IBO

New York City Independent Budget Office
Fiscal Brief

May 2004

Analysis of the Mayor's Executive Budget for 2005

Also available at ...

Detailed Tables on IBO's Revenue and Expenditure Estimates

...www.ibo.nyc.ny.us

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

SUMMARY

Despite the upturn in the local economy and IBO's forecast of improving revenue growth, the city's fiscal condition remains problematic. While IBO expects the city will end the current fiscal year with a $1.6 billion surplus, a shortfall of more than $3 billion is projected for 2006—just 14 months from now—a gap the budget plan does little to address.

IBO anticipates that the city will add 14,900 jobs this calendar year, followed by gains of 45,200 in 2005 and 47,600 in 2006. Still, the number of jobs in the city is not expected to exceed the December 2000 peak until late in 2009. While tax revenue is projected to grow by 16 percent this year to $27.0 billion, growth from 2004 to 2005 will be more modest, increasing by 2.3 percent to $27.6 billion. This slower growth is partly due to a scheduled rollback of last year's temporary increases of sales and income taxes. Total revenue growth will average 1.6 percent annually from 2004 through 2008, rising from $47.4 billion to $50.5 billion.

City spending will grow at a faster rate than total revenue, increasing in 2005 by $700 million to total $48.1 billion. IBO projects spending will continue to rise at an average annual rate of 3.2 percent and reach $53.8 billion in 2008.

Among the key findings in this analysis:

- The overall increase in city-funded spending is being driven largely by "nondiscretionary" spending: Medicaid; debt service; the settlement of lawsuits against the city; and pensions, health care, and other fringe benefits for city workers. IBO projects that these expenditures will grow by $4.7 billion, from $14.2 billion in 2004 to $18.9 billion in 2008—an average annual rise of 7.5 percent.
- In contrast, city-funded spending on most agency programs and services will grow at a much slower pace than total city spending (excluding Medicaid), from $19.0 billion in 2004 to $21.0 billion in 2008—an average annual rise of 2.6 percent.
- The Executive Budget contains a number of proposals or assumptions that if unrealized could reduce the projected $474 million surplus in 2005 and widen the gap for 2006 and beyond. The largest—and most difficult to quantify—is the resolution of the lawsuit on school financing.

At least in the near term, relief from rising nondiscretionary spending will be marginal at best. To meet these mounting costs, the city must reevaluate its approach to other portions of the budget—tax and non-tax revenues as well as savings in agency and program spending.

THE EXECUTIVE BUDGET

The budget plan presented last month by the Mayor contrasted remarkably from the budget he presented just a year ago. In the 2004 Executive Budget, the Mayor included $620 million in measures by city agencies to reduce spending, sought $2.7 billion in state fiscal relief, and warned of a contingency plan that included $1 billion more in savings by agencies and $600 million in givebacks from the city's unions. A year later, the 2005 Executive Budget included no new agency savings program (except what was previously announced in January's Preliminary Budget), a comparatively modest $400 million request for additional state assistance, a $250 million tax rebate for homeowners, and $652 million to cover wage increases with the municipal unions.

Total Revenue and Expenditure Projections

Dollars in millions

	2004	2005	2006	2007	2008	Average Change
Revenues	$ 47,375	$ 48,549	$ 48,133	$ 49,082	$ 50,499	1.6%
city-funded revenues	*33,193*	*34,872*	*34,520*	*35,348*	*36,691*	2.5%
Expenditures	47,375	48,075	51,337	52,830	53,796	3.2%
city-funded expenditures	*33,193*	*34,398*	*37,724*	*39,096*	*39,988*	4.8%
IBO Surplus/(Gap) Projection	**$ -**	**$ 474**	**$ (3,204)**	**$ (3,748)**	**$ (3,297)**	

SOURCE: IBO.
NOTES: IBO projects a surplus of $1,643 million for 2004, $337 million above the Bloomberg Administration's forecast. The $337 million is used to prepay additional 2005 expenditures, leaving 2004 with a balanced budget. City-funded revenues and expenditures exclude state and federal categorical grants. Projections are net of intra-city revenues and expenditures.

