Fiscal 2005 Preliminary Budget Response

Part II

City Council Tax Revenue Forecast

Fiscal 2004-2008

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OVERVIEW OF TAX REVENUE AND THE ECONOMY

After a year of anticipation it is finally clear that both the national and City economies are growing. Now the issue is the pace of the recovery. The national economy has been growing for over two years and the City's economy has been growing for close to six months. As the national recovery continues it pulls the City forward. Improving financial markets are boosting income in the City. The arts and entertainment and the accommodation sectors are growing due, in part, to the return of domestic tourism. Even the badly hurt information sector is showing some life. Housing prices continue to rise and the commercial real estate market shows signs of improvement. The City had a deeper recession than the nation and, therefore, it has a longer path to recovery. But the City is poised to stay on pace in income, and perhaps even in employment, with the nation as a whole.

Income sensitive taxes like the personal income tax and the business taxes are already showing the effects of the recovery. At the time of writing, and correcting for various timing issues, February tax collections are already more than $250 million over the Preliminary Budget plan. In Fiscal 2004, the Council projects that total tax revenue will be $319 million over the estimate from the Office of Management and Budget (OMB) found in the Fiscal 2005 Preliminary Budget. For Fiscal 2005, total tax revenue is anticipated to be $581 million over OMB's estimate. For the rest of the plan period, the Council forecast remains above OMB, with differences increasing to $768 million in Fiscal 2006, $735 million in Fiscal 2007 and $840 million in Fiscal 2008.[a]

Déjà Vu: A Jobless Recovery

By most measures of income and output the nation's economy shows evidence of continued growth. In 2003, Gross Domestic Produce (GDP) grew at an annual rate of 3.1 percent. This growth accelerated in the second half of 2003. After posting a blistering growth rate of 8.2 percent in the third quarter, the national economy continued to grow at a respectable rate of 4.1 percent in the fourth quarter. The major components of GDP posted strong rates of growth. Personal consumption expenditure increased 2.7 percent, real non-residential investment grew 9.6 percent, business spending on equipment and software rose 15.1 percent, and real residential fixed investment grew 8.6 percent.

Table 1: Percent Change in GDP, 2003:Q1 – 2003:Q4

2003:Q1	2003:Q2	2003:Q3	2003:Q4
2.0%	3.1%	8.2%	4.1%

Source: Bureau of Labor Statistics

Council Finance is predicting that, in 2004, GDP will see its fastest rate of growth in 20 years, at 4.7 percent. Pre-tax corporate profits grew 12.8 percent in 2003 and are forecast to grow 13.9 percent in 2004. In addition, personal income increased by 3.2 percent in 2003 and is expected to grow 4.3 percent in 2004.

[a] *For details see Tables 7-9.*

But there is another side to the story. The striking thing about this recovery is the lack of jobs. Since February 2001, the US economy has lost 2.9 million private sector jobs. Recent months have seen growth in employment but at an anemic pace. In February 2004, the economy did not generate any private sector jobs (a total of 21,000 government jobs were generated). From November 2003 to February 2004, the private sector of the U.S. economy generated a total of 210,000 jobs.

Table 2: Monthly Change in Private Sector Jobs in US (SAR)

November	December	January	February
99,000	8,000	103,000	0

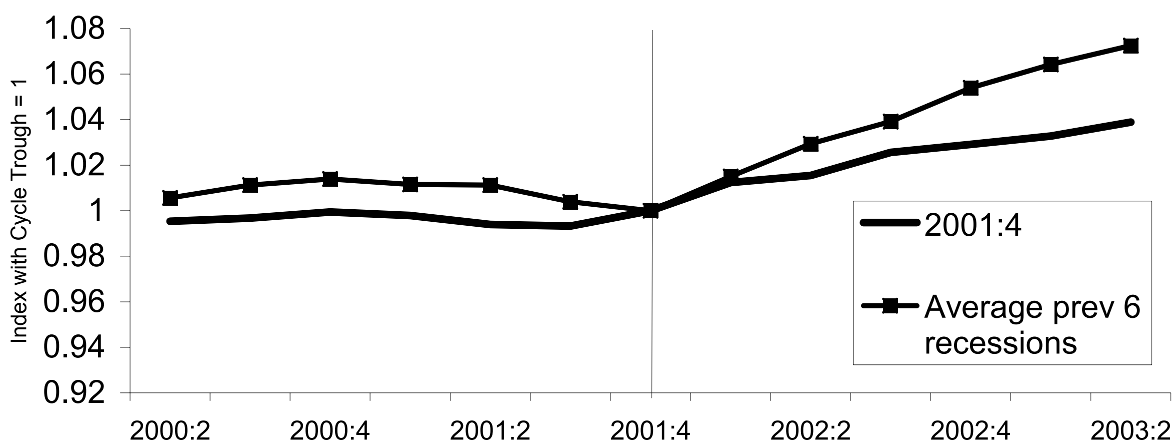
Source: Bureau of Labor Statistics

Thus, the national economy is generating jobs, but at an insufficient pace to absorb the growing U.S. labor force. The economy needs to add approximately 150,000 jobs a month just to keep up with the expanding size of the nation's labor force. Over the past four months, the average monthly private sector job increase has been only 52,500.

The question is how to read the prospects of rising income combined with stagnant employment. Apparently, businesses are extracting expanded output from the existing workforce in an effort to keep unit labor costs down. Thus, what we're seeing is accelerated productivity growth combined with a rebound in corporate profitability. Eventually, this situation will translate into expanded investment and job growth, but the timing is uncertain.

Council Finance does a 'top down' forecast. We start with a national forecast from the econometrics firm Global Insight and use these national variables, and other information, to forecast the local economy. The national forecast cited here is based on Global Insight's January 2004 control forecast.

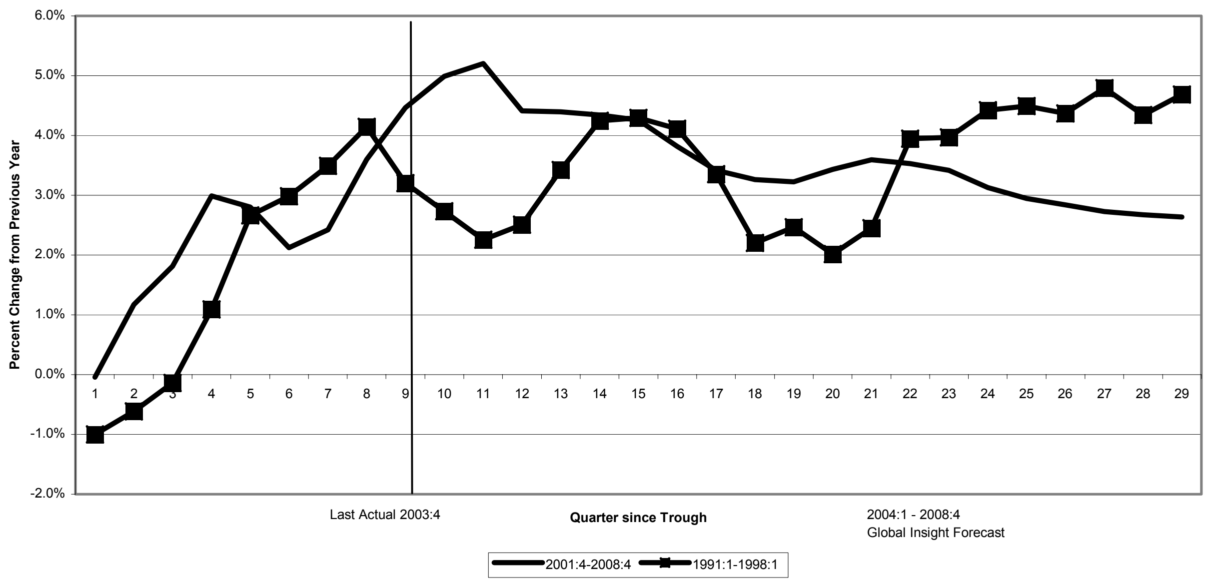
Figure 1: Real GDP - Compared With Six Previous Recessions



Source: National Bureau of Economic Research

Compared to the average recession and recovery since World War II, this one is atypical; the recession has been shallow and the recovery weak (Figure 1). But, compared to the 1990s recession, the prospects are more rosy (Figure 2). The current recovery is doing at least as well as 1991-1997, and Council Finance believes that it should do as well or slightly better throughout the forecast period.

