Review of the Four-Year Financial Plan for the City of New York

December 2003

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State Comptroller

Office of the State Deputy Comptroller for the City of New York
Report 11-2004

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I. Executive Summary

One year ago, the City projected a $6.4 billion budget gap for FY 2004 and even larger gaps for subsequent years. The November 2003 financial plan, however, projects a surplus of $513 million for FY 2004 and substantially smaller out-year budget gaps of $1.8 billion in FY 2005, $3.4 billion in FY 2006, and $3.9 billion in 2007 (see Table 1).

The turnaround in the outlook for the City's finances is due to a combination of City and State actions during FY 2003, which raised taxes and reduced planned spending; as well as assistance from the federal government, mostly in the form of Medicaid relief in FY 2004. In addition, the economy is improving faster than anticipated in the June Plan, which has resulted in unforeseen tax revenues. Job losses have diminished, the housing market has remained strong, and Wall Street is showing significant improvement. The City has raised its forecast of Wall Street profits for calendar year 2003 to $18.8 billion—$11 billion more than assumed in the June Plan and an increase of 170 percent over the 2002 level.

Since the FY 2004 surplus is not likely to be needed in the current fiscal year, the City has prudently used most of the surplus to fund budget stabilization accounts of $213 million in FY 2005 and $200 million in FY 2006, thereby reducing the budget gaps projected for those years. The November Plan allocates the remaining $100 million of the surplus to double the amount of operating resources available in FY 2004 to finance the City's capital program on a pay-as-you-go basis, and the City has allocated $200 million in operating resources in each of fiscal years 2005 through 2009 for this purpose. Pay-as-you-go financing is another prudent fiscal practice, although the City could decide at a later date to use these resources to narrow the size of the out-year budget gaps and meet its capital commitments with bond proceeds.

The out-year gaps are projected to more than double, from $1.8 billion in FY 2005 to nearly $3.9 billion by FY 2007, in part because the tax increases authorized by the State will be phased out over the next few years. City-funded spending is projected to grow at an average annual rate of 4.8 percent—more than twice the projected inflation rate—during fiscal years 2005 through 2007, while revenues are projected to increase at an average annual rate of only 2.1 percent. Pension costs are projected to grow at an annual rate of 20.4 percent, which reflects pension fund investment losses. Debt service costs, despite deep cuts to the capital program, are projected to grow at an annual rate of 8 percent, and health insurance costs for both municipal employees and the indigent are projected to grow at an annual rate of 8.1 percent.

Our review of the November Plan identified budget risks valued at $514 million in FY 2004, increasing to $731 million by FY 2007 (see Table 2). Despite the budget risks in FY 2004, the City will have little difficulty maintaining budget balance because it still has reserves of about $500 million and could draw upon the resources deposited in the budget stabilization accounts if needed. The out-year gaps, however, could total $2.4 billion in FY 2005, $4.1 billion in FY 2006, and almost $4.6 billion in FY 2007 if all these risks materialize.

Most of the budgetary risk relates to an initiative to refinance $2.2 billion in outstanding bonds of the Municipal Assistance Corporation, which date back to the 1970s fiscal crisis. The initiative would save the City about $2.5 billion over a five-year period, but would cost the State $5.1 billion over the next 30 years. The Local Government Assistance Corporation, which would be required under State law to transfer $170 million annually to the City to effectively fund the cost of the refinancing, has filed a lawsuit challenging the constitutionality of the law.

Tax revenues are likely to exceed the conservative estimates in the November Plan by at least $100 million in FY 2004 and by $150 million in subsequent years, and the City is likely to receive $150 million from the Battery Park City Authority in FY 2005 from the purchase of City-owned land. Our review, however, has identified additional risks, such as higher costs in the uniformed agencies, which could offset these benefits.

The size of the out-year budget gaps will also depend on whether future wage increases for municipal employees will be funded entirely with productivity savings, as assumed in the November Plan. The City established a $200 million reserve for collective bargaining in FY 2003, which would be sufficient to fund a wage increase of about 2 percent, but wage increases at the projected inflation rate without offsetting productivity savings would widen the projected gaps by $770 million in FY 2004, and by as much as $2.1 billion by FY 2007. In addition, the State faces a budget gap of up to $6 billion next year, and the actions taken by the State to balance its budget could affect the City's budget.

The local economy is showing signs of improvement, but this good news is tempered by the fact that the City still faces significant out-year budget gaps. To close these gaps, the economic recovery will have to be sustained and the City will require continued assistance from the State and federal governments.

Table 1
Four-Year Financial Plan

(in millions)

	FY 2004	FY 2005	FY 2006	FY 2007
REVENUES				
Taxes				
General Property Tax	$11,274	$ 11,576	$ 11,999	$ 12,443
Other Taxes	14,619	13,943	14,414	14,949
Tax Audit Revenue	545	506	506	506
Miscellaneous Revenue	4,319	4,869	4,205	4,173
Unrestricted Governmental Aid	831	585	585	585
Anticipated Federal & State Aid	- - -	- - -	- - -	- - -
Less: Intra-City Revenues	(1,179)	(1,100)	(1,099)	(1,098)
Grant Disallowances	(15)	(15)	(15)	(15)
Subtotal: City Funds	$ 30,394	$ 30,364	$ 30,595	$ 31,543
Other Categorical Grants	901	778	798	813
Inter-Fund Revenues	342	326	319	315
Total City & Inter-Fund Revenues	$ 31,637	$ 31,468	$ 31,712	$ 32,671
Federal Categorical Grants	5,056	4,513	4,495	4,506
State Categorical Grants	8,328	8,261	8,245	8,317
Total Revenues	$ 45,021	$ 44,242	$ 44,452	$ 45,494
EXPENDITURES				
Personal Service				
Salaries and Wages	$ 16,603	$ 16,356	$ 16,352	$ 16,354
Pensions	2,555	3,165	3,958	4,335
Fringe Benefits	4,801	5,058	5,348	5,644
Subtotal - Personal Service	$ 23,959	$ 24,579	$ 25,658	$ 26,333
Other Than Personal Service				
Medical Assistance	$ 4,123	$ 4,541	$ 4,747	$ 4,944
Public Assistance	2,351	2,246	2,254	2,255
Pay-As-You-Go Capital	200	200	200	200
All Other	12,272	12,050	12,256	12,458
Subtotal - Other Than Personal Service	$ 18,946	$ 19,037	$ 19,457	$ 19,857
Debt Service	2,582	3,485	3,726	3,965
Budget Stabilization & Prepayments	413	(213)	(200)	- - -
General Reserve	300	300	300	300
Subtotal - Expenditures	$ 46,200	$ 47,188	$ 48,941	$ 50,455
Less: Intra-City Expenses	(1,179)	(1,100)	(1,099)	(1,098)
Total Expenditures	$ 45,021	$ 46,088	$ 47,842	$ 49,357
Gaps To Be Closed	**$ - - -**	**$ (1,846)**	**$ (3,390)**	**$ (3,863)**

Table 2
OSDC Risk Assessment of NYC Financial Plan
(in millions)

	Better/(Worse)			
	FY 2004	**FY 2005**	**FY 2006**	**FY 2007**
Gaps per November 2003 Plan	**$ - - -**	**$ (1,846)**	**$ (3,390)**	**$ (3,863)**
OSDC Budget Risks				
Tax Revenues	100	150	150	150
Battery Park City Authority	- - -	150	- - -	- - -
Private Bus Subsidy	- - -	(147)	(150)	(154)
TSASC Trapping Event	(52)	(63)	(66)	(74)
Uniformed Agencies	(56)	(185)	(160)	(160)
MAC Debt Service	(506)	(496)	(497)	(493)
OSDC Risk Assessment	**(514)**	**(591)**	**(723)**	**(731)**
Remaining Gaps to be Closed	**$ (514)**	**$ (2,437)**	**$ (4,113)**	**$ (4,594)**
Other Risks and Offsets				
Reserves[1]	500	300	300	300
Wage Increases at the Projected Inflation Rate[2]	(770)	(1,200)	(1,600)	(2,100)

[1] The November Plan includes an annual general reserve of $300 million, and the City is likely to realize savings of at least $200 million in FY 2004 from overestimating prior years' expenses.

[2] The Mayor maintains that future wage increases will be funded entirely with productivity savings. Wage increases without any offsetting productivity improvements would increase the projected gaps by the amounts shown in the table.

II. Fiscal Year 2004

As shown in Table 3, the November Plan anticipates a surplus of $513 million because revenues are projected to be $582 million higher than in the June Plan, mostly as a result of higher business and real estate–related tax collections. While expenditures are expected to exceed the estimates in the June Plan by $336 million, the net impact on the budget would be mostly offset if in FY 2004 the City successfully implements additional agency gap-closing initiatives that are valued at $267 million. The City used the projected surplus to fund budget stabilization accounts in fiscal years 2005 and 2006, and to double the amount of operating resources available in FY 2004 to finance the City's capital program on a pay-as-you-go basis.

Table 3
Financial Plan Reconciliation
Changes since the June 2003 Plan

(in millions)

		Better/(Worse)		
	FY 2004	**FY 2005**	**FY 2006**	**FY 2007**
Surplus/(Gaps) per June 2003 Plan	**$ - - -**	**$ (2,014)**	**$ (3,238)**	**$(3,285)**
Revenues				
Tax Revenues	575	65	43	58
Absentee Landlord Tax	(44)	(45)	(47)	(48)
MBBA Proceeds for Education	197	- - -	- - -	- - -
Battery Park City Authority	(82)	54	51	16
Reimbursement for Stock Exchange Costs	71	- - -	- - -	- - -
Delay in Airport Lease Payment	(200)	200	- - -	- - -
Other Non-Tax Revenue	65	66	110	127
Subtotal	**582**	**340**	**157**	**153**
Expenditures				
Medicaid	(248)	(163)	(226)	(418)
Public Assistance	(59)	(69)	(69)	(69)
Other Health and Social Services	(47)	(47)	(46)	(47)
Municipal Employee Health Insurance	- - -	(48)	(53)	(56)
Uniformed Agency Overtime	(118)	(23)	(23)	(23)
Private Bus Subsidy	(79)	- - -	- - -	- - -
Additional FY 2003 Surplus Roll	110	- - -	- - -	- - -
Debt Service	103	93	7	(50)
Other	2	(6)	25	58
Subtotal	**(336)**	**(263)**	**(385)**	**(605)**
Agency Gap-Closing Program	**267**	**78**	**76**	**74**
Net Change During FY 2004	**513**	**155**	**(152)**	**(378)**
Budget Stabilization Account	(413)	213	200	- - -
Pay-As-You-Go Capital	(100)	(200)	(200)	(200)
Gaps per November 2003 Plan	**$ - - -**	**$ (1,846)**	**$ (3,390)**	**$ (3,863)**

Sources: NYC Office of Management and Budget; OSDC analysis

A. Revenue Changes

Tax collections during the first four months of the fiscal year are stronger than expected, and in response the City has raised its forecast of FY 2004 tax revenues by $575 million compared to the forecast in the June Plan. These additional revenues are drawn from all the major nonproperty taxes, with the greatest amounts coming from business ($183 million) and real estate–related ($160 million) taxes. The better tax revenue outlook reflects the improvement in the economy—smaller job losses and better performance on Wall Street—that are already evident in year-to-date collections or are expected in the coming months. However, the November Plan anticipates that little of this additional revenue will recur in subsequent years, primarily because real estate activity—most notably mortgage refinancing—is expected to slow in the face of rising interest rates. Also, the City projects that Wall Street profits will drop back after the strong rebound in calendar year 2003. In addition, the November Plan reflects the Mayor's proposal to rescind the property tax increase on absentee landlords, which was enacted at the City Council's urging but which the Mayor claims has proved difficult to administer.

