New York, New Jersey, Connecticut, Delaware, and the Philadelphia Region

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Local governments from Second (New York, Northern New Jersey and Fairfield County, Connecticut) and Third (Eastern Pennsylvania, Southern New Jersey and Delaware) Federal Reserve District States are highly dependent on 1) state aid derived from personal income and sales taxes, 2) capital gains on asset valuations generated from the Financial, Insurance, and Real Estate (FIRE) industries, and 3) local property tax revenue.[1]

Sales tax and intergovernmental aid supported by personal income taxes and employment, and property taxes generated from the value of the property tax base are revenues most vulnerable to the economic downturn, housing market decline and financial crisis. The tax drain on both states and municipalities that depend on these revenues to fund operating expenses will continue to worsen as business activity, retail sales and employment weaken.

Increased foreclosures and decreased home values will create cash flow problems for localities, as property taxes go unpaid. Relative to national positions, localities in Federal Reserve Districts 2 and 3 are within close proximity to Wall Street. As bonuses and corporation and real estate taxes continue to decline, lower income taxes paid by fewer workers, and lower sales taxes from fewer purchases made by residents, will further reduce local government coffers.

Federal Reserve District #2

1. **New York State**

Real property taxes (43.7%) followed by state aid (23.9%) and sales tax revenues (12%) generate the majority of revenues raised by New York State's local governments.[2] Three major revenue sources are especially vulnerable to current economic conditions: 1) state aid, 2) sales tax and 3) real estate related revenues including property and mortgage taxes.

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[1] Delaware does not impose a sales tax

[2] Data represent Fiscal Year 2006. Office of the State Comptroller, 2008 Annual Report

State Aid: As an income-reliant state, New York State and localities are particularly vulnerable to declining income tax collections as a result of reduced financial sector bonuses, increases in financial sector unemployment and falling capital gains. The finance sector provides 20% of New York State revenues.[3] While the nation's unemployment rate increased 3.08% from 6.5% to 6.7% in October 2008, New York State's unemployment rate increased 7.02%, from 5.7% to 6.1% during the same time period. As a result, income taxes have declined from July 2007 through September 2008 by 1.3%.

Sales Tax: New York localities and cities are the most reliant on sales tax revenues, and their relative dependence has increased over the last decade. Sales taxes are economically sensitive. For the period July 2007 through September 2008 sales taxes in the State have declined by 2.6% as a result of spending habit adjustments in response to the economy. Going forward, lower sales taxes from fewer purchases made by residents, will further reduce local government revenues. The majority of localities in New York State (43 out of the 57) have some form of sales tax sharing arrangement with other local governments within their boundaries. Five of these localities include school districts in their distributions. A number of localities earmark sales tax revenues for certain expenses such as Medicaid, capital projects and debt service.

Property and Mortgage Tax: Property tax collections in New York localities are especially sensitive to the weakening real estate market and could fall short of forecasts by FY 2012. One of eleven states that imposes mortgage fees on real estate transactions, end of year 2008 data show that revenues from mortgage tax collections in New York State localities have decreased by $1.92 million, or 5.2% from prior fiscal year 2007 receipts.[4] Since these receipts are subject to the volume and dollar amount of residential real estate transactions, they are particularly vulnerable to the financial crisis and economic downturn. According to the S&P/Case-Shiller Home Price Index, although home prices in the New York metropolitan area have fallen by 7.3% between September 2007 and September 2008, whereas the decline in a number of other metropolitan regions has exceeded 25%, the downward trend of home prices in the New York metropolitan area will continue into 2009.[5] The number of sales occurring in the first quarter (January–March) decreased in 2008 when compared to 2007 for every region of the State. The decrease was greatest in the downstate regions, with the number of sales decreasing 31 % below that of the first quarter of 2007. In addition to decreasing sales, the median sale price has declined in most areas as well.[6]

