IBO

New York City Independent Budget Office

Fiscal Brief

May 2001

# Analysis of the Mayor's Executive Budget for 2002

## OVERVIEW

Slower economic growth is making the city's fiscal choices increasingly difficult. If the Mayor's Executive Budget proposals are adopted, IBO projects that the budget for the upcoming fiscal year will be roughly in balance, without producing a significant year-end surplus. Absent such a surplus, however, it will be particularly difficult for the city to address a $3.3 billion shortfall for fiscal 2003—which begins in just over a year.

*The current fiscal year.* Strong economic growth and Wall Street's bull market in calendar year 2000—particularly in the first half of the year—have boosted current tax receipts. IBO expects the year to end with a surplus of $2.7 billion; $2.4 billion will be used to help balance the 2002 budget with the remaining $345 million used for 2003.

Although local employment growth continues to outpace the nation's, recent indicators suggest that the city has begun to feel the combined impact of the U.S. slowdown and weaker financial markets. Declines in U.S. corporate profits have already begun to slow the growth of business tax receipts. And despite the continuing strength of total personal income tax collections, withholding—a gauge of current economic activity—has declined for two consecutive months.

*Choices for 2002.* Changes since the Mayor released his Preliminary Budget in January will make it more difficult to balance the 2002 budget. Slower economic growth will translate into slower growth in taxes. IBO projects that baseline tax revenues will rise just 0.4 percent over the next year. To cover the additional costs of labor agreements like the one with DC37, the city has added $285 million to its budget for 2002.

The Executive Budget includes a number of proposals to bring the 2002 budget into balance. Beyond the reductions included in the Preliminary Budget, the Administration proposes another $154 million in agency spending cuts and revenue initiatives for 2002. The Mayor also shifts $269 million in pay-as-you-go capital funding for stadiums and schools out of the expense budget and proposes to use tobacco bonds proceeds to repay $150 million in closure costs for the Fresh Kills landfill. In contrast, the Executive Budget adds $101 million in tax reductions.

*Out-year gaps.* IBO projects that under these proposals, the city would face a modest shortfall of $379 million (0.9 percent of total spending) in 2002. Although the economic forecast strengthens at the end of calendar 2001, IBO projects gaps of $3.3 billion (7.5 percent) in 2003, growing to $4.9 billion (10.3 percent) in 2005. These gaps are larger than estimated by the Administration, in part because IBO includes funds for future labor settlements in 2003 and beyond.

