As Economy Weakens, City’s Budget Gaps Swell

AFTER SEVERAL YEARS of amassing large budget surpluses, New York City now faces swelling budget gaps as a long and deep recession erodes jobs and tax revenues. IBO projects that the city will lose 243,000 jobs from the peak during the first quarter of 2008 and tax revenues will fall by $2.8 billion in fiscal year 2009 to $34.7 billion and then decline by $380 million more in 2010.

Recognizing that the city will not be generating large surpluses to cover the shortfall between recurring revenues and expenses, the Bloomberg Administration and the City Council have ended the property tax rate cut six months ahead of schedule, taken steps to generate additional revenues, and cut spending. Despite these efforts, the city faces daunting budget gaps beginning in 2010—the upcoming fiscal year.

Based on IBO’s estimates of revenue and expenses under the November 2008 financial plan, adjusted for the tax measures adopted last month, we project that the budget gap for fiscal year 2010 has grown to $4.3 billion (10.4 percent of city-funded revenues). With little recovery of the local economy anticipated before the end of calendar 2010, we expect the fiscal year 2011 gap to reach nearly $7.0 billion (15.9 percent of city-funded revenues).

ECONOMIC OUTLOOK

U.S. Economy. What IBO and other forecasters expected in May to be a brief and mild U.S. recession has become a deep and increasingly global downturn. Already a year old, the recession is one of the longest since World War II and is now expected to last through 2009. (In this section, all references are to calendar, not fiscal years.) The downturn that began in the housing sector spread to the financial industry and has now affected the entire economy.

Financial institutions’ huge losses, coupled with uncertainty about the soundness of the firms that remain, have reduced the supply of credit, despite billions of dollars of government assistance and unprecedented policy actions by the Federal Reserve. Although mortgage interest rates have come down, the housing market continues to suffer from falling prices and foreclosures, causing a myriad of related industries to stagger and contributing to declines in consumer spending. With credit tight and consumer confidence weak, business investment has also declined.

IBO forecasts a 1.5 percent contraction in inflation-adjusted gross domestic product (real GDP) in 2009, after growth of just 1.2 percent in 2008. Peak-to-trough, the U.S. employment loss (seasonally adjusted) is expected to reach 4.3 million jobs (3.1 percent), with nearly three-quarters of the job losses occurring in the fourth quarter of 2008 and the first and second quarters of 2009. By the end of 2009, the national economy will start to grow again, with real GDP rising 2.1 percent in 2010 and by an average of 4.9 percent in the following two years. IBO expects the U.S. unemployment rate to climb to 8.0 percent in 2009 as workers are laid...
off, and then climb further to 8.7 percent in 2010 as the number of workers seeking employment dwarfs new job opportunities in an initially weak expansion. Once economic growth resumes inflation will again moderate—rising from 0.9 percent in 2009 to 2.7 percent in 2010.

**New York City Economy.** New York City has lagged the nation in its entry to this recession, but as the global center of the financial industry, the city’s economy is expected to turn down more sharply, stay down longer, and recover more gradually than the nation as a whole. Wall Street firms have been battered by the turmoil in financial markets, losing $11 billion in 2007 and another $31 billion through September 2008. Whether or not major regulatory reforms are enacted, the financial industry that emerges from the current crisis is likely to be smaller, less highly leveraged, and less profitable. IBO forecasts profits in the securities industry of $7 billion in 2009 and then about $10 billion per year in 2010 through 2012—for from the near-record profit of $21 billion the industry enjoyed in 2006.

Wall Street’s losses and the broad-based U.S. recession have led to employment declines in New York since the first quarter of 2008, declines which have steepened over time. From April through November, the city has lost 28,200 jobs on a seasonally adjusted basis (0.7 percent); 23,300 of the losses came in October and November. IBO forecasts continued local job losses through the end of 2010, with a total loss of 242,700 jobs (6.4 percent) from a peak of 3,774,800 jobs in the first quarter of 2008. Employment growth will resume in 2011 (0.8 percent annual growth) and accelerate in 2012 (2.5 percent), but employment at the end of 2012 is projected to still be less than its most recent peak. The forecast employment decline is greater than the 228,100 jobs the city lost over 11 quarters beginning in the first quarter of 2001, but less than the five-year loss of 368,100 jobs that began in the first quarter of 1988.