Figure 2: Real GDP - Current Recovery Compared With the 1990s

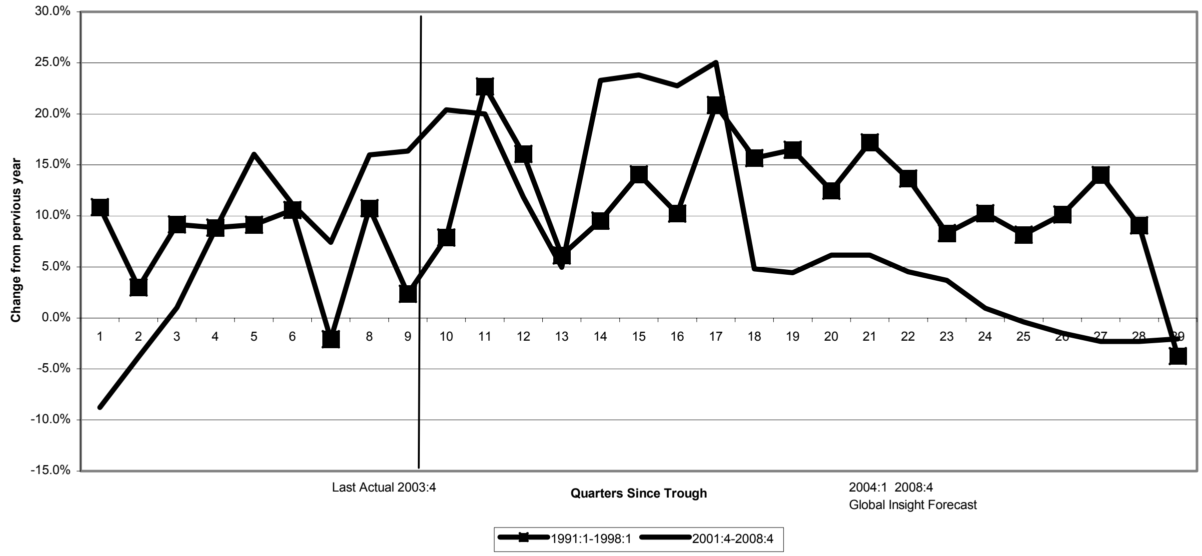


Sources: Council Finance, Global Insight, and Bureau of Economic Analysis

Figure 2 compares GDP growth for the early 1990s, starting with the economy's low point in the first quarter of 1991, with the current recovery, starting with the economy's low point in the fourth quarter of 2001. The last actual data point is for the fourth quarter of 2003, which is the ninth quarter of the current expansion. After this point the figure shows Council Finance's forecast of GDP into 2008. The two recoveries roughly resemble each other. The main difference is that Council Finance is expecting better growth in 2004 (10^{th} through the 13^{th} quarter of the expansion) than occurred in the same period of the last expansion.

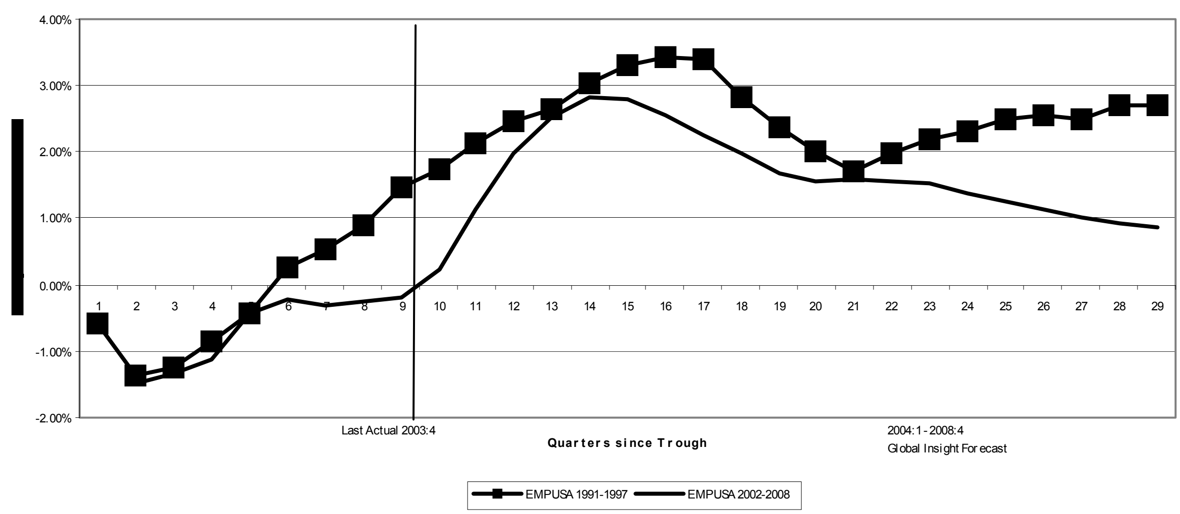
Pre-tax corporate profits are also following the 1990s pattern, and once again doing a little better than in the same period of the earlier recovery. In the current expansion, profits are powered by expanding demand and high productivity growth. This high productivity growth, combined with modest wage growth, has lowered unit labor costs by 1.2 percent in 2003 and increased profit margins.

Figure 3: Pre-Tax Corporate Profits - Current Recovery Compared With the 1990s



Sources: Council Finance, Global Insight, and Bureau of Economic Analysis (NIPA)

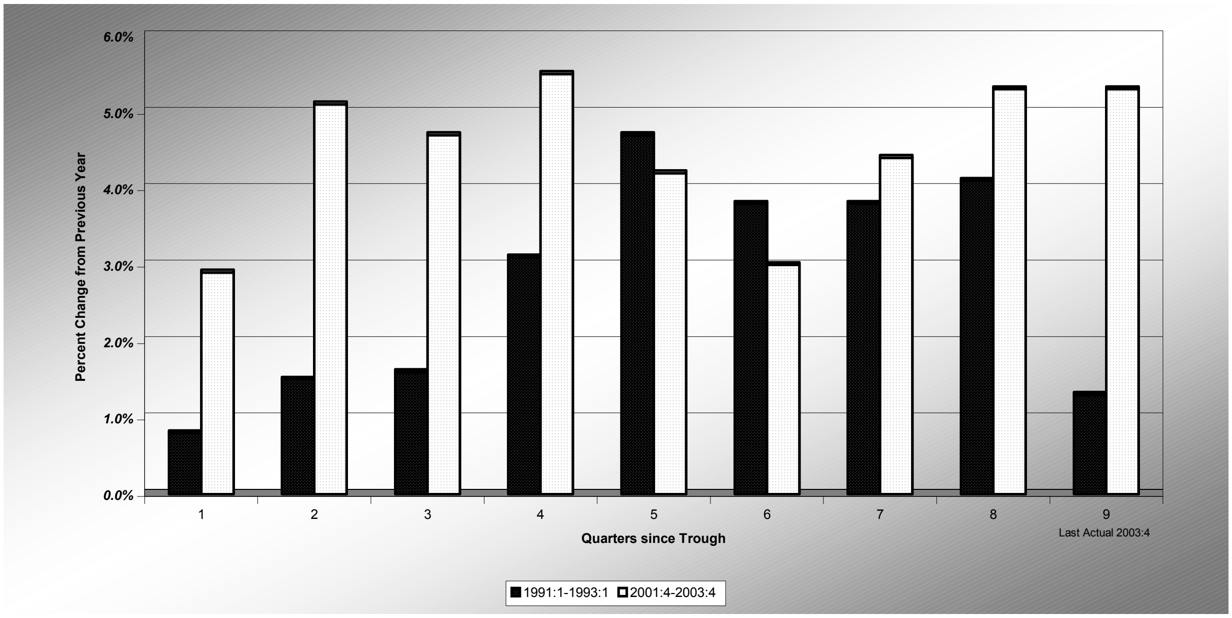
Figure 4: Total Non-Farm Employment - Current Recovery Compared With the 1990s



Sources: Council Finance, Global Insight, and Bureau of Labor Statistics

It is with total employment that the current expansion deviates from the experience of the early 1990s. Calendar year 2003 (quarters 6 to 9 in Figure 4) is especially different from its early 1990s equivalent. Looking back to Figure 2, GDP grew a little faster in the spring and summer of 1992 than it did in the spring of 2003. The main story is productivity growth (Figure 5).

