



Review of the Financial Plan of the City of New York

Thomas P. DiNapoli
New York State Comptroller

Kenneth B. Bleiwas
Deputy Comptroller

Report 10-2008

February 2008

- The City projects a surplus of \$4.1 billion for FY 2008, but \$2.5 billion of that amount was generated in prior years.
- The budget gaps have widened since the beginning of the fiscal year, to \$2.8 billion in FY 2009, \$5.3 billion in FY 2010, and \$6.6 billion in FY 2011.
- Agency actions in the Mayor's proposed gap-closing program would generate \$543 million in FY 2008 and \$885 million in FY 2009—the most since FY 2002.
- The Department of Education has enacted a mid-year cut of \$180 million and will cut \$324 million next year.
- The seven largest financial firms based in New York City lost \$28.6 billion during the second half of 2007. The January Plan assumes that the securities industry will lose 8,000 jobs.
- Wall Street bonuses fell by only 2 percent in 2007, to \$33.2 billion, as firms sought to retain high-performing employees.
- Prices for single-family homes are forecast to decline by 6.6 percent between 2007 and 2009, and co-op/condo prices are expected to decline by 8.3 percent.
- The City has benefited from a weak dollar, which has made real estate attractive to foreign investors and has boosted the tourism and hotel industries.
- Nondiscretionary spending will consume 50 percent of City fund revenues by FY 2011, up from 33 percent in FY 2000. Debt service alone will consume 13.6 percent of City fund revenues.
- The stock market has been unusually volatile, and pension fund investment earnings are falling short of expectations.

Over the past five years, New York City has generated successively larger budget surpluses from extraordinary Wall Street activities, rapidly rising real estate values and transactions, and conservative revenue forecasts. Most of the resources were used to close future budget gaps, but a large portion was also used to fund reserves.

Last June, the City's financial plan was based on what appeared to be very conservative economic assumptions. Over the summer, however, the subprime mortgage credit crisis sent shockwaves through the national and local economies.

The securities industry, along with the banking and mortgage industries, suffered large losses during the second half of calendar year 2007 as financial firms and banks wrote off more than \$145 billion in bad debt. Further write-offs are anticipated in 2008, and losses have spread to bond insurers and other financial institutions. Financial firms have announced plans to lay off thousands of workers in the City and have already begun to shed jobs to shore up profits.

The City quickly responded, in October and then again in January, by further reducing its revenue forecasts and by instructing its agencies to curtail planned spending. Combined collections from business and real estate transaction taxes are now projected to be \$2.6 billion lower in FY 2009 than in FY 2007, and personal income taxes are forecast to be lower by \$690 million. Although the real estate market is showing signs of weakening, property tax collections will grow by about \$900 million annually as past increases in market values are phased in (as required under State law).

Although the City has substantially lowered its economic expectations since the beginning of the fiscal year, additional downside risks have developed over the past few weeks. The likelihood of a national recession has grown, and even if a recession is avoided, the economic downturn could be deeper and longer than assumed in the

Figure 1
OSDC Risk Assessment of NYC Financial Plan
(in millions)

	<i>Better/(Worse)</i>				
	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Gaps Per January Plan	\$ - - -	\$ - - -	\$ (4,224)	\$ (5,598)	\$ (5,324)
Tax Revenue	250	(200)	(100)	(100)	(100)
State AIM Payments	(164)	(164)	(164)	(164)	(164)
Uniformed Agency Overtime	(40)	(100)	(100)	(100)	(100)
Agency Actions	(25)	(70)	(65)	(65)	(65)
Health Insurance Savings	- - -	(200)	(200)	(200)	(200)
Anticipated Federal and State Aid	- - -	(100)	(100)	(100)	(100)
MTA Subsidy	- - -	- - -	- - -	(300)	- - -
OSDC Risk Assessment¹	\$ 21	\$ (834)	\$ (729)	\$ (1,029)	\$ (729)
Gaps to be Closed	\$ 21	\$ (834)	\$ (4,953)	\$ (6,627)	\$ (6,053)

¹ The January Plan assumes that the City sales tax rate, which is scheduled to decline from 4 percent to 3 percent on July 1, 2008, upon the termination of the Municipal Assistance Corporation, will be reauthorized by the State at the current level—thus preventing the loss of \$1.2 billion annually. The Plan also includes a general reserve of \$100 million in FY 2008 and \$300 million annually thereafter.

City's January 2008 Financial Plan (the "January Plan"). In addition, the securities industry may not recover as quickly and job losses may be more widespread than the City anticipates.

Even assuming the successful implementation of the Mayor's proposed gap-closing program, the remaining budget gaps will exceed \$4.2 billion in FY 2010 and reach almost \$5.6 billion by FY 2011. Given the potential for slippage in the Mayor's program and for further future revenue shortfalls, the remaining gaps could total \$834 million in FY 2009, \$5 billion in FY 2010, and \$6.6 billion in FY 2011 (see Figure 1).

Closing budget gaps of this magnitude will be challenging during an economic slowdown because the City is unlikely to generate large surpluses as it did in recent years. In addition, nondiscretionary spending, particularly debt service, is rising rapidly and will consume nearly half of City fund revenues by FY 2011. While the City has considerable margin in the current fiscal year and the FY 2009 budget situation remains manageable at this time, closing the out-year gaps will require difficult choices.

Economic Trends

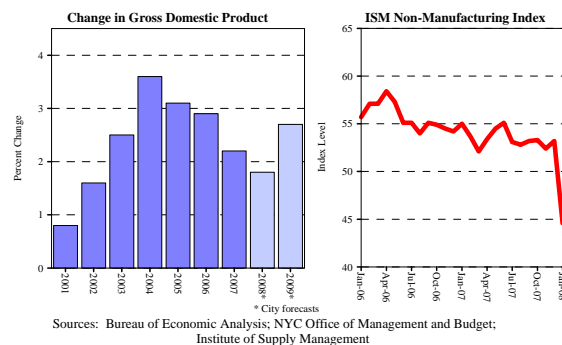
The national gross domestic product (GDP) grew by only 0.6 percent during the fourth quarter of 2007 as the impact of falling home values, rising foreclosures, the credit crunch, and consumer restraint took a toll on the national economy. For all of 2007, the GDP grew by only 2.2 percent—the slowest rate of growth since 2002.

