Analysis of the Mayor’s Executive Budget for 2007

THE MAYOR’S 2007 EXECUTIVE BUDGET and four-year financial plan follows much the same pattern as his other recent budget plans: There is a swell of unanticipated tax revenues that create a large surplus in the current fiscal year, followed by expectations of steep shortfalls in the future. Accordingly, the Mayor has increased his estimate of the surplus for 2006 by $185 million as well as his gap estimates, which have grown by $132 million for 2008 and $702 million for 2009.

Much as he did in the Preliminary Budget, the Mayor has sought to take a significant portion of this year’s surplus “off the table” so that it cannot invite calls for ongoing new spending or tax cuts that could be difficult to sustain in the future. In addition to the portion of the surplus set aside in the Preliminary Budget through the creation of the retiree health insurance trust fund and the deferral of tobacco revenues, the Executive Budget includes the early retirement of some Transitional Finance Authority debt and a subsidy to the Health & Hospitals Corporation (HHC) that will be paid back over several years. If not for these measures, this year’s surplus, which IBO estimates to be $3.5 billion would be nearly $2.0 billion higher.

Despite the continuation of a relatively cautious approach, spending under the Mayor’s plan would exceed revenue growth in the years after 2007. But these shortfalls may not be as steep as the Mayor anticipates. IBO’s estimated 2008 budget gap is $1.1 billion less than the Mayor’s, and lower by similar amounts in 2009 and 2010. This is largely because of our substantially higher expectations of out-year property tax revenue as well as our higher projections for personal and business income tax receipts and lower estimate of Medicaid spending.

REVENUES

IBO’s tax revenue forecast for 2006 is $33.3 billion—$3.7 billion (12.5 percent) higher than the city’s projection when the budget was adopted last June. The continuing surge of unanticipated tax revenues—the new forecast is $913 million higher than what IBO projected just two months ago—is fueled largely by the strength of the city’s property transactions, although higher than expected income tax receipts have also contributed substantially to the revenue surplus. With the revised forecast for 2006, tax revenue is now projected to grow by 8.9 percent from 2005.

This growth is expected to end abruptly in 2007 with tax revenues falling to $32.5 billion, a 2.4 percent decline. Modest growth resumes in 2008, with baseline tax revenues (not including the effect of the proposed extension of the real property tax rebate and the recently announced enhanced credit for film production) averaging 4.5 percent annually through 2010 when they are expected to reach $37.0 billion.
Slower revenue growth in 2007 is due to several factors. One factor is that the housing market is expected to return to a more normal pace with a decline in the number of transactions and leveling off of sales prices. As a result, the real estate transfer taxes generated by the sale and financing of real property are expected to fall by $804 million from 2006 to 2007 (a decline of 31 percent). Despite the precipitous decline, revenues from these taxes are still projected to exceed the totals for every year prior to 2005 and to be roughly twice the levels prevailing at the start of this decade.

Another factor is that personal income tax (PIT) revenue is also expected to drop from 2006 to 2007, declining by $513 million (7.1 percent). The expiration of the 2003 three-year tax increase last December accounts for most of the decline. The temporary increase ran through the first half of 2006 and yielded $395 million in tax revenue. IBO's projection of slower economic growth in calendar year 2007 and the expectation that more refunds will be paid out later this fall account for the balance of the overall decline in the PIT forecast for 2007.

A third factor is business income taxes. IBO expects these taxes, which had been growing at double digit rates since 2003, to slow sharply, with growth in 2007 falling to 2.6 percent from 12.3 percent in 2006 and 29.6 percent in 2005. This drop-off parallels an anticipated slowing in corporate profit growth, the effect of higher interest rates on Wall Street net revenues, and a general slowing of the city economy.

Property Tax Fuels Out-Year Growth. The real property tax accounts for much of the resumption in tax revenue growth expected in 2008 and beyond. IBO projects an 8.8 percent increase in property tax revenue in 2008 (6.8 percent if the $400 homeowner rebate, which is scheduled to expire after 2007, is renewed). Because assessment increases are phased in for many properties, revenues can continue to grow even if current market values have begun to slow or even decline. The pipeline of deferred assessment increases from recent years will help to keep real property tax revenue growing briskly through 2010 when revenue is expected to reach $15.7 billion.

Some other key taxes are not projected to generate as much revenue in the out-years as in the recent past. Property transfer tax revenues are expected to slip again slightly in 2008 and 2009, falling by 3.7 percent and 2.0 percent respectively, before stabilizing in 2010. The income and sales taxes are expected to see steady growth in 2008 through 2010, although the rates will be generally lower than in the 2003 through 2006 period.

