher than it was throughout the 1980s, and remains close to the long-term average over the post-fiscal crisis period. When the exaggerated booms and busts of debt-incurring power during the early- and mid-1990s are removed, it is clear that the exhaustion of the city’s current borrowing capacity is primarily the result of increased borrowing. Given planned borrowing and projections of property values over the next several years, the city is expected to exceed the combined GO/TFA debt limit in 2000.

While there is a strong case for a more broadly based debt limit, the question of how high a prudent limit should be remains unresolved. As long as increases in capital spending continue to outpace revenue growth, however, there will be upward pressure against this or any other debt limit.

Figure 4-11.
Four Capital Commitment Programs Dominate 2000 Capital Plan

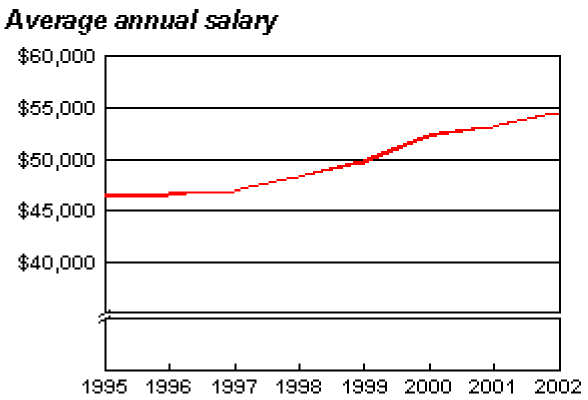


SOURCE: Independent Budget Office.

Capital Commitments. The city's capital commitment plan is a projection of the total dollar value of contracts that will be entered into during the course of a fiscal year for projects that have been authorized in the capital budget. The 2000 commitment plan contains a target of $5.5 billion. However, since some projects will invariably experience delays that prevent them from being implemented by year's end, the city must set total commitments higher than the target amount. For 2000, the city has authorized total commitments for capital projects worth $6.1 billion.

Capital commitments are forecast to increase significantly over the next several years. While annual commitments from 1989 to 1998 averaged $4.2 billion, IBO projects that commitments will average $5.4 billion from 1999 through 2002.

Figure 4-12.
Salaries of City Workers on the Rise



SOURCE: Independent Budget Office.

Supplementary Information on City Labor Costs

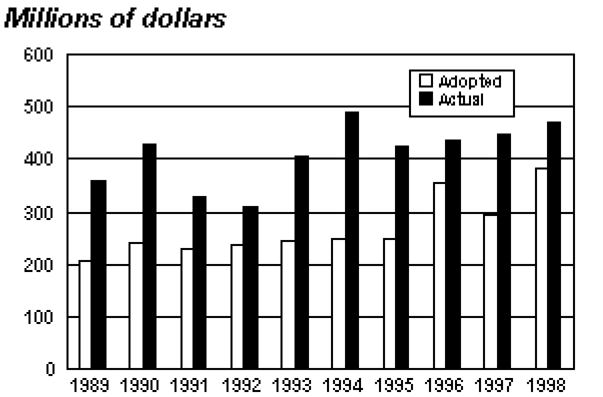
Total Personnel Costs. More than half of the city's budget is used to pay the salaries and fringe benefits of its employees. Salaries account for about three-quarters of personnel costs while fringe benefits (including pensions) comprise the remainder. The rate of increase in total personnel costs is expected to be modest because pension contributions are forecasted to decrease through 2002. IBO projects that personnel costs will rise at an average annual rate of 2.5 percent over the next several years, reaching $19.8 billion in 2002. Excluding payments made for pensions, personnel costs are expected to grow at an average annual rate of 3.9 percent.

Salaries. As illustrated in Figure 4-12, the average salary of a city employee, excluding fringe benefits, was stable from 1995 through 1997, but has since begun to rise and will continue to climb through 2001. This trend results from the way recent collective bargaining agreements were structured—providing no increases in the first two years of the five-year contracts but significant raises during the last three years.

In order to develop a realistic measure of the city's long-term fiscal condition, we assume that city workers will receive additional raises once existing labor agreements begin to expire in 2000 and 2001, with annual increases based on the projected rate of inflation. The cumulative cost to the city of adjusting city-funded salaries for inflation is projected to be $40 million in 2000, $310 million in 2001, and $761 million in 2002.

Overtime. Overtime costs are affected by many factors including collective bargaining agreements, management initiatives, planned events, and emergencies. Although the city has taken steps to reduce overtime expenditures, management initiatives related to public safety and unforeseen agency needs have resulted in increased annual overtime expenditures since 1995. Overtime expenditures in 1999 are expected to surpass the all-time high of $490 million reached in 1994. Based on current overtime spending averaging $9.6 million a week, IBO projects that overtime expenditures will total $497 million in 1999. That level of spending is projected to continue through 2002.

Figure 4-13.
Overtime Spending Consistently Exceeds Adopted Budget Levels



SOURCES: IBO; NYC Comprehensive Annual Financial Reports of the Comptroller, 1989-1998.

The city has historically underfunded overtime, resulting in the need to increase overtime allocations during the year by modifying the budget. As illustrated in Figure 4-13, actual overtime expenditures exceeded the adopted levels in each of the last ten years. In 1994, actual overtime spending was nearly double the level initially budgeted. For 1999, IBO estimates that actual overtime will exceed the amount included in the adopted budget by $124 million or 33 percent. For 2000 through 2002, we assume that overtime spending will be $500 million annually and will exceed financial plan projections by more than 30 percent each year.

Pension Costs. We estimate that pension costs will be $1.3 billion in 2000, a decrease of 9.3 percent from 1999. Pension costs will continue to decrease to $1.2 billion in 2001 and to $812 million in 2002. This decrease is the result of the extraordinary investment earnings the city has recognized in recent years coupled with IBO's assumption that such earnings will be used to reduce future pension contributions.

Footnotes

1	When we refer to market values and assessments, we are including only taxable property. The assessed value for tax purposes reflects the required phase-in of assessment changes for apartment, commercial, and industrial buildings.
2	For a discussion of constraints on city property tax growth, see *New York City's Fiscal Outlook*, (IBO, February 1997) pp. 29-34
3	For an analysis of the abatement and some of its shortcomings see *The Coop/Condo Abatement and Residential Property Tax Reform*, (IBO, December 1998).
4	This surcharge, whose proceeds have generally been used to fund criminal justice programs, expired by law after tax year 1998-eliminated by a conscious legislative decision not to renew it. The other surcharge, equal to 14 percent of pre-surcharge tax liability, will expire at the end of 1999 unless renewed. Because this latter surcharge has been already renewed three times by the city and state, IBO's forecast assumes its continuation.
5	Specifically, surcharge elimination will reduce the city's personal income tax revenues by $506 million in 2000, $525 million in 2001, and $541 million in 2002.
6	Employees will receive 1998 year-end bonuses mostly in the December 1998 through February 1999 period.
7	In addition, starting with tax year 1997, resident payers of the unincorporated business tax are entitled to a credit against their personal income tax liability. (This tax cut affects the city's collection of personal, as opposed to business, income taxes.)
8	The extent to which clothing sales tax cuts stimulate additional spending and increase other city tax revenues was examined in IBO's fiscal brief, *Would Clothing Sales Tax Cuts Pay for Themselves?* (IBO, June 1997).
9	See IBO, *Welfare Reform Revisited: Implementation in New York City*, September 1998, for greater detail.
10	The federal government is providing additional funds to reduce

	class sizes during at least the first year.

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