The November Plan also reflects the benefit of savings that accrued to the Battery Park City Authority when it refinanced outstanding debt. The June Plan assumed that the City would receive a one-time benefit of $150 million in FY 2004, but instead the benefit will total $232 million and will be realized during fiscal years 2004 through 2008. The November Plan, however, does not reflect the anticipated sale of City-owned property to the Authority, which could benefit the FY 2005 budget by $150 million. The City, with the Governor's assistance, has also reached an agreement with the Port Authority of New York and New Jersey to settle the City's claims for retroactive airport lease payments. The June Plan anticipated receiving $200 million in FY 2004 and $583 million in FY 2005, but now receipt of the full amount is anticipated in FY 2005.

Finally, in FY 2004, the City will receive $424 million in bond proceeds from the Municipal Bond Bank Agency. The proceeds represent a lump sum payment in lieu of State education aid owed to the City from prior school years. About half of the proceeds will be used to remove a receivable from the City's books, and the remaining $197 million will be used to fund the City's operating budget. The State provided the City with $62 million for prior year payments in the current fiscal year and, although there is no guarantee, it is expected that the State will appropriate a similar amount in future years, which will be used to pay debt service on the bonds over the next 20 years. The City is using the bond proceeds in its budget rather than allocating them to the Department of Education because the City already allocated a like amount to the department when it became clear that the transaction would not be completed in FY 2003 as planned.

B. Expenditure Changes

The November Plan assumes that expenditures will exceed the estimates in the June Plan by a net of $336 million in FY 2004 and by $605 million by FY 2007. The most significant change was a large increase in projected Medicaid spending—$248 million in FY 2004, $163 million in FY 2005, $226 million in FY 2006, and $418 million in FY 2007—as a result of higher-than-anticipated utilization and higher costs for medical services, with prescription drugs and managed care expenditures growing most rapidly. Public assistance costs are also expected to be higher because of an increase in the caseload, which had declined by 63 percent between fiscal years 1995 and 2003; and because of a State-approved increase in the housing portion of the monthly welfare benefit. Other social service costs are also now projected to be higher than forecast in the June Plan.

In addition, overtime costs in the uniformed agencies are projected to be higher by $118 million in FY 2004 and by smaller amounts in subsequent years. While the June Plan assumed that the Metropolitan Transportation Authority would take on the financial and operating responsibilities of the seven private bus companies currently subsidized by the City, the City and the MTA have yet to reach any agreement and the November Plan rescinds all of the savings anticipated for FY 2004. The Plan does still anticipate annual savings of about $150 million beginning in FY 2005. Health insurance costs are expected to be higher than the amounts projected in the June Plan for fiscal years 2005 through 2007 because the Health Insurance Plan of Greater New York is expected to increase health insurance premiums by 10.4 percent in FY 2005, compared with the June Plan assumption of 8 percent.

Debt service costs are projected to be lower than projected in the June Plan by a total of $213 million, reflecting an increase in the FY 2003 surplus transfer, lower interest rates, and seasonal borrowing needs.

C. Agency Gap-Closing Program

In October 2003, as a first step toward addressing the out-year budget gaps, the budget director requested that the agencies identify $300 million in recurring resources to help narrow the out-year gaps. The November Plan includes an agency gap-closing program that would generate $267 million in FY 2004, but only about $75 million would recur in subsequent years. These resources are in addition to the $2.1 billion in gap-closing actions already in place for FY 2004, which were included in the June Plan. (See Report 9-2004, *Review of the Four-Year Financial Plan for the City of New York,* issued July 2003.)

The agency program would reduce costs by $156 million in FY 2004. More than half of the savings would come from reestimates in spending and shifts of costs to other levels of government. The largest cost shift occurs in the Police Department, which expects $38 million in federal reimbursement in FY 2004 for providing security at the United Nations (most of these costs were incurred in prior years). Also, the Sanitation Department expects $10 million in FY 2004 from proceeds of State bond acts. Finally, cuts to the Department of Education, which accounted for about 25 percent of the value of past agency gap-closing programs, are limited to just $28 million (10 percent) because of the State maintenance-of-effort requirement.

The agency program also includes actions that will increase revenues by $111 million in FY 2004. More than half of this amount—$65 million—would come from asset sales and property auctions, and the Department of Finance expects to receive an additional $20 million in business taxes as part of the City tax amnesty program in FY 2004. Agency revenue initiatives would generate only $10 million in recurring resources.

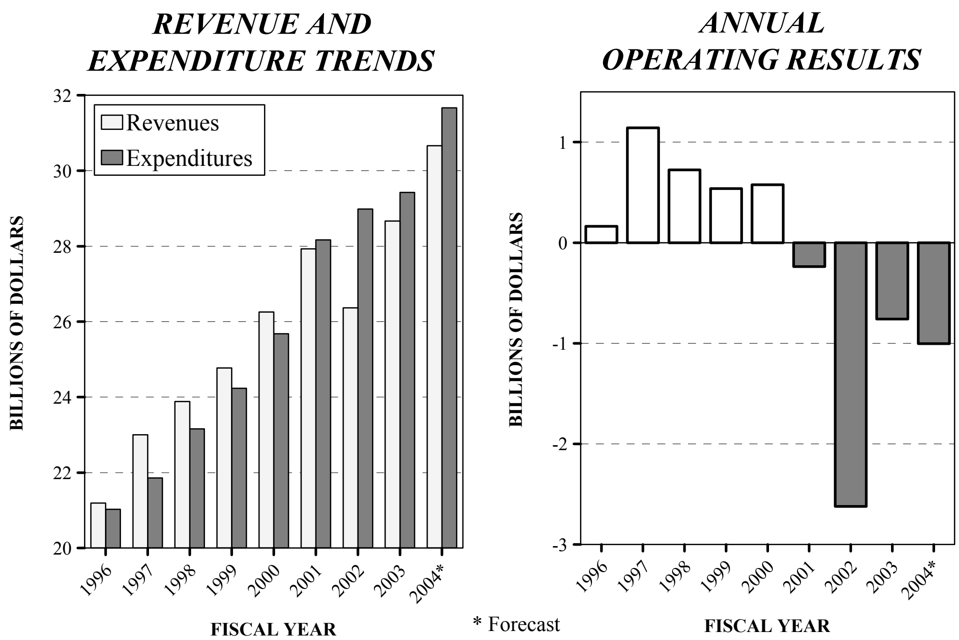
D. Risk Assessment

Our review of the November Plan identified budget risks valued at $514 million in FY 2004 (see Chapter III, "Revenue and Expenditure Trends," for a detailed discussion), but the City has reserves of about $500 million in FY 2004 and could draw upon the resources deposited in the budget stabilization accounts if needed. Most of the budgetary risk relates to an initiative to refinance $2.3 billion in outstanding bonds of the Municipal Assistance Corporation, which date back to the 1970s fiscal crisis. The initiative would save the City about $2.5 billion over a five-year period, but would cost the State $5.1 billion over the next 30 years. The Local Government Assistance Corporation, which would be required under State law to transfer $170 million annually to the City to effectively fund the cost of the refinancing, has filed a lawsuit challenging the constitutionality of the law. While tax revenues are likely to exceed the conservative estimates in the November Plan by at least $100 million in FY 2004, our review has identified additional risks, such as higher costs in the uniformed agencies, which would offset these benefits.

III. Revenue and Expenditure Trends

Between fiscal years 1996 and 2000, City-funded spending grew by 22 percent, an annual average growth rate of 5.1 percent—more than twice the local inflation rate.[3] Under normal circumstances, the City would have been unable to support such a rapid rate of growth, but revenues fueled by the Wall Street boom grew even faster (see Graph 1). While expenditures continued their rapid rate of growth in FY 2001—increasing by 9.7 percent—revenues grew more slowly, by only 6.4 percent. Consequently, expenditures exceeded revenues by more than $200 million in FY 2001—a clear sign of fiscal stress, which was masked by the City's practice of transferring the prior year's surplus to the following year.

Graph 1



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

Ignoring this warning, the City called for spending to increase by 5.7 percent in the adopted budget for FY 2002. The budgetary impacts of the economic slowdown and the attack on the World Trade Center, however, resulted in a decline in revenues—the first such reduction since FY 1995 and the largest in more than 20 years. The City balanced the FY 2002 budget, but only after taking into account surplus transfers from prior years and $361 million in bond proceeds from the Transitional Finance Authority.

[3] City-funded expenditures have been adjusted for the City's practice, which can distort expenditure patterns, of transferring the surplus from one year to the next by prepaying a portion of the following year's expenses.

In the absence of these resources, the City would have incurred a deficit of $2.6 billion from current-year operations[4] (see Graph 1).

The City was on course in November 2002 to incur an operating deficit of $3.5 billion in FY 2003 as a result of lower revenue forecasts, rising pension costs, and other factors. At that time the City enacted a mid-year property tax increase, and took other actions to generate recurring benefits. These actions reduced the FY 2003 operating deficit to $759 million, which was more than offset by $1.5 billion in bond proceeds (i.e., deficit financing) from the Transitional Finance Authority to cover revenue losses related to the attack on the World Trade Center. In FY 2004, the current-year deficit is projected to increase to $1 billion, but the resulting deficit will be more than offset by surplus resources transferred from FY 2003. This picture would improve if the City does not need to expend the $300 million general reserves budgeted in FY 2004.

Despite the small setback in recurring budget balance in FY 2004 compared with the significant gains made during FY 2003, the City's finances experienced a significant turnaround in the past year (see Graph 2). In November 2002, the City projected a $6.7 billion budget gap for FY 2004 and even larger gaps for subsequent years. The November 2003 financial plan, in contrast, projects a $513 million surplus for FY 2004 and substantially smaller out-year budget gaps of $1.8 billion in FY 2005, $3.4 billion in FY 2006, and $3.9 billion in 2007.

The turnaround is due to a combination of City and State actions taken during FY 2003, which raised taxes and reduced planned spending, as well as assistance from the federal government, mostly in the form of Medicaid relief in FY 2004. In addition, the gradual improvement in the City's economy is beginning to be reflected in tax revenue collections. Job losses have diminished, the housing market has remained strong, and Wall Street is showing significant improvement. The combination of higher-than-planned revenues and additional cost-reduction actions are expected to generate a surplus of $513 million in FY 2004.