Comparative Forecasts. Even with a projected slowdown in tax revenues in 2007 and IBO's forecast of moderate growth in the out-years, our forecast for overall tax revenues exceeds the Bloomberg Administration's for each year of the financial plan. The differences are relatively small in 2006 and 2007 ($185 million and $220 million, respectively) but then widen considerably in 2008 through 2010 and average more than $1 billion a year. The largest differences are in the forecasts for business income, personal income, and property taxes. For the income taxes the differences are likely due to our expectation of a milder economic slowdown in 2007, particularly in the securities industry. The wide gaps in the property tax forecasts in 2008 through 2010 stem from our projection of slower albeit continued growth in market values and different estimates of the remaining pipeline of deferred assessment increases.
Mayoral initiatives such as the hiring of 800 new officers and 400 civilians at the police department and increasing the number of protective services staff at the Administration for Children’s Services, as well as targeted investments in several other agencies. There is also new spending because of court mandates, actions by other levels of government, or other external developments. Examples of these include increased spending for special education placements at private schools and growing charter school enrollments, requirements under the federal Help America Vote Act, and rising energy costs.

Two of the Mayor’s largest spending initiatives—subsidies for the Health & Hospitals Corporation and the New York City Housing Authority (NYCHA)—are one-time actions that occur during the current fiscal year. In addition to helping the public hospitals and housing authority with their fiscal problems, these subsidies reduce the 2006 surplus by nearly $500 million.

**Health & Hospitals Corporation.** One of the largest new expenditures is a subsidy for the fiscally ailing public hospital system that was included in the modification of the city’s 2006 budget in April. In a complex arrangement, the city is making an extraordinary Medicaid payment of $575 million, which triggers a similar federal payment for a total of nearly $1.2 billion in funds to HHC. The hospital corporation will then use part of these extra funds to pay some of the debt service costs that would otherwise have been paid by the city. The assistance the city began providing HHC in 2004 will be reduced in 2006, 2007, and 2008 as well. The end result is that HHC will receive an infusion of $575 million this year, and by 2008 the city will save an amount roughly equal to its $575 million payment through reduced subsidies and debt service costs. For 2006, the repayment totals $190 million, making the net cost of the transaction this year $385 million.

**New York City Housing Authority.** The city will provide one-time assistance of $100 million to the housing authority to help it implement a multi-year plan to stabilize its finances. NYCHA has faced recurring operating deficits for several years, which it has financed by drawing down reserve funds.

**Retiree Health Trust Fund.** The April modification of the 2006 budget also included the first of two $1 billion payments into the newly created trust fund for retiree health costs. Money drawn from the trust fund can only be used to pay retiree health care costs. As of now, there are no guidelines specifying how much, if any, of a given year’s retiree health costs should be paid from the trust. According to the Mayor’s budget office, the intent is to pay all retiree health care costs from the trust and to use the amounts included in the city’s expense budget each year to reimburse the fund for the costs. In contrast, expense budget dollars would be freed up if in any year the budget does not appropriate the full amount necessary to reimburse the trust fund.

The trust fund comes in anticipation of new accounting rules that go into effect in about two years, which will require the city to show on its balance sheet the future liability for retiree health costs. Initial estimates put this liability as high as $50 billion. While there is no requirement that the city fund these liabilities in the same way it treats pensions, there may be pressure in the future to do so.

**Medicaid.** While Medicaid is still a major expense for the city, it is not growing as fast as it once was because the state has capped how much the local share of Medicaid can grow from one year to the next and Albany has assumed the city’s share of Family Health Plus costs. IBO projects that the city’s Medicaid expenditures will increase from $4.9 billion in 2007 to $5.3 billion in 2010, $96 million to $130 million less than the Bloomberg Administration’s estimates for each of these years. IBO’s projections are lower because the Mayor’s office has not yet fully accounted for the effect of the caps in their estimates, which they intend to do when the 2007 budget is adopted.

**Growing Expenditures.** Much of the growth in city spending is limited to a few discrete portions of the budget over which the city has limited near-term control.

City pension contributions continue to rise at a face pace, increasing at an average rate of 9.5 percent annually through 2010. The city’s pension contributions are expected to grow from $4.0 billion in 2006 and level off at $5.7 billion after 2009. Changes in certain actuarial assumptions are saving the city money in 2006 and 2007, but causing higher contributions in the ensuing years. The cost of health benefits for current city employees also continue to climb rapidly, rising from $2.9 billion in 2006 (not including payments to the retiree trust fund) to $3.9 billion in 2010.