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

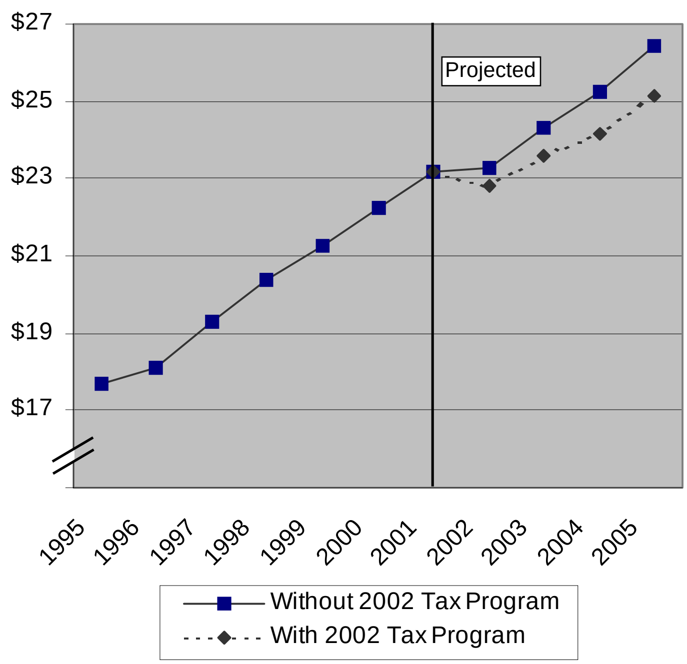
## TAX REVENUES

Continued local economic strength is helping to sustain growth in the city's baseline tax revenues—excluding proposed changes in tax policy—at a brisk 5.4 percent rate for 2001; much of this revenue growth is attributable to stronger economic growth in the first half of calendar 2000. In contrast, IBO's economic and revenue forecast for fiscal 2002 is more restrained, with baseline tax revenues expected to rise just 0.4 percent to $23.3 billion. We project that revenues will grow more rapidly as the economy strengthens over the remainder of the forecast period, with baseline tax revenues rising at an average annual rate of 3.3 percent from 2002 through 2005 to reach $26.4 billion.

Much of this baseline tax revenue growth would be offset if the Mayor's tax reduction program is enacted, however. IBO estimates that the tax program would lower city revenues by $501 million in 2002, with the cost growing to $1.3 billion in 2005. If implemented, the plan would reduce tax revenues by 1.7 percent in 2002 and limit the average growth for the years 2002 to 2005 to 2.0 percent.

**Tax Revenues Barely Grow in 2002**

*Billions of Dollars*




SOURCE: IBO.

IBO's baseline tax revenue forecasts are slightly higher than the city Office of Management and Budget's (OMB) for the current year ($68 million) and significantly higher than OMB's forecasts for 2002 and 2003 ($440 million and $303 million, respectively). Much of the difference is accounted for by IBO's more optimistic forecasts for the personal income, sales, and property-related taxes, all of which are particularly sensitive to conditions in the local economy. In 2004 and 2005, IBO's revenue forecast is very similar to OMB's.

***Baseline revenues.*** IBO projects that baseline real property tax revenues will total $8.6 billion in 2002, an increase of 6.7 percent over 2001; without the scheduled expiration of the coop/condo abatement, property tax revenues would grow 4.4 percent. The continuing phase in of past appreciation in market values will help sustain property tax revenue growth for several years, even if current market conditions weaken. As a result, increases in real property tax revenues are expected to average 4.9 percent annually from 2003 to 2005.

Personal income tax (PIT) collections are expected to fall by 4.6 percent in 2002, due to the slowing economy and the impact of already-enacted tax cuts, particularly the state's School Tax Relief (STAR) program and the restructuring of the income tax surcharge. In 2003 through 2005, with stronger economic growth and all currently-enacted tax cuts fully in effect, income tax revenue growth is projected to resume at an average annual rate of 5.0 percent. While brisk, this growth is much slower than the 8.1 percent average from 1997 to 2000.

With the local economy slowing, IBO projects that baseline sales tax collections will increase 3.8 percent to $3.9 billion in 2002, considerably below this year's growth of 6.3 percent. Sales tax revenues will pick up more strongly in 2003 and 2004 as the pace of the local economy picks up.

Of the city's major tax sources, the business income taxes are most affected by changes in the national economy and collections have slowed over the course of this year. With the U.S. economy weakening significantly and the local economy expected to experience a more modest slowdown, IBO forecasts that business income tax revenues will fall by 15.2 percent in 2002; the largest decline will be in the general corporation tax (20.4 percent). Revenue growth will resume in 2003, although at a slower rate than occurred in 1997 through 2000.

***Tax program.*** The Mayor's tax program was significantly revised between the Preliminary and the Executive Budgets. A new proposal to further cut the personal income tax (PIT) surcharge was introduced, while the timing of several of the other proposals was changed. The changes shift the preponderance of proposed tax savings from businesses to individuals. IBO projects that implementing the Executive Budget tax program would cost $501 million in 2002, $101 million more than the cost of the Preliminary Budget

*See **Tax Revenues** on page 4*

## EXPENDITURES

While the introduction to the Executive Budget expresses a need for "caution" because of the national economic slowdown, IBO estimates that city-funded spending, excluding debt service, would grow 5.5 percent in 2002 under the Mayor's budget proposal. Expenditures rise despite $846 million in agency spending cuts and revenue initiatives, $154 million more than in the Preliminary Budget. An additional $1.7 billion in agency actions are proposed to balance 2003. The overall increase in expenditures is caused by the impact of recent labor settlements as well as higher spending by a number of agencies. A number of key changes follow.

