IBO

New York City Independent Budget Office

Fiscal Brief

May 2009

Analysis of the Mayor's Executive Budget for 2010

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THE U.S. ECONOMY REMAINS IN THE MIDST OF A SEVERE RECESSION, but there is evidence that it is contracting more slowly than earlier in the year and financial markets are showing signs of improvement. Despite these hopeful signs, the city continues to face significant budget challenges. Although IBO's estimate of tax revenues for fiscal years 2009 and 2010 are respectively $390 million and $641 million below the Bloomberg Administration's, the major fiscal difficulties come in 2011 and beyond.

IBO estimates that under the Mayor's Executive Budget plan a budget gap of $1.1 billion in 2010 remains to be closed. There are some uncertainties in the Mayor's 2010 plan such as the proposed sales tax increases and the creation of a new pension tier to help reduce labor costs, which if Albany does not approve, could make balancing the upcoming year's budget more difficult. In addition, contracts with the United Federation of Teachers and District Council 37 expire during 2010 and settlements could increase the level of the gap.

But the tougher challenges now appear to be in the subsequent years of the financial plan, when there is no longer a substantial surplus from the flush years of the recent past to help bridge the shortfalls and the temporary flow of federal stimulus dollars begins to dry up. IBO projects a 2011 gap of $5.6 billion, 12.9 percent of city-funded revenue, and $1.0 billion more than the Mayor estimated. Our 2012 gap of $5.8 billion is 12.7 percent of city-funded revenue, and $666 million higher than the Mayor's estimate. Based on our forecast that recovery from the recession will be slow, IBO does not expect the financial and real estate markets to surge and boost tax revenues enough to grow our way out of these gaps.

TAXES AND THE ECONOMY

Though the U.S. recession and the city's economic downturn continue—and both are expected to extend into next year—the outlook for the U.S. and local economies is somewhat less grim than it had been last winter. There is some evidence that the national economy is now contracting at a slower rate than at the beginning of this year, and so far, the local employment decline is not as great as predicted only a few months ago. There are encouraging signs that consumer confidence, while still low, has stabilized, as have financial markets, and there is less uncertainty about the government's response to the recession. Still, IBO forecasts a prolonged local downturn, and there is still considerable risk that conditions will be worse than we forecast.

U.S. Economy. There has been a loss of 5.7 million jobs nationwide since December 2007—4.2 percent of total employment. Real gross domestic product (GDP) plummeted at an annual rate of over 6 percent in each of the last two quarters, and IBO forecasts another quarter of declining GDP, but at a slower rate (2.4 percent). As federal stimulus spending spreads and

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businesses replenish their depleted inventories, economic growth is expected to resume later this year. Aggressive monetary policy keeping interest rates at near historic lows will also contribute to the eventual recovery. The nation's output is expected to increase slightly in the second half of 2009 and then expand steadily, with real GDP growing at 2.8 percent in 2010 and 5.7 percent in 2011. (In the economic discussion all references are to calendar years.) The depth of the current recession, here and in other countries, is expected to cause the consumer price index to fall this year and rise slightly in 2010 and beyond, when inflation reaches only 2.0 percent.

The downturn in U.S. employment is expected to last longer. IBO forecasts a loss of another 2.9 million jobs through the rest of 2009, followed by little change until employment growth slowly resumes in the second half of 2010 and accelerates in 2011 and 2012. The unemployment rate, which typically lags behind other economic indicators, is expected to peak at 9.8 percent late this year and remain at that level through the first half of 2010, when the economic recovery induces workers to return to what will still be a weak labor market. After 2010, when economic growth strengthens, the unemployment rate is expected to fall steadily.

Local Economy. The downturn in New York City's economy started later than the nation's recession, and it will end later. But recent data indicate that the employment decline has not been as steep as predicted by many forecasters, and IBO has trimmed its estimate of the number of jobs the city will lose before economic growth resumes.