City spending on debt service—principal and interest payments on debt issued to finance the capital program—is expected to increase rapidly as well. Debt service will rise from $5.0 billion in 2006 to a projected $6.1 billion in 2010, growing at an average rate of 10.1 percent annually when adjusted for prepayments. Debt service will consume 12.4 percent of tax revenues in 2006, and 16.5 percent in 2010.

The cost of settling lawsuits against the city is also expected to rise, growing from $586 million in 2006 to $778 million in
2010, an average annual increase of 7.3 percent.

UNCERTAINTIES

There are a number of uncertainties that could have substantial budgetary effects for the city. The Mayor has budgeted funds to cover wage increases for municipal workers at roughly half the rate of inflation—considerably less than recent settlements. If the Bloomberg Administration and the unions settled future contracts at the rate of inflation, the cost would be roughly $300 million more than is set aside for 2007 and $1 billion more by 2010, barring any significant productivity givebacks.

The eventual resolution of the Campaign for Fiscal Equity (CFE) case and new federal welfare rules could also pose costs for the city. Based on comments by a state Supreme Court judge as well as some of the proposed solutions, a settlement of CFE may include additional city education spending along with new state aid. Changes to the federal Temporary Assistance to Needy Families program include higher work requirements for welfare recipients. These requirements are likely to increase city costs, especially for child care. The extent of these cost increases will not be known until federal regulations implementing these changes are released.

Additionally, important details about implementation of the recent agreement for the state to help finance $6.5 billion for school construction have not yet been announced. One important unknown is whether leaders in Albany will continue to appropriate sufficient building aid each year to back the new bonds that will be issued to finance much of the construction without offsetting reductions in other types of aid.

Debt service for $4.7 billion of the capital funds (another $1.8 billion will be funded directly by the state dormitory authority) will be paid with existing as well as incremental state building aid. Building aid, which reimburses school districts for a portion of the debt service for education capital spending, currently flows into the education department’s operating budget. The legislation allows the transfer of existing as well as incremental building aid from the department’s operating budget to the Transitional Finance Authority, which will issue the bonds and use the redirected building aid to pay debt service. The Bloomberg Administration is assuming that not all of the assigned building aid will be needed to pay the annual debt service and the unused portion will be returned to the department—eliminating the need to use city tax dollars to fill the gap opened in the school system’s operating budget. If the state’s building aid program does not grow by enough over the course of the financing period to cover the new debt service or, if in the future, the Legislature and the Governor treat the incremental building aid as part of the city’s “regular” share of overall state aid, then the value of the capital financing package would be smaller than anticipated.

Our economic and tax revenue projections include both upside potential and downside risks. Over the past two years, the local economy has generated considerably more in tax revenues than forecasters expected based on their economic outlook. If the higher-than-expected tax receipts are the result of long-term changes that IBO and others have not yet accounted for, tax revenues could again be much higher than our projections.

Conversely, there are a number of factors that could temper the economic forecast underlying our tax revenue projections. These include interest rates, oil prices, and the housing market. After its most recent short-term interest rate hike, the Federal Reserve indicated that the series of gradual increases of the federal funds rate are now coming to an end and that future actions would depend on the performance of the economy. IBO’s forecast assumes no additional hikes this year. Further interest rate increases could slow economic growth this year and worsen the deceleration already anticipated for next year. Continuation of current—or higher—oil prices could similarly hold the economy back and spur inflation. A downturn in the housing market could also have a significant impact on the real estate and construction industries, and a decline in housing values could dampen the consumer activity that has been driven by the sharp rise in housing equity.

CONCLUSION

For the second consecutive year, the city will close its fiscal year with a surplus of well over $3 billion. This year’s $3.5 billion surplus is generated despite several measures that pull roughly $2 billion out of the 2006 budget, much of it for use in 2008 and beyond. Indeed, the city’s current fiscal condition is so strong that even with our expectation of next year’s slower economy IBO projects a surplus of more than $400 million in 2007. If used to prepay upcoming expenditures, this surplus would lower our projected 2008 shortfall to $2.0 billion, 5 percent of anticipated 2008 city-funded spending. How long this fiscal good fortune lasts will depend on the economy and on decisions the Mayor and City Council make about taxing and spending in the coming months.

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