Review of the Financial Plan of the City of New York

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- **The City expects tax revenues to exceed the estimates in the July 2006 Financial Plan by $2.2 billion in FY 2007, $2 billion in FY 2008, and about $1.5 billion annually thereafter.**
- **The FY 2008 budget gap has been reduced from $3.8 billion to $510 million, but the City still faces large budget gaps in subsequent years.**
- **Wall Street profits are projected to reach $14.5 billion in 2006, an increase of 53.6 percent over last year's level.**
- **The City's unemployment rate has declined to 4.1 percent—the lowest level in 30 years.**
- **Commercial real estate vacancy rates are declining and rental rates are rising. Vacancy rates on prime Midtown properties are nearing 7 percent, compared with 10 percent in 2004.**
- **Spending on nondiscretionary items (e.g., debt service and pension contributions) is projected to consume 49 percent of City fund revenues by FY 2009, compared with 37 percent in FY 2003.**
- **Debt service will increase by 63 percent during the financial plan period and consume 14.7 percent of City fund revenues by FY 2010.**
- **The rapid growth in pension contributions over the past seven years will slow by 2010, but the contribution will remain at a high level—$5.8 billion—which is almost four times larger than the average contribution during the 1990s.**
- **By 2009, teachers' salaries will have increased by more than 40 percent since 2002 (with the implementation of the new UFT contract), making salaries more competitive with surrounding suburban school districts.**
- **Since FY 2002, the City has increased its contribution to the Department of Education by $3.4 billion—more than twice the increase in the State's contribution.**
- **Some City-related public authorities, such as the Housing Authority and the Health and Hospitals Corp., face financial difficulties.**

Last year, New York City realized (by our estimation) an unprecedented $6.4 billion in unanticipated resources after covering obligatory liabilities. The City used a portion of these resources to increase its reserves and to help financially strapped City-related public authorities. The remaining surplus of $3.8 billion, a new record, was transferred to the current fiscal year (FY 2007) to help balance the budget.

After record gains last year, the City is off to a strong start in FY 2007. On November 1, 2006, the City released a modification of its four-year financial plan (the "November Plan"). The November Plan shows increases in City fund revenues that are unprecedented at this point in the budget cycle: $2.3 billion in FY 2007, $1.9 billion in FY 2008, and about $1.5 billion in fiscal years 2009 and 2010.

Even after increasing the City's reserve for collective bargaining, the November Plan projects a surplus of $1.9 billion for FY 2007—the largest surplus ever projected by the City at this point in the budget cycle.

The FY 2007 surplus, coupled with an expectation of higher recurring revenues, has reduced the projected FY 2008 budget gap from $3.8 billion to $510 million—the smallest out-year gap as a percent of City fund revenues at this point in the financial planning process. Although the budget gaps in subsequent years have also been reduced, they remain substantial (e.g., $4 billion in FY 2009).

Our analysis indicates that revenue collections will continue to exceed expectations (see Figure 1), and these additional resources should be sufficient to close the remaining budget gap projected for FY 2008. In addition, the FY 2007 surplus may grow even larger as the year progresses, and could approach last year's record of $3.8 billion.

New York City's budget is benefiting from a strong local economy. Many large Wall Street firms are posting record revenues and profits, which are driving up personal income and business tax collections, and though the residential real estate market has begun to cool, the commercial real estate market continues to heat up. Another sign of the City's resurgence is the number and size of economic development projects in various stages of progress. These projects, moreover, are not limited to a single borough or area; they are occurring throughout the City.

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

			Better/(Worse)	
	FY 2007	**FY 2008**	**FY 2009**	**FY 2010**
Gaps Per November Plan	**$ - - -**	**$ (510)**	**$ (4,068)**	**$ (3,608)**
Tax Revenues	300	250	200	200
Debt Service	85	50	25	(35)
Medicaid	75	75	75	75
Hiring Delays	25	- - -	- - -	- - -
IRS Refund	- - -	140	- - -	- - -
UFT Settlement	(70)	(60)	(100)	(85)
Uniformed Agency Overtime	- - -	(75)	(75)	(75)
OSDC Risk Assessment	**$ 415**	**$ 380**	**$ 125**	**$ 80**
Surplus Transfer	(415)	415	- - -	- - -
Gaps to be Closed*	**$ - - -**	**$ 285**	**$ (3,943)**	**$ (3,528)**
Additional Risk				
Wage Increases at the Projected Inflation Rate	- - -	(40)	(180)	(400)
Welfare to Work Penalties	- - -	(130)	(130)	(130)

* The November Plan includes a general reserve of $299 million in FY 2007 and $300 million annually thereafter. In addition, savings from overestimating prior years' expenses could total $300 million in FY 2007.

While City-funded spending grew by 28.5 percent over the past three years, revenues grew even faster. City-funded spending is projected to grow by another 8.7 percent in FY 2007, but revenues are projected to rise by only 3.1 percent. (The FY 2007 budget will be balanced by transferring resources from prior years.) Most of the increased spending reflects the rising cost of nondiscretionary spending, such as debt service and pension contributions.

In recent years, outstanding labor agreements were one of the largest risks facing the City's budget. The City, however, now has current agreements with most of the largest municipal unions, and has adequate reserves to fund the pattern for all employees, which greatly limits the potential liability from unsettled contracts during the current round of collective bargaining.

The Governor-elect has outlined an ambitious reform agenda that could affect the City. For example, he intends to settle the Campaign for Fiscal Equity lawsuit, which could direct billions in additional resources to the City's public schools but could require an increase in the City's education contribution.

