Review of the Financial Plan of the City of New York

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- **Inflation has risen to levels not seen since the early 1990s, reaching 4.1 percent during the first four months of calendar year 2005. Oil prices, high consumer and business debt levels, and widening federal budget and trade deficits are also causes for concern.**
- **City-funded spending is projected to grow by 7.4 percent in FY 2006, but Medicaid, debt service, pensions, and health insurance are projected to increase by 12 percent.**
- **The adopted State budget will provide the City with $317 million in gap-closing assistance and an additional $323 million in education aid in FY 2006.**
- **Actions taken by the State since August 2004 will reduce annual City-funded Medicaid costs by $1 billion by FY 2009.**
- **Medicaid, debt service, pensions, and health insurance will consume more than half of City fund revenues in FY 2009, despite a slowdown in the growth of Medicaid and pension contributions.**
- **The financial plan does not reflect changes in methods proposed by the City Actuary that, if approved, would reduce pension contributions by $1.3 billion over a three-year period, but would increase future costs.**
- **Tax revenues could be higher by $700 million and failure to obtain State approval to reinstate the sales tax exemption on clothing purchases would yield another $400 million.**
- **Wage increases at the inflation rate for uniformed employees and teachers for the 2002-2005 contract period would cost about $1 billion more than the City set aside through FY 2005, and an additional $900 million annually thereafter.**
- **Wage increases at the projected inflation rate for all employees in the next contract period would exceed the City's reserve in 2006 through 2009 by $180 million, $510 million, $800 million, and $1.1 billion, respectively.**

The City has managed its budget well since the attack on the World Trade Center, and the economy continues to improve. We are concerned, however, about whether the recovery can be sustained throughout the financial plan period.

The City projects a record surplus of $3.3 billion for FY 2005 because of a surge in tax revenues. The City plans to use the entire surplus to balance the FY 2006 budget even though it projects a $4.5 billion budget gap for FY 2007. While the City is on track to develop a surplus next year, a number of unresolved issues could affect its size and widen the out-year gaps.

The largest near-term budget risk is the completion of the current round of collective bargaining. The City has yet to reach new labor agreements with its uniformed employees or its teachers. It has set aside resources to fund wage increases at the District Council 37 pattern, but these employees are seeking larger increases.

The out-year budget gaps have grown in the past year, in part because the City has begun to set aside resources to help fund the next round of collective bargaining. Although the level of risk has been reduced, the City still faces a potentially large liability. In addition, any resolution of the Campaign for Fiscal Equity lawsuit could require an increase in City funding for education.

Our review has identified potential resources that could contribute to a FY 2006 surplus and narrow the FY 2007 budget gap. For example, the financial plan does not include any savings from changes in actuarial methods proposed by the City Actuary—only the costs of revised assumptions. Also, the State may not approve the Mayor's proposal to reinstate the sales tax exemption on clothing purchases. Finally, tax revenues are likely to be higher than forecast. Even if these resources materialize, the City will have to take additional actions to help balance the FY 2007 budget.

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

	Better/(Worse)				
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**
Gaps per May 2005 Plan	**$ - - -**	**$ - - -**	**$ (4,473)**	**$ (4,236)**	**$ (3,703)**
Tax Revenues	100	400	200	- - -	- - -
Federal Actions	- - -	(50)	- - -	- - -	- - -
Uniformed Agency Overtime	- - -	(50)	(50)	(50)	(50)
OSDC Risk Assessment	**$ 100**	**$ 300**	**$ 150**	**$ (50)**	**$ (50)**
Gaps to be Closed[1]	**$ 100**	**$ 300**	**$ (4,323)**	**$ (4,286)**	**$ (3,753)**

[1] The City has a general reserve of $40 million in FY 2005 and $300 million annually in subsequent years.

Economic Overview

New York City's economic expectations have softened since February 2005. In general, inflation and interest rates are now projected to be higher throughout the financial plan period, while economic growth is projected to be lower, most notably in calendar years 2006 and 2007.

The City now projects a modest slowdown in the national economy in calendar year 2005, but greater deterioration after that. The Federal Reserve is expected to successfully ward off the risk of higher inflation by slowly and steadily raising interest rates. As a result, the pace of inflation is projected to increase in 2005 but then slow in 2006. National employment is also projected to accelerate in 2005 and then slow in the following years.

Although Wall Street profits eased in calendar year 2004, the City expects that increased activity in underwriting and mergers and acquisitions will help boost profits in 2005. Higher interest rates, however, are expected to lower profits in 2007.