***Labor settlements and pension adjustments.*** The Mayor's Executive Budget assumes that the terms of the recent DC 37 wage settlement will be extended to all city employees at a cost of $615 million in 2001, $1.2 billion in 2002, $1.6 billion in 2003 and $1.7 billion in 2004 and 2005. The current settlement, however, expires at the end of 2002, and the budget makes no provision for future collective bargaining agreements after that. IBO projects that a wage agreement based on the projected rate of inflation beginning in 2003 would increase city-funded costs by an additional $299 million in 2003, $566 million in 2004, and $874 million in 2005.

The city has also had to budget for increased pension costs. The financial markets' performance has lowered the return on the city's pension investments, requiring an infusion of cash into the system to meet the actuarial investment return assumption of 8 percent annual growth. This additional spending comes in the wake of even larger increases associated with enhanced pension benefits approved last year by the state. Taken together, the budget for the city's contribution to employee pensions, which last year were assumed to be declining at nearly 5 percent annually, are now projected to grow at an average annual rate of 8 percent, reaching $1.8 billion a year in 2005.

***Education.*** After four consecutive years of significant increases in city funding for the Board of Education (BOE), the Mayor's Executive Budget for fiscal year 2002 would hold city funding nearly flat. The Administration has budgeted for a $34 million increase in city BOE funds—less than 1 percent—above the forecast 2001 level. Because of restrictions on how some of the money is to be spent, the slight increase in city funds under the 2002 budget proposal actually results in a $141 million *decrease* in city funds immediately available to the school system. The Mayor would hold $85 million outside the BOE budget and subject to his control. In addition, the Mayor would reserve $284 million in city funds for BOE collective bargaining—$90 million more than in the 2001 budget.

The budget also would cut $75 million in Board of Education pay-as-you-go (PAYGO) capital spending for 2002, moving it to the capital budget, where it will be funded instead by city-issued debt. This would result in the city receiving less state building aid because capital expenses must be incurred to be eligible for reimbursement. PAYGO incurs the entire expense at the time the work is done, while debt financing typically spreads it out over 30 years.

***Stadium financing.*** The Administration also removed funding for major league sports facilities from the expense budget ($194 million in 2002 and $573 million total). These funds have not yet been added to the capital budget; the extent of the city's participation in the proposed new stadiums has not been finalized. The city has budgeted $15 million in 2005, funds that would be put towards the issuance of $600 million in stadium-related debt.

***Fresh Kills closure.*** The city proposes to use $150 million in proceeds from the issuance of tobacco-bond (TSASC) debt for landfill closure expenses at Fresh Kills. Much of these costs were incurred over the past three years, but were not eligible for matching funds from the State Clean Water/Clean Air Bond program. To date, these costs have been met through the city's expense budget. The city would now use the tobacco debt—which is not a liability of the city, and is repaid from the payments made by tobacco companies to the states in settlement of 1998 litigation—to pay for these non-recurring closure costs.

***Health and Hospitals Corporation.*** Several Executive Budget initiatives would help the Health and Hospitals Corporation (HHC) address its budget gap for 2001 and beyond. To help HHC pay for the outpatient services provided to uninsured parents of needy children, the city would establish a program, HHC Plus, at an annual recurring cost of $67 million. HHC will also receive a one-time allocation of $20 million of city funds in 2001 to reimburse the corporation for the cost of treating uninsured immigrants. In addition, the Mayor has proposed a swap, whereby HHC would assume the management and responsibility for its malpractice costs, and the city would assume payment of the corporation's debt service. This proposal is predicated on the belief that HHC will more effectively hold down its malpractice costs if it is directly responsible for them. The swap would increase city spending by about $20 million in 2002, with slightly smaller amounts projected for subsequent years.