The City's economy remains strong and there are no signs of a recession but one of the greatest risks to the City's budget would come from a prolonged economic downturn. Fortunately, the City has prudently increased its reserves during the current economic expansion, which would mitigate the impact of any short-term adverse development.

Economic Trends

The City is currently experiencing strong economic growth. Although the financial plan assumes that a slowing national economy will greatly diminish local growth during calendar year 2007, the economy is expected to rebound the following year. The City's assumptions include the following.

- Wall Street profits are projected to reach $14.5 billion in 2006, which is 53.6 percent higher than last year. The financial plan assumes profits will decline to $10.1 billion in 2007 as a result of higher interest costs and lower revenues, but then rebound in 2008.
- Local job growth will slow from an average gain of 53,900 jobs in 2006 to 20,800 in 2007, but the City expects higher gains in subsequent years as the economy strengthens.
- Wage growth will follow a similar pattern, falling from over 8 percent in 2006 to about 2 percent in 2007, and then rebounding.
- Inflation will be somewhat higher in the near term, but will ease by 2008 and remain low in subsequent years.
- The commercial real estate market will remain strong, with lower vacancy rates and higher rental rates throughout the period.

The City's economy, with its large business and finance sectors, is heavily influenced by the condition of the national economy. After three years of solid growth, the national economy has begun to soften. The pace of growth in the gross domestic product (GDP) has slowed as 2006 has progressed, with the third-quarter increase falling to 1.6 percent—the lowest rate since early 2003.

The 17 interest rate increases made by the Federal Reserve over the past two years have substantially cooled the housing market, putting a drag on GDP growth. The combination of stagnant or falling home values, a reduction in the ability of home owners to refinance their mortgages, and a surge in energy prices over the summer has begun to constrain consumer spending, which accounts for two thirds of economic activity. Easing energy prices, if sustained, may help consumer budgets.

The slowing in the national economy, however, has not yet had a significant impact on the City's economy. For example, while the rate of national job growth has eased somewhat this year, the pace of local job growth has remained strong, even exceeding the national rate during the summer (see Figure 2).

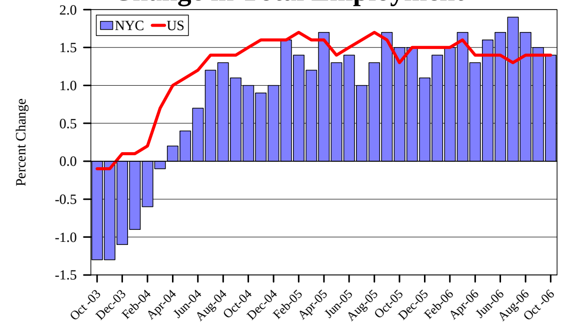
Overall, the City added 56,300 jobs in the first ten months of 2006 compared to the same period last year—the best rate of job growth since 2000. If the job gain is retained for the rest of the year, it would be the sixth-highest increase since the fiscal crisis of the 1970s. In addition, the unemployment rate in the City has dropped to 4.1 percent in October 2006—a record low.

Wall Street, the engine of the City's economy, is enjoying rapid growth. Profits at the large securities firms are reaching new highs in 2006, driven by record activity in mergers and acquisitions and by significant profits generated through the firms' trading on their own accounts. Wall Street added 7,200 jobs in the first ten months of 2006—the largest gain since 2000. The rate of job growth, however, has begun to slow, and the Securities Industry and Financial Markets Association warns of lower profits in 2007.

The City's inflation rate rose sharply in mid-2006 as energy prices spiked, but the rate has since eased as energy prices have fallen (see Figure 3). In the first ten months of 2006, local inflation averaged 3.9 percent, unchanged from the same period last year.

Figure 2

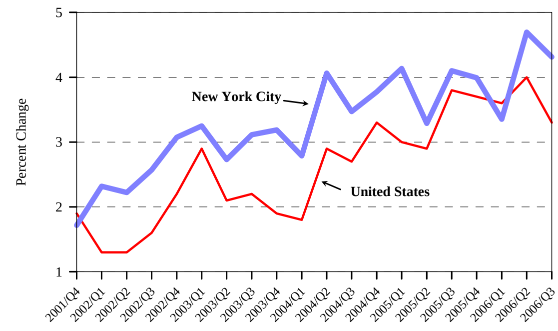
Change in Total Employment



Note: Change is from the same month one year earlier.
Sources: NYS Dept. Of Labor; U.S. Bureau of Labor Statistics; OSDC analysis

Figure 3

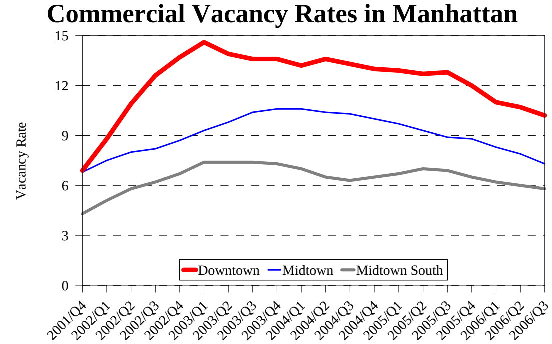
Inflation Rates



Source: U.S. Bureau of Labor Statistics

Figure 4

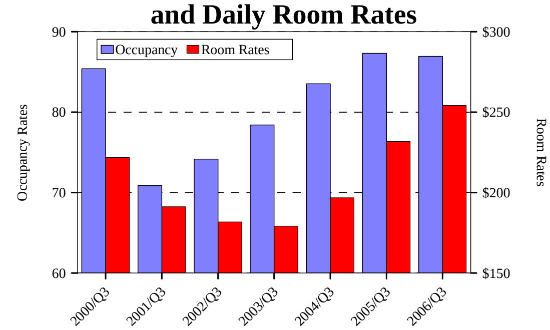
Commercial Vacancy Rates in Manhattan



Note: Data is a four-quarter moving average for premium (Class A) commercial space.
Sources: Colliers ABR; OSDC analysis

