New York State

Economic Report

February 2005

Sheldon Silver
Speaker

Herman D. Farrell, Jr.
Chairman

New York State Assembly
Ways and Means Committee Staff

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Assembly Ways and Means Committee

Prepared by the
Assembly Ways and Means Committee Staff

February 28, 2005

Dear Colleagues:

I am pleased to provide you with the New York State Assembly Ways and Means Committee's *Economic Report* for 2005 and 2006. This report continues our commitment to providing clear and accurate information to the public by offering complete and detailed assessments of the national and State economies.

As this report summarizes, growth is expected on both the State and national levels in 2005 and 2006. This growth will be a result of robust consumption spending and investment spending. Although several risks are present (including oil shocks, dollar depreciation, budget and trade deficits, and various other world issues), the outlook is positive.

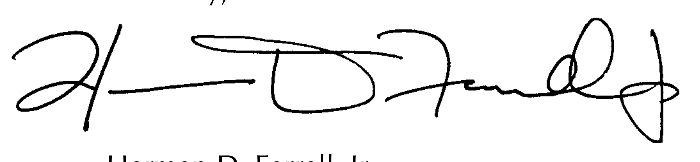
In 2003, the State economy continued to perform poorly when compared to the nation in terms of both employment and wages. However, the State economy expanded in 2004 and will benefit in 2005 and 2006 as the nation continues on a path of economic recovery. This recovery will be supported by growth in service-providing sectors. New York City and Wall Street should help to fuel State growth.

The Ways and Means Committee staff's assessments and projections presented in this report are reviewed by an independent panel of economists, including professionals from major financial and manufacturing corporations and prestigious universities, as well as respected private forecasters. Assembly Speaker Sheldon Silver and I would like to express our appreciation to the members of our Board of Economic Advisors. Their dedication and expert judgment have been invaluable in helping to refine and improve the forecasts. While they have served to make the work of our staff the best in New York State, they are not responsible for the numbers or views expressed in this document.

I wish to also acknowledge the dedicated and talented staff of the Assembly Ways and Means Committee and the many hours of work that went into producing this report. They play a vital role in our State's budget process.

As we continue our efforts toward enacting a budget that is fair and equitable for all New Yorkers, I look forward to working with each of you.

Sincerely,



Herman D. Farrell, Jr.
Chairman

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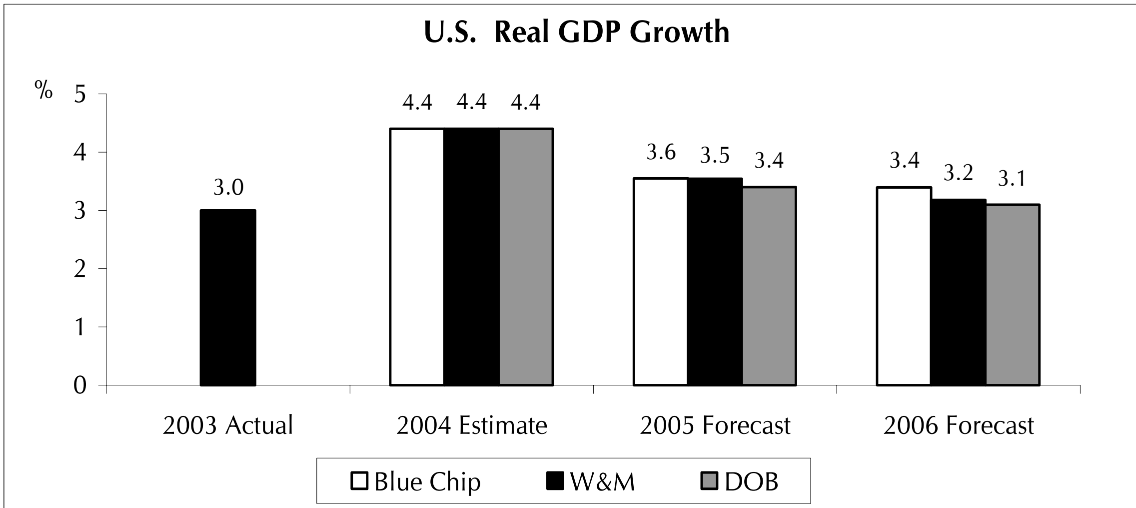
EXECUTIVE SUMMARY

United States

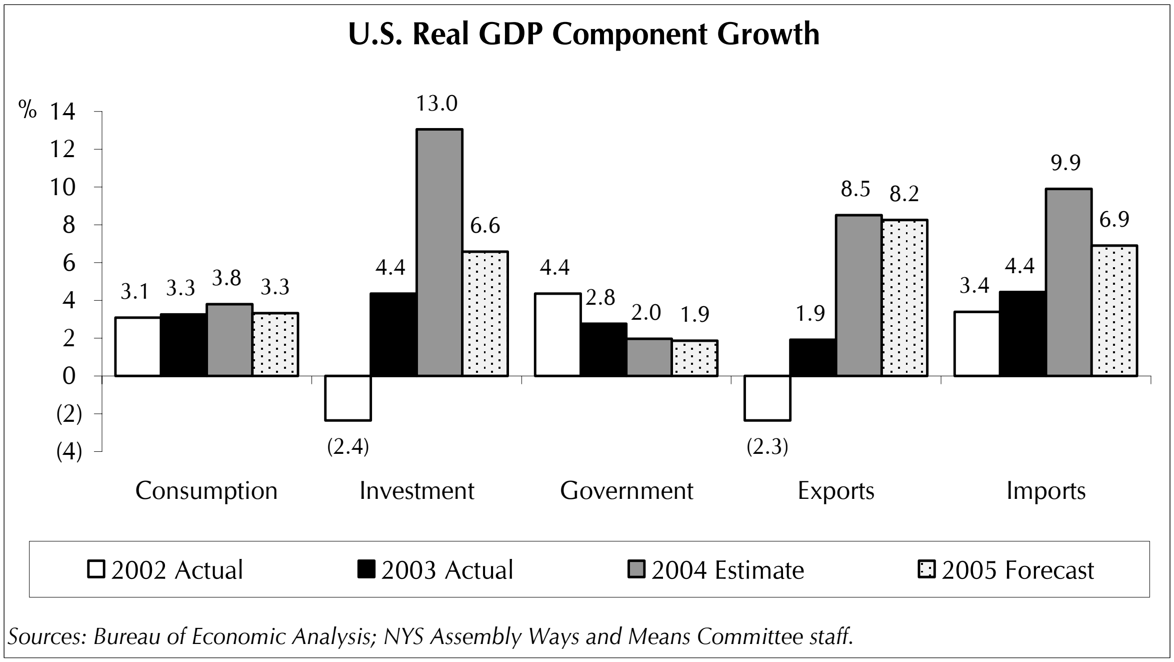
- Economic expansion is expected to continue into 2005 and 2006, with the economy growing at a rate close to the long-term trend rate of 3.5 percent.

- The NYS Assembly Ways and Means Committee staff estimates that national economic growth, as measured by real Gross Domestic Product (GDP), accelerated to 4.4 percent during 2004. Real GDP will continue to grow in 2005 and 2006, due in large part to robust consumption spending as well as a big swing in investment spending compared to 2001-03.



Sources: Blue Chip Economic Indicators, February 2005; NYS Assembly Ways and Means Committee staff; NYS Division of the Budget, New York State 2005-06 Executive Budget with 30-Day Changes , February 2005.

- The NYS Assembly Ways and Means Committee staff estimates that personal consumption spending growth increased to 3.8 percent during 2004 following the 3.3 percent growth in 2003. Due in part to continued employment recovery and personal income growth, personal consumption spending is forecast to continue to grow at a rate of 3.3 percent year-over-year in 2005 and 3.0 percent in 2006.



- The NYS Assembly Ways and Means Committee staff forecasts that investment spending will continue to expand in 2005, growing 6.6 percent year-over-year after increasing an estimated 13.0 percent in 2004 and 4.4 percent in 2003. It is forecast to slow to 3.8 percent in 2006. Factors contributing to the continued recovery in business investment include: strong growth in corporate cash flow, continued favorable financing conditions, and rising capital goods orders.

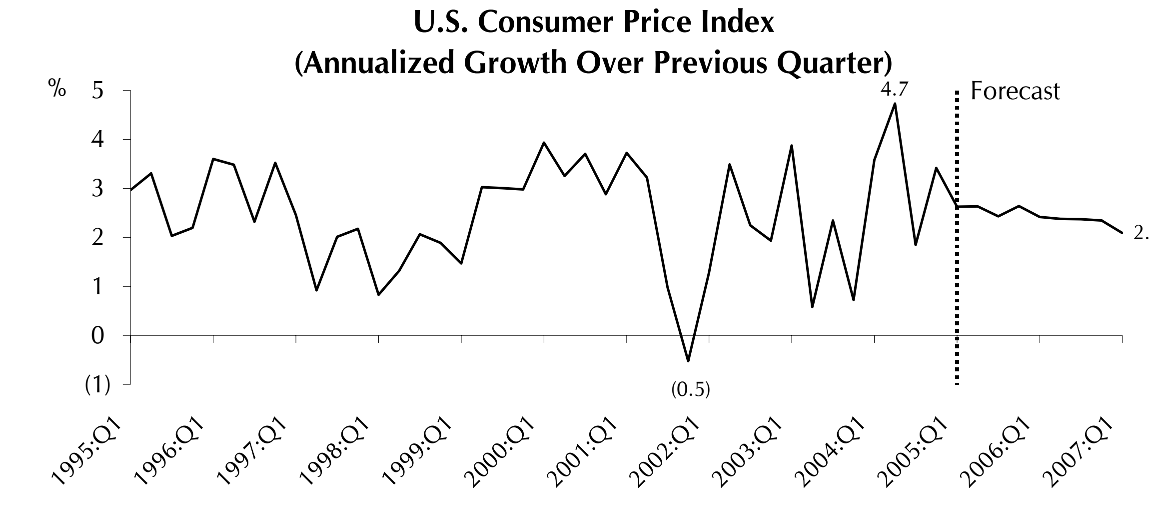
- U.S. employment growth is expected to modestly strengthen in 2005 and 2006 after growth of 1.1 percent year-over-year in 2004.

- During the recent employment downturn, 2.5 million manufacturing jobs were lost. In the seven quarters of the employment recovery between the second quarter of 2003 and the first quarter of 2005, the manufacturing sector will lose 188,400 jobs.

- The largest number of jobs created in the recovery will be in education and health, other services, and leisure and hospitality.

- The outsourcing of jobs to offshore locations and the fear of job loss have received considerable attention recently. Although the problem of offshore outsourcing may be part of a long-term historic process, it is unclear whether the losses outweigh the gains to the United States or New York from the international flow of jobs.

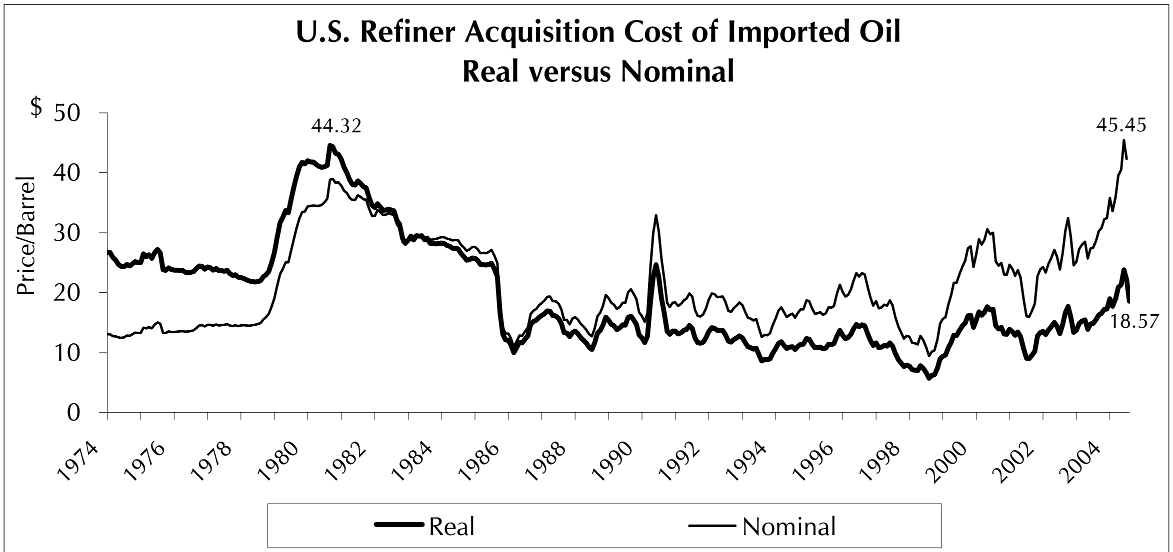
- The NYS Ways and Means Committee staff predicts that consumer prices will increase 2.8 percent year-over-year in 2005 and 2.5 percent in 2006. Increases in consumer and producer prices in 2004 were driven by volatile energy prices and a weakening dollar, while most other prices remained relatively stable.



Note: The first forecast period is 2005:Q1.
Sources: Bureau of Labor Statistics; NYS Assembly Ways and Means Committee staff.

- High energy prices continue to remain an issue for the United States economy. The varied and unpredictable nature of the factors influencing energy prices adds to the difficulty of reliably predicting future price movements. This uncertainty (as well as the current high price) can be a drag on economic growth and adds to the uncertainty in the forecast.

- The price of oil has increased in the past two years to historic nominal highs. However, if the price of oil is adjusted for inflation, oil prices are not as high as in the early 1980s.



Note: Real values are inflation-adjusted using CPI: All Urban Consumers 1982-84 = 100. Data is monthly through December 2004.
Sources: Bureau of Labor Statistics; Energy Information Administration.

- Rising short-term rates, economic expansion, and ongoing federal budget deficits will contribute to a rise in long-term interest rates in the next few years. Long-term rates did not decline nearly as sharply as short-term rates during the 2001 recession and early stages of recovery. In the third and fourth quarters of 2004 long-term rates fell; however, both short- and long-term rates are still relatively low and likely to rise.

U.S. Real GDP Forecast Comparisons
(Percent Change)

	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Ways and Means	3.0	4.4	3.5	3.2
Blue Chip Consensus	3.0	4.4	3.6	3.4
Division of the Budget	3.0	4.4	3.4	3.1
Economy.com	3.0	4.4	3.5	3.3
Macroeconomic Advisers	3.0	4.4	3.8	3.9
Global Insight	3.0	4.4	3.5	3.1

Sources: NYS Assembly Ways and Means Committee staff; Blue Chip Economic Indicators, February 2005; New York State 2005-06 Executive Budget with 30-Day Changes, February 2005; Global Insight, U.S. Executive Summary, February 2005, <http://www.globalinsight.com>; Economy.com, February 2005, <http://www.economy.com>; Macroeconomic Advisers Base Forecast, January 2005.

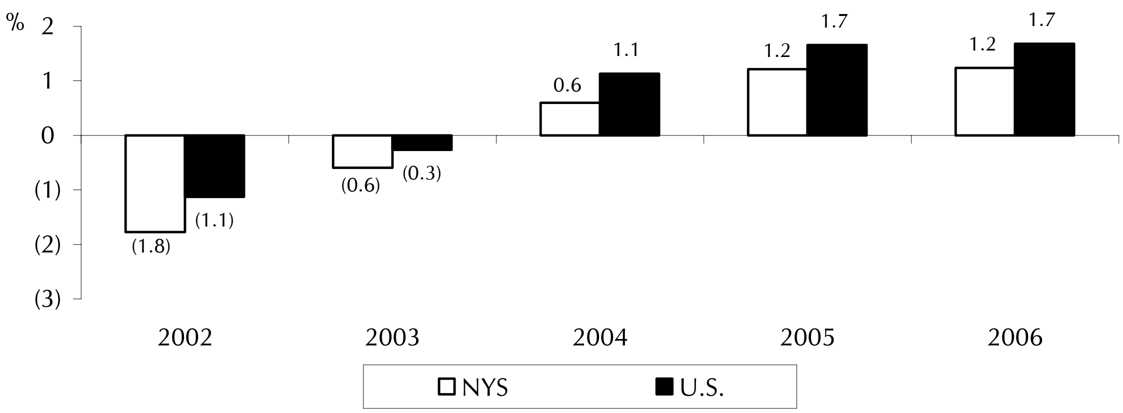
- The NYS Assembly Ways and Means Committee staff forecast for overall national economic growth in 2005 is 3.5 percent, 0.1 percentage point lower than the February 2005 Blue Chip Consensus forecast of 3.6 percent. Both Economy.com's forecast and Global Insight's forecast are 3.5 percent, the Division of the Budget's forecast is 3.4 percent, and Macroeconomic Advisers' forecast is 3.8 percent.

New York State

- The New York State economy continues to lag the United States economy in terms of employment growth. However, the State will continue to benefit as the nation maintains an expansion. Both employment and wages are expected to grow in 2004 and 2005.

- The recovery in New York State employment is expected to strengthen in 2005; employment is expected to grow 1.2 percent in 2005 compared to 0.6 percent in 2004. The education and health sector will create the largest number of jobs in 2005.

Employment Growth
New York State versus U.S.

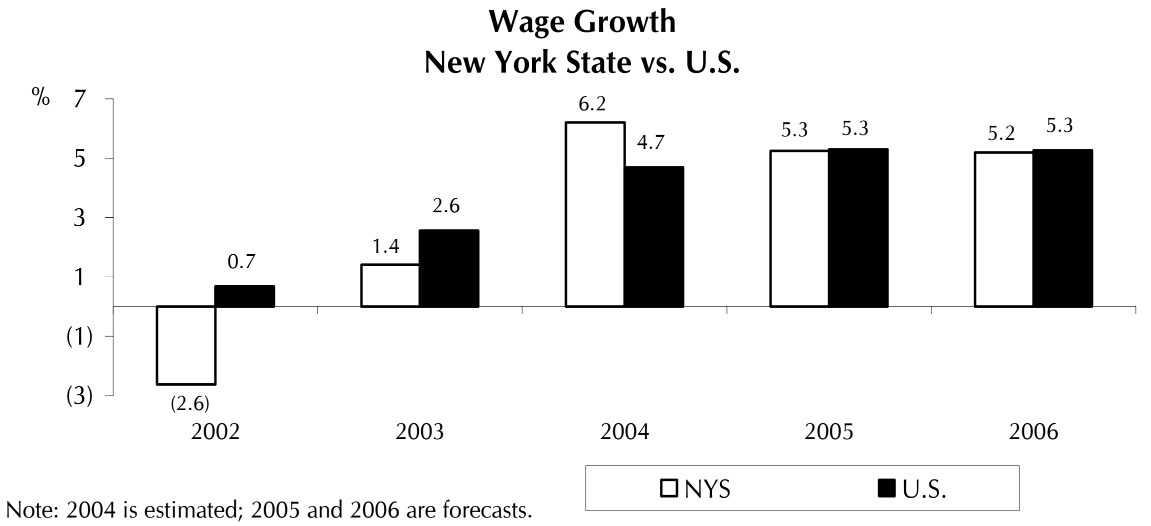


Note: 2005 and 2006 are forecasts; New York State data for 2004 is estimated.
Sources: NYS Department of Labor, QCEW; Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

- About a third of the job loss in the recent employment downturn in New York was in the manufacturing sector. The loss of manufacturing jobs in the national employment downturn was almost as large as the loss of jobs overall. A good part of the manufacturing job loss in the recent recession was structural, and these jobs are not expected to return with the recovery.

- Securities industry employment in New York is expected to experience growth averaging 2.9 percent in 2005 and 2.6 percent in 2006. This follows a sharp decline during 2002 and 2003. For the nation, securities industry employment is expected to grow faster, averaging 3.9 percent in 2005 and 3.3 percent in 2006.

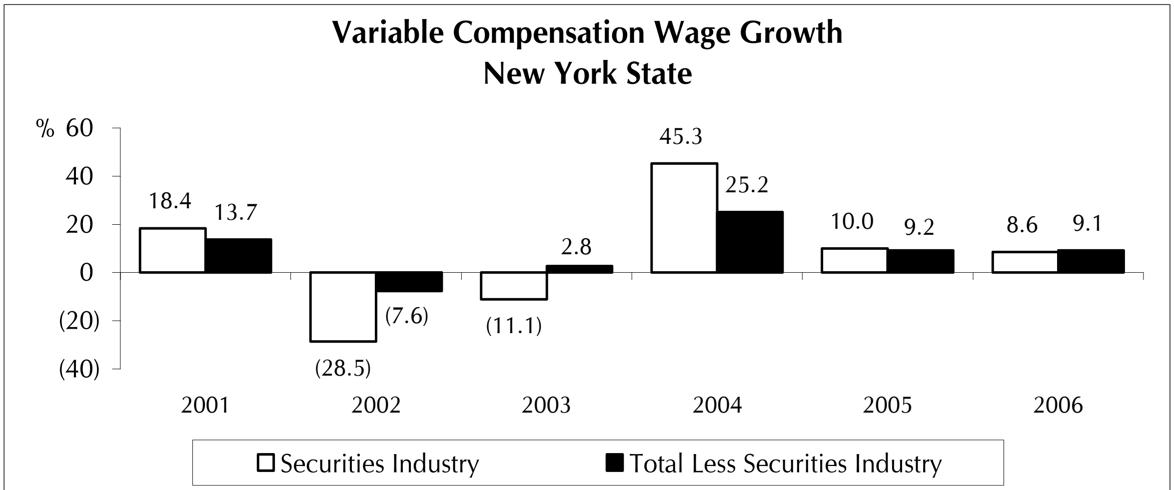
- Estimates show that New York State wages grew at a faster rate than the nation in 2004, 6.2 percent in the State versus 4.7 percent in the nation. State wages are forecast to grow 5.3 percent in 2005 and 5.2 percent in 2006.



Note: 2004 is estimated; 2005 and 2006 are forecasts.
Sources: New York State Department of Labor; Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

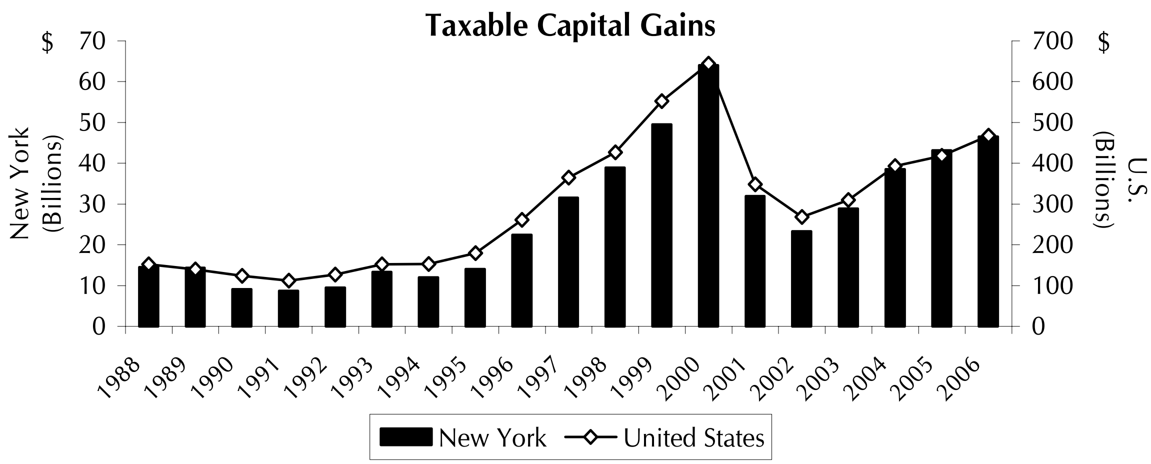
- Growth in the service-producing industries is providing the majority of the growth to New York State wages. In particular, the education and health sector grew faster than any other sector in 2003.

- The NYS Assembly Ways and Means Committee staff estimates that New York State total variable compensation, which was $32.1 billion or 8.3 percent of total State wages in 2003, increased by 33.3 percent to $42.8 billion for 2004. Variable compensation growth will be 9.5 percent in 2005 and 8.9 percent in 2006. Securities industry growth and particularly strong Mergers and Acquisitions activity will help boost variable compensation.



Note: 2004 is estimated; 2005 and 2006 are forecasts.
Source: NYS Assembly Ways and Means Committee staff.

➢ New York State capital gains less losses are expected to be 33.0 percent higher in 2004 than in 2003. This will be followed by an increase of 10.9 percent in 2005 and an increase of 9.3 percent in 2006. Even after the large anticipated increase in 2006, capital gains in New York will be only 71.8 percent of their peak level from 2000.



Note: The first forecast period is 2003.
Sources: U.S. Department of the Treasury; NYS Department of Taxation and Finance; NYS Assembly Ways and Means Committee staff.

➢ The NYS Assembly Ways and Means Committee staff's 1.2 percent employment growth forecast for 2005 is 0.1 percentage point below Economy.com's 1.3 percent, 0.1 percentage point above the Division of the Budget's 1.1 percent, and 0.2 percentage point higher than Global Insight's 1.0 percent.

NYS Forecast Comparisons
(Percent Change)

	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Employment (Nonfarm)				
Ways and Means	(0.6)	0.6	1.2	1.2
Division of the Budget	(0.6)	0.6	1.1	1.1
Economy.com	(0.6)	0.5	1.3	1.1
Global Insight	(0.6)	0.5	1.0	1.1
Wages				
Ways and Means	1.4	6.2	5.3	5.2
Division of the Budget	1.4	6.2	4.9	5.2
Economy.com	1.6	4.8	4.1	4.6
Global Insight	1.6	4.9	4.8	5.3

Sources: NYS Assembly Ways and Means Committee staff; New York State 2005-06 Executive Budget with 30-Day Changes, February 2005; Economy.com, February 2005, <http://www.economy.com>; Global Insight, Short-term Outlook for New York, winter 2004/05.

- The NYS Assembly Ways and Means Committee staff's 5.3 percent wage growth forecast for 2005 is 0.4 percentage point higher than the Division of the Budget's forecast, 1.2 percentage points higher than Economy.com's forecast, and 0.5 percentage point higher than Global Insight's forecast.

INTRODUCTION

United States Economy

The 2001 recession, which lasted nine months from March through November 2001, turned out to be hardly a recession by the standard of real Gross Domestic Product (GDP). Unlike in other U.S. post-World War II recessions, real GDP did not decline for two consecutive quarters during the 2001 recession. When measured from the peak to the trough, real GDP decreased a mere 0.2 percent, making the 2001 recession the mildest during the post-World War II era. Year-over-year the U.S. economy grew 0.8 percent during 2001 and continued to expand in the following years: 1.9 percent in 2002 and 3.0 percent in 2003.

This mild recession, followed by a strong recovery in output, was helped in large part by robust growth in personal consumption spending, which was, in turn, fueled by fiscal as well as monetary stimulus. Strong growth in federal government spending due in part to the September 11, 2001, terrorist attacks and the war in Iraq also helped boost the economy.

After it softened a bit during the second quarter of 2004, the U.S. economy bounced back, growing 4.0 percent in the third quarter and an estimated 3.8 percent in the fourth quarter, making the second quarter softness look temporary. In fact, the composite index of U.S. coincident indicators has been on a rise for seventeen months since April 2003, indicating the U.S. economy is still expanding (see Figure 1).[1] The index of U.S. leading economic indicators, a key gauge of future economic activity, stopped its four-month decline in November 2004, showing an upward trend overall in recent months.[2]

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[1] The Conference Board's composite index of U.S. coincident indicators consists of nonfarm payroll employment, real personal income less transfer payments, real sales in the manufacturing and trade sectors, and industrial production.

[2] The Conference Board's composite index of U.S. leading indicators consists of ten monthly time series. These include the average weekly hours worked by manufacturing workers, new orders for consumer goods, new orders for non-defense capital goods, stock prices measured by the S&P 500 composite stock price index, initial jobless claims, vendor performance, building permits, money supply measured by M2 adjusted for general price inflation, consumer expectations, and the spread between the 10-year Treasury note yield and the federal funds rate.

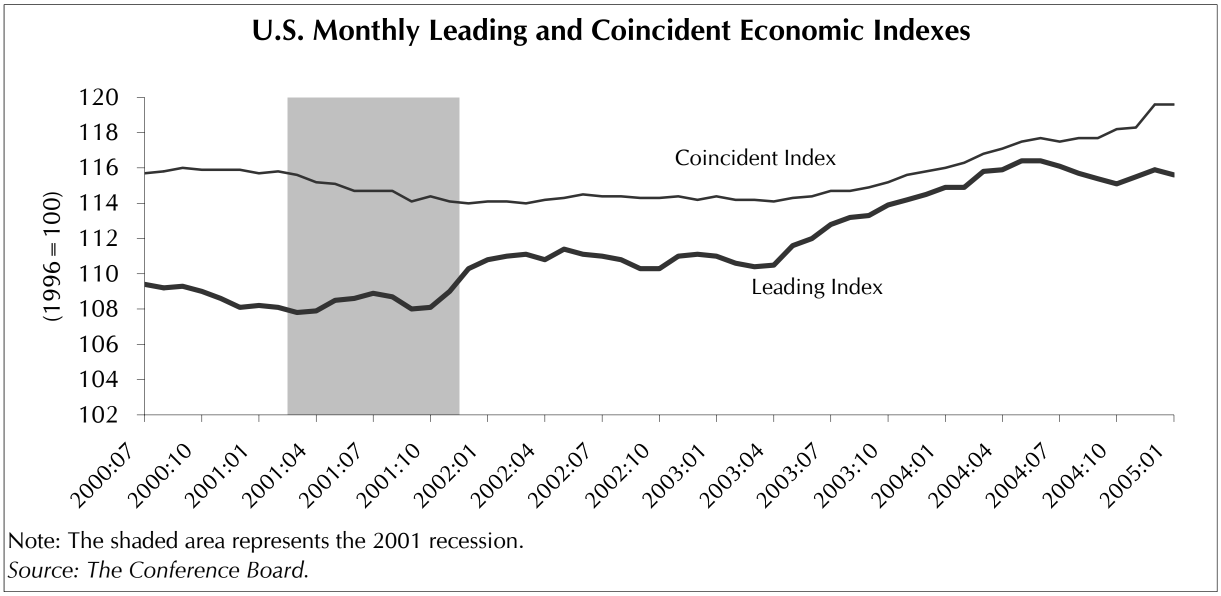

Figure 1

In the near future, personal consumption spending should be helped by personal income growth that continues to be healthy. Employment growth, though sluggish compared to previous recoveries, is expected to continue. Despite month-to-month ups and downs, light vehicle sales still remain solid. Continued growth in the housing market—both existing and new home sales have been at record highs—should help support household net worth growth. Despite a surge in December 2004, housing starts have shown signs of weakness in recent months and, as a result, residential construction will likely weaken in the near future. However, as more capacity is being utilized by business, and industrial production is rising as well (see Figure 2), business capital spending will likely continue to expand. It also will be helped by the recent improvement in corporate balance sheets as well as the big surge in business cash flow seen over the past couple of years. Although interest rates have started rising, business financing conditions are still quite favorable. Inventory investment has rebounded significantly over 2003 and should remain strong as the inventory-to-sales ratio is still quite low. Net exports will be less of a drag on economic growth as the U.S. dollar is expected to depreciate further. Robust growth in federal defense and public security spending as well as recovery in state and local government spending will also help boost the economy during its recovery.

Oil prices are expected to decline somewhat in coming months. Although oil prices measured by the refiner's acquisition cost have been at a record high in current dollars, they are still just about half of the 1981 peak when adjusted for general price inflation (see the Prices section on page 33).[3] Also, the economy is generally more efficient in its oil use now than it was in the early 1980s.[4]

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[3] See page 39 for results from a simulation analysis of how some U.S. key variables would fare if oil prices should jump to $70 per barrel and stay there throughout 2006.

[4] In 1975, the U.S. economy consumed roughly 1,400 BTUs of petroleum to produce each dollar's worth of GDP. According to the Department of Energy, it took less than 700 BTUs to produce one dollar's worth of

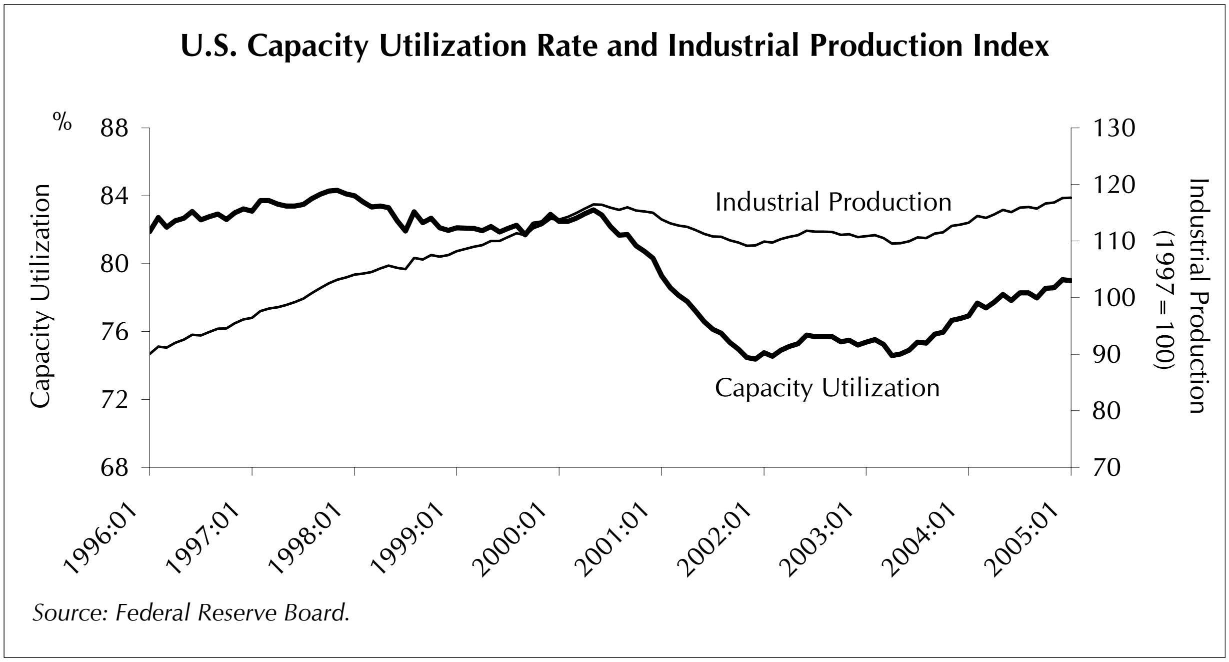
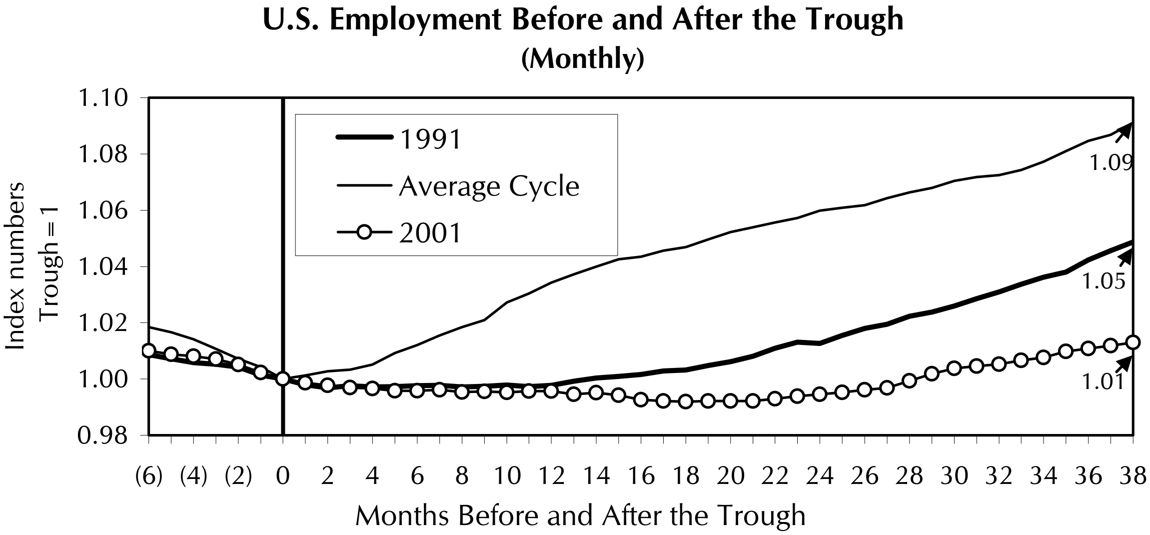


Figure 2

The 2001 recession and recovery thereafter are unique in another sense. Employment loss continued for an unusually long period—it lasted for 28 months, which is about 2.5 times as long as the typical duration of employment loss during post-World War II era recessions (see Figure 3). Even after employment bottomed out in May 2003, the pace of job growth was and continues to be sluggish compared to earlier recoveries. The average monthly job gain since May 2003 has been 137,300, while the average monthly job gain during the typical post-World War II era employment recovery was 190,600. After the 1990-91 recession, the national economy created 219,000 payroll jobs a month on average during the nine-year employment recovery. The slow pace of job growth in the current recovery has been ascribed to strong productivity growth and offshore outsourcing (see Offshore Outsourcing section on page 29), among other factors. Rising health care and benefits costs may also be responsible for sluggish employment recovery.