The financial activities industry is expected to lose 82,300 jobs (17.4 percent)—48,900 jobs (26.1 percent) in securities alone. While IBO forecasts slow employment growth for the financial industry starting in the second quarter of 2011, only one-fourth of the finance jobs lost in this recession are expected to return by 2012. Professional and business services and the information sector, which derive much of their business from the financial sector, are also projected to be hit hard, losing 70,500 jobs (11.8 percent) and 24,400 jobs (14.2 percent), respectively, from peak to trough.

With the housing market in disarray and credit conditions extremely tight, IBO forecasts a loss of 17,700 construction jobs (13.7 percent) and slow growth thereafter, as glutted real estate markets take time to clear. Retail trade will also be hard hit by the recessions here and abroad, with a projected job loss of 20,900 (6.9 percent) by the first quarter of 2011. The leisure and hospitality industry will also suffer from declines in business travel and tourism.

The jobs outlook in the education and health services sectors, which have increased steadily in the last 20 years, is relatively bright. Together these sectors account for almost one in five city jobs and are expected to grow by an average of 0.7 percent annually in 2009 and 2010, and by 2.0 percent in 2011 and 2012.

Both residential and commercial markets have weakened and are expected to decline further in the coming years. So far in the recession, home prices in the city have not fallen as precipitously as in other parts of the country, but the drop in the volume of sales has been steep. Apartment sales have also tumbled, particularly since the mid-September financial market collapse, and prices even in Manhattan which had seemed impervious to economic conditions, have begun to fall. As the local economy weakened in 2008, the number of large-scale commercial property transactions sharply declined. IBO forecasts steep decreases in Manhattan office rents in 2009 and 2010, followed by modest declines through 2012 as financial sector restructuring continues to reduce demand for office space.

### Total Revenue and Expenditure Projections

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**Adjusted for Prepayments and Discretionary Transfers:**

- **Total Expenditures**: $63,620, $65,519, $69,523, $71,768 (4.1%)
- **City-Funded Expenditures**: $46,109, $47,932, $51,101, $53,035 (4.8%)

**Source:** IBO.

**Notes:** IBO projects a surplus of $568 million for 2009, $1.235 billion below the Bloomberg Administration’s forecast. The surplus is used to prepay some 2010 expenditures, leaving 2009 with a balanced budget. Estimates exclude intra-city revenues and expenditures. Figures may not add due to rounding.

**REVENUE OUTLOOK**

The city’s revenue outlook has become increasingly grim as the unanticipated severity of the national recession has compounded the budgetary effect of the New York City-centered financial...
market crisis. IBO’s tax revenue forecast calls for a sharp fall in receipts this year and further declines in 2010. Even after accounting for last month’s vote to raise real property and hotel taxes, IBO projects $34.7 billion of tax revenues in fiscal year 2009, 7.5 percent less than in 2008, and $34.3 billion in 2010, a further decline of 1.1 percent. Tax revenues are expected to begin recovering and bounce back to $36.6 billion in 2011 and to reach $38.7 billion in 2012—about 3.3 percent above 2008.

IBO’s 2009 tax revenue forecast is $1.2 billion lower than the Mayor’s Office of Management and Budget (OMB) projected in its November financial plan, before the depth of the recession had become clear. IBO’s forecast remains lower than OMB’s for the next three years, by $1.6 billion, $1.9 billion, and $2.0 billion in 2010, 2011, and 2012, respectively.

The forecast of two consecutive years of declining tax revenues, following a year (2008) in which total tax revenue was essentially flat, marks a stunning turnaround from the recent past. After the last downturn, in the five years from 2002 through 2007 revenues grew by a total of 73.8 percent with annual growth averaging 11.7 percent—despite the expiration of several temporary tax increases towards the end of this period. The strongest growth occurred in the tax sources most closely related to real estate and finance: the transfer taxes that are assessed when properties are sold or refinanced, and the business income taxes which depend heavily on the profits of Wall Street firms.