Wall Street added 3,200 jobs in 2004, and the City expects Wall Street to add another 3,400 jobs in 2005. Strong year-end Wall Street bonuses fueled a rebound in wage growth in the City in 2004, but growth is expected to ease in the years that follow as the economy slows.

Monthly employment data for early 2005 show job gains in most industries, although total gains have slowed since January. The City projects that employment will increase by nearly 40,000 jobs in 2005, but expects a slowdown by 2007.

Local inflation has risen to annualized rates not seen since the early 1990s, reaching 4.1 percent during the first four months of 2005. While higher energy costs have affected both national and local inflation rates, core inflation—i.e., inflation on all items except food and energy—was 1.3 percentage points higher in the City than in the nation during this period. Despite the relatively high inflation rate so far this year, the City forecasts that local inflation will average 3 percent for the year before falling to 2.4 percent in 2006.

The economic risks to the City's Financial Plan have not changed much since February. Inflation and interest rates are two major factors that will continue to determine whether economic growth can be sustained. Other risks include high oil prices, high consumer and business debt levels, widening federal budget and trade deficits, and the declining value of the dollar.

Fiscal Year 2005

For a second consecutive year, the City has benefited from an unexpected surge in tax revenues. In particular, real estate–related tax revenues were $1.2 billion, or 81.6 percent, higher than projected in June 2004, and personal income and business tax revenues were higher by $1.5 billon. Although spending in FY 2005 now exceeds the June 2004 estimates by $470 million, agency actions will more than offset the potential budgetary impact. Consequently, the City did not need to draw upon its reserves.

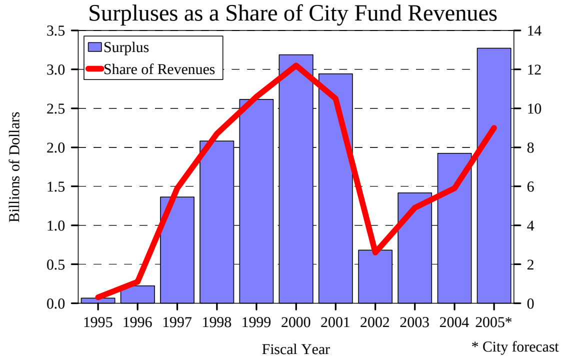
The net result is that FY 2005 will end with a surplus of nearly $3.3 billion (see Table 2), and these resources will be used to help balance the FY 2006 budget. While the budget gap projected for FY 2006 is essentially unchanged from the June 2004 forecast, the gaps for fiscal years 2007 and 2008 are substantially larger.

Table 2
Financial Plan Reconciliation
June 2004 Plan vs. May 2005 Plan
(in millions)

	Better/(Worse)			
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**
Surplus/(Gaps) per June 2004 Plan (Restated)	**$ 220**	**$ (3,894)**	**$ (4,522)**	**$ (3,681)**
Revenues				
Real Property Tax	$ (48)	$ 313	$ 504	$ 647
Real Estate–Related Taxes	1,185	263	166	74
Personal Income Tax	929	507	354	134
Business Taxes	566	392	411	281
All Other Taxes	248	174	177	102
Subtotal	**2,880**	**1,649**	**1,612**	**1,238**
Anticipated State Aid	(201)	(196)	(94)	(77)
Anticipated Federal Aid	(50)	- - -	- - -	- - -
TSASC	(120)	120	(2)	(2)
Battery Park City	(150)	- - -	- - -	- - -
Other	194	100	50	44
Total	**2,553**	**1,673**	**1,566**	**1,203**
Expenditures				
Medicaid*	(184)	(334)	(508)	(699)
Department of Education	(147)	(105)	(110)	(110)
Energy Costs	(55)	(113)	(127)	(110)
Agency Needs	(14)	(365)	(175)	(204)
Collective Bargaining	(95)	(187)	(437)	(713)
Uniformed Agency Overtime	(125)	12	(9)	(9)
Pension Contributions	(7)	(648)	(496)	(400)
Fringe Benefits	34	(69)	(29)	(32)
City Debt Service	129	113	(48)	(86)
Hudson Yards Debt Service	(6)	(46)	(95)	(139)
Total	**(470)**	**(1,742)**	**(2,034)**	**(2,502)**
Reserves				
Prior-Year Expenses	200	- - -	- - -	- - -
General Reserve	260	- - -	- - -	- - -
Total	**460**	- - -	- - -	- - -
Agency Actions	**508**	- - -	- - -	- - -
Net Change During FY 2005	**$ 3,051**	**$ (69)**	**$ (468)**	**$ (1,299)**
Surplus/(Gaps) per May 2005 Plan	**$ 3,271**	**$ (3,963)**	**$ (4,990)**	**$ (4,980)**