The difference between the two budget plans would seem to suggest a striking turnaround in the city's fiscal condition. In fact, the city is at best running in place while the finish line keeps moving further away. The 2004 budget is balanced—with a surplus estimated by IBO of $1.6 billion—through a combination of using a similar size surplus from 2003, spending reductions, higher than expected tax revenue, and tax increases. If not for the 2004 surplus, which is being used to prepay some of next year's expenses, there would be a significant gap in 2005. With expenditure growth continuing to outpace revenue growth and the Executive Budget taking limited steps to address this, IBO projects the 2006 shortfall will grow to $3.2 billion—9.3 percent of city revenue. In addition, if a number of Executive Budget proposals are not resolved or aid expectations are unmet, the $474 million surplus IBO projects for 2005 could shrink, thereby increasing the gap in 2006 and beyond.

Economic Update. Recent evidence suggests that the U.S. economy is maintaining a solid recovery, with payroll employment growing by 288,000 in April, following a 377,000 rise in March. Data for the first three months of calendar year 2004 confirm that after lagging the upturn in the national economy, a recovery in the local economy is finally underway. January brought the first substantial job gains in three years (though February and March gains were smaller). There were solid job gains in the professional services, health care, arts, and hotel sectors. In the securities sector, the number of jobs fell again, although industry data indicate that spending by firms on compensation is starting to rise. Finally, continued appreciation in the residential property markets suggests that demand remains strong.

Economic Outlook. IBO expects the local recovery to gradually pick up steam through 2004, with sustained moderate growth in 2005 through 2008. The city is expected to gain 14,900 jobs from 2003 to 2004, followed by gains of 45,200 in 2005 and 47,600 in 2006. Even with these solid gains, the number of jobs in the local economy is not expected to exceed the December 2000 peak until late in 2009.

Although expected job growth is strongest in 2005 and 2006, IBO's forecast of real (inflation-adjusted) personal income growth indicates that the expansion will be stronger in 2004 than in 2005 through 2008. Personal income is expected to grow by 4.1 percent this year, but then slow to 2.8 percent real growth in 2005.

For the securities sector, IBO expects very slow job growth (less than 1 percent annually) beginning in late 2004. Securities industry profits appear to be maintaining the high levels of late-2003 and IBO now expects profits for this year to be $18.4 billion. With compensation and other expenses increasing, industry profits—which grew from $7.0 billion in 2002 to $16.7 billion in 2003—are expected to grow more slowly through 2008, but remain below their 2000 peak.

Revenue Forecast. IBO estimates that revenue from all sources will total $47.4 billion in 2004 and $48.5 billion in 2005. By 2008, revenue is expected to reach $50.5 billion. Annual growth from 2004 through 2008 will average 1.6 percent. City revenue, which excludes state and federal categorical grants, is expected to grow somewhat faster, with annual growth averaging 2.5 percent from 2004 through 2008.

Tax Revenue. Tax revenue is by far the largest portion of city revenue. Baseline tax revenue—before accounting for the

Mayor's proposed homeowner tax rebate and permanent repeal of the absentee landlord surcharge—will total $27.0 billion in 2004, $1.1 billion higher than anticipated when the current budget was adopted last June, and 16.0 percent higher than the revenue collected in 2003. While increases in the property, personal income, and sales tax rates account for much of this year's tax revenue growth over the previous year, almost half is attributable to improved economic conditions.

IBO's forecast for 2004 is $409 million higher than in our March 2004 report on the Preliminary Budget. The increase is largely due to the continued strong growth in the property transfer taxes, although the forecast for most other tax sources is also slightly higher.