The city's economy continued to grow, albeit slowly, for much of the national recession's first year. Revised data indicate that city employment peaked later than previously thought, at 3.8 million jobs in the third quarter of 2008. City employment began to decline in the fourth quarter, and IBO forecasts a total loss of 254,500 jobs by the middle of 2010—6.7 percent of the employment peak. While some industries will continue to shed jobs into 2012, three-fourths of the job loss is expected to occur by the third quarter of this year. This total loss of jobs is greater than the employment decline during the 2001–2003 recession (228,500 jobs) but less than the decline from 1989 through the end of 1992 (377,500 jobs).

The battered financial activities sector (excluding real estate) accounts for a particularly large share of the employment decline—56,800 jobs (16.2 percent of the sector's recent peak employment) through the first quarter of 2012. Over half of the projected decline consists of high-paying jobs in the securities industry—32,400 jobs, (or 17.2 percent of industry employment at its recent peak). In the last two years, net losses for Wall Street firms as a whole totaled $53.6 billion. While low borrowing costs are currently boosting the earnings of many firms, many also are continuing to write down the value of troubled assets. On balance, IBO forecasts another $4.7 billion of industry losses in 2009. In the following years, the securities industry as a whole is expected to become profitable again, with estimated annual earnings in the $8 billion to $9 billion range—far less than the profits enjoyed by firms in most of the 11 years before 2007. With the expectation of a smaller, more regulated, less leveraged, and less profitable financial sector, few of the lost jobs are expected to return by 2013.

The professional and business service sector, which derives much of its business from financial firms, is expected to lose even more jobs than finance itself—67,100 jobs or 11.0 percent of its employment at the recent peak. With continued problems in real estate financing and a huge inventory of unsold apartments, employment in construction is also expected to sharply decline, by 28,000 jobs before hitting bottom in the middle of 2012; job growth is slow thereafter. The recession's effect on business travel and tourism factor into employment losses in leisure and hospitality (19,900 jobs), retail (27,500 jobs), and transportation (10,700 jobs). The health and education sector, which includes social assistance, is the only major industry expected to be larger a year from now than it was in the third quarter of 2008, and it is expected to grow steadily from 2011 through 2013.

The decades-long decline of manufacturing in

Total Revenue and Expenditure Projections
Dollars in millions

	2009	2010	2011	2012	2013	Average Change
Total Revenues	$60,972	$59,327	$61,981	$63,768	$67,432	2.5%
Total Taxes	*35,139*	*33,808*	*36,229*	*38,615*	*41,514*	4.3%
Total Expenditures	60,972	60,451	67,586	69,595	72,348	4.4%
IBO Surplus / (Gap) Projections	**-**	**$(1,124)**	**$(5,605)**	**$(5,827)**	**$(4,916)**	
Adjusted for Prepayments and Discretionary Transfers:						
Total Expenditures	$63,638	$65,226	$68,116	$69,595	$72,348	3.3%
City Funded Expenditures	45,343	46,897	49,439	51,559	53,661	4.3%

SOURCE: IBO.

NOTES: IBO projects a surplus of $2.067 billion for 2009, $429 million 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.

the city typically accelerates during recessions, but with current manufacturing employment (85,200 jobs) being less than a third of what is was at the start of the 1989-1992 downturn, there are fewer manufacturing jobs for the city to lose. Still, we project a decline of 13,700 manufacturing jobs through mid-2010, followed by more gradual losses through 2013.

Although employment in some nonmanufacturing sectors will continue to decline, total employment is expected to begin growing again in the second half of 2010. IBO forecasts employment growth of 0.9 percent in 2011 (33,000 jobs), 1.9 percent in 2012 (69,300 jobs), and 1.5 percent in 2013 (54,900 jobs). By the fourth quarter of 2013, New York City employment is expected to be 2.0 percent (75,700) below its recent peak in the summer of 2008.

Overall job losses and their concentration in high-paying industries, plus smaller bonuses in the financial services industry, are expected to reduce personal income by 2.9 percent this year. Personal income is expected to grow by 0.9 percent in 2010 as the economy starts to take off and Wall Street profitability returns. As the recovery strengthens in 2011, annual income growth accelerates to 3.9 percent.