Figure 5

New York City Hotel Occupancy and Daily Room Rates



Source: PKF Consulting

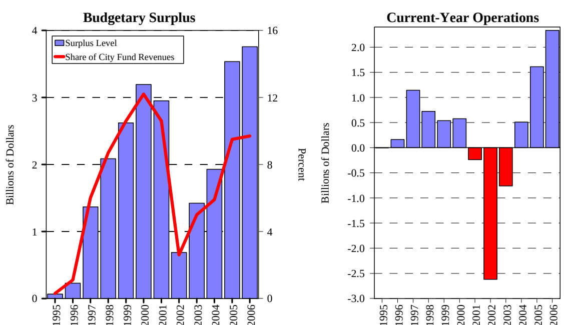
The commercial real estate market continues to thrive, as vacancy rates for prime commercial properties in each of the three Manhattan submarkets continue to decline (see Figure 4) and rental rates continue to rise. While the residential real estate market has begun to cool, property values continue to rise—although at slower rates. Data from Moody's Economy.com show that in the second quarter of 2006, median home values increased by at least 7.4 percent compared with the same period last year. The increase, however, was significantly smaller than in prior years, and price decreases have been reported in the surrounding suburbs.

In 2005, a record 42.6 million visitors traveled to the City, and the number is expected to reach 44.4 million in 2006. Hotels continue to operate with occupancy rates close to 90 percent (considered full occupancy) even as average daily room rates climb over $250 (see Figure 5).

Annual Operating Results

The City ended FY 2006 with a surplus of $3.8 billion, which was the largest surplus on record in absolute dollars and the fourth-best as a percent of City fund revenues (see Figure 6). These resources were transferred to the following year to help balance that year's budget, continuing a practice the City has followed since FY 1982.

Figure 6
Results of Operations



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

This estimate excludes $2.6 billion in resources that were used by the City to fund the Health Benefits Trust Fund and other discretionary initiatives that improved the City's fiscal position or assisted City-related public authorities (see Figure 7). By our estimation, the City generated $6.4 billion in surplus resources during FY 2006 after covering obligatory liabilities.

Figure 7
Discretionary Actions Taken in FY 2006
(in millions)

Contribution to Retiree Health Benefits Trust Fund	$ 1,000
Increase Reserve for Disallowances	527
Increase Health and Hospitals Corporation Subsidy	385
Prepay Transitional Finance Authority Debt Service	350
Defer TSASC Revenue	233
Increase New York City Housing Authority Subsidy	120
Total	**$ 2,615**

Source: OSDC analysis

The November Plan projects a budget surplus of $1.9 billion for FY 2007, and the City intends to transfer these resources to FY 2008. The transfer of resources between years, however, masks the relationship between recurring revenues and expenditures. We believe a more accurate picture of the City's fiscal condition is obtained by examining the results of current-year operations—the difference between revenues and expenditures incurred in the current year.

In FY 2002 the City posted a current-year deficit of $2.6 billion, but last year it posted a record current-year surplus of $2.3 billion—an improvement of nearly $5 billion (see Figure 6). At the start of the current fiscal year, the City was on track to end the year with a current-year deficit of $2.6 billion because the FY 2007 budget relied so heavily on last year's surplus. Based on the revisions in the November Plan, the deficit has been reduced to $684 million. While the deficit is likely to turn to surplus as the year progresses, it is unlikely to match last year's record level.

Revenue and Expenditure Trends

Reflecting the continued strength in the local economy, the City has raised its tax revenue forecast by $2.2 billion in FY 2007, $2 billion in FY 2008, and about $1.5 billion in each of fiscal years 2009 and 2010 (see Figure 8). These revisions exceed last year's record first-quarter revisions. The positive impact was mitigated by an increase in the reserve for collective bargaining, based on the July 2006 agreement with District Council 37; a shortfall in anticipated education aid; and higher debt service costs (see "Expenditure Trends" for further discussion).

As a result, the November Plan projects a budget surplus of $1.9 billion in FY 2007, which the City intends to transfer to FY 2008. The transfer, coupled with an expectation of higher recurring revenues, has reduced the projected FY 2008 gap

Figure 8
Financial Plan Reconciliation
July 2006 Plan vs. November 2006 Plan
(in millions)

		Better/(Worse)		
	FY 2007	**FY 2008**	**FY 2009**	**FY 2010**
Surplus/(Gaps) Per July 2006 Plan	**- - -**	**$ (3,810)**	**$ (4,584)**	**$ (4,069)**
Revenue Changes				
Real Estate Transaction Taxes	$ 812	$ 559	$ 476	$ 462
Business Taxes	739	605	550	573
Personal Income Tax	382	492	163	186
All Other Taxes	294	298	281	308
Subtotal	**2,227**	**1,954**	**1,470**	**1,529**
Child Care Tax Credit	- - -	(42)	(43)	(44)
Non-Tax Revenues	27	(5)	(5)	(4)
Total	**2,254**	**1,907**	**1,422**	**1,481**
Expenditure Changes				
Collective Bargaining	(256)	(452)	(783)	(930)
TFA Debt Service	(113)	(227)	(284)	(272)
State Education Aid	(41)	(41)	(41)	(41)
General Obligation Debt Service	128	160	190	209
Pensions	22	24	27	29
Other Agency Expenses	(48)	(17)	(15)	(15)
Total	**(308)**	**(553)**	**(906)**	**(1,020)**
Net Change During FY 2007	**$ 1,946**	**$ 1,354**	**$ 516**	**$ 461**
Surplus Transfer	**(1,946)**	**1,946**		
Surplus/(Gaps) Per November 2006 Plan	**$ - - -**	**$ (510)**	**$ (4,068)**	**$ (3,608)**