GDP in 2000. For more details, see New York State Assembly Ways and Means Committee, *New York State Economic Report 2000 & 2001,* February 2001, 2; Goldman Sachs, *U.S. Economic Analyst*, October 22, 2004, no. 04/43; and Goldman Sachs, *Global Economic Weekly*, October 20, 2004, no. 04/37.



Note: The trough month for the 1991 cycle is 1991:03 and the trough month for the 2001 cycle is 2001:11. These trough dates are based on the National Bureau of Economic Research's (NBER) business cycle dates.
Source: Bureau of Labor Statistics.

Figure 3

While productivity growth is expected to slow to a more sustainable rate of around 2.4 percent, the nation will likely gain around 182,000 payroll jobs a month. The employment recovery will be broad, cutting across economic sectors, with services leading the way. Even the manufacturing sector, which finally bottomed out in the first quarter of 2004 after almost six years of precipitous decline (3.4 million jobs, or 19.0 percent decline), will likely add some jobs in 2005.

Despite the positive signs mentioned above, the economic environment remains uncertain, with many risks to the current forecast. Large deficits in the U.S. current account and federal budget as well as new lows in the value of the U.S. dollar against some major currencies may have very serious economic repercussions both at home and abroad. Any future terrorist attack as well as further deterioration of the situation in Iraq can have a large impact on spending and investment, as well as hinder confidence in the future performance of the economy. The future course of oil prices is an additional risk factor. The slow rate of employment growth for much of 2004 makes consumption spending an area of concern. It is also uncertain how long consumption can remain strong as interest rates are expected to rise and job growth remains uncertain.

New York State Economy

New York State continued to perform poorly when compared to the nation in 2003. As Figure 4 shows, 2003 wages increased by 2.6 percent in the nation, while in New York the increase was 1.4 percent. Employment fell slightly in both the nation and the State, however the State had a larger drop.

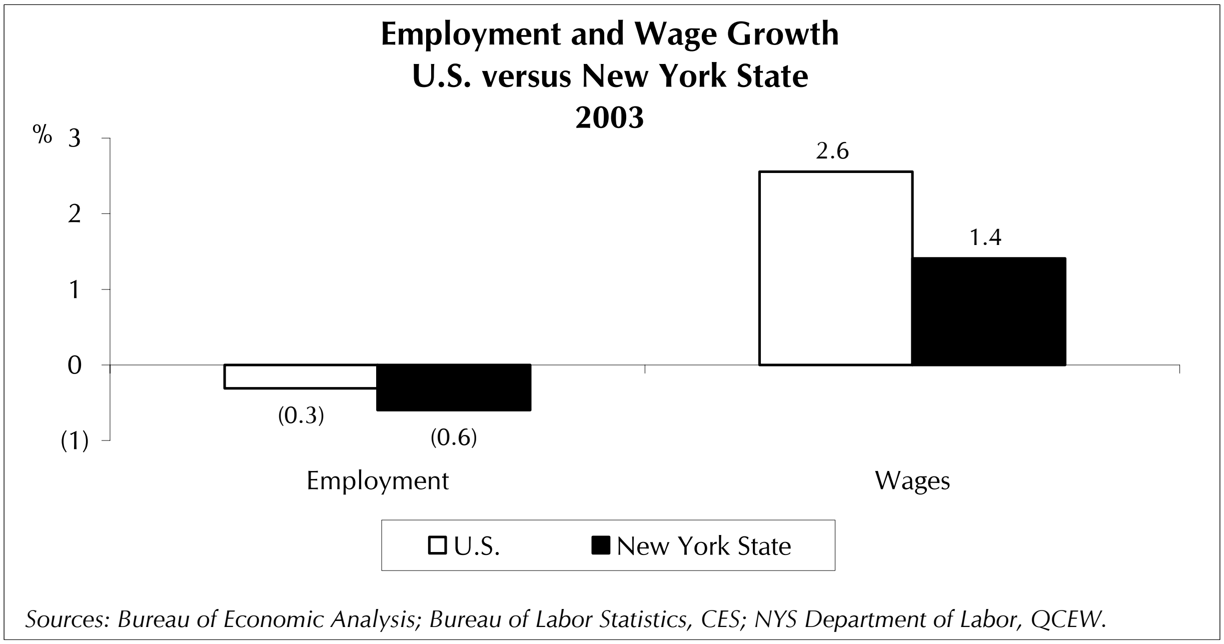


Figure 4

New York State has lagged the nation in growth for a number of reasons, including:

* A greater dependence in New York State on financial markets combined with uncertainty and volatility in the stock market caused by concern over oil prices, changing interest rates, and general fear of further terrorist activities.

* High costs of production relative to the nation.

* Wage losses in the securities industry during 2003.

* A long-term trend of declining employment in manufacturing.

* Large employment losses in the information, professional services, and other services sectors in the recent employment downturn.

New York will benefit as the rest of the nation continues to recover. However, the State will continue to lag the nation in employment growth. New York City will help to fuel the State growth, as New York City employment growth turned positive in early 2004 and continues to post gains.

As in the nation, service-producing industries, mainly financial services and professional and business services, support New York's employment recovery. Goods-producing industries, specifically manufacturing, continued to lose the most jobs in the State during 2004.

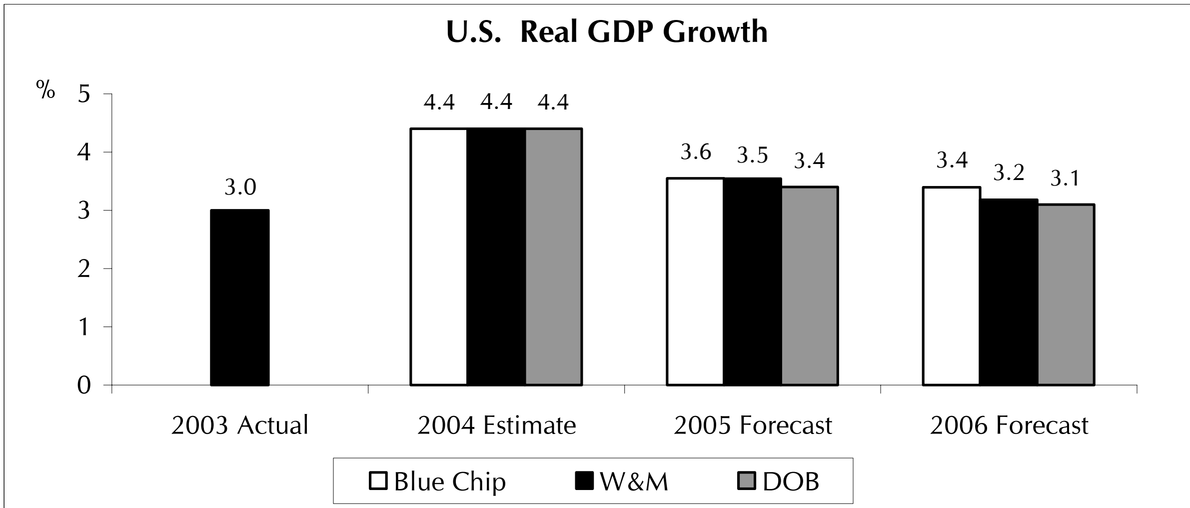
Variable wages in New York will benefit from rebounding profits in the securities industry. Mergers and Acquisitions, in particular, grew rapidly in 2004 and will continue to gain strength in 2005.

UNITED STATES ECONOMIC FORECAST

Coming out of the "soft spot" in the second quarter of 2004, a national economic expansion is expected to continue into 2005 and 2006. Business uncertainty, which thus far has hindered a strong recovery, is expected to gradually lift. Private consumption spending will grow at a rate similar to the long-term trend, as personal income growth remains steady. Investment spending growth is expected to remain strong as financing conditions still remain quite favorable, accumulated cash flow is abundant, and inventory rises. Month-over-month employment growth, although slower compared to earlier recoveries, is expected to continue.

Gross Domestic Product

The NYS Assembly Ways and Means Committee staff estimates that the national economy, as measured by real Gross Domestic Product (GDP) growth, accelerated to 4.4 percent during 2004 (see Figure 5). The acceleration was due in large part to robust consumption spending as well as a big swing in investment spending compared to 2001-03. The 2004 growth rate is 1.4 percentage points up from the 3.0 percent growth in 2003.

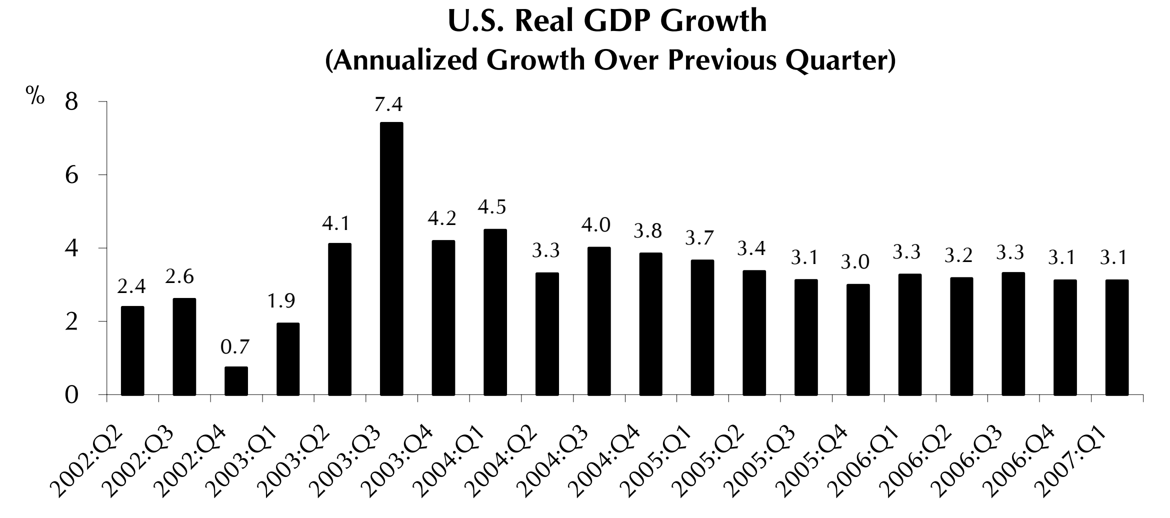


Sources: Blue Chip Economic Indicators, February 2005; NYS Assembly Ways and Means Committee staff; NYS Division of the Budget, New York State 2005-06 Executive Budget with 30-Day Changes , February 2005.

Figure 5

Real GDP growth is forecast to slow to 3.5 percent year-over-year in 2005, as both consumers and businesses will likely become more cautious of spending. On a quarterly basis, real GDP is expected to grow between 3.0 and 3.7 percent in 2005, after growing approximately 3.8 percent in the fourth quarter of 2004 (see Figure 6). Real GDP is forecast to grow 3.2 percent in 2006, a rate slightly lower than the long-term trend.[5]

[5] In general, when components of GDP are discussed throughout this document, the numbers refer to real (inflation-adjusted) data. However, it is important to note that inflation for the components of consumption



Note: The first forecast period is 2004:Q4.
Sources: Bureau of Economics Analysis ; NYS Assembly Ways and Means Committee staff.

Figure 6

Consumption

Personal consumption spending growth dropped to a mere 1.6 percent in the second quarter of 2004 after growing four percent or so for several quarters. Among other things, a significant increase in crude oil prices cut into the consumer's purchasing power. A rise in market interest rates caused refinancing activity to drop and, as a result, consumer cash flow got pinched. A smaller-than-expected size of actual tax refunds from summer 2003 tax cuts as well as a weakness in equity markets and equity wealth also constrained consumer spending.[6] Lackluster employment growth failed to boost consumer confidence.

However, the softness seen in the second quarter of 2004 is likely to be a temporary lull. First of all, personal consumption spending grew another healthy 4.6 percent in the fourth quarter of 2004, following a strong 5.1 percent in the third quarter. Employment recovery is expected to continue and personal income growth has been healthy and will

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has behaved quite differently. Prices for goods, particularly durable goods, have actually been flat or even declining. Prices for services have been rising about three percent a year. Therefore, what is happening for nominal expenditures in the various components of consumption can be quite different from what is happening in real dollars. These price changes also have important implications for corporate profits. Firms, particularly those that produce goods, have been complaining of a lack of pricing power, which can hurt corporate profits.

[6] The Bush Administration's projection for the effects of the tax cut was a decline in federal "personal declarations and final settlements less refunds" (i.e., the components of personal income tax receipts other than withholding) from 2003 to 2004 of about $60 billion. But the actual decline currently being assumed by the Bureau of Economic Analysis is only about $0.6 billion, indicating a smaller than expected impact from the tax cut. For more details, see the Bureau of Economic Analysis, "Federal Budget Estimates for Fiscal Year 2005," *Survey of Current Business*, March 2004, 14-24; and the Bureau of Economic Analysis, *National Income and Product Accounts*, Table 3.4U.

likely continue to be robust (see Figure 7). Household net worth rebounded sharply during 2003, thanks to continued growth in real estate values and a strong recovery in corporate equity values (see Figure 8). Although corporate equity markets have shown weakness in recent months, the housing market has remained strong—both existing and new home sales have been at record highs. As a result, household net worth will likely continue to grow, helping support consumption spending growth. Both new orders and shipments for consumer goods continue to exhibit a steady upward trend, signaling a robust pace of consumer spending growth in coming months (see Figure 9).

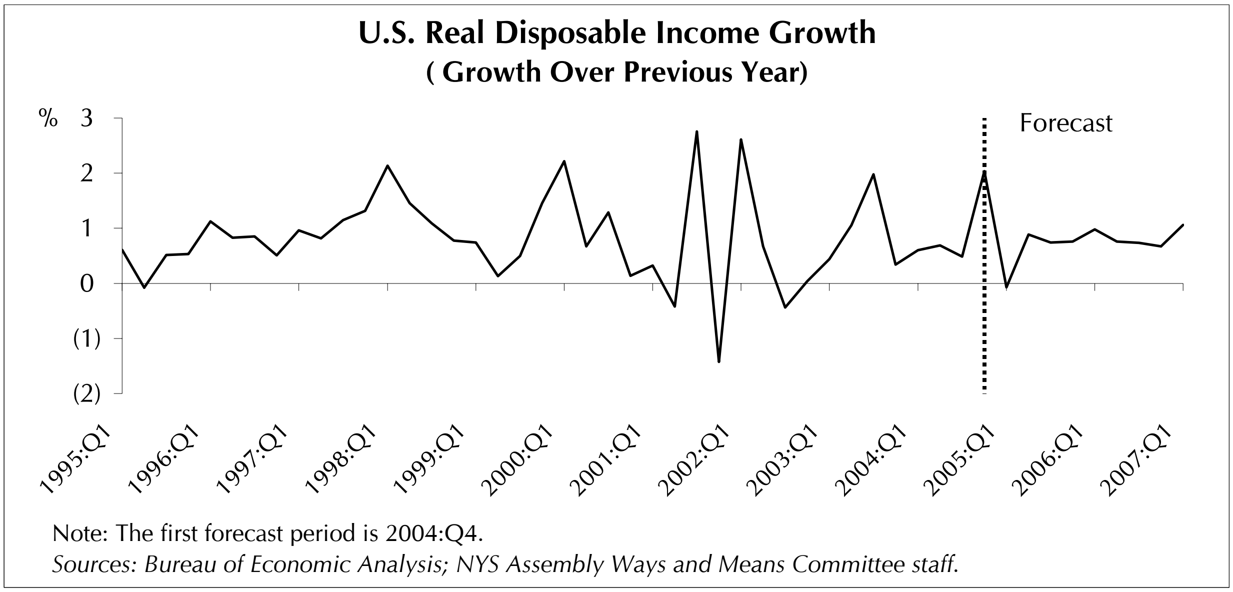

Figure 7

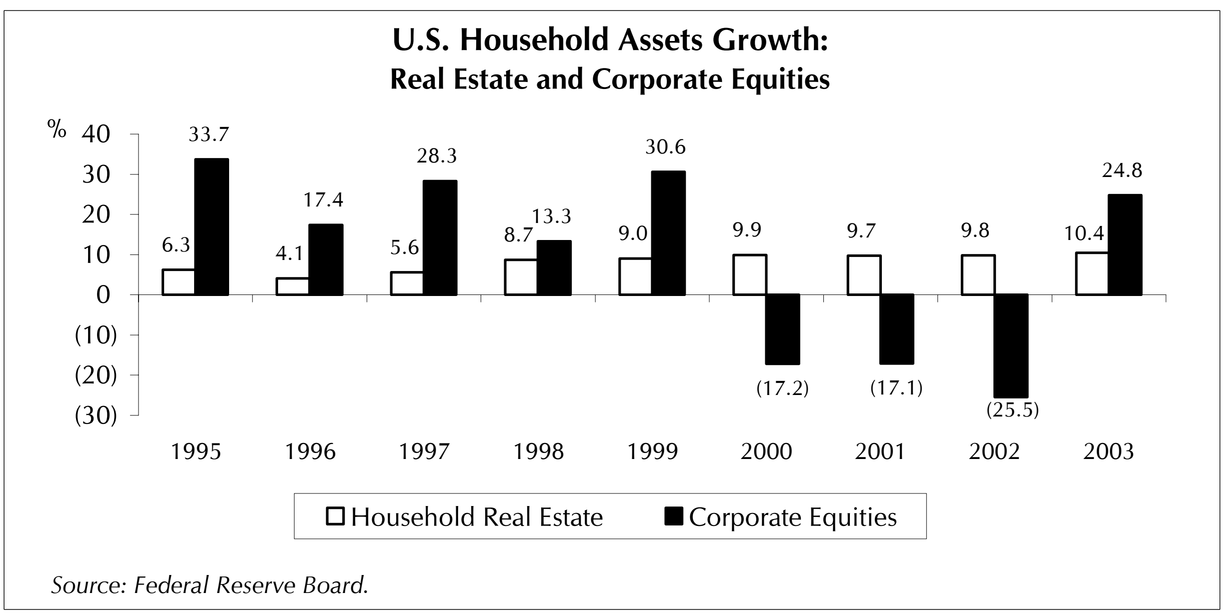

Figure 8

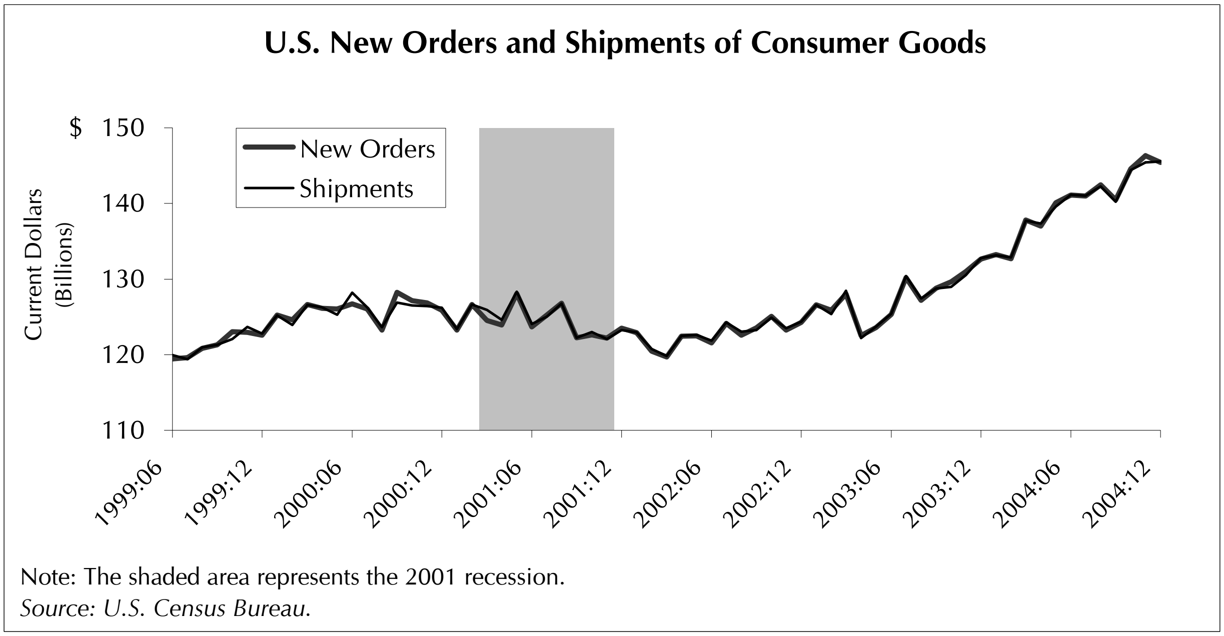

Figure 9

However, there are forces that may negatively affect consumer spending. Although it shot up sharply due to the Microsoft dividend of $32.4 billion paid out on December 2, 2004, the near-record low saving rate may force consumers to be more cautious of spending and increase saving, especially when cash flow from refinancing is likely to drop with interest rates expected to rise (see Figure 10).

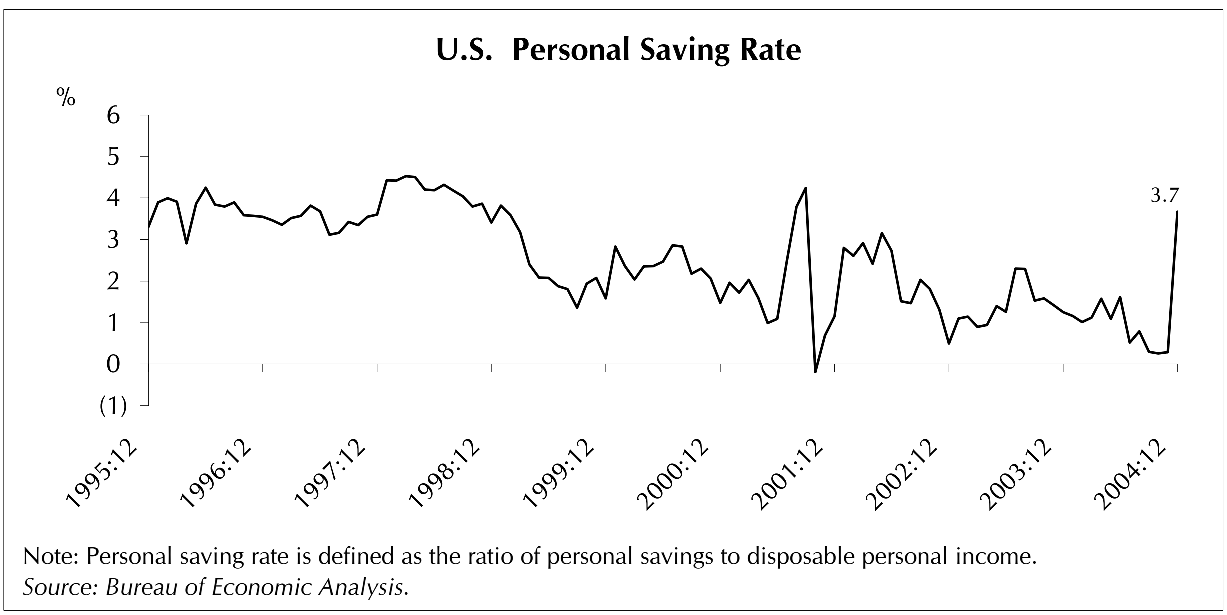

Figure 10

Although the compensation (i.e., wages and salaries plus benefits) of workers has been rising faster since 2000 compared to earlier years, growth in various benefits payments has driven most of this increase in compensation (see Figure 11).[7] As a result, take-home pay has not been rising much. Employment growth is also uncertain, posing a major downside risk to consumer income.

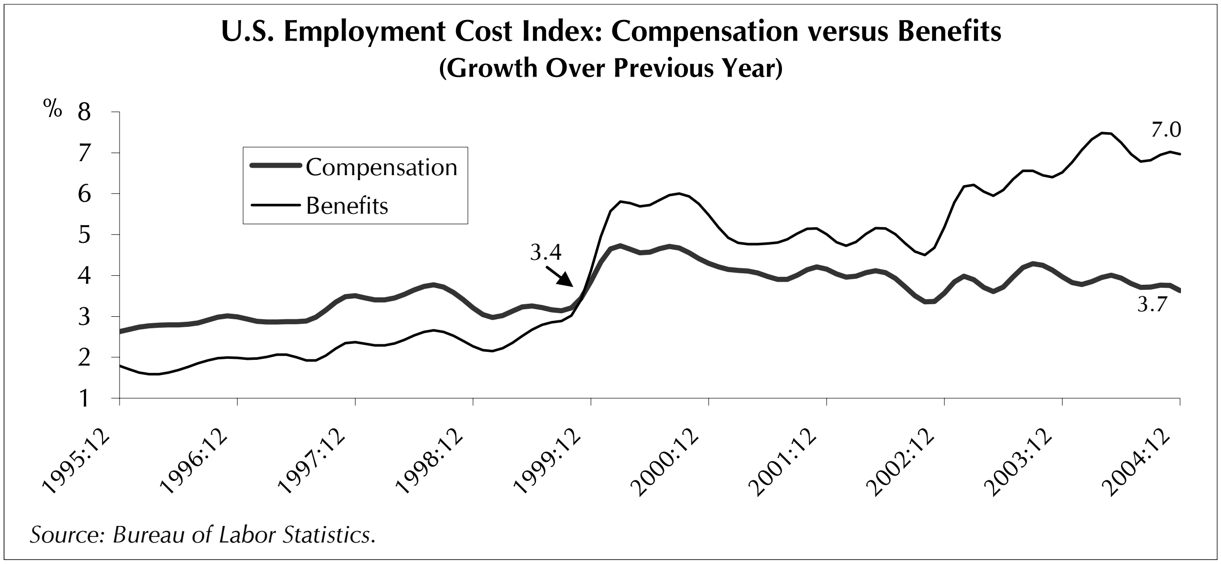

Figure 11

The Assembly Ways and Means Committee staff estimates that consumption spending growth increased to 3.8 percent during 2004 after growing 3.3 percent in 2003. It will then slow to 3.3 percent in 2005 and 3.0 percent in 2006 (see Figure 12 and Table 1).

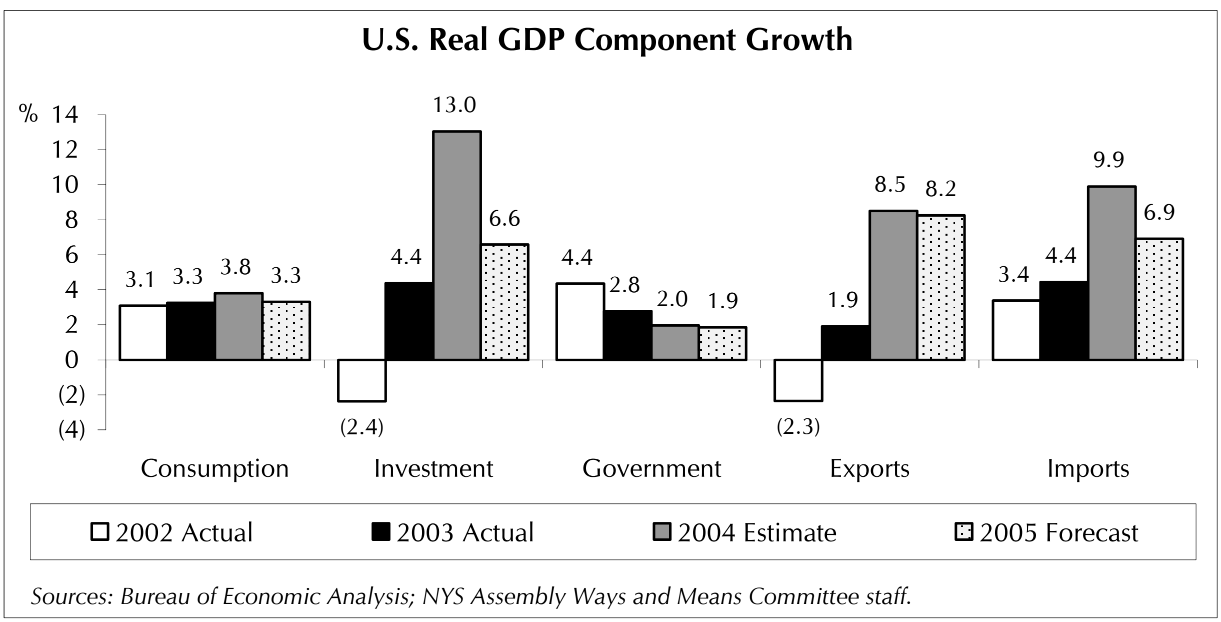

Figure 12

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[7] Benefits include paid leave; supplemental pay such as overtime; life, health and disability insurance; retirement savings; legally required benefits such as social security and unemployment insurance; and other benefits such as severance pay. Benefits account for about 28 percent of total compensation.

Table 1

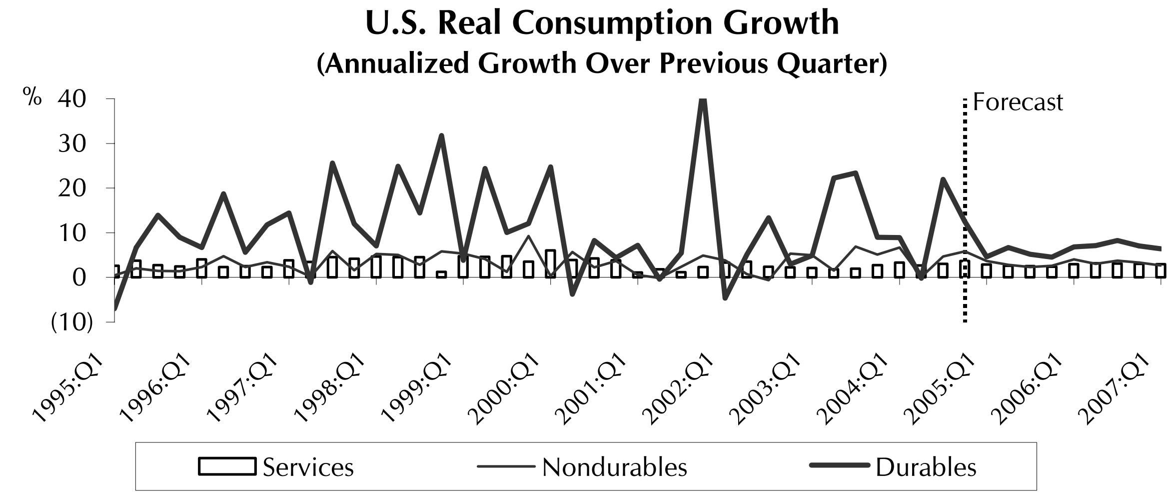
U.S. Economic Outlook (Percent Change)	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Real GDP	3.0	4.4	3.5	3.2
Real Consumption	3.3	3.8	3.3	3.0
Real Investment	4.4	13.0	6.6	3.8
Real Exports	1.9	8.5	8.2	8.9
Real Imports	4.4	9.9	6.9	5.8
Real Government	2.8	2.0	1.9	2.1
Federal	6.6	4.7	3.2	2.7
State and Local	0.7	0.4	1.1	1.8
Personal Income	3.2	5.4	5.3	5.4
Wages & Salaries	2.6	4.7	5.3	5.3
Transfer Income	4.1	5.3	5.1	5.5
Corporate Profits (Accounting Basis)	15.4	11.8	27.0	10.9
Corporate Profits (Economic Basis)	16.8	15.2	9.9	8.1
Productivity	4.5	4.0	2.4	2.4
Employment	(0.3)	1.1	1.7	1.7
CPI-Urban	2.3	2.7	2.8	2.5
S&P 500 Stock Price	(3.2)	17.3	11.7	9.9
Treasury Bill Rate (3-month)*	1.0	1.4	3.0	3.9
Treasury Bond Rate (10-year)*	4.0	4.3	4.5	5.1

* Annual average rate.
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Standard & Poor's; NYS Assembly Ways and Means Committee staff.

Services consumption, the least volatile as well as the largest component of consumption (about 58 percent of the total), grew an estimated 2.8 percent during 2004 following a 2.2 percent growth during 2003.[8] It is forecast to further expand by 2.9 percent during 2005, due to robust growth in consumer spending on medical care and housing services as well as "other" services including personal business services. Nondurable goods consumption grew an estimated 4.5 percent year-over-year during 2004, accelerating further from the above-trend 3.7 percent growth in 2003. Due in part to slower growth in after-tax personal income, nondurable goods consumption is likely to slow to 3.6 percent in 2005. Durable goods consumption, the most volatile as well as smallest component (about 13 percent of the total consumption), grew 7.4 percent year-over-year during 2003, after growing 4.3 percent or higher for several years in a row, including during the 2001 recession (see Figure 13). A good part of the steady growth in durable goods consumption for the past two years can be ascribed to the unusually strong auto sales due to various incentives. Auto sales and housing activity (which indirectly affects durable goods purchases) are not expected to achieve their current record levels in 2005. Durable goods

[8] The 58 percent share is an average based on the last five years of data.

consumption spending growth is thus forecast to slow to 4.7 percent year-over-year during 2005, following an estimated 6.9 percent growth during 2004.



Note: The first forecast period is 2004:Q4.
Sources: Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 13

Investment

Private investment spending dropped sharply in the 2001 recession after an excessive run-up during the investment boom of the 1990s. It declined nearly 7.9 percent year-over-year during 2001 and another 2.4 percent in 2002. This created pent-up demand for business equipment and software, which, combined with capital depreciation tax incentives provided by the federal government, led to its strong rebound in 2003. In particular, business spending on information-processing equipment and software increased 12.0 percent in 2003. On the other hand, business construction spending, which was hit particularly hard during the recent recession, continued to contract in 2003 declining 5.6 percent year-over-year. Business construction had declined 2.3 percent in 2001 and 17.8 percent in 2002. In contrast, residential construction spending posted a positive, though small, gain even during 2001 and 2002 due mainly to record low interest rates. Residential construction grew 0.4 percent in 2001, followed by a healthy 4.8 percent in 2002 and 8.8 percent in 2003.

The Ways and Means Committee staff forecasts that investment spending will continue to expand in 2005, growing 6.6 percent year-over-year after increasing an estimated 13.0 percent in 2004 and 4.4 percent in 2003. It is forecast to slow to 3.8 percent in 2006.

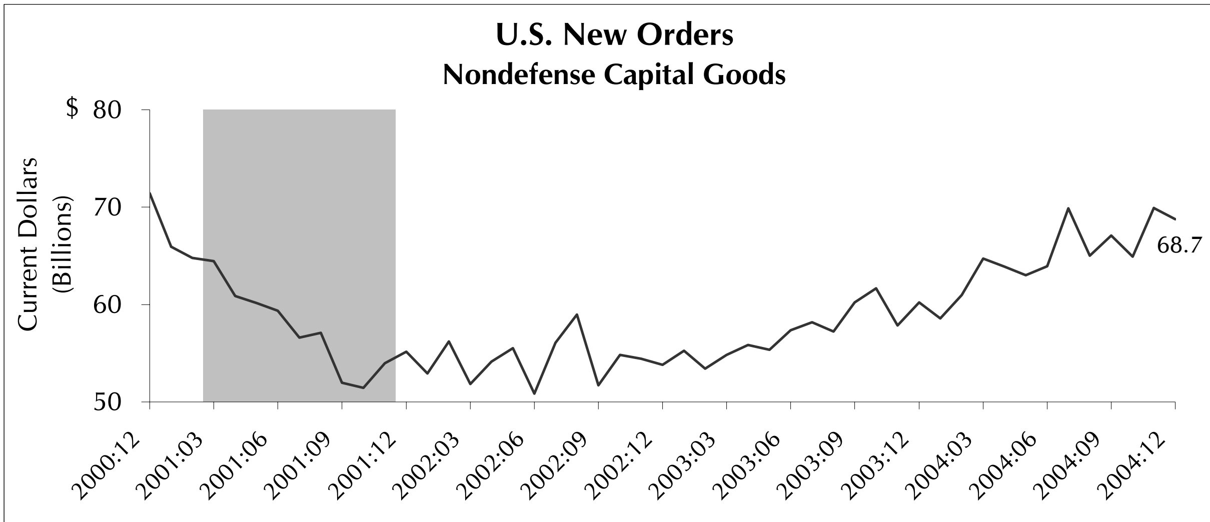
Several factors will contribute to furthering this recovery in business investment spending including:

* **Strong growth in corporate cash flow** (see the Corporate Profits section on page 40). Corporate profits have been steadily improving since the end of 2001.

