IBO

New York City Independent Budget Office
Fiscal Brief

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Analysis of the Mayor's Executive Budget for 2006

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SUMMARY

DESPITE THE CITY'S CURRENT FISCAL HEALTH, the prognosis for the upcoming years is less than certain. A budget gap of $4.5 billion—nearly the magnitude following September 11 and the recent recession—lies on the not-too-distant horizon of fiscal year 2007, yet the Mayor's Executive Budget for 2006 does little to address this shortfall.

The city will end the current year with a record surplus of $3.3 billion, as continued local economic growth and a booming real estate market have pushed tax revenues above expectations. This surplus will be used to prepay some 2006 expenses, much as the 2004 surplus was used to prepay 2005 expenses. This two-year pattern of surpluses available to mask underlying gaps may be about to change as IBO expects economic growth will level off and the real estate market will slow down.

Total city spending continues to rise at a faster pace than revenues. IBO projects expenditures will grow from $53.2 billion in 2005 to $57.6 billion by 2009, an average annual rate of increase of 2.0 percent. But total revenues will grow at an average annual rate of just 0.5 percent, rising from $53.2 billion in 2005 to $54.3 billion in 2009.

Among the key findings in the analysis:

- IBO projects that tax revenues will fall by roughly $200 million in 2006 to $29.8 billion as several temporary tax increases expire and revenue from property transfer taxes show the effects of higher interest rates and fewer real estate sales. IBO does not expect the real estate slowdown to be as marked as the slump in the late 1980s and early 1990s.
- The property tax is the only tax that will grow strongly in 2006, with IBO projecting revenue to increase by 8.0 percent to $12.4 billion as the recent rise in values is phased in. By 2009, we expect property tax revenue to total $15.2 billion.
- Spending increases continue to be driven by a few big-ticket items including pensions and fringe benefits for city workers, debt service, and Medicaid. IBO projects that these expenditures, along with the cost of settling lawsuits against the city, will grow from 2005 through 2009 at an average annual rate of 6.8 percent (adjusted for prepayments).

If revenue growth cools in 2006 as IBO expects, there will not be a sizable surplus available from 2006 to help close the 2007 gap. The longer we wait to address the gaps in 2007 and beyond, the deeper spending cuts and steeper revenue increases will have to be to bring the budget into balance.

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THE EXECUTIVE BUDGET

With tax revenue continuing to outpace expectations, the city's current fiscal condition remains strong. IBO estimates the city will end the current fiscal year with a surplus of $3.3 billion. Bolstered by this record surplus, the Mayor's Executive Budget for 2006 presents no new agency savings program and restores some previous reductions. The cost of these spending restorations and some new initiatives total $125 million. The budget for 2006 also proposes $235 million in tax reductions and sets aside $100 million for future labor settlements.

The basic contours of the 2006 Executive Budget are similar to last year's. If not for the large surplus expected at the end of this year, which is being used to prepay some of next year's expenses (just as the 2004 surplus was used to prepay some 2005 expenses), a considerable 2006 gap would need to be closed.

This pattern of surpluses available to mask underlying gaps may be about to change. With the real estate boom expected to weaken and economic growth projections leveling off, tax collections are not likely to exceed expectations to the extent they have in the past two years. That means it is unlikely there will be a sizeable surplus available from 2006 to close the 2007 gap, which is estimated to be $4.5 billion—12.3 percent of taxes and other local revenues.

The main step the city has taken over the past year to address out-year gaps is to limit the rate of growth in expenditures on city services. Spending by agencies on programs and services, absent any new labor contracts, continues to grow at a rate below inflation under the Executive Budget for 2006. But overall city spending is expected to grow at a considerably faster pace, driven primarily by debt service, Medicaid, and pensions and fringe benefits for city workers. Increases in these expenditures underlie the city's 2007 gap, which has grown by $706 million since IBO's estimate last May.

REVENUES

Fueled by continued local economic growth and a booming real estate market, tax revenues have demonstrated remarkable strength in 2005. IBO now projects that total tax revenues for the year will be $30.0 billion, which is $3.3 billion (8.7 percent) higher than the Mayor's estimate when the 2005 budget was adopted last June and $964 million higher than our forecast just three months ago.

The growth can be seen in many of the city's taxes: business income taxes are up 27 percent from last year, the personal income tax is up 14 percent, and the sales tax is up 10 percent. Perhaps the most spectacular gains have occurred in the property transfer taxes because this year's growth follows three previous years of very high collections. Since 2002, the real property transfer tax (RPTT) has gained 111 percent and the mortgage recording tax (MRT) increased by 131 percent. Combined, these two taxes now account for 6.6 percent of total tax revenue, up from 4.2 percent just three years ago.

IBO's forecast of total tax revenues for 2005 exceeds the Mayor's Executive Budget forecast by just $75 million. Although the two forecasts of total tax revenues are very similar, estimates of individual taxes diverge sharply. The strong current year collections for the business income and sales taxes result in higher IBO forecasts. The Mayor's outlook for the transfer taxes is even more robust than IBO's.