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[3] Bram, U., Orr, J., Rosen, Rae. (2008). Employment in New York-New Jersey Region: 2008 Review and Outlook. *Current Issues in Economics and Finance. Second District Highlights*. Federal Reserve Bank of New York, Volumes 14, Number 7, (September/October 2008)
[4] NYS Department of Tax Collection; US Census Data
[5] http://www.osc.state.ny.us/osdc/rpt8-2009.pdf
[6] http://www.osc.state.ny.us/localgov/datanstat/annreport/08annreport.pdf

2. **Northern New Jersey**

Although New Jersey possesses one of the strongest economic bases nationally, a slowing national economy and the deflation of the real estate bubble have weighed heavily on the state's economy which will impact New Jersey's localities. Similar to New York State, municipalities in New Jersey depend primarily on state aid (29.3%) and own source property taxes (38.7%).[7]

State Aid: The primary state source of local aid is the income tax, exposing New Jersey local residents to unemployment and income repercussions as a result of the current economic recession and financial crisis. The most significant short-term risk for New Jersey municipalities is the financial sector's volatility. Slow job growth is expected to continue in 2008, with employment once again increasing just 0.1% before picking up to 0.4% in 2009 and 0.9% in 2010 to close out the decade. Slower growth in wages and business investment will weaken sales and income taxes at the state level, spilling over to municipalities. Personal income is expected to decline to annual increases of 3.8% in 2008, 4.2% in 2009, and 4.7% in 2010 from the 5.8% recorded in 2007. Gross income tax (GIT) of $3.03 billion for the first six months of fiscal year 2008-2009 are 3.3% below last year's levels. The two most important components of the GIT prior to April final payments are quarterly estimated payments, primarily from taxpayers with significant non-wage income, and withholding, primarily from taxpayers with regular paychecks. Estimated payments and withholding are down 9.5% and 2.0% respectively. The expiration of the alternative minimum assessment and anticipated slowdown in corporate pre-tax profit growth will have a downward impact on corporation business taxes. The expansion of New Jersey's earned income tax credit (EITC) and weakening income growth rates will adversely impact state coffers directly, and municipalities indirectly.

Property Tax: Residents in New Jersey's localities rely heavily on property tax, paying the highest property tax in the nation. Property taxes are most sensitive to declines in home prices and foreclosures. Residential building permits have fallen to just 26,000 in mid-2007 from a 40,000-unit pace in 2005 and are projected to decline to less than 25,000 in 2008. Home prices, which fell significantly in 2007, are expected to continue that decline through 2008. The level of foreclosure activity in the state continued to intensify last month, showing a dramatic 75% increase over last year, even as the number of properties actually going to auction dropped off slightly. Foreclosure filings on 8,473 properties across the state were filed in October, with Essex, Bergen and Salem localities driving the activity, according to the latest data compiled by RealtyTrac, an online marketplace for foreclosed properties.

3. **Fairfield County, Connecticut**

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[7] Data derived from U.S. Census Bureau 2001-2002

Municipalities in Connecticut derive 39.1% of revenue from state aid and 45.6% from property tax. Connecticut municipalities are most vulnerable to 1) unemployment and 2) the decline in financial asset values in 2008, which will limit or reduce taxes collected on capital gains. Given that Connecticut's economy and wealth are heavily tied to the financial services and Fortune 500 companies centered in the greater New York City area, the financial crisis and slumping real estate market have had a significant impact on this part of the region.

State Aid: Recent devastation in the financial industry is already leading to lower tax collections from businesses, which will lead to lower taxes on bonuses and executive compensation and then spill over into the rest of the economy to other sources of tax collections including restaurant and retail industries. Connecticut's share of GDP in the Finance and Insurance industry in 2007 was 16.5% compared to the Nation's 8.1%. Tax revenues from the finance sector are particularly vulnerable as the number of residents without jobs increases and home sales decline. Such is the case in Daren, Connecticut where 27% of residents work in the financial industries, followed by Westport.

Real Estate Conveyance Tax: The municipal real estate conveyance tax is an important revenue source to localities in Fairfield County. Compared to the same period last year, the town's revenue from house sales is down by more than half. Darien has collected $209,000 from the conveyance tax since July 1, 2008 compared to $542,000 last year at this point. Real estate inventory is selling about 40% less this year compared to the same period last year. Regarding subprime mortgages, the Mortgage Bankers Association reports that, for first-quarter 2008, Connecticut ranked 24th highest of the 50 states in exposure to subprime mortgages, holding 11.0% of subprime loans and the 18th highest with respect to the percentage of subprime loans 90 days past due or in foreclosure--14.8%.