Baseline Tax Revenue Forecast. With the city's economy forecast to contract further this year and little recovery expected before the second half of next year, IBO projects that the city's tax revenues will fall by $2.5 billion (6.6 percent) in fiscal year 2009 and by another $2.2 billion (6.3 percent) in 2010. This back-to-back decline—which follow a year (2008) of essentially no tax revenue growth—would mark the first time in at least three decades that the city experienced consecutive years of falling tax revenues.

The tax sources that account for much of the revenue decline—the business and personal income taxes and the property transfer taxes—are the ones that accounted for much of the tax revenue boom the city enjoyed from 2003 through 2007. During the economic expansion, those taxes—which are closely linked to the financial and real estate markets—more than doubled, growing from $7.8 billion to $17.0 billion. They are now expected to contract by 37.4 percent to $10.6 billion by 2010. Although these taxes will resume growing in 2011, by 2013 they will still be below their 2007 peak. In contrast, the rest of the city's tax sources—including its largest, the property tax—grew more slowly during the boom (32.2 percent) and are expected to show modest growth (8.6 percent) even during the downturn.

Our baseline tax revenue forecast—which includes the additional revenue from increases in property and hotel tax rates that were adopted last December but excludes the Mayor's proposed increases in the sales tax that have not yet been enacted—is actually slightly less pessimistic than our forecast in March, consistent with revisions to our economic forecast. As a result of these revisions, we have increased our projections for some taxes since our last forecast, most notably for the personal income and general corporation taxes.

IBO's tax revenue projections are nonetheless significantly lower than those of the Mayor's Office of Management and Budget (OMB). For 2009, IBO estimates that tax revenues will be $390 million lower than OMB expects, with the difference widening to $641 million in 2010, and then $960 million in 2011. The difference narrows in 2012 and by 2013 IBO's forecast exceeds OMB's by $546 million. Just a few taxes are driving most of these differences. Our property tax estimate is $364 million lower than OMB's in 2010 due to IBO's expectation that market values and, hence, the levy will contract somewhat faster than OMB is forecasting and that adjustments resulting from assessment appeals and delinquencies will be greater.

Some of the other large differences between IBO and OMB tax projections are in the business and personal income taxes. IBO's business tax estimates are $170 million lower in 2009 and $207 million in 2010; for the personal income tax (PIT), we are $260 million lower in 2009 and $109 million in 2010.

Business Income Taxes. After falling by $600 million (10.0 percent) in 2008, revenues from the business income taxes—the general corporation tax (GCT), the unincorporated business tax (UBT), and the banking corporation tax (BCT)—are projected to decline by another $570 million (10.5 percent) in 2009 and $1.1 billion (22.6 percent) in 2010. By 2010, they will be 37.6 percent below their 2007 peak of $6.0 billion. However, business income tax revenues in 2010 will still be far above the previous trough of $2.3 billion in 2003.

Most of the decline in 2009 is due to the GCT, which is expected to end up $627 million (21.4 percent) below the level of 2008. (There will also be a small drop in the UBT, offset by an unexpected—and only temporary—uptick in the BCT.) In 2010 the GCT is expected to fall another $308 million (13.4 percent), but steeper drops are forecast in the BCT ($270 million, 38.6 percent) and the UBT ($514 million, 28.0 percent).

These declines are mainly due to the collapse of profits in the financial sector and its impacts on real estate and business services. While the steepest securities industry losses occurred at the end of calendar year 2008, IBO expects additional losses through the middle of calendar year 2009 and the city economy overall to continue to shrink through the middle of calendar year 2010. Business tax revenue growth is forecast to resume in

2011, but will remain relatively weak through 2013: 7.4 percent in 2011, 10.4 percent in 2012, and 10.9 percent in 2013. This reflects what is expected to be a slow recovery of the city economy from the current recession.

Personal Income Tax. IBO has reduced its 2009 personal income tax forecast to $6.9 billion (including Transitional Finance Authority-dedicated revenue), 20.8 percent lower than 2008. While withholding collections have been surprisingly strong given the job losses in the past half year, and refunds for 2008 have not been as high as feared, taxpayers' first quarterly estimated payments against 2009 liability were weak, and final returns payments for tax year 2008 have been lower than previously expected.