* **Still favorable financing conditions** (see the Interest Rates section on page 42) helping to keep borrowing costs down for investment spending. The result is affordable borrowing for needed capital expenditures.

* **Nonmilitary capital goods orders** rising in recent months (see Figure 14). As businesses continue to see signs of an economic expansion, orders for capital equipment should continue to increase.

* Both **capacity utilization and industrial production** on a rise supporting further expansion in business capital spending (see Figure 2 on page 3).



Note: The shaded area represents the 2001 recession.
Source: U.S. Census Bureau.

Figure 14

In constant dollar terms, information-processing equipment and software investment, which accounts for 52.6 percent of total equipment investment, is estimated to have grown by 16.1 percent in 2004.[9] It is forecast to slow to 10.2 percent during 2005 and 7.8 percent during 2006, after growing at a double-digit rate for two years in a row. Industrial, transportation, and other equipment investment, which had declined for eleven quarters since the second quarter of 2000, started turning around beginning in the second quarter of 2003. It is forecast to grow 11.8 percent year-over-year during 2005 and 8.6 percent during 2006, after growing an estimated 9.8 percent in 2004. Overall,

[9] The share of 52.6 percent is an average based on the last five years of data.

equipment investment is estimated to have grown 13.4 percent year-over-year during 2004, after growing 6.4 percent in 2003. It will grow 10.9 percent during 2005 and 8.1 percent in 2006 (see Figure 15).

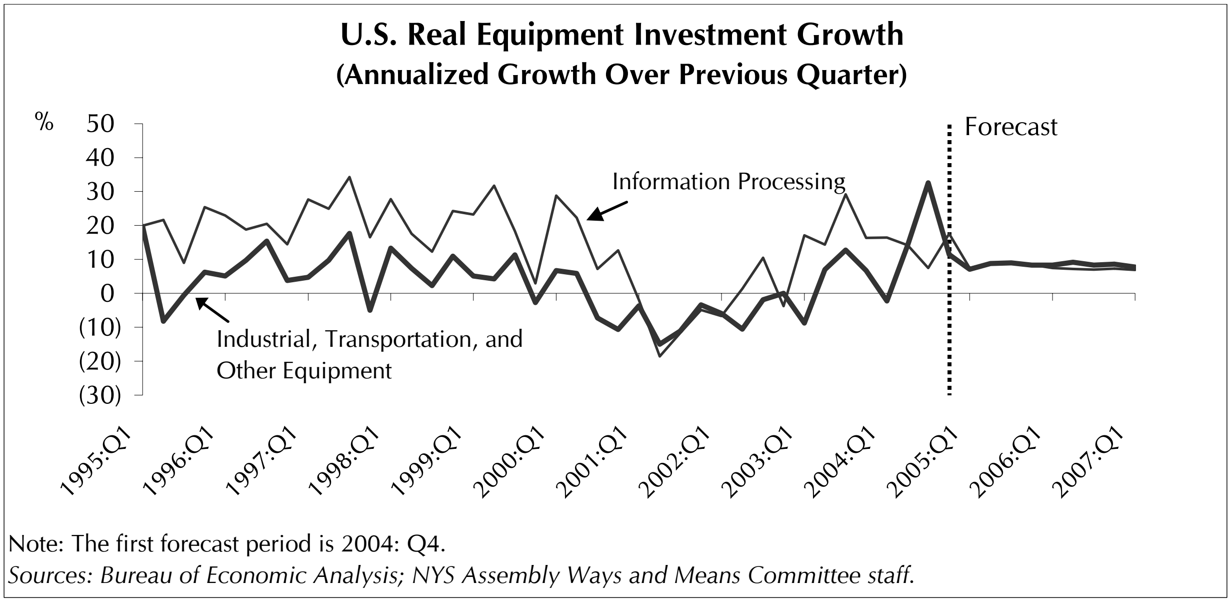


Figure 15

Nonresidential construction spending has declined eleven out of sixteen quarters since the fourth quarter of 2000. It is estimated to have grown a mere 1.3 percent year-over-year during 2004. It is forecast to continue to gradually recover during 2005 and 2006, growing 2.2 percent and 3.9 percent, respectively (see Figure 16). On the other hand, as mortgage rates are expected to rise and housing starts are likely to weaken, residential construction, which has increased sixteen out of seventeen quarters since the third quarter of 2000, is likely to start weakening in the second half of 2005 (see Figure 17 and Figure 18). It is forecast to slow to 2.0 percent year-over-year during 2005, after surging 9.5 percent in 2004 and 8.8 percent in 2003. It is then forecast to decline by 3.4 percent in 2006.

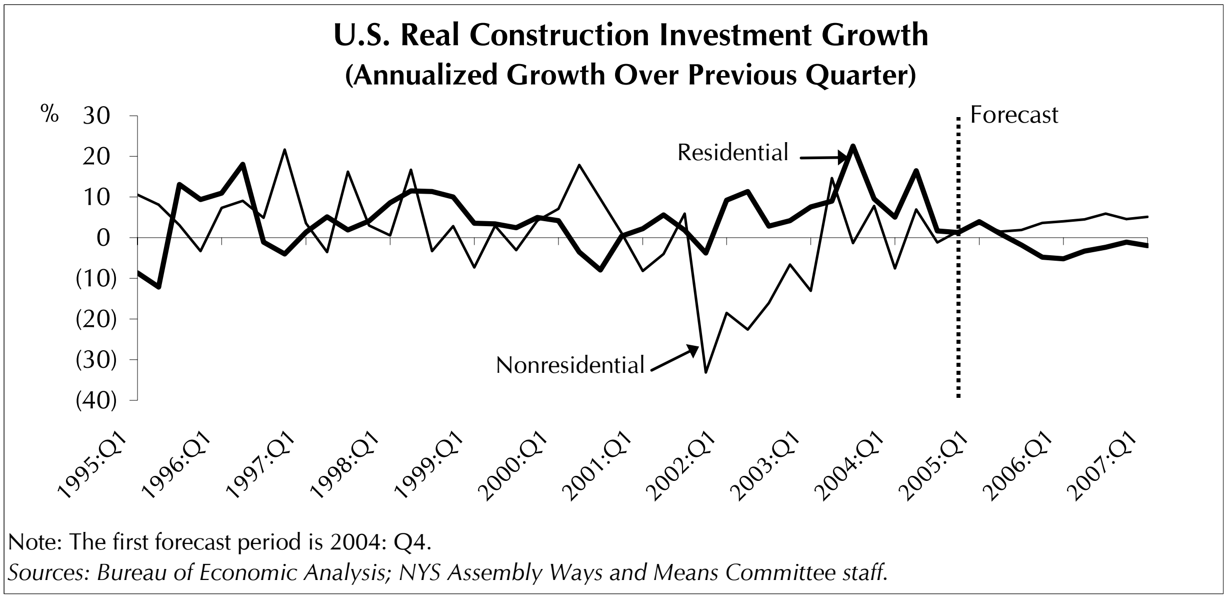


Figure 16

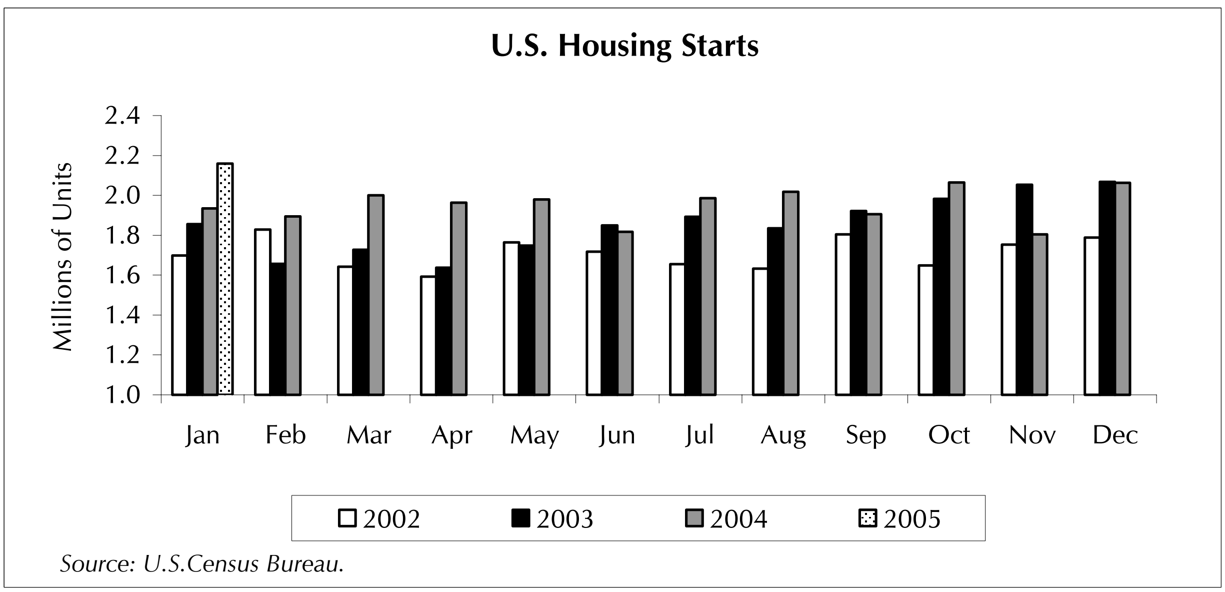


Figure 17

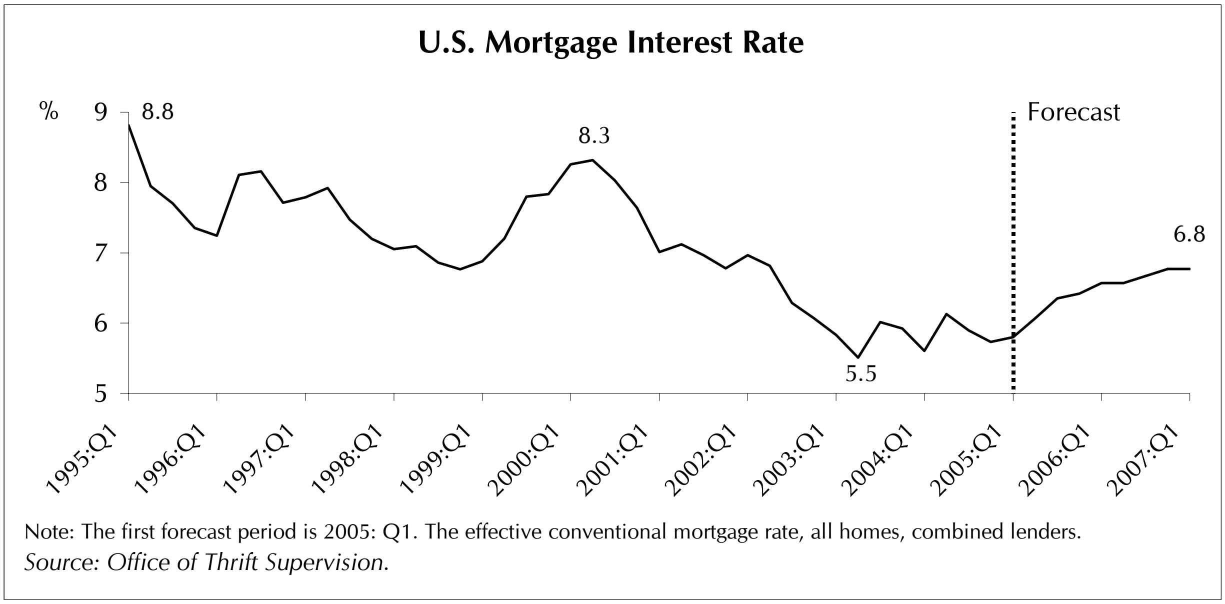


Figure 18

Despite holding only a three to four percent share in total business investment spending, inventory investment tends to be more volatile and cyclical than other components of investment and is therefore closely scrutinized by economists. Inventory investment appears to have bottomed out and should begin to grow again (see Figure 19).

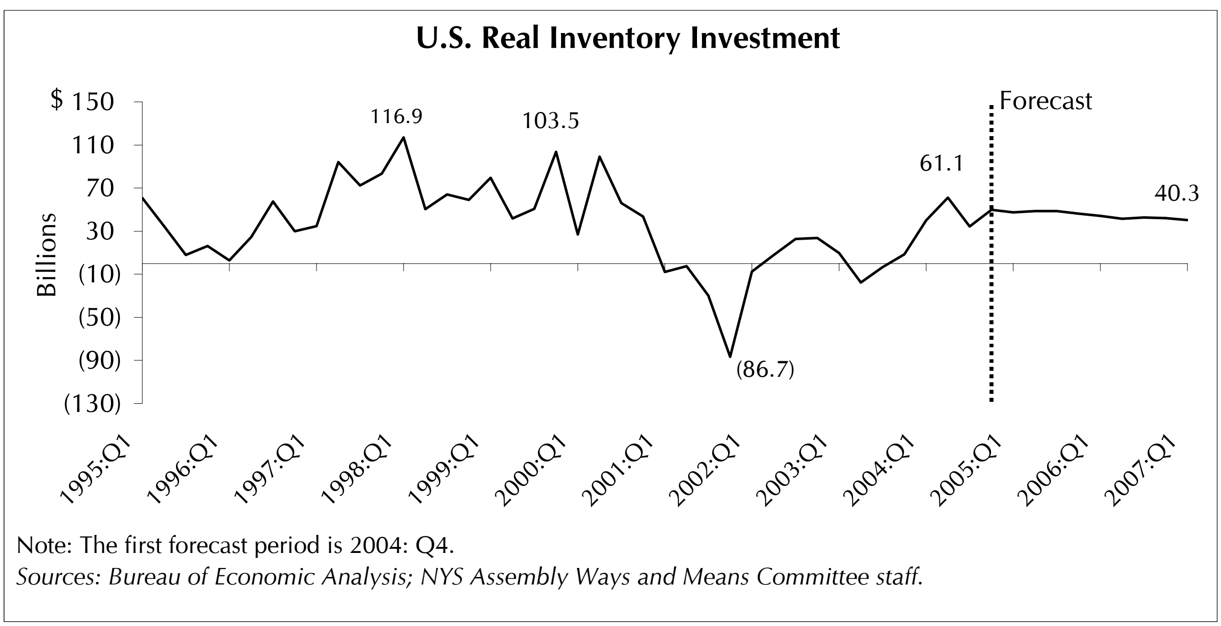


Figure 19

The inventory/sales ratio, which is often used to track inventory levels, has experienced a long-term downward trend (see Figure 20). This trend has been caused in part by information technology that has enabled companies to more efficiently produce and distribute goods when they are needed rather than holding large buffers of materials, works in progress, and finished goods. Despite this downward long-term trend, the inventory/sales ratio experienced a short-term peak in 2001 suggesting over-investment in inventory. This was followed by a rapid decline. Currently this ratio is below the long-term trend and is likely to rise.

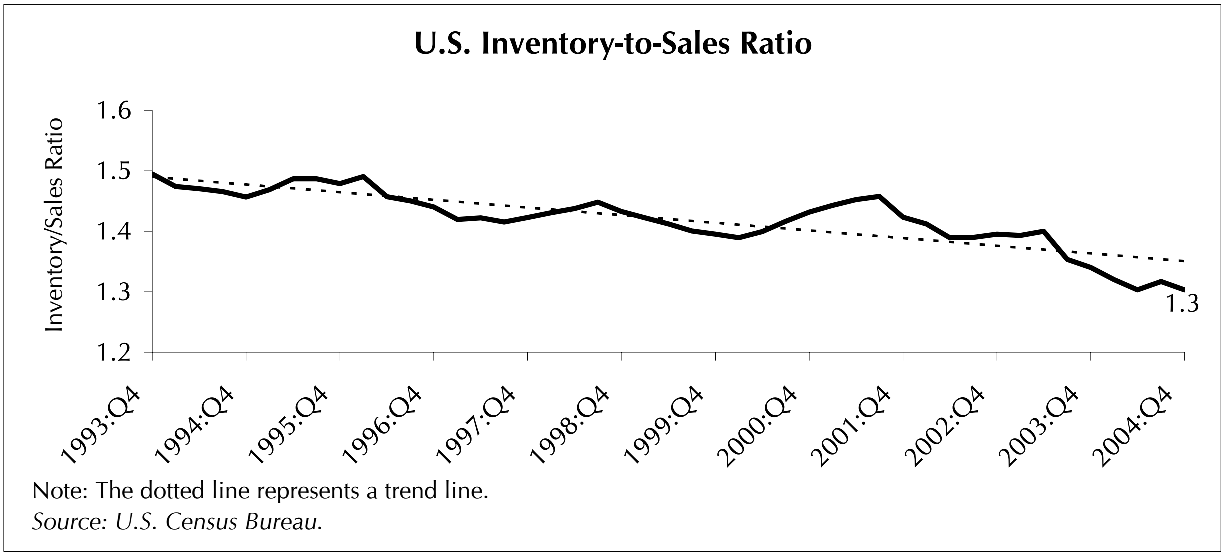


Figure 20

Government Spending

Federal Government Spending

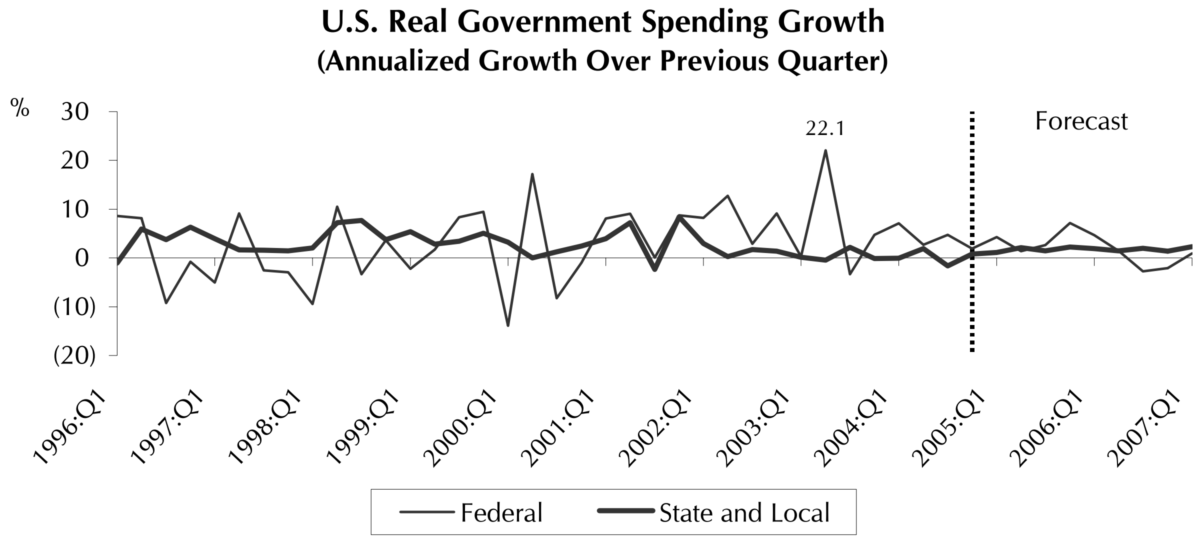
In constant dollars, federal government spending is expected to grow 3.2 percent in 2005 and 2.7 percent in 2006. This largely reflects continuing increases in defense spending. The increase in federal government spending is expected to occur despite slower growth in non-defense discretionary spending.

After falling at an annual rate of 0.9 percent in the national economic expansion between the first quarter of 1991 and the first quarter of 2001, real federal government spending rose at an annual rate of 5.9 percent during the national recession between the first quarter of 2001 and the fourth quarter of 2001.[10] This largely reflects the increase in discretionary federal government spending including the increase in defense spending (see Figure 21). Discretionary countercyclical federal government spending has become stronger in recent years.[11] The countercyclical response of the federal government in the recent recession included both increased spending and tax cuts: the contribution of the tax cuts to 2003 GDP growth is estimated at 0.8 percentage point, and the contribution of increased spending to 2003 GDP growth is estimated at 0.5 percentage point.[12]

[10] These growth rates are the averages of annualized quarter-to-quarter growth rates during these periods.

[11] Alan J. Auerbach, "Is There a Role for Discretionary Fiscal Policy?" National Bureau of Economic Research, Working Paper no. 9306, October 2002.

[12] Mark M. Zandi, "Fiscal Policy Assessment," *Regional Financial Review*, June 2004, 13-22.



Note: The first forecast period is 2004:Q4.

Sources: Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 21

Estimates of the contribution of tax cuts to the long-run growth have found that the effect of the recent tax cuts on long-run growth is small.[13] This is due to the small effect of the tax cuts on the expansion of productive capacity. Further, it is estimated that the effect of recent fiscal policies on near-term consumption was not as high as in previous tax cut episodes.[14] If other types of tax cuts that placed more income in the hands of lower income groups were enacted, they may have had a larger impact on aggregate spending.[15] The increase in deductions for depreciation have had the effect of advancing investment plans scheduled for the future into the 2002-04 period, when the policy was effective.[16]

If the economy had been operating at full capacity, the cumulative effect of changes in fiscal policy in recent years would have been a deterioration of the federal budget balance from a surplus of 1.1 percent of GDP in fiscal year 2001 to an estimated deficit of 3.1 percent of GDP in fiscal year 2005.[17] The size of the deterioration in the actual balance is similar in magnitude indicating that the deterioration of the budget balance was largely on account of changes in fiscal policy and not due to the deterioration of the economy.[18]

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[13] U.S. Congress, Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, March 2003, Table 17.

[14] Alan J. Auerbach, op cit.

[15] Mark M. Zandi, op cit.

[16] Alan J. Auerbach, op cit.

[17] This is based on the "standardized budget balance," which is calculated under the assumption that the economy is operating at full capacity. The deterioration in the budget balance due to the economic downturn is therefore excluded from the standardized budget balance.

[18] Data is from the Congressional Budget Office web site: <http://www.cbo.gov/> (August 2004). See also Richard Berner and David Greenlaw, "Will Fiscal Restraint Slow the U.S. Economy in 2005," *Blue Chip Economic Indicators*, July 10, 2004. A recent calculation from Economy.Com suggests that two-thirds of the

This also indicates that the economy will not grow out of the deficits as it recovers; changes in fiscal policy will be required to reduce the budget deficit.

State and Local Government Spending

State and local government spending is expected to grow 1.1 percent in 2005 and 1.8 percent in 2006 in constant dollars. State and local government spending is affected by the cyclical loss of revenue during economic downturns. Most state and local governments have responded more to fiscal conditions in the recent past than to the changes in economic conditions: they increase taxes or reduce spending when there is budgetary pressure.[19] Though there is increased need for higher spending during periods of economic slowdown, such as increased spending on public assistance, countercyclical spending has been the role of the federal government. However, many states have used reserve funds to help smooth expenditures.[20]

State and local government spending growth is expected to improve in 2005 and 2006, on account of improvement in revenue and in the near-term economic outlook (see Figure 21). In the third quarter of 2003, the combined state and local government revenues from the personal income tax, the corporate income tax, and the sales tax rose for the first time since 2000.[21] In the first half of 2004, state and local government revenue growth from the personal income tax and the sales tax was the strongest it has been since 2000.[22] However, state tax revenue was below its 2000 peak by 8 percent in 2004, after adjusting for inflation and population growth.[23]

Exports and Imports

The Assembly Ways and Means Committee staff forecasts that, in constant dollars, exports will grow 8.2 percent in 2005 and 8.9 percent in 2006 after rising 8.5 percent in 2004. With the U.S. economy expected to grow faster than the rest of the world, imports are forecast to grow 6.9 percent year-over-year in 2005 and 5.8 percent in 2006, following 9.9 percent growth in 2004 (see Figure 22). Net exports, defined as exports minus imports, have declined (becoming more negative) every year since 1995, adversely affecting GDP. This trend is expected to continue in 2005, but end in 2006 when net exports will increase

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deterioration in the federal budget balance between 2000 and 2003 was due to changes in fiscal policy. See Mark M. Zandi, "Fiscal Realities," *Regional Financial Review*, February 2004, 13-19.

[19] Alan J. Auerbach, "Fiscal Policy, Past and Present," *Brookings Papers on Economic Activity*, 2003, no. 1, March 2003, 75-134.

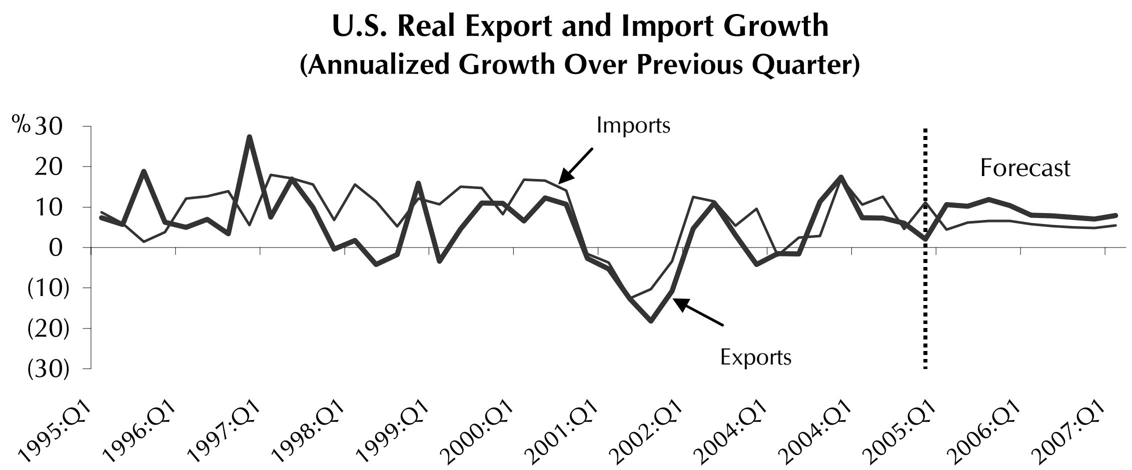
[20] James M. Poterba, "Budget Institutions and Fiscal Policy in the U.S. States," National Bureau of Economic Research, Working Paper no. 5449, February 1996.

[21] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*, January 2004, Box 2-1, 36.

[22] Nicholas W. Jenny, "No Big Surprise, State Tax Revenue Continues Recovery," no. 57, *State Revenue Report*, Nelson A. Rockefeller Institute of Government, September 2004, Table 4.

[23] Donald Boyd, "State and Local Governments Face Continued Fiscal Pressure," Nelson A. Rockefeller Institute of Government, January 2005.

slightly. However, the growth in dollar level for net exports in 2006 will be much smaller than the difference in percentage growth rates between imports and exports would seem to imply. This is because the base level of imports is about 50 percent higher than the level of exports. For example, in 2004 real exports were $1.1 trillion while real imports were $1.7 trillion. Therefore, exports must increase at a higher percentage rate than imports just to keep net exports from declining.



Note: The first forecast period is 2004:Q4.
Sources: Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 22

During most of the recovery following the 2001 recession, the value of the dollar was generally falling (see Figure 23). However, in the second quarter of 2004 the dollar briefly regained strength. The decline in the dollar during much of the recovery was a positive factor for net exports, helping to boost exports and reduce imports. However, the decline of the dollar can hurt the prices of United States assets. In addition, a declining dollar can cause increased inflation. This is partly because imported raw materials become more expensive. In addition, the increased prices of competing imports in dollars reduce the pressure on domestic manufacturers to keep prices down.

The dollar is expected to decline further. The dollar recently fell to four-year lows against the Yen and record lows against the Euro. U.S. Treasury Secretary John Snow has recently reiterated his pledge that the U.S. government policy remains one of a "strong dollar."[24] Yet at the same time, Snow maintained that markets must determine the value of the dollar, making it difficult to say how U.S. policy would be able to maintain a strong dollar since markets appear to be moving in the other direction.

[24] "U.S. Snow Repeats Strong-Dollar Policy Unchanged," *Reuters*, November 18, 2004.

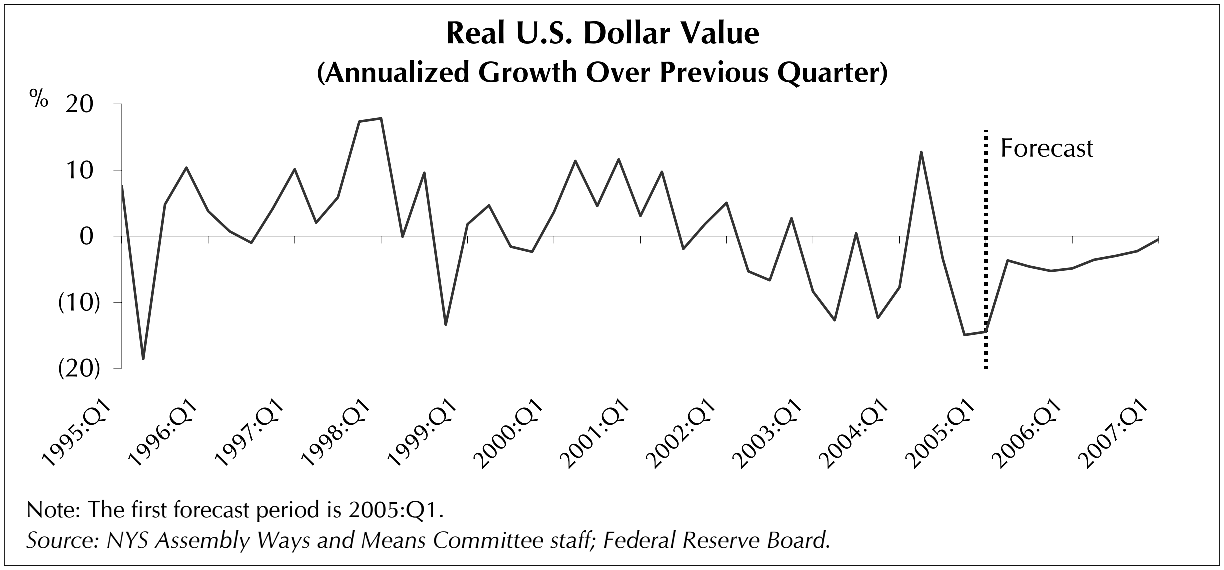


Figure 23

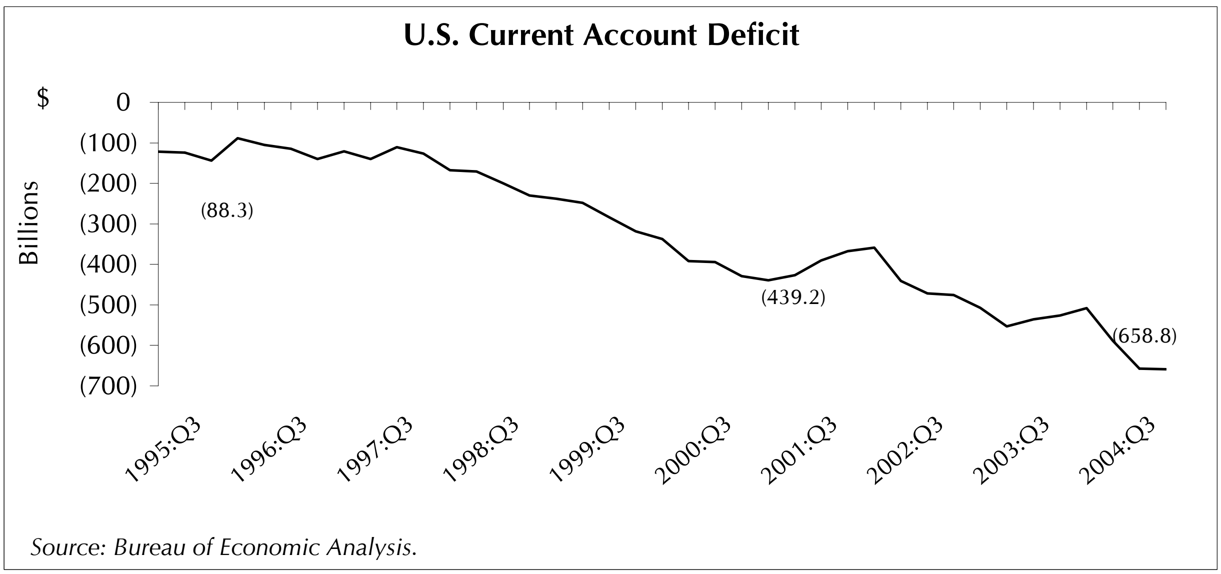


Figure 24

As seen in Figure 24, the decline of the dollar is being driven in large part by the growing current account deficit, which reached a record high of $658.8 billion in the third quarter of 2004. Federal Reserve Chairman Alan Greenspan, who in the past had argued that the current account deficit is not as serious an issue as some economists have suggested,[25] raised his own concerns about the long-term consequences of persistent current account deficits in a recent speech.[26] However, in a more recent London speech

[25] See for example: Alan Greenspan, "The Evolving U.S. Imbalance and Its Impact on Europe and the Rest of the World," *Cato Journal* 24, spring/summer 2004, 1-11.

[26] Comments are from speech given on November 19, 2004, in Frankfurt, Germany.

on February 4, 2005, Greenspan seemed less concerned about the threat presented by the current account deficit.[27]

The current forecast assumes that although the dollar may decline, it will not suffer a dramatic collapse, as some economists fear, during the forecast period. Therefore, the decline in the dollar will have a positive impact on GDP by raising exports and reducing imports. In addition, a stronger global economy will help to improve exports.

On December 26, 2004, an earthquake in the Indian Ocean created a tsunami that resulted in one of the most destructive natural disasters in human history. Well over a hundred thousand people died and millions have been left homeless. The total price for rebuilding has been estimated at $12.5 billion.[28] The tsunami is likely to significantly reduce tourism and affect the regional economy within the effected countries. However, output is expected to remain strong for most major U.S. trading partners. Tourism will most likely shift to other countries rather than be reduced. In addition, while the September 11th terrorist attacks had a broad psychological effect on consumption and caused a shift in business expenditures away from productive capital and towards increased security and backup facilities, the tsunami will not have any such large effect on the world economy.

Developed nations are all expected to have positive growth in 2004 and 2005, according to a poll of forecasters taken by the *Economist*.[29] However, the United States is expected to grow faster than any other developed nation in both 2004 and 2005. The Euro area is expected to grow 1.6 percent in 2005, while Canada, the largest trade partner for the United States, is expected to grow 3.0 percent. Japan is expected to return to positive growth after years of stagnant economic performance, with growth of 3.0 percent in 2004 and 1.6 percent in 2005.

Much of the developing world is experiencing rapid growth. China has been a focus of considerable attention, with growth in the fourth quarter of 2004 at 9.5 percent. The Chinese government has been acting to slow growth to a more controlled pace. Some other Asian countries are also growing very rapidly, including India and Malaysia. Some South American countries are also expanding rapidly, with 15.8 percent GDP growth in the third quarter of 2004 for Venezuela. With economic activity worldwide expanding for nearly all of our significant trading partners, the global economy will be a positive stimulus for the United States economy.

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[27] Greg Ip, "Greenspan Expects Trade Gap to Improve after Dollar's Drop," *Wall Street Journal*, February 7, 2005, A2.

[28] Owen Bowcott, "Tsunami Rebuilding Bill Outstrips World's Gifts," *Observer*, February 25, 2005.

[29] "Economic and Financial Indicators," *Economist*, February 12, 2005, 104.