Sources: NYC Office of Management and Budget; OSDC analysis

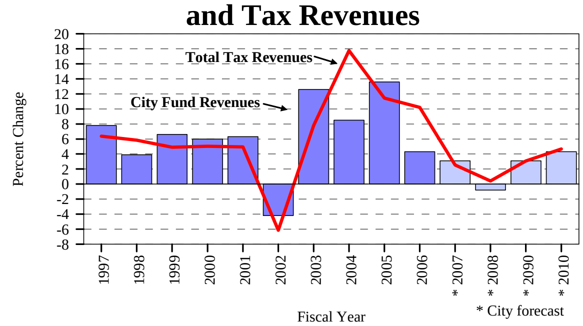
from $3.8 billion to $510 million. While the out-year budget gaps were narrowed by about $500 million, the gaps still remain substantial—at $4.1 billion in FY 2009 and $3.6 billion in FY 2010. In addition, the full impact of the recent tentative agreement with the United Federation of Teachers has not yet been included, and the City could be required to shoulder a portion of the cost of settling the Campaign for Fiscal Equity lawsuit.

Revenue Trends

The November Plan raised the forecast of City fund revenues by nearly $2.3 billion. Most of the increase comes from higher tax revenues from real estate transactions ($812 million), business taxes ($739 million), and personal income taxes ($382 million). Due to this extra revenue, City fund revenues will increase by 3.1 percent in FY 2007 (see Figure 9) rather than decline by 2.9 percent as projected in the July 2006 Plan.

Nonetheless, the November Plan shows that City fund revenues will decline in FY 2008 by 0.8 percent based on the assumption of an economic slowdown, before rebounding in subsequent years. Our analysis indicates that tax revenues, particularly business taxes, are likely to be higher by $300 million in FY 2007 and by smaller amounts in subsequent years.

Figure 9
Annual Change in City Fund Revenues and Tax Revenues



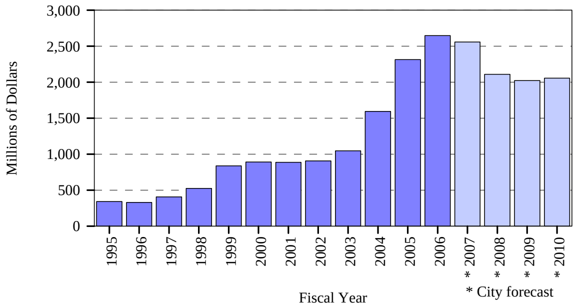
Note: Assumes implementation of the proposed tax reduction program, and adjusts for debt service on TFA and tobacco bonds and the transfer of TSASC revenues to benefit FY 2008.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

Major revenue trends include the following.

- Collections from taxes on real estate transactions are now expected to total $2.6 billion in FY 2007 and $2.1 billion in FY 2008 (see Figure 10). The projections are, respectively, $812 million and $559 million more than anticipated in the July Plan.

These estimates assume continued growth in commercial real estate and resiliency in the residential market. The November Plan forecasts only a 3.5 percent decline in collections from last year's record level, but a drop of 17.5 percent in FY 2008. The July Plan had assumed that severe downturns in both the commercial and residential real estate markets would reduce collections by 35 percent in FY 2007 and by another 11 percent in FY 2008.

Figure 10
Collections of Real Estate Transaction Taxes



Note: Collections include the mortgage recording and real property transfer taxes.
Sources: NYC Office of Managment & Budget; OSDC analysis

- Personal income tax collections are projected to reach $7.2 billion in FY 2007, which is $382 million higher than previously projected based on expectations of strong capital gains realizations and wage growth propelled by Wall Street. While the revised estimate represents a reduction of 1.3 percent from last year's level, collections would have increased by 4.2 percent if not for the expiration of the high-income surcharge. The City has proposed that the State enact a City child and dependent care credit, which would reduce personal income tax collections by about $42 million beginning in FY 2008.

- Business taxes (general corporation, banking corporation, and unincorporated business taxes) are now expected to generate $5.3 billion in FY 2007, an increase of $739 million from the July Plan estimate because corporate profits, especially for Wall Street, remain very strong. While the revised forecast for FY 2007 represents an increase of 5.5 percent compared with last year, collections are projected to remain essentially unchanged over the next three years before resuming modest growth in FY 2010.

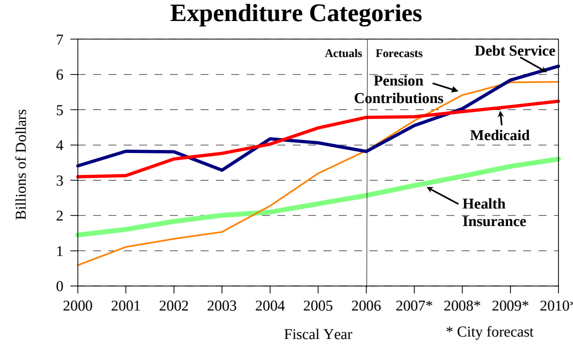
  The revised business tax forecast also includes a $250 million increase in business tax audit expectations in FY 2007, and increases of $50 million annually in fiscal years 2008 through 2010. The FY 2007 increase reflects the receipt of two very large general corporation tax audits—FY 2007 audit collections for this tax total $516 million through October 2006, compared to $359 million in all of FY 2006.