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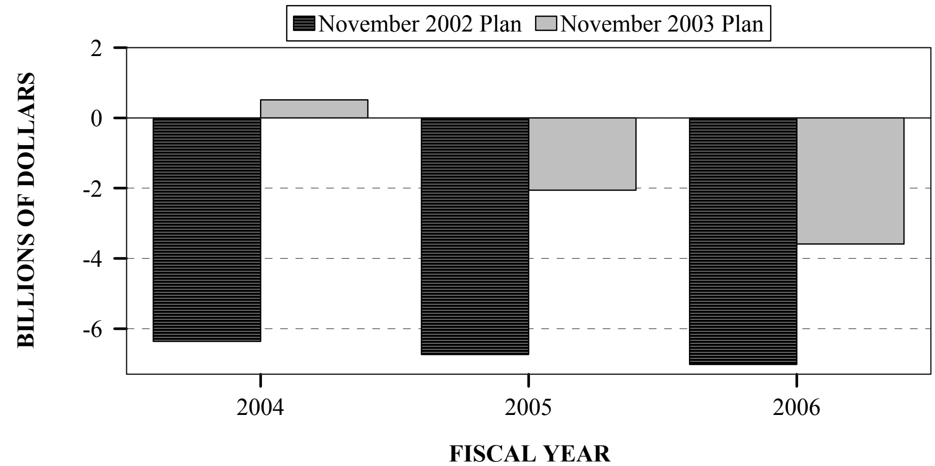
[4] Current-year operations measure revenues and expenditures that were generated in the current fiscal year, and exclude the benefits of prior years' surpluses and deficit financing.

Graph 2

CITY PROJECTED BUDGET GAPS



Note: The budget gaps projected for fiscal years 2005 and 2006 in the November Plan exclude the transfer of the FY 2004 projected surplus.
Sources: NYC Office of Management and Budget; OSDC analysis

A. Revenue Forecasts

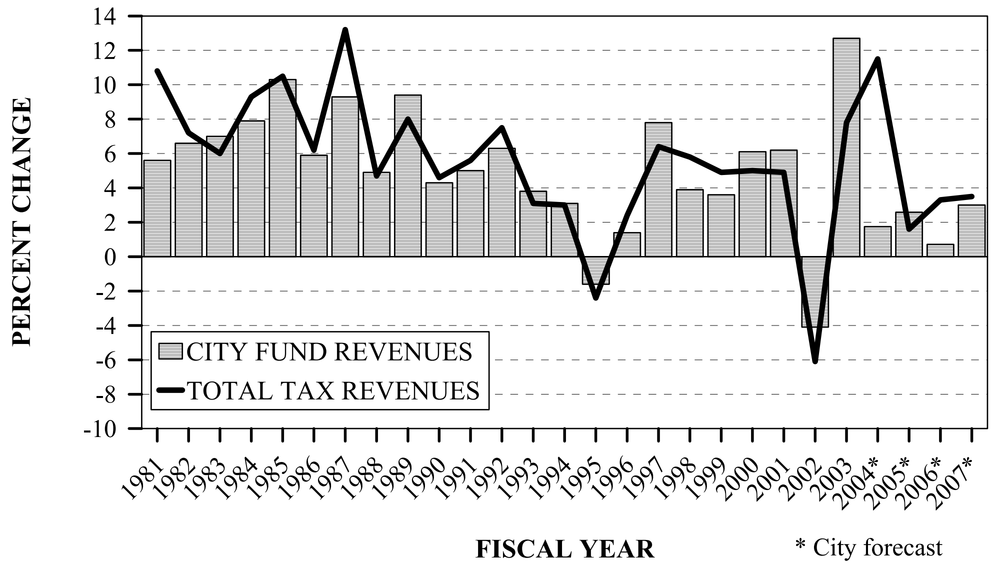
City fund revenues[5] are projected to total $30.6 billion in FY 2004, an increase of only 1.8 percent over the FY 2003 level (see Graph 3), but $633 million more than was forecast at the start of the fiscal year. Higher-than-expected tax collections account for most of the additional revenues, with growth in total taxes expected to reach 11.5 percent. The City also expects to receive $276 million of additional unrestricted State aid in FY 2004, with $197 million related to the payment for prior-year education aid.

In FY 2005, although tax revenue growth is expected to slow as some of the recent tax increases begin to expire, City fund revenues are projected to increase by 2.6 percent with the receipt of $783 million from the airport lease agreement with the Port Authority. The loss of this lump sum payment in FY 2006, however, is expected to hold City fund revenue growth to 0.7 percent in that year, after which growth is expected to rebound to 3 percent in FY 2007.

[5] Our estimates of City fund revenues include the portion of personal income tax revenues dedicated to pay debt service on bonds issued by the Transitional Finance Authority, and tobacco settlement revenues dedicated to pay debt service on tobacco bonds.

Graph 3

ANNUAL CHANGE IN CITY FUND REVENUES



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

Based upon our review, we believe the potential exists for higher tax revenue collections than the November Plan anticipated. Tax collections could be higher by $100 million in FY 2004, primarily from the business and real estate–related taxes. While we do not see recurring benefits from the real estate–related taxes after FY 2004, business taxes and personal income taxes may be understated relative to the City's economic assumptions for the recovery in wages and profits. Thus, there is potential for additional revenues of $150 million annually in the later years of the Plan period. In addition, the November Plan does not reflect the anticipated sale of City-owned property to the Battery Park City Authority, which could benefit the FY 2005 budget by $150 million.

1. Tax Revenues

Much of the recent growth in tax revenues can be attributed to tax increases. During FY 2003, a mid-year increase in the real property tax rate provided the City with $837 million in revenues for that year, and the annualized amount of the increase for FY 2004 will generate another $890 million in revenues, bringing the total annual value of the rate increase to $1.7 billion. Moreover, a three-year personal income tax surcharge will result in $680 million in additional revenues, and the combination of a one-quarter percentage point rate increase and the elimination of the sales tax exemption on individual clothing items that cost less than $110 will generate $388 million in revenues this year. In total, the tax program will provide the City with $2.8 billion in FY 2004.

Despite strong collections from real estate–related taxes during the first four months of FY 2004, these taxes are expected to end the year lower than the previous year as a result of an expected slowdown in mortgage refinancing on the mortgage-recording tax. This trend continues into FY 2005, when these taxes are projected to decline by 8.7 percent.

As shown in Table 4, collections for the business taxes through October of this year have been strong, and are expected to increase by 5.8 percent compared to FY 2003. Business taxes are expected to continue to strengthen and are projected to increase by 6.4 percent in FY 2005. In fiscal years 2006 and 2007, growth in real estate–related taxes is forecast to resume, and business taxes are expected to continue their upward trend. Real property taxes are projected to increase at an average annual rate of 5.9 percent during the Plan period.

Table 4
Growth in Tax Revenues

(in millions)

	FY 2003	FY 2004	Annual Change	FY 2005	FY 2006	FY 2007	Four-Year Average
Property Tax	$ 9,943	$ 11,317	13.8%	$ 11,621	$ 12,046	$ 12,491	5.9 %
Nonproperty Taxes							
Personal Income Tax	4,490	5,346	19.1%	5,412	5,479	5,552	5.5 %
Sales Tax	3,551	3,924	10.5%	3,899	3,988	4,201	4.3 %
Business Income Taxes	2,746	2,904	5.8%	3,092	3,285	3,445	5.8 %
Real Estate–Related Taxes	1,474	1,379	-6.4%	1,259	1,319	1,406	-1.2 %
Other Taxes	1,693	1,771	4.6%	1,776	1,831	1,835	2.0 %
Subtotal	13,954	15,324	9.8%	15,437	15,901	16,438	4.2 %
Total Taxes	**$ 23,897**	**$ 26,642**	**11.5%**	**$ 27,058**	**$ 27,947**	**$ 28,929**	**4.9 %**

Note: Excludes tax program and includes portion of personal income tax revenues used to pay debt service on bonds issued by the Transitional Finance Authority. Totals may not add due to rounding.
Sources: NYC Office of Management and Budget; OSDC analysis

While year-to-date personal income tax collections have risen 9 percent, the City expects growth to accelerate in the second half of the fiscal year as a result of higher Wall Street bonuses, an improvement in capital gains realizations, and the retroactive imposition of the income tax surcharge. Combined with the rate increase already reflected in withholding, these factors will increase growth to 19.1 percent in FY 2004. In subsequent years, the personal income tax continues to rise, although at a slower rate as the tax increase is phased out, with growth rates of 1.2 percent expected in both fiscal years 2005 and 2006, followed by a 1.3 percent gain in FY 2007.

Boosted by a rate increase and the loss of the sales tax exemption on individual clothing items that cost less than $110, sales tax revenues are expected to increase by 10.5 percent in FY 2004; however, those same revenues are expected to decline by 0.6 percent in FY 2005 as the clothing exemption is restored. Revenues are forecast to increase again beginning in FY 2006.

2. Economic Assumptions

The City's more optimistic revenue forecast reflects recent trends in the national economy, which has shown signs of improvement. In particular, Gross Domestic Product (GDP) increased 8.2 percent during the third quarter of 2003. While the increase in GDP has not yet manifested itself in significant increases in national employment, it is possible that recent productivity gains may slow and companies will soon create jobs to meet growing demand. Following the strong growth in the third quarter, the City is now forecasting GDP to increase by 3 percent during 2003, compared to a forecast of 1.9 percent in the June Plan.

The City's current forecast for national employment has been reduced, with employment expected to decline by 0.3 percent during 2003, compared to no change in the June Plan. For 2004, the City's forecast for national job growth has been lowered to 1.1 percent from the previous forecast of 1.8 percent. Projections for other areas of the national economy, such as personal income, also show lower rates of growth in 2003 and 2004 than were previously forecast, although the outlook for corporate profits has improved. Beyond 2004, the City is expecting a slowdown in GDP growth, with an increase of 3.7 percent forecast for both 2005 and 2006, and growth of 3.5 percent forecast for 2007. However, job growth is expected to accelerate nationwide in 2005, rising by 2.4 percent, and then to slow to 1.8 percent in 2006 and 1.5 percent in 2007.

Although the City's economy is expected to lag behind the nation's economy, the current outlook is more optimistic than earlier forecasts. At the time the City's budget was adopted, City employment was expected to decline by 2.1 percent during 2003, while the current expected rate of job loss is 1.5 percent. Also, the City is now expecting slightly higher job growth next year (0.7 percent) than in its previous forecast (0.6 percent). More significantly, the City is projecting higher growth in both wages and personal income, with expected wage growth of 1.7 percent in 2003 and 5.7 percent in 2004, and growth in personal income of 2.4 percent in 2003 and 5.4 percent in 2004.

In the later years of the Plan, the City forecasts an improving City economy, with employment gains of 1.4 percent in 2005, 1.1 percent in 2006, and 1.3 percent in 2007. Wages are also expected to increase annually through 2007, with rates of growth of 2.9 percent in 2005, and 3.9 percent in both 2006 and 2007. Growth rates forecast for personal income are also expected to be 4.3 percent in 2005, 5.1 percent in 2006, and 5.3 percent in 2007.

Higher projected wages in the City in 2003 and 2004 can be attributed in part to expected improvement on Wall Street. Wall Street profits amounted to $7 billion in 2002, but are now projected to reach almost $19 billion in 2003. If achieved, this would be the second-highest level of annual profits for Wall Street after the $21 billion reached in 2000. Preliminary profits for the first three quarters of 2003 total $12 billion. Thus, securities industry profits in 2003 will be substantially higher than in 2002, which will result in a rise in year-end bonus payments and thereby increase wages and personal income in the City. With the broad financial market indices up around 20 percent for the year through early December (and gains for the Nasdaq and Russell 2000 at more than twice that increase), capital gains realizations are also likely to increase this year after two years of decline. The City is currently forecasting a 10 percent decline in realizations.