Employment

The forecast of U.S. employment shows a profile of strengthening employment growth in 2004, and stable employment growth in 2005 and 2006 (see Figure 25). After growing 1.1 percent in 2004, it is expected that employment will grow 1.7 percent year-over-year in both 2005 and 2006 (see Table 2). It is expected that there will be 2.2 million more jobs in 2005 compared to 2004. The largest additions to employment in 2005 are expected to be in education and health, administrative and other services, leisure and hospitality, and construction. All sectors will experience an increase in employment in 2005. Employment is estimated to have increased in most sectors in 2004; in manufacturing and information, annual employment growth will only resume in 2005.

Note: The first forecast period is 2005:Q1.
Sources: Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

Figure 25

Table 2

U.S. Employment by Sector
(Percent Change)

	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
TOTAL	(0.3)	1.1	1.7	1.7
Government	0.3	0.2	0.7	0.7
Education & Health	2.4	2.2	2.6	2.5
Retail Trade	(0.7)	0.8	1.2	1.7
Manufacturing[1]	(4.8)	(1.1)	0.2	0.0
Other Services[2]	0.8	2.2	3.1	3.4
Leisure & Hospitality	1.6	2.5	1.8	1.7
FIRE[3]	1.6	0.9	1.8	1.6
Construction	0.3	3.4	2.9	1.9
Wholesale Trade	(0.8)	0.8	1.5	1.9
Professional Services	(0.7)	2.0	2.6	2.7
Transp. & Utilities[4]	(1.2)	1.2	2.2	2.0
Information	(6.0)	(1.6)	0.4	0.7
Mgmt. of Companies	(1.1)	1.8	1.0	1.0

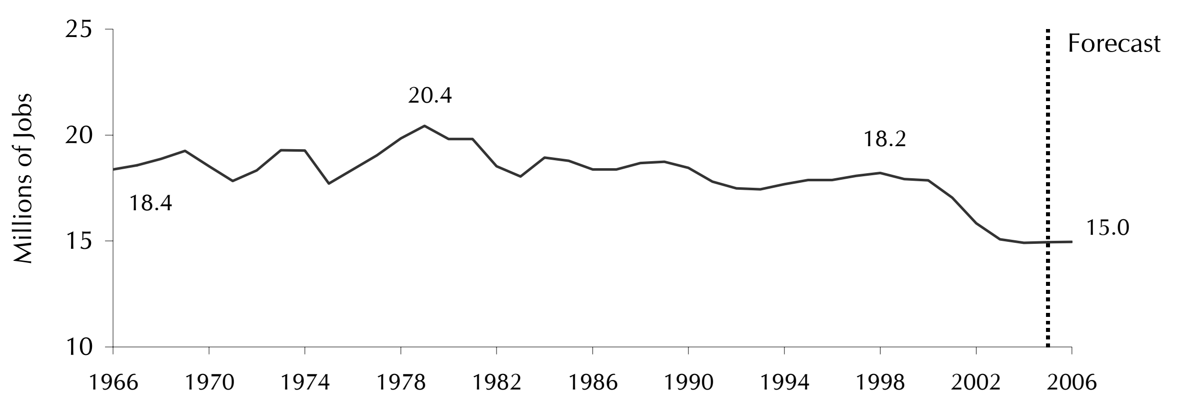
[1] Including Mining and Logging.
[2] Including Administrative, Support, and Waste Management Services.
[3] Financial Activities including Finance, Insurance, Real Estate, Rental, and Leasing.
[4] Transportation, Warehousing, and Utilities.
Sources: Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

The output loss in the recent recession was small and limited to two quarters. This reflected strong consumption demand unlike the 1990-91 recession; the cyclical decline in activity in the recent recession was driven by the fall in investment demand.

The loss of jobs in the 2001 recession was much too large to be explained by the cyclical fall in demand. This was particularly true of the large decline of employment in the manufacturing sector (see Figure 26). Manufacturing job losses were caused by many factors including productivity growth, the shifting of jobs overseas, and a deterioration of the deficit in U.S. trade in goods. The interpretation of employment change data was also affected by what some experts argue has been a significant increase in the numbers of the self-employed, and by the divergence in the employment estimates of the establishment and payroll surveys.[30]

[30] For more information on these issues, see New York State Assembly Ways and Means Committee, *Economic Report,* February 2004, 22-34.

The Ways and Means forecast for labor productivity growth for 2005 is 2.4 percent. This is similar to other forecasts for labor productivity growth in the near future.[31] The acceleration in labor productivity growth in the 1990s is attributed to the fall in the price of computer hardware and the influence of information technology use.[32] Recent estimates suggest that the contribution of information technology to the growth of productivity and to the improvement in the quality of capital equipment is much larger than the share of information technology in production and investment. This indicates the pervasive nature of the effects of information technology use, which has the characteristics of a general-purpose technology, and therefore, the capacity to raise living standards in the long run. However, the extent to which short-run or cyclical factors have contributed to the increase in productivity growth in recent years is not clearly known.[33] Besides, it is argued that the sources of the observed improvements in labor productivity may have changed, even since the mid-1990s: in the second half of the 1990s the use of improved technology and capital equipment may have been the primary source of the improvements in labor productivity, but more recently, cost-cutting measures in response to competitive pressure on business may also have contributed substantially.[34]



Note: The first forecast period is 2005. The data in the graph is annual.
Sources: Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

Figure 26

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[31] In "The 'New Economy': Post Mortem or Second Wind?" *Journal of Economic Perspectives* 16, no. 2, spring 2002, Martin N. Baily argues that the labor productivity trend growth rate is between 2.2 and 2.7 percent. Dale W. Jorgensen and others expect that labor productivity will grow 2.6 percent per year in the 2004-14 period. Also see Dale W. Jorgensen, Mun S. Ho, and Kevin J. Stiroh, "Will the U.S. Productivity Resurgence Continue?" *Current Issues in Economics and Finance*, 10 no. 3, December 2004.

[32] This also includes improvements in communications technology.

[33] Dale W. Jorgensen, Mun S. Ho, and Kevin J. Stiroh, op cit.

[34] Laurence H. Meyer, *A Term at the Fed*, HarperCollins, New York, 2004, p. 200.

Job Losses in the Recent Recession

During the employment downturn in this recession, 2.7 million jobs were lost (see Table 3). This was 1.2 million higher than the number of jobs lost from the employment peak to trough during the national recession of 1990-91. In the 2001 recession, the job loss was mostly in the manufacturing sector: the number of manufacturing sector jobs lost was almost as large as the total job loss. Though the job loss in the 2001 recession was larger than in the 1990-91 recession, the losses were spread over twice as many quarters in the 2001 recession, partly a reflection of the structural nature of the manufacturing job loss.

Table 3

U.S. Job Gains and Losses in Recent Recessions and Recoveries
(Based on turning points in Total Employment)

	Downturn of 1990-91		Downturn of 2001-03	
	Downturn	Recovery	Downturn	Recovery
Time Period	*1990:Q2-1991:Q3*	*1991:Q3-1993:Q1*	*2001:Q1-2003:Q2*	*2003:Q2-2005:Q1*
Duration (Quarters)	*5*	6	9	*7*
Total	(1,501.0)	1,611.0	(2,659.0)	2,885.8
Other services[1]	(127.6)	525.7	(231.8)	575.0
Education and Health	643.0	556.0	1,151.0	660.1
Leisure and Hospitality	(31.3)	351.0	105.3	525.7
Retail Trade	(349.6)	48.9	(450.8)	216.6
Construction	(588.7)	(53.0)	(137.7)	402.0
Prof. & Tech.	(38.3)	145.8	(342.9)	251.0
Transp. & Utilities[2]	(19.4)	33.9	(283.6)	124.6
Manufacturing[3]	(814.2)	(283.0)	(2,498.7)	(188.4)
Wholesale Trade	(93.4)	(110.4)	(224.5)	80.5
FIRE[4]	(78.3)	82.0	202.3	168.9
Government	58.7	334.0	698.0	119.7
Information	(15.3)	(19.7)	(519.0)	(52.8)
Management	(38.2)	(1.0)	(121.7)	49.4

Note: Level change is in thousands. The length of the recovery periods are set at the number of quarters it takes for the employment gain to exceed the loss of jobs in the most recent downturn.

[1] Including Administrative, Support, and Waste Management Services.

[2] Transportation, Warehousing, and Utilities.

[3] Including Mining and Logging.

[4] Financial Activities including Finance, Insurance, Real Estate, Rental, and Leasing.

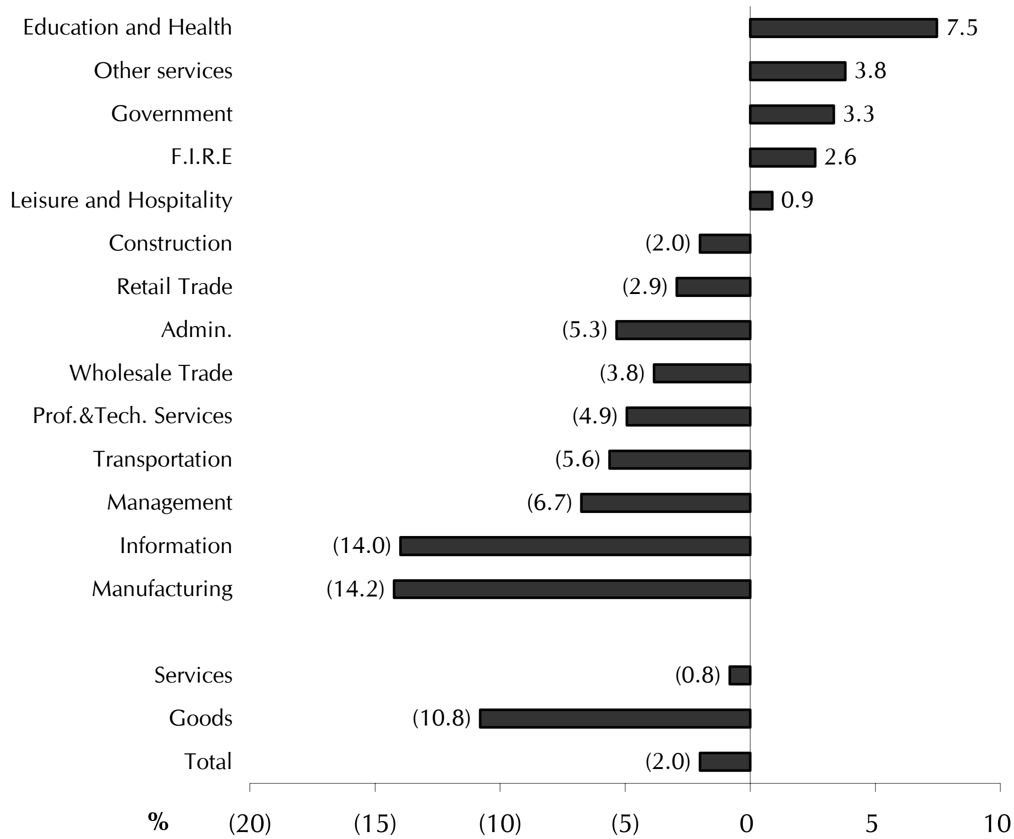
Sources: Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

There were intense job losses in a number of other sectors. In the information sector, 519,000 jobs were lost during the downturn. In management, transportation, professional services, and wholesale trade, the rate of job loss was high, indicating that a mix of cyclical and structural factors were responsible for the loss of jobs (see Figure 27).

In comparison with the 1990-91 recession, the job losses in the manufacturing and information sectors were much larger in the 2001 recession. Employment in the construction sector was not affected as much in the recent downturn as in the 1990-91 recession. Government jobs grew much faster in the 2001 recession.

There were strong employment gains in education and health. In this sector, employment grew 7.5 percent, adding 1.2 million jobs during the general employment downturn. This reflects the steady growth in demand for these services, which was not affected by the cyclical fall in demand.

U.S. Employment Growth
Employment Downturn: 2001:Q1 - 2003:Q2



Note: For notes on sector defintions, see Table 2.
Source: Bureau of Labor Statistics, CES.

Figure 27

Sectoral Employment Gains in the Recovery

Table 3 on page 27 shows that 2.7 million jobs were lost during the recent employment downturn; it is expected that the economy will add 2.9 million jobs between the second quarter of 2003 and the first quarter of 2005. Therefore, the recovery of the jobs lost during the recent employment downturn will take seven quarters. The employment recovery after the recent employment downturn is thus quicker than the employment recovery after the downturn of 1990-91. This is a reflection of the extended period during which the manufacturing job loss occurred. Though total employment turned down during the first quarter of 2001, manufacturing employment started to decline in the second quarter of 2000. Therefore, the entire manufacturing sector job loss is not counted in the total employment loss calculation during the period in which there was the downturn in total employment. If the entire manufacturing sector job loss occurred during the period of the downturn in total employment, the employment loss during the downturn would be larger, and it would take a longer period of recovery to regain the number of jobs lost.

Though sectors other than manufacturing will contribute most to the employment recovery, the slowdown in the rate of manufacturing sector job loss is important. The information sector, which also experienced significant employment loss in the recent downturn, will continue to lose jobs. These are the two sectors in which the long-run or structural nature of the job loss is most evident.

In the education and health sector, the gain in employment is expected to continue. The pace of employment generation in these sectors in the employment recovery is expected to be the same as during the employment downturn, reflecting steady growth in the demand for these services, unaffected by cyclical conditions. In all sectors which experienced a loss of jobs during the downturn other than manufacturing and information, employment will increase in the recovery. The largest increase in employment will be in education and health, administration and other services, and leisure and hospitality.

Offshore Outsourcing

The outsourcing of jobs to offshore locations and the fear of job loss have sparked the anger of those who see corporations exploiting tax loopholes while making large profits and sending U.S. jobs offshore.

The rapid expansion and plummeting costs of global communications and the further progress toward an integrated international economy created the conditions favoring the growth of offshore outsourcing or “offshoring” in non-manufacturing sectors that were previously unaffected by the movement of jobs overseas. Since the 1950s, manufacturing jobs have moved to various countries. However, in today’s service-oriented economy, offshoring differs in some fundamental respects from what used to be characterized as “runaway” shops. Offshoring has rapidly expanded beyond manufacturing to affect professional and business services, retail and wholesale trade, and healthcare.

Notwithstanding the lack of accurate counts, the media often report that an estimated 300,000 to 500,000 jobs are moving offshore each year.[35] The most frequently cited estimates are from Forrester Research that projects a loss of 3.3 million jobs by 2015, including 1.7 million back-office jobs and 473,000 information-technology jobs; other studies have projected much higher job losses.[36] The Forrester Research publication states that "over the next fifteen years, 3.3 million U.S. service industry jobs and $136 billion in wages will move offshore to countries like India, Russia, China, and the Philippines. The IT industry will lead the initial overseas exodus." Furthermore, in May 2004, Forrester increased its estimate of how many U.S. services jobs will go offshore in the near term.

The critical question for New York is whether it is more vulnerable to job losses from offshoring than other parts of the country. Indeed, New York employs a larger percentage of its total employment in sectors generally thought to be at risk of offshoring as compared to the U.S. as a whole. New York State's employment share in the information sector, the FIRE sector, and in the professional, scientific, and technical services sector exceeds that of the U.S. Thus, New York could be considered disproportionately adversely affected by the rise in offshoring activity.

Benefits and Drawbacks of Offshore Outsourcing

Corporations and some economists regard outsourcing as positive and necessary for the economy, business, and consumers. However, outsourcing is also cited as one reason for the "jobless" economic recovery experienced through early 2004. Weighing the pros and cons of outsourcing is complicated because a benefit to one region or segment of the economy may harm another. Besides, a negative initial impact may turn into beneficial outcomes in the longer run or vice-versa.

"Insourcing" is the forgotten side of the outsourcing debate. According to one estimate from the Organization for International Investment (OFII), U.S. subsidiaries of foreign companies support nearly one-half million jobs in New York State alone. However, this figure is based on Foreign Direct Investment (FDI), which is refuted by some as not providing an appropriate indication of the number of jobs being insourced.[37]

A new government outsourcing survey found a relatively small number of U.S. jobs moved abroad in 2004, raising complaints that the report picked up only a fraction of the total number of jobs lost to outsourcing. This is the only official U.S. Labor Department

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[35] Paul Magnusson, Alexandra Starr, "Outsource This: The Dems Smell Blood," *Business Week*, March 1, 2004, 47.

[36] John C. McCarthy, et.al., "3.3 Million U.S. Services Jobs To Go Offshore," Forrester Research, Inc., November 11, 2002.

[37] Organization for International Investment, "'Insourcing' Supports Nearly 500,000 Jobs in New York; The Forgotten Side of the 'Outsourcing' Debate," Washington, D.C., April 7, 2004. State-specific information on "insourcing" and the overall economic impact of U.S. subsidiaries of foreign companies is available at <http://www.ofii.org>. A study that refutes the use of FDI is Dean Bakes and David Rosnick, "Public Misconception 103 Bad Sources on 'Insourcing'," Center for Economic and Policy Research (Washington, D.C.), March 29, 2004.

statistic on the number of jobs moved overseas. However, the survey doesn't intend to present a comprehensive number of jobs relocated abroad. The survey tallies only larger companies that have had layoffs of 50 workers or more. Smaller companies and those that have fewer layoffs are left out of the mix.[38] Furthermore, the U.S. government had suspended the reporting of this statistic after its initial reporting (for the first quarter of 2004), primarily due to the inability of employers to identify those layoffs associated with jobs moved overseas.[39]

Offshore Outsourcing Conclusion

For some observers, offshore outsourcing is an irreversible trend. Individual states arguably have too small a reach to directly impact U.S. trade policy, and have limited means to soften the impact of economic dislocation. They may find themselves even more constrained as a result of the decline of resources accompanying the loss of jobs in the short-term. However, well thought out policies could still have a positive impact on reducing outsourcing or cushioning its negative impact on workers. Possible policy changes include adjustments to unemployment insurance for outsourced jobs, improved worker training and retraining, changes to tax policy, and measures that make U.S. employment more competitive, such as reducing the cost to business of health benefits, among other possibilities.[40]

Offshoring is thus still raising more questions than providing answers. At the very least, a better understanding of offshoring seems particularly important to New York, which has a workforce with jobs possibly more vulnerable to offshoring than the nation at large.

In an exhaustive study published recently, the economic effects of offshoring and potential policy responses were analyzed. In "Offshoring in the Service Sector: Economic Impact and Policy," the author finds that although the offshoring of service jobs hurts some workers, offshoring should not permanently lower employment or production in the United States. The author indicates that the average living standard can benefit in the long

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[38] Michael Schroeder and Joseph Rebello, "U.S. Survey Finds Few Jobs Moving To Offshore Homes," *Wall Street Journal*, June 11, 2004, A2.

[39] Joseph Rebello, "Job Losses from Outsourcing Prove Hard for U.S. to Quantify," *Wall Street Journal*, November 22, 2004, A2.

Figures for the second and third quarters of 2004 were eventually released along with data for the fourth quarter of 2004 on February 16, 2005. The separation of 5,134 U.S. workers was associated with out-of-country relocations in the fourth quarter of 2004, representing roughly 42 percent of all separations related to the movement of work and only about four percent of all nonseasonal/nonvacation extended mass layoff separations. For more details, see the Bureau of Labor Statistics, "Extended Mass Layoffs in the Fourth Quarter of 2004 and Annual Averages for 2004," February 16, 2005.

[40] One possible measure that could be taken is to appeal to national pride in consumer choices by the use of labeling that indicates how much of a good's or service's labor came from the U.S. However, such labeling would need to be regulated and based on value-added to prevent deceptive claims of "Made in the USA" when only final assembly occurs in the U.S.

run if the nation implements policies to retrain displaced workers and thus move them into expanding industries.[41]

Perhaps most importantly, one must consider that "the loss of jobs to other parts of the world is merely part of a longer-term process in which lower-value and lower-productivity jobs migrate to places with lower wages and lower productivity of labor. This process has played out for centuries within the United States and across the rest of the world."[42] However, one must acknowledge the detrimental effects or costs placed on our economy by worker dislocation and examine the extent to which this movement of jobs overseas may be encouraged by our national tax system.

Personal Income

The Ways and Means Committee staff forecasts that most of personal income components are expected to remain strong or grow faster during the current forecast period (see Figure 28). Personal income is estimated to have grown 5.4 percent in 2004 after an increase of 3.2 percent in 2003. It is forecast to further grow 5.3 percent in 2005 and 5.4 percent in 2006.

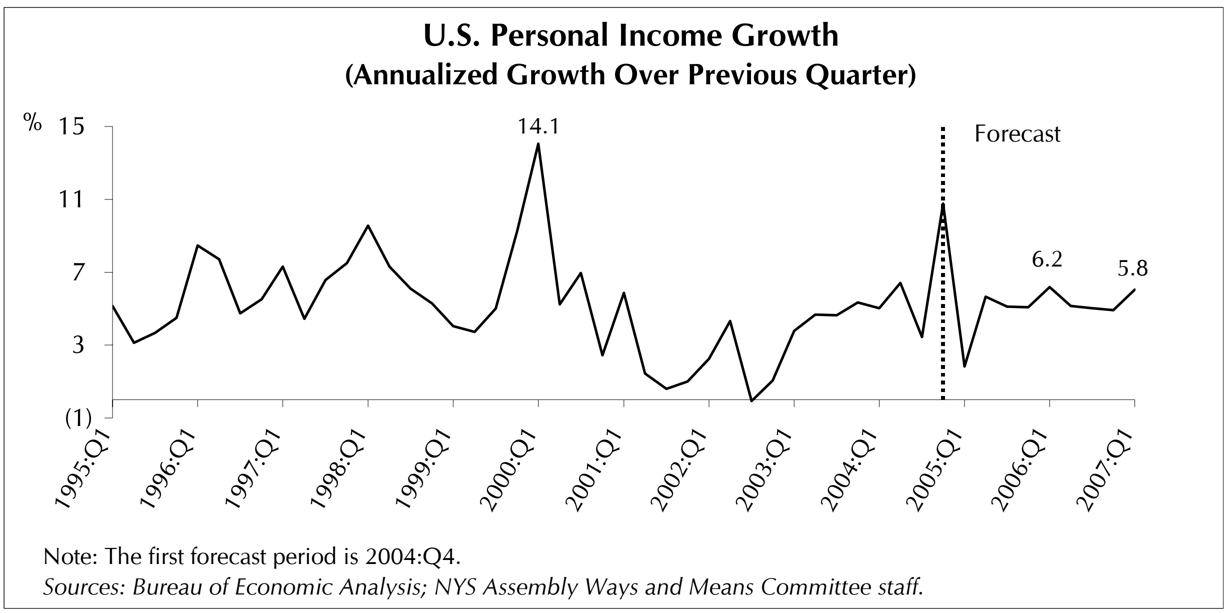

Figure 28

Wages and salaries income is the largest component of total personal income and accounted for around 55 percent in 2003. With a gradual improvement expected in payroll employment as well as average wages, this component grew an estimated 4.7 percent year-

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[41] For further discussion and a comprehensive listing of recent relevant research, please see C. Alan Garner, "Offshoring in the Service Sector: Economic Impact and Policy," *Federal Reserve Board of Kansas City Economic Review* 89, no. 3, third quarter 2004, 5.

[42] Robert A. Eisenbeis, "Taking the Long View on Outsourcing," *Econ South*, Federal Reserve Bank of Atlanta, vol. 6, no. 2, Second Quarter 2004, 1.

over-year during 2004. It is forecast to grow further by 5.3 percent in 2005 and another 5.3 percent in 2006, due to continued gains in employment. Proprietor's income is forecast to grow 7.1 percent in 2005 and 5.7 percent in 2006 after growing an estimated 8.2 percent in 2004. Recent strong growth in this component of personal income may have been due in part to the growth in self-employment that has been fueled by the jobless recovery and outsourcing. Benefits income, or "employer's contributions to employee pension and insurance funds," is forecast to increase 7.4 percent in 2005 and 6.5 percent in 2006, due partially to rising healthcare costs, which have jumped up significantly in recent years. Benefits income is estimated to have grown 8.2 percent in 2004.

Dividend income is forecast to increase in 2005 and 2006 by 2.8 percent and 6.1 percent, respectively. It is estimated to have grown by 12.3 percent in 2004.[43] This hefty increase in dividend income in 2004 is in large part due to the Microsoft dividend of $32.4 billion (or $129.6 billion at an annual rate) paid out on December 2, 2004.

With more interest rate hikes expected, interest income is forecast to continue to increase 3.4 percent year-over-year in 2005 and 4.6 percent in 2006. Interest income is estimated to have grown 1.7 percent in 2004.[44] As a record level of mortgage refinancing activity entailed a large amount of financing costs in 2003, rental income, a comparatively small component of personal income, fell by 10.0 percent, the largest decline since 1986.[45] With refinancing activity expected to subdue, however, rental income is expected to grow by 1.5 percent in 2005. It grew an estimated 7.6 percent in 2004.

With unemployment expected to continue to decrease as economic recovery progresses, personal unemployment insurance receipts will experience a gradual decrease over the forecast period. However, with Medicare benefits expected to surge in 2006 due to the new prescription drug program, transfer income is forecast to accelerate again to 5.5 percent in 2006, after slowing down to 5.1 percent in 2005 from an estimated growth of 5.3 percent during 2004.

Prices

The Ways and Means Committee staff predicts that the general price level, as measured by the Consumer Price Index (CPI), will increase 2.8 percent year-over-year in 2005 and 2.5 percent in 2006. Inflation was 2.7 percent in 2004.

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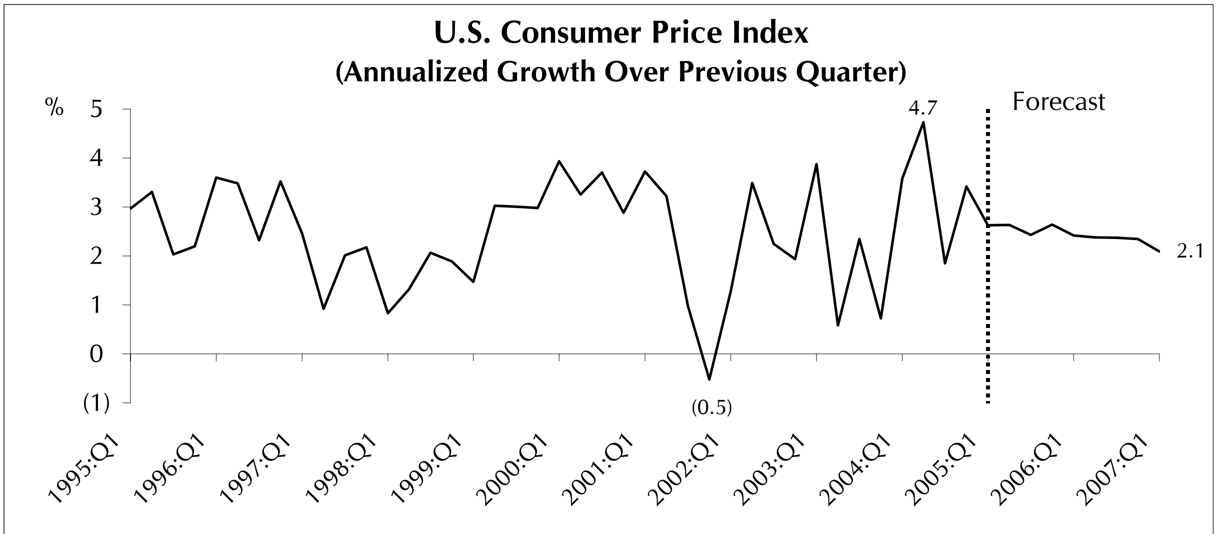
[43] In July 2004, BEA revised down net corporate dividends for each of the thirteen quarters that were subject to revision. The size of the downward revision grew steadily over the thirteen quarter period (the first quarter of 2001 through the first quarter of 2004), reaching $46.4 billion or 10.3 percent by the first quarter 2004.

[44] Interest income was also revised down through the revision period. The downward revision reached $32.8 billion or 3.4 percent by the first quarter of 2004.

[45] BEA's computation of imputed rental income (or the so-called "rent on owner-occupied dwellings") calls for subtracting depreciation, hazard insurance premiums, maintenance costs, and financing costs from rent received.

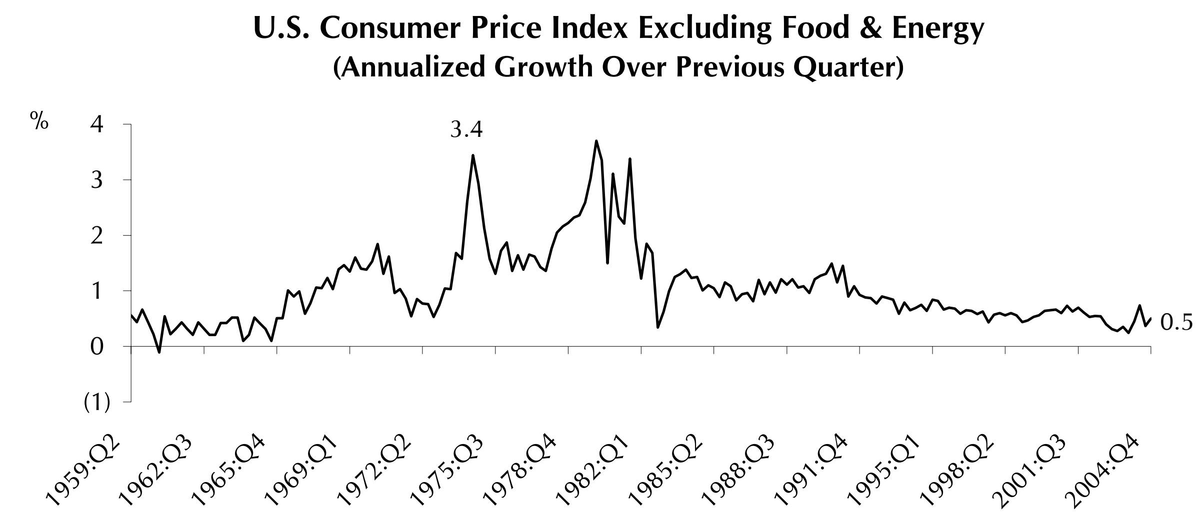
Increases in consumer and producer prices in 2004 were driven by volatile energy prices (see Figure 29). Inflation reached 4.7 percent in the second quarter of 2004, and has since declined to a quarterly rate of between two and three percent. A sustained increase in oil prices led to record high gasoline prices in 2004. The weakening dollar has also caused inflationary pressure.



Note: The first forecast period is 2005:Q1.
Sources: Bureau of Labor Statistics; NYS Assembly Ways and Means Committee staff.

Figure 29

Although growth in producer prices has been slow, rising energy prices in 2003 and 2004 have contributed to the price increases in raw materials for producers. Much of this rise was due to energy costs, specifically the sharp increase in natural gas prices. Although energy prices have led to increases in the CPI, inflation as measured by the CPI excluding food and energy (otherwise known as core inflation) has been quite low throughout 2003 and 2004 (see Figure 30).



Note: Data shown through fourth quarter of 2004.
Source: Bureau of Labor Statistics.

Figure 30

Oil and Energy Prices

Energy prices continue to remain a critical issue for the United States economy. Energy prices generally are more volatile than other prices, and the past year has been no exception. The varied and unpredictable nature of the factors influencing energy prices adds to the difficulty of reliably predicting future price movements. Current political and geographical considerations continue to add uncertainty to future energy prices, including prices of oil, gasoline, and natural gas. A cold winter also puts pressure on energy supplies. General uncertainty surrounding the energy markets has also pushed up the price of crude futures.

The price of oil (as measured by the U.S. refinery's average acquisition price of imported oil) has increased in the past two years. However, if the price of oil is adjusted for inflation, oil prices are not as high as in the early 1980s (see Figure 31).

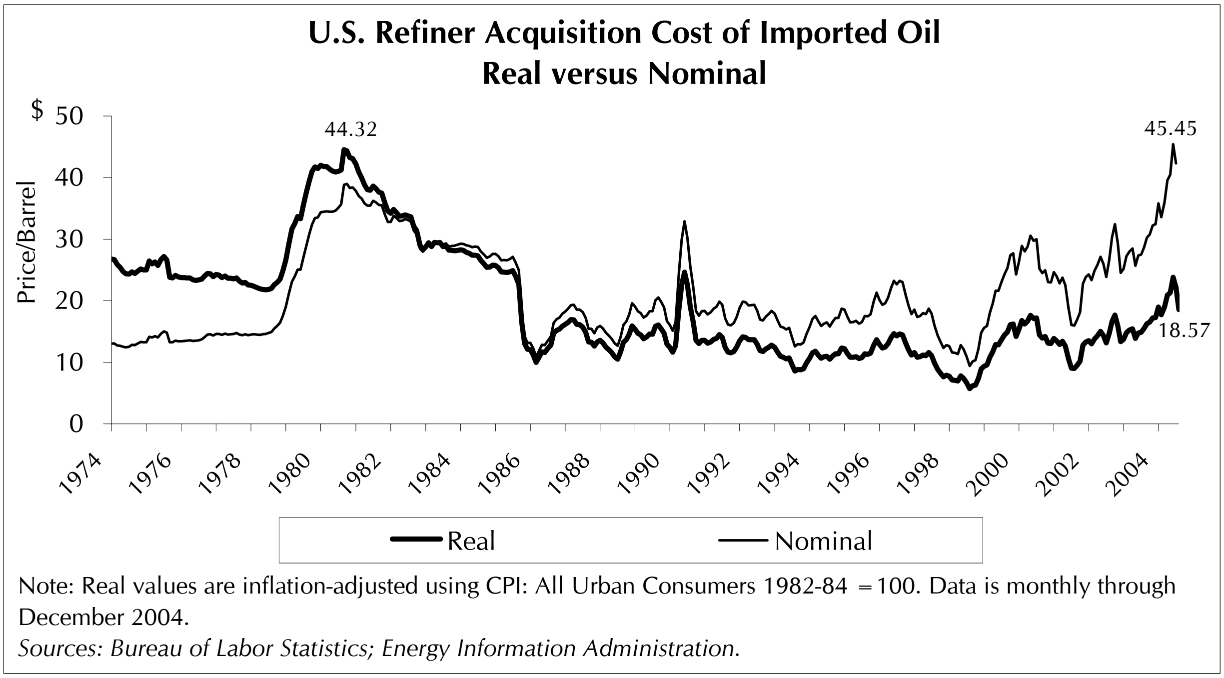


Figure 31

The price of oil futures in general continues to be high. Both the New York Mercantile Exchange (NYMEX) crude oil futures market and the International Petroleum Exchange Brent Crude futures market consistently set new record highs in 2004, reflecting expectations of high oil prices in the future. These expectations will likely continue as long as the uncertain conditions surrounding political conflicts, terrorism, and labor disputes persist. The one-month futures price had peaked on October 26, 2004, at $55.17 (see Figure 32).

