IBO

New York City Independent Budget Office

Fiscal Outlook

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Tax Revenues Slip, Labor Costs Rise: City's Fiscal Outlook Dims

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AFTER FIVE YEARS OF GROWING SURPLUSES, New York City's fiscal outlook has dimmed. Due primarily to weakening economic growth and the rising cost of recent municipal labor settlements, IBO projects a budget gap of $3.1 billion in 2009—roughly $360 million more than the Bloomberg Administration estimated in October. Our gap projections of $4.6 billion in 2010 and $6.3 billion in 2011 are a bit lower than the Mayor's. But there is ample reason to be concerned that if the financial industry's condition worsens or the local housing market slumps more than expected, the city's fiscal picture could become even darker.

Economic Outlook. The fallout from the collapse of the housing bubble—which began more than a year ago in many areas of the country—has extended into credit markets and is expected to slow the national economy. While growth was strong through much of last year, it is now expected to have slowed sharply in the fourth quarter, bringing annual real Gross Domestic Product growth for all of 2007 to 2.2 percent.[1] IBO is not expecting a U.S. recession, as is reflected in our forecast that the national economy will slow further in 2008, before turning up late in the year.

U.S. home prices, sales volume, and housing starts have all declined in 2007. As a result, employment in industries ranging from construction to the home improvement retail sector has begun to shrink. Consumer spending growth, which until now has been sustained in large part through homeowners' ability to withdraw equity from their rapidly appreciating homes, is expected to slow as declining home values restrict this source of cash. Falling home prices are also preventing many recent buyers from refinancing their subprime mortgages and defaults are rising sharply.

Problems in the U.S. housing market have spilled over into financial services—the industry that drives the New York City economy. As defaults have risen, the value of mortgage- and other asset-backed debt has plummeted. Financial institutions have written off billions of dollars of assets and sharply reined in lending and other activities, making it difficult even for credit-worthy individuals and businesses to borrow.

For Wall Street firms, the impact of the credit crisis was evident in the $3.8 billion loss reported in the third quarter of 2007—the first collective quarterly loss by New York Stock Exchange member firms in nine years. IBO's baseline forecast assumes that Wall Street firms approximately break even in the fourth quarter, resulting in only $5.0 billion in profits for 2007. This would be a decline of more than 75 percent in profits from the near record $20.9 billion for 2006. Profits are expected to recover to a relatively modest $8.8 billion in 2008 and $12.2 billion in 2009—far lower levels than forecast only a few months ago. Employment in the financial services industry (securities, banking, and insurance) is projected to decline by 5,900 jobs in 2008 and another 4,000 in 2009, and then grow very slowly.

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Total Revenue and Expenditure Projections

Dollars in millions

	2008	2009	2010	2011	Average Change
Revenues	$59,157	$59,119	$62,077	$64,248	2.8%
City-funded Revenues					
Taxes	*34,941*	*35,331*	*37,336*	*39,012*	3.7%
Other Revenues	*7,708*	*6,793*	*6,896*	*6,961*	-3.3%
Expenditures	$59,157	$62,215	$66,662	$70,563	6.1%
City-funded Expenditures	*42,649*	*45,221*	*48,817*	*52,288*	7.0%
IBO Surplus/(Gap) Projection	**$-**	**$(3,096)**	**$(4,585)**	**$(6,315)**	

SOURCE: IBO.
NOTES: IBO projects a surplus of $1.92 billion for 2008, $333 million below the Bloomberg Administration's forecast. The surplus is used to prepay some 2009 expenditures, leaving 2008 with a balanced budget. Estimates exclude intra-city revenues and expenditures. Includes the Bloomberg Administration's tax proposals. May not add due to rounding.