Figure 5: Business Sector Productivity - Current Recovery Compared With the 1990s



Source: Bureau of Economic Analysis

Productivity growth is stronger in this recovery than in the 1990s, especially in quarters 8 and 9 which correspond to the second half of 2003. The current rate of productivity growth is unlikely to continue. Last year, output per hour in the business sector grew 4.5 percent. This year, Council Finance expects a slower but still strong rate of growth of 3.6 percent, which will slow still further to 2.3 percent in 2005. With productivity growth below the growth of output, we will see net job creation.

So, in terms of GDP and profits growth, we are in a pattern similar to the early 1990s period. But because of strong productivity growth employment is lagging. It is an income driven, rather than employment driven recovery.

There are risks to the recovery. Because of the weak employment situation, profits have gained at the expense of labor. The increased profits have spurred investment, but the anemic wage and employment growth can weaken confidence both directly and indirectly through its effect on consumer confidence. This could set off a vicious cycle of falling demand, decreasing output and employment, which in turn decreases investment and consumption. In such a scenario, other problems, such as consumer debt (see below), would become more severe. However, such a scenario remains unlikely with a probability of less than 25 percent.[b]

The City and the Nation

The City recession has been different from that of the nation as a whole because the boom affected the City differently than the nation. The boom lasted slightly longer in the City. But when the bursting of the stock market bubble and 9/11 set the recession in motion, it was deeper in the City.

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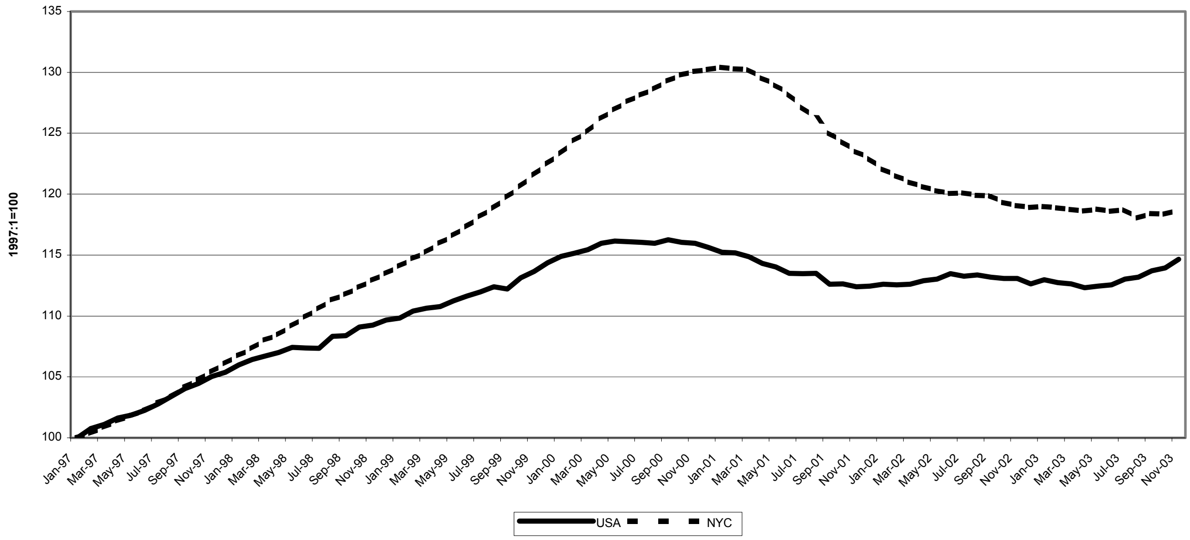
[b] *This is only slightly higher than the probability of a renewed boom. See the March Executive Forecast of Global Insight.*

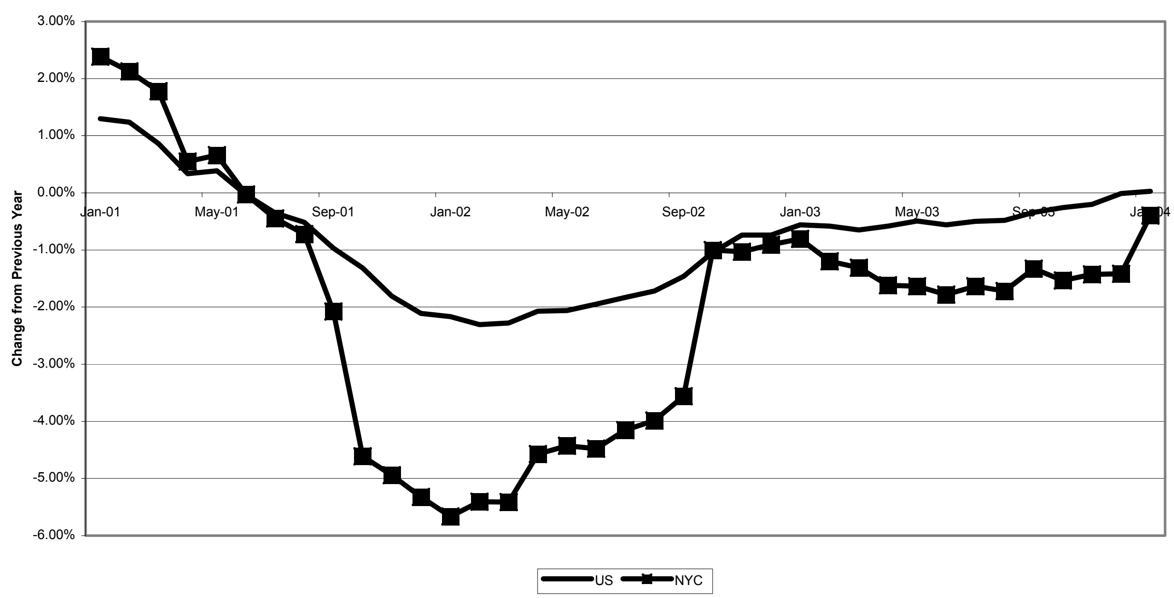
Figure 6: Index of Coincident Indicators - New York City and the US



Sources: National Bureau of Economic Research, Federal Reserve Bank of New York

The effect of 9/11 is clearly visible in the comparison between employment in New York City and the nation. Prior to 9/11 the City was following the national pattern. The attack significantly increased the depth of the City's problems. But as the recovery progresses, the City is increasingly returning to the national pattern.

Figure 7: Private Sector Employment - New York City and the US



Source: New York State Department of Labor, Bureau of Labor Statistics

The City: Déjà Vu, Too

As with the national economy, there is also strong evidence that New York City continues to be in an economic recovery phase. Data from the Securities Industry Association show that NYSE member firms recorded $3.0 billion of pre-tax profits during the third quarter of 2003. Although these results were 45 percent lower than the $5.4 billion achieved during the second quarter, as well as below the $3.5 billion posted during the first quarter of this year, they nonetheless exceeded profits registered in six of eight quarters in 2001 and 2002. Furthermore, the year-to-date total pre-tax profits reached $11.9 billion. With only one quarter to go in 2003, total pre-tax profits are already 72 percent ahead of last year's full-year total of $6.9 billion and 14 percent above 2001's full-year total of $10.4 billion. For the full-year, profits will most likely come very close to the $16.3 billion posted in 1999, thereby turning 2003 into one of the most profitable years ever.

Data recently released by the National Association of Purchasing Managers-New York indicate that the New York City economy has been expanding for the past six months. Its main gauge of current economic activity in New York City, the NY-Business Condition Index (BCI), increased for the sixth consecutive month, rising to 267.2 in February from 257.3 in January. From September 2003 to February 2004, the BCI jumped from 222.2 to 267.2, or 20 percent.

Table 3: NYC Business Conditions Index, Sept. – Feb. 2004

	September	October	November	December	January	February
NY- BCI	222.2	226.4	227.3	242.6	257.3	267.2

Source: National Association of Purchasing Managers – New York

Another measure partly reflecting the economic recovery currently taking place in New York City is the five-month continuous increase in consumer confidence. From a low of 70.1 recorded in September, the Siena College Overall Index of Consumer Confidence for New York City increased to 87.1 in January, an increase of 24 percent.