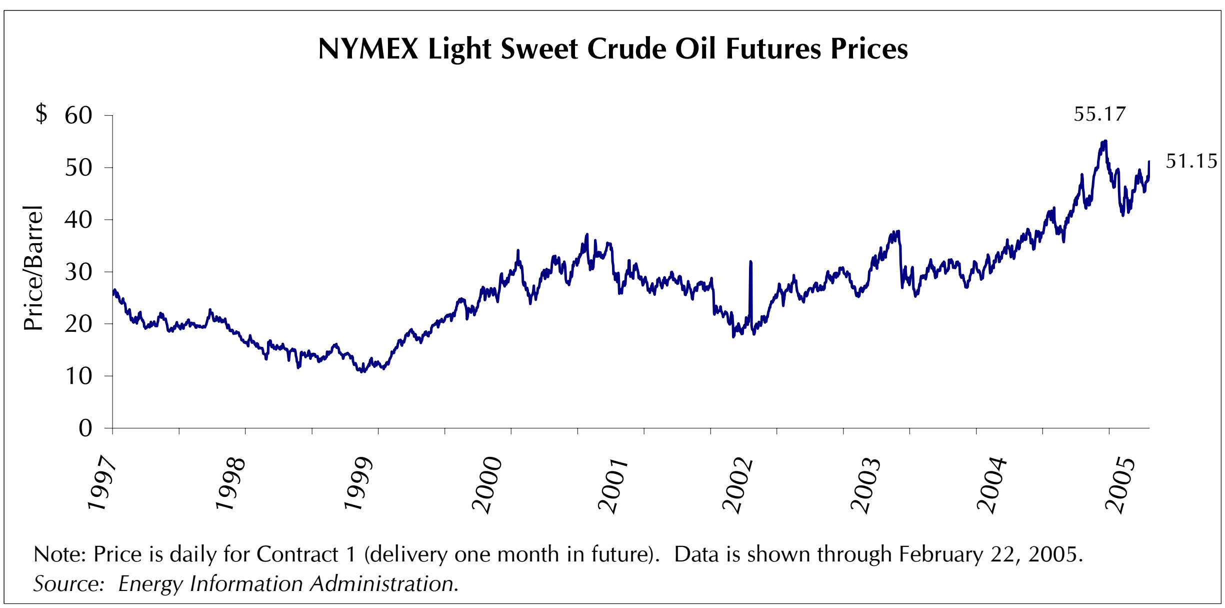


Figure 32

Many global issues have contributed to oil supply uncertainty. Some of the major supply concerns in 2004 were:

Russia: Oil producer Yukos (the largest in Russia) has been plagued by problems that continue in 2005. After a several-month-long struggle with the Russian government, Yuganskneftegaz, the largest oil producing unit in the company, was sold at auction in December.[46] Yukos has also filed for bankruptcy protection in American courts, and there are rumors that China has been offered a stake in their assets.[47]

Nigeria: Nigeria is one of the largest oil exporters in the world. Political unrest in the country helped to push U.S. oil futures over $50/barrel in late September 2004, as rebels threatened war against the nation's government and a disruption of oil supply. Threats of strikes by oil workers continue to plague the nation, and job disputes led to a shutdown in production in December 2004.

Iraq: Iraq has yet to reach a sustained level of output. Although the country has picked 2 million barrels a day as a production target, fighting and sabotage have continued to undermine the country's efforts to steadily offer help in meeting soaring world oil demand.

Norway: The country also had labor troubles in 2004. A strike by oilrig workers persisted for four months before ending in October after government intervention. Norwegian production in 2004 declined by about 70,000 barrels per day.[48]

Venezuela: One of the world's top oil exporters, Venezuela has suffered from political tensions throughout 2004. Venezuela has yet to recover from a strike that resulted in the firing of thousands of oil industry workers and damage to the country's oil reservoirs.

Hurricanes: Repeated hurricanes in the Gulf of Mexico damaged petroleum facilities and forced evacuation of oil platforms. Output from the Gulf of Mexico dipped 500,000 barrels a day in response to difficulties resuming production after the storms. The fall in oil prices in November and December was partially due to the return of oil production from the Gulf of Mexico.[49] However, Gulf production remains down by over 100,000 barrels per day.[50]

OPEC: OPEC is producing at almost full capacity, limiting their influence over prices. Saudi Arabia is reported as the only country in the cartel with spare production capacity. However, OPEC contends in their January 2005 monthly oil market report that their

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[46] Khodorkovsky Gives Up Yukos Stake, January 12, 2005, <http://www.cnn.com/2005/WORLD/europe/01/12/russia.yukos.ap/index.html>.

[47] Chris Buckley, "At a Crucial Oil Juncture, a Russian Calls on China," *New York Times*, January 12, 2005.

[48] See <http://www.opec.org>.

[49] Energy Information Administration, "Short Term Energy Outlook," January 11, 2005, <http://www.eia.doe.gov/emeu/steo/pub/contents.html.>

[50] OPEC, *Monthly Oil Market Report*, January 2005, <http://www.opec.org>.

production increase in 2004 of 3.5 million barrels per day was enough to meet rising demand.

While supply remains uncertain, demand continues to show strong growth. The United States continues to account for the largest share of oil demand. Demand in the United States continues to grow, and larger portions of the demand are being met by imports. In 2003, America consumed over 20 million barrels per day. Over half of this oil was imported, and 42.3 percent of the imported oil came from OPEC countries.[51] Japan had the next largest demand for a single country with 5.6 million barrels a day, followed closely by China with 5.5 million barrels a day. However, in 2004, oil demand in China overtook Japan. Data available for 2004 indicates China is consuming an average of 6.5 million barrels per day compared to Japanese demand of 5.4 million. Oil demand in China has grown significantly, and continues to surge. This has led to competition between the United States and China for available oil (see Figure 33). Demand in India is also growing at a fast pace.

Prices are not the only indicator affected by the energy outlook, as consumer sentiment was volatile throughout 2004 as consumers reacted to high gasoline and energy prices as well as a weak employment outlook. In December, confidence was up partially in response to falling energy prices.

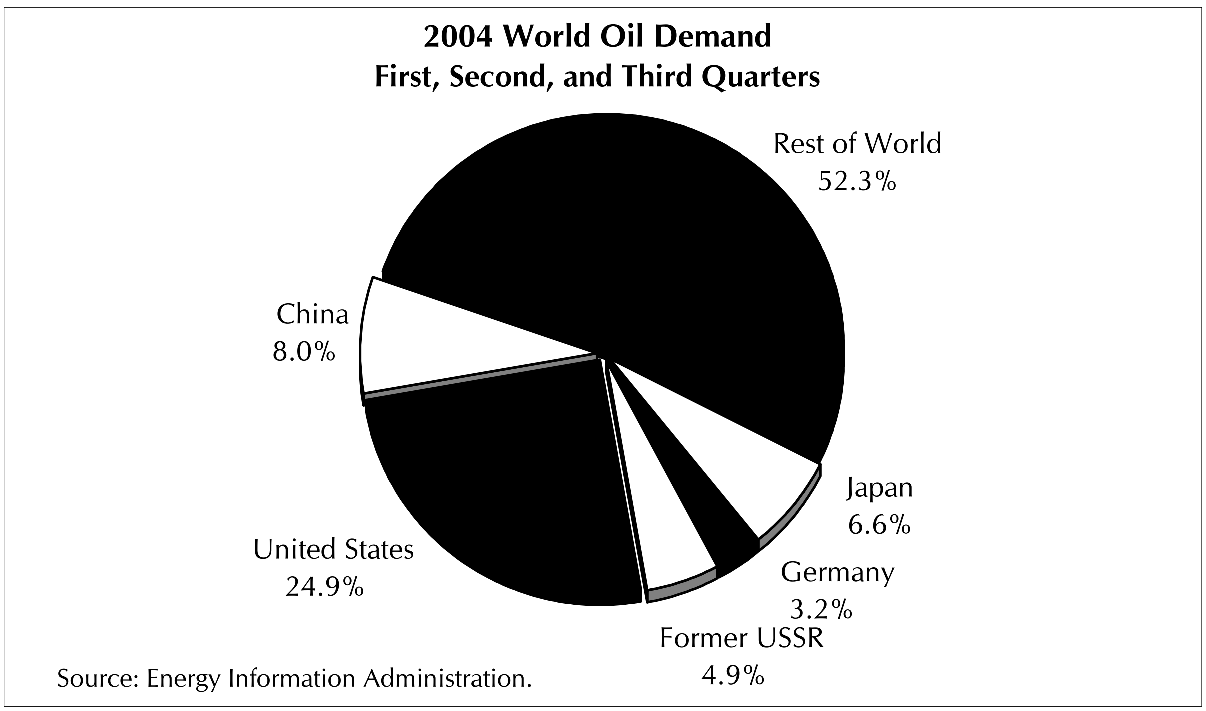


Figure 33

[51] See Petroleum Imports by Country of Origin, 1960-2003
<http://www.eia.doe.gov/emeu/aer/txt/ptb0504.html>.

Oil Price Sensitivity Analysis

Oil prices represent a significant risk to the forecast and there is no formal way to reliably predict oil prices. Therefore, a sensitivity analysis regarding the effect of a higher oil price on major United States economic variables is useful.

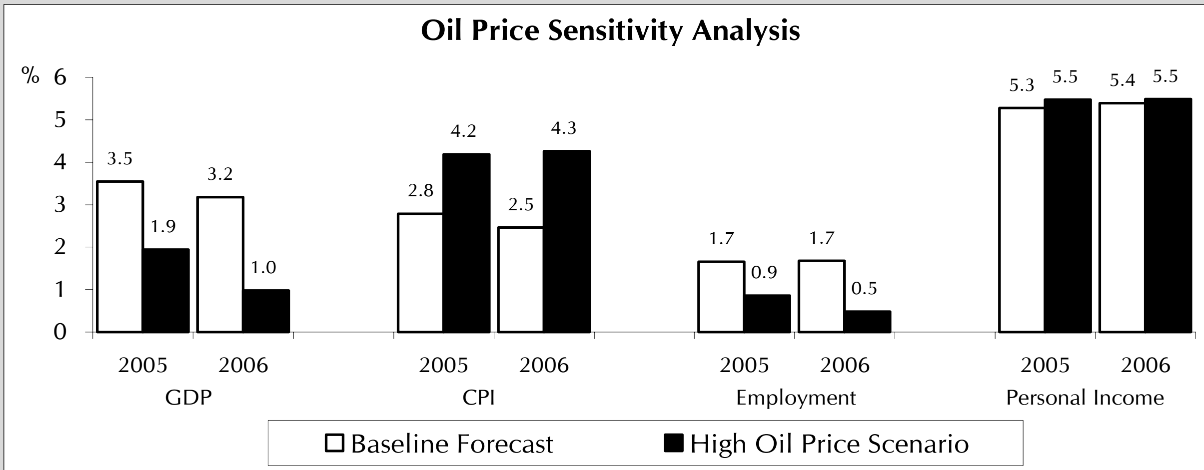
For the purposes of this exercise, the baseline scenario uses an oil price of $36 for 2004, $40 for 2005, and $37 for 2006. The oil price is forecast to peak at $42 in the first quarter of 2005, then is forecast to gradually decline through the forecast period. The High Oil Price Scenario was run using an oil price of $70 per barrel throughout the forecast period. Most other exogenous variable assumptions were held constant in the scenario, with the exception of a few that could be heavily influenced by the price of oil, such as world output growth and light vehicle sales.

A high oil price would decrease real GDP growth for both 2005 and 2006. Consumers would be hit hard by higher oil prices that sharply cut into their purchasing power. Business capital spending would also be hit hard as the cost of some capital goods would rise sharply and their profit margins get squeezed. The baseline forecast predicted GDP growth of 3.5 percent for 2005 and 3.2 percent for 2006, while a high oil price could cut growth to 1.9 percent in 2005 and 1.0 percent in 2006 (see Figure 34).

Employment growth would also decline if higher oil prices were to persist. A drop of 0.8 percentage point in 2005 and 1.2 percentage points in 2006 could occur.

General consumer prices could be over one percentage point higher if oil prices were to stay high for a longer duration. The Ways and Means Committee staff currently forecasts that prices will rise 2.8 percent in 2005. This number could reach 4.2 percent with high oil prices. Similarly, prices in 2006 could grow between 2.5 and 4.3 percent depending on oil prices.

Personal income growth may also be faster as wage rates and other personal income components (measured in nominal terms) may get adjusted up for higher inflation. Higher oil prices could add 0.2 percentage point to personal income growth in 2005 and 0.1 in 2006.

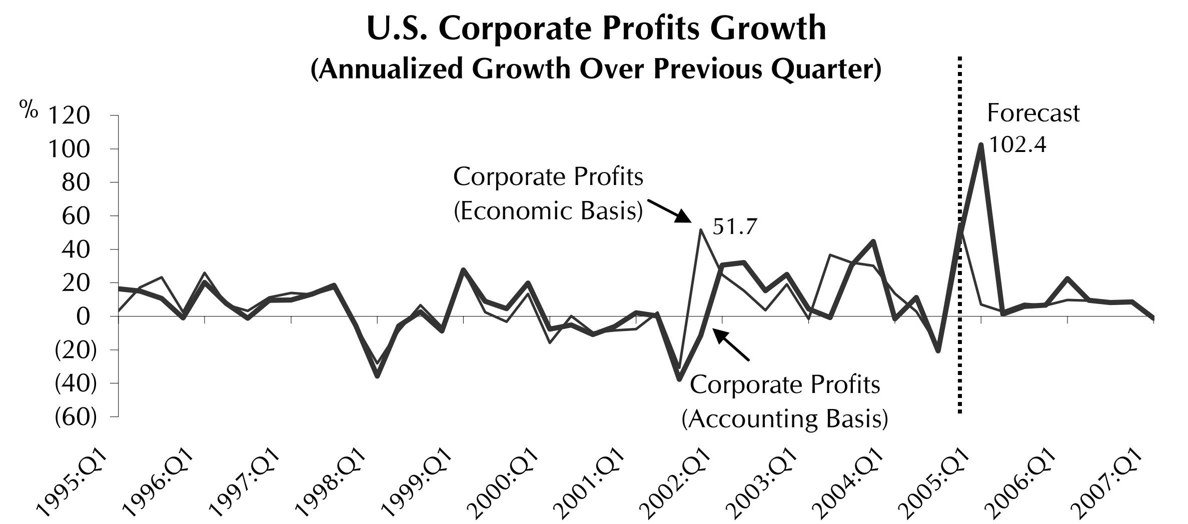


Source: New York State Assembly Ways and Means Committee staff analysis.

Figure 34

Corporate Profits

Pre-tax corporate profits (often referred to as accounting profits) have been quite volatile in recent quarters (see Figure 35). They also have recently moved less in tandem with economic profits, which is another measure of corporate profits that are directly related to economic factors rather than accounting rules.[52] This was due mainly to a recent increase in the volatility of capital depreciation adjustments (the so-called bonus depreciation) as well as the volatility of the underlying economic profits. The 2004 annual "three-year revision" of the National Income and Product Accounts by the Bureau of Economic Analysis made the recent mismatch between economic and accounting profits more pronounced than seen previously. Economic profits were revised down for each of the thirteen quarters covered in the 2004 revision starting from the first quarter of 2001 through the first quarter of 2004. The downward revision amounted to $60.9 billion, or 5.0 percent by the first quarter of 2004. The size of revision in accounting profits was smaller ($29.7 billion, or 3.2 percent) but the revision was upward, for capital depreciation adjustments were revised downward by $92.4 billion, or 27.9 percent, by the first quarter of 2004.



Note: The first forecast period is 2004:Q4.

Sources: Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 35

[52] Accounting profits (also known as "before-tax profits" in NIPA Table 1.12) are derived from economic profits, which are computed based on net national output. Since net national output is gross national output minus capital depreciation, a decline in capital depreciation, with all other factors held equal, would result in larger net national output and larger economic profits. Two adjustments are made to economic profits to arrive at accounting profits: one is capital depreciation adjustment and the other is inventory valuation adjustment. These adjustments convert capital depreciation and inventory withdrawals from historical cost to replacement cost, which is the measure used in the BEA's national income and product accounts.

Due in large part to a big decline in capital depreciation in the fourth quarter of 2001, economic profits rose a strong $88.5 billion or at an annualized rate of 51.7 percent from the previous quarter.[53] Economic profits rose again in the second quarter of 2003 by $74.2 billion or at an annualized rate of 36.7 percent. It was due in part to a decline in capital depreciation as well as faster growth in output relative to labor and interest costs. A decrease in rental costs also contributed to the economic profits spurt. Despite these large increases in corporate profits on an economic basis, corporate profits on an accounting basis declined 11.5 percent and 0.8 percent, respectively, in those two quarters. The main reason for this recent decline in accounting profits was that U.S. corporations were allowed a 30 percent bonus first-year depreciation deduction for qualified equipment, software, and leasehold property under the provisions in the Job Creation and Worker Assistance Act of 2002. The additional first-year deduction was raised to 50 percent in the Jobs and Growth Tax Relief Reconciliation Act of 2003. Consequently, corporations wrote-off $111.7 billion as depreciation in the fourth quarter of 2001 and $240.2 billion in the first quarter of 2004.

Despite the recent surge in volatility, corporate profits on an accounting as well as economic basis have been improving since 2001 when profits declined 8.5 percent and 6.2 percent, respectively. Economic profits are estimated to have increased by 15.2 percent year-over-year during 2004, following another healthy rebound of 16.8 percent in 2003. The large improvement in 2003 and 2004 is due to robust growth in productivity, among other reasons. With output growth slowing and labor and interest costs rising, economic profit growth will slow to 9.9 percent during 2005 and further down to 8.1 percent during 2006. Due to robust growth in economic profits, accounting profits are estimated to have increased by 11.8 percent during 2004, following a healthy year-over-year rebound of 15.4 percent during 2003. As the 50 percent bonus depreciation deduction expired on January 1, 2005, accounting profits are forecast to surge 102.4 percent in the first quarter of 2005, resulting in a 27.0 percent year-over-year growth in 2005. It is forecast to slow to 10.9 percent in 2006.

With both employment and unit labor cost growing more slowly during the current expansion than previous expansions, robust productivity growth has contributed to the recent strength in corporate profits. As a result, the share of corporate profits in national income has recently risen to around 12 percent from the nine-year low 8.0 percent seen in the third quarter of 2001, while the share of labor income (the sum of wages and salaries and employee benefits) has declined to around 64 percent from the 66.8 percent seen in the same quarter (see Figure 36). Although the labor income share may gain in the near future as employment recovers, the current importance of corporate profits in national income will likely remain mostly intact during the forecast period.

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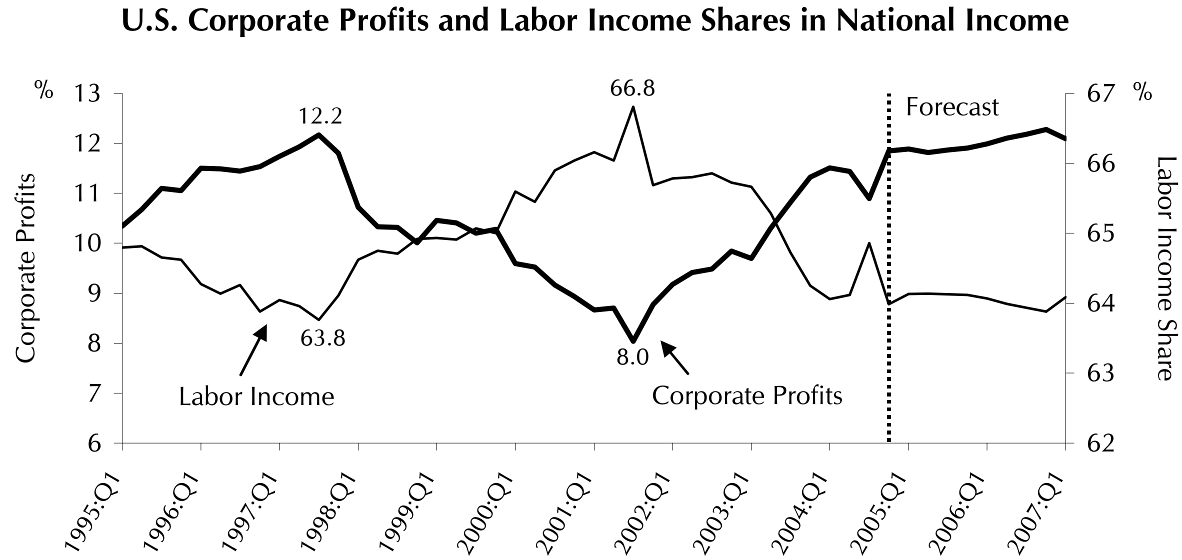
[53] Capital depreciation usually increases over time as physical capital stock accumulates. But as a large amount of property was destroyed by the September 11th terrorist attacks, capital depreciation surged in the third quarter of 2001, followed by a sizable decline in the fourth quarter. Capital depreciation similarly surged in the third quarter of 2004, when a series of powerful hurricanes swept through Florida, destroying many properties. As a result, corporate profits on an economic basis declined significantly in the same quarter.



Note: The first forecast period is 2004:Q4. Corporate profits in this chart refer to economic profits. Labor income refers to wages and salaries plus employee benefits.
Source: Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 36

Interest Rates

The Federal Reserve increased the federal funds rate at their February 2005 meeting from 2.25 to 2.5 percent. This followed five quarter-point increases in June, August, September, November, and December 2004. Before the June increase, the federal funds rate had remained at an unusually low rate of 1.0 percent for a year. The federal funds rate had not been this low since 1961 using weekly data. Short-term interest rates are still at a very low level, and further rate increases are expected. The only questions are how much rates are going to increase and how quickly.

Although the federal funds rate is extremely low, it is important to note that increases in the rate may have some effect on economic output and inflation regardless of the rate level. Thus, it is not just the rate itself that is indicative of expansionary or contractionary monetary policy—the change must also be taken into account as an indicator of policy direction. Though there are important reasons not to keep the federal funds rate long-term at its current low level, the Federal Reserve is not likely to increase the rate rapidly. They more likely will increase the rate at a steady, moderate tempo.

Long-term rates declined in the third and fourth quarter of 2004. This occurred despite increases to the federal funds rate and rising short-term rates in general. The decline in long-term rates was due to rising economic uncertainty, which caused investors to put money into bonds rather than stocks, helping to keep rates low.

Rising short-term rates, economic expansion, and ongoing federal budget deficits will contribute to a rise in long-term interest rates in the next few years. Long-term rates did not decline nearly as sharply as short-term rates during the 2001 recession and early stages of recovery. However, these rates are still relatively low and likely to rise.

The "twin deficits," referring to a high current account deficit along with a high federal government deficit, add to the risk for rapidly rising interest rates. Both the United Nations and the International Monetary Fund have recently warned that the U.S. twin deficits threaten to put the world's economy off balance.[54] Both the trade deficit and the federal deficit have reached record levels. The United Nations warns that even if a declining dollar helps in the short-term to reduce the trade deficit, this would cause an improvement in the U.S. economy while at the same time hurting economic growth in Japan and Europe. This would lead to increased U.S. spending on imports while reducing demand abroad for U.S. goods, reversing some of the improvement in the trade deficit caused by the falling dollar. The federal deficit is being hurt in part by spending in Iraq and Afghanistan, which is expected to cost $105 billion this year (in addition to defense spending in the budget submitted by the president), up from $88 billion in 2004 and $78.6 billion in 2003.[55] Other spending and taxation policy choices have also increased the federal deficit. The high twin deficits imply that the U.S. is relying greatly on foreign investors to finance both government and consumer spending. Currently, the largest holder of U.S. debt is Japan. China is the second largest holder and is rapidly increasing its share of U.S. debt (see Figure 37). This presents a risk of rising interest rates if foreigners become less interested in buying U.S. financial assets.

[54] Elizabeth Becker, "U.N. says U.S. Deficits Hurting Global Economy," *New York Times*, January 26, 2005, Finance/Business p. 3.

[55] Jonathan Weisman, "Record '05 Deficit Forecast," *Washington Post*, January 26, 2005, p. A1.

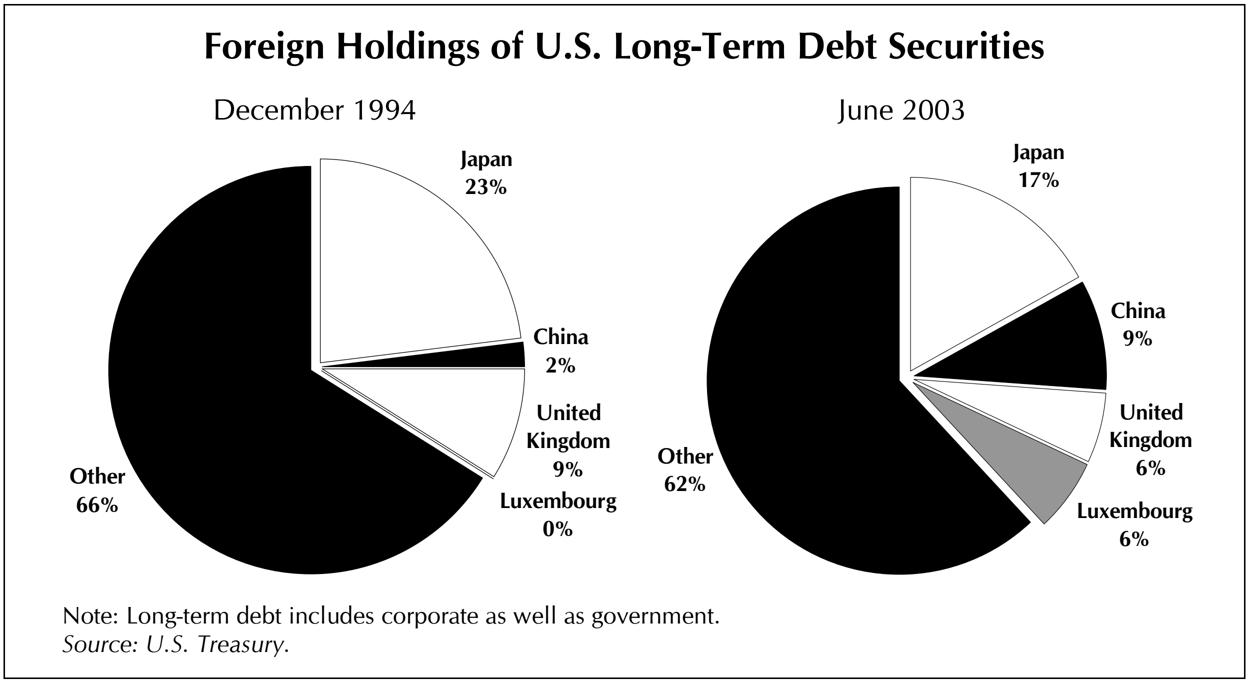


Figure 37

The federal funds rate is expected to increase from 1.95 percent in the fourth quarter of 2004 to 3.35 in the fourth quarter of 2005. The three-month Treasury bill rate is expected to increase from 2.02 percent in the fourth quarter of 2004 to 3.37 percent in the fourth quarter of 2005. The ten-year Treasury note rate is forecast to increase from 4.17 percent in the fourth quarter of 2004 to 4.77 percent in the fourth quarter of 2005 and 5.27 percent in the fourth quarter of 2006 (see Figure 38).

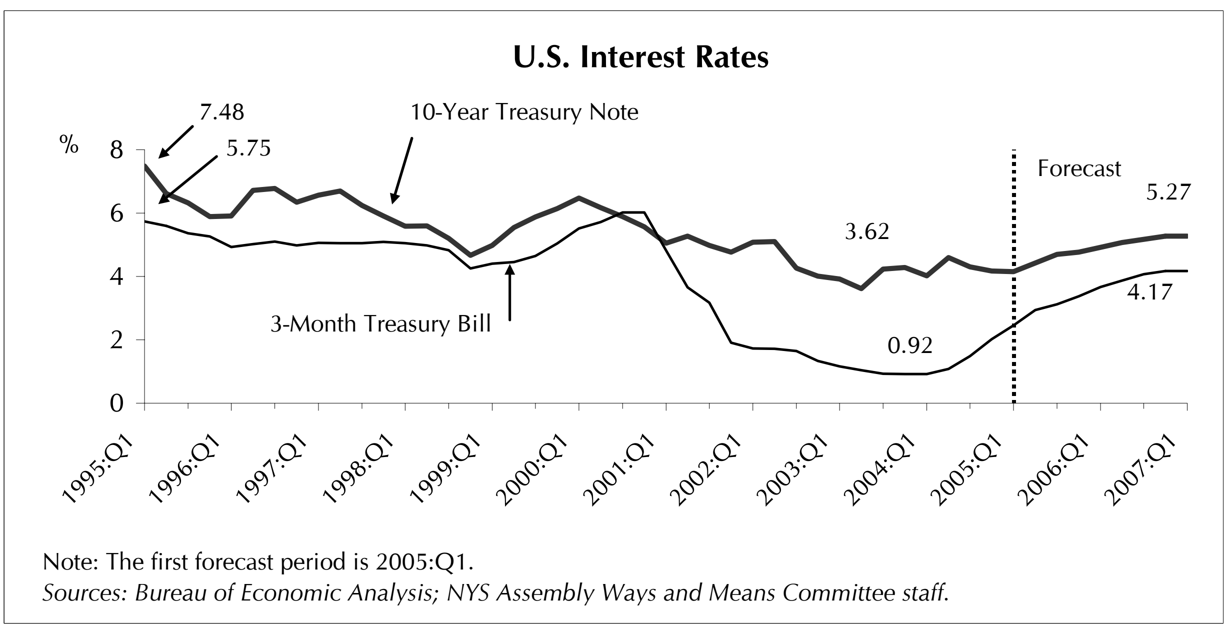


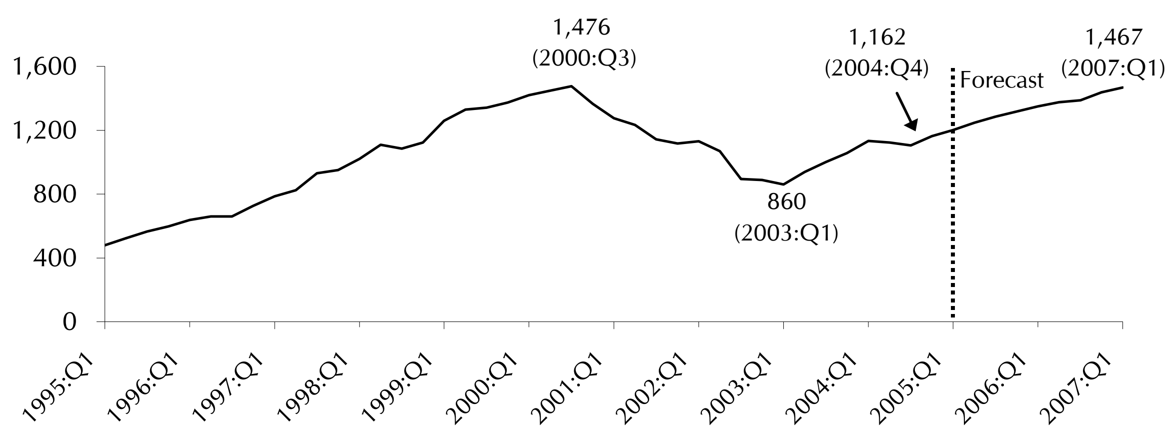
Figure 38

Stock Market

Using year-end values, the S&P 500 stock price index was up 9.0 percent in 2004 after rising 26.4 percent in 2003. The stock market, measured by yearly average value of the S&P 500 index, increased 17.3 percent year-over-year in 2004 following annual declines for three years straight in 2001, 2002, and 2003.[56] However, these numbers do not tell the full story of what has been happening over shorter intervals in the stock market. The year-over-year growth in 2004 was mainly due to the decline that took place during 2003. In the second and third quarters of 2004, the stock market declined from the previous quarter. The S&P 500 index is forecast to grow 11.7 percent year-over-year during 2005 and 9.9 percent in 2006.

After rising rapidly throughout most of the 1990s and into 2000, stock prices as measured by the S&P 500 index declined sharply from late 2000 until early 2003. The decline took away about half of the stock price gains experienced since 1990 and contributed significantly to the 2001 recession and slow recovery. Since the first quarter of 2003, stock prices have generally been rising, although at a modest pace. The S&P 500 is not expected to return to its former peak of 1,476 reached in the third quarter of 2000 during the forecast period (see Figure 39).

S&P 500 Price Index



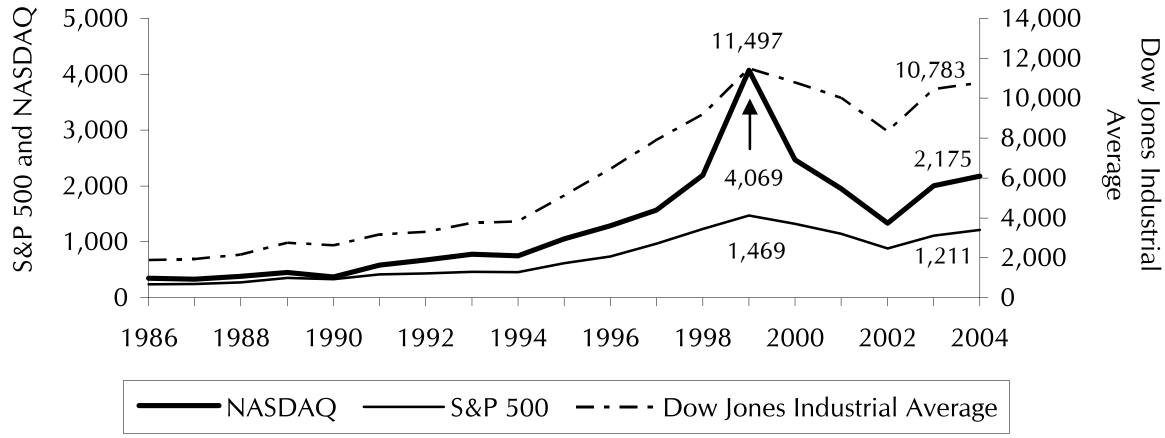
Note: The first forecast period is 2005:Q1.
Source: Economy.com; NYS Assembly Ways and Means Committee staff.

Figure 39

The NASDAQ and Dow Jones Industrial Average (DJIA) have shown trends similar to the S&P 500 (see Figure 40). Based on year-end price, all three markets peaked in 1999

[56] This method of comparison is used to be consistent with other growth rates cited in this report. However, yearly growth rates for the stock market are often cited using year-end values rather than yearly averages.

and bottomed out in 2002.[57] Though the pattern was similar, the NASDAQ had a much more pronounced peak and trough, consistent with the higher volatility of this market which is heavily weighted towards growth and technology stocks. While the S&P 500 and DJIA are well on their way towards their prior peaks, the NASDAQ remains at only about half of its peak value.



Source: Securities Industry Association (year-end index values).

Figure 40

Comparison with Other Forecasting Groups

The Assembly Ways and Means Committee staff forecast for overall national economic growth in 2005 is 3.5 percent, 0.1 percentage point lower than the February 2005 Blue Chip Consensus forecast of 3.6 percent. Economy.com's and Global Insight's forecasts are 3.5 percent, and the Division of the Budget's forecast is 3.4 percent (see Table 4). The February 2005 Blue Chip Consensus forecast is the average of fifty-four forecasters. Thirty-four of these forecasters, or 63 percent, have 2005 GDP growth forecasts at least as high as the Committee staff forecast.

[57] The 2000 peak in the S&P 500 discussed previously was based on quarterly data. However, since stock prices started declining in the first half of 2000, the annual average price was higher in 1999 than in 2000.

Table 4

U.S. Real GDP Forecast Comparisons

(Percent Change)

	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Ways and Means	3.0	4.4	3.5	3.2
Blue Chip Consensus	3.0	4.4	3.6	3.4
Division of the Budget	3.0	4.4	3.4	3.1
Economy.com	3.0	4.4	3.5	3.3
Macroeconomic Advisers	3.0	4.4	3.8	3.9
Global Insight	3.0	4.4	3.5	3.1

Sources: NYS Assembly Ways and Means Committee staff; Blue Chip Economic Indicators, February 2005; New York State 2005-06 Executive Budget with 30-Day Changes, February 2005; Global Insight, U.S. Executive Summary, February 2005, <http://www.globalinsight.com>; Economy.com, February 2005, <http://www.economy.com>; Macroeconomic Advisers Base Forecast, January 2005.

The Ways and Means Committee staff forecasts 3.2 percent economic growth for 2006. This is 0.1 percentage point above the Division of the Budget's forecast of 3.1 percent. Economy.com's forecast is 3.3 percent, Global Insight's forecast is 3.1 percent, and Macroeconomic Advisers' 2006 forecast is 3.9 percent.