**Business Income Taxes.** From 2003 to 2007, combined revenues from New York City’s three business income taxes—general corporation tax (GCT), banking corporation tax (BCt), and unincorporated business tax (UBt)—nearly tripled to more than $6.0 billion. In 2008 these revenues declined 9.6 percent, to $5.4 billion. But as the impact of the financial market crisis and the national recession spreads across the city economy, 2009 revenues are projected to plunge to $4.1 billion, a record 23.7 percent drop. IBO forecasts a further slide of $414 million (10.1 percent) to $3.7 billion in business tax revenues in 2010. Never before have business tax receipts fallen for three consecutive years, nor has the loss of revenue been as large as the one now forecast: a cumulative drop of $2.3 billion, or 38.0 percent. Modest growth is expected to return in 2011 and 2012, but by the latter year, combined business tax revenues are projected to have increased to only $4.4 billion, far below the 2007 peak.

The plummet of business tax revenues is in large part the result of the seismic shocks that have been roiling Wall Street since the summer of 2007. New York City, which last year was home to five major investment banks, now has none; all five have been forced out of business, sold to other institutions, or converted to bank holding companies. (To date these changes have not been accompanied by shifts in business income liabilities among taxes—in particular, from the GCT to the BCT—but any such shifts would significantly affect these taxes.)

From 2007 to 2008, GCT net revenues declined $200 million, to $2.9 billion. They are projected to fall to $2.3 billion in 2009 and $1.9 billion in 2010—a three-year retrenchment of $1.3 billion that will erase more than two-thirds of the spectacular GCT revenue growth from 2004 through 2007. This decline reflects both a steep drop in gross collections and an even sharper rise in refunds.

The always volatile BCT rose from $212 million in net revenues in 2003 to $1.2 billion in 2007 and then fell back to $628 million in 2008. IBO forecasts another sharp decline, to $277 million in 2009. BCT refunds surged starting in April 2008, and have continued to run strong in 2009, and they are now projected to total $275 million for this year, offsetting nearly half of the forecast $552 million in gross collections. BCT net revenues are expected to reach only $464 million in 2010, as collections increase but refunds still run high. Continuing low growth in collections and gradually declining refunds will contribute to moderate increases in BCT revenues in 2011 and 2012.

The UBt has historically been the most resilient business tax in economic downturns, and it appears that this will again be the case. Projected UBt revenue losses in 2009 and 2010 are smaller than those for the GCT and BCT, but they will still offset 44 percent of the UBt gains from 2003 to 2008. From an all time peak of $1.9 billion in 2008, UBt revenues are projected to fall by $290 million (15.5 percent) to $1.6 billion in 2009 and then by another $169 million (10.7 percent) to $1.4 billion in 2010—the first double-digit percentage declines in UBt revenues in 35 years. IBO expects a modest recovery, with revenues climbing back to $1.6 billion by 2012.

**Personal Income Tax.** IBO has significantly lowered its forecast of personal income tax (PIT) revenue for 2009 through 2012, reflecting the deterioration of the economic outlook and the expectation of a smaller and less profitable financial sector. PIT receipts are now expected to decline significantly in 2009 and 2010 and then grow moderately in 2011 and 2012.

Though PIT collections so far this fiscal year are just slightly lower than they were during the same period last year, IBO expects that PIT revenues in 2009 will fall short of 2008 levels by $1.4 billion (16.2 percent). Record securities industry losses in 2008 will reduce year-end bonuses, depressing withholding revenue through March. Withholding will also fall as severance pay to workers laid-off earlier this year runs out. In addition, it appears that many taxpayers have not yet adjusted their quarterly estimated payments to reflect their investment losses. Because
they are likely to have already overpaid their calendar year 2008 liabilities, we expect these taxpayers to greatly reduce upcoming quarterly payments and/or request an unusually high level of refunds once they file annual returns in the spring.

Unlike the last economic downturn, when a 22.2 percent decrease in PIT in 2002 was followed by no growth in 2003, IBO expects the 2009 decline to be followed by a second year of sharp decline. IBO forecasts $6.3 billion in PIT revenue in 2010, 14.6 percent ($1.1 billion) less than in 2009. Estimated payments—pulled down by lower capital gains realizations—account for the bulk of the projected revenue decline. Withholding is expected to decline further as job losses spread throughout the local economy.