Table 4: Consumer Confidence Index for NYC, Sept. – Feb. 2004

	September	October	November	December	January	February
Overall	70.1	77.3	79.9	85.6	87.1	81.6
Current	68.2	76.9	79.2	85.6	87.1	78.1
Future	71.3	77.6	80.3	85.6	87.1	83.9

Source: Siena College Research Institute

However, New York City's economy still is failing to generate enough jobs to offset the job losses of the last three years. For example, from a peak of 3,254,600 private sector jobs in December 2000 to 3,019,500 in December 2003, the City's economy has experienced a continuous decline totaling 235,100 jobs. However, from August to January of 2004 the pace of this decline slowed considerably. For instance, while in August 2003 the City's private sector job count was down by 50,500 jobs compared to a year earlier, by January of 2004 the year-over-year monthly decline had slowed to only 11,700 jobs (Table 5).

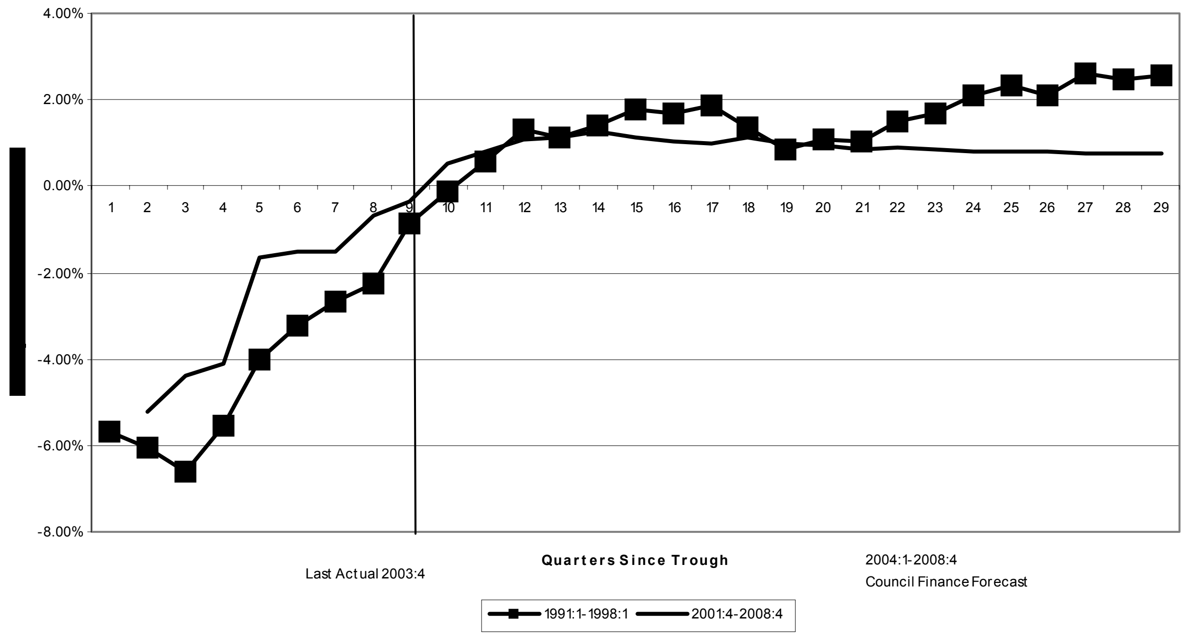
Table 5: Change in Private Sector Jobs in NYC, Year-Over-Year

August	September	October	November	December	January
-50,500	-39,300	-45,800	-43,000	-42,800	-11,700

Source: New York State Department of Labor

But this needs to be put into perspective, once again by comparing the current situation with the last recovery (see Figure 8). Overall we are on a similar path, which Council Finance believes will continue, though perhaps without the growth associated with the start of the financial market boom of 1997.

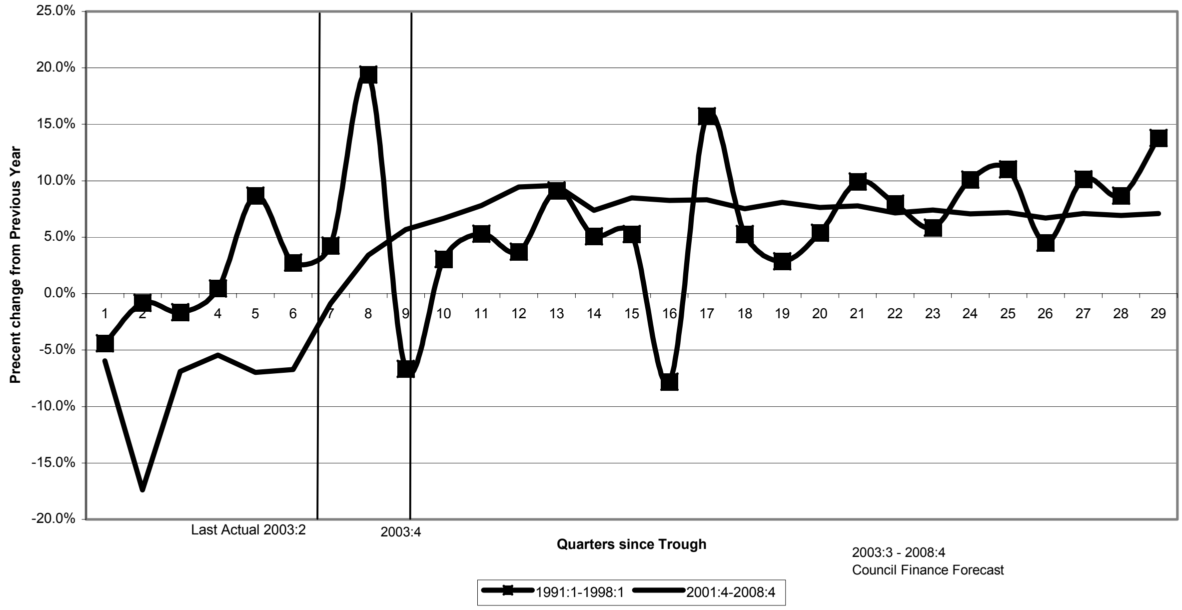
Figure 8: NYC Private Sector Employment - Current Recovery Compared With the 1990s



Sources: Council Finance, New York State Department of Labor

Private sector wages in New York City are heavily dependent on Wall Street and its year-end bonuses. Bonus income was especially hard hit in the recent recession. However, given Wall Street's recovery, Council Finance believes that this will change and solid growth will return in 2004 (Figure 9). There is already evidence of this. Withholdings for the personal income tax reflect the wages being paid to City residents. February's withholdings, corrected for changes in tax policy, were up 27 percent compared to the same time last year. This is a result of this year's strong Wall Street bonuses. For the fiscal year as a whole, withholdings are up 9.4 percent, once again corrected for changes in the tax laws.

Figure 9: NYC Total Private Sector Wages - Current Recovery Compared With the 1990s



Sources: Council Finance, New York State Department of Labor

In summary, Council Finance is seeing an economic recovery that is a bit stronger than the previous recovery over the next six quarters, comprising the remainder of Fiscal 2004 and Fiscal 2005.

Table 6: City Council Finance Division Economic Forecast

NATIONAL ECONOMY	CALENDAR 2004	CALENDAR 2005	CALENDAR 2006	CALENDAR 2007	CALENDAR 2008
Real Gross Domestic Product	4.7%	4.0%	3.4%	3.3%	2.7%
Consumer Price Index	1.4%	1.3%	1.5%	1.9%	2.1%
Unemployment Rate	5.7%	5.3%	5.3%	5.3%	5.4%
LOCAL ECONOMY					
Private Sector Employment Change from Prior year (000s)	40.0	48.1	48.9	43.5	23.3
Consumer Price Index	2.0%	1.6%	1.8%	2.2%	2.5%
Average Wage	6.1%	5.5%	5.5%	5.3%	5.3%
Personal Income	4.7%	4.9%	4.9%	5.0%	5.0%

The growth in income that we have already experienced will translate into increased employment starting in the second quarter of 2004. Council Finance's employment forecast is similar to OMB's Fiscal 2005 Preliminary Budget forecast but we are more optimistic about wages and income in the City. It is the greater income growth that contributes to our higher revenue projections.