While many economists expect the nation to slip into a recession, the January Plan assumes a short economic slowdown. The January Plan assumes that GDP growth will slow to 1.8 percent in 2008, but then pick up to 2.7 percent in 2009 (see Figure 2). Recessionary concerns, however, prompted the Federal Reserve to lower interest rates by an unprecedented 1.25 percentage points in the second half of January 2008 and Congress to enact a fiscal stimulus package. These concerns intensified after a sharp drop in the Institute for

Supply Management's non-manufacturing index (also see Figure 2).

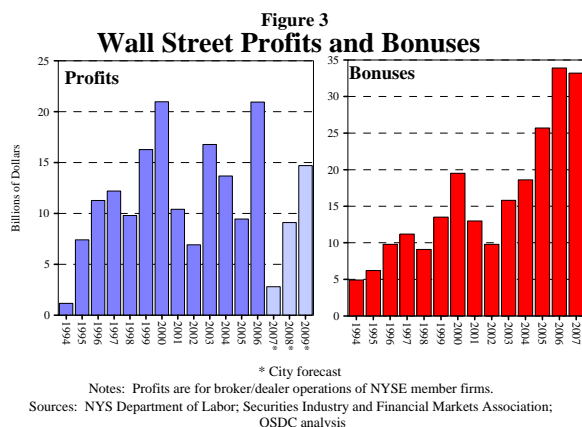
Wall Street, a central pillar of New York City's economy, has been severely affected by the national housing downturn and the credit crisis. The securities industry, which generated near-record profits in 2006, was on track for another strong year until the subprime credit crisis widened in July 2007.

Figure 2
Measures of National Economic Performance



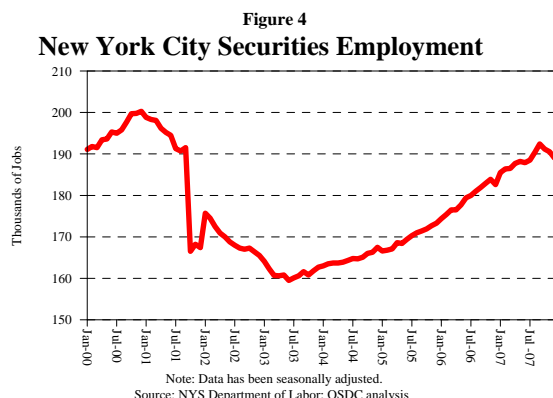
The securities industry, along with the banking and mortgage industries, suffered large losses during the second half of the year as financial firms and banks wrote off more than \$145 billion in bad debt. The seven largest financial firms headquartered in New York City, for example, lost \$28.6 billion during the second half of 2007. Further write-offs are anticipated in early 2008, and losses have spread to bond insurers and other financial institutions.

The January Plan assumes that Wall Street profits will total \$2.8 billion in 2007—the lowest level since 1994 (see Figure 3)—but it now seems likely that the industry will report a small loss for the first time in 17 years. The Plan also assumes that profits will rebound in 2008 to \$9.1 billion, an assumption that may also be optimistic given the potential for additional write-offs.



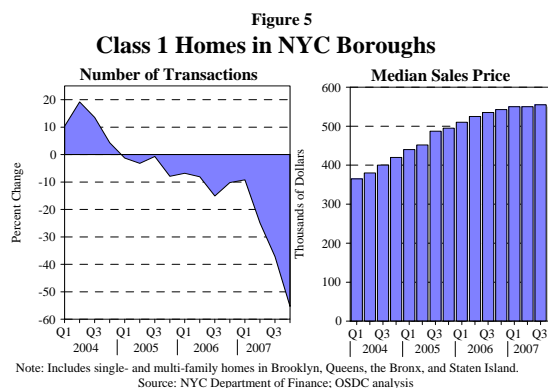
Despite the sharp decline in Wall Street profits in 2007, bonuses remained near record levels. The State Comptroller estimated that bonuses totaled \$33.2 billion, only 2 percent less than the record set in 2006, as firms sought to retain high-performing employees. Bonuses will decline sharply in 2008 if profitability remains subdued.

Many Wall Street and other financial firms have announced plans to shed jobs to shore up profits. Although average employment in the securities industry grew by 9,300 jobs during 2007, the industry has begun to lose jobs (see Figure 4). The January Plan assumes that the securities industry will lose more than 8,000 jobs before growth resumes in early calendar year 2009. Job losses in the securities industry will hold down employment gains in other sectors, such as business and professional services, information, and retail trade.



Thus far, the rate of job growth has slowed much less in the City than it has nationally. The City added 54,500 jobs during 2007 and the January Plan assumes net job growth of 5,200 in 2008 and 14,600 in 2009, driven by gains in education and health care, leisure and hospitality, and business services. Although job losses are expected to be concentrated in the construction, finance, information, and trade sectors, losses may be greater and more widespread if a recession occurs. The January Plan assumes job growth will not accelerate until 2010, when an average of 26,000 jobs will be added annually through 2012.

The City's real estate market has also proved more resilient than markets elsewhere in the nation, but the local residential real estate market has been weakening. Sale prices for condominiums and cooperative apartments in Manhattan continue to rise, but the rate of growth has slowed. Home sales in the other boroughs have fallen dramatically and the median sale price is no longer rising (see Figure 5), and foreclosures are on the rise. Prices for single-family homes are forecast to decline by 6.6 percent between 2007 and 2009, and prices for co-ops/condos are expected to decline by 8.3 percent. Single family home sales are expected to decline by 46.1 percent from the 2006 level and by 26.1 percent by 2011 for coops/condos.