The resumption of local economic growth by the end of calendar year 2010 will increase the city’s PIT revenue after 2010—by $714 million (11.4 percent) in 2011 and $340 million (4.9 percent) in 2012. The expiration at the end of calendar year 2010 of preferential tax rates on capital gains is expected to spur capital gains realizations, boosting estimated payments and payments with final returns in 2011. By 2012 PIT receipts will reach $7.3 billion—still below the levels of 2007 and 2008.

**Transfer Taxes.** Mortgage recording tax (MRT) and real property transfer tax (RPTT) revenues 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. Revenues dropped to $2.6 billion in 2008, as the number of real estate sales and mortgage refinancing declined sharply. IBO expects collections to continue their dramatic slide in 2009, with combined collections of $1.6 billion. Even with this decline of more than 50 percent over two years, collections will only be about 9 percent below the levels of 2004. Transfer tax revenues are expected to hit bottom in 2010. IBO’s estimates for 2009 and 2010 for both taxes are below OMB’s November 2008 projections. This reflects the worsening economic situation and the extremely low collections in November and December as lending nearly ceased.

One important factor behind the precipitous decline in transfer tax revenues has been the abrupt drop in sales of very large commercial properties, which had been responsible for a significant share of tax revenue in recent years. In fiscal year 2008, there were 11 sales of commercial properties valued at more than $500 million. However, since the credit market meltdown of September 2008, there have been no reported sales in this price range.

**Real Property Tax.** Because changes in property values are only gradually reflected in tax bills, the city’s real property tax (RPT) is the city’s most stable tax source, with little immediate change in revenue even when the local economy contracts. That stability will be important as revenue from other taxes plummet.

Last month the City Council agreed to the Mayor’s request to rescind the 7 percent cut in property tax rates, effective January 1, 2009. Because the increase takes effect mid fiscal year, it actually occurs in two steps: one from 2008 to 2009 and another from 2009 to 2010. At the same time, the Mayor agreed to release the $400 homeowner rebate checks that he had proposed scuttling. IBO assumes that consistent with current law, the rebates will not be paid after this year. IBO’s RPT forecast reflects the rate increase and this year’s rebate payment.

IBO now projects that RPT revenue will total $14.4 billion in 2009, a 10.1 percent increase from 2008. IBO’s forecast is $234 million lower than OMB’s November projection, mostly due to our inclusion of the $256 million cost of the rebate.

Because of the gradual phase-in of past increases in property values and the second step of the tax rate increase, revenues are expected to continue growing at double-digit rates in 2010, rising by 11.8 percent to $16.1 billion. As the pipeline of lagged assessment increases is used up, more of the expected declines in property values will be reflected in tax bills, and revenue growth will slow to 4.5 percent in 2011 and 4.8 percent in 2012.

**Sales and Hotel Occupancy Taxes.** So far this year, sales tax collections have exceeded receipts for the same period last year, although the difference is shrinking and the outlook for the coming months has worsened. IBO now projects that revenue will total $4.7 billion in 2009, down 3.1 percent from last year. An even larger decline is expected for 2010, when sales tax revenue will fall by 7.1 percent to $4.4 billion. Revenues will rebound somewhat in 2011 and 2012, reaching $5.0 billion.

Sales tax collections are greatly influenced by personal income and wage levels, both of which are forecast to decline significantly. Indeed, retail sales may already have slowed. The Federal Reserve’s December overview of economic conditions reported “pronounced weakening” in New York City retail sales. Complete data for the holiday season is not yet available, but the results are expected to be disappointing with retailers having offered steep markdowns to attract customers.

Local retailers and hotels also depend on tourism, particularly foreign tourists who spend more on average than their domestic counterparts. Although the 47 million visitors in calendar year 2008 was a record, IBO expects tourism to decline in 2009. Domestic travel began to contract early last year, while foreign tourism began
to slow more recently, as recession spread abroad and the dollar began to recover value against foreign currencies. Revenues per hotel room in October and November were down 10 percent to 20 percent from the same months last year. With recession in the U.S. and in many other countries expected to persist at least through 2009, tourism will be weak for the next few years.