Table 7: Council Finance Tax Revenue Forecast

($ IN MILLIONS)

	2004	2005	2006	2007	2008
Real Property	$11,335	$11,818	$12,361	$12,922	$13,579
Personal Income	5,426	5,618	5,745	5,872	6,228
General Corporation	1,513	1,672	1,781	1,900	1,979
Banking Corporation	273	325	433	356	390
Unincorporated Business	904	958	1,002	1,059	1,110
Sales	3,931	3,937	4,035	4,210	4,441
Commercial Rent	428	437	448	463	484
Real Property Transfer	469	467	487	507	527
Mortgage Recording	609	522	530	541	556
Utility	290	284	286	291	297
Hotel	206	226	246	260	286
All Other	1,290	1,264	1,266	1,285	1,319
Audits	545	506	506	506	506
Total Taxes	**$27,218**	**$28,034**	**$29,125**	**$30,172**	**$31,701**

Table 8: Council Finance Forecast Compared to the Preliminary Budget

($ IN MILLIONS, ABOVE / (BELOW) FISCAL 2005 PRELIMINARY BUDGET)

	2004	2005	2006	2007	2008
Real Property	$0	$9	$82	$124	$229
Personal Income	157	256	333	408	389
General Corporation	59	105	98	114	98
Banking Corporation	32	34	75	(47)	(37)
Unincorporated Business	24	32	36	53	66
Sales	19	50	59	36	45
Commercial Rent	8	7	7	7	14
Real Property Transfer	(10)	23	19	4	(8)
Mortgage Recording	37	63	52	30	18
Utility	(4)	6	8	7	13
Hotel	(3)	(4)	(1)	(1)	13
All Other	0	0	0	0	0
Audits	0	0	0	0	0
Total Taxes	**$319**	**$581**	**$768**	**$735**	**$840**

Table 9: Council Finance Tax Revenue Forecast Growth Rates

	2004	2005	2006	2007	2008
Real Property	14.0%	4.3%	4.6%	4.5%	5.1%
Personal Income	21.7%	3.5%	2.3%	2.2%	6.1%
General Corporation	22.3%	10.5%	6.5%	6.7%	4.2%
Banking Corporation	28.2%	19.0%	33.2%	-17.8%	9.6%
Unincorporated Business	8.6%	6.0%	4.6%	5.7%	4.8%
Sales	11.2%	0.2%	2.5%	4.3%	5.5%
Commercial Rent	7.7%	2.1%	2.6%	3.2%	4.6%
Real Property Transfer	-8.7%	-0.3%	4.3%	4.0%	3.9%
Mortgage Recording	15.8%	-14.3%	1.5%	2.1%	2.8%
Utility	-1.8%	-1.9%	0.6%	1.7%	2.1%
Hotel	7.1%	9.7%	8.7%	6.0%	9.9%
All Other	9.2%	-2.0%	.2%	1.5%	2.6%
Audits	-4.5%	-7.2%	0.0%	0.0%	0.0%
Total Taxes	**13.9%**	**3.0%**	**3.9%**	**3.6%**	**5.1%**

TAX FORECASTS

February Tax Collections

The strength of the economic recovery is reflected in year-to-date collections through February of the principal City taxes. OMB's Fiscal 2005 Preliminary Budget was issued in January, but as of February the collections for the fiscal year were already close to a half billion dollars over that plan (See Table 10). A portion of the difference from plan reflects timing in posting collections and other technical issues rather than the underlying strength in revenue from the tax. This is especially true of the real property tax and real property transfer tax. Taking this into account, we can conservatively estimate that revenues from the principal taxes are more then $250 million over plan as of February. The difference from plan was broad based with collections from all of the major taxes, except the real property transfer, hotel and utility taxes, at or above plan. It is important to note how well the income sensitive taxes - the personal income tax and the business taxes - are doing. Their combined collections are more than $217 million over plan. At the time of writing some of the February numbers are preliminary and thus may change.

Table 10: Fiscal 2004 Year-To-Date Tax Collections
(In Millions)

(+ Better / - Worse)	Compared to Preliminary Budget Estimates
Real Property	$201
Personal Income	$136
General Corporation	$35
Banking Corporation	$31
Unincorporated Business	$15
Sales	$35
Commercial Rent	$7
Real Property Transfer	$(19)
Mortgage Recording	$71
Utility	$(16)
Hotel	$(1.5)
Total Taxes	**$494.5**

Personal Income Tax

Council Finance's forecast of the personal income tax (PIT) for the current fiscal year is based on collections data through February and historical seasonal patterns in monthly collections. On this basis, the Council's forecast is higher than OMB's, by $157 million for Fiscal 2004. The forecast for the remainder of the plan period (Fiscal 2005 through 2008) incorporates projections of the local economy that are more optimistic than OMB, resulting in higher estimates of $256 million in Fiscal 2005 and $333 million in Fiscal 2006.

Personal income tax collections can be viewed as having two related components: a) income derived from the high wage financial sector, and b) income derived from the rest of the economy. The sources of divergence between Council Finance's and OMB's forecasts are differing assumptions concerning the recovery in the financial sector and timing of changes in the local economy. Council Finance anticipates a stronger rise in securities profits and faster growth in the local economy than OMB over the forecast period.

Different perspectives on the Wall Street recovery and the local economy are reflected in Council Finance's and OMB's forecasts of the various components of the PIT. Council Finance's forecast of withholding is based on its forecast of wage income and collections data through early March. Withholding, on a common rate and base, has increased about nine percent so far this fiscal year. Total withholding collections (including the tax increase), is expected to end Fiscal 2004 with a 16.3 percent increase over Fiscal 2003 and 2.8 percent growth in Fiscal 2005. Slightly higher growth, averaging 4.5 percent, is expected in Fiscal 2006 and the outyears, as the temporary rate increase phases out and the economy continues to pick up. OMB's forecast is for a growth rate of 12.2 percent in withholding for Fiscal 2004 and 3.1 percent in Fiscal 2005.

The estimated payments forecast is based on Council Finance's forecast of realized capital gains and New York City personal income. Both the Council and OMB expect similar increases in estimated payments, in the 39 percent to 42 percent range, in Fiscal 2004. During the remainder of the forecast period, Council Finance expects estimated payments to increase 4.3 percent in Fiscal 2005 followed by an average decline of 9.5 percent through Fiscal 2007, before increasing 7.4 percent in Fiscal 2008. OMB anticipates a 1.4 percent increase in Fiscal 2005 and with an average decline of 7.5 percent through Fiscal 2007, finally growing 7.2 percent in Fiscal 2008. From Fiscal 2004 to 2008, the Council expects $84 million more in estimated payments than projected by OMB.

Council Finance's forecasts of withholding and estimated payments are used to forecast other components of the PIT--final year returns and refunds. In Fiscal 2004, OMB anticipates a 1.4 percent decline in finals, while the Council anticipates a 32 percent increase. For Fiscal 2005, Council Finance anticipates 5.3 percent growth, while the Administration is predicting a large 40.7 percent increase. The result is a positive variance of $74 million combined for Fiscal 2004 and 2005. Over the forecast period, the net difference in final returns is the Council's expectation of $116 million more than projected by the Administration.

Income tax refunds are expected to decline and then stabilize as estimated payments and withholding better reflect taxpayers' previous years' liabilities. Council Finance and OMB differ in the drop and leveling off of refunds. In Fiscal 2004, the Council is projecting income tax refunds to decline 6.7 percent and OMB expects a 14.7 percent drop. Continued differences in the outyears result in Council Finance projecting $99.5 million more in refunds over the Fiscal 2004 through 2008 period.

The net PIT forecast also includes two other settlement components: 1) assessment payments from tax audits, and 2) State/City offsets or reconciliation of distributions between the State and the City.

Business Taxes

For Fiscal 2004, based on collections information through February and business activity in the first quarter of the calendar year, Council Finance projects that business tax collections, in total, will be higher than the January Plan targets by $115 million. This year will mark the first year of positive growth in the business taxes after two years of steep decline. As it stands, at Council's current projected targets, total business tax collections will be about $388 million above the targets at the time of budget adoption last June.