Demand for office space remains strong and the City has benefited from a weak dollar, which has made residential and commercial Manhattan real estate attractive to foreign investors. The cheap dollar has also given the tourism industry a boost. The number of visitors set a record of 46 million in 2007, driven by a 17 percent jump in the number of foreign tourists, which contributed to strong sales tax collections. Hotel occupancy exceeded 86 percent and room rates averaged \$304—also a record. With the dollar expected to remain weak in 2008, tourism will remain strong.

Figure 6
Financial Plan Reconciliation
June 2007 Plan vs. January 2008 Plan
(in millions)

	<i>Better/(Worse)</i>			
	FY 2008	FY 2009	FY 2010	FY 2011
Surplus/(Gaps) Per June 2007 Plan	\$ - - -	\$ (1,550)	\$ (3,397)	\$ (4,369)
Revenue				
Real Estate Transaction Taxes	\$ (1)	\$ (214)	\$ (278)	\$ (362)
Real Property Tax	15	(181)	(237)	(313)
Personal Income Taxes	(19)	(532)	(494)	(460)
Business Taxes	(507)	(604)	(347)	(234)
All Other Taxes	<u>237</u>	<u>40</u>	<u>86</u>	<u>95</u>
Subtotal	\$ (275)	\$ (1,491)	\$ (1,270)	\$ (1,274)
Mayoral Initiatives	68	239	283	301
Tax Audit	500	- - -	- - -	- - -
Non-Tax Revenue	<u>61</u>	<u>158</u>	<u>17</u>	<u>11</u>
Total	354	(1,094)	(970)	(962)
Expenditures				
Collective Bargaining	(92)	(438)	(1,075)	(1,610)
Energy	(27)	(78)	(152)	(183)
Pensions	(22)	153	12	210
Health Insurance	(2)	(39)	(42)	(46)
Other Agency Expenditures	(30)	(16)	1	19
Debt Service	43	110	153	102
Savings from Prior Years' Expenses	500	- - -	- - -	- - -
General Reserve	200	- - -	- - -	- - -
Pay-As-You-Go Capital Financing	<u>100</u>	<u>200</u>	<u>200</u>	<u>200</u>
Total	670	(108)	(903)	(1,308)
Net Change During FY 2008	\$ 1,024	\$ (1,202)	\$ (1,873)	\$ (2,270)
Surplus/(Gaps) Per January 2008 Plan	\$ 1,024	\$ (2,752)	\$ (5,270)	\$ (6,639)

Sources: NYC Office of Management and Budget; OSDC analysis. Totals may not add due to rounding.

The City has lowered its economic expectations since the beginning of the fiscal year, but significant downside risks remain. The likelihood of a national recession has grown in just the past few weeks. Even if a recession is avoided, the economic downturn could be deeper and longer than the City expects. In addition, the January Plan assumes that the local inflation rate will slow from 2.9 percent in 2008 to 2 percent annually in later years, but increased worldwide demand for energy could lead to higher costs, fueling inflationary pressures (local inflation rose 3.7 percent in January 2008). Finally, the securities industry may not recover as quickly and the real estate market could weaken more than the City is anticipating.

Financial Plan Reconciliation

Since the beginning of the fiscal year, there has been a net improvement of more than \$1 billion in the City's outlook for FY 2008 (see Figure 6). Unlike recent years, the improvement comes from drawing down reserves and unanticipated revenue from tax audits—not from economic activity.

Business tax collections in FY 2008 are now expected to decline sharply from the level forecast in June 2007, reflecting heavy losses in the securities industry. The budgetary impact was eased by an audit of one financial firm that yielded \$400 million and by higher-than-expected sales tax collections (\$170 million). While the October 2007 Plan forecast large declines in revenue from the personal income tax and from real estate transaction taxes, the decline did not materialize because Wall Street bonuses were higher than expected and Manhattan real estate transaction activity remained strong. Revenues also benefitted from the elimination of certain mayoral proposals from the January Plan that did not receive State approval, including tax cuts and a new public authority to finance transportation projects.

As shown in Figure 6, the credit crisis is expected to exact a heavier toll on tax revenues beginning in FY 2009, with cumulative losses of more than \$4 billion during fiscal years 2009 through 2011 as the impact ripples through the economy.

As a result, the out-year budget gaps have widened since the start of the fiscal year—by \$1.2 billion in FY 2009 to reach \$2.8 billion; by \$1.9 billion in FY 2010 to reach nearly \$5.3 billion; and by \$2.3 billion in FY 2011 to reach \$6.6 billion. The growth reflects the impact of revised economic assumptions that lowered projected revenues, and higher-than-planned costs associated with actual and anticipated labor contracts.

Program to Eliminate the Gap

The January Plan projects budget gaps of \$2.8 billion for FY 2009, \$5.3 billion for FY 2010, \$6.6 billion for FY 2011, and \$6.3 billion for FY 2012. To balance the FY 2009 budget and to narrow the out-year gaps, the Mayor has proposed a Program to Eliminate the Gap (see Figure 7).

The City is counting on \$1 billion in surplus funds from FY 2008 to narrow the FY 2009 budget gap to \$1.7 billion. To close the remaining gap and to narrow the out-year gaps, the City is relying on agency actions and assistance from the municipal unions and the federal and State governments.

Agency actions are expected to generate \$543 million in FY 2008, \$885 million in FY 2009, and about \$740 million annually thereafter. Expense reductions account for 91 percent of the anticipated resources. Most would come from reducing services or scaling back planned enhancements rather than from productivity or management improvements. More than three quarters of the savings would come from personnel actions, which would reduce planned staffing levels by 4,100 employees.

Nearly one quarter of the staff reduction would come from a two-year delay in the expansion of the police force.

The Department of Education (DOE) has been ordered to impose a mid-year cut of \$180 million and to cut another \$324 million next year. The DOE has cut school budgets by \$100 million this year, which will fall hardest on extracurricular programs and professional development, and plans to cut school budgets by \$181 million next year. The DOE also plans to seek additional State aid for special education, impose a hiring freeze, implement unspecified purchasing efficiencies, and reduce repairs and maintenance. The programmatic impact has not been identified.