***Debt service.*** The city's capital program has been growing in recent years, in part to catch up on a backlog of deferred maintenance. The resulting increase in borrowing has made debt

*See* ***Expenditures*** *on page 4*

*Expenditures from page 3*

service one of the fastest growing components of city spending. In 2002, debt service (including Transitional Finance Authority debt and after adjusting for prepayments) will total $4.1 billion, $175 million more than in 2001. Debt service payments will rise an additional $340 million in 2003, and reach a total of nearly $5 billion by 2005—consuming 19 cents of every city tax dollar. IBO

**Details of Pricing Differences Between IBO and the Administration**
Items that Affect the Gap
*Dollars in Millions*

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| **Gaps as Estimated by the Mayor** | **$ -** | **$ -** | **$ (2,781)** | **$ (2,898)** | **$ (2,721)** |
| **IBO Pricing Differences:** | | | | | |
| Revenues: | | | | | |
| Taxes | 68 | 440 | 303 | (13) | (86) |
| Tax Reduction Program | - | (7) | (12) | (32) | (8) |
| Other Revenues | - | (296) | 21 | (383) | (338) |
| Total Revenues | 68 | 137 | 312 | (428) | (432) |
| Expenditures: | | | | | |
| Programs and Overtime | (102) | (482) | (564) | (736) | (900) |
| Labor Cost Increases | - | - | (299) | (566) | (874) |
| Prepayment Adjustment | 34 | (34) | - | - | - |
| Total Expenditures | (68) | (516) | (863) | (1,302) | (1,774) |
| Total Pricing Differences | - | (379) | (551) | (1,730) | (2,206) |
| **IBO Surplus/(Gap) Estimate** | **$ -** | **$ (379)** | **$ (3,332)** | **$ (4,628)** | **$ (4,927)** |

SOURCE: IBO.
NOTES: Negative pricing differences (in parentheses) widen the gap estimated by the Mayor. Positive pricing differences narrow the gaps.

*Tax Revenues from page 2*

program. In 2005, the new tax program would cost $1.3 billion, little changed from the Preliminary Budget.

The PIT cut would follow a restructuring of the surcharge enacted earlier this year. The surcharge, initially enacted in 1991 as an across-the-board 14 percent of base liability, was modified to reduce the surcharge to 7 percent for income in the lower brackets and 14 percent for income in the top bracket. The Administration now proposes to lower the two surcharge rates to 3.5 percent and 10.5 percent. The cut would cost $179 million in 2002, rising to $212 million by 2005. As with the recent surcharge restructuring, lower income taxpayers would receive a greater percentage reduction in their tax burdens. However, two-thirds of the benefits would be received by the 10 percent of filers with incomes above $100,000.

Although the proposal to extend the coop/condo property tax abatement is unchanged, the rest of the Preliminary Budget's tax proposals have all been altered. The Administration now proposes to eliminate the commercial rent tax over two years beginning in 2002, rather than the three years proposed in the Preliminary Budget. The revenue loss would grow from $129 million in 2002 to $459 million by 2005. Establishment of a PIT credit for shareholders of certain small businesses (corporations organized under subchapter S of the federal tax code) operating in New York City would be delayed until 2003, as would a proposed cut in the hotel occupancy tax. Provision for a city-level earned income tax credit is delayed until 2004. A proposal for a phased-in 10 percent across-the-board reduction in business income tax rates—projected to reduce business taxes by $307 million in 2005—has been replaced by unspecified business tax reforms that would save firms $75 million beginning in 2005.

The Executive Budget also delays the Mayor's proposal to eliminate the sales tax on clothing items costing more than $110 until 2004. (Although the Mayor has stated that he intends to return to the Preliminary Budget schedule with the cut beginning in 2002, IBO's figures follow the schedule outlined in the Executive Budget.) IBO

**In addition to this overview, IBO has just released a separate report on the Mayor's education proposals. Our next report will focus on proposed changes in tax policy.**

**Additional tables detailing IBO's economic, revenue, and spending projections can be found on our Web site at www.ibo.nyc.ny.us or contact IBO at 212-442-0632.**