Federal Reserve District #3

4. **Eastern Pennsylvania**

Municipalities in Pennsylvania derive 21.2% of revenues from state aid, 12% from property taxes and 16.8% from income taxes. Pennsylvania has a flat income tax rate of 3.07%. The primary state source of local aid is the income tax, exposing Pennsylvania local residents to unemployment and income repercussion as a result of the financial crisis. However, broad-based flat income taxes, like those in Pennsylvania, do appear to be more stable, providing revenues that do not suffer declines as severe as other states during recessions.[8]

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[8] Bruce, Donald, William F. Fox and M.H. Tuttle. "Tax Base Elasticities: A Multi-State Analysis of Long-run and Short-run Dynamics." University of Tennessee, 2004, 20

State aid: The Pennsylvania Department of Revenue reports that as of December 2008 year to date sales tax receipts and personal income tax revenue are below estimate by 3.1% and 2.0%, respectively. General fund collections are below projections by $657.9 million, or 6.8% below estimates. Revenues associated with jobs in manufacturing and fees from building permits are most vulnerable to the economic slowdown for municipalities in Eastern Pennsylvania. The Federal Reserve of Philadelphia reports a 0.5 % decline in Pennsylvania's coincident index in October 2008 for the 10th consecutive month. Payroll employment and average hours worked in manufacturing have also declined. Pennsylvania's economic activity is down 3.7 % since October 2007, which is the worst 12-month data since 1992. As of July 2008, year-over-year employment figures reflect losses in manufacturing (2.5%), information (2.4%), construction (2.0%), and financial activities (1.0%). Education and health services employment grew by 1.9%, followed by professional and business services at 1.3% and leisure and hospitality at 1.2%. U.S. Bureau of Labor Statistics unemployment figures for August place unemployment at 5.8%, a significant increase from last year but still below the nation's 6.1%. Going forward, the prospective decline in consumption spending will limit or reduce state tax collections.
Property Tax: Since Pennsylvania municipalities had not seen as high a rate of housing appreciation as other parts of the nation, a somewhat milder housing market correction is taking place. The State's exposure to the housing crisis is more closely tied to lost construction employment and financial services activity than home value declines. On a quarter-to-quarter basis, the house price indexes for Pennsylvania declined in the third quarter, although less than the national drop and experienced a year-to-year decline. The Federal Housing Finance Agency reported that the U.S. all-transactions home price index (HPI), which includes both purchase prices and refinancing appraisal prices, declined 2.7% in the third quarter of 2008 from the second quarter. In the third quarter, the HPI decreased 1.5% in Pennsylvania. The national year-to-year decrease in the third quarter was 4.0%, the largest year-to-year decline in the history of the index, which goes back to 1975. The year-to-year decrease in Pennsylvania (0.6) was less than the national decline. Over the past 12 months, more metropolitan areas in the three-state Federal Reserve District #3 had house price declines than had increases. All of the areas posting increases were in Pennsylvania.

5. **Delaware**

Municipalities in Delaware receive 6.1% from the State, 14.2% form property tax, 11.2% from income tax. The primary state source of local aid is the income tax, exposing Delaware localities to unemployment and income repercussion as a result of the financial crisis.
State aid: The rise in unemployment and the decline in financial asset values in 2008, which will limit or reduce taxes collected on capital gains, will adversely impact Delaware's state tax collections. Economic indicators suggest that the finance-insurance-