The Mayor has begun negotiations with the Municipal Labor Council, which represents the City's labor unions, in the hope of achieving \$200 million in recurring employee health insurance savings beginning in FY 2009. No progress has been reported, and thus it is difficult to assess the likelihood of realizing any anticipated savings. Similarly, it

Figure 7
Program to Eliminate the Gap
(in millions)

	FY 2008	FY 2009	FY 2010	FY 2011
Baseline Surplus/(Gaps)	\$ 1,024	\$(2,752)	\$(5,270)	\$(6,639)
Agency Actions				
Dept. of Education	180.1	324.3	273.5	271.5
Social Services	75.9	21.0	21.4	21.4
Sanitation	37.5	53.7	23.4	22.5
Police Department	33.8	95.6	24.4	15.0
Admin. for Children's Svcs.	21.8	37.3	34.2	34.2
Fire Department	19.8	23.0	22.5	22.4
Transportation	17.8	20.3	23.1	23.6
Health & Mental Hth. Svcs.	17.0	19.9	19.1	19.1
Information Technology	12.3	15.9	16.8	16.8
Homeless Services	10.6	15.6	11.7	11.7
Health and Hospitals Corp.	10.1	---	9.0	0.9
Citywide Admin. Svcs.	9.3	11.9	12.9	12.9
Finance	9.0	14.9	16.9	16.9
Elected Officials	8.9	23.4	21.1	31.1
Libraries	8.0	16.2	16.2	16.2
Youth	8.0	9.7	9.7	9.7
CUNY	5.8	9.6	9.6	9.6
Correction	5.1	12.7	15.0	15.0
Parks	1.9	15.7	15.7	11.7
Fringe Benefits	25.8	45.7	49.3	55.1
Procurement Savings	---	55.5	55.5	55.5
Other	24.7	42.9	45.2	48.0
Total	543	885	746	741
Health Insurance Savings	---	200	200	200
Federal & State Actions	---	100	100	100
Total Program	1,567	1,185	1,046	1,041
Surplus Transfer	(1,567)	1,567	---	---
Remaining Gaps	\$ ---	\$ ---	\$ (4,224)	\$ (5,598)

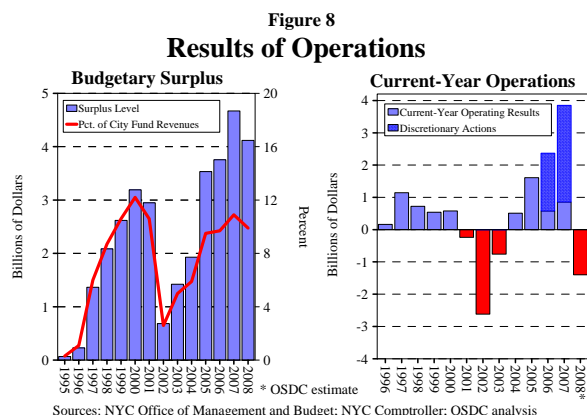
Source: NYC Office of Management and Budget

remains uncertain whether the City will realize \$100 million in resources from federal and State actions, even though the City estimates that it provides about \$11 billion more in resources to each source than it receives back in benefits. The agency program includes \$70 million in actions, such as curtailing library hours, which may not be approved by the City Council.

Even if the City successfully implements the gap-closing program, it would still be left with budget gaps of \$4.2 billion in FY 2010, \$5.6 billion in FY 2011, and \$5.3 billion in FY 2012. These gap estimates, moreover, assume an economic slowdown rather than a recession and a relatively faster recovery than appears likely at this time. The Mayor has stated that recent real property tax cuts, valued at about \$1.2 billion annually, could be rescinded to help close the gaps.

Results of Current-Year Operations

In recent years, surging Wall Street profits and rising real estate values and transactions, combined with conservative revenue forecasts, resulted in successively larger City budget surpluses (see Figure 8). The City transferred most of these resources to future years to close projected budget gaps, but also used a significant portion to fund reserves and discretionary actions that improved the City's fiscal position.



The transfer of resources between years masks the relationship between recurring revenues and expenditures. A clearer picture of the City's fiscal condition can be obtained by examining the results of current-year operations—the difference between revenues and expenditures in the current year. This entails adjusting for surplus transfers and other factors that impede transparency.

For the first time in five years, spending could exceed current-year resources, resulting in a current-year deficit of \$1.4 billion—a clear sign of fiscal stress. The FY 2008 budget will be balanced with surplus resources accumulated in prior years.

Impact of the Proposed State Budget

The Governor's proposed budget would increase education aid to New York City by \$539 million for the 2008-2009 school year, which is \$390 million less than anticipated in the City's financial plan (see Figure 9).

The Governor also proposed a number of initiatives that would increase City costs by a net of \$175 million during this year and next, with most of the impact to come from the proposal to partially restore payments to the City under the Aid and Incentives to Municipalities (AIM) program. The Governor has promised to fully restore the program next year, though a similar promise last year went unfilled.

Figure 9
Impact of the Governor's Proposed Budget
On New York City's Financial Plan
(in millions)

	<i>Better/(Worse)</i>	
	FY 2008	FY 2009
Education Aid	\$ 24	\$ (390)
Other Proposals		
AIM Payments	(164)	- - -
Social Services	(15)	(64)
Preschool Special Education	(5)	(21)
Tax Administration	(3)	(11)
Mandate Relief	6	16
Other Actions	12	74
Total	\$ (169)	\$ (6)

Sources: NYS Division of the Budget; OSDC analysis

Education Aid

In 2007, the State and the City agreed to increase education funding by \$5.4 billion over four years as part of the resolution of the Campaign for Fiscal Equity (CFE) litigation. Both the State and the City met their commitments in the first year, and the Governor has proposed increasing State education aid by \$539 million next year—a cumulative two-year increase of \$1.3 billion. The proposed increase is \$122 million less than promised last year, and includes building aid that would fund the State's share of school reconstruction and not educational programs. The Mayor has increased his four-year commitment to boost City funding for education, but 78 percent of

the additional resources are dedicated to fund collective bargaining and higher pension and debt service costs, which leaves less than one quarter to fund new educational initiatives.