Outlook for 2006. The outlook for 2006 is quite different. Although IBO expects local employment and personal income to continue growing at moderate rates (1.2 percent and 3.6 percent, respectively), tax revenues are expected to fall as several temporary tax increases expire and the transfer taxes show the effects of higher interest rates and a slowdown in property sales. Tax revenues will fall to $29.8 billion (a decline of 0.7 percent). IBO's outlook is $355 million higher than

Total Revenue and Expenditure Projections
Dollars in millions

	2005	2006	2007	2008	2009	Average Change
Revenues	$ 53,229	$ 50,473	$ 50,956	$ 52,472	$ 54,310	0.5%
City-funded Revenues						
Taxes	*30,006*	*29,806*	*30,345*	*31,804*	*33,483*	*2.8%*
Tax Reduction Program	*(32)*	*(257)*	*(184)*	*(17)*	*(38)*	*n/a*
Other Revenues	*7,424*	*6,114*	*5,924*	*5,829*	*6,008*	*-5.2%*
Expenditures	$ 53,229	$ 50,193	$ 55,410	$ 56,462	$ 57,562	2.0%
City-funded Expenditures	*37,398*	*35,383*	*40,539*	*41,606*	*42,705*	*3.4%*
IBO Surplus / (Gap) Projection	**$ -**	**$ 280**	**$ (4,454)**	**$ (3,990)**	**$ (3,252)**	

SOURCE: IBO.
NOTES: IBO projects a surplus of $3.3 billion for 2005, $56 million above the Bloomberg Administration's forecast. The surplus is used to prepay some 2006 expenditures, leaving 2005 with a balanced budget. Estimates exclude intra-city revenues and expenditures.

the Mayor's for 2006, with the biggest differences coming in the transfer taxes.

IBO projects that the personal income tax will contract by $288 million (4.5 percent). This is due largely to the expiration of the three-year rate increase for high-income taxpayers on December 31, 2005. The sales tax is projected to decline with the end of the 0.125 percent surcharge this spring. Business income taxes are expected to fall, with collections expected to resume more typical patterns following two years of unusually strong growth.

The largest declines in 2006 will be in the transfer taxes. IBO projects the RPPT will fall by $245 million to $652 million, a decline of 27.3 percent. We expect the MRT to fall even more precipitously, declining by $360 million (32.7 percent) to $741 million. The revenues from these taxes are affected by overall economic conditions, and particularly interest rates. Higher interest rates tend to reduce the overall number of real estate transactions: sales in the case of the transfer tax and both sales and mortgage refinancings in the case of the mortgage recording tax. Higher interest rates also depress property prices, reducing tax revenue from each transaction.

Looking at what happened during the last major decline in the New York City real estate market offers some perspective on the forecast decline for the MRT and RPTT. Between 1987 and 1992 the total value of real estate transactions in the city plunged from $23.2 billion to $8.2 billion, a decline of 65 percent. The largest one-year decline was between 1990 and 1991, when sales revenue fell from $13.8 billion to $8.7 billion. The 37 percent drop in the value of transactions that year was accompanied by a 16 percent decline in the number of transactions, a 25 percent drop in the average price per transaction, and a 39 percent fall in RPTT revenues.

While IBO anticipates a slowdown in the city's real estate market during the next few years, this downturn should be of lesser magnitude and shorter duration than the slump of the late 1980s and early 1990s. Because of a steep decline in mortgage refinancing activity, MRT revenues will fall more sharply than RPTT collections, and will recover more slowly.

Alone among the city's major tax sources, the property tax is expected to grow in 2006 (up 8.0 percent). The property assessments that will be the basis for next fiscal year's bills are already largely completed and reflect the strong real estate markets of the last 12 months.

Outlook for 2007 through 2009. IBO expects total tax revenues to resume growing in 2007, with accelerating growth through 2009, when it is projected to total $33.5 billion. The property tax will grow consistently (averaging 7.0 percent annually from 2007 to 2009), thanks in large part to the pipeline of previous assessment increases which are still being phased in. The personal income tax also is expected to show strong growth (annual average of 5.0 percent). After a two-year decline, the transfer taxes are expected to resume growing in 2008 and 2009, although at far slower rates than in recent years.

Tax Program. The Mayor's Executive Budget includes several tax policy proposals. The largest concerns the sales tax exemption for clothing items costing less than $110. In spring 2003, the state Legislature suspended the exemption as part of a package of tax increases designed to help the city deal with the fiscal fallout from the local recession and the 9/11 attacks. The suspension was originally scheduled to last one year, from June 1, 2003 through May 31, 2004. Last year, the state extended the suspension for an additional year through May 31, 2005. While last January's Preliminary Budget assumed that the suspension would end as scheduled, the new state budget extended the suspension once again, this time through March 31, 2007. IBO estimates that the state action adds $252 million to city revenues in 2006 and $173 million in 2007, when the suspension covers only three-quarters of the fiscal year. The Mayor is now proposing to forego this revenue by asking the state to lift the suspension as of June 1, 2005 and once again make clothing items costing less than $110 exempt from the sales tax.