One other notable change in the City's economic forecast was a lowering of inflation expectations. The City currently projects a local inflation rate of 2.6 percent in calendar year 2003, which is projected to decline to 1.7 percent in 2004 and then average 2 percent annually over the following three years. For the first ten months of calendar year 2003, inflation has averaged 3.1 percent compared to the same period last year, and *Global Insight* (formerly DRI-WEFA) is forecasting inflation in the metropolitan area to average 3.1 percent in 2003, 2.2 percent in 2004, and 2.7 percent over the subsequent three years. Over the entire period, the City's average annual forecast is about one-half a percentage point lower than in the June Plan or in *Global Insight*'s current forecast.

3. Port Authority Airport Lease Agreement

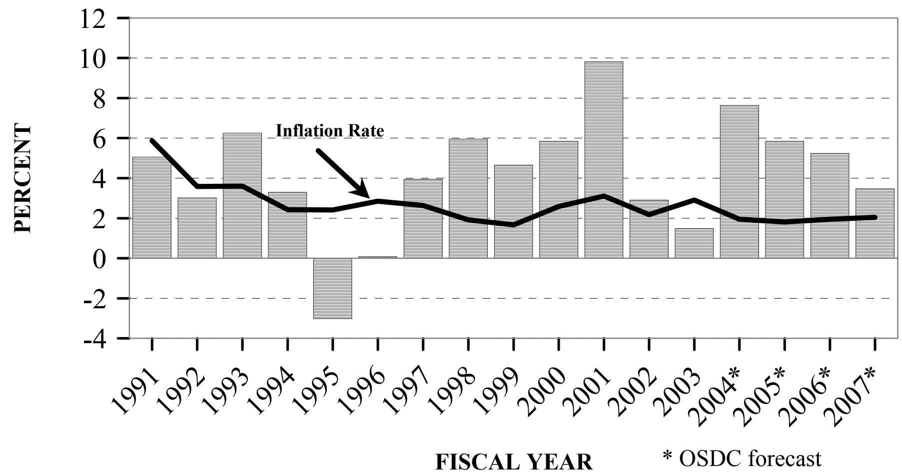
For the past eight years, the City's financial plan has anticipated a settlement with the Port Authority of New York and New Jersey (PA) for retroactive airport lease payments. The City claimed it was owed additional monies under the existing lease and that the terms of the agreement were too favorable to the PA. The City refused to extend the lease, which was scheduled to terminate in 2015, and threatened to privatize the operation of the airports. In October 2003, the City and the PA reached an agreement to extend the PA's lease for JFK and LaGuardia airports through 2050. Under the agreement, which was approved by the PA's Board of Commissioners on December 11, 2003, the City will receive a one-time $500 million lump sum payment and the minimum annual rent will be raised to $93.5 million from the current $3 million. The PA also agreed to make the effective date of the lease revision retroactive to January 1, 2002, although the November Plan delays the initial payment under the new lease until FY 2005. The agreement also assures that the PA will spend $10 million annually during the next five years for capital projects in Queens, and will increase the minimum annual payment-in-lieu-of-taxes (PILOT) to the City for the World Trade Center site, from $2 million to $14 million. The PILOT is projected to increase as the site is redeveloped.

B. Expenditure Forecasts

After increasing far more quickly than the local inflation rate during fiscal years 1997 through 2001, growth in City-funded expenditures during fiscal years 2002 and 2003[6] averaged 2.2 percent, which is slightly lower than the average inflation rate for those years (see Graph 4). City-funded spending, however, is projected to increase by 7.6 percent in FY 2004 and then increase by 5.8 percent in FY 2005, 5.2 percent in FY 2006, and 3.5 percent in FY 2007. Overall, City-funded expenditures are projected to grow at an annual average rate of 5.5 percent during fiscal years 2004 through 2007.

Graph 4

CHANGE IN CITY-FUNDED EXPENDITURES



Sources: NYC Office of Management and Budget; OSDC analysis

The major factors behind the growth in spending are mostly beyond the City's direct control (see Table 5). Debt service costs[7] are projected to increase by $558 million (16.9 percent) in FY 2004 and by nearly $1.6 billion during the Plan period (an average annual rate of growth of 10.1 percent), despite cuts to the capital budget. Pension costs are projected to grow by $852 million (55.6 percent) in FY 2004 alone, and by more than $2.6 billion during the Plan period—an average annual growth rate of 28.4 percent—because the City will have to make up for pension fund investment shortfalls during fiscal

[6] City-funded expenditures have been adjusted for surplus transfers and include debt service on bonds issued by TSASC and the Transitional Finance Authority.

[7] Debt service estimates include City general obligation bonds, revenue bonds of the TFA, MAC, and TSASC, and lease payments. The November Plan assumes that MAC bonds will be refinanced, which will generate annual savings of $500 million beginning in FY 2004.

years 2001 through 2003. Medicaid costs are projected to increase by $177 million in FY 2004 and by a total of more than $1 billion during the Plan period, an average annual rate of growth of 6.3 percent. In addition, health insurance costs for municipal employees are projected to increase at an average annual rate of 9.3 percent during the Plan period.

Table 5
Growth in City-Funded Expenditures
(Adjusted for Surplus Transfers)

	(in millions)			Increase/(Decrease)			
	FY 2003	**FY 2004**	**Annual Change**	**FY 2005**	**FY 2006**	**FY 2007**	**Four-Year Average**
Salaries and Wages	$ 9,977	$ 9,673	(3.1) %	$ 9,634	$ 9,677	$ 9,654	(0.8) %
Medicaid	3,763	3,940	4.7 %	4,394	4,601	4,798	6.3 %
Debt Service	3,311	3,869	16.9 %	4,418	4,630	4,869	10.1 %
Health Insurance	2,006	2,131	6.2 %	2,395	2,631	2,868	9.3 %
Pensions	1,532	2,384	55.6 %	2,993	3,784	4,161	28.4 %
Other	8,833	9,672	9.5 %	9,684	9,949	10,144	3.5 %
Total	**$ 29,422**	**$ 31,668**	**7.6 %**	**$ 33,517**	**$ 35,272**	**$ 36,494**	**5.5%**

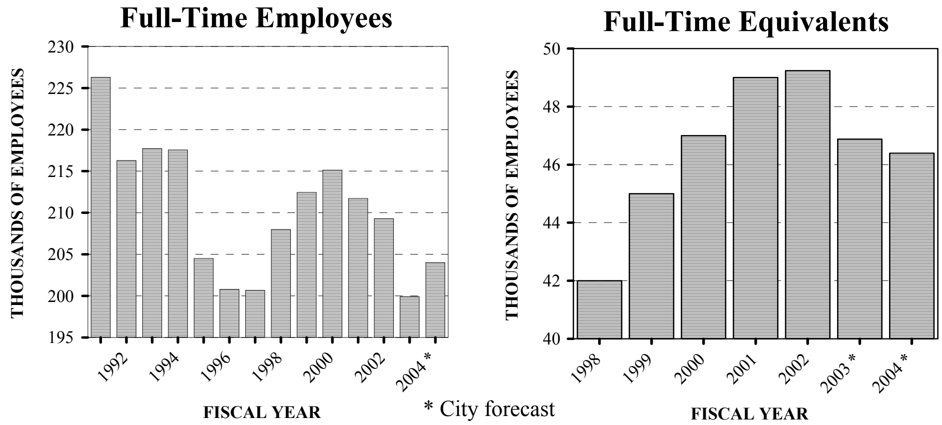
Note: Totals may not add due to rounding.
Sources: NYC Office of Management and Budget; OSDC analysis

1. Personal Service Costs

City-funded personal service costs—which include wages, salaries, fringe benefits, and pensions—are projected to increase by a net of nearly $3 billion during fiscal years 2004 through 2007, an average annual increase of 5.1 percent and more than twice the projected inflation rate. These estimates reflect rapidly growing costs for fringe benefits, such as pensions and health insurance. Salary and wage costs are projected to decline by $304 million in FY 2004 and then hold steady in subsequent years, which reflects both the impact of the actions taken by the City to balance the FY 2004 budget and the Plan assumption that future wage increases will be funded with productivity improvements.

The City-funded workforce declined by 11,756 full-time equivalents during FY 2003, which is 6,393 more than the June Plan anticipated. The additional reductions took place in the Department of Education, which shifted more workers to State and federal lines and laid off more employees than anticipated; the Administration for Children's Services, which experienced higher-than-planned attrition; and the Department of Parks and Recreation, which hired fewer seasonal workers than anticipated. During FY 2003, the full-time City-funded workforce contracted by 9,393 employees, which reduced the workforce to its lowest level since June 1985, and the part-time workforce declined by 2,363 full-time equivalents, a reduction of 5 percent (see Graph 5). The November Plan assumes that the workforce will increase during FY 2004 by a net of 3,612 employees—4,095 additional full-time employees, mostly in the Department of Education and the Department of Social Services, which would be partly offset by 483 fewer part-time employees (see Appendix for details).

Graph 5
CITY-FUNDED WORKFORCE



Note: Full-time and part-time employee projections for FY 2004 have been adjusted for recent reclassificiations between categories for purposes of comparability with prior years.

Sources: NYC Office of Management and Budget; OSDC analysis

Pension Fund Contributions

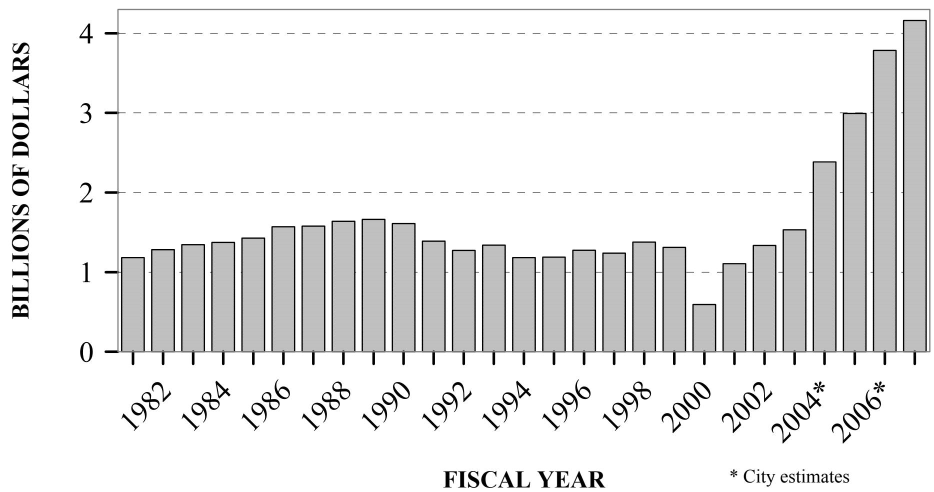
Rapidly rising pension contributions present a significant obstacle to long-term budget balance. The City's contribution to the pension funds averaged $1.4 billion during fiscal years 1981 through 1999, but contributions are projected to rise to nearly $2.4 billion in FY 2004 and to reach nearly $4.2 billion by FY 2007 (see Graph 6). The November Plan assumes that pension contributions will increase at an average annual rate of 28.4 percent during the Plan period, which is 15 times faster than the local inflation rate and more than 7 times faster than other City-funded expenditures.

Almost 90 percent of the projected increase in pension contributions is attributable to poor investment performance, including the impact of corporate scandals, during fiscal years 2001 through 2003. The pension funds lost more than 8 percent on their investments in each of fiscal years 2001 and 2002, and gained only 3.8 percent in FY 2003 compared with an actuarial assumption of an 8 percent gain. The pension funds, however, are on track to exceed their investment earnings targets in the current fiscal year. We estimate that as of the end of November 2003, the pension funds earned nearly 10 percent on their investments. However, because of prior poor investment returns, current investment gains of 10 percent will not reduce the City's future pension fund contributions.