Hotel occupancy tax revenue has grown strongly in recent years—from $184 million in 2002 to $379 million in 2008. Given the expected decline in visitors however, rapid growth will not continue. The impact of fewer visitors will be offset somewhat by an increase in the hotel tax rate enacted by the City Council in December. In March 2009, the hotel tax will climb to 5.875 percent from the current 5.0 percent rate. IBO's hotel tax forecast includes the additional revenue from the rate increase ($20 million in 2009, $55 million in 2010). Even with the increase, IBO projects that hotel tax receipts will edge down 1.8 percent in 2009, to $370 million. Growth is forecast to resume in 2010—revenue will total $421 million ($366 million without the increase)—and reach $489 million by 2012. The rate increase accounts for much of the difference between IBO's and OMB's hotel tax forecasts beginning in 2010.

**SPENDING AND SAVINGS**

IBO estimates that based on the Mayor's November 2008 financial plan, city spending growth will substantially outpace revenue growth. We project that total expenditures (city, state, and federal funds) will rise from $59.6 billion in 2009 to $71.8 billion in 2012. Looking only at city-funded spending on an annual operating basis—the level of funds needed to run the city in a given year, which adjusts for the use of surpluses to prepay future expenses—spending will grow 4.0 percent in 2010 and an additional 6.6 percent in 2011, when it will reach $51.1 billion.

This growth in spending occurs even as the Mayor and City Council have taken steps to reduce expenditures. The November financial plan included spending reductions by city agencies that totaled $381.5 million in the current fiscal year and $866.7 million in 2010. By far the largest share of the savings—$180.5 million in 2009, $385.4 million in 2010—will come by slowing the planned rate of increases in the Department of Education budget. More than half of the education savings come directly from individual school budgets: $103.6 million in 2009 and $256.1 million in 2010. In addition, the financial plan included $80.1 million in revenue-raising initiatives by agencies in 2009 and $216.4 million in 2010. The largest of these initiatives is the police department's plan to hire more traffic agents and step up efforts to issue violations to drivers who “block the box,” generating an estimated $76.2 million in additional fine revenue.

The Mayor's gap closing initiatives in the November financial plan mark the third round of actions taken by the city since the Wall Street financial crisis began in late 2007. With each successive round it becomes more difficult to avoid cuts to core services and actual reductions in spending rather than merely slowing anticipated increases in spending. With additional projected budget deficits to be closed, it is likely that future gap closing plans will include substantial cutbacks in services.

As in past years, much of the growth in city spending is being driven by just a few discrete portions of the budget. Because these budget obligations are largely determined by long-standing agreements it is difficult to obtain significant savings in these areas, particularly in the short term.

**Debt Service.** Despite a one-year “stretch out” of the city’s four-year capital commitment plan announced last spring, debt service continues to increase rapidly. Debt service, adjusted for the use of surpluses to make prepayments and to include Transitional Finance Authority debt, is projected to grow at an average annual rate of 14.5 percent from 2009 through 2012, when it is expected to total $6.5 billion.

The capital plan announced last May projected a $5.1 billion push out of projects originally intended for the 2009–2012 period into 2013. But other changes such as new spending commitments and the rolling of commitments originally intended to occur in 2008 into the 2009–2012 period resulted in a smaller $1.6 billion net reduction to the capital plan. The 2009–2012 capital plan now totals $41.4 billion. Under the new four-year plan, commitments for housing and economic development, health and social services, and park, library, and cultural projects increased. The largest cutback, $1.6 billion, is to education projects.

**Pensions.** The nearly unprecedented declines in the stock market—2008 saw the largest percentage decline in the S&P 500 index since the 1930s—is increasing the city's cost of funding pensions for municipal employees. With the pension funds' investments suffering significant losses, the city has had to substantially increase its expected contribution to the funds. Last May, to cover losses the Mayor increased the city's expected contribution to the pension funds in 2010–2012 by a total of $670 million.

Anticipating additional pension fund losses, the Mayor's November financial plan added more funds for pensions: $82 million in 2010, $395 million in 2011, and $672 million in 2012. With this additional funding, city pension spending is now projected to rise from $6.2 billion in 2009 to $7.5 billion in 2012. To cover the latest addition of funds for expected losses, the Mayor has proposed using $1.15 billion from the Retiree
Health Benefits Trust Fund; using these trust fund dollars to pay a portion of retiree health costs frees up an equivalent amount of annual operating funds to cover the rising pension costs. The reduction of $1.15 billion is nearly half of the $2.5 billion the city has deposited into the trust fund over the past few years and undermines the city’s goal of beginning to fund its enormous liability for future retiree health care expenses.