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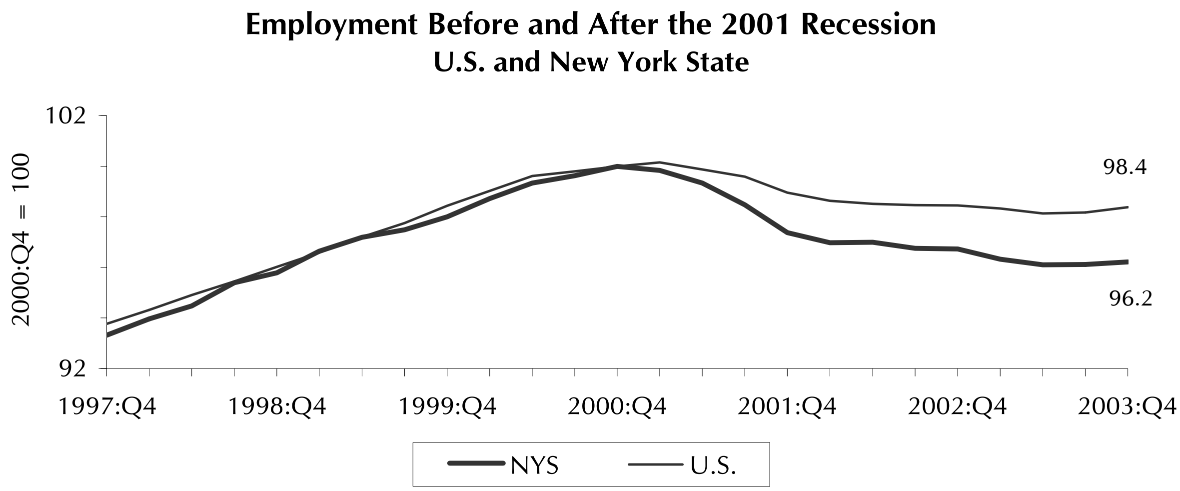
NEW YORK STATE ECONOMIC FORECAST

The New York State economy continues to lag the United States economy in terms of employment growth. However, the State will continue to benefit as the nation maintains an expansion. Both employment and wages are expected to grow in 2004 and 2005.

Employment

Figure 41 shows that the rate of decline in employment in New York State during the recent recession was faster than the rate of employment decline in the nation. The percent loss in State employment from the State employment peak to trough was 3.9 percent, compared to 1.9 percent in the United States in the same period.[58] If New York State declined at the rate of the U.S. during the period of employment decline in the State, 172,400 fewer State jobs would have been lost. The State's employment decline started around the same time as the nation, but the rate of decline was much steeper during 2001, due in part to the effects of September 11th.



Sources: Bureau of Labor Statistics, CES; NYS Department of Labor, QCEW.

Figure 41

The recovery in State employment is expected to strengthen in 2005; employment is expected to grow 1.2 percent in 2005 compared to 0.6 percent in 2004 (see Table 5). Total employment is expected to increase by 100,200 jobs in 2005. The education and health sector will create the largest number of jobs in 2005; in this sector employment is expected

[58] Calculation is based on seasonally adjusted Quarterly Census on Employment and Wages (QCEW) data for New York State. Seasonally adjusted employment and wage data for the U.S. are available from the Bureau of Economic Analysis and from the Bureau of Labor Statistics. Seasonally adjusted state employment data are also available from the Current Employment Statistics program of the Bureau of Labor Statistics. However, data from the Quarterly Census on Employment and Wages program which are more comprehensive (compared to data from the Current Employment Statistics program) are not seasonally adjusted by the Bureau of Labor Statistics or by the New York State Department of Labor. Therefore, the Ways and Means Committee staff seasonally adjusted the Quarterly Census on Employment and Wages data using the X-12 seasonal adjustment procedure. This seasonal adjustment procedure is also employed by federal government agencies.

to grow 2.1 percent, resulting in an increase of 29,100 jobs. The strengthening economic recovery will also result in notable job gains in other services, retail trade, and leisure and hospitality, which reflect the strengthening economic recovery in the State. The employment recovery in New York State will be slower than the U.S. recovery (see Figure 42).

Table 5

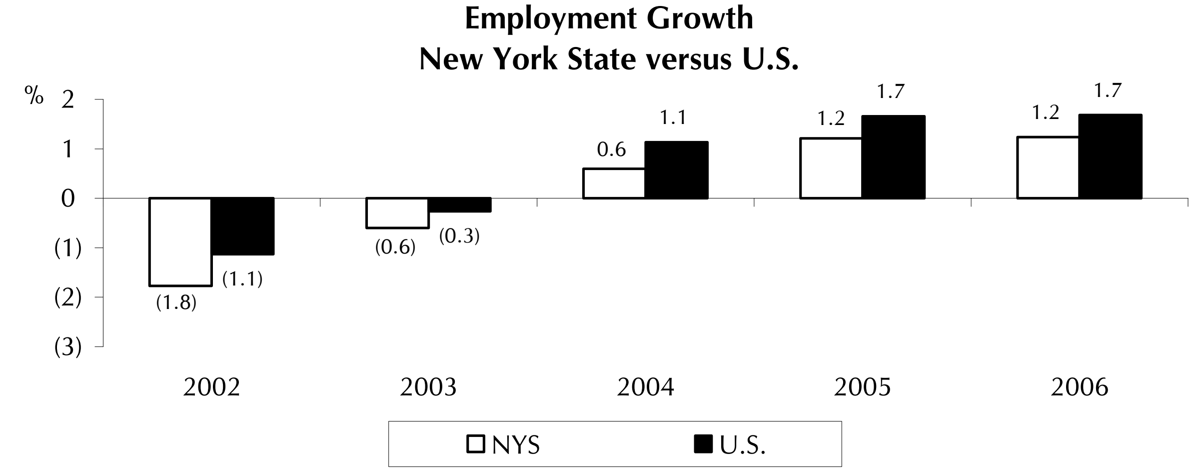
ECONOMIC INDICATORS
New York State

		Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Personal Income	***Percent Change***	**2.3**	**6.0**	**5.1**	**5.4**
	Level Change	15.4	40.4	36.5	40.5
Wages and Salaries	***Percent Change***	**1.4**	**6.2**	**5.3**	**5.2**
	Level Change	5.4	24.1	21.6	22.5
Total Employment	***Percent Change***	**(0.6)**	**0.6**	**1.2**	**1.2**
	Level Change	(49.3)	49.1	100.2	103.5
Government	***Percent Change***	**(0.1)**	**0.6**	**0.3**	**0.5**
	Level Change	(1.7)	8.1	4.4	7.7
Education & Health	***Percent Change***	**2.1**	**1.6**	**2.1**	**2.0**
	Level Change	28.1	22.2	29.1	28.8
Wholesale Trade	***Percent Change***	**(0.9)**	**0.3**	**1.5**	**1.5**
	Level Change	(3.3)	1.2	5.2	5.2
Retail Trade	***Percent Change***	**(0.4)**	**1.0**	**1.6**	**1.5**
	Level Change	(3.0)	8.2	13.8	13.5
Other Services[1]	***Percent Change***	**(1.0)**	**1.1**	**2.1**	**1.8**
	Level Change	(7.1)	7.9	15.2	13.0
FIRE[2]	***Percent Change***	**(1.3)**	**0.7**	**1.5**	**1.3**
	Level Change	(9.3)	5.0	10.2	9.5
Manufacturing[3]	***Percent Change***	**(6.0)**	**(2.8)**	**(1.1)**	**(1.1)**
	Level Change	(38.9)	(17.4)	(6.6)	(6.6)
Leisure & Hospitality	***Percent Change***	**0.8**	**2.0**	**2.0**	**1.7**
	Level Change	5.0	13.0	12.8	11.2
Professional Services	***Percent Change***	**(0.6)**	**1.3**	**2.3**	**2.0**
	Level Change	(3.0)	6.5	11.9	10.7
Construction	***Percent Change***	**(1.0)**	**0.6**	**1.6**	**1.4**
	Level Change	(3.2)	2.0	5.1	4.5
Information	***Percent Change***	**(6.8)**	**(2.0)**	**0.1**	**0.6**
	Level Change	(20.1)	(5.4)	0.3	1.6
Transp. & Utilities[4]	***Percent Change***	**(0.9)**	**0.2**	**1.4**	**1.3**
	Level Change	(2.2)	0.4	3.6	3.4
Mgmt of Companies	***Percent Change***	**1.3**	**(0.5)**	**0.9**	**0.9**
	Level Change	1.5	(0.6)	1.0	1.1
CPI	***Percent Change***	**3.1**	**3.5**	**3.3**	**2.8**

Note: Boldface numbers represent percent changes and regular type numbers represent level changes. Income and wages are in billions of dollars. Employment is in thousands.

[1] Including Administrative, Support, and Waste Management Services.
[2] Financial Activities including Finance, Insurance, Real Estate, Rental, and Leasing.
[3] Including Mining.
[4] Transportation, Warehousing, and Utilities.

Sources: Bureau of Economic Analysis; NYS Department of Labor, QCEW; Bureau of Labor Statistics; NYS Assembly Ways and Means Committee staff.



Note: 2005 and 2006 are forecasts; New York State data for 2004 is estimated.
Sources: NYS Department of Labor, QCEW; Bureau of Labor Statistics, CES; NYS Assembly Ways and Means Committee staff.

Figure 42

Table 6 gives an indication of the pace of the expected employment recovery in New York State. During the recent economic downturn, 330,200 jobs were lost in the State. These losses were spread over ten quarters between the fourth quarter of 2000 and the second quarter of 2003. It is expected that it will take fourteen quarters for the State to reach the level of employment prior to the employment downturn. By the first quarter of 2007, the employment recovery is expected to generate 339,200 jobs.

The sectoral unevenness in the recovery is evident in Table 6. As in the U.S. employment recovery, job loss in the New York State manufacturing sector and the information sector are expected to continue as other sectors participate in the employment recovery. Employment growth in the education and health sector and the government sector will continue in the recovery; in both sectors employment increased during the downturn in the State and the nation. The largest increase in employment during the recovery is expected to be in education and health, other services, retail trade, and leisure and hospitality; these sectors experience strong cyclical changes in demand.

Between the years 2000 and 2003, the State economy lost 247,300 jobs. During the same period, the health care sector created 40,000 jobs. During the 2000-03 period, employment increased in the health care, social assistance, education, leisure and hospitality, and management sectors. These sectors gained 101,300 jobs, while the rest of the economy lost jobs.

The capacity of the health care sector to create jobs could be affected significantly by the proposed cuts to Medicaid growth in the Executive Budget proposals for fiscal year

2005-06.[59] The Ways and Means Committee staff estimates that the proposed cuts of $2.5 billion would result in a loss of 36,500 jobs, of which 20,500 will be lost from the health care sector, and 16,000 from other sectors. If implemented, these cuts may affect the growth of health care employment significantly over 2005 and 2006.

Table 6

Employment Change: Recession and Recovery
New York State
(Thousands)

	Downturn of 1989-92		Downturn of 2000-03	
	Employment Downturn	Employment Recovery	Employment Downturn	Employment Recovery
	1989:Q1 - 1992:Q4	1992:Q4 - 1998:Q4	2000:Q4 - 2003:Q2	2003:Q3 - 2007:Q1
Duration (Quarters)	**15**	**24**	**10**	**14**
Total Employment	**(554.7)**	**584.0**	**(330.2)**	**339.2**
Manufacturing[1]	(185.7)	(72.1)	(125.9)	(28.0)
Professional Services	(30.1)	98.8	(56.8)	37.3
Information	(22.1)	39.4	(55.7)	(0.1)
FIRE[2]	(61.1)	19.6	(54.7)	31.4
Other Services[3]	(48.1)	129.5	(42.8)	47.1
Wholesale Trade	(58.3)	10.9	(30.0)	15.1
Retail Trade	(102.1)	54.8	(29.3)	43.5
Transp. & Utilities[4]	(7.6)	10.5	(23.4)	11.3
Construction	(104.1)	54.4	(12.8)	14.3
Leisure & Hospitality	(30.4)	69.3	4.4	43.1
Mgmt of Companies	(9.7)	(1.3)	4.4	2.7
Government	(20.3)	4.8	22.0	22.8
Education & Health	124.9	165.2	77.2	98.4

Note: The first forecast period is 2004:Q3. The employment recovery period was set at the number of quarters for the job gain to exceed the number of jobs lost in the downturn. The data were seasonally adjusted by NYS Assembly Ways and Means Committee staff.

[1] Including Mining.

[2] Financial Activities including Finance, Insurance, Real Estate, Rental, and Leasing.

[3] Including Administrative, Support, and Waste Management Services.

[4] Transportation, Warehousing, and Utilities.

Sources: NYS Department of Labor, QCEW; NYS Assembly Ways and Means Committee staff.

The regional unevenness in the rate of job loss in the recent recession is displayed in Figure 43. The regional effects of the recent recession were also different from the effects of the 1990-91 recession, particularly in the New York City suburbs and in upstate New York. The largest decline among the State's regions in both the 1990-91 and 2001 recessions was in New York City. In New York City, the rate of employment decline was steeper than in the State in both recessions, while the rates of employment decline in

[59] New York State Assembly Ways and Means Committee, *Statistical and Narrative Summary of the Executive Budget, Fiscal Year April 1, 2005, to March 31, 2006*, January 2005.

upstate New York were slower than the State. In the 1990-91 recession, the New York City suburbs experienced steeper job decline compared to the State, while in the 2001 recession, the employment losses in the New York City suburbs were milder than the State.

The regional concentration of the employment loss is partly due to the regional effects of the events of September 11th. The disruption of economic activity below 14th Street in Manhattan affected an area that accounted for 7.6 percent of State private sector employment and 15.4 percent of State private sector wages in the year before September 11th.[60] Manhattan lost 7.0 percent of its private sector employment, compared to the loss of 3.4 percent in New York State. In the year after September 11th, Manhattan accounted for 55.5 percent of the State's job loss.

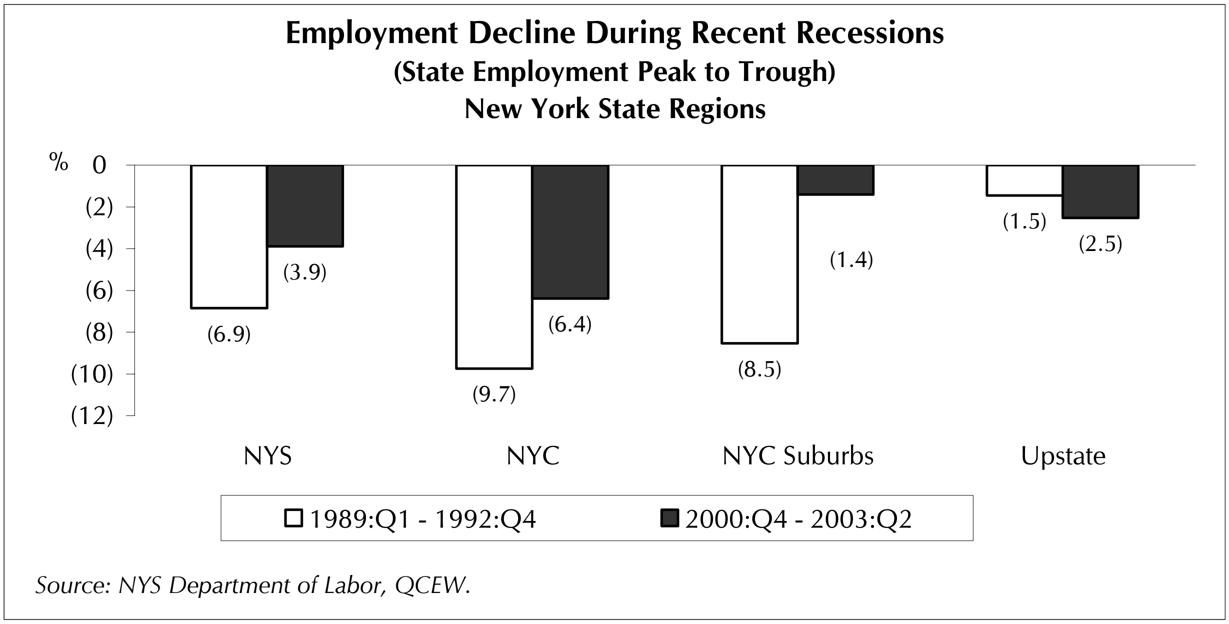


Figure 43

In downstate New York, the employment decline was milder during the 2001 recession compared to the 1990-91 recession. This reflects the milder effect of the 2001 recession on employment in both New York City and its suburbs. New York City experienced the fastest decline in employment in both recessions. In upstate New York, the rate of job loss was faster in the 2001 recession compared to the 1990-91 recession.

The fastest rate of decline in employment during the employment downturn associated with the 2001 recession was in the State's securities industry, information, and manufacturing sectors (see Table 7). However, professional services, transportation and utilities, wholesale trade, and administrative and other services lost jobs at rates between 5 and 10 percent. In a number of sectors, the rate of job loss was much higher in New York City compared to other regions: these include manufacturing, information, professional

[60] For details, see New York State Assembly Ways and Means Committee, *The Lower Manhattan Economy after September 11th*, February 2005.

services, transportation and utilities, administrative and other services, construction, retail trade, and non-securities FIRE.

Table 7

Employment Change
During the State Employment Downturn
(Percent)

	New York State	New York City	NYC Suburbs	Upstate New York
Total	(3.9)	(6.4)	(1.4)	(2.5)
Securities[1]	(18.7)	(18.4)	**(29.8)**	(5.9)
Information	(17.1)	**(21.3)**	(14.6)	(6.8)
Manufacturing[2]	(17.0)	**(24.5)**	(10.7)	(16.5)
Professional Services	(9.9)	**(14.8)**	(3.2)	(3.4)
Transportation and Utilities[3]	(8.4)	**(12.0)**	(4.1)	(6.3)
Wholesale Trade	(7.9)	**(9.1)**	(8.8)	(4.7)
Other Services[4]	(5.6)	**(9.8)**	(0.5)	(3.8)
Construction	(4.4)	**(9.4)**	1.4	(5.1)
Retail Trade	(3.3)	**(4.7)**	(2.4)	(2.9)
Non-Securities FIRE[1]	(2.4)	**(6.1)**	1.1	2.6
Leisure and Hospitality	(0.4)	**(0.7)**	(0.6)	0.3
Government	1.6	**(0.8)**	3.0	3.2
Management	3.8	11.9	**(3.9)**	(1.6)
Education and Health	5.9	6.6	5.8	**4.9**

Note: Employment change is for the 2000:Q4 to 2003:Q2 period. Bolded numbers are largest decline (slowest growth) in each sector.

[1] Securities and Non-securities FIRE together constitute the FIRE sector. FIRE includes Finance, Insurance, Real Estate, Rental, and Leasing.
[2] Including Mining.
[3] Transportation, Warehousing, and Utilities.
[4] Including Administrative, Support, and Waste Management Services.
Source: NYS Department of Labor, QCEW.

In the securities industry and in the information sector, the rate of job loss was high in New York City and in the New York City suburbs. In manufacturing, the rate of job loss was the highest in New York City, followed by upstate New York. There was an increase in employment in the education and health sector in all regions of New York State.

Though the steepest employment loss in New York State in the recent recession was in the securities industry, the largest numbers of jobs lost were in manufacturing, information, and professional services. More than a third of the State's job loss was in manufacturing, and more than half of the State's manufacturing sector job loss was in upstate New York (see Table 8). The manufacturing sector job loss in upstate New York was almost as large as the total upstate job loss. In professional services, information, the securities industry, non-securities FIRE, and construction, most of the job loss was in New York City. In retail trade, other services, and transportation and utilities, there were significant job losses in upstate New York. While most sectors were affected adversely by the economic downturn, there were notable job gains in education and health, and all regions shared in this increase. Government employment increased in the New York City suburbs and in upstate New York, while it declined in New York City.

Table 8

Employment Change
During the State Employment Downturn

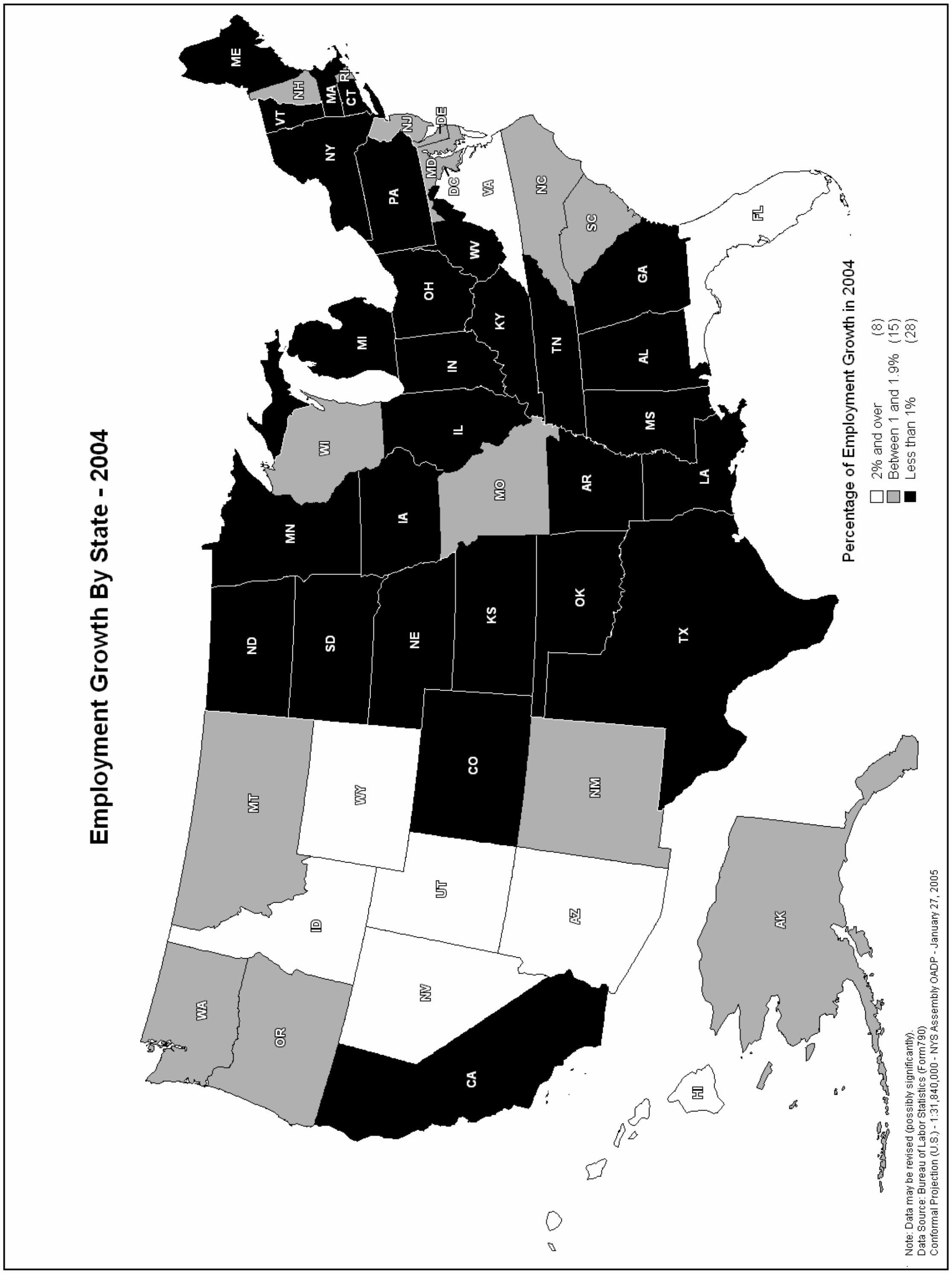
	New York State	New York City	NYC Suburbs	Upstate New York
Total	(330,229)	(231,861)	(30,984)	(67,383)
Manufacturing[1]	(125,939)	(40,982)	(18,282)	(66,674)
Information	(56,760)	(41,252)	(11,410)	(4,098)
Professional Services	(55,660)	(47,763)	(4,225)	(3,672)
Other Services[2]	(42,814)	(33,896)	(1,064)	(7,854)
Securities[3]	(40,225)	(35,654)	(4,173)	(399)
Wholesale Trade	(30,043)	(13,728)	(11,943)	(4,372)
Retail Trade	(29,250)	(13,084)	(6,667)	(9,499)
Transportation and Utilities[4]	(23,433)	(15,564)	(2,843)	(5,025)
Construction	(14,493)	(11,306)	1,652	(4,838)
Non-Securities FIRE[3]	(12,788)	(17,292)	1,435	3,069
Leisure and Hospitality	(2,381)	(1,885)	(1,072)	576
Management	4,408	6,119	(1,164)	(546)
Government	21,993	(4,503)	10,112	16,383
Education and Health	77,156	38,930	18,661	19,565

Note: Employment change is for the 2000:Q4 to 2003:Q2 period.
[1] Including Mining.
[2] Including Administrative, Support, and Waste Management Services.
[3] Securities and Non-securities FIRE together constitute the FIRE sector. FIRE includes Finance, Insurance, Real Estate, Rental, and Leasing.
[4] Transportation, Warehousing, and Utilities.
Source: NYS Department of Labor, QCEW.

Regional Comparisons

New York State employment growth continues to lag most states in the nation. Using preliminary 2004 data, the State was ranked only 39th. Employment in the nation as a whole has continued to post only sluggish gains after the recession. However, some states are doing better than others, as shown by the employment map on page 56. The western states, with the exception of California, are performing better than the rest of the nation. However, some states on the east coast, such as Florida and Virginia, maintained higher growth in 2004.

Nevada was the fastest growing state in the nation in 2004, growing about 4.5 percent. This is almost two percentage points higher growth than Hawaii which ranked second with 2.6 percent employment growth. Nevada has led the nation in employment growth for some time, a fact the Las Vegas Chamber of Commerce attributes to growth in high-tech sectors, manufacturing, and a booming residential construction sector.



Manufacturing Sector

About a third of the job loss in the recent economic downturn in New York State was in the manufacturing sector.[61] In the State as in the nation, the rate of manufacturing job loss is too large to be explained by the temporary loss of demand during the recent recession. In fact, it is estimated that a good part of the job loss in the recent recession was structural, and that these jobs will not return with the recovery (see Figure 44). Recent calculations show that at the beginning of the 2001 recession, 67 percent of the State's jobs were in industries affected by structural change.[62] This motivates an examination of changes in the manufacturing sector in the State over longer time periods.

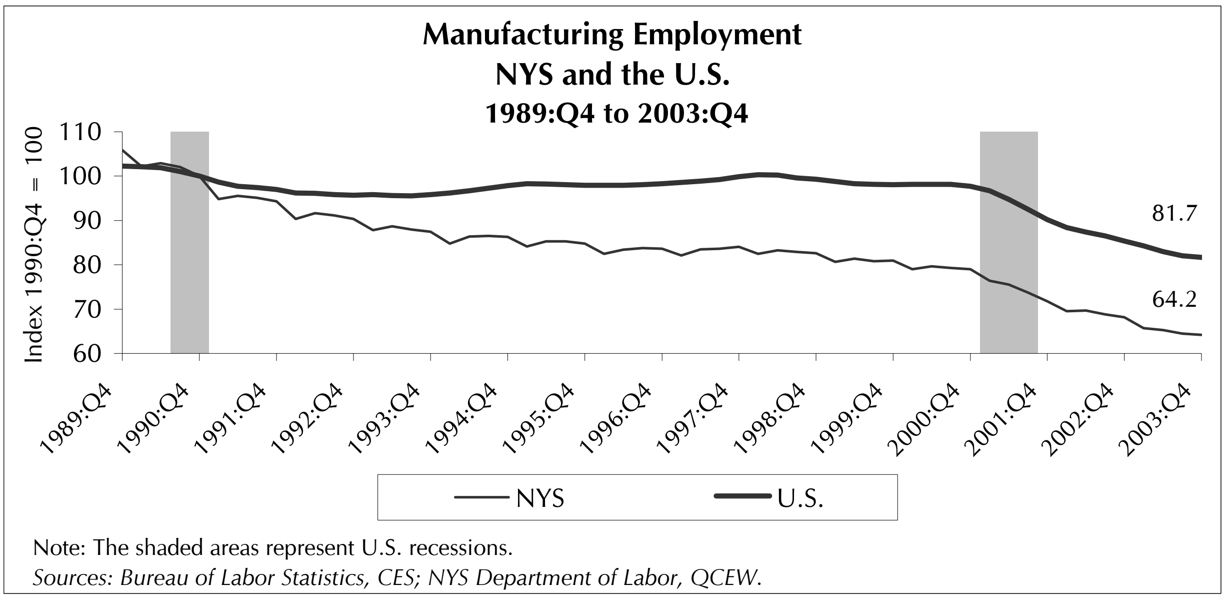


Figure 44

Manufacturing job loss in the recent recession was due to a mix of structural and cyclical factors. A good part of the job loss reflects structural job losses due to increased productivity. In fact, in the 1986-01 period, there were employment losses in the State's manufacturing industries in which output rose significantly (see Figure 45). An important consequence of the improvements in productivity in New York State manufacturing is the larger employment decline in low-skilled occupations.[63] In the nation, manufacturing employment in high-skilled occupations increased in recent decades, while in the State, it declined. A recent study concluded that in 2000, productivity levels in the State were

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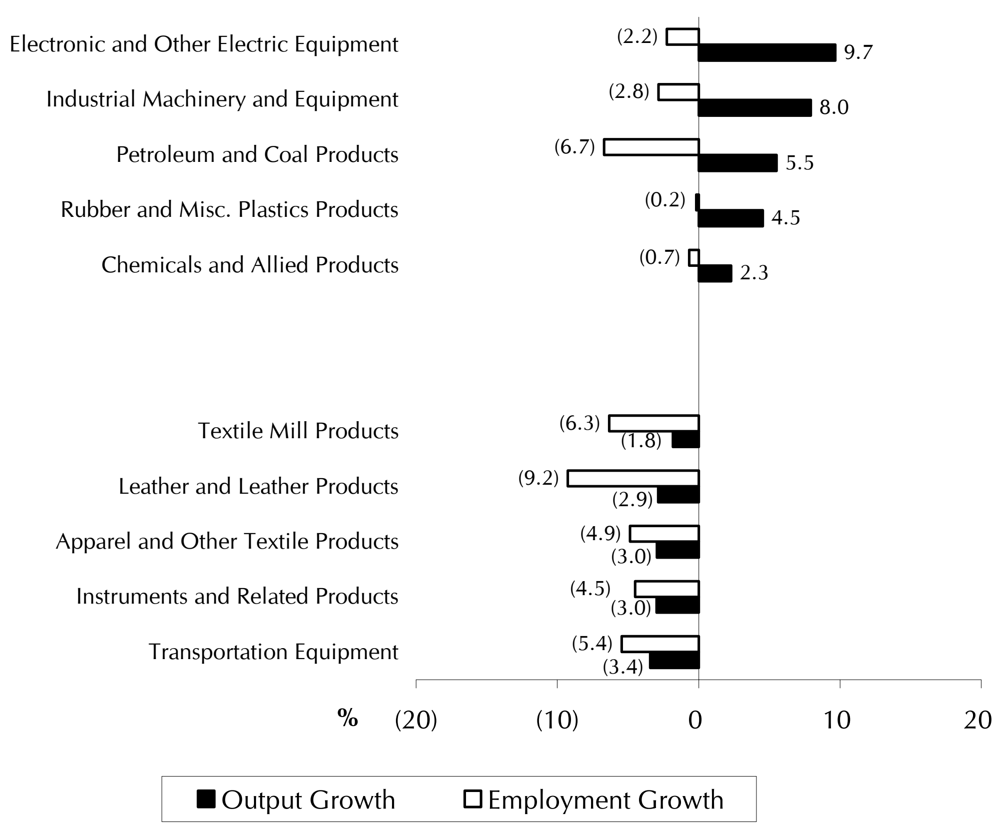
[61] The data on manufacturing industries in this section is based on the Standard Industrial Classification System.

[62] Erica L. Groshen, Simon Potter, and Rebecca J. Sela, "Economic Restructuring in New York State," *Current Issues in Economics and Finance 10*, no. 7, Table 1 and Chart 4, Federal Reserve Bank of New York, June 2004.

[63] Richard Deitz, "Restructuring in the Manufacturing Workforce: New York State and the Nation," *The Regional Economy of Upstate New York*, Federal Reserve Bank of New York, Buffalo Branch, winter 2004.

higher in 11 of 21 manufacturing industry groups than in the nation.[64] Cyclical and other temporary changes also affect manufacturing industries to varying degrees. For example, the fall in investment demand during recessions affects the demand for industrial and computer equipment more than other manufacturing industries. Similarly, a rise in energy prices affects the chemical industry and the auto industry the most.[65]

New York State Manufacturing Sector
Five Fastest Growing and Declining Industries
Average Annual Output and Employment Growth, 1986-01



Note: The fastest growing and declining industries are defined with respect to industry output.
Sources: Bureau of Economic Analysis; NYS Department of Labor, QCEW

Figure 45

New York State manufacturing employment has been in decline for many decades and this job loss continued throughout the 1990s (see Figure 44). However, there was a much sharper decline in State manufacturing employment after the recession began.

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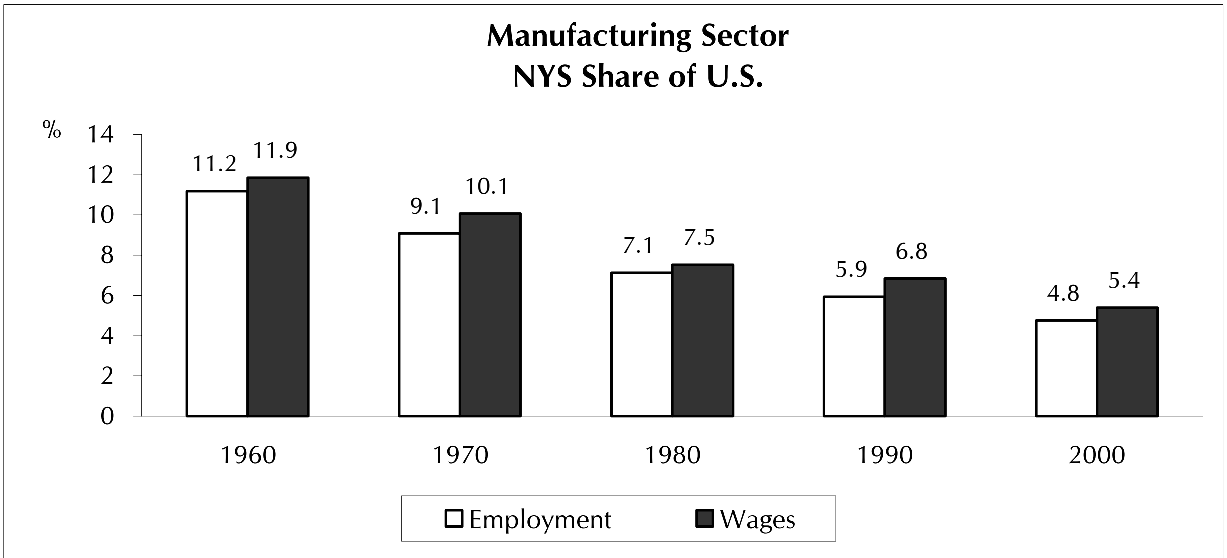
[64] Matt Kane and Olwen Huxley, "Manufacturing in the Northeast-Midwest," Northeast-Midwest Institute, October 2002.

[65] Clare Ansberry, "As U.S. Manufacturers Recover, High Oil Prices Pinch Some Sectors," *Wall Street Journal*, August 23, 2004, A2.

Several factors relating to the recession and to other recent developments affected the rate of recent job loss in New York State manufacturing. Manufacturing employment was also affected by the events of September 11th, particularly the New York City apparel industry. Upstate New York accounted for over half of the State's manufacturing job loss in the recent downturn.

In the analysis of changes in the State's manufacturing sector, the loss of the State's share in the nation is emphasized. It is argued that regional differences in the sources of demand, in the average wage, and in the degree of unionization are the most significant factors in explaining the differences in the rate of regional manufacturing employment growth in the U.S.[66] Technological changes and infrastructure improvements also played a key role in the migration of manufacturing activity from the port cities of the Northeast to the South and the West.[67] Figure 46 shows that the share of the State in U.S. manufacturing employment fell from 11.2 percent in 1960 to 4.8 percent in 2000, while the State's share of U.S. manufacturing wages fell from 11.9 percent in 1960 to 5.4 percent in 2000. This relative decline of New York State manufacturing is a central aspect of the decline in manufacturing employment in the State.



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics, CES.