real estate (FIRE) industry contributes a significantly larger share of activity in Delaware than nationally and is most vulnerable to the financial crisis and economic turndown. In Delaware 44.7% of the FIRE industry contributes to GDP, 10.4% to Employment and 13% of all earnings of state residents' employment in the industry as a share of total state personal income. Nationally, the FIRE industry accounts for 20.8% of GDP, 6.0% employment and 7.6% as a share of total personal income. Delaware does not have a general sales tax. The Delaware employment forecast remains weak, reflecting the national outlook. Income tax rates in Delaware range from 2.2 to 5.9%, which are most vulnerable to losses in the FIRE industry. According to the Bureau of Labor statistics, at the end of 2007, Delaware's unemployment rate was 3.5%, with fewer than 16,000 unemployed Delawareans looking for work. At the end of 2008, more than 25,000 residents were out of work, with the state's unemployment rate at 5.6%. These numbers do not include an additional 1,750 job losses as a result of the state's auto industry -- as Chrysler closed its Newark auto assembly plant, parts suppliers Mopar and Lear closed shop in Delaware and General Motors cut workers at its Boxwood Road assembly plant.
Property Tax: The housing market will directly impact property valuations and property taxes. The housing market was relatively stagnant in Delaware in 2008. Foreclosure filings were up in Delaware, although the problem was not as acute as in other states across the country. In the third quarter of 2008, the Home Price Index, according to the Federal Housing Finance Agency decreased from the second quarter of 2008 by 1.0% in Delaware, less than the national decrease of 2.7%. The national year-to-year decrease in the third quarter was 4.0%, the largest year-to-year decline in the history of the index, which goes back to 1975. The year-to-year decrease in Delaware (1.8%) was less than the national decline.

6. **Southern New Jersey**

In southern New Jersey growth has diminished in the housing market, which may be the result of national trends as opposed to local forces. As of the third quarter of 2008, New Jersey experienced a 2.1% decrease in total tax collections from the same time last year as a result of falling personal income and sales tax collections.
State Aid: State sales tax collections are projected to continue to decline as consumers cut back on retail spending. The current employment index fell from 1.1 in the first quarter of 2008 to -24.3 in the second quarter, currently at its lowest level since the second quarter of 2001. Nominal retail sales fell 4.0% at an annual rate during the third quarter of 2008, the first quarterly decline since the 5.2% decrease in the first quarter of 2002. Sales of big-ticket durable goods were particularly weak. Sales of automobiles and light trucks fell 19.0 % from the second quarter to the third quarter 2008. In Southern New Jersey, the latest monthly data indicate that sales tax collections have slipped. The number of jobs throughout the region has already declined from 2006 to 2007 mainly concentrated in the lodging and casino sectors. Besides lower tax collections from earnings, the decline in financial asset values in 2008 will limit or

reduce taxes collected on capital gains. The economic conditions that are reducing personal income tax collections are also reducing corporate income tax collections, which fell on a year-to-year basis in the second and third quarters.

Property Tax: The Federal Housing Finance Agency reported that the U.S. all-transactions home price index (HPI), which includes both purchase prices and refinancing appraisal prices, declined 2.7% in the third quarter of 2008 from the second quarter. In the third quarter, the HPI decreased 2.4% in New Jersey. The year-to-year decrease in New Jersey (4.9%) was greater than the national decline of 4.0%. Over the past 12 months, more metropolitan areas in the three-state region had house price declines than had increases. The largest housing price decline in the three-state region was in the Ocean City, N.J. area, which registered a 10% decline in house prices during the past 12 months.

Conclusion

Local governments in New York, Connecticut, and New Jersey, whose primary sources of revenues are property tax, and state aid that derives from income and sales tax receipts, are most vulnerable to the financial crisis and economic downturn. In New York State, New York City and downstate localities are vulnerable because of declining employment opportunities and decreased property values. While cities in Fairfield County are vulnerable because of unemployment and the decline in financial asset values, which limit or reduce taxes collected on capital gains, New Jersey localities are most vulnerable because of future loss in property taxes as housing values decline. Localities in Eastern Pennsylvania are vulnerable due to losses in manufacturing jobs and fees from building permits, but not as vulnerable in the housing market since Pennsylvania municipalities had not seen as high a rate of housing appreciation as other parts of the nation. Localities in Delaware are not as vulnerable on the housing front, but remain vulnerable because of reliance on the finance sector for employment and income tax revenues.