- Real property tax collections are projected to total $13 billion in FY 2007—an increase of 4 percent over last year's level—and then to increase at a steady rate of about 4.8 percent in subsequent years (assuming that the proposed extension of the current real property tax rebate program, valued at $256 million annually, is approved). These estimates reflect expectations of continued growth in assessed values. Even if real property values were to decline during the financial plan period, the impact would be minimized by provisions in State law, such as those that phase in changes in property values over a five-year period.

Expenditure Trends

FY 2007 expenditures are projected to grow by 8.7 percent, or $3.3 billion, over the FY 2006 level. The growth is driven by higher spending for debt service, pension contributions, actual and anticipated collective bargaining costs, and health insurance costs (see Figure 11). Between fiscal years 2008 and 2010, expenditures are projected to increase at an average annual rate of 4.2 percent. In contrast to prior years, Medicaid is no longer expected to be a major factor behind the growth in spending because the State capped the growth in the local share of Medicaid at 3 percent per year.

Figure 11
Trends in Selected City-Funded Expenditure Categories



Note: Adjusted for surplus transfers. Medicaid includes the City's Medicaid payments to HHC.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

Major expenditure trends include the following.

- Salaries and wages are projected to rise at an average annual rate of 5.4 percent between fiscal years 2006 and 2009, reflecting the cost of actual and anticipated labor agreements.

- Overtime spending in the uniformed agencies is now expected to reach $631 million in FY 2007—$60 million more than in the July Plan. While spending could be higher by $118 million, the budgetary impact could be offset by reserves and federal and State grants. Overtime spending is expected to decline in subsequent years, but we believe overtime will remain at current levels, which would increase future costs by $75 million annually.

- Debt service[1] is projected to reach $4.6 billion in FY 2007—an increase of 19 percent over last year's level—and then rise at an annual average rate of 11 percent through the remainder of the financial plan period. Our analysis indicates that debt service costs could be lower by $85 million in FY 2007, $50 million in FY 2008, and $25 million in FY 2009, and then higher by $35 million in FY 2010, based on the current issuance schedule for Hudson Yards Infrastructure Corporation bonds.

- Medicaid costs, including the Health and Hospitals Corporation (HHC), will total $4.8 billion in FY 2007 and then rise by about 3 percent annually to $5.2 billion in FY 2010, reflecting State actions to contain the growth in the local share of Medicaid. Our analysis indicates that these costs could be lower by $75 million annually based on current trends.

- Pension contributions have grown rapidly since FY 2000 and are projected to reach $5.8 billion by FY 2009—nearly four times larger than the average contribution during the 1990s. The growth is primarily due to pension fund investment shortfalls experienced during fiscal years 2001 through 2003, benefit enhancements, and recent labor settlements.

- Health insurance costs are projected to rise from $2.8 billion in FY 2007 to $3.6 billion in FY 2010, at an average annual rate of 8.1 percent, reflecting anticipated increases in health insurance premiums.

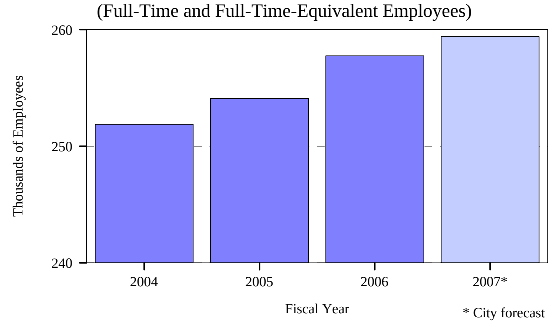
- Judgments and claims (including those related to HHC) are projected to increase by 20 percent, or $99 million, to total $602 million in FY 2007, and then grow at an average annual rate of 7.5 percent during the remainder of the financial plan period. The November Plan assumes that the City will not incur any liability arising from the cleanup of the World Trade Center site. The City expects that such claims will be covered by its captive insurance company, but at this time it is impossible to determine whether the $1 billion insurance fund will be sufficient.

The City-funded workforce (both full-time and full-time equivalents) grew by 5,870 employees between fiscal years 2004 and 2006 (see Figure 12). Most of the increase has been concentrated in the Department of Education and the Parks and Police departments (civilians only).

Figure 12

City-Funded Workforce

(Full-Time and Full-Time-Equivalent Employees)



Sources: New York City Office of Management & Budget; OSDC analysis

The City-funded workforce is projected to grow by 1,646 employees during FY 2007, with most of the planned additions in social services agencies. The mayoral agencies, however, were below planned levels for September 2006 by 1,793 employees, mostly in the Department of Social Services and in civilian employees in the Police Department. The social services agencies are unlikely to fill all 1,000 of their vacancies, and this could generate City-funded savings of $25 million in FY 2007.

[1] These estimates include debt service on general obligation bonds and bonds issued by the TFA and TSASC.

Other Developments

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

Collective Bargaining

After protracted delays and sometimes contentious negotiations, in October 2005 the City concluded the 2002-2005 round of collective bargaining with its largest unions. While the agreements provided for substantial wage increases, the City obtained productivity improvements and other savings that helped fund the costs of the agreements. In the case of the Patrolmen's Benevolent Association (PBA) and the United Federation of Teachers (UFT), however, the City was unable to reach agreements without the involvement of the State Public Employment Relations Board (PERB).

In July 2006, the City reached an agreement with District Council 37 that provides for wage increases of 10 percent over a 32-month period ending March 2, 2008. In addition, the City recently reached a tentative agreement with the UFT—nearly one year before the current agreement expires—that provides for wage increases of 7 percent over a two-year period ending in October 2009.