The Governor also has proposed an 18-month lag in building aid reimbursement for approved capital projects, which the City believes could delay school construction projects. Also, the Governor would cap building and transportation aid at levels appropriated by the State Legislature in exchange for a \$179 million unrestricted grant, which is about equal to the amount the City would be expected to claim during the year.

Other Initiatives

The following proposals by the Governor also could affect the City's financial plan.

- Eliminate State funding for juvenile detention (\$20 million) and increase the local share of public assistance costs (\$30 million). For example, the City's share of Family Assistance would rise from 25 percent to 27 percent, and Safety Net Assistance would rise from 50 percent to 52 percent.
- Require localities to fund the cost of evaluating children for preschool special education services (\$21 million).
- Increase the amount the State charges the City for administering the personal income tax, by \$10 million. Last year, the State increased the charge from \$40 million to \$70 million.
- Restructure Medicaid rates, which could cost the Health and Hospitals Corporation \$40 million in FY 2009. (Federal regulations, effective May 2008, will reduce supplemental Medicaid payments by \$400 million annually unless Congress intervenes.)

Although not part of the proposed budget, the Governor would increase State subsidies to the Metropolitan Transportation Authority by an additional \$300 million in 2010, which could require a City match.

Mandate Relief

The Wicks law requires the City to issue separate bids for electrical, plumbing, and heating and cooling work for construction projects that cost more than \$50,000. The Governor has proposed increasing this cost threshold to \$3 million, which received informal agreement last year.

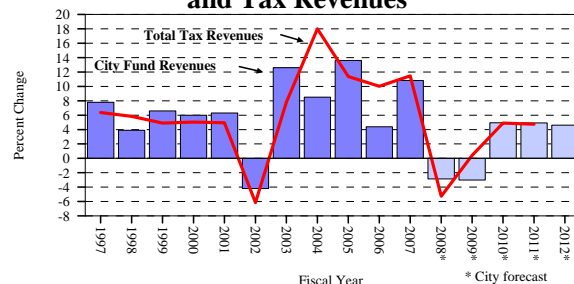
The City continues to benefit from State initiatives implemented in prior years. These include the State cap that limits the annual growth in the local share of Medicaid to 3 percent, and the State takeover of the local share of the Family Health Plus program, which together benefit the City by \$937 million during fiscal years 2008 and 2009.

Revenue Trends

Although the City's June 2007 Financial Plan appeared to be based on conservative economic assumptions, the economic landscape changed dramatically during the summer. In response, the City has revised its economic assumptions and has further reduced its revenue expectations.

City fund revenues are projected to decline by 2.9 percent in FY 2008 (see Figure 10), but this decline will be due mostly to the impact of tax cuts enacted in the spring of 2007.¹ Excluding these tax cuts (which reduce tax collections by \$1.5 billion), collections hold steady at the FY 2007 level.

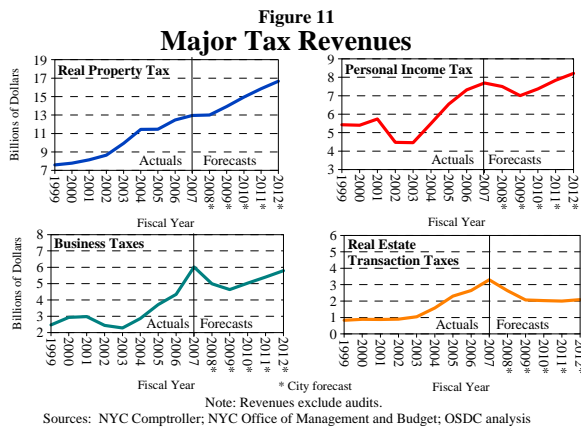
Figure 10
Annual Change in City Fund Revenues and Tax Revenues



Notes: Includes the proposed gap-closing program. Adjusted for debt service on TFA and tobacco bonds and the transfer of TSASC revenues to benefit FY 2008.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

Although tax collections may exceed expectations in FY 2008, the impact of the deteriorating economic environment will be felt next year. The January Plan assumes that City fund revenues will decline by only 3 percent in FY 2009, but economically sensitive nonproperty taxes will decline by 7.9 percent. The larger decline reflects a dramatic reduction in business tax collections due to lower Wall Street profitability, as well as a sharp falloff in tax revenues from real estate transactions as the number of transactions and sale prices decline (see Figure 11). The potential exists for an even greater revenue decline in FY 2009.

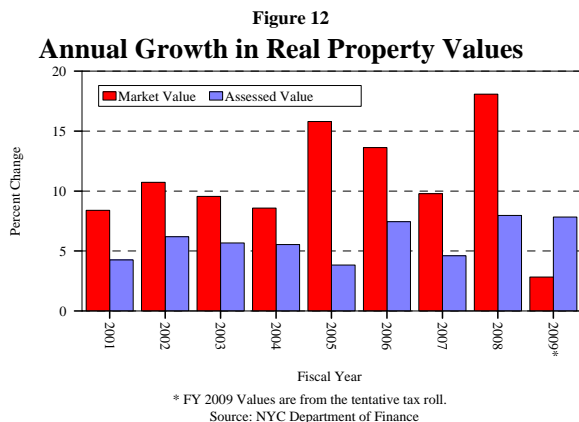
¹ The January Plan assumes a full restoration in payments under the Aid and Incentives to Municipalities program, but the Governor has proposed a partial restoration.



If the economy and Wall Street recover as quickly as the January Plan assumes they will, the City will see a rebound in tax collections, with gains of 5.9 percent in FY 2010, 5.4 percent in FY 2011, and 5.1 percent in FY 2012. City fund revenues would increase at an average annual rate of 4.8 percent during this period.

Forecasts for individual taxes are discussed below.