The Mayor also has proposed new tax abatements starting in 2006 for renovations of small rental buildings and repairs at Mitchell-Lama developments. The Mayor estimates the combined first year cost to be $5 million in forgone revenue.

EXPENDITURES

IBO estimates that total spending for 2006 under the Executive Budget is $50.2 billion. Total spending will continue to rise at an average annual rate of 2.0 percent from 2005 through 2009 and reach $57.6 billion.

In addition to the spending on service restorations and some new initiatives, the 2006 budget includes $234 million in added expenditures. The largest of these are $71 million for the Metropolitan Transportation Authority's takeover of the private bus lines and $57 million for campaign matching funds for this fall's elections. IBO projects that police overtime will cost $89 million more than currently budgeted for 2006, bringing the total expenditure for police overtime to $350 million.

A few big-ticket items remain the major cause of the growth in city spending. These include pensions and fringe benefits for city workers, Medicaid, and debt service on the funds the city borrows. IBO projects that these expenditures, along with the cost of settling lawsuits against the city, will grow from 2005 through 2009 at an average annual rate of 6.8 percent after adjusting for prepayments. The city has limited control, at least in the short run, over much of these fast-rising costs.

Pension contributions have been a fast growing portion of the city budget and are expected to rise from $3.2 billion in 2005 to $4.9 billion in 2007, and then begin to decline some as the funds' stronger recent investment gains are phased in.

Several Executive Budget changes are pushing city pension costs higher than previously estimated. Based on recommendations in a biennial, independent study, some of the assumptions used to calculate the city's contribution to the pension funds are changing. This is increasing the city's pension costs by $325 million in 2006 and $304 million in 2007. The City Actuary also is correcting some data, including accounting for 1,000 retired teachers. These changes are adding $222 million to the city's pension costs in 2006 and $225 million in 2007. The Executive Budget also drops the anticipation of $325 million in pension contribution savings in 2006 and $200 million in 2007 that had been part of the Preliminary Budget; all or part of these savings may be attained at a later date.

The cost of health insurance and other fringe benefits for city workers also continue to rise rapidly. Spending on fringe benefits is expected to increase from $3.0 billion in 2005 to $3.9 billion 2009, excluding the education department.

Debt service payments on the funds the city borrows and our share of Medicaid expenditures also continue to push spending upwards. Debt service is expected to increase from $4.2 billion in 2005 to $5.9 billion in 2009 after adjusting for prepayments. While changes at the state level have slowed the rate of increase in the city's share of Medicaid spending, even a reduced growth rate still puts pressure on the city budget because the total cost is so large. IBO estimates that city Medicaid spending will grow from $4.9 billion in 2005 to $5.5 billion in 2009.

Uncertainties. Two other issues threaten to exert additional pressure on city spending. Teachers and uniformed services employees have been workng without contracts for several years. Funds sufficient to cover these settlements based on the pattern set by District Council 37 agreements are in a labor reserve. The city is awaiting an arbitration panel decision on police officer contracts that expired beginning in 2002. Depending on the terms of the binding decision, the city could be liable for retroactive pay increases, which cannot be offset by productivity gains for those past years and which could well exceed the funds in the reserve. The panel's decision also may set the pattern for settling the other expired contracts. Moreover, many other union contracts expire as of June 30. Although the Executive Budget now sets aside some money for these *future* labor settlements—$100 million in 2006, increasing to $900 million in 2009—these funds may not suffice. Each 1 percent increase in wages for all city workers costs $218 million and compounds rapidly, resulting in $1.1 billion in additional city spending by 2009.

A resolution of the Campaign for Fiscal Equity lawsuit also could prove costly for the city. A court-appointed panel determined that spending should rise over several years until it is $5.6 billion (adjusted for inflation) above the current year. If the city were to fund roughly one quarter of this, as in an example presented by the campaign, the city's share could be over $1 billion annually. The Governor has appealed the court ruling and a settlement is unlikely until at least next year.

CONCLUSION

The city's current fiscal health is good, but the prognosis for the following years is less certain. IBO projects that expenditures will grow at a faster pace than revenues, leaving a budget gap of $4.5 billion in 2007 and $4.0 billion in 2008. With gaps of nearly this magnitude in the wake of September 11 and the recession, the Mayor and City Council acted aggressively to close shortfalls through a combination of spending reductions and tax increases.

More recently, the approach to impending budget gaps has been one of "wait and see." The 2006 Executive Budget follows suit. While this method has worked so far largely because of strong growth in tax collections driven by the continued local economic recovery and a booming real estate market, our forecast for tax revenues suggests this is less likely to continue.

Without a sizeable surplus projected in 2006, the city will be unable to mask the 2007 shortfall with prepayments. The longer we wait to address the gaps in 2007 and beyond, the deeper and steeper the measures to bring the budget into balance may need to be.

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