Figure 46

Though the share of New York State in U.S. manufacturing fell in the 1980s and the 1990s, two aspects of the changes in the manufacturing sector in these decades merit discussion. The first of these is the reversal of the job gains in the manufacturing sector in the nation. Between 1960 and 1980, the State lost 367,200 manufacturing jobs while the

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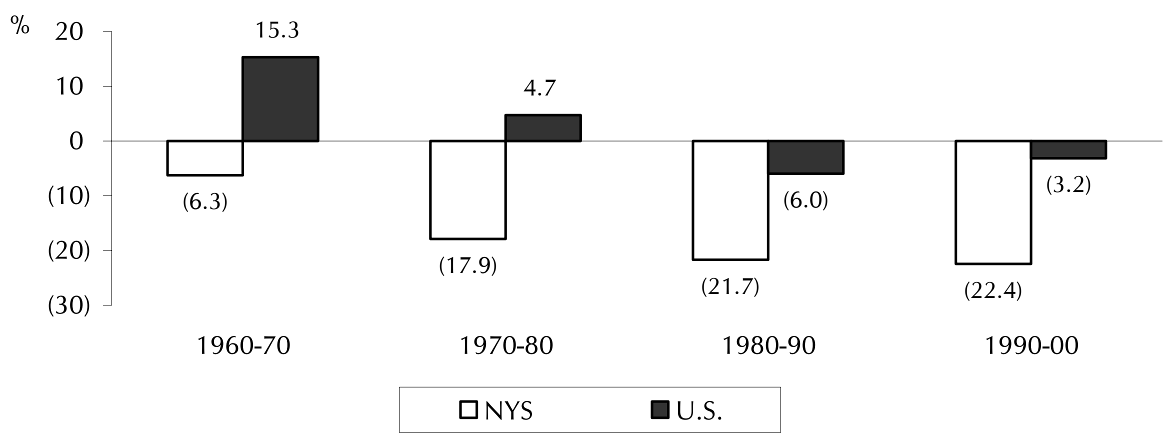
66 Robert W. Crandall, *Manufacturing on the Move*, Brookings Institution, Washington D.C., 1993.

67 Jason Bram and Michael Anderson, "Declining Manufacturing Employment in the New York-New Jersey Region: 1969-99," *Current Issues in Economics and Finance*, 7, no.1, Federal Reserve Bank of New York, January 2001.

nation gained 3,494,300. In contrast, between 1980 and 2000, both the State and the nation lost manufacturing jobs: the State lost 563,000 manufacturing jobs compared to the loss of 1,833,500 manufacturing jobs in the nation. The rate of manufacturing job loss was much higher in New York State in both these periods (see Figure 47). However, the loss of manufacturing jobs in the U.S. as a whole implies that a regional redistribution of manufacturing employment may not be the only factor in the changes in manufacturing employment in recent decades. In the 1980-2000 period, while employment fell in the State and in the nation, wages rose indicating that productivity gains occurred in the State and in the nation.

Manufacturing Employment Growth



Source: Bureau of Labor Statistics, CES.

Figure 47

The second aspect is the similarity in the State and the nation in the changes in the composition of manufacturing output in recent decades. This similarity is seen in a comparison of the growth rates of output in manufacturing industries in Table 9. In both the State and in the nation, the industry growth rates of output varied widely, indicating significant changes in the composition of manufacturing output. In the 1986-01 period, the fastest growing durable goods industries were the same in the State and in the nation: electronics and industrial machinery. The fast growth of nondurable goods industries such as petroleum, rubber, and chemicals was also common to both New York State and the nation. However, in many prominent New York State manufacturing industries, notably instruments, transportation equipment, apparel and textiles, output growth performance in the State diverged significantly from the nation. In fact, the largest employment losses among the State's manufacturing industries in this period were in instruments, which experienced a loss of 76,500 jobs, and in apparel, which experienced a loss of 67,800 jobs. This indicates that while there could be factors common to the State and the nation at work in some industries, in others the competitive position of the State has weakened relative to the nation.

Table 9

Manufacturing Sector: Average Annual Output Growth 1986 to 2001 (Percent)		
Industry	**NYS**	**U.S.**
Manufacturing	**0.5**	**3.0**
Durable goods	**1.7**	**4.8**
Electronic and Other Electric Equipment	9.7	13.0
Industrial Machinery and Equipment	8.0	9.6
Stone, Clay, and Glass Products	1.4	1.3
Fabricated Metal Products	0.2	1.8
Primary Metal Industries	(0.0)	1.5
Furniture and Fixtures	(0.5)	1.5
Miscellaneous Manufacturing	(0.5)	3.2
Lumber and Wood Products	(0.6)	(0.7)
Instruments and Related Products	(3.0)	2.1
Transportation Equipment	(3.4)	0.9
Nondurable goods	**(0.6)**	**0.7**
Petroleum and Coal Products	5.5	3.5
Rubber and Misc. Plastics Products	4.5	5.5
Chemicals and Allied Products	2.3	2.9
Tobacco Products	1.1	(8.6)
Paper and Allied Products	(1.0)	0.2
Food and Kindred Products	(1.1)	0.6
Printing and Publishing	(1.3)	(1.3)
Textile Mill Products	(1.8)	0.1
Leather and Leather Products	(2.9)	(2.0)
Apparel and Other Textile Products	(3.0)	(0.9)

Source: Bureau of Economic Analysis.

The consequence of the relatively faster growth of some industries is seen in Figure 48. The share of electronics in State manufacturing output increased from 5.5 percent in 1986 to 18.3 percent in 2001; the share of industrial machinery in State manufacturing output increased from 5.7 percent in 1986 to 15.2 percent in 2001. The output of chemicals and allied products, an important nondurable good producing industry in the State, increased 2.3 percent per year in the 1986-01 period. Not all the largest manufacturing industries increased their share between 1986 and 2001: among the largest five industries, printing and publishing, and instruments and related products experienced a fall in their share of manufacturing output.

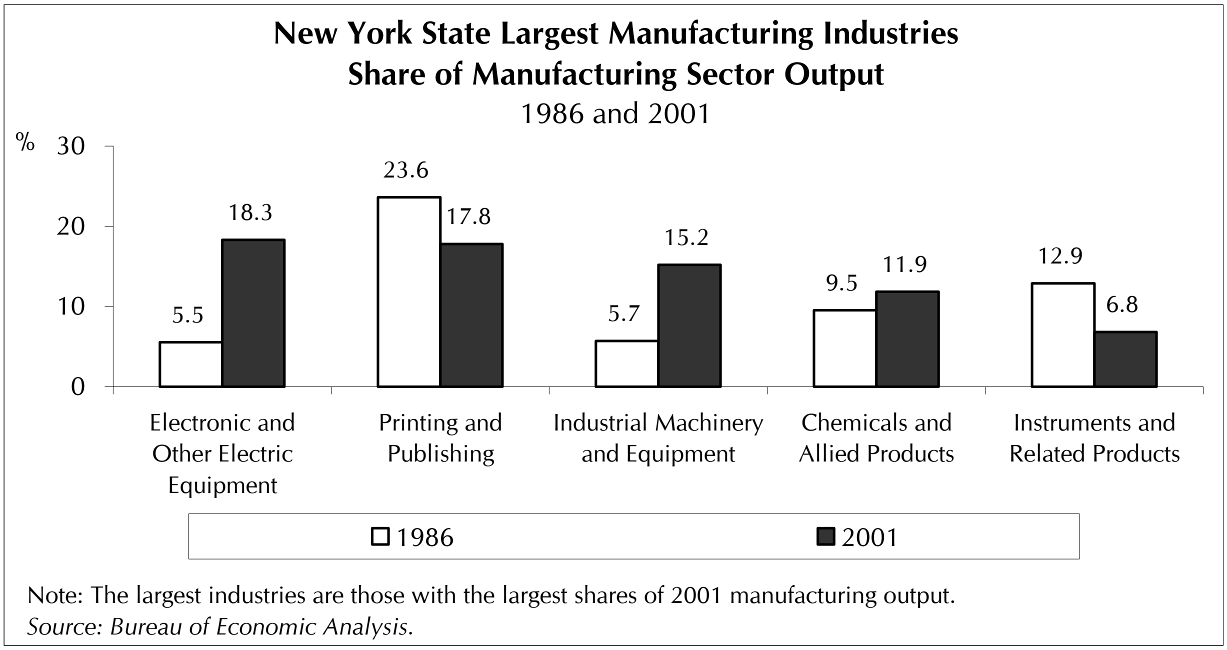


Figure 48

Securities Industry

Securities industry employment in New York is expected to grow 2.9 percent in 2005 and 2.6 percent in 2006. This follows a sharp decline during 2002 and 2003 and a return to positive growth in 2004 (see Figure 49). Growth for the industry turned positive in the first quarter of 2004 and is expected to remain positive for the entire forecast period. However, 2006 employment will still not exceed its 2001 peak. Securities industry employment will grow faster in the nation than in New York State, averaging 3.9 percent in 2005 and 3.3 percent in 2006.

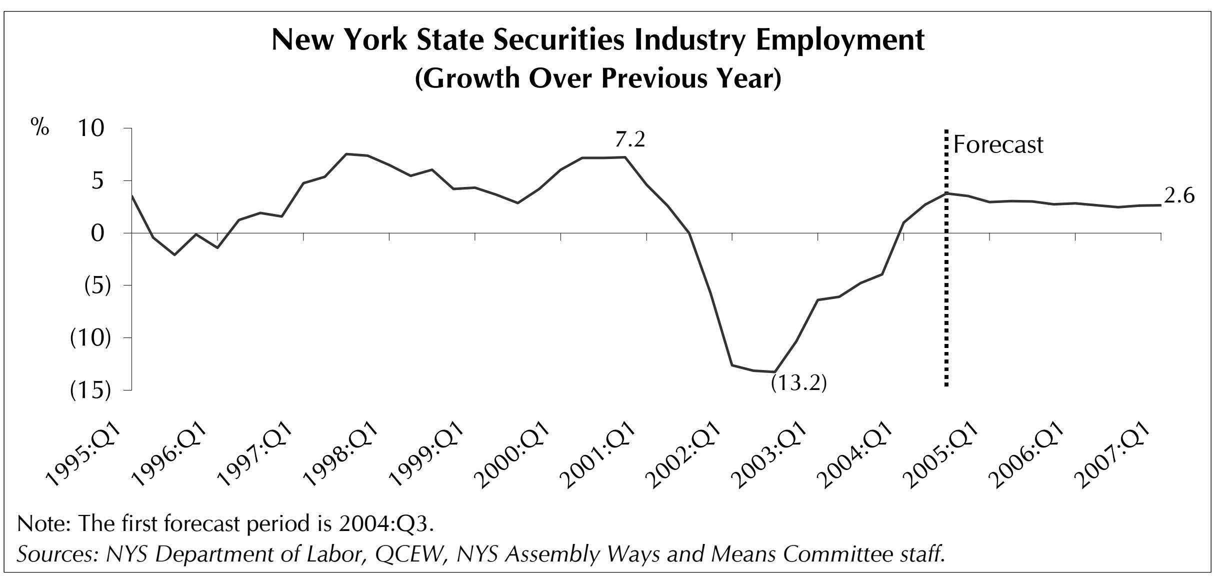


Figure 49

Forty-five percent of securities industry employment in New York State is in the securities brokerage area, making this the largest category of employment (see Figure 50). The next largest categories are investment banking and securities dealing with 22.2 percent and portfolio management with 9.5 percent. Combined, these three categories make up three-quarters of securities industry employment in New York.

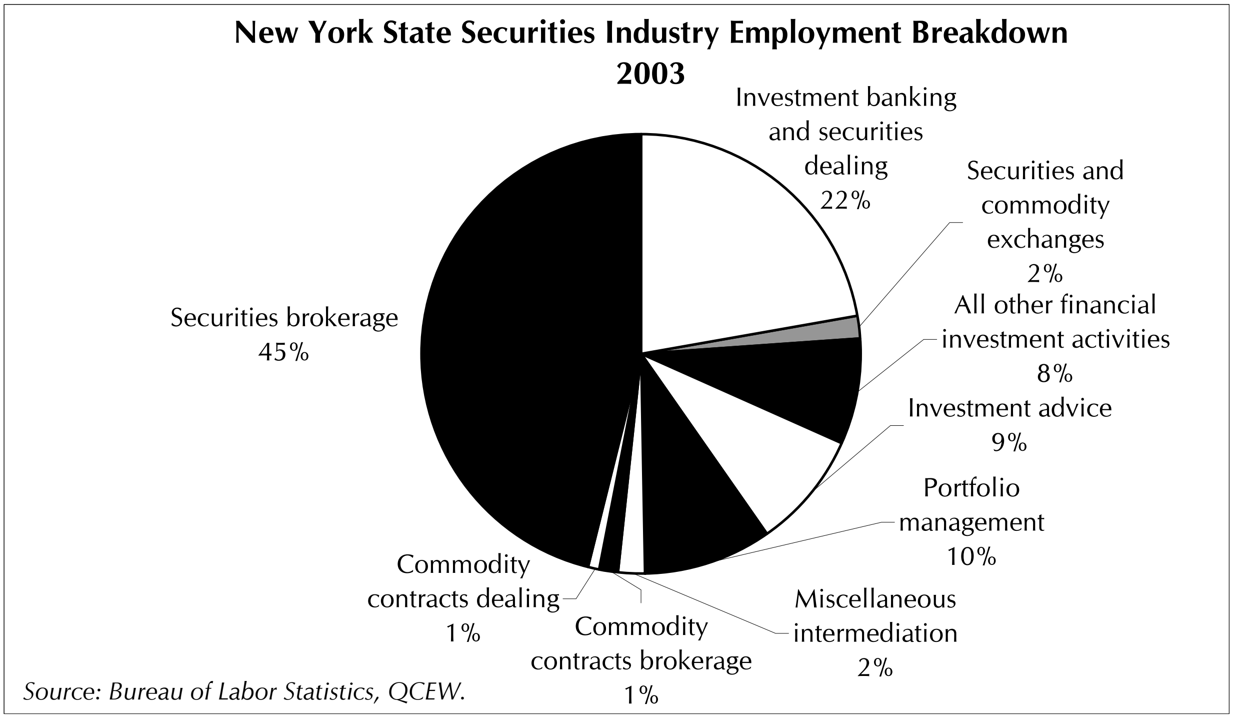


Figure 50

As of 2003, New York's share of total securities industry employment in the United States was 23.1 percent. New York owes its large share of the industry in part to the securities brokerage business, where it holds 27.5 percent of total employment (see Figure 51). This is also the largest employment category (at the NAICS 5-digit level) within the securities industry. Not surprisingly, New York also holds a particularly large share of employment on the securities and commodity exchanges. However, employment on the exchanges only makes up about one percent of the industry total. Of course, employment on the exchanges is somewhat misleading in terms of its importance because the presence of the exchanges helps keep many other securities industry jobs (for example, at dealer and brokerage firms) in the area. However, at the same time, there are many other reasons for securities industry employment to remain concentrated in New York City outside of the presence of the exchanges. New York's share is weakest in the commodities dealing area. Although its share is certainly respectable at 13.7 percent, New York is not the dominant state in the commodities business.

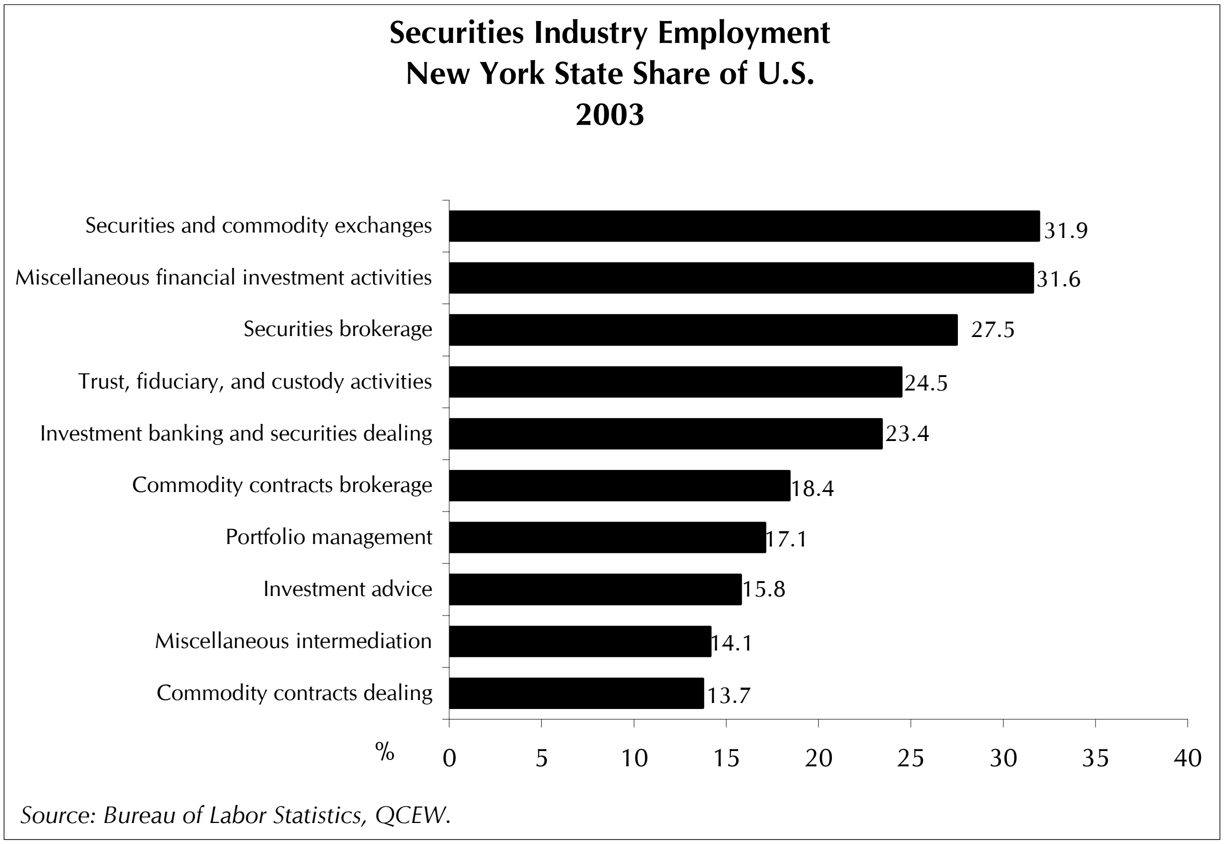
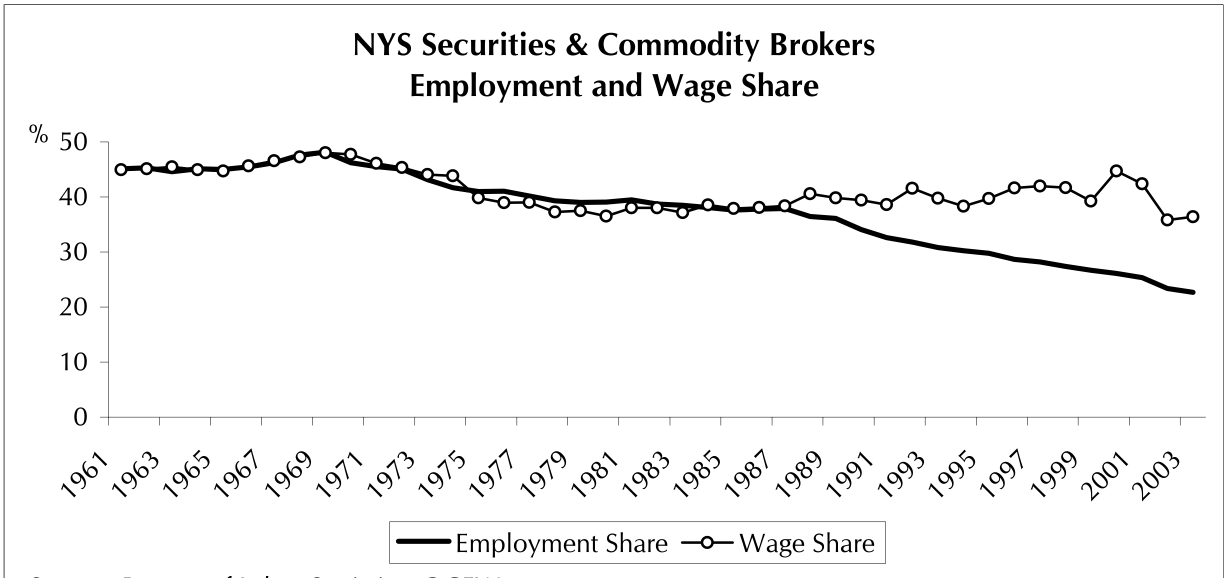


Figure 51

People studying the securities industry often note that there has been a long-term trend of declining regional concentration in employment.[68] Since its peak around 1970, New York's share of securities industry employment has almost been cut in half. This has not been due to a loss of jobs in New York. In fact, securities industry employment has been rising long-term in New York. Industry employment in other states has simply been rising more rapidly.

Though the State's share of industry employment does show a decline, this is not true for wages (see Figure 52). Although New York's wage share did peak about the same time as employment and fell in the 1970s, since 1980 the State's wage share has actually been quite stable, despite the drop in employment share, except for a drop following September 11th. This suggests that while peripheral staffing positions have been shifted out-of-state, the most vital and highest paying positions remain in New York City. Often, companies talk about moving "back-office" and processing positions out of New York. However, it is likely companies find it worthwhile to keep key positions close to the exchanges and the network of people that are linked to the securities industry.

[68] For example, see Securities Industry Association, "Securities Industry Employment," *Securities Industry Trends* 30, no. 1, March 17, 2004.

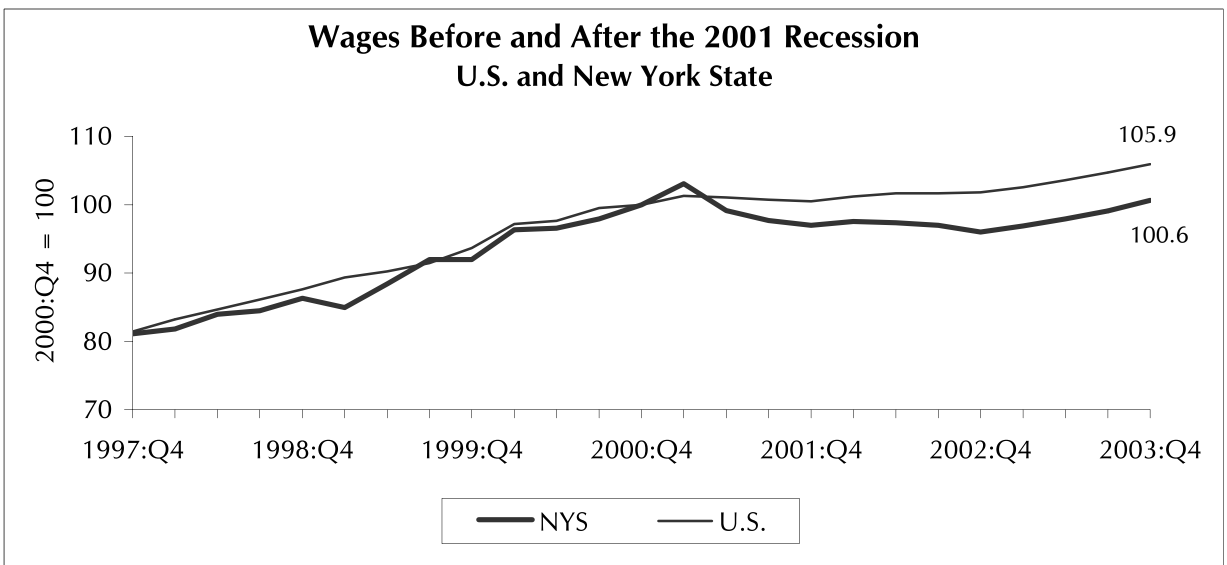


Source: Bureau of Labor Statistics, QCEW.

Figure 52

Wages

Wages in New York State surpassed the level at the start of the 2001 recession in the fourth quarter of 2003 after falling in 2001, as shown in Figure 53. United States wages, however, did not fall below their 2001 level. While wages in the nation continued on a general upward trend throughout the 2001 recession, New York State wages dipped.

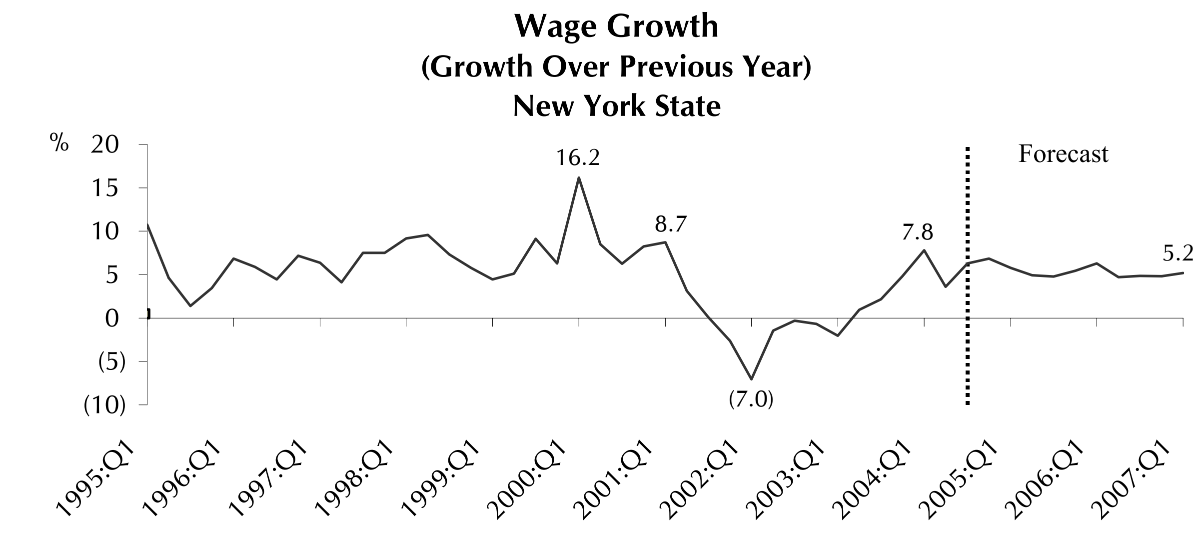


Sources: Bureau of Labor Statistics, CES; NYS Department of Labor, QCEW.

Figure 53

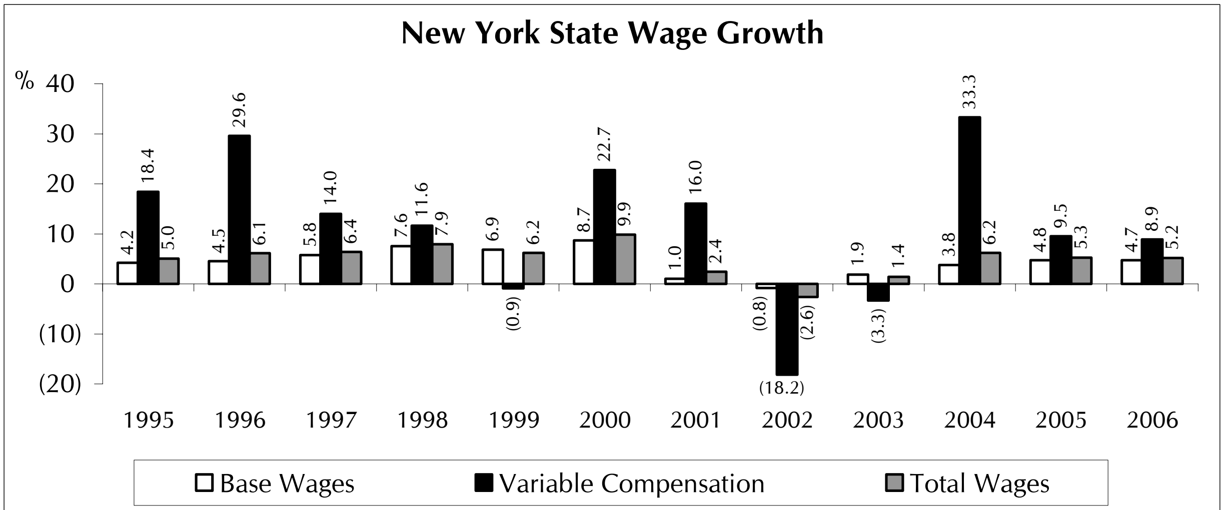
Although wage growth in New York State has not reached the high levels seen in 2000, it has rebounded from a low of negative 7.0 percent in the first quarter of 2002 (see

Figure 54). Fueled by a surge in variable compensation wages in the securities industry, wage growth was particularly strong in the first quarter of 2004, reaching 7.8 percent compared to the same quarter a year ago. As employment and average base wages are expected to continue to recover, the Ways and Means Committee staff forecasts that State base wages will increase 4.8 percent in 2005 (see Figure 55). State total wages, which are the sum of base wages and variable compensation wages, are estimated to have grown 6.2 percent in 2004, and forecast to grow 5.3 percent in 2005 (see Figure 56).



Note: The first forecast period is 2004:Q3.
Sources: NYS Department of Labor, QCEW; NYS Assembly Ways and Means Committee staff.

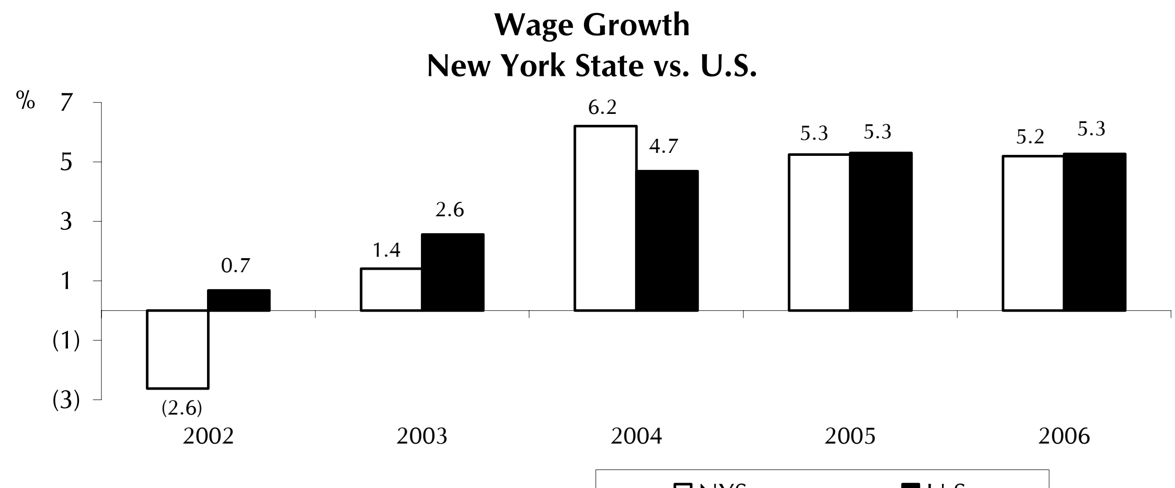
Figure 54



Note: 2004 and earlier are estimates; 2005 and 2006 are forecasts. Base wages and variable compensation sum to total wages, which are taken from NYS Department of Labor, QCEW.
Source: NYS Assembly Ways & Means Committee staff estimates.

Figure 55

Since 1990, annual wage growth in New York State has been varied, hitting a high of 9.9 percent in 2000 and a low of negative 2.6 percent in 2002. Since 2002, wages have rebounded slowly, growing 1.4 percent in 2003. Using preliminary data, New York State had higher wage growth in 2004 than the nation, due mainly to a strong surge in variable compensation in the first quarter. State wages are forecast to grow the same as the United States in 2005 and slightly slower in 2006 (see Figure 56).



Note: 2004 is estimated; 2005 and 2006 are forecasts.

Sources: NYS Department of Labor, QCEW; Bureau of Economic Analysis; NYS Assembly Ways and Means Committee staff.

Figure 56

The wage change during the recent recession was regionally concentrated in New York City, as shown in Figure 57. Upstate and the New York City suburbs performed relatively well when compared to New York City. While the State lost 2.1 percent of wages, New York City lost 6.9 percent. Both the New York City suburbs and Upstate gained wages during the recent recession.

In the 1990-91 recession, none of the four areas shown in Figure 57 lost wages. In fact, there were double digit gains in all four areas. The City performed the best in terms of wages during the 1990-91 recession.

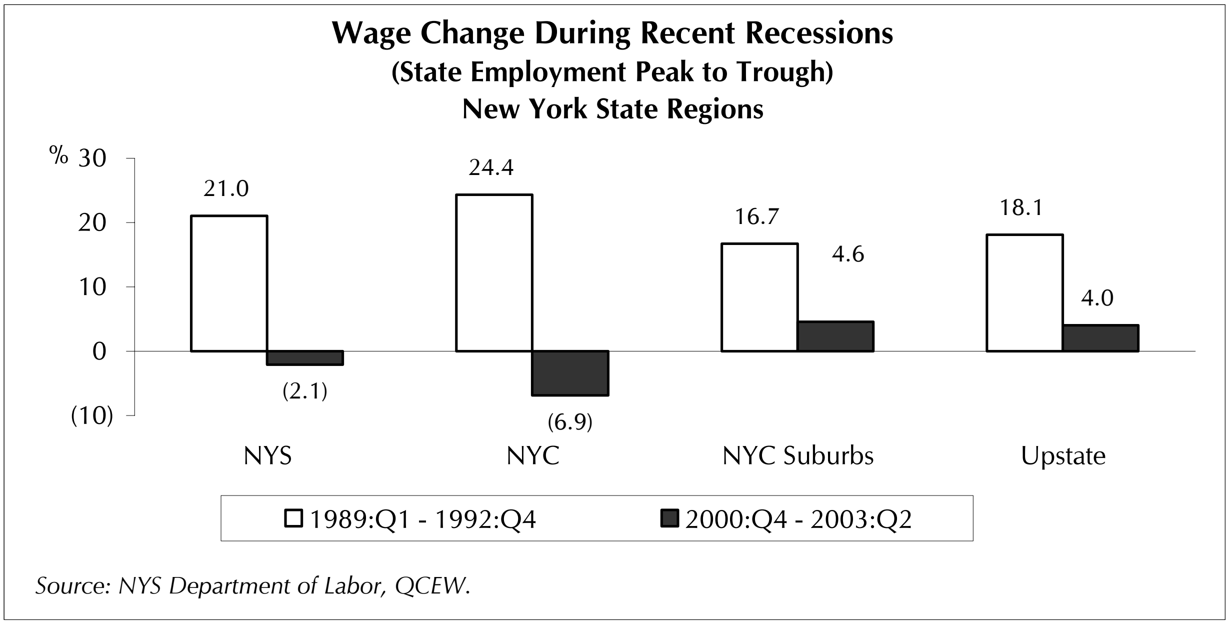


Figure 57

Sectoral Growth

Growth in service-producing industries is providing the most growth to New York State wages. The sector with the fastest growing wages in 2003 was education and health (see Figure 58).

The securities industry, one of the most important industries in the State, continued to have declining wages in 2003. Wages in the industry dropped 5.6 percent in 2003. Other industries in the FIRE sector did comparatively better, as wages in non-securities FIRE increased by 3.6 percent. The securities industry also has an effect on variable wages, one of the most important and volatile components of wages.