The UFT agreement would increase starting salaries for new teachers to more than $45,500 by May 2008, and would lift top salaries over $100,000. According to the UFT president, after the implementation of the new agreement, teachers' salaries will have increased by more than 40 percent between 2002 and 2009, making salaries more competitive with surrounding suburban school districts.

The City has not reached a new agreement with the PBA, despite mediation by the PERB. The City maintains that recent agreements with other uniformed employees should set the pattern for the PBA agreement. For example, last fall's agreement with the Uniformed Firefighters Association provides for wage increases of 6.15 percent over a 26-month period. The PBA, however, is seeking larger wage increases. It seems likely that the PERB will settle the dispute through binding arbitration—just as with the last agreement, which called for wage increases of 10 percent over a two-year period, but offset those costs through productivity and other cost-saving actions, such as a reduction in starting salaries.

The full budgetary impact of the tentative UFT agreement has not yet been reflected in the City's financial plan. The agreement, which has a cumulative cost of $1.3 billion during the financial plan period, could increase costs beyond the amounts in the City's labor reserve by $70 million in FY 2007, $60 million in FY 2008, $100 million in FY 2009, and $85 million in FY 2010 if it is ratified as expected. Although the agreements with District Council 37 and the UFT do not include productivity savings, the City hopes to conduct separate negotiations with the Municipal Labor Committee, the umbrella group for the City's unions, to lower the City's health insurance costs.

The City's financial plan assumes that wages will increase annually by 1.25 percent after the expiration of current or tentative agreements, or in cases where the City believes a pattern has been set by another union. Wage increases at the projected inflation rate during these years would increase costs by $40 million in FY 2008, $180 million in FY 2009, and $400 million in FY 2010.

Campaign for Fiscal Equity Litigation

After 13 years of litigation, the *Campaign for Fiscal Equity v. State of New York* lawsuit remains unresolved. Beginning in 2001, the courts have consistently ruled that the State's system of education finance is unconstitutional and have ordered the State to ensure that the City's public schools receive sufficient resources to provide a sound basic education.

In March 2006, the Appellate Division ruled in favor of the plaintiffs and ordered the State to take steps to ensure that the City's schools receive an operating aid increase, phased in over five years, of between $4.7 billion and $5.6 billion, as well as $9.2 billion in capital funds. The ruling was appealed, and on November 20, 2006, the Court of Appeals concluded that a minimum increase in operating aid of $1.93 billion, in 2004 dollars and with appropriate adjustments, was reasonable. The court, however, left it to the legislative process to determine the actual increase in operating aid to the City's schools. Previously, the Governor had proposed that the City receive additional funding of $4.7 billion over five years.

Shortly after the Appellate Division ruling, the State and the City reached an agreement that provides $11.2 billion in capital funding for school construction projects, in two ways. The State authorized the Dormitory Authority of the State of New York to provide the City's public school system with $1.8 billion in capital grants. Also, the State authorized the TFA to issue up to $9.4 billion in bonds backed by State building aid in support of the Department of Education's current $13.1 billion five-year capital program.

The Governor-elect has stated his readiness to settle the litigation, as well as his belief that the City should fund between 30 percent and 50 percent of the increased contribution to the operating budget. The Mayor believes the City has done enough, and has pointed out that since FY 2002, the base year upon which the proposed higher contributions are based, the City has increased its contribution to the department by nearly $3.4 billion. (The State has increased its contribution by $1.5 billion during this period.)

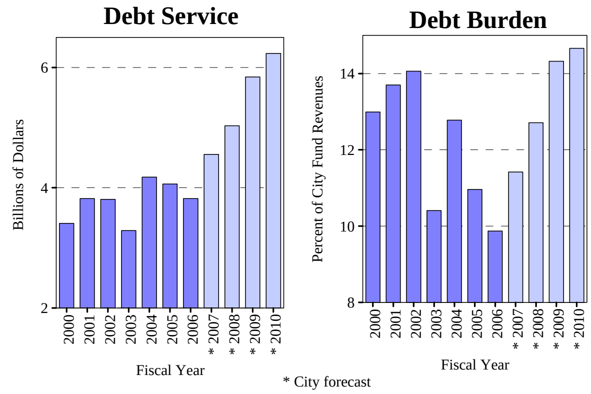
In the past, we have attempted to calculate the potential impact that any settlement could have on the City's budget. At this time, however, the terms of a settlement are under discussion and too many variables remain undetermined—including the amount, if any, of the City's contribution, and whether the City would receive credits for its increases since 2002—to provide a useful calculation. In addition, the budgetary impact of any settlement could be mitigated by the fact that the City's financial plan already contemplates modest increases in City-funded education aid over the next few years, and the City could be credited with the cost of funding the recent tentative agreement with the UFT.

Rising Debt Burden

Debt service that is funded directly through the City's operating budget, or with funds that would have otherwise benefited the City's operating budget, is projected to rise from $3.8 billion in FY 2006 to $6.2 billion in FY 2010 (see Figure 13)—an increase of 63 percent during the financial plan period, or 6.5 times the expected rate of inflation.

Debt service will increase at an annual average rate of 13 percent during fiscal years 2007 through 2010—six times the rate of growth of City fund revenues. Thus, debt service will consume an increasing share of City fund revenues: from 9.9 percent in FY 2006 to 14.7 percent by FY 2010. Nevertheless, the City's credit rating remains at its highest level ever.