- Real property tax collections are projected to rise by \$920 million in FY 2009, an increase of 7.1 percent, even though the slowdown in the real estate market is expected to hold the increase in citywide market values to less than 3 percent—the lowest rate of growth since FY 1998. (The recently released tentative property tax roll for FY 2009 shows market values for one-, two-, and three-family homes declining by 0.9 percent—the first decline in 15 years.) In contrast, citywide market values rose at an average annual rate of 11.8 percent between fiscal years 2000 and 2008.



Despite weakening real estate values, real property tax collections are expected to grow by about \$900 million annually because billable assessed values are still growing at an

average annual rate of 6 percent, reflecting the phase-in of prior increases in market value as required under State law (see Figure 12) even as market values decline.

- Personal income tax collections are expected to decline by 2.5 percent in FY 2008 (\$192 million) and by another 6.6 percent in FY 2009 (\$495 million) because of slower job and wage growth, and lower capital gains and year-end bonuses. The January Plan assumes that personal income tax collections will grow by 5.4 percent annually during fiscal years 2010 through 2012 as the economy improves.
- Business tax collections are projected to decline by 17 percent (\$1 billion) in FY 2008 and by another 7.1 percent (\$355 million) in FY 2009. The decline in FY 2008 reflects the impact of the credit crunch on financial firms. The additional decline in FY 2009 reflects a weaker economy and tax credits to Wall Street firms for overpaying their taxes during FY 2008. (Rather than seek a refund, financial firms generally apply overpayments against the following year's tax liability.) Collections are expected to grow at 7.7 percent annually during fiscal years 2010 through 2012.
- Real estate transaction tax collections (the mortgage recording and real property transfer taxes) more than tripled from fiscal years 2003 through 2007, reaching \$3.3 billion in FY 2007. Collections are projected to decline by 20 percent in FY 2008 and by another 21 percent in FY 2009 (a two-year loss of \$1.2 billion), driven by continued residential sales and prices declines (including in Manhattan) and the expectation of lower commercial sales and prices. Collections are projected to stabilize during fiscal years 2010 and 2011, before growth resumes in FY 2012.

Recently, some sales of commercial properties have been “distressed,” after owners have encountered cash flow problems due to an inability to access new financing. While such sales generate a tax benefit for the City, they could also be a sign of developing problems in Manhattan’s commercial real estate market.

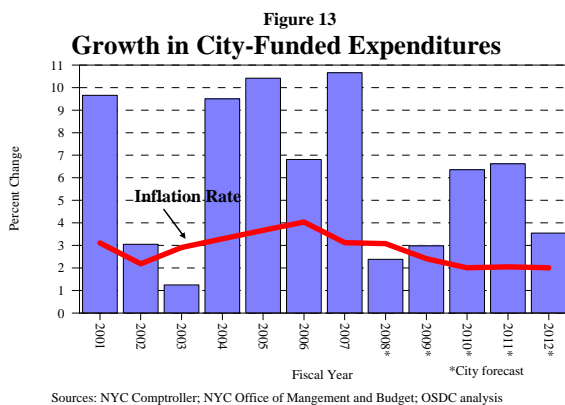
- Sales tax collections are projected to rise by 1.8 percent in FY 2008, but the rate of growth rises to 4.2 percent after adjusting for the increase in the clothing exemption.

Collections are projected to decline by only 1.3 percent in FY 2009 (\$62 million) because the impact of the economic slowdown would be mitigated by continued strength in tourism. The January Plan assumes an economic recovery would boost collections by an average annual rate of 5.4 percent in subsequent years.

Expenditure Trends

City-funded expenditures grew at average annual rates of nearly 10 percent during fiscal years 2004 and 2005, and of 8.8 percent during fiscal years 2006 and 2007.² Most of the growth was due to the rising cost of debt service, Medicaid, pensions, and other employee benefits. The City also contributed \$2.5 billion to the Retiree Health Benefits Trust Fund (\$1 billion in FY 2006 and \$1.5 billion in FY 2007), and prepaid nearly \$1.3 billion in outstanding debt in FY 2007. Excluding these discretionary actions, spending would have grown more slowly, by 2.5 percent in FY 2006 and by 7.5 percent in FY 2007.

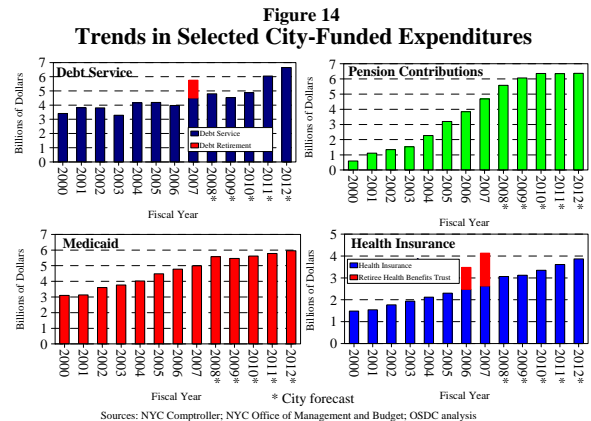
The January Plan assumes that City-funded spending will grow by only 2.4 percent in FY 2008 and by 3 percent in FY 2009 (see Figure 13). These estimates, however, assume the successful implementation of the Mayor's proposed gap-closing program, which would reduce planned spending by \$458 million in FY 2008 and by \$700 million annually thereafter.



Most of the growth in spending during the financial plan period is driven by higher employee compensation costs (e.g., collective bargaining costs, health insurance, and pension contributions)

² Adjusted for surplus transfers and for debt service on bonds issued by the Transitional Finance Authority (TFA) and by TSASC.

and higher debt service (see Figure 14). Nondiscretionary expenditures (i.e., pension contributions, Medicaid, debt service, and employee health insurance costs) are projected to consume 50 percent of City fund revenues by FY 2011, up from 33 percent in FY 2000.