For 2010, IBO forecasts a further 16.5 percent decline in PIT revenue to $5.8 billion. Continued job losses and a poor outlook for capital gains will weaken withholding and estimated payments further. PIT collections are expected to resume growing in the second half of calendar year 2010, with collections reaching $6.7 billion, $7.4 billion, and $8.4 billion in 2011, 2012, and 2013, respectively. Accelerating job growth in the latter half of the forecast period will result in robust withholding growth, averaging a healthy 9.8 percent in these three years. Capital gains realizations will also improve, especially in calendar year 2010, the last year of preferential federal tax rates, and this will swell estimated payments.

Transfer Taxes. The city's real property transfer tax (RPTT) and mortgage recording tax (MRT), collectively known as the transfer taxes, are collected when real property is bought and financed. Collections exploded with the real estate boom from 2003 through 2007 and are now collapsing during the subsequent bust. IBO projects that total collections from the RPTT and MRT will reach $1.3 billion in 2009, a 59.9 percent drop since the 2007 peak of $3.3 billion.

Moreover, the extent of the decline continues to grow with our current RPTT forecast 10.1 percent below IBO's March projection, and the current MRT forecast 16.7 percent below our March estimate.

Despite low interest rates and some rebound in refinancing activity, the city's real estate market remains in a slump. The number of transactions has declined much more than prices, an indication that further drops in prices are yet to come. Large commercial transactions, an important source of transfer tax revenue, have declined precipitously. As a result, transfer tax revenues are projected to drop further in 2010. The RPTT is projected to decline to $605 million, and the MRT to $506 million. At $1.1 billion the combined transfer tax revenue would be at the lowest level since 2003.

Revenues from the transfer taxes are expected to begin a slow recovery in 2011. By 2013 RPTT revenues are forecast at $839 million and MRT revenues at $717 million, for a total of $1.6 billion.

Real Property Tax. The city's largest tax revenue source is also the one major tax that is expected to continue growing right through the forecast period. The rate of growth will slow from 10.3 percent this year—which was pushed up by the mid-year rate increase—to 4.9 percent in 2013. This pattern is attributable to the structure of the city's property tax which only slowly adjusts billable assessed value—the base for the tax—to changes in market values.

Sales Tax Policy Changes. The Mayor has proposed raising the city's sales tax rate by 0.5 percentage points and eliminating the sales tax exemption on clothing. IBO estimates that these two proposals together would yield the city $960 million in 2010, with the amount of new revenue growing each year so that it reaches $1.1 billion by 2013. OMB's estimates are slightly lower, with the difference attributable to OMB's somewhat lower forecast for the overall sales tax.

The rate change would increase the city sales tax to 4.5 percent, effective June 1, 2009 and would bring the combined state and city sales tax rate to 8.875 percent. (The state rate is 4.0 percent, and an additional 0.375 percent is levied in all localities in the Metropolitan Commuter Transportation District.) At that level, the city would have the highest sales tax rate in the New York metropolitan area; it is currently lower than the rate in Nassau and Suffolk counties and equal to the rate in much of Westchester.

The Mayor plans to eliminate the sales tax exemption on all clothing and footwear, which has been in effect in the city on and off since 2000. (There would be two sales tax-free weeks each year for clothing and footwear purchases costing under $500.) This change would result in New York City retailers charging sales tax on all clothing items, putting them at a competitive disadvantage with merchants in New Jersey, which has no sales tax on clothing.

New York, like other jurisdictions, often looks to sales tax increases when revenues are falling because they can be implemented quickly and usually generate less outrage from taxpayers because they pay in small amounts with each purchase rather than a lump sum such as with property taxes. However, sales taxes, especially on clothing, tend to be regressive as they take up a larger share of income of less affluent households because spending on basic needs does not increase proportionately with income.

EXPENDITURES

Based on the Mayor's plan, IBO estimates that total spending will grow from $61.0 billion in 2009 to $72.3 billion in 2013. Although the Mayor's budget plan shows a decline in spending between 2009 and 2010, the actual level of funds used to provide services in 2010 is higher than presented. When adjusted for the use of prior-year surpluses to prepay 2010 expenditures, city-funded spending to meet 2010 needs is $46.9 billion, $1.6 billion above this year.