Figure 13



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

Although the capital program appears affordable in the current economic environment, it could limit the City's options during an economic slowdown or contraction. The City's budget director has asked the agencies (excluding the Department of Education) to explore the impact of stretching the current four-year program across five years—an effective reduction of 25 percent. Although the amount of savings from such an action would be small during the first few years, the cumulative impact would accelerate with each passing year. Over a ten-year period, the City would realize cumulative savings of $2.2 billion.

Federal Medicaid Audit

The federal Office of the Inspector General (OIG) of the Department of Health and Human Services is conducting six audits of Medicaid reimbursement for services provided to schoolchildren in New York State. The audits cover calendar years 1990 through 2001 and entail $1.4 billion in claims.

So far, the OIG has completed four audits and has found that many of the claims submitted by school districts in New York State were not sufficiently documented. For New York City, the OIG is recommending disallowances of $436 million for speech therapy and another $96 million for transportation services—a total of $531 million. (The OIG recommended $379 million in disallowances for upstate school districts that provided these services.) The two remaining audits have not been completed, but the City could face additional disallowances of up to $259 million.

The State and the City disagree with the OIG's recommendations and have raised objections based on policy and law. The State has indicated that it will appeal if the OIG does not withdraw its recommendations. In the interim, the City has stopped claiming federal Medicaid reimbursement for the services in question, which increased City costs by $86 million annually. In addition, the City made a $542 million contribution to its reserve for disallowance last year, and thus raised the total reserve to $899 million—more than enough to cover the potential liability.

Federal Work Participation Rates

Beginning in October 2006, the federal government no longer credits states for reductions in their public assistance caseloads since federal fiscal year (FFY) 1995 when calculating mandated work participation rates for welfare recipients. Instead, the base year is now FFY 2005.

In August 2006 the City's work participation rate was 43 percent, which was below the federally mandated rate of 50 percent. In addition, participation rates could decline because of federal regulations, which became effective in October 2006, that reduce the types of allowable work activities.

According to the Commissioner of the Human Resources Administration, the City could incur penalties of up to $130 million. (The City Council estimates the potential risk at $300 million.) Before any penalties would be imposed, however, the State and the City would have an opportunity to implement a corrective action plan.

Post-Employment Benefits

New accounting rules require governmental entities to calculate and disclose their current and future obligations for post-employment benefits other than pensions in a manner that is similar to their accounting for pension obligations. These other post-employment benefits (OPEBs) include health insurance, supplemental welfare benefits, and Medicare Part B, all of which the City currently funds on a pay-as-you-go basis.

Using the Frozen Entry Age Actuarial Cost Method, the City estimates that the annual required contribution (ARC) for FY 2006 was $55.7 billion. This estimate is based on a number of assumptions, including a one-year amortization period and an annual discount rate of 4 percent.

The ARC is comprised of two components: the unfunded actuarial accrued liability (UAAL), and the normal cost. As of June 30, 2005, the date of the initial actuarial valuation, the City estimated its UAAL at $50.5 billion. The normal cost, which represents the portion of the actuarial cost of projected benefits allocated to the current year, was estimated at $3 billion. In addition, the City incurred interest costs of $2.1 billion.

In FY 2006 the City made payments of $2.2 billion, representing its contribution to the Retiree Health Benefits Trust Fund and the cost of the benefits on a pay-as-you-go basis, and thus its OPEB obligation at the end of the year totaled $53.5 billion.

The new accounting rules do not require governmental entities to fund these liabilities on an actuarial basis, but the credit rating agencies, when determining their ratings, will consider the size of these liabilities and how they are addressed. New York City is required to comply with these requirements in its FY 2008 financial statements, but met the standard two years earlier.

Retiree Health Benefits Trust Fund

In FY 2006, the City created a Retiree Health Benefits Trust Fund and contributed $1 billion to help pay down unfunded accrued liabilities, and the November Plan assumes the City will contribute an additional $1 billion in FY 2007. The combined $2 billion contribution would be invested, and the principal and interest dedicated to retiree health benefits. In addition, the November Plan assumes that the City will annually contribute an amount equal to the projected cost on a pay-as-you-go basis, which is expected to grow from $1.4 billion in FY 2007 to $1.8 billion by FY 2010.

According to the local law establishing the trust fund, the City's annual liability for retiree health and welfare benefits will be paid for by the fund. During the annual budget adoption process the City will determine how much will be paid into the trust from current revenues. Thus, the City could forgo all or part of its planned contribution to the trust fund to the extent that funds are available, and could thereby free up resources for other purposes. In this manner the trust fund could also serve as a rainy-day fund, although that is not its intended purpose. Alternatively, the City could choose to make higher-than-planned contributions and further pay down the unfunded liability.

IRS Refund

On November 8, 2006, the Internal Revenue Service (IRS) announced a settlement that will refund $140 million to 73,000 uniformed workers who were injured in the line of duty and wrongly forced to pay Social Security and Medicare taxes on disability pay for a period of six months or less from 1989 to 2005. The IRS will refund the City an additional $140 million in FY 2008 because the City paid the employer's share of these taxes.

The settlement came more than three years after the City sued the IRS, arguing that the payments were tax-exempt, like workers' compensation payments. Earlier this year, the IRS promulgated new regulations adopting the City's position.

Employees will be unable to obtain refunds directly from the IRS. Instead, the City will claim the employees' share of the refund, but only for those who submit signed consent forms. The City's Office of Payroll Administration will contact all affected employees with details on how to collect their refunds.

City-Related Public Authorities

The following public authorities have a financial relationship with the City that could affect the City's finances during the financial plan period.