Tax revenue is not expected to grow nearly as fast from 2004 to 2005—the total is projected to be $27.6 billion, 2.3 percent above the 2004 level. This slower growth is due in part to a scheduled rollback of the temporary income and sales tax increases enacted for 2004. Without the sunset provisions, personal income tax growth in 2005 would exceed 5 percent and sales tax revenue would grow by 4.5 percent (rather than declining by 2.8 percent), roughly matching the 5.1 percent increase forecast for the property tax. Real property transfer taxes are a second factor behind the deceleration of tax revenue in 2005. In particular, mortgage recording tax and real property transfer tax collections—which are highly sensitive to changes in interest rates—are expected to decline by 26.1 percent and 11.0 percent, respectively, in the face of anticipated interest rate increases later this year.

Tax revenue growth is expected to pick up a bit in 2006 when revenue will be $28.7 billion, or 4.0 percent above the 2005 level; revenue growth would be over 5 percent without the sunsets. Growth will average 3.6 percent annually in the last two years of the Financial Plan, with tax revenue forecast to reach $30.8 billion in 2008.

IBO's tax revenue forecast exceeds that of the Mayor's for each year of the forecast period. In 2004, due primarily to higher business and personal income tax forecasts, IBO's estimate of total tax revenue is $119 million higher. For 2005, when IBO's property tax forecast also is well above the Mayor's, the total difference is $350 million. The difference between the two forecasts is widest for 2006, when IBO's projection of total tax revenue, again thanks mainly to higher forecasts for income and property taxes, exceeds the Mayor's by $690 million.

Expenditures. IBO estimates that spending will increase in 2005 by $700 million from 2004 and total $48.1 billion. Spending will continue to rise at an average annual rate of 3.2 percent (not adjusted for prepayments)—twice the rate of total revenue growth—and reach $53.8 billion in 2008.

Several changes since January's Preliminary Budget have contributed to this increase in projected spending. Rather than saving over $150 million annually in subsidies through a takeover of the seven private bus lines in the city by the Metropolitan Transportation Authority, the city has agreed to continue to provide the agency with the same subsidy. The Bloomberg Administration also reached a labor settlement with District Council 37 (DC 37) and has now put $652 million in the budget to cover that agreement as well as the assumption of similar settlements with the other municipal unions—though it is unlikely that the teachers, police, and fire unions will agree to the same pact. Based on the DC 37 settlement, the budget assumes that 2 percent wage hikes in 2005 for the city's other unions are to be funded through productivity savings, which IBO projects would need to total roughly $300 million. The DC 37 pact achieves the savings by reducing starting salaries by 15 percent for two years, fewer days off, and the attrition of roughly 1,000 workers.

Additionally, the Executive Budget includes a $200 million subsidy in 2005 for the Health and Hospitals Corporation (including $17.6 million for debt service)—a break from the past decade in which the city reduced aid to the public hospitals. The Mayor's budget also provides $90 million for new third grade programs, funded in part through a $57 million cut to summer school programs for students other than third graders. The budget also optimistically assumes the state will provide $75 million to cover part of the proposed teachers' contract settlement and will continue to provide a $62 million "fiscal stabilization" grant—funds previously earmarked to help cover the last teachers' contract. Also included is $84 million for the anticipated cost of the new lead paint law.

As IBO completed this report, the state's highest court upheld the proposed takeover of the city's Municipal Assistance Corporation debt service. While the timing of the takeover remains unclear, IBO's budget projections reflect the Executive Budget assumption that the city will save $1 billion in 2005. This development eliminates a major risk to the Mayor's budget plan.

"Uncontrollable" Costs. City-funded spending on most agency programs and services will grow at a much slower pace than total city spending. IBO projects that agency and program spending (excluding Medicaid) will increase by $2.0 billion,

from $19.0 billion in 2004 to $21.0 billion in 2008—an average annual rise of 2.6 percent.