* State actions to slow the growth in Medicaid are reflected in the City's gap-closing program.
Sources: NYC Office of Management and Budget; OSDC analysis

Graph 1
City Budget Surpluses
Surpluses as a Share of City Fund Revenues



Sources: NYC Office of Management and Budget; OSDC analysis

The FY 2005 surplus is the largest on record (see Graph 1), although as a percent of City fund revenues it is smaller than the level reached in FY 2000 (9 percent in FY 2005 compared to 12.2 percent in FY 2000). The May 2005 Plan shows that all of the surplus will be consumed in FY 2006—no resources will be transferred into FY 2007 to help close that year's budget gap.

Revenue Reestimates

Tax revenues are projected to exceed the June 2004 estimates by nearly $2.9 billion in FY 2005. The City also raised its revenue forecasts for fiscal years 2006 and 2007 by about $1.6 billion each year, and by $1.2 billion in FY 2008.

More than 40 percent ($1.2 billion) of the additional revenue forecast for FY 2005 comes from higher-than-expected revenues from real estate transactions. Although the Federal Reserve has been increasing short-term interest rates for almost a year, long-term rates have not really responded—the rate on the ten-year Treasury bond has actually fallen since June 2004—and mortgage rates remain near last year's levels. Refinancings have tapered off, but purchase activity remains strong, so the expected sharp drop in transaction activity has yet to occur.

While tax collections from real estate transactions are now expected to drop sharply in FY 2006, a 12 percent increase in property values[1] will significantly increase real property tax revenues during fiscal years 2006 through 2008 compared to the estimates made in June 2004.

Personal income tax collections are expected to exceed the June 2004 estimates for FY 2005 by $929 million. The additional revenue comes mostly from higher-than-expected wage growth and, more importantly, from a surge in year-end final and extension payments. Business tax collections will exceed the June 2004 estimates by $566 million in response to local economic performance that was better than anticipated.

Last year, the State budget was adopted in August 2004, too late to be reflected in the City's adopted budget for 2005. The June 2004 Financial Plan assumed that State actions would benefit the City by $400 million in FY 2005, but the budget that was eventually approved by the State provided the City with gap-closing assistance of $199 million, or $201 million less than anticipated. (Most of the assistance came from a postponement of the reinstatement of the sales tax exemption for clothing, and a phased takeover of the Family Health Plus program.) The City also did not realize an additional $50 million in expected federal aid.

Tobacco settlement revenues are now projected to be lower by $120 million in FY 2005 because a downgrade of tobacco manufacturers' investment ratings required TSASC to increase its reserves for the protection of its bondholders. The City expects to recoup these resources in FY 2006 through actions that are still unspecified. Finally, the receipt of $150 million from the sale of property to the Battery Park City Authority has been removed from the May 2005 Plan. Although no obstacles stand in the way of completing this transaction, a new date for this transaction has not yet been set.

Expenditure Reestimates

While expenditures are now projected to exceed the estimates in the June 2004 Plan by $470 million in FY 2005, this impact will be offset with savings from agency actions. Expenditures during fiscal years 2006 through 2008 are projected to exceed the June 2004 estimates by $1.7 billion, $2 billion, and $2.5 billion, respectively. Although the impact in FY 2006 should be mostly offset by higher-than-anticipated revenues, the unexpected spending caused the budget gaps to widen by $468 million in FY 2007 and by $1.3 billion in FY 2008.

Medicaid is expected to cost $1.7 billion more during fiscal years 2005 through 2008 than projected in June 2004. These estimates did not anticipate the cost-containment and other actions taken by the State that will reduce the City's costs. The benefits of such State actions are reflected in the City's gap-closing program and are discussed later in this report.

While pension contributions are essentially unchanged for FY 2005, the City's projections grew by $648 million for FY 2006, $496 million for FY 2007, and $400 million for FY 2008. The higher estimates reflect the recommendations of an independent actuarial consultant who assessed the pension funds pursuant to a biennial review mandated by the City Charter.

In addition, the City increased its reserves for collective bargaining by $95 million in FY 2005, $187 million in FY 2006, $437 million in FY 2007, $713 million in FY 2008, and $988 million in FY 2009. Of these amounts, about $90 million would be used to fund labor agreements with social service providers and franchise bus operators beginning in FY 2005. The balance would be set aside as a reserve to help fund the next round of collective bargaining for

[1] The increase in actual assessed values is based on the preliminary real property tax roll that was released in January 2005.