New York City Housing Authority

In February 2006, the New York City Housing Authority (NYCHA) projected a $182 million budget gap for calendar year 2006 and similar gaps for subsequent years. The NYCHA is relying on $100 million in transitional assistance from the City to balance its 2006 budget and ease the burden on residents as other actions that will generate recurring benefits are implemented. These actions include raising rents for higher-income tenants, applying for federal grants, and other management actions.

The NYCHA gap-closing program, however, has encountered delays and is now projected to fall short of its target by $20 million in 2006. In addition, the NYCHA has identified $31 million in new spending needs, such as higher collective bargaining costs. Moreover, the NYCHA has not received federal approval for actions that are valued at $44 million in 2006 and at even more in subsequent years, which puts these resources at risk as well.

With fewer than two months remaining in its fiscal year, the NYCHA is relying on actions that would produce short-term savings rather than implementing actions that would generate recurring benefits. If these actions prove insufficient, the NYCHA has indicated that it would draw down its reserves, which currently total $300 million—the minimum level allowed by the federal government.

Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) projects annual budget gaps, on an accrual basis, which approach $1 billion during fiscal years 2007 through 2010. While HHC will balance the FY 2007 budget on a cash basis, its cash reserves could be exhausted during the financial plan period unless it reduces costs or receives additional reimbursement for services provided to the uninsured. Last year, the State and the City worked together to facilitate a large one-time federal Medicaid enhancement. It is likely that HHC will have to implement similar actions in the future to maintain budget balance.

The New York State Commission on Health Care Facilities in the 21st Century released its recommendations to improve the health care system in New York State. The commission recommended 9 facilities for closure and 48 for reconfiguration to provide more preventive and primary care services. The recommendations will go into effect unless all are rejected by the Governor and the State Legislature. The commission also suggested that the State undertake a comprehensive review of medical reimbursement policies, but it did not make specific recommendations. None of the facilities targeted for closure or reconfiguration are operated by HHC, but it could be affected by other reforms adopted by the State to reduce Medicaid expenditures or to reform health care systems.

Off-Track Betting Corporation

For the past two years, the New York City Off-Track Betting Corporation (OTB) has experienced serious fiscal stress stemming from its statutorily mandated distributions to the City, State, and racing industry; as well as rising expenses. To deal with these financial pressures, the OTB has taken a number of steps, such as delaying payments and implementing cost reductions.

As of October 2006, the OTB had $18 million in cash, which officials believe will be enough to sustain operations in FY 2007. Two issues could have a significant impact on the OTB's operations: the reopening of the Yonkers Raceway, an OTB competitor that was renovated to include video lottery terminals (VLTs); and the sale of the State's racing franchise.

Partly as a result of the temporary closure of the Yonkers Raceway, the OTB experienced its largest "handle" (i.e., total bets received) in FY 2006. In October 2006, the Yonkers Raceway reopened with improved facilities and the new VLTs. Also, the New York Racing Association's contract to operate the State's racing franchise (the Aqueduct, Belmont Park, and Saratoga racetracks) will expire on December 31, 2007. In an effort to improve the racing industry, the State has opened up the bidding process. The winning bid, which could include an option to merge with OTB operations, will be awarded in 2007.

West Side Development

On September 27, 2006, the Governor, the Mayor, and the Metropolitan Transportation Authority (MTA) announced an agreement to facilitate the development of the Western Rail Yard in Manhattan. Under the agreement, the MTA will receive all sale or lease proceeds from development of the site, which must adhere to City planning guidelines and the Uniform Land Use Review Process. The Hudson Yards Infrastructure Corporation (HYIC), a local development corporation, will purchase a 50 percent interest in the development rights over the Eastern Rail Yard from the MTA, for $200 million.

As part of this agreement, the MTA will construct the extension of the No. 7 subway line, which will be funded through the issuance of $2 billion in bonds by the HYIC. The City will also fund cost overruns of up to $100 million for real estate and condemnation costs; it is unclear who would be liable for any overruns in excess of this amount.

In total, the HYIC will issue $3 billion in bonds to finance the subway extension and other improvements. These bonds will be backed primarily by payments-in-lieu-of-taxes (PILOTs) assessed on new development within the Hudson Yards Special District. Although the HYIC is expected to incur debt service beginning in 2007, the development is not projected to generate sufficient revenues to cover the interest costs until at least 2015. The City Council has expressed its support of a City undertaking to pay, subject to annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. The City estimates the interest costs at nearly $1 billion through 2015, but the interest subsidy could total about $6 billion if no development occurs. Repayment of the principal would begin after the project generates sufficient revenues to cover interest costs.

Lower Manhattan Redevelopment

The Lower Manhattan Development Corporation, the joint State-City agency created in 2001 to oversee the rebuilding of the World Trade Center (WTC) and the revitalization of Lower Manhattan, announced in August 2006 that it would be closing most of its operations over the next few months. Although detailed transition plans have not been issued, oversight of the rebuilding is expected to be transferred to City and State entities.

In April 2006, the Port Authority of New York and New Jersey, the Governor, the Mayor, and Silverstein Properties, the leaseholder of the WTC site, reached an agreement over each entity's responsibilities at the site. Under this agreement, the Port Authority is responsible for the construction of the Freedom Tower and Tower 5, and Silverstein is responsible for the three remaining buildings.

As part of the agreement, the completion date for the project was moved up to 2012 (three years earlier than originally planned). If Tower 5 is developed as a residential building, the total amount of commercial space will be reduced from 10 million square feet to 8.8 million square feet. In addition, the remaining Liberty Bonds were divided between the Port Authority ($702 million for the Freedom Tower) and Silverstein ($2.6 billion to finance the three additional commercial towers on the site).

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