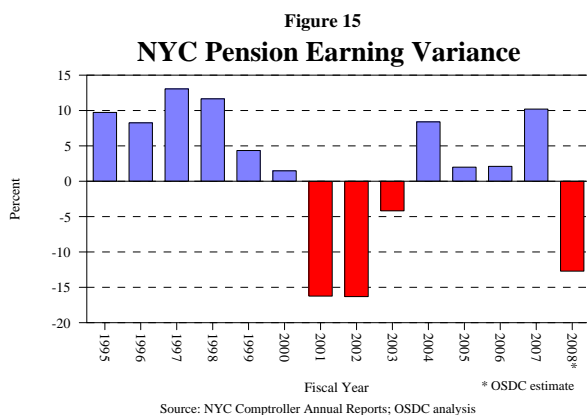
The January Plan assumes that City-funded staffing levels will grow by only 250 employees during the second half of the fiscal year, and will reach 267,499 by June 30, 2008, which is 3,235 fewer than projected at the beginning of the fiscal year. These estimates reflect the impact of the Mayor's proposed gap-closing program.

The January Plan is premised on the following major expenditure assumptions.

- Salaries and wages will grow by 4.6 percent in FY 2009, 11.5 percent in FY 2010, and 8.3 percent in FY 2011, reflecting the cost of actual and anticipated labor agreements. Overtime in the uniformed agencies will total \$649 million in FY 2009, \$36 million less than the FY 2008 forecast, and then remain at that level through FY 2012. Our analysis indicates that overtime costs could be higher by \$40 million in FY 2008 and by \$100 million annually through FY 2012.
- Debt service will average \$4.7 billion during fiscal years 2008 through 2010, but will reach \$6.6 billion by FY 2012 (an increase of 40 percent) because of an expansion in the capital program.
- Fringe benefits will total \$5.6 billion in FY 2009, primarily reflecting higher health insurance premiums for families and non-elderly individuals. By FY 2012, fringe benefits are projected to reach \$6.5 billion—17 percent higher than the FY 2008 level.

- Medicaid will decline by 2 percent in FY 2009 to \$5.5 billion. Through FY 2012, Medicaid is projected to grow by 3 percent annually—the capped rate specified under State law.
- Pension contributions averaged about \$1.5 billion during most of the 1990s, but have increased rapidly over the past five years as a result of shortfalls in investment earnings, increased benefits, and demographic changes.

Pension contributions will increase by 19.1 percent in FY 2008 to reach \$5.5 billion and then will rise to \$6.4 billion by FY 2010, and then remain at that level. These estimates reflect the benefit of exceptional FY 2007 pension fund investment earnings, which were more than twice the 8 percent expected rate of return, and the cost of establishing a \$200 million annual reserve beginning in FY 2010 to fund the recommendations of a City Charter-mandated biennial audit and actuarial reestimates.



Through the first seven months of FY 2008, the pension funds have lost about 4.7 percent on their investments (see Figure 15), a shortfall of 12.7 percent from the 8 percent expected rate of return. The stock market has been unusually volatile, but such a shortfall at the end of the year could require increased pension contributions of \$169 million in FY 2010, \$338 million in FY 2011, and \$507 million in FY 2012, essentially offsetting the benefit of last year's gains.

- Energy costs will increase by 9.3 percent in FY 2009 to \$895 million, rising to \$994 million by FY 2012. The increase is due to higher transmission and delivery charges from Con Edison; higher production charges from the New York Power Authority; and the

closing of the Poletti power plant in Queens. The City's estimates are based on an assumption of \$85 per barrel (ppb) for oil, which is substantially less than the peak of \$100 ppb reached in recent weeks.

- Judgments and claims expenditures (including those for the Health and Hospitals Corporation) will increase by 8.3 percent to \$688 million in FY 2009, and rise at an annual rate of 7.6 percent to \$856 million in FY 2012.
- Public assistance costs are projected to decline by 2.5 percent to \$430 million during FY 2009, because of declines in caseload, and to remain at that level through FY 2012.

Other Issues

The following issues could have a significant impact on the City's financial plan.

Collective Bargaining

The Patrolmen's Benevolent Association (PBA) is seeking larger wage increases through binding arbitration than the City has been willing to offer through negotiation for fiscal years 2005 and 2006. (The other uniformed unions accepted wage increases of 3 percent and 3.15 percent for those years.) The City's recent agreements with the other uniformed unions include side letter agreements that permit the unions to reopen negotiations if another uniformed union receives larger wage increases through collective bargaining or arbitration. A decision for the PBA will come after March 3, 2008, when both parties are scheduled to submit their closing briefs.

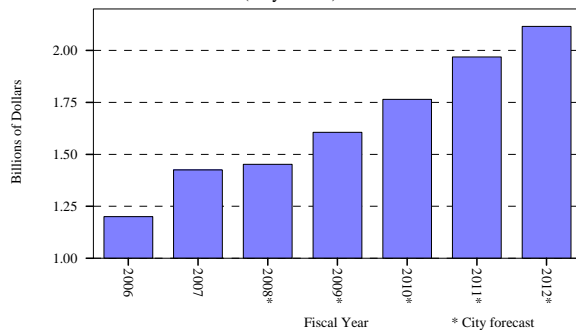
Accounting Standards

In October 2007, the Office of the Actuary reported that the City's actuarial accrued liability for post-employment benefits other than pensions (OPEBs) for past services was \$56.1 billion as of June 30, 2006. The present value of future OPEB obligations was estimated at \$45.9 billion. Overall, the present value of projected OPEB benefits, as of June 2006, totaled \$102 billion, an increase of \$10 billion over the prior year.

The City funds the cost of OPEBs on a pay-as-you-go basis. These costs are projected to rise from \$1.2 billion in FY 2006 to \$2.1 billion by FY 2012 (see Figure 16), an increase of 76 percent. The City also contributed \$2.5 billion in surplus resources during fiscal years 2006 and

2007 to the Retiree Health Benefits Trust Fund, which is intended to help fund the cost of future obligations. While the trust cannot be used for any purpose other than to pay OPEBs, the City could use the fund's resources to meet its OPEB pay-as-you-go obligations, thus freeing up a like amount to help balance the budget. In this manner the trust fund could serve as a rainy-day fund, although that is not its intended purpose.