**Fringe Benefits.** The cost of health insurance and other fringe benefits for current city workers also continues to grow at a more rapid pace than most other city spending. Spending on fringe benefits on an operating basis is expected to grow by $670 million from 2009 through 2012, when it will total $4.5 billion.

**UNCERTAINTIES**

A number of uncertainties cloud the city’s near-term fiscal picture. Perhaps the biggest uncertainty is the local economy. Although our forecast presumes a deep recession both nationally and locally, the rapid deterioration in current conditions suggests that the risk for an even steeper decline is greater than the chance of a faster-than-expected turnaround. But it is not just the economy that could make the city’s fiscal outlook even darker.

**State Budget.** The budget proposed by Governor David Paterson would reduce state aid the city had anticipated. For example, the Governor’s plan provides roughly $600 million less in education aid than anticipated in the Mayor’s November financial plan and eliminates $327 million in state revenue sharing that the city was expecting. Considering the fiscal and political difficulties confronting Albany, it is unlikely that state aid will increase greatly when the state budget is finalized.

**Health Insurance Savings.** The city’s current budget plan includes $200 million in annual unspecified savings beginning in 2010 in the cost of health insurance for city workers. The Mayor has included this savings goal in previous budgets without success and it is unclear that he will succeed in negotiating these savings with municipal unions now.

**Pollution Remediation.** The city currently has a waiver from meeting the Governmental Accounting Standards Board’s Statement 49, which requires New York and other localities to pay for certain pollution remediation expenses through their operating budgets rather than capital budgets. As of 2011, the city could have an additional operating expense of $500 million annually based on the Mayor’s preliminary estimate.

**Transit, Housing, and Hospitals.** Although transit, public housing, and public hospitals are not technically city agencies, each of them plays a major role in the city’s daily life—and each faces significant budget challenges. Both the Metropolitan Transportation Authority and New York City Housing Authority currently have large budget shortfalls and have pressed the city for assistance. In addition, a proposal by the Ravitch Commission to help fund the transportation authority with a payroll tax does not exempt public employees and therefore would increase city personnel costs by approximately $100 million based on our initial estimate.

The Health and Hospitals Corporation is on firmer fiscal footing in the short term, largely because of recent city aid. But IBO expects the public hospitals’ cash reserves will be drained by 2012. In addition, the Governor’s budget plan would cut reimbursements and hike assessments on hospitals in an effort to curb Medicaid spending growth. If implemented, these changes would accelerate the erosion of the public hospitals’ fiscal condition.

**THE COMING MONTHS**

There are signs that federal aid may provide some fiscal relief for the city. President-elect Barack Obama has stated his intention of promoting a large economic stimulus plan that will include assistance for states. Bills already in Congress would provide construction aid for public transit and temporarily increase the federal share of Medicaid. But the extent of any budget relief will depend on the details, such as whether the state would be required to share Medicaid savings with local governments.

Absent a major infusion of federal aid, the city faces a budget gap of $4.3 billion in the fiscal year that starts in just six months and nearly $7.0 billion in 2011. The November financial plan includes a potential $800 million in unspecified tax increases in the upcoming year, and after the plan’s release the Mayor sought an additional $1.4 billion in city-funded savings from agencies. Moreover, accounting adjustments that occur at the end of every fiscal year will provide some help in narrowing the budget shortfalls. Yet all of these actions would not be sufficient to close even the projected 2010 gap.

The Mayor and the City Council must address these gaps on the eve of a municipal election year, a time when many officials are hesitant to support spending cuts or tax increases and risk the ire of various voting blocs. They may also need to adjust fiscal expectations longer term. Structural changes will make Wall Street unlikely to generate the level of tax revenues that have helped fill city coffers in the past.

**ENDNOTES**

1Unless otherwise noted, IBO’s revenue projections take into account three tax policy changes that were adopted by the City Council on December 18, 2008: rescinding the 7 percent real property tax rate cut as of January 1, 2009, distribution of $400 property tax rebates this fiscal year, and enactment of a 0.875 percentage point increase in the hotel tax.

2All collection figures include PIT revenue dedicated to the Transitional Finance Authority.