These estimates for the remainder of the current fiscal year are based primarily on taxes already collected as well as on known information on securities industry incomes—the prime predictor of business tax collections. Should the industry add an additional billion dollars or so in profits - $3 billion is expected in the fourth quarter and at least that amount in the first quarter of 2004 - the City could experience a large windfall in Fiscal 2004.

For the year-to-date it is estimated that collections are already more than $80 million above plan and more than 30 percent higher than the same period in Fiscal 2003. Council Finance's forecast assumes that the current surplus will, essentially, hold for the remainder of the year, ending the year $115 above plan. The GCT is predicted to end the year 22 percent higher than last year. The bank tax will rebound sharply by 28 percent and UBT collections will pick up slightly, ending the year with nine percent growth.

With total revenue in the securities sector more than doubling in calendar year 2003, and Council Finance projections for at least another $15 billion profits for the coming year, business tax collections should continue to expand—by 10 percent—in Fiscal 2005.

Council Finance's projected surplus of nearly $171 million in Fiscal 2005 is primarily due to higher levels projected in Fiscal 2004 but also due to higher expected growth rates in Fiscal 2005. The higher growth rates, in turn reflect Council Finance's expectation of higher securities industry profits: OMB is forecasting a decline in securities industry profits to $12 billion in calendar year 2004. In contrast, with a recovery in incomes in full swing by mid-year, the Council is expecting business incomes to be growing at rates near their historical trend growth rates. The GCT leads the way, growing 11 percent, while the relatively smoothly growing UBT rises six percent.

The volatile banking corporation tax (BCT) is projected to grow 19 percent in Fiscal 2005. New York based banks are still working off overpayments from previous years and the costs of mergers and other financial reorganizations have reduced banks' taxable profits. We can expect to see accelerated growth rates in bank tax collections through Fiscal 2006. The low collections levels in the past two years have triggered expanded audit procedures, which should also produce additional revenue in the current fiscal year.

The differences between forecasts carry through to similar variances in the outyears of the plan period, even though Council Finance and OMB's projected growth rates converge--to approximately eight percent in Fiscal 2006. By Fiscal 2007, collections for the three business taxes, combined, surpass the previous peak levels recorded in Fiscal 2001.

Sales Tax

In Fiscal 2004, Council Finance is forecasting 11.2 percent growth and $18.6 million more in sales tax revenue than OMB's Preliminary Budget forecast. In its Preliminary Budget, OMB left its sales tax forecast unchanged relative to the November Plan, though November's estimate was $41 million greater than the estimate when the budget was adopted in June. However, collections have exhibited a robust 11.3 percent growth through the first eight months of the current fiscal year. Advance monthly sales for retail trade and food services in February were up 0.6 percent over the previous month but 7.9 percent greater than February a year earlier. In addition, the Federal Reserve Board's Beige Book March issue reports strong sales in New York City, particularly in spring apparel and related items.

Council Finance's optimistic Fiscal 2004 forecast is largely due to a strengthening economy, a temporary sales tax surcharge, and Albany's repeal of a sales tax exemption on clothing and footwear under $110. A one-eighth percent increase in the sales tax rate, from 4.0 percent to 4.125 percent, was imposed by Albany towards the end of Fiscal 2003, effective June 4, 2003 through May 31, 2005. This was in addition to Albany's repeal of the sales tax exemption on clothing and footwear under $110, effective June 1, 2003 until May 31, 2004. When adjustments for these legislative changes are factored in, growth in Fiscal 2004 is forecast at a healthy 3.6 percent.

Still, a note of caution is in order. The most recent Federal Reserve report, issued on February 27, places the household debt service ratio at 13.1 percent. The financial obligations ratio, a broader measure than the debt service ratio, is reported at 18.3 percent. Both are at historical highs though the debt service ratio is slightly lower than in the Reserve's previous report. In addition, consumer credit increased at an annual rate of 8.5 percent in January, up from 3.8 percent in the fourth quarter. The January increase was due to both revolving and non-revolving credit. Of these three, the debt service ratio is the best measure for assessing the extent of American household indebtedness and for reviewing the financial health of the overall consumer sector. It measures the portion of income committed by households to paying interest and principal on their debt. When this ratio is high, households have less money available to purchase goods and services. As a result, households with a high debt service ratio are more likely to default on their obligations when they suffer adversity, such as job loss or illness.

Both the debt service ratio and the financial obligations ratio rose over the 1990s and, though historically high, have remained essentially flat over the last two years. However, in evaluating household debt burdens, debt-to-income ratios, which have been rising for over 50 years, must also be considered. But with household assets rising as well, the ratio of net worth to income is currently higher than its long-run average, thereby offsetting heavy debt service ratios. This is certainly true of the City. The market value of one-, two- and three-family homes as well as cooperatives and condominiums has risen in excess of 20 percent over the market value of the Fiscal 2004 final assessment roll, as reported in the Fiscal 2005 tentative assessment roll. When historically low interest rates and the continued, though slowing, mortgage refinancing such low interest rates have generated are included, it is expected that households can manage their debt without curtailing their consumption.

Council Finance estimates revenue in excess of $50 million over OMB's forecast for Fiscal 2005. Growth is 0.2 percent, reflecting the re-instatement of the clothing and footwear sales tax exemption. Because of Council action, the exemption on clothing and footwear under $110 will return on June 1, 2004, the earliest date permitted by law. Adjusting for this effect, growth is forecast at 5.2 percent in Fiscal 2005. This increase relative to Fiscal 2004 reflects the influence of the continuing national recovery (growth of 4.7 percent in real terms is expected) and a less responsive local economy. The trend is moderate growth rather than vigorous demand because, while income is up, job generation is modest.

In Fiscal 2006, growth is forecast at 2.5 percent. This low growth rate is largely due to the phasing out of the 1/8 percent rate increase, effective May 31, 2005. In the outyears, as the national and local economies gain momentum, Council Finance expects growth to return to trend, averaging 4.9 percent yearly, and cumulative collections to exceed OMB by $80.9 million.

Utility Tax

Utility tax collections of $290 million are forecast for Fiscal 2004, $4 million less than OMB's Preliminary Budget forecast. This tax is significantly influenced by the vagaries of the oil and gas industries. The price of crude oil reached $37.04 a barrel on March 11th while natural gas prices reached a record high in calendar year 2003, averaging $5.40 per million British thermal units ($/MMBtu), and closing on the New York Mercantile Exchange on March 11th at $5.63 $/MMBtu. These prices reflect increased demand for energy in 2003, particularly in the fourth quarter. The upward pressure on prices due to increased demand was further exacerbated by a relatively weak dollar and geopolitical uncertainty in the Middle East, where the majority of the OPEC cartel's 11 member states are located, in addition to internal problems in Iraq and Venezuela. At its February 10th meeting in Algiers, the cartel, which provides two-fifths of the world's oil supply, decided to lower output by 1 million barrels daily, effective April 1, 2004. This move is an attempt to reduce a projected significant oil surplus in the seasonally low demand second quarter. OPEC's preferred price band for crude is $22-$28 a barrel. Despite the proposed four percent drop in output, the currently high oil prices will be unsustainable as spring and summer weather reduces demand, resulting in a 1.8 percent decline in utility tax collections in Fiscal 2004.

In Fiscal 2005, prices are expected to drop further as world oil supplies stabilize. Council Finance forecasts $6.4 million more in utility tax revenue than OMB. In the outyears, as the world economy is forecast to exceed 3 percent annual growth, increased demand will exert upward pressure on energy prices resulting in a 1.5 percent average annual growth with cumulative collections $28.1 million greater than OMB.

Hotel Tax

Council Finance predicts $206 million in hotel tax collections in Fiscal 2004, representing an increase of 7.1 percent from the previous year. This is $3 million lower than OMB's estunate. The hotel industry is experiencing a relatively weak recovery from the devastation of the 9/11 attack and the recent recession. Occupancy rates, 67.1 percent in January 2004, have recovered to their pre-9/11 level, but average daily room rates still lag behind their peak of $256 prior to the attack. Nonetheless, recovery is expected to continue, albeit slowly. As business and tourist travel are strongly correlated to income, the robust 4.7 percent growth in the national GDP expected in calendar year 2004 will boost domestic travel to the City. The number of both day-trippers and overnight visitors are expected to increase. In addition, growth in excess of 3 percent is forecast for the world economy over the next four years thereby adding to the volume of international visitors. Unfortunately, the continuing fallout from persistent geopolitical volatility mutes the growth in international travel. Nonetheless, a rising ratio of foreign to domestic visitors is crucial to the health of the hotel industry as foreign visitors generally spend more than domestic visitors.