Figure 16
Pay-As-You-Go Cost of OPEBs
(City Funds)



Sources: Office of the Actuary, NYC Office of Management and Budget; OSDC analysis

In addition, Governmental Accounting Standards Board (GASB) 49, which becomes effective with respect to the City on July 1, 2008, affects the accounting treatment of pollution remediation costs. Currently, many of these costs are included in the City's capital budget and financed through the issuance of bonds. Unless there is a change in applicable law, these costs cannot be financed through bond issuances after GASB 49 takes effect.

The City recently asked KPMG to help provide an understanding of the potential pollution remediation projects that could become obligations of the City and not be afforded capital funding. According to the City, preliminary estimates indicate that GASB 49 could result in additional operating budget costs of approximately \$500 million annually.

Financial Emergency Act

The Financial Emergency Act (FEA), which was scheduled to terminate on July 1, 2008, was extended in 2003 when the State refinanced and took on responsibility for the remaining debt of the Municipal Assistance Corporation, which had helped the City meet its cash flow and capital financing needs during the period immediately following the City's 1975 fiscal crisis.

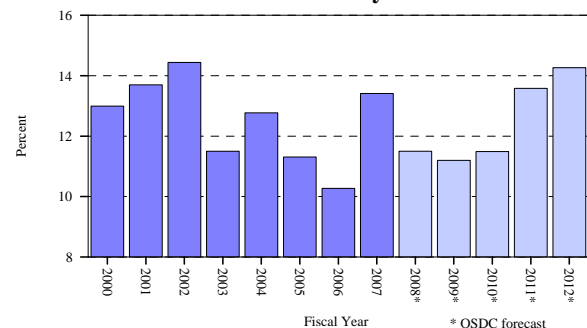
While the FEA was effectively extended until 2033, the power to impose a control period is still set to expire on July 1, 2008. The Governor has proposed, on the Mayor's recommendation, that the Financial Control Board's authority to impose a control period also be extended, and that the board's authority to phase in the implementation of new accounting standards be broadened to provide for a waiver.

Rising Debt Burden

Debt service consumed, on average, nearly 11.5 percent of City fund revenues during fiscal years 2003 through 2006 (see Figure 17). While the debt burden is expected to be about the same during fiscal years 2008 through 2010, the burden would jump to 13.6 percent by FY 2011 as the impact of the economic downturn slows revenue growth and as the cost of the City's capital program grows.³ City-funded capital commitments are expected to average \$7.1 billion during the financial plan period, which is 71 percent higher than the average of the four prior years.

Figure 17

Debt Service as a Percent of City Fund Revenues



Note: Excludes TFA Building Aid Revenue Bonds

Sources: NYC Office of Management & Budget; NYC Comptroller's Office; OSDC analysis

Constitutional Debt Limit

The Transitional Finance Authority (TFA) was created in March 1997, as a temporary financing mechanism, at a time when the City was approaching its constitutional debt limit as a result of a downturn in the real estate market.⁴ The TFA is currently unable to issue new money bonds because it has reached its \$13.5 billion cap.

³ In FY 2007, the City used surplus resources to defease \$1.3 billion in debt that was due in fiscal years 2009 and 2010. This action had the effect of increasing the FY 2007 debt burden from 10.5 percent to 13.4 percent, and reducing the burden for fiscal years 2009 and 2010.

⁴ The State Constitution limits the City's general debt-incurring power to 10 percent of the five-year average of the full valuation of taxable real estate.

The Governor has proposed, on the Mayor's recommendation, that the City be allowed to issue any combination of TFA and GO bonds as long as the total does not exceed the State constitutional debt limit by more than \$13.5 billion.⁵ The proposal would permit the City to realize savings from diversifying its financing vehicles; it would also allow the City to effectively exceed the constitutional debt limit without amending the State Constitution.

Insured Variable Rate Municipal Bonds

Many of the same insurers that insure municipal bonds also cover mortgage-backed securities and collateralized debt obligations (which have plummeted in value). These firms are now undercapitalized and some have lost their AAA ratings. In light of the market turmoil, interest rates on insured municipal variable rate and auction rate debt have risen in recent months. While interest costs have risen for the City as well, they have so far been offset by savings from other financing instruments. Although the implications of the current situation are not fully known, City officials have prepared contingency actions to minimize their interest rate exposure.

Lower Manhattan Redevelopment

Redevelopment in Lower Manhattan continues, although several projects are behind schedule and over budget. The cost of the Fulton Street Transit Center has grown from \$750 million to \$1.2 billion, which is \$300 million more than budgeted. While the Metropolitan Transportation Authority (MTA) intends to complete the underground portion of the project, funds are insufficient to complete the transit center itself. Similarly, the cost of the new PATH station has grown from \$2.2 billion to \$3.4 billion.

Also, the Port Authority of New York and New Jersey recently completed excavation and preparation work at Ground Zero but paid a late penalty of \$14.4 million to Silverstein Properties, the leaseholder of the site. While work is progressing on the Freedom Tower (scheduled for completion in 2012), demolition of the former Deutsche Bank building has not resumed.

West Side Development

The State has scaled back plans to expand the Jacob K. Javits Convention Center in an effort to reduce the cost of the project. The new plan includes 100,000 square feet of new space—much less than the 2 million square feet in the original plan—and is estimated to cost \$1.6 billion. The State also now plans to sell a State-owned parcel of land located between 39th and 40th streets to generate an estimated \$400 million. The Mayor opposes the sale (which requires the approval of the State Legislature and the City to rezone the parcel) because it would prevent a northward expansion of the center in the future.

The cost of expanding the No. 7 subway line, which is budgeted at \$2.1 billion, is growing due to rising construction costs. A planned subway station at 41st Street and 10th Avenue is not currently funded, but could be included in the final project if funding is made available. It has not been decided who will be responsible for cost overruns should they occur.

⁵ TFA bonds backed by State-appropriated building aid would be excluded from the Governor's proposed calculation of the City's debt limit, which implies that these bonds are obligations of the State and not the City—as the State Comptroller has long suggested.