Despite the recent improvement in the stock market, higher pension contributions will place an increasing burden on the City's budget, leaving fewer resources for other municipal services. Pension costs consumed only 4 percent of City fund revenues in FY 2001, but are projected to consume 13.1 percent by FY 2007. Similarly, pension contributions are projected to reach 26.5 percent of salaries and wages by FY 2007, compared with an average of 11 percent during fiscal years 1992 through 2001.[8]

Graph 6

CITY-FUNDED PENSION CONTRIBUTIONS



Sources: NYC Office of Management and Budget; OSDC analysis

An actuarial consultant hired by the City has completed a biennial review of the methodologies and assumptions used to calculate pension contributions, as required by law. The consultant did not propose changes in the investment earnings and wage assumptions, but did propose changes in a number of other assumptions, such as overtime, that could increase City pension contributions by approximately $250 million annually. The City Actuary is currently reviewing the consultant's recommendations.

Collective Bargaining

The City had limited success during the past year in obtaining assistance from the municipal labor unions to help balance the budget. The 2002 June Plan counted on more than $500 million in annual assistance from the municipal unions, but the City realized

[8] Pension contributions as a percentage of salaries and wages is a widely used measure to determine the burden that pension costs place on the budget. In FY 2000, because of the impact of a market restart, pension contributions represented less than 5 percent of salaries.

only $277 million of this amount in FY 2003 and declining amounts in subsequent years. These savings were achieved with the support of the unions and with State legislation that permitted the City to extend, over ten years, planned pension contributions to fund cost-of-living allowances for retirees.

The 2002 November Plan assumed $600 million in annual assistance from the municipal unions beginning in FY 2004. To realize these savings, the City made a number of suggestions, including that employees pay a portion of their health insurance premiums; that increases in health insurance costs be limited so as not to exceed increases in the Medical Consumer Price Index; that the workweek be lengthened to 40 hours for all employees; that vacations and holidays be reduced; and that pension benefits for new employees be reduced. Instead, the municipal unions offered low-interest loans from the Health Insurance Stabilization Fund and some health insurance savings, and recommended that the City defer contributions to the pension funds and implement another early retirement program. The City rejected most of these proposals because most would only defer costs and not result in recurring savings.

The 2003 November Plan assumes that future wage increases will be funded entirely with productivity savings. However, the City has established a collective bargaining reserve of $200 million for FY 2003, which is sufficient to fund a wage increase of about 2 percent, recognizing that even labor agreements that provide for productivity improvements may have a net cost in the first year. Without productivity savings, wage increases at the projected inflation rate would increase costs by $275 million in FY 2003, $770 million in FY 2004, $1.2 billion in FY 2005, $1.6 billion in FY 2006, and $2.1 billion in FY 2007.

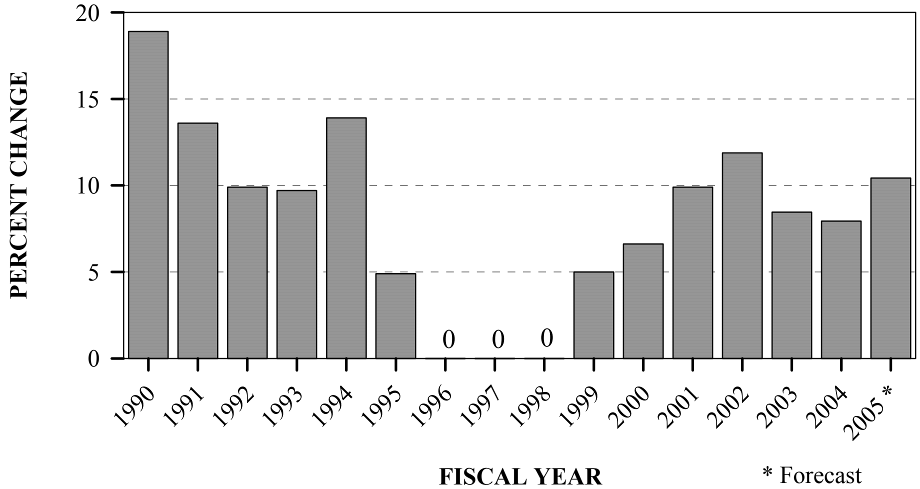
Health Insurance

City-funded health insurance costs are projected to grow from $2.1 billion in FY 2004 to nearly $2.9 billion by FY 2007, reflecting rapidly rising health insurance premiums. Premiums grew at a double-digit pace during the early 1990s, but the City then negotiated a three-year freeze in rates for fiscal years 1996 through 1998 as part of a package to help the City balance its budget during a period of fiscal stress. Since then, health insurance premiums have resumed growth at a rapid rate, reflecting national cost trends for medical and hospital care (see Graph 7). The Health Insurance Plan of Greater New York (HIP) increased premiums by 9.9 percent in FY 2001, 11.9 percent in FY 2002, 8.5 percent in FY 2003, and 7.9 percent in FY 2004.[9]

[9] Under agreements between the City and its unions, premiums paid to HIP determine the City's cost for all municipal insurance providers.

Graph 7

ANNUAL CHANGE IN HEALTH INSURANCE PREMIUMS



Sources: NYC Office of Management and Budget; HIP

The November Plan reflects HIP's intention to increase premiums for active employees and retirees under the age of 65 by 10.4 percent in FY 2005—the June Plan assumption for 2005 was 8 percent—and assumes that premiums for these employees will increase by 8 percent annually thereafter. Health insurance premiums for Medicare-eligible retirees are projected to increase by 6 percent in FY 2004 and by 14 percent annually thereafter. In addition, Medicare Part B premiums, which the City pays for its retirees and their families, are scheduled to increase by 13.5 percent in 2004.

A January 2001 agreement between the City and the Municipal Labor Committee calls for negotiations on restructuring the funding sources for municipal health insurance, with the goal of reducing the City's contribution by $100 million in FY 2003 and $100 million in FY 2004.[10] The agreement guarantees the savings and states that if the parties are unable to restructure benefits, the committee will provide these savings through another source. Since the parties were unable to restructure benefits, the City drew down $150 million from the Health Insurance Stabilization Fund, leaving the fund with assets of $280 million on December 8, 2003. The City expects that the remaining $50 million it is owed will be drawn down from the fund by the end of the fiscal year.

[10] For a detailed discussion of this issue see OSDC Report 9-2001, *Review of the Financial Plan for the City of New York: Fiscal Years 2001-2005*, issued March 2001.

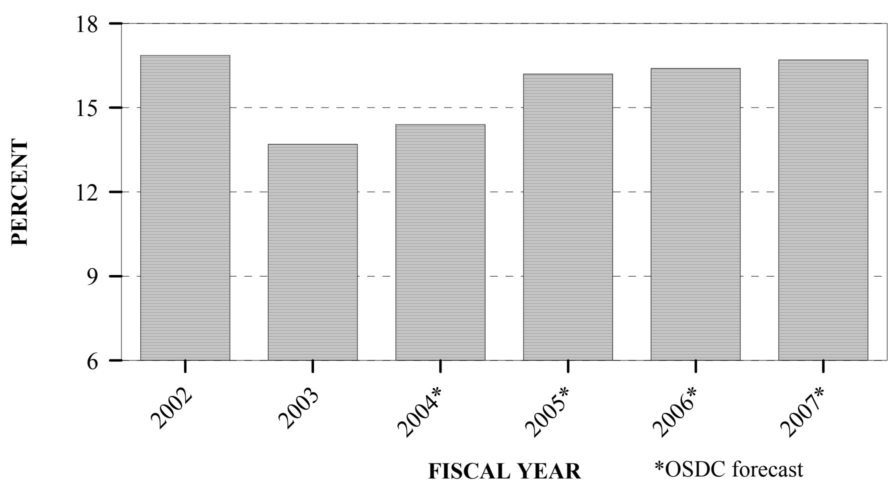
The Health Insurance Stabilization Fund was established to relieve employees who were paying health insurance premiums for Group Health Insurance and Blue Cross coverage that were higher than the premiums charged by HIP. As part of the January 2001 agreement, the City and Municipal Labor Committee (MLC) agreed that the Health Insurance Stabilization Fund would fund an expansion in drug coverage. However, these expenses have been higher than planned and could deplete the fund in the near future. The City and the MLC are negotiating to resolve the future of these benefits.

2. Debt Service

Debt service costs are projected to reach nearly $3.9 billion in FY 2004, an increase of $558 million, or 16.9 percent, over the FY 2003 level. Debt service costs are projected to reach $4.9 billion by FY 2007, which is an annual average increase of 10.1 percent, or more than five times the projected inflation rate. The debt service burden (debt service as a percent of tax revenues and offsetting revenues, including amounts to support TFA and TSASC debt service) is projected to reach 16.6 percent by FY 2007 (see Graph 8). The City's projected debt service burden has been greatly reduced during fiscal years 2003 through 2007 because of bond refundings, cuts to the capital program, an increase in property and personal income taxes, and the anticipated early retirement of MAC bonds. Without these actions, the debt service burden would have reached 20 percent by FY 2005.

Graph 8

NEW YORK CITY DEBT SERVICE BURDEN



Sources: NYC Office of Management and Budget; OSDC analysis

The State Legislature, over the Governor's veto, passed legislation that would provide an annual $170 million payment to New York City through the Local Government Assistance Corporation (LGAC), with the understanding that these resources would be assigned by the City to a local development corporation (STAR Corporation) that would refinance outstanding Municipal Assistance Corporation (MAC) bonds. The refinancing would relieve the City of about $500 million in annual debt service costs during fiscal years 2004 through 2008. While this transaction would benefit the City budget by $2.5 billion over the five-year period, the cost to the State would total $5.1 billion if the bonds were to be amortized over 30 years, as is currently contemplated.

On August 13, 2003, LGAC filed a lawsuit challenging the constitutionality of the legislation and seeking to prevent the issuance of bonds by STAR Corporation. The State Supreme Court granted the City's motion for summary judgment, but the plaintiffs appealed that decision to the State Appellate Division, which had previously issued a preliminary injunction preventing STAR Corporation from issuing bonds pending appeal. Oral argument on the appeal took place on November 18, 2003, and a decision is pending. In addition, the losing party might appeal to the Court of Appeals. Even a favorable decision for the City could come too late to complete the transaction in the current fiscal year as planned, and the courts could also rule against the City. Thus, the City may not be able to refinance MAC bonds as planned, which could put the anticipated savings at risk.

Bonds issued by TSASC are backed by revenues from the national settlement with tobacco companies. Moody's Investor Service recently downgraded a major original participating manufacturer, R.J. Reynolds, to below investment grade, which triggered a "trapping event" in TSASC bonds. This event requires TSASC to reserve a portion of revenues received until the total amount trapped equals 25 percent of the outstanding principal, which is expected to total $266 million by FY 2008. Unless the City takes actions to release the trapped funds, it is estimated that tobacco settlement revenues that would otherwise accrue to the City's budget would be reduced by approximately $52 million in FY 2004, $63 million in FY 2005, $66 million in FY 2006, $74 million in FY 2007, and $11 million in FY 2008. The City has stated that it is considering options that would release the trapped funds, including the refunding of TSASC's outstanding bonds and other alternatives that do not involve a refunding, which the City has not made public for evaluation. The City no longer intends to fund a portion of its capital program with proceeds from the sale of future TSASC bonds because recent events have made these bonds too costly.