Revenue in Fiscal 2005 is estimated at $226 million, growing 9.7 percent from Fiscal 2004 but lower than OMB's 10 percent growth rate and $4 million lower than OMB's estimate for the year. This slower growth relative to OMB reflects the slow return to robust foreign tourist activity. In the outyears, with the national and local economies picking up momentum, growth at an average annual rate of 8.2 percent is expected, as tourism and business travel return to more normal levels.

Real Estate and Related Taxes

Real Estate Tax Levy

Like any tax, the size of the real estate tax levy depends upon the rate charged and the tax base. For the real property tax, the base is the billable assessed value (BAV) of all taxable real property in the City. On November 25, 2002, the Council and the Mayor agreed to increase the average tax rate by 18.49 percent to $12.283, effective for the second half of Fiscal 2003. The Fiscal 2003 levy increased by 15.3 percent over Fiscal 2002; 9.25 percent of the increase was due to the tax rate increase and almost 6 percent to the increase in the BAV. In Fiscal 2004, the average tax rate of $12.283 was maintained, and the tax levy increased by 14.6 percent over Fiscal 2003. Like last year, 9.25 percent of the growth was due to the rate increase and nearly 6 percent to the growth in the BAV.

Both OMB and Council Finance base their forecasts of the levy for the plan period on the current average tax rate: changes in the levy will be based on any growth in the BAV.

The size and growth of the BAV is conditioned both by the amount of and changes in the market value of taxable real property in the City. The changes in the market value of real estate have been remarkable in recent years, growing at an average annual rate of 8.45 percent for the past five years (Fiscal 2000 through 2004). However, market value growth on the Fiscal 2005 Tentative Roll of Taxable Real Property released by the Department of Finance (DOF) on January 15th, showed unprecedented growth of 17.2 percent from Fiscal 2004. Some of the increase in market value growth is attributable to changes in DOF's assumptions and techniques used in the assessment computer models.[c]

The BAV reflects economic conditions with a considerable lag. Assessed value is calculated using information on comparable sales (Class 1) or property income and expenses (Classes 2 and 4) that is one to three years old. Because of the caps on assessment increases for Class 1 properties, much of the recent growth in that class's market value (averaging 11.4 percent a year from Fiscal 2000 to 2004) will not be captured on the assessment rolls.[d] The market value of Class 1 properties has shown the strongest growth of the four property tax classes over the past several years, increasing by an historical high of 21.7 percent on the tentative assessment roll.

For properties in Classes 2 and 4, changes in assessed value are phased in over five years. From Fiscal 2000 through 2004, market value growth has averaged 7.5 percent a year for Class 2 properties and 5.5 percent for Class 4. Therefore, the growth of recent years has left a considerable pipeline of increases that will have an impact during our forecast period and offset somewhat any slowdown in market value growth. On the tentative roll, market values for Class

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[c] *At the time of the release of the tentative roll, DOF (with the Department of Investigation) also released the Joint Task Force Charged with Eliminating Corruption in the Department of Finance's Real Property Assessment Unit, Final Report. In this report, DOF outlined changes in the assessment process already in place as well as recommendations for future improvements in the assessment process and suggested legislative changes in the real property tax law.*

[d] *Class 1 assessment increases are subject to a six percent annual cap and may not exceed 20 percent over five years. Increases in assessments of Class 2 small properties with less than 11 units are capped at eight percent a year and 30 percent over five years.*

2 properties shot up by 21.2 percent in Fiscal 2005, after an increase of only 3.6 percent in Fiscal 2004. Some of the increase in market values, especially for rental properties and condominiums (which rose by 28.3 percent and 20.2 percent, respectively) may be revised downward on the final roll. Market values of Class 4 commercial and hotel properties have rebounded since the attack on the World Trade Center in 2001. In Fiscal 2005 the market value growth for Class 4 real estate rose by 7.3 percent, a return to the average pre-9/11 growth in Fiscal 2001 and 2002. In addition, some of the increase in value for Classes 2 and 4 was due to the improved assessment procedures implemented by the Department of Finance in response to the recent bribery scandal that involved most of Manhattan's tax assessors who artificially lowered the assessments on more than 500 properties over a period of several years.

The BAV on the final assessment roll for Fiscal 2004 was $99.602 billion, but on the tentative assessment roll for Fiscal 2005, the BAV broke the $100 billion barrier for the first time, rising to $105.453 billion.[e] Actions by the Tax Commission and the Department of Finance generally produce a final BAV lower than the tentative one. In the Preliminary Budget, OMB estimates that the BAV on the final roll will be nearly $0.9 billion lower than the tentative roll for a total of $104.550 billion and a growth of 5.0 percent from Fiscal 2004. Based on their estimate of the final BAV for Fiscal 2005, OMB projects a real property tax levy of $12.857 billion. Council Finance estimates a final BAV of $104.624 billion, yielding a levy of $12.866 billion that is $9 million more than OMB's projection.

Council Finance estimates that the BAV will increase by 5.1 percent in Fiscal 2005. The growth in the BAV is forecast to slowdown only slightly for the remainder of the plan period: to 4.8 percent in Fiscal 2006, with an average annual growth of 4.7 percent from Fiscal 2006 through 2008. The mild improvement in the City's economy and pick-up in private sector employment will continue to keep growth in the BAV fairly solid for the plan period, bolstered by the pipeline effect discussed above.

In the outyears of the plan period, Council Finance forecasts levies of $13.482 billion in Fiscal 2006, and $14.086 billion and $14.778 billion in Fiscal 2007 and 2008, respectively. (The levy's growth rates are the same as those of the BAV--an average of 4.7 percent a year from Fiscal 2006 through 2008.) These projections are $82 million more than OMB's forecast of the levy in Fiscal 2006, and $124 million and $229 million more in Fiscal 2007 and 2008, respectively. OMB forecasts a much sharper decline in market values for Classes 2 and 4 in Fiscal 2006, of 1.5 percent and 2.5 percent, respectively. Growth in market value is anticipated to rise by only 1.8 percent a year for Class 2 and 2.8 percent for Class 4 from Fiscal 2006 through 2008. OMB may revise upward these market value assumptions in the Executive Budget after they take into account the sharp increases in market value on the tentative assessment roll.

In order to reward all taxpayers who helped the City out with its fiscal problems for the last two years by paying property taxes based on an 18.49 percent increase in the property tax rate, the Council has proposed reducing the average tax rate by two percent beginning in Fiscal 2005. A discussion of this initiative, its policy and fiscal implications, is contained in Part I of the response.

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[e] *The School Tax Relief or STAR exempt BAV has been included in both the tentative and final rolls throughout this discussion, while the BAV does not include the veteran's taxable BAV.*

OTHER REAL ESTATE TAXES

Mortgage Recording Tax

The mortgage recording tax (MRT) has had remarkable collections in recent years, growing by an annual average of 20.6 percent for the last five years from Fiscal 1999 to 2003 due to a robust real estate market. Growth in revenue reached its peak of 75.9 percent in Fiscal 1999. In Fiscal 2003 collections increased by 10.4 percent to the highest historical level of $526 million, primarily as a result of a strong housing market and residential refinancing, following a 17.3 percent increase in Fiscal 2002. Strength in the residential market and refinancings has continued beyond what both OMB and Council Finance forecast in November, resulting in substantial upward revisions in both forecasts for the plan period.

In the Preliminary Budget, OMB forecast that the MRT would increase by 8.7 percent in Fiscal 2004 to $572 million, an increase of $71 million from November and $193 million since the budget was adopted in June. But year-to-date collections through February are already $71 million over plan. Council Finance increased its estimate by $97 million from November, to a total of $609 million, or $37 million above OMB. Recent statistics show that housing prices remain strong and mortgage rates continue at historic lows. According to the Office of Federal Housing Enterprise Oversight (OFHEO) quarterly house price index released on March 1, home prices in the New York metropolitan area (MSE) rose 9.8 percent in the fourth quarter of 2003 when compared to the same quarter last year. For all of 2003, home prices are up 9.1 percent. The average rate on a 30-year, fixed-rate mortgage was 5.41 percent for the week ended March 12, according to Freddie Mac, while the rates for the 15-year, fixed-rate mortgage, a popular option for refinancing, averaged 4.69 percent.