City workers (the current round of collective bargaining is discussed later in this report).

Spending for education exceeded the estimates in the June 2004 Plan by more than $100 million annually, largely because of unexpected year-end overspending in FY 2004. Overtime in the uniformed agencies was $125 million higher than expected in FY 2005, with most of the overspending occurring in the police and fire departments, and other agency spending is projected to be higher by $365 million in FY 2006.

Debt service in FY 2005 will be lower than assumed in the June 2004 Plan because there is no need for short-term borrowing given the City's large cash balance. Debt service in FY 2006 is also less because of savings from bond refundings. In fiscal years 2007 and 2008, however, debt service costs will be higher than previously forecast because of increases in planned capital spending and interest costs related to developing the far West Side of Manhattan.

In FY 2005, the City drew down its $300 million general reserve by $260 million and it anticipates savings of $200 million from overestimating prior years' expenses. The City is likely to realize additional savings in the current year and at least an equal amount in FY 2006.

Balancing the FY 2006 Budget

The May 2005 Plan projects budget gaps of $4 billion for FY 2006 and about $5 billion for each of fiscal years 2007 and 2008. The City intends to narrow the FY 2006 budget gap to $700 million by transferring the FY 2005 surplus into FY 2006; it will close the remaining gap through a combination of federal, State, and City actions (see Table 3).

Table 3
Gap-Closing Program
(in millions)

	Better/(Worse) FY 2006	FY 2007	FY 2008
Gaps to be Closed	**$ (3,963)**	**$ (4,990)**	**$ (4,980)**
FY 2005 Surplus	3,271		
Agency Actions	475	318	317
State Actions	317	375	443
Federal Actions	50	- - -	- - -
Debt Service	85	1	1
Tax Reductions	(235)	(177)	(17)
Total	**$ 3,963**	**$ 517**	**$ 744**
Remaining Gaps	**$ - - -**	**$ (4,473)**	**$ (4,236)**

Sources: NYC Office of Management & Budget; OSDC analysis

The FY 2006 gap-closing program will have only a minimal effect on the out-year budget gaps because the City is relying so heavily on nonrecurring resources (i.e., the FY 2005 surplus) to balance the FY 2006 budget. Even with the implementation of the FY 2006 gap-closing program, the May 2005 Plan projects budget gaps of $4.5 billion in FY 2007, $4.2 billion in FY 2008, and $3.7 billion in FY 2009.

Agency Actions

Agency actions are expected to generate $475 million in FY 2006, but the recurring value declines to slightly more than $300 million because many actions are expected to generate only one-time savings. The largest contribution is expected from the Police Department ($131 million in FY 2006), but most of the savings would come from an overestimation of salaries and from federal reimbursement for overtime related to homeland security.

State Actions

The February 2005 Plan assumed that New York State would take actions to produce gap-closing assistance of $500 million in FY 2006, $200 million in FY 2007, and $100 million in each subsequent year. For the first time in 20 years, the State adopted its budget on time, and the impact of the adopted State budget is included in the May 2005 Plan. The City estimates that the State budget will provide $317 million in gap-closing assistance (see Table 4) and another $323 million in education aid in FY 2006. It remains to be seen whether the City will reduce services or increase City funding to offset a $121 million reduction in the State's allocation of surplus federal welfare funds beginning in FY 2006.

The value of the State gap-closing actions are projected to grow in subsequent years and reach $733 million by FY 2009. Thus, while the City received $183 million less than expected in gap-closing assistance for FY 2006, it expects to receive about $1 billion more through FY 2009 than assumed in the February 2005 Plan. The availability of these resources, however, may depend on the State's own financial condition.

Table 4
State Gap-Closing Assistance
(in millions)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Eliminate Sales Tax Exemption	$ 23	$ 230	$ 166	- - -	- - -
Medicaid Cost-Containment	- - -	76	88	88	88
Medicaid Cap	- - -	- - -	110	344	634
Other	- - -	11	11	11	11
Total	**$ 23**	**$ 317**	**$ 375**	**$ 443**	**$ 733**

Sources: NYC Office of Management and Budget; OSDC analysis

Most of the State assistance, as outlined below, comes from eliminating the sales tax exemption on clothing purchases of less than $110, imposing a cap on the local share of Medicaid, and implementing Medicaid cost-containment initiatives.