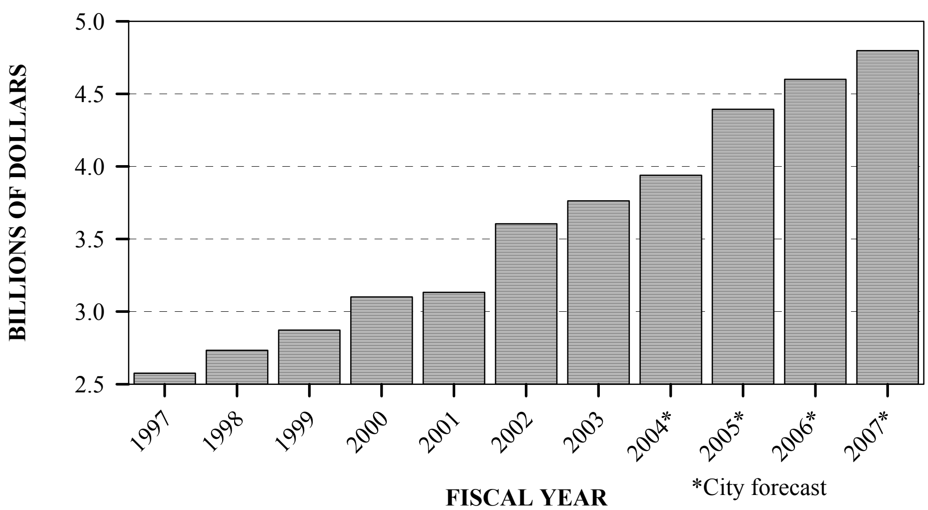
3. Medical Assistance

City-funded Medicaid expenditures are projected to exceed the amounts in the June Plan by $248 million in FY 2004, $163 million in FY 2005, $226 million in FY 2006, and $418 million in FY 2007. According to City officials, the increases reflect higher costs for drugs and enrollment in managed care plans. City-funded Medicaid drug expenditures increased, on average, by 21 percent annually between fiscal years 1997 and 2003. Between fiscal years 1999 and 2003 expenditures for managed care rose by an average of 38 percent annually, reflecting the transition from fee-for-service to mandatory managed care as well as the expense of efforts to raise awareness about public health insurance programs. Expenditures for other costly services, such as hospital inpatient and outpatient care, clinics, and nursing homes are projected to increase marginally during the plan period—a result of the impact of managed care and improvements such as shorter hospital stays.

City-funded Medicaid expenditures are now projected to total $3.9 billion in FY 2004, $4.4 billion in FY 2005, $4.6 billion in FY 2006, and $4.8 billion in FY 2007 (see Graph 9). On average, City-funded Medicaid expenditures are projected to increase by 6.3 percent annually during fiscal years 2004 and 2007. Medicaid expenditures are growing faster than City-fund revenues and are projected to consume an average of 14.4 percent of City-fund revenues during fiscal years 2004 through 2007, compared to 12.5 percent between fiscal years 1999 and 2003.

Graph 9

CITY-FUNDED MEDICAID EXPENDITURES



Sources: NYC Office of Management and Budget; OSDC analysis

The November Plan assumes that the federal government will not extend the temporary increase in federal Medicaid reimbursement that reduced City spending by $232 million in FY 2004, but the Plan also assumes that the State will renew the Medicaid cost-containment measures that saved the City $134 million in FY 2004. The State, however, is considering reforms in Medicaid financing to help ease the fiscal burdens on local governments. Both the Governor and the State Senate have formed separate commissions to propose reforms in Medicaid, possibly during the Governor's next budget proposal. While the federal government has recently approved a Medicare drug benefit for the elderly, City officials believe that the federal government would recoup most of the savings generated from this bill.

4. Public Assistance

Public assistance is essentially comprised of three programs. The largest is the Family Assistance program, which is administered by the State and assists families for a maximum of five years with federal funds from an annual block grant. The two other programs are components of the State's Safety Net Assistance program. One program primarily serves single adults and the other serves families who exhaust their federal benefits. Benefit levels for all three programs are the same, but the average grant per person can vary based on the needs of recipients. The State and City generally share equally in the cost of the two Safety Net Assistance programs.

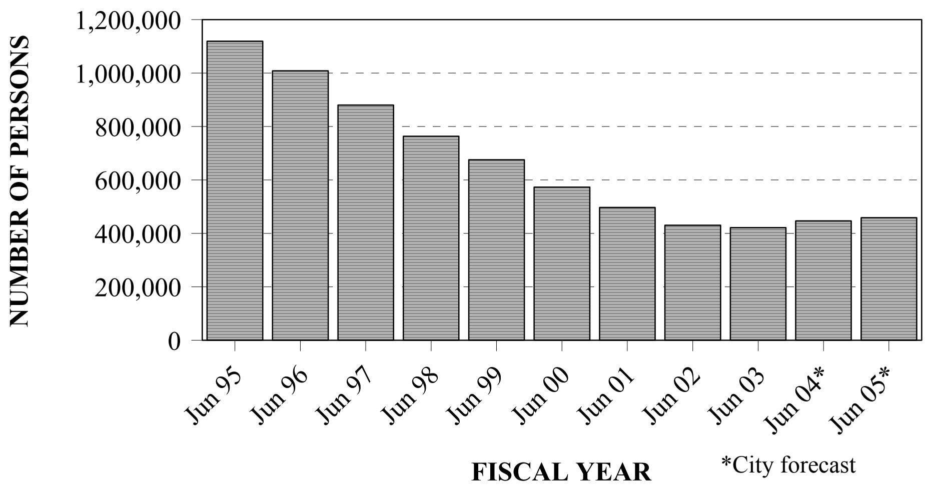
As of October 2003, 432,789 persons were receiving public assistance in New York City. The November Plan assumes that the caseload will rise to 446,902 by June 2004 and continue to rise in subsequent years, ending the large annual decreases of previous years (see Graph 10). The projected caseload increase reflects the impacts of the local recession, the federal welfare time limit, and the State increase in the housing portion of the monthly cash assistance benefit. For cash assistance, the City projects that it will spend $487 million in FY 2004, $538 million in FY 2005, and $542 million in fiscal years 2006 and 2007. Of the amount budgeted for FY 2004, about $166 million provides monthly benefits to Family Assistance recipients; $182 million is budgeted for adults on Safety Net; and $139 million goes to Safety Net families that have exhausted their federal welfare benefits.

As a condition of receiving the annual $2.4 billion federal welfare block grant, New York State must meet a minimum spending requirement that is equivalent to 75 percent to 80 percent of its SFY 1994-95 welfare expenditures, including local government expenditures. In recent years, when New York State spent more than the federal minimum, the State reimbursed localities for their share of overspending. During FY 2003, the State chose not to reimburse localities, which increased City-fund expenditures for cash assistance, although fewer people were receiving cash assistance.

Given the State's budgetary stress, the State may again choose not to reimburse localities for welfare-related expenditures in excess of the federally mandated minimum.

Graph 10

PUBLIC ASSISTANCE RECIPIENTS



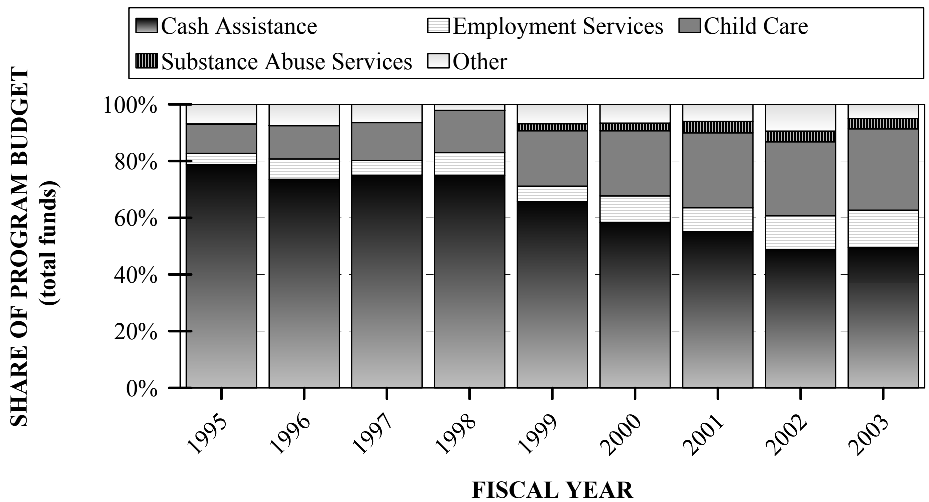
Sources: NYC Human Resources Administration, NYC Office of Management and Budget; OSDC analysis

Since FY 1995, the number of people who are receiving cash assistance in New York City has declined by 62 percent, which has freed up funds for other public assistance services. For example, the portion of the public assistance budget allocated to cash assistance is projected to decline from 79 percent ($2.7 billion) in FY 1995 to 49 percent ($1.1 billion) in FY 2003. The portion of the public assistance budget allocated to employment services, child care, and substance abuse counseling has risen from 14 percent ($495 million) in FY 1995 to 46 percent ($1 billion) in FY 2003. The City also used resources generated from caseload declines to upgrade its data maintenance systems in order to comply with federal and State welfare reform reporting requirements and to track various program indicators or outcomes that could be used to inform future service delivery (see Graph 11). However, neither the State nor the City have allocated resources to assist former welfare recipients who may still be in need of services and who are not accessing available services.

Congress has put off implementing changes to the landmark welfare reform law enacted in 1996, as well as other programs that serve people whose incomes are below poverty level. The changes under consideration could have a significant impact on the City's budget and on those who depend on these programs. For example, Congress is debating whether to raise mandatory minimum work participation rates, which will require the provision of additional employment services such as training, child care, and transportation subsidies. The President has proposed block grants for Section 8, a federal program that provides housing subsidies, which would shift the costs of rising rents and rising demand for housing subsidies to the City and State. This could exacerbate the problems already faced by low-income families seeking affordable housing in the City.

Graph 11

PUBLIC ASSISTANCE SERVICES BUDGET



Note: "Other" includes administrative program expenses and expenditures for food and utilities assistance.