In Fiscal 2005, both OMB and Council Finance forecast a decrease in revenue followed by a mild recovery in Fiscal 2006. Some of the factors that will be damping growth in collections include increases in interest rates that may occur by the end of calendar year 2004 slowing down refinancings, and the continuing high purchase prices of homes making them less affordable for many New York City residents. Council Finance forecasts that revenue will fall by 14.3 percent in Fiscal 2005 compared with OMB's projected decrease of 19.8 percent. Council Finance expects that interest rates will experience less of a rise than OMB, which accounts for some of the difference in the forecasts. In Fiscal 2006, Council Finance anticipates that revenue will only grow by 1.5 percent, while OMB forecasts a strong rebound in growth of 4.1 percent. However OMB's forecast results in a total of $478 million, which is lower than the Council's level of $530 million. In Fiscal 2006 through 2008 both Council Finance and OMB anticipate that the City's economy will experience stronger growth: Council Finance projects that revenue from the MRT will increase at an average annual rate of 2.1 percent compared with OMB's forecast of 5.4 percent, and collection levels will be slightly above OMB's estimates.

Real Property Transfer Tax

The real property transfer tax (RPTT) also saw remarkable growth, expanding at an historically high rate of 47.5 percent in Fiscal 1999. Growth averaged 14.0 percent a year from Fiscal 1999 through 2003. Unlike the MRT, strength in commercial real estate transactions has been driving growth in the RPTT. In Fiscal 2003, RPTT revenue reached a historically high level of $513 million, increasing by more than 20 percent from Fiscal 2002. However, collections were bolstered by sales of large "trophy" buildings. With the decline in large commercial transactions and the slowdown in the commercial real estate market, both Council Finance and OMB forecast a decrease in collections in Fiscal 2004, of 8.7 percent and 6.6 percent, respectively. The Council forecasts revenue from the RPTT will total $469 million, $10 million less than OMB. Year-to-date collections through February are $19.1 million below OMB's plan. However, administrative delays in posting cash receipts make current cash collections appear lower than they may actually be. In an attempt to correct for this, OMB's plan includes a negative net accrual of $13.8 million, consisting of $41.2 million accrued to Fiscal 2003 and an estimated $27.4 million accrued from Fiscal 2005 into 2004.

In Fiscal 2005, Council Finance expects that collections from the RPTT will decline slightly, by 0.3 percent, compared with OMB's projected decrease of 7.3 percent, because of Council Finance's view that the commercial real estate market will recover earlier and that interest rates will remain slightly lower than OMB's forecast. Both OMB and Council Finance forecast a return to growth in Fiscal 2006, but the Council expects that the increase in the tax revenue will be somewhat lower. From Fiscal 2006 through 2008, growth in the RPTT will average 4.1 percent compared with OMB's forecast of 6.4 percent.

Commercial Rent Tax

In Fiscal 2004, Council Finance projects that revenue from the commercial rent tax (CRT) will total $428 million, exceeding OMB's Preliminary Budget estimate by $8 million, for a growth of 7.7 percent from Fiscal 2003. As of February, year-to-date commercial rent tax (CRT) collections for Fiscal 2004 are $6.6 million above OMB's plan. Growth in revenue will abate somewhat in Fiscal 2005, increasing by 2.2 percent compared with OMB's growth of 2.4 percent.

Like real estate prices, commercial rents in Manhattan have shown remarkable growth in the past few years until the recent slowdown in the economy. Like the nation, however, the City is still waiting for meaningful change in its employment picture. Stronger job growth will be needed to sustain the fledgling economic recovery currently underway. Although not especially bad from the tenant's perspective, the office market will continue to be soft until more robust job creation translates into stronger demand for office space. The Manhattan primary office market vacancy rate declined to 11.6 percent in the 4th quarter of 2003, from an average of 12.4 percent in the second and third quarters of the year. However, a great deal of sublease space remains unused and new or rehabilitated office space will be available in 2004. Average asking rents in Manhattan are increasing slightly, though still below last year's levels. But even with these negative indicators, the Manhattan commercial market continues to remain one of the strongest markets in the country. As the economy eventually gains momentum over the coming months, employment growth will improve and demand for office space will increase.

Council Finance forecasts an average annual growth in the CRT of 3.45 percent from Fiscal 2006 through 2008 that is slightly above OMB's forecast of 3.0 percent. As the City's economy recovers and employment in the financial sector increases, growth in collections will return to the historical trend.

Forecasting the CRT is difficult because so much of the tax base has been reduced by legislative actions. The current effective tax rate is 3.9 percent, down from 6.0 percent. A substantial number of businesses are exempt from paying the tax. As of Fiscal 2002, only tenants with base rents over $250,000 located in Manhattan south of 96th Street pay the CRT. In addition, businesses with rents between $250,000 and $300,000 pay a reduced tax on a sliding scale. The Commercial Revitalization Program for Lower Manhattan also includes a CRT reduction for eligible tenants.

Table 11: Fiscal 2005 Preliminary Budget Economic Forecast

NATIONAL ECONOMY	CALENDAR 2004	CALENDAR 2005	CALENDAR 2006	CALENDAR 2007	CALENDAR 2008
Real Gross Domestic Product	4.7%	3.8%	3.3%	3.3%	2.8%
Consumer Price Index	1.7%	1.6%	1.7%	2.1%	2.2%
Unemployment Rate	5.7%	5.4%	5.5%	5.5%	5.7%
LOCAL ECONOMY					
Non-agricultural Employment Change from prior year (000s)	39.9	51.3	30.7	45.1	34.8
Consumer Price Index	2.4%	1.8%	2.0%	2.4%	2.5%
Average Wage	4.5%	3.9%	4.3%	4.5%	4.4%
Personal Income	5.3%	4.9%	5.3%	5.8%	5.5%

Source: Office of Management and Budget.

Table 12: Fiscal 2005 Preliminary Budget Tax Revenue Forecast
(Levels and Change from the November Plan, In millions)

(+Better/-Worse)	2004	2005	2006	2007	2008
Tax Revenue					
Real Property	$11,335	$11,809	$12.278	$12,798	$13,350
(Change)	18	188	232	307	NA
Personal Income	5,123	4,387	4,434	4,484	4,850
(Change)	(27)	(1)	(28)	(49)	NA
General Corporation	1,454	1,567	1,683	1,786	1,881
(Change)	63	130	142	182	NA
Banking Corporation	241	291	358	403	427
(Change)	30	(40)	(27)	(24)	NA
Unincorporated Business	880	926	966	1,006	1,044
(Change)	10	10	15	0	NA
Sales	3,912	3,887	3,976	4,174	4.398
(Change)	0	0	0	(15)	NA
Commercial Rent	420	430	441	456	470
(Change)	13	13	14	14	NA
Real Property Transfer	479	444	468	503	535
(Change)	50	20	16	12	NA
Mortgage Recording	572	459	478	511	538
(Change)	71	78	75	75	NA
Utility	294	278	278	284	284
(Change)	0	0	0	0	NA
All Other	821	778	791	776	786
(Change)	20	(29)	(35)	(25)	NA
Taxes Excluding Audits	**$25,531**	**$25,256**	**$26,151**	**$27,181**	**$28,561**
(Change)	**248**	**369**	**405**	**477**	**NA**
Tax Audits	545	506	506	506	506
(Change)	20	1	1	1	NA
Tax Revenue PEGS	0	2	3	3	3
(Change)	(21)	1	1	2	NA
Tax Program / Other Initiatives	$0	($250)	($259)	($263)	($267)
(Change)	44	(205)	(212)	(215)	NA
STaR Aid	677	715	722	770	806
(Change)	24	39	9	34	NA
Total Taxes After Reduction	**$26,753**	**$26,229**	**$27,122**	**$28,197**	**$29,609**
(Change)	**315**	**204**	**204**	**298**	**NA**