- The elimination of the sales tax exemption on clothing purchases under $110 is currently scheduled through March 31, 2007, and will generate additional revenues for the City of $23 million in FY 2005, $230 million in FY 2006, and $166 million in FY 2007. These estimates include the cost of two one-week tax-free holidays each year (when clothing purchases under $110 would be tax-exempt). The exemption would be restored one year earlier if the Governor proposes tax cuts in next year's State budget.
- Medicaid cost-containment initiatives will reduce City-funded costs by a net total of $76 million in FY 2006, and by $88 million annually thereafter. The initiatives include freezing managed care premiums, requiring prior authorization for certain drug prescriptions, and implementing a preferred drug list, benefit reductions, and a hospital tax.
- Growth in the local share of Medicaid will be capped at 3.5 percent in calendar year 2006, 3.25 percent in calendar year 2007, and 3 percent annually thereafter. While the City does not anticipate any savings from this initiative in FY 2006, it projects savings of $110 million in FY 2007, $344 million in FY 2008, and $634 million in FY 2009.

  The State budget also gives New York City (as well as other localities) the opportunity, in calendar year 2008, to exchange a portion of its sales tax and personal income tax revenues for a full State takeover of the City's Medicaid expenditures. The City Council must pass a resolution declaring the City's intent to exercise this option by September 30, 2007.

Federal Actions

The May 2005 Plan assumes that the federal government will take actions that will provide the City with a one-time benefit of $50 million in FY 2006, which is $200 million less than assumed in the February 2005 Plan. In April 2005, Congress agreed on a federal budget plan that would cut Medicaid by $10 billion and the Food Stamp program by $600 million over five years nationwide. The impact on New York State and New York City has yet to be determined.

Tax Reduction Program

In addition to the real property tax rebate program enacted last year, the Mayor has proposed a new tax reduction program valued at $235 million in FY 2006, but which declines in value to $38 million by FY 2009. The Mayor's program must be approved by both the City Council and the State Legislature. The proposed program includes the following components.

- Reinstatement of the sales tax exemption on clothing purchases priced at less than $110, effective June 1, 2005. The recent State budget delays reinstatement until April 1, 2007, and an earlier reinstatement would reduce City tax revenues by $23 million in FY 2005, $230 million in FY 2006, and $166 million in FY 2007. As the State just eliminated the exemption for FY 2006, it seems unlikely that it would approve the Mayor's proposal.
- Other elements of the proposed tax reduction program would provide property tax relief for renovations and senior citizens, and would change the income allocation methods for the

unincorporated business tax. Collectively, these items are valued at $5 million in FY 2006, rising to $38 million in FY 2009.

Debt Service

The gap-closing program includes $85 million in debt service savings in FY 2006—from two bond refundings valued at $52 million, and the "calling" of certain other bonds that allowed the City to free up $33 million held in an escrow account.

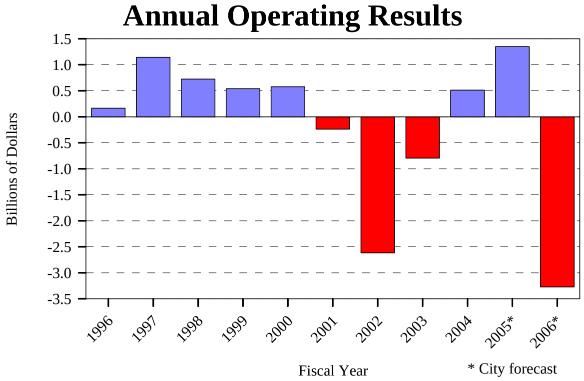
Revenue and Expenditure Trends

City-funded expenditures (adjusted for surplus transfers) rose by 22 percent between fiscal years 1996 and 2000—far faster than the local inflation rate. 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.

While expenditures continued their rapid growth in FY 2001—increasing by 9.8 percent—revenues grew more slowly, by only 6.5 percent. Consequently, expenditures exceeded revenues by more than $200 million in FY 2001—a clear sign of fiscal stress (see Graph 2), which was masked by the City's practice of transferring the prior year's surplus to the following year.

Graph 2

Annual Operating Results



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

The FY 2002 budget did not address the imbalance, and instead called for spending to increase by 5.7 percent. The budgetary impacts of the economic slowdown and the attack on the World Trade Center, however, resulted in a decline in revenues—the first 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 bond proceeds from the Transitional Finance Authority (TFA). In the absence of these resources, the City would have incurred a deficit of $2.6 billion from current-year operations.

The City was on course in November 2002 to incur an operating deficit of $3.5 billion in FY 2003, but it narrowed the deficit to $795 million after