Sources: NYC Office of Management and Budget; OSDC analysis

5. Judgments and Claims

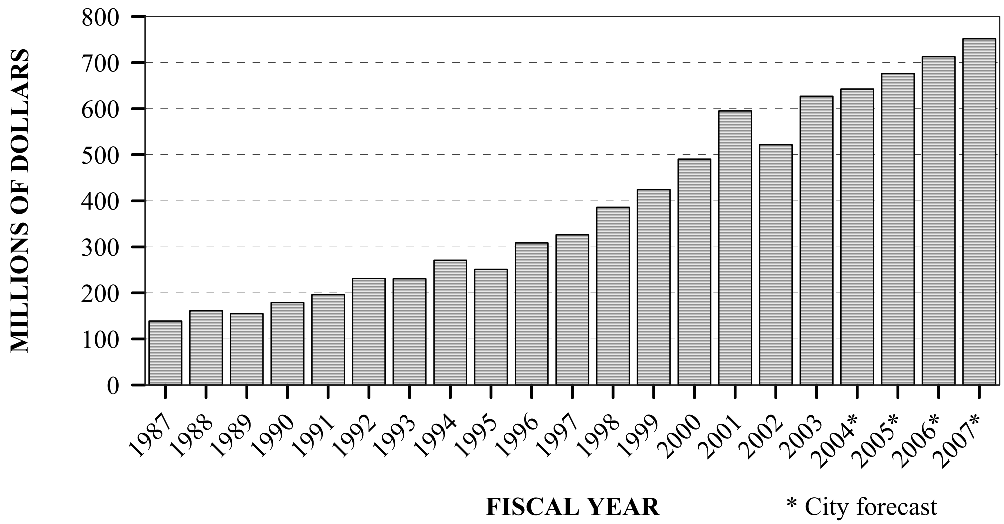
The November Plan projects that expenditures for judgments and claims will increase from $643 million in FY 2004 to $752 million by FY 2007 (see Graph 12). In previous years, growth in spending has been driven by an increase in the number and size of high-cost cases and by high medical malpractice payouts. Expenditures for cases that cost $1 million or more have tripled since FY 1996, and are projected to total $265 million in FY 2004. Medical malpractice cases, the most costly type of claim, constitute about one third of all judgments and claims expenditures. In FY 2004, the City projects that it will spend $185 million on such cases.

The City's estimates do not reflect any potential liability arising from the Staten Island Ferry accident of October 15, 2003, or from the World Trade Center attack on September 11, 2001. To date, 118 claims worth more than $2 billion have been filed against the City for the Staten Island Ferry accident, but the City is seeking to limit its liability to $14.4 million (the value of the ferry) under a Federal Maritime Act from the

1850s. The World Trade Center disaster has generated 1,653 lawsuits and 424 notices of claim against the City, with an aggregate value of about $13 billion. Instead of suing the City, about 500 World Trade Center claimants have opted to join the federal Victims Compensation Fund, which will lower the City's potential liability. The fund will stop accepting claims on December 22, 2003. The ultimate outcome and fiscal impact of these potential liabilities on the City is not currently predictable.

Graph 12

JUDGMENTS AND CLAIMS EXPENDITURES



Sources: NYC Comptroller's Office; NYC Office of Management and Budget

The November Plan also does not reflect potential savings from recent City legislation that shifts responsibility for trip-and-fall accidents from the City to private property owners, excluding owners of one-, two-, and three-family homes. The City spends an average of $60 million annually on trip-and-fall accidents, the most costly case category after medical malpractice cases. The City estimates that savings from the recent legislation could increase each year and could reach $50 million annually by FY 2009.

6. Uniformed Agencies

Over the past several years, overtime costs in the Police Department have increased dramatically and have far exceeded planned levels. In FY 2003, the department spent a record $376 million on overtime, but the November Plan assumes that overtime costs will total $235 million FY 2004. While the department acknowledges that overtime in FY 2004 is anticipated to reach last year's level, it expects to fund the additional cost with savings from the difference in salaries between recent hires and retiring police officers. Nevertheless, our analysis indicates that overtime costs could still be underfunded by $50 million in FY 2004. In addition, the November Plan assumes that police overtime will average nearly $200 million annually during fiscal years 2005 through 2007, far less than recent experience would indicate. We estimate that overtime costs are likely to exceed planned levels in these years by $150 million in FY 2005, and by $125 million annually thereafter. Our estimates of higher overtime are based on several factors. First, the size of the police force has been reduced in recent years, from a peak of 40,754 in October 2000 to a projected 34,774 by June 2004. Second, the City underestimates the cost of security at public events. For FY 2004, the City budgeted $51 million for this kind of security, which was less than half of what was spent the previous year. Third, overtime expenditures for ongoing anti-terrorism measures have been higher than budgeted.

The Fire Department spent a record $178 million on overtime in FY 2003 to maintain adequate staffing with simultaneous high rates of retirement, sick leave, and line-of-duty injuries related to the World Trade Center tragedy. The November Plan assumes that overtime costs in the Fire Department will total $157 million in FY 2004, but also assumes that overtime will decline to $100 million beginning in FY 2005, well below recent trends in actual overtime spending. While this represents an ambitious reduction in overtime costs, our analysis indicates that it is achievable if the department is able to increase its number of firefighters, as planned.

In FY 2003, the Mayor unilaterally suspended recycling of glass and plastics; proposed reducing the City's recycling pickups from biweekly to weekly; and proposed reducing regular trash pickups from two and three days per week to one and two days per week. In June 2003, the City Council mandated full restoration of the recycling program by April 2004 and restored trash pickups to two and three days per week. The City has not yet funded the additional cost of the recycling program, and regular trash pickups are funded only in FY 2004. We estimate that the costs of these restorations could exceed amounts in the November Plan by $6 million in FY 2004 and $35 million annually thereafter.

IV. Covered Organizations

Covered organizations are semi-autonomous agencies subject to the Financial Emergency Act, which include but are not limited to the Board of Education,[11] the Health and Hospitals Corporation, and the New York City Transit Authority, which is a component agency of the Metropolitan Transportation Authority. The City has a financial relationship with these agencies and may be called upon to provide additional funding to help balance their budgets.

A. Department of Education

In June 2003, the New York State Court of Appeals ruled that New York State had failed to fulfill its constitutional mandate to provide a sound, basic education to New York City public school students. The court ordered the State to determine the cost of providing a sound, basic education and then to ensure that every City school is provided with these resources by July 30, 2004.

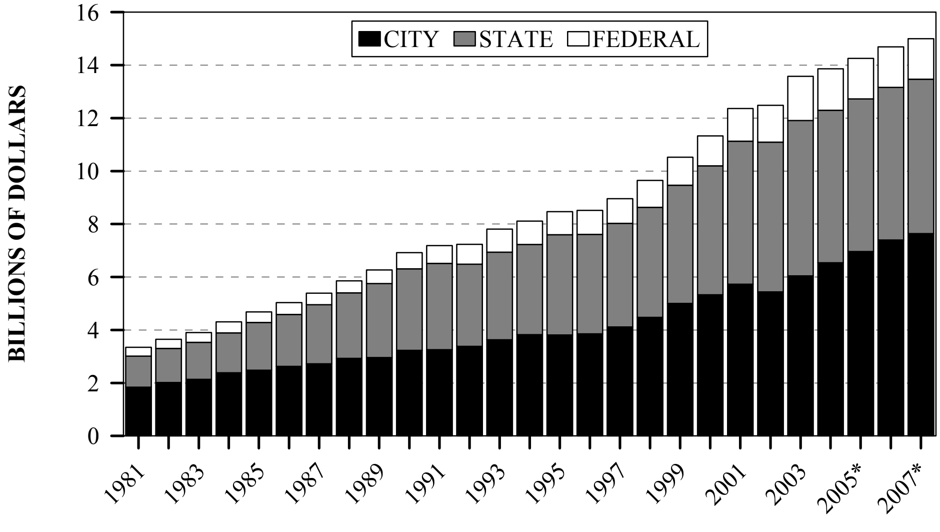
In response to the court mandate, the New York State Board of Regents recently proposed that the State substantially increase the amount of education aid to local school districts and reform current formulas used to distribute education aid to reflect differences in regional costs, poverty rates and local school districts' ability to fund education. The Governor has appointed a commission to recommend reforms by March 2004, and the Campaign for Fiscal Equity (CFE), plaintiffs in the lawsuit, will present a reform proposal and cost estimates to the State Legislature in April 2004. If the State fails to comply with the deadline, a special master could be appointed to monitor implementation of the court's mandate. Although the outcome of the CFE litigation could result in a substantial increase in funding to the Department of Education, it is still unknown whether an increase in State education aid will come at the expense of State funding for other programs or whether the City will be called upon to increase its contribution.

In total, the Department of Education is projected to spend $13.9 billion in FY 2004 (see Graph 13). Of this amount, the City would contribute $6.5 billion, including $1.4 billion for pensions and debt service; the State would provide $5.7 billion; the federal government would contribute $1.6 billion; and other categorical revenues, such as fees and private donations, would account for the remainder. The City's contribution meets the State maintenance of effort requirement, which precludes the City from reducing its contribution (excluding funding for pensions and debt service), below the prior year's level unless there is a reduction in City revenues.

[11] The Board of Education has been renamed the Department of Education by the Mayor, although the legal name remains unchanged.

Graph 13

EDUCATION FUNDING SOURCES



Note: Analysis includes debt service and pensions.
Sources: NYC Office of Management and Budget; OSDC analysis

Between fiscal years 2004 and 2007, City funding for education is projected to increase by 17 percent to $7.6 billion. Nearly 90 percent of the increase comes from higher spending for debt service, pensions, and fringe benefits, which comprise almost half of all City-funded education expenditures. Salaries and wages are projected to increase by only 1 percent, reflecting declining student enrollment, teacher turnover, and the absence of an agreement on a new teacher contract.

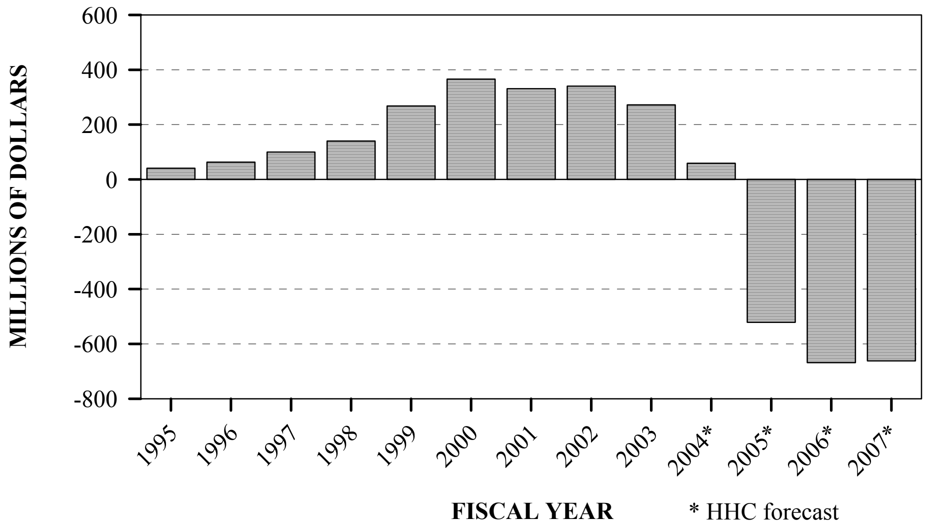
The November Plan assumes that the department will lay off 486 skilled-trade workers—carpenters, painters, plumbers, and electricians—and replace them with contractors. While the plan assumes that this initiative will be budget-neutral, the department believes that productivity will increase. In addition, City officials and municipal unions are negotiating new labor contracts. Contract stipulations governing daily work are under consideration. According to Department of Education officials, existing work rules impede effective management and could adversely impact the Mayor's education policy agenda. The teachers' union filed a complaint against the Department of Education for unfair labor practices and for refusing to negotiate a new teachers' contract.

B. Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) could end FY 2004 with a cash balance of only $59 million, much lower than in previous years, and it projects large out-year budget gaps (see Graph 14). In recent years, HHC accumulated large cash balances because of retroactive Medicaid reimbursements, additional federal funds to facilitate the transition to managed care, and higher City subsidies, which are no longer available.