The overall increase in spending is being driven largely by a few items that are sometimes referred to as nondiscretionary or uncontrollable costs. These costs include Medicaid; debt service; the settlement of lawsuits against the city; and pensions, health care, and other fringe benefits for city workers. IBO projects that this set of expenditures will grow by $4.7 billion, from $14.2 billion in 2004 to $18.9 billion in 2008—an average annual rise of 7.5 percent.

While in most instances these costs are fixed for the city in the short run, the city also makes decisions that affect their future level of spending. For example, the city has little choice but to pay the interest and principal on borrowing it has already incurred, but it can make choices about how much new borrowing to undertake. The city's most recent capital plan totals $31.8 billion, a record four-year plan total. The plan requires $2.5 billion in new borrowing to pay for projects such as the $1.5 billion overhaul of the city's emergency response system, the modernization of two public hospitals, and improving Manhattan and Brooklyn piers for cruise ships. The added borrowing will raise annual debt service by $87 million [NOTE: this is a corrected amount] by 2008 to a total of $5.3 billion, 14.4 percent of city revenue.

Several other items in this part of the budget are growing at a fast pace, although the amount of city control varies. For example, IBO anticipates that the city's share of Medicaid spending will grow at an average annual rate of 5.3 percent (adjusted for a one-time increase in the federal share), rising from $4.2 billion in 2004 to $5.1 billion in 2008. While federal and state mandates determine who is covered and for what services, the city could stop actively seeking to enroll more New Yorkers on Medicaid as a means of controlling future costs. But the city has roughly 2 million uninsured residents whose health care needs can be more expensive to meet in the public hospitals. Spending on pensions will increase at an even faster average annual rate of 17.5 percent, growing from $2.3 billion in 2004 to $4.3 billion in 2008. The city has legal obligations regarding pension costs, though it can seek to reduce future spending through labor negotiations.

Uncertainties. There are a number of proposals included in the Executive Budget that depend upon decisions by other governmental entities. If they remain unresolved or other aid expectations are unmet, then the $474 million surplus projected for 2005 could shrink, which would also widen the gap in 2006 and beyond.

School Financing. The state's highest court has ordered the Legislature to develop a new education financing system to resolve the lawsuit brought by the Campaign for Fiscal Equity. Since the suit seeks to ensure that the city has adequate resources for its schools, many have assumed the settlement would solely involve more state aid. In fact, a new financing arrangement could require the city to spend considerably more than the $5 billion it already allocates for public schools.

State and Federal Aid. The Executive Budget anticipates $550 million in state and federal gap-closing assistance, with $400 million coming from the state. Although the Governor includes by his accounting $418 million in aid for the city, much of it comes in proposals that are unlikely to be accepted either by the Legislature or the Mayor and City Council.

Pension Costs. Based on a set of recommendations by an independent auditor, the city may need to increase its contribution to the pension funds by as much as $300 million a year. The city actuary will make the final determination and has not yet decided which, if any, recommendations to adopt.

CONCLUSION

Despite the upturn in the local economy and IBO's forecast of rising revenue, the city's fiscal condition remains problematic. While ending 2004 with a projected $1.6 billion surplus, the anticipated $474 million surplus in 2005 could be reduced by a few of the uncertainties in the budget plan for next year. Even if the 2005 Executive Budget holds, the city faces a significant shortfall of more than $3 billion in 2006—just 14 months from now. The city's failure to begin to address this large gap now will make it harder to deal with in the future.

Causing the city's budget balance to wobble is a rise in spending that will continue to outpace revenue growth. The growth in expenditures is centered in the so-called nondiscretionary spending areas such as Medicaid, debt service, and pensions. While it is true that much of this spending is determined by prior agreements or state and federal mandates, the city does make decisions that affect the future level of these expenditures as well.

At least in the near term, relief from nondiscretionary spending will be marginal at best because of the limited legal, political, and practical control the city has over the size of these expenditures. To meet these mounting costs, the city must reevaluate its approach to other portions of the budget—tax and non-tax revenues as well as savings in agency and program spending.