After gaining 62,200 jobs in 2006 (1.7 percent annual growth), IBO expects the city to have gained 41,100 jobs in 2007 (1.1 percent annual growth). But total employment growth will be less than 500 jobs in 2008 and a relatively weak 20,800 jobs (0.6 percent) in 2009. In addition to job losses in the financial services industry, IBO forecasts declines in information, construction, and manufacturing over the next two years. In contrast, professional and business services, leisure and hospitality, health, and education will continue to add jobs, although at a slower pace than in recent years. Reflecting the overall lack of employment growth and actual declines in financial industry compensation, personal income growth is expected to decelerate, from 11.4 percent in 2006 and 8.5 percent in 2007, to just 3.3 percent annual growth in 2008 and 3.2 percent in 2009.

IBO expects the local commercial real estate market to remain strong, in large part due the continued tight supply of modern office space until after 2011. Our forecast for Manhattan office rents is for continued growth, although at a slower pace than in the past two years as slower employment growth eases demand. Residential prices are forecast to remain flat, with moderate growth in Manhattan offsetting price declines elsewhere in the city. Industry reports indicate that one factor sustaining Manhattan apartment prices has been the cheap dollar relative to European currencies, which has attracted foreign buyers and is expected to continue doing so.

Revenue Outlook. With our outlook for much slower economic growth, particularly for the local economy with its dependence on the financial services industry, IBO is projecting that total tax revenues this year will be $2.4 billion (6.5 percent) lower than 2007. This slowdown was partially anticipated in the city's financial plan when the current budget was adopted last June, but sharp declines in Wall Street profits since the summer—with some firms sustaining losses—now point to a much greater decline.

Overview. IBO's tax revenue forecast for the current year is $35.0 billion, $775 million less than the projection in the 2008 Adopted Budget and 6.5 percent lower than the total for last year.[2] The losses on Wall Street and slower employment growth are expected to have an even larger effect next year when tax revenues are forecast to be $1.0 billion lower than expected when the current budget was adopted. The year-over-year growth for 2009 will be weak (1.6 percent), with total tax revenues reaching $35.6 billion (excluding the Bloomberg Administration's tax proposals).

Aggregate tax revenue growth is expected to be stronger in 2010 (5.8 percent), with revenues finally exceeding their 2007 level. Growth is expected to be even stronger in 2011 at 10.5 percent, when revenues are expected to reach $39.3 billion, still $1.3 billion below the amount anticipated in the June financial plan. Even with the projected recovery after 2008, overall 2008-2011 city revenue growth is not expected to keep pace with inflation. City taxes on property transfers are expected to decline—similar to transfer tax declines nationwide—in the collapse of the housing bubble and a drop in mortgage financing. But given the concentration of financial services firms in New York City, the impact of Wall Street's losses on personal and business income taxes will be considerably larger here than elsewhere.

Transfer Taxes. Revenue from the property transaction taxes (the mortgage recording tax, MRT, and the real property transfer tax, RPTT) were at an all-time high in 2007 at $3.3 billion, having grown at an average annual rate of 24.6 percent since 2001. But the number of transactions for the first three-quarters of the year fell by 8 percent compared with a year ago and prices were nearly flat—continued growth in median residential prices in Manhattan was largely offset by lower prices elsewhere. IBO now expects transfer tax revenues to decline by 29.1 percent during 2008 to $2.3 billion, and then decline by another 13.5 percent to $2.0 billion in 2009.

IBO forecasts a major residential market slowdown in calendar years 2008 and 2009, with fewer transactions and stagnant prices. This slowdown will extend to Manhattan, although median prices there are expected to increase modestly. Declines in the other boroughs are expected to be more pronounced. Refinancing activity will continue to drop, which will further depress MRT revenue. On the commercial side, we expect fewer transactions worth more than $100 million, although this volatile portion of the market will not dry up entirely.

IBO's revenue forecast assumes a three-year decline for the MRT, with growth not expected to resume until 2011. Recovery for the RPTT will be faster, with a 38.3 percent decline from 2007 to 2009 followed by modest growth in 2010 and 2011 at an annual average rate of 4.1 percent. Combined revenues for the two taxes in 2011 are projected to total $2.1 billion—35.8 percent below their 2007 peak.