Graph 14

HHC YEAR-END CASH BALANCE



Sources: NYC Office of Management and Budget; OSDC analysis

Starting in FY 2005, HHC will have difficulty maintaining a positive annual cash balance, as a result of several factors. Medicaid managed care is reducing the corporation's revenue even while service utilization has increased. Between April 2003 and July 2003, the corporation lowered its Medicaid revenue projections by $54 million in FY 2005, $63 million in FY 2006, and $74 million in FY 2007. Also, collective bargaining agreements for most HHC employees expired in June 2002, and the current plan does not reflect the potential for higher costs.

HHC projects large cash deficits of $521 million in FY 2005, $668 million in FY 2006, and $662 million in FY 2007. To balance its budget, HHC intends to take actions during FY 2004 that would increase the size of the year-end cash balance and that would generate recurring resources, and it is counting on additional federal and State assistance.

The gap-closing program assumes savings of $70 million in FY 2005 and up to $100 million by FY 2007 from unspecified workforce reductions and increased productivity. Staff reductions, however, run the risk of eroding service quality and could result in a loss of HHC patients to voluntary hospitals. The program also assumes that cost-containment and revenue-enhancement strategies, such as increasing enrollment in public health insurance programs, will generate $95 million in recurring resources. HHC further assumes that it will obtain additional federal or State assistance of $135 million in FY 2005 and $450 million in each of fiscal years 2006 and 2007—assumptions that appear unlikely.

To remain fiscally solvent in the managed care environment, HHC is attempting to improve service quality and to attract privately insured patients. The corporation is reducing the average wait times for outpatient services and has set 60 minutes as the optimal wait time, a goal that may not be reached for several years. Since June 2002 when this initiative began, average wait time in six hospital clinics was reduced by 45 percent, to 79 minutes. So far in FY 2004, HHC has reduced the general care average length of stay in its hospitals to 4.9 days, from 5.1 days in FY 2003, which is now lower than many voluntary hospitals in New York City. A national hospital accreditation organization rated the quality of services at HHC hospitals higher than most hospitals nationwide.

C. New York City Transit Authority

The New York City Transit Authority is the largest operating agency within the Metropolitan Transportation Authority (MTA). On October 28, 2003, the MTA released a revised budget for 2003 and a four-year financial plan for calendar years 2004 through 2007. The October Plan shows year-end cash balances of $225.1 million for 2003 and $36.2 million for 2004—slightly improved over the July forecast. But only six months after the largest fare hike in its history, the MTA projects large and growing out-year budget gaps of about $840 million in 2005, $1.3 billion in 2006, and $1.5 billion in 2007.

A recent report by the State Comptroller found even though the year-end cash balance for 2003 could be higher than projected in the October Plan, the out-year gaps could be larger because the MTA is counting on speculative resources in those years (see Report 10-2004, *Review of the Financial Plan for the Metropolitan Transportation Authority*, for further details.)

The revenue projections in the October Plan assume that fare and toll revenue will increase by about $230 million, or 5 percent beyond the increases already assumed by its agencies in their budgets for calendar years 2005 and 2006, and by $475 million or 10 percent over agency assumptions for 2007. If utilization does not increase fast enough to generate these additional revenues, the MTA has said it might curtail fare and toll discounts. In addition, expenditures are underestimated because the MTA has included the benefit of savings from cost-reduction actions valued at $80 million in 2005, $129 million in 2006, and $174 million by 2007, but which are unspecified. When these factors are taken into account, the projected gaps total $1.1 billion in 2005, $1.7 billion in 2006, and $2.1 billion in 2007.

The debt service projections in the MTA's October Plan are based on broad assumptions about the size of the 2005-2009 capital program. These assumptions include inflationary growth of core investments and progression of network expansion projects according to projected milestones. Thus, the October Plan assumes that the 2005-2009 capital program would total $26.6 billion—40 percent more than the current program—and would include $9.3 billion for the Second Avenue Subway and the East Side Access project, which would permit the Long Island Rail Road to enter Grand Central Station. The October Plan assumes, however, that the City will finance the extension of the No. 7 subway line. Moreover, the October Plan does not identify funding sources needed to plug a $6.7 billion funding gap in the 2005-2009 capital program, which represents about 25 percent of the resources needed to fully fund the program. Nevertheless, the October Plan projects that debt service costs will more than double from $797 million in 2004 to $1.7 billion by 2007, and we estimate that debt service costs could reach $2.5 billion by 2014.

On December 15, 2003, the MTA announced that the budget outlook for calendar years 2003 and 2004 had improved by $152 million compared to the estimates in the October Plan. Our review of the October Plan found that the 2003 year-end cash balance could be higher by $50 million, due largely to higher real estate-related tax revenues. The MTA estimates that the 2003 year-end cash balance will be higher by $141 million due to higher real estate-related tax revenues, lower debt service costs, and timing. The MTA is also projects a net improvement of $11 million for 2004, mostly from higher real estate-related tax revenues.

Most of the additional resources anticipated by the MTA in 2003 are expected to come from lower debt service costs than assumed in the October Plan. The MTA is only now acknowledging that the Triborough Bridge and Tunnel Authority (TBTA) obtained $39 million in additional savings in 2002 from the MTA's debt restructuring initiative. These savings were not reflected in the July Plan or the October Plan even though the TBTA's audited financial statements were completed in April 2003. In addition, the MTA plans one fewer debt issuance in 2003 than assumed in the October Plan ($13 million) and interest rates on TBTA variable rate debt are expected to be less than anticipated in the October Plan ($20 million).

The MTA plans to use the $152 million in additional resources to narrow the budget gap for 2005 from $840 million to $688 million, but the budget gaps in the October Plan for calendar years 2006 and 2007 would be unaffected. In addition, the MTA is still counting on $121 million in additional governmental assistance in FY 2004, which seems unlikely given the budget gaps faced by the State and City, and savings from unspecified actions and revenue from an increase in utilization above the estimates assumed by the agencies in their budgets for calendar years 2005 through 2007.

Appendix
City-Funded Staffing Levels

The City-funded workforce, including both full-time and part-time employees, contracted by 11,756 employees during FY 2003, but the November Plan assumes that the workforce will expand by 3,612 during FY 2004 (see Table 6). The most significant changes in staffing levels are described below.

- The Department of Education reduced its workforce by 2,252 employees during FY 2003, which entailed cuts in the number of school aides and family paraprofessionals. During FY 2004, the Department plans to add 1,327 pedagogues and 866 nonpedagogical employees, which would offset the FY 2003 reductions.
- The Police Department cut the cadet class scheduled for July 2003 by 1,900, which will reduce the police force to 34,774 officers by June 2004, compared to a force of 40,754 officers in October 2000. The Department plans to add 300 traffic enforcement agents in FY 2004 to generate more ticket revenue.
- The Fire Department reduced the number of firefighters by 435 during FY 2003 by closing 6 engine companies and by cutting manning in 23 engine companies, but it plans to add 225 firefighters during FY 2004.
- The Department of Correction reduced the number of uniformed employees by 1,107 during FY 2003 in response to a decline in the inmate population.
- The Department of Sanitation reduced its workforce by 990 employees during FY 2003, primarily by cutting back the recycling program. Weekly recycling and glass pickups are scheduled to resume in April 2004, but the 260 new hires associated with this initiative have not been reflected in the November Plan.
- The Department of Parks and Recreation reduced its workforce by 950 employees during FY 2003 and plans to reduce its workforce by another 350 employees during FY 2004.
- The Administration for Children's Services reduced its workforce by 1,509 employees during FY 2003, but plans to add 594 employees in FY 2004, after adjusting for the transfer of employees to the Department of Social Services.
- The Department of Social Services reduced its workforce by 1,196 employees during FY 2003. While the workforce is projected to increase by 944 in FY 2004, 59 percent of the increase is attributable to the transfer of employees from the Department of Children's Services (558 employees).

Table 6
City-Funded Staffing Levels
(Full-Time and Full-Time Equivalents)

Increase/(Decrease)

		Fiscal Year			Annual Change		Two-Year Change
		FY 2002	FY 2003	FY 2004	FY 2003	FY 2004	
Public Safety		**83,778**	**80,022**	**79,362**	**(3,756)**	**(660)**	**(4,416)**
Police Dept.	Uniformed	36,790	36,120	34,774	(670)	(1,346)	(2,016)
	Civilians	14,521	14,054	14,235	(467)	181	(286)
Fire Dept.	Uniformed	11,314	10,879	11,104	(435)	225	(210)
	Civilians	4,530	4,297	4,320	(233)	23	(210)
Correction	Uniformed	9,893	8,786	8,772	(1,107)	(14)	(1,121)
	Civilians	1,511	1,323	1,462	(188)	139	(49)
District Attys. & Prosecutors		3,864	3,412	3,377	(452)	(35)	(487)
Probation Department		912	763	904	(149)	141	(8)
Other		443	388	414	(55)	26	(29)
Health and Welfare		**25,137**	**21,837**	**23,071**	**(3,300)**	**1,234**	**(2,066)**
Social Services		10,258	9,062	10,006	(1,196)	944	(252)
Children's Services		7,889	6,380	6,416	(1,509)	36	(1,473)
Health and Mental Hygiene		4,564	4,006	4,428	(558)	422	(136)
Homeless Services		2,054	2,109	1,962	55	(147)	(92)
Other		372	280	259	(92)	(21)	(113)
Environment & Infrastructure		**18,777**	**16,563**	**16,400**	**(2,214)**	**(163)**	**(2,377)**
Sanitation	Uniformed	7,680	7,006	7,074	(674)	68	(606)
	Civilians	2,067	1,751	1,842	(316)	91	(225)
Dept. of Transportation		2,320	2,035	2,056	(285)	21	(264)
Parks & Recreation		6,323	5,373	5,023	(950)	(350)	(1,300)
Other		387	398	405	11	7	18
General Government		**8,269**	**8,041**	**8,590**	**(228)**	**549**	**321**
Finance		2,364	2,166	2,308	(198)	142	(56)
Law Department		1,312	1,285	1,278	(27)	(7)	(34)
Citywide Admin. Services		1,406	1,346	1,520	(60)	174	114
Taxi & Limo. Commission		424	447	481	23	34	57
Investigations		322	269	270	(53)	1	(52)
Board of Elections		356	373	328	17	(45)	(28)
Info. Technology & Telecomm.		392	552	709	160	157	317
Other		1,693	1,603	1,696	(90)	93	3
Housing		**1,467**	**1,399**	**1,547**	**(68)**	**148**	**80**
Buildings		863	893	963	30	70	100
Housing Preservation		604	506	584	(98)	78	(20)
Department of Education		**112,687**	**110,435**	**112,628**	**(2,252)**	**2,193**	**(59)**
	Pedagogues	91,110	90,049	91,376	(1,061)	1,327	266
	Non-Pedagogues	21,577	20,386	21,252	(1,191)	866	(325)
City University of New York		**5,750**	**6,033**	**6,185**	**283**	**152**	**435**
	Pedagogues	3,465	3,674	3,912	209	238	447
	Non-Pedagogues	2,285	2,359	2,273	74	(86)	(12)
Elected Officials		**2,667**	**2,446**	**2,605**	**(221)**	**159**	**(62)**
Total		**258,532**	**246,776**	**250,388**	**(11,756)**	**3,612**	**(8,144)**

Sources: NYC Office of Management and Budget; OSDC analysis