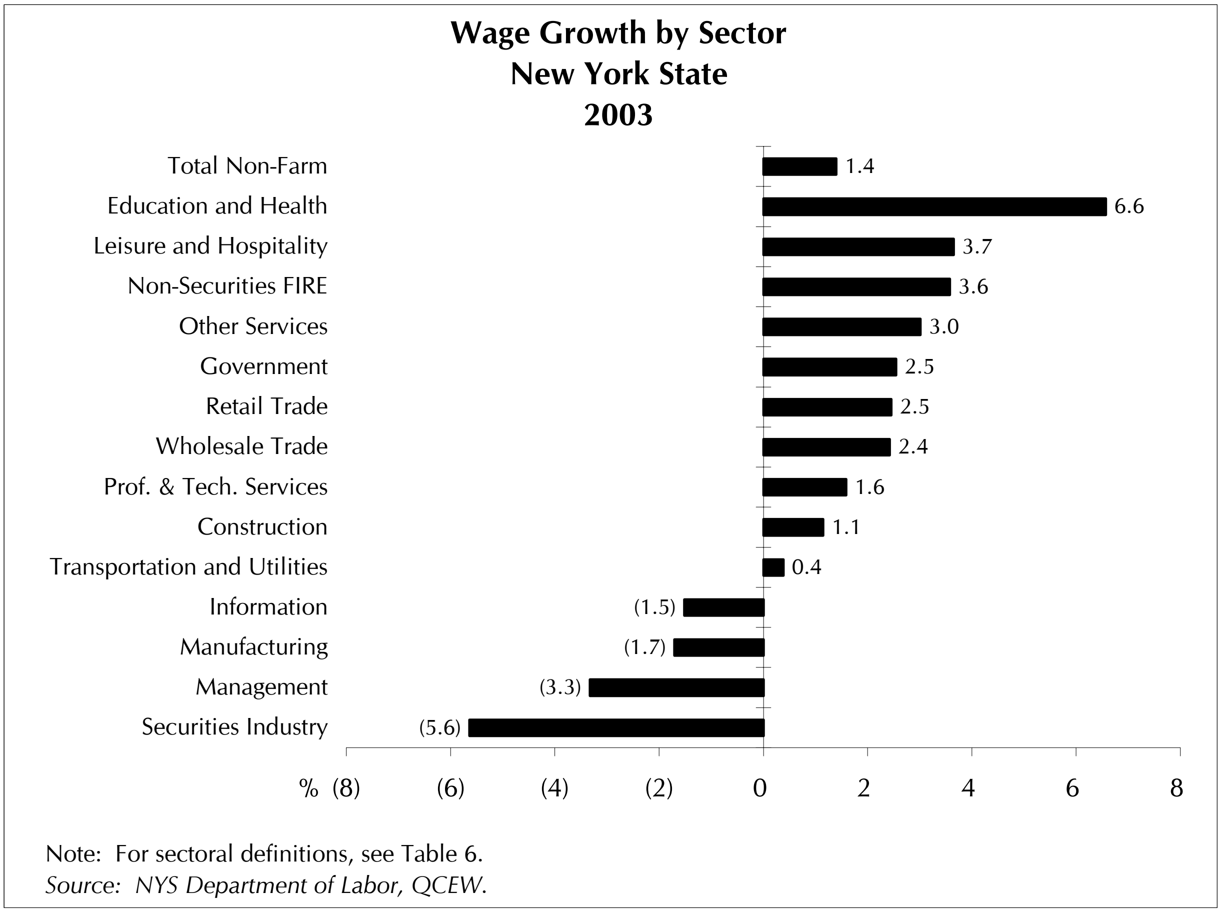


Figure 58

Variable Compensation

Variable compensation is the most volatile component of State wages and plays an important role in forecasting State wages.[69] Securities industry variable compensation has made up 44.4 percent of total variable compensation in the State over the last five years.

The Assembly Ways and Means Committee staff estimates that State total variable compensation, which was $32.1 billion or 8.3 percent of total State wages in 2003, increased by 33.3 percent to $42.8 billion for 2004 (see Figure 55 on page 66). Growth will slow down to 9.5 percent year-over-year during 2005 and 8.9 percent in 2006. Variable compensation will grow faster than total wages over this period and will make up

[69] There is no known series of data for state or national variable compensation. The NYS Assembly Ways and Means Committee staff estimates variable compensation based on seasonal variations in wage patterns. These seasonal patterns are broken down by sector (at the NAICS three-digit level) to improve the precision of the estimate. The growth in this variation over time is also accounted for in the estimate. Since this estimate is based on seasonal variation, it may underestimate bonuses and commissions that come at frequent intervals throughout the year. It also may underestimate stock options to the extent that they are exercised throughout the year. On the other hand, in some cases non-variable pay may be included in variable compensation if there are regular seasonal patterns (such as if overtime regularly occurs in a certain quarter). Therefore, variable compensation contains high uncertainty—even in terms of the data history.

11.2 percent of total wages by 2006. Securities industry variable compensation is expected to grow slightly faster than other industries in 2005 and slightly slower than other industries in 2006 (see Figure 59).

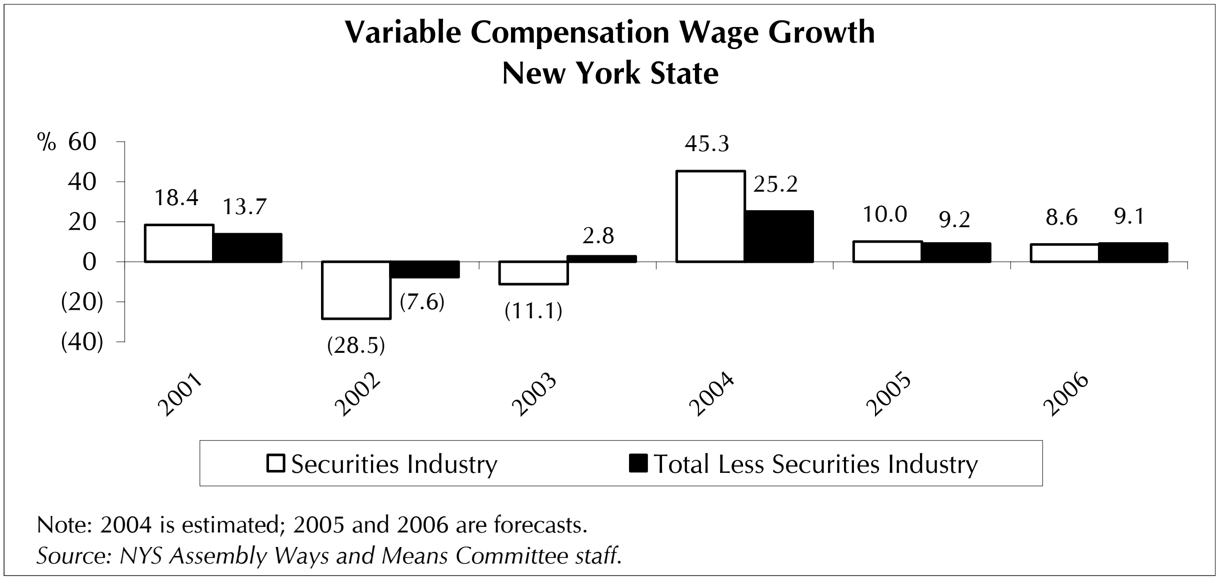


Figure 59

Securities industry variable compensation is linked with both securities industry revenue and profits. Securities industry profits are estimated to have declined in 2004 after recovering in 2003 from their low point of $6.9 billion in 2002. Although the stock market is not booming, it is no longer in decline, and pent-up demand for investment banking services may help to drive revenue higher in 2005. However, interest rates are expected to rise and it is possible that rising rates may have a negative effect on the securities industry. Industry profits and revenue suffered last time when there was an environment of rapidly rising rates (see Figure 60). However, much of the harm was caused by unanticipated rising rates. Rising rates have been expected for some time in the current situation. Therefore, as long as rates do not increase more rapidly than anticipated, rising rates may have little effect on industry profitability.

While Wall Street bonuses overall are expected to rise, there is always considerable variability regarding who gets these larger bonuses. For bonuses paid in 2004 and early 2005, the commodity traders and merger and acquisition bankers are expected to get the largest bonus growth due to strength in these particular business lines.[70] In prior years, other business lines such as bond trading or equities had performed the strongest and staff in these areas received the largest bonus growth.

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[70] Adrian Cox, "Wall Street's Biggest Bonuses Favor Oil Traders, Merger Bankers," Bloomberg, January 19, 2005.

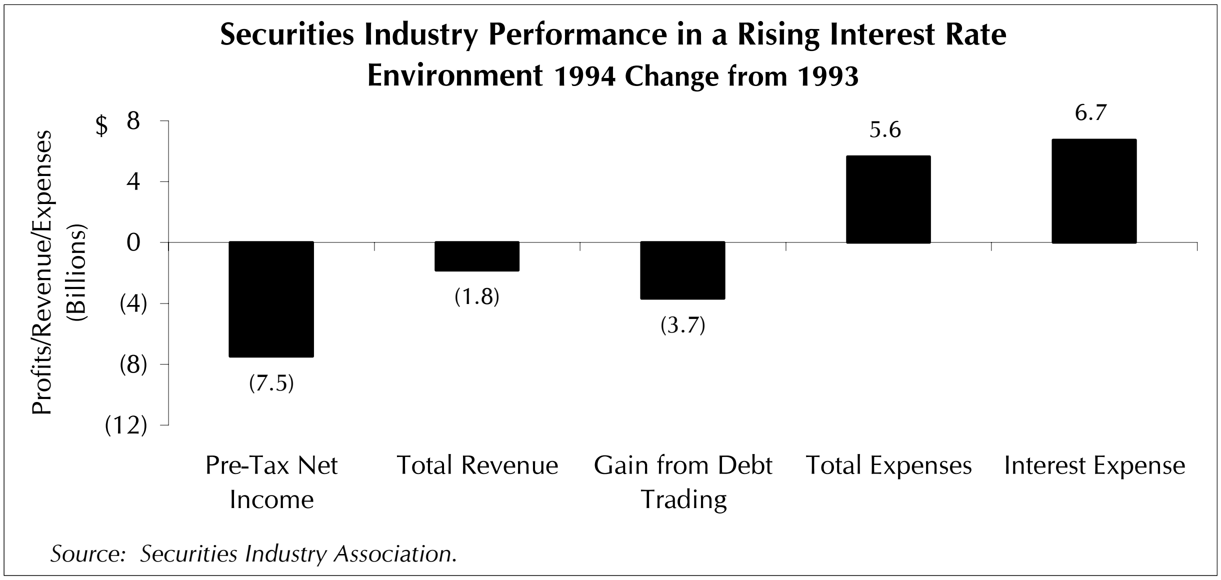


Figure 60

Financial markets and the securities industry were severely shaken by scandals and the bursting of a stock market bubble. However, both in terms of market performance and industry profitability, the worst appears to be over. Profits and revenue both peaked in 2000 (see Figure 61). This was followed by two years of sharp decline in both revenue and profits. But even in 2002, profits and revenues were only low compared to recent years. From a longer historical perspective, profits and revenue have both been much lower at times. In 2003, profits rebounded while revenue did not. In 2004, it is estimated that profits declined while revenue rose slightly.

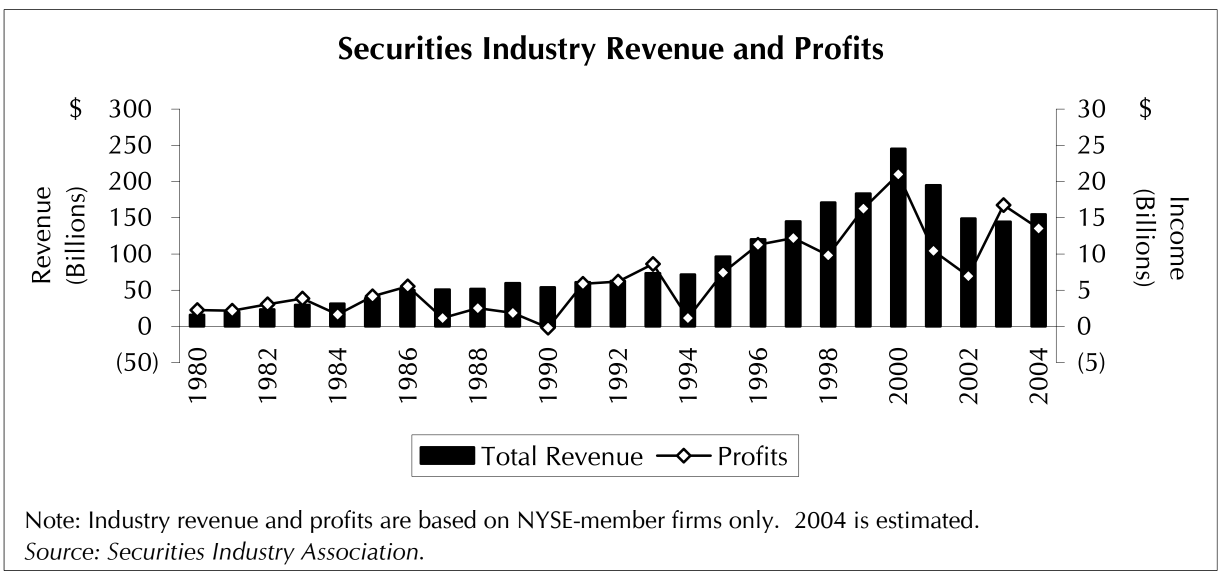


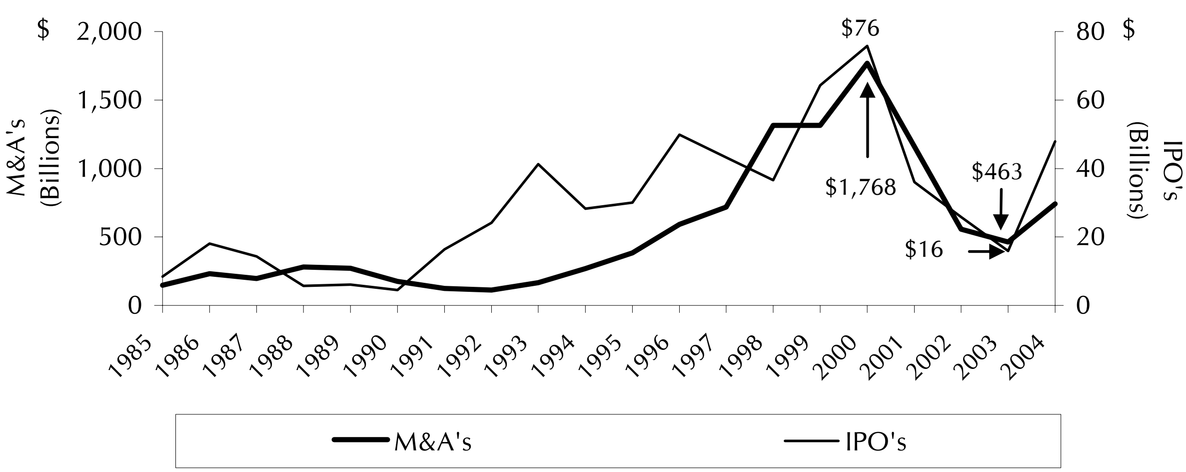
Figure 61

Strong Mergers and Acquisitions (M&A) and Initial Public Offering (IPO) activity growth was seen in 2004, and this growth is expected to continue in 2005. M&A and IPO activity both peaked in 2000. Although both have rebounded, they have not yet come close to their prior peaks (see Figure 62). M&A activity in 2005 is expected to increase rapidly due to several factors. Companies have a strong desire to make deals to achieve economies of scale. Large levels of available cash exists on corporate balance sheets, motivating corporations to put this excess cash to use. In addition, healthy stock market growth may make M&A deals attractive, yet prices are low enough that companies still might consider potential targets to be a "bargain." Finally, low interest rates are making financing cheaper for these deals, and companies do not expect these rates to last much longer. M&A activity is expected in 2005 to reach levels in the general range of those seen in 2001, 1998, and 1999, but short of the $1.8 trillion seen in 2000.

Although strong M&A activity is assumed here, there is the potential for another record year similar to 2000. Therefore M&A activity has some upside potential to the New York wage forecast. Stock options and IPO activity have some upside potential to the forecast as well. In the case of stock options, this upside potential exists because a large portion of securities industry bonuses are not paid in cash. When bonuses are paid in stock options, the date they are cashed is typically years after they were issued, and therefore there can be some unexpected growth in wages from options issued several years ago.

IPO activity has also been strong and is expected to continue to show rapid growth. However, this growth will be offset by weakness in bond underwriting revenue. Mutual fund revenue is expected to grow strongly in part due to concern about retirement savings fueled by discussion of social security reform. Offsetting these positive factors will be weak bond-related revenue and low growth in other areas such as commissions.

Mergers and Acqusitions and Initial Public Offerings

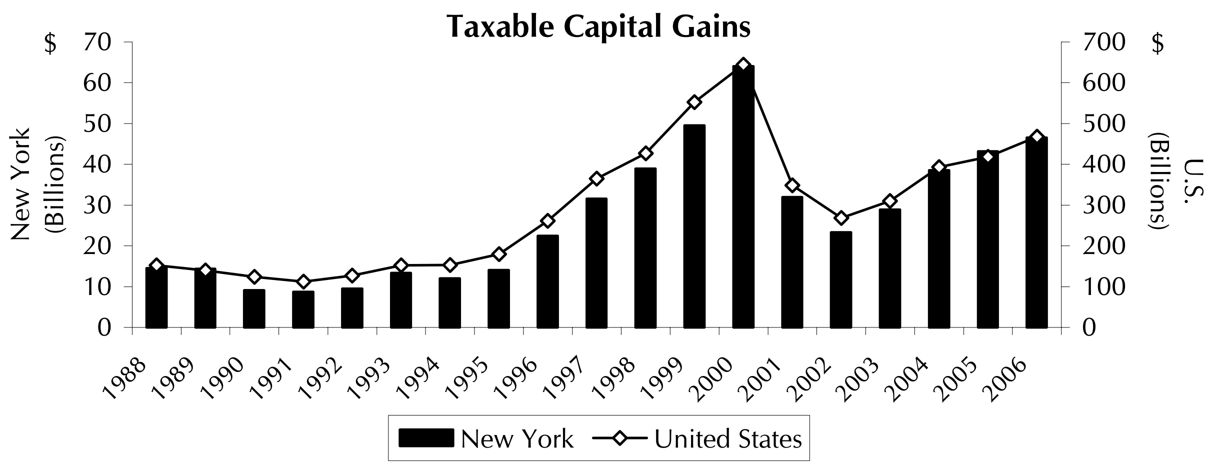


Note: M&A's are completed deals, IPO's are "true" IPO's.
Source: Securities Industry Association.

Figure 62

Capital Gains

After rising rapidly during the booming stock market of the late 1990s, capital gains realizations plummeted in 2001 and are estimated to have declined further in 2002 and then increased in 2003 for both the State and the nation (see Figure 63). In 2004, capital gains for the nation are expected to be $393.3 billion, while New York State capital gains are expected to be $38.6 billion. This will be followed by capital gains of $418.0 billion in 2005 for the nation and $43.1 billion for the State. In 2006, capital gains for the nation and State respectively are expected to be $467.4 billion and $46.5 billion. After accounting for offsetting capital losses, New York State capital gains less losses are expected to be $36.9 billion in 2004, an increase of 33.0 percent from the prior year. This will be followed by gains less losses for the State of $40.9 billion in 2005, an increase of 10.9 percent and $44.7 billion in 2006, and an increase of 9.3 percent. Even after the anticipated increases in 2004 through 2006, capital gains less losses in New York will be at only 71.8 percent of their peak level from 2000.



Note: The first forecast period is 2003.

Sources: U.S. Department of the Treasury; NYS Department of Taxation and Finance; NYS Assembly Ways and Means Committee staff.

Figure 63

The Ways and Means staff capital gains forecasting process involves three steps: 1) forecasting U.S. gains; 2) linking New York gains to U.S. gains; and 3) estimating New York losses. A variety of variables are used in forecasting capital gains that relate to financial asset prices and ownership, housing prices, the securities industry, and tax rates. Most of the variability in the forecast occurs in the national forecast, with the translation of national gains to State gains and the calculation of losses being less prone to error. The forecast for national capital gains yielded results in line with other national forecasts.

Probably the single most important factor in driving capital gains both for the nation and New York is the performance of financial markets, particularly equity markets. Weak stock market performance is expected to reduce gains during the forecasting period until 2006. Tax rates also affect how and when people choose to realize their market gains.

Comparison with Other Forecasting Groups

The Assembly Ways and Means Committee staff's 1.2 percent employment growth forecast for 2005 is 0.1 percentage point higher than the Division of the Budget's 1.1 percent, and 0.1 percentage point lower than Economy.com's forecast of 1.3 percent (see Table 10).[71]

The Committee staff's 5.3 percent wage growth forecast for 2005 is 0.5 percentage point above the 4.8 percent forecast reported by Global Insight, and 0.4 percentage point higher than the Division of the Budget's forecast.

Table 10

NYS Forecast Comparisons
(Percent Change)

	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Employment (Nonfarm)				
Ways and Means	(0.6)	0.6	1.2	1.2
Division of the Budget	(0.6)	0.6	1.1	1.1
Economy.com	(0.6)	0.5	1.3	1.1
Global Insight	(0.6)	0.5	1.0	1.1
Wages				
Ways and Means	1.4	6.2	5.3	5.2
Division of the Budget	1.4	6.2	4.9	5.2
Economy.com	1.6	4.8	4.1	4.6
Global Insight	1.6	4.9	4.8	5.3

Sources: NYS Assembly Ways and Means Committee staff; New York State 2005-06 Executive Budget with 30-Day Changes, February 2005; Economy.com, February 2005, <http://www.economy.com>; Global Insight, Short-term Outlook for New York, winter 2004/05.

[71] Global Insight and Economy.com use the employment data (BLS 790) compiled by the Bureau of Labor Statistics and the wages and salaries data compiled by the Bureau of Economic Analysis. The NYS Division of the Budget and the NYS Assembly Ways and Means Committee staff use the Covered Employment and Wages data (QCEW) from the NYS Department of Labor.

RISKS TO THE FORECASTS

Risks to the National Forecast

Downside Risks

Oil prices are difficult to predict, therefore they represent a significant risk to the forecast. Recent developments in the oil market have made it extremely difficult to identify a clear outlook for crude oil prices. Both supply and demand factors are in question. While it is reasonable to assume that demand for oil will continue to grow, it is not known whether or not supply will be able to keep up with demand. Supply has been constrained for several reasons, many of them difficult to predict (e.g., strikes in major oil producing countries such as Norway and Nigeria, political instability involving countries such as Iraq, and weather-related factors such as damage to oil infrastructure from hurricanes). These events have led to general disagreement on the direction of oil prices and the magnitude of their effect on growth. Therefore, oil price uncertainty is present in the forecast.[72]

Employment growth in the recovery has been slower than expected. Lower employment growth, coupled with a downturn in earnings and personal income as well as rising interest rates could have an adverse effect on consumer spending.

With a record high current account deficit and new lows in the value of the dollar against some currencies, there is concern among some economists that the current situation is unsustainable.[73] While U.S. consumers are spending rather than saving almost all of their income, the government is running high deficits. The government's deficit spending is only being financed due to the high current account deficit. Fortunately, there is currently strong demand from foreigners to invest in U.S. financial assets. If foreigners suddenly shift away from their desire to invest in the United States, the result could be a dramatic collapse in the dollar, which would have very serious economic repercussions both at home and abroad.

It is assumed in the forecast that China's economy will gradually slow its rapid pace of growth. However, a hard landing in China would have a serious negative impact on the world economy and on the United States. China imports many U.S. goods, so a hard landing in China would reduce the market for U.S. exports. Other countries also depend on China for exports.

Uncertainty about many things (including the Iraq conflict, terrorism, energy prices, and economic conditions in general) may present a downside risk to the forecast. As consumers become more uncertain about general economic conditions, consumer

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[72] See Oil Price Sensitivity Analysis on page 39.

[73] For example, see Maurice Obstfield and Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited," National Bureau of Economic Research, Working Paper no. 10869, October 2004.

confidence is likely to fall, causing decreases in consumer spending. Energy prices are also having an effect on consumer confidence, especially gasoline prices.

Terrorism remains a concern, both terrorism on American soil and worldwide attacks. The nature of terrorism contributes to the uncertainty surrounding the future. The costs of fighting terrorism also continue to mount with no set limits. Another attack of the magnitude of September 11th would have a major downside effect on the economy.

Inflation has lately been driven mostly by rising energy prices. The weaker dollar has also put pressure on inflation, and could lead to higher inflation than expected in 2005. The declining dollar also adds risk to the oil price forecast. Producers who sell their oil in dollar-denominated currency must compensate for a loss of buying power brought about by the declining dollar; therefore, there is upward pressure on the dollar price of oil.

There is also the risk of rapidly rising interest rates. The short-term rate is primarily dependent on the Federal Reserve's Federal Open Market Committee's setting of the federal funds rate target. The current low long-term rate is a reflection of market confidence in the Federal Reserve's ability to control inflation. Such higher interest rates would dampen the rate of growth in both consumption and investment spending.

Upside Potential

An end to the violence in Iraq, as well as continued rebuilding within the country, would have a positive effect on the economic outlook. Rebuilding would help Iraq produce more oil, therefore helping to ease oil worries.

Oil prices could decline more than expected which would have a positive affect on the U.S. economy.

A dollar that continues to weaken could lead to a significant turn in the trade deficit due to stronger exports. This would positively affect GDP.

If the employment situation were to strengthen for several months in a row, it could cause a boost in consumer confidence. This would help to increase consumer spending.

Risks to the New York State Forecast

Downside Risks

As always, the United States economy presents a risk to the New York State forecast. If the United States economy were to grow slower than predicted, it is likely the New York State economy would also grow slower. Conversely, more positive growth in the nation could lead to higher growth in New York State.

Terrorism is still a concern for New York State, especially the risk of attack within New York City boundaries. Terror warnings continue for buildings and landmarks in the New York City area, adding to a feeling of uncertainty.

The securities industry outlook also presents a downside risk for the New York State economy. Securities industry profits in the second and third quarters of 2004 were lower than expected, and as the sector represents one of the main economic drivers of the New York City economy, a downturn in the industry could lead to a negative effect on the State economy.

Housing price appreciation also represents a concern for the State, especially in Long Island. According to the Federal Reserve Bank of New York, housing prices in the region are about double the prices in 1998. Prices rose about 12 percent in 2004 alone. Some fear this may indicate a possible housing bubble.

Upside Potential

Since the securities industry is both highly volatile and a major driver of State wages, there is always the potential for unexpected strength, particularly since the industry is performing well below its peak level for profits and revenue. The national economy could also perform better than expected, leading to improved New York State performance.

The declining dollar could also have an impact on New York State. A weaker dollar means New York is less expensive to come to, a plus for the tourism industry.

APPENDIX A

The North American Industry Classification System (NAICS)

Code	NAICS Title
11	**Agriculture, Forestry, Fishing and Hunting**
111	Crop Production
112	Animal Production
113	Forestry and Logging
114	Fishing, Hunting and Trapping
115	Support Activities for Agriculture and Forestry
21	**Mining**
211	Oil and Gas Extraction
212	Mining (except Oil and Gas)
213	Support Activities for Mining
22	**Utilities**
221	Utilities
23	**Construction**
236	Construction of Buildings
237	Heavy and Civil Engineering Construction
238	Specialty Trade Contractors
31-33	**Manufacturing**
311	Food Manufacturing
312	Beverage and Tobacco Product Manufacturing
313	Textile Mills
314	Textile Product Mills
315	Apparel Manufacturing
316	Leather and Allied Product Manufacturing
321	Wood Product Manufacturing
322	Paper Manufacturing
323	Printing and Related Support Activities
324	Petroleum and Coal Products Manufacturing
325	Chemical Manufacturing
326	Plastics and Rubber Products Manufacturing
327	Nonmetallic Mineral Product Manufacturing
331	Primary Metal Manufacturing
332	Fabricated Metal Product Manufacturing
333	Machinery Manufacturing
334	Computer and Electronic Product Manufacturing
335	Electrical Equipment, Appliance, and Component Manufacturing
336	Transportation Equipment Manufacturing
337	Furniture and Related Product Manufacturing
339	Miscellaneous Manufacturing
42	**Wholesale Trade**
423	Merchant Wholesalers, Durable Goods
424	Merchant Wholesalers, Nondurable Goods
425	Wholesale Electronic Markets and Agents and Brokers

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The North American Industry Classification System (NAICS) -- *(continued)*

Code	NAICS Title
44-45	**Retail Trade**
441	Motor Vehicle and Parts Dealers
442	Furniture and Home Furnishings Stores
443	Electronics and Appliance Stores
444	Building Material and Garden Equipment and Supplies Dealers
445	Food and Beverage Stores
446	Health and Personal Care Stores
447	Gasoline Stations
448	Clothing and Clothing Accessories Stores
451	Sporting Goods, Hobby, Book, and Music Stores
452	General Merchandise Stores
453	Miscellaneous Store Retailers
454	Nonstore Retailers
48-49	**Transportation and Warehousing**
481	Air Transportation
482	Rail Transportation
483	Water Transportation
484	Truck Transportation
485	Transit and Ground Passenger Transportation
486	Pipeline Transportation
487	Scenic and Sightseeing Transportation
488	Support Activities for Transportation
491	Postal Service
492	Couriers and Messengers
493	Warehousing and Storage
51	**Information**
511	Publishing Industries (except Internet)
512	Motion Picture and Sound Recording Industries
515	Broadcasting (except Internet)
516	Internet Publishing and Broadcasting
517	Telecommunications
518	Internet Service Providers, Web Search Portals, and Data Processing Services
519	Other Information Services
52	**Finance and Insurance**
521	Monetary Authorities - Central Bank
522	Credit Intermediation and Related Activities
523	Securities, Commodity Contracts, and Other Financial Investments and Related Activities
524	Insurance Carriers and Related Activities
525	Funds, Trusts, and Other Financial Vehicles
53	**Real Estate and Rental and Leasing**
531	Real Estate
532	Rental and Leasing Services
533	Lessors of Nonfinancial Intangible Assets (except Copyrighted Works)
54	**Professional, Scientific, and Technical Services**
541	Professional, Scientific, and Technical Services

*** continued on next page ***

The North American Industry Classification System (NAICS) -- *(continued)*

Code	NAICS Title
55	**Management of Companies and Enterprises**
551	Management of Companies and Enterprises
56	**Administrative and Support and Waste Management and Remediation Services**
561	Administrative and Support Services
562	Waste Management and Remediation Services
61	**Educational Services**
611	Educational Services
62	**Health Care and Social Assistance**
621	Ambulatory Health Care Services
622	Hospitals
623	Nursing and Residential Care Facilities
624	Social Assistance
71	**Arts, Entertainment, and Recreation**
711	Performing Arts, Spectator Sports, and Related Industries
712	Museums, Historical Sites, and Similar Institutions
713	Amusement, Gambling, and Recreation Industries
72	**Accommodation and Food Services**
721	Accommodation
722	Food Services and Drinking Places
81	**Other Services - except Public Administration**
811	Repair and Maintenance
812	Personal and Laundry Services
813	Religious, Grantmaking, Civic, Professional, and Similar Organizations
814	Private Households
92	**Public Administration**
921	Executive, Legislative, and Other General Government Support
922	Justice, Public Order, and Safety Activities
923	Administration of Human Resource Programs
924	Administration of Environmental Quality Programs
925	Administration of Housing Programs, Urban Planning, and Community Development
926	Administration of Economic Programs
927	Space Research and Technology
928	National Security and International Affairs

Source: Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002.

APPENDIX B

Employment and Wages in NAICS Sectors, 2003

	Employment (Thousands)		Wages ($ in Billions)	
	U.S.	**NYS**	**U.S.**	**NYS**
Total	**129,998.8**	**8,201.8**	**$5,103.5**	**$388.2**
Government	21,584.9	1,421.7	815.0	62.7
Education & Health	16,587.1	1,390.6	579.1	50.3
Retail Trade	14,920.4	852.0	367.3	21.9
Other Services	13,070.3	721.3	354.4	21.7
FIRE	7,975.4	692.3	389.4	71.7
Leisure & Hospitality	12,175.5	642.7	700.1	14.0
Manufacturing	15,080.0	614.5	267.1	29.7
Professional Services	6,627.7	506.0	422.8	35.5
Wholesale Trade	5,607.9	350.4	288.7	20.3
Construction	6,732.0	316.6	275.4	15.4
Information	3,188.4	275.3	185.4	19.4
Transport & Utilities	4,762.3	256.0	365.7	11.3
Management of Companies	1,687.1	120.3	120.1	13.0

Note: Some NAICS sectors are grouped with others. For sector definitions, see Appendix A.

Sources: NYS Employment and Wages: NYS Department of Labor, QCEW; U.S. Employment: Bureau of Labor Statistics, CES; U.S. Wages: Bureau of Economic Analysis.

APPENDIX C

U.S. Economic Outlook	Actual 2003	Estimate 2004	Forecast 2005	Forecast 2006
Real GDP*	10,381.3	10,841.8	11,226.2	11,583.1
Real Consumption*	7,355.5	7,634.7	7,887.7	8,124.8
Real Investment*	1,628.8	1,841.3	1,962.4	2,037.2
Real Exports*	1,031.8	1,119.5	1,211.9	1,319.6
Real Imports*	1,550.3	1,703.8	1,821.5	1,926.8
Real Government*	1,909.4	1,946.9	1,983.1	2,025.7
*Federal**	689.6	722.0	745.2	765.2
*State and Local**	1,219.9	1,224.9	1,237.8	1,260.5
Personal Income**	9,161.8	9,659.1	10,168.8	10,717.0
Wages & Salaries**	5,103.5	5,342.5	5,627.9	5,924.3
Transfer Income**	1,335.4	1,406.3	1,478.3	1,559.1
Corporate Profits (Accounting Basis)**	874.5	977.6	1,241.6	1,377.2
Corporate Profits (Economic Basis)**	1,021.1	1,176.4	1,292.9	1,397.2
Productivity (1992 = 100)	129.0	134.2	137.3	140.7
Employment***	130.0	131.5	133.7	135.9
CPI-Urban (1982-84 = 100)	184.0	188.9	194.2	198.9
S&P 500 Stock Price (1941-43 = 10)	963.7	1,130.6	1,262.5	1,387.7
Treasury Bill Rate (3-month)****	1.0	1.4	3.0	3.9
Treasury Bond Rate (10-year)****	4.0	4.3	4.5	5.1

* In billions of chained 2000 dollars.
** In billions of dollars.
*** In millions.
**** Annual average rate.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Standard and Poor's; NYS Assembly Ways and Means Committee staff.

APPENDIX D

ECONOMIC INDICATORS New York State					
		Actual 2003	**Estimate 2004**	**Forecast 2005**	**Forecast 2006**
Personal Income	***Percent Change***	**2.3**	**6.0**	**5.1**	**5.4**
	Level ($)	679.2	719.6	756.1	796.6
Wages and Salaries	***Percent Change***	**1.4**	**6.2**	**5.3**	**5.2**
	Level ($)	388.2	412.2	433.9	456.4
Total Employment	***Percent Change***	**(0.6)**	**0.6**	**1.2**	**1.2**
	Level	8,201.8	8,250.9	8,351.1	8,454.5
Government	***Percent Change***	**(0.1)**	**0.6**	**0.3**	**0.5**
	Level	1,421.7	1,429.7	1,434.2	1,441.8
Education & Health	***Percent Change***	**2.1**	**1.6**	**2.1**	**2.0**
	Level	1,390.6	1,412.8	1,441.9	1,470.6
Wholesale Trade	***Percent Change***	**(0.9)**	**0.3**	**1.5**	**1.5**
	Level	350.4	351.6	356.8	362.0
Retail Trade	***Percent Change***	**(0.4)**	**1.0**	**1.6**	**1.5**
	Level	852.0	860.2	874.0	887.5
Other Services[1]	***Percent Change***	**(1.0)**	**1.1**	**2.1**	**1.8**
	Level	721.3	729.2	744.4	757.5
FIRE[2]	***Percent Change***	**(1.3)**	**0.7**	**1.5**	**1.3**
	Level	692.3	697.3	707.5	717.0
Manufacturing[3]	***Percent Change***	**(6.0)**	**(2.8)**	**(1.1)**	**(1.1)**
	Level	614.5	597.0	590.5	583.9
Leisure & Hospitality	***Percent Change***	**0.8**	**2.0**	**2.0**	**1.7**
	Level	642.7	655.7	668.5	679.7
Professional Services	***Percent Change***	**(0.6)**	**1.3**	**2.3**	**2.0**
	Level	506.0	512.5	524.4	535.1
Construction	***Percent Change***	**(1.0)**	**0.6**	**1.6**	**1.4**
	Level	316.6	318.6	323.7	328.2
Information	***Percent Change***	**(6.8)**	**(2.0)**	**0.1**	**0.6**
	Level	275.3	269.9	270.2	271.9
Transp. & Utilities[4]	***Percent Change***	**(0.9)**	**0.2**	**1.4**	**1.3**
	Level	256.0	256.4	260.0	263.4
Mgmt of Companies	***Percent Change***	**1.3**	**(0.5)**	**0.9**	**0.9**
	Level	120.3	119.7	120.8	121.8
CPI	***Percent Change***	**3.1**	**3.5**	**3.3**	**2.8**
	Level	197.8	204.8	211.5	217.4

Note: Boldface numbers represent percent changes and regular type numbers represent the level. Income and wages are in billions of dollars. Employment is in thousands.

[1] Including Administrative, Support, and Waste Management Services.

[2] Financial Activities including Finance, Insurance, Real Estate, Rental, and Leasing.

[3] Including Mining.

[4] Transportation, Warehousing, and Utilities.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; NYS Department of Labor, QCEW; NYS Assembly Ways and Means Committee staff.