Business Income Taxes. As with the transfer taxes, 2007 is also expected to mark the peak of a period of extraordinary revenue growth for the business income taxes (the general corporation tax, the unincorporated business tax, and the banking corporation tax), which grew an average of 27.4 percent a year since 2003, to reach a combined revenue total of $6.0 billion. Given IBO's forecast of sharply lower Wall Street profits, diminished growth in U.S. corporate profits, and slower growth in the city economy, this period of business tax revenue growth is now expected to end. IBO projects that business income tax revenues will fall to $5.5 billion (a decline of 8.3 percent) in 2008, followed by another 5.5 percent decline in 2009 to $5.2 billion. The largest decline is expected to be in the bank tax: down $324 million (26.6 percent) in 2008 and another $197 million (22.0 percent) in 2009. Combined business income tax revenue growth will resume in 2010 and 2011, although by the latter year nominal revenues will have only barely surpassed their 2007 peak.

IBO's forecast of a two-year, 13.3 percent business tax revenue decline in 2008 and 2009 can be compared to the 23.4 percent two-year drop during the city's last downturn in 2002 and 2003 and the 19.8 percent drop in 1989 and 1990. During the two earlier periods the city experienced recessions rather than the slow growth IBO is now projecting for 2008-2009.

Personal Income Tax. With the decline in Wall Street profits now expected to cause a drop in bonus payments this year, along with IBO's more pessimistic outlook for local employment growth, withholding and quarterly estimated payments are expected to slow, and net refunds (refunds minus final returns payments) are now forecast to increase. As a result, IBO expects personal income tax (PIT) revenue to fall by $624 million this year to $7.1 billion (down 8.1 percent from the 2007 level), with virtually no growth anticipated for 2009. IBO's new projection for 2008 is $601 million lower than had been anticipated when the current budget was adopted.

PIT revenue growth is expected to resume in 2010 and average 5.0 percent annually through 2011, when revenue will reach $7.9 billion. Note that IBO's forecast assumes that current law on federal capital gains tax rates will be followed so that the current preferential rates will expire in calendar year 2011. Under that scenario, capital gains realizations would surge in 2010 as taxpayers lock in the preferential treatment.

Other Taxes. The effects from the difficulties in the real estate markets and in the financial services industry on other key city

What if Wall Street's Woes Deepen?

IBO's revenue forecast is based on an economic outlook that assumes the remaining mortgage-related losses by individual financial firms in the fourth quarter of 2007 will be offset by profits in other parts of the industry, making the fourth quarter a wash and resulting in an annual profit of $5 billion for Wall Street firms as a whole. Profits rebound only modestly to $8.8 billion in 2008.

With the credit crisis still unfolding, near-term forecasts of Wall Street revenues and profits are particularly difficult. While there appears little reason to think our assumptions are too pessimistic, there is a reasonable chance that they are overly optimistic. If Wall Street firms absorb deeper losses and mount a slower recovery than in our baseline forecast, there would be a corresponding effect on city tax revenues.

To get a sense of the possible impact we tested an alternative scenario in which Wall Street loses another $4.6 billion in the fourth quarter of 2007, reducing total profits for the year to just $500 million, with an increase to only $5.1 billion in 2008 and $10.4 billion in 2009. With heavy job losses in the financial sector, overall New York City employment growth would fall by 8,700 in 2008, then increase by only 15,000 the following year.

Under these conditions, 2008 tax revenues would be $237 million below our baseline forecast. For 2009, revenues would be $263 million below IBO's baseline. The declines from our baseline would exceed $300 million in 2010 and 2011, with revenues not expected to regain their 2007 level until 2011, when they would reach $39.0 billion.

Neither IBO's baseline economic scenario nor our more pessimistic alternative assumes a national recession. However, if the U.S. economy were to be pulled down by one or more factors such as lower demand resulting from declines in housing, or lower investment caused by tightened access to credit, the effects on local economic variables— and the revenue forecast—would be much greater.

tax revenue sources are expected to be milder. Real property tax revenue is expected to grow throughout the period, averaging 6.9 percent annually, despite IBO's forecast that market value growth will average only 4.7 percent annually from 2008 to 2011 compared to an average of 13.5 percent for the three years ending in 2008. The reason is the very large pipeline of deferred assessment increases that are still being phased in. For 2009, with more than $6 billion of deferred increases for commercial and apartment building properties being phased in, assessed value for tax purposes is expected to grow by 8.1 percent to $134.5 billion. Note that our property tax forecast assumes continuation of this year's 7 percent tax rate cut.

IBO also expects the hotel occupancy tax to continue growing, fueled largely by foreign visitors attracted to the city in part by the lower value of the dollar. Revenue is expected to rise from $341 million in 2008 to $367 million in 2009, with growth averaging 6.5 percent annually through 2011. Spending by tourists is expected to help offset weakness in other spending to keep the sales tax growing at a weak average annual rate of 1.8 percent from 2008 through 2011.

Labor Costs. One of the more striking features of the October Financial Plan was the addition of funding in anticipation of labor settlements with all city employees along the lines of those recently reached with several uniformed unions. This would include the members of District Council 37, the largest civilian union, whose contract expires next March 2, as well as the Teamsters Union, whose contract ends September 12. The financial plan assumes two annual increases of 4.0 percent. Despite its forecast of no growth in the municipal workforce, the financial plan projects average growth in salaries and wages—including the labor reserve—of 6.2 percent a year from 2008 through 2011. With growth in pension contributions projected to slow beginning in 2010, the growth rate of fringe benefits (including pensions) is slightly less—5.4 percent.

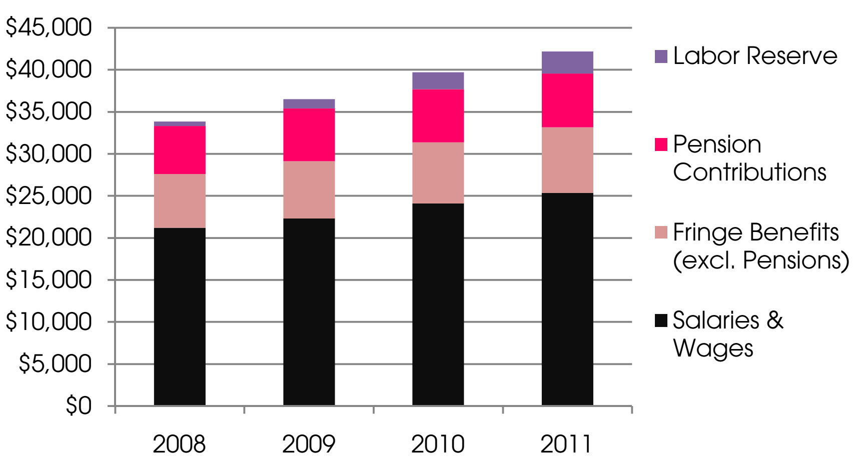
Recent Settlements and Upcoming Arbitration. During fiscal year 2007, the city and the Uniformed Firefighters Association reached a two-year agreement covering roughly fiscal years 2007 and 2008. The agreement provided for two annual compounded 4.0 percent wage hikes. The Bloomberg Administration later reached settlements covering four years with most other uniformed unions and establishing the current uniformed wage pattern of four annual compounded raises of 4.0 percent through 2011.

The United Federation of Teachers (UFT) and the Council of Supervisors and Administrators (CSA) have also reached agreements on their contracts. The UFT contract, which covers just over two years, extending through October 2009, provided 7.1 percent increases. The CSA contract, which had expired in July 2003, extends to March 2010, and provides a total increase of 23.2 percent over its 80-month duration.

The Patrolmen's Benevolent Association (PBA), representing the city's roughly 23,000 police officers, remains the only major union with an expired contract. The PBA is currently engaged in arbitration before a state Public Employment Relations Board (PERB) panel that will decide the terms of the PBA contract covering the period August 1, 2004 through July 31, 2006. During this period, the prevailing uniformed wage pattern was annual increases of 3.0 percent and 3.15 percent, for a cumulative increase of 6.24 percent, which the PBA has refused to accept. The PERB panel's decision is expected early this year. Ironically, the city and PBA will have to begin negotiating again as the PERB-imposed contract decision will have already expired.

Projected Personal Services Spending, October Financial Plan

Dollars in millions



SOURCES: IBO; Mayor's Office of Management and Budget.

Funding for Wage Increases. The city's labor reserve is used to recognize and plan for the costs of labor settlements. It funds the expected civilian and uniformed wage increases as well as Social Security and Medicare (FICA) and pension costs that arise from wage increases.

When the budget for fiscal year 2007 was adopted, the labor reserve was funded based on the assumption of 2.0 percent increases through 2008, and 1.25 percent increases in future years. As agreements were subsequently reached with the uniformed unions, funds were transferred from the labor reserve to individual agencies to recognize higher salary costs, FICA and pension expenses, and other components of the settlements.

If labor settlements exceed what has been budgeted, the city makes additional contributions to the labor reserve in the financial plan. Since recent contract settlements have exceeded the original assumptions, additional funds have been added to the labor reserve both to cover these agreements and to extend the prevailing pattern to the other unions.

Departing from past practice, the October Financial Plan assumes two annual 4.0 percent wage hikes for civilians during the next contract round, covering roughly fiscal years 2009 and 2010. For subsequent years, the Bloomberg Administration has resumed the previous assumption of 1.25 percent wage increases, yielding a cumulative increase of 10.88 percent over four years. Because the Mayor had previously funded the labor reserve based on annual 1.25 percent increases, assuming that any additional wage increases would be offset by productivity enhancements and other givebacks, the assumption of 4.0 percent increases required substantially greater funding in the labor reserve—$418 million in 2009, $1.055 billion in 2010, and $1.591 billion in 2011.

Future Risks. If the state arbitration panel grants police officers a higher wage increase than the pattern for the affected years, it could have serious financial repercussions for the city. Agreements with the other uniformed unions include a "contract reopener clause" for all the settled uniformed contracts with start dates prior to the end of the PBA contract. If the PERB arbitration panel awards wage increases in excess of the uniformed wage pattern, other uniformed unions would have the right to open up their contracts and bargain again. While the city has no obligation to grant additional wage hikes, this clause puts pressure on the city to renegotiate the recently settled agreements.

Another risk the city faces is the performance of its pension funds investments. Better-than-expected investment returns in 2007 allowed the city to reduce projected pension contributions by $125 million in 2009, rising to $350 million in 2011. Investment performance so far in 2008 has proved to be disappointing, however, and these anticipated savings may end up being reversed next year.

Conclusion. The city's fiscal outlook has changed markedly since the 2008 budget was adopted last June. Weakening U.S. and local economic growth is taking a toll on the city's revenues, and if Wall Street's mortgage- and credit-related woes worsen, it will further depress city tax revenues and deepen our projected budget gaps for the coming years. Rising labor costs, which already play a significant role in growing budget shortfalls in the out-years of the financial plan, could become a larger factor as well depending upon the outcome of the state arbitration panel's decision on a contract for police officers.

While there are considerable risks to our projections, there are also some options at hand for addressing at least a portion of the shortfalls. The Mayor has already sought proposals for about $1 billion in savings from agencies for next year and beyond, which would cut the 2009 gap by a third. There is also a $2.5 billion trust fund that can be used to pay all or part of about $1 billion in annual health care costs for retirees. In addition, when first proposing the 7 percent property tax rate reduction last year, the Mayor said it should only be continued if affordable. The property tax reduction, which costs the city about $1 billion annually in foregone revenue, is currently continued in each year of the financial plan. But these options would only be sufficient to close the 2009 shortfall, leaving even more difficult decisions for addressing the gaps in the future years—gaps that could grow if our projections prove too optimistic.

ENDNOTES

[1]In this section on the economic outlook, references to years are for calendar years.

[2]Tax revenue figures include tax audit revenue and personal income tax collections directed to the Transitional Finance Authority, but exclude STAR reimbursements from New York State.

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