Spending and Workforce Reductions. The Executive Budget includes $324 million in new spending reductions and revenue increases by city agencies for 2010 under the rubric of Programs to Eliminate the Gap. This follows much larger agency actions of $1.1 billion in November 2008 and $918 million in January 2009, for a total of $2.3 billion in 2010 reductions over the past seven months.

More than a third of the agency spending cuts in the most recent round would come through reducing the municipal workforce. City-funded employment now totals about 370,000 including part-time positions and staff who are largely funded with city support at the libraries, cultural institutions, public housing authority, public hospitals, and other organizations that are not city agencies.

Under the Mayor's plans since last November, 13,540 positions would be eliminated in 2010, nearly 3,760 through layoffs. The largest reductions would come at the police department, where nearly 2,070 uniformed officers would be lost through attrition and 990 civilian jobs would be cut, 395 through layoffs. The Department of Education would shed just over 1,900 jobs, including 1,440 pedagogical positions through attrition and 475 other positions, including more than 340 through layoffs. The Administration for Children's Services would lose nearly 1,000 positions, more than 600 through layoffs. Although not typically counted towards city job cuts, about half the total layoffs accounted for in the Mayor's plan would come at organizations other than city agencies, including more than 900 in the library systems and 400 at cultural institutions.

The cumulative rounds of proposed spending reductions also appear to increasingly affect the availability of some city services. Of the city's roughly 100,000 subsidized child care slots, nearly 2,000 slots would be eliminated for "low-priority" children, including those in working families and those whose parents are seeking work but not on welfare. The city's three library systems say the reduction in their city subsidy will have multiple effects: for example, the Brooklyn system says spending on books, periodicals and other materials will be cut by 30 percent and weekday hours at most branches will be reduced to five hours a day. In addition, a number of agencies still have substantial unspecified cuts. The education department, for example, has not said how $376 million in cuts will be applied in schools.

Conversely, some portions of the budget continue to grow substantially. Debt service, including Transitional Finance Authority debt and adjustments for prepayments, will grow from $4.7 billion in 2009 to $6.5 billion in 2013, an annual average increase of 8.4 percent. Similarly, the cost of fringe and pension benefits for city workers, excluding the Mayor's proposed pension and health care savings, will grow steadily. City pension contributions will rise from $6.3 billion in 2009 to $7.7 billion in 2013, a 5.3 percent annual average increase. These estimates presume a 20 percent loss on pension fund investments in 2009; if losses are greater the city's contribution will be higher beginning in 2011. Fringe benefit costs (excluding the education department) grow from $3.8 billion in 2009 to $5.0 billion in 2013, a 7.1 percent annual average rise.

Federal Stimulus Funding. If not for the temporary infusion of federal dollars from the stimulus act, proposed headcount reductions and service cuts would have likely been deeper in the 2010 Executive Budget. Under the stimulus act the city benefits from $1.6 billion in direct fiscal relief over three years ($447 million in 2009, $850 million in 2010 and $295 million in 2011) through the federal government assuming a larger share of Medicaid costs. While substantial, the level of Medicaid fiscal relief flowing through Albany is actually $400 million less than anticipated in the Mayor's January 2009 Financial Plan.

In addition to the Medicaid funding, the city has budgeted just over $1 billion in 2010 in other stimulus act funds and $981 million in 2011. Almost all of these funds are for education: $952 million in 2010 and $961 million in 2011. Nearly half of the education funds are passed down from Albany to restore proposed state cuts; some other stimulus dollars are used to soften the effect of proposed city cutbacks for programs such as summer jobs for youth and homelessness prevention.

While stimulus act funds lessen the need for cash-strapped cities and states to make deeper near-term cuts that would further weaken the economy, absent a major economic resurgence New York and other governments may face tough budgetary decisions in a year or so as the federal funds run out. For example, in response to a proposed reduction in state education funding the Bloomberg Administration projected last January that 14,000 teacher positions would have to be eliminated in 2010. Under the Mayor's most recent financial plan, that same reduction in teachers has been pushed out until 2013, when stimulus dollars are no longer available and neither state aid nor city tax revenues are expected to be sufficient to fill the funding shortfall.

Capital Spending. The five-year capital plan through 2013 released in conjunction with the Executive Budget also includes significant reductions. The plan reduces city-funded commitments by nearly $4 billion to $37.1 billion. The largest single programmatic cut is $888 million to bridge and highway projects, a 21.6 percent reduction. Capital commitments for housing are reduced by $486 million, a 24.9 percent cut. Funding for parks projects is reduced by $338 million, a 14.0 percent cut. School construction spending, on the other hand, rises slightly.

Uncertainties. Whether the economy will recover as expected may pose the biggest uncertainty for the Mayor's budget plan. But a number of proposals in the Mayor's 2010 budget may not be achieved and, along with other factors such as the expiration of two major union contracts, could put additional strain on next year's budget balance.

Economic Forecast Risks. While IBO's local economic outlook is less gloomy than a few months ago, significant risks remain. The Obama Administration's efforts to confront the recession in a number of ways—including fiscal stimulus spending, tax cuts, and support for troubled financial firms—have restored a measure of confidence in the economy. But the effectiveness of these actions on the U.S. and local economies remains to be seen.

With actions to stabilize the financial system now in place, the federal government has turned its attention to regulatory changes in an effort to limit risks that can threaten the overall financial system. A question for New York City is the extent to which such changes would also constrain financial firms' profits and professional compensation, which together account for a large share of the city's tax revenue base.

Pensions and Unspecified Health Savings. The Mayor's budget plan for 2010 assumes $200 million in savings from the creation of a new pension tier with reduced benefits and ongoing contributions from employees and $200 million in unspecified health benefit savings. The new Tier V pension plan would only apply to newly hired city workers.

Even if approved by Albany, the Bloomberg Administration's savings assumption in 2010 appears questionable. Increases or decreases in the city's contributions to the pension funds are calculated using a one-year lag methodology. Under this approach, changes to the city's pension liabilities resulting from hiring or other factors during 2010 do not effect pension contributions until 2012. The city's actuary stated in a "Fiscal Note" discussing the Tier V proposal that there are other valid methodologies for determining the city's contributions, and his office plans to review changes in 2010 or 2011.

The proposal for unspecified health benefit savings to be negotiated with the municipal labor unions first appeared in the budget for 2008. The proposal has been repeatedly postponed since then without the Bloomberg Administration and the unions coming to terms. A separate proposal that municipal workers pay 10 percent of their health care premiums to save $357 million has been delayed to 2011.

Sales Tax Increases. While the state Legislature has typically approved measures allowing the city to raise local taxes, it is less certain that Albany would do so if the measures do not have the support of both the Mayor and the City Council. The Council Speaker and a number of members have voiced concerns over the Mayor's plan to raise the sales tax by half a percentage point and to repeal the exemption of sales tax on clothing, arguing that it places an unfair burden on lower income residents and that it will cost the city jobs. The 2010 plan counts on $960 million in revenue from these tax increases.

Plastic Bag Fee. The proposal to charge a five cent fee on plastic bags also requires Albany approval, where support for the measure appears mixed. The 2010 plan projects $100 million in revenue from this new fee.

Union Contracts. Two major union contracts expire in 2010. The United Federation of Teachers contract ends in October and most District Council 37 member contracts expire next March. Together these unions represent about two-thirds of city employees. Each 1 percent wage increase for all municipal employees costs roughly $290 million in city funds.

DECISIONS AHEAD

While there are a number of uncertainties in the budget plan, one thing is certain: significant actions will need to be taken to bring 2011 and later years into balance. We cannot expect much additional fiscal help from Washington. Nor should we expect the kind of resurgence on Wall Street or in the real estate markets that sends tax revenues soaring beyond projections. Given that this a municipal election year, the difficult decisions about spending cuts and tax increases that lie ahead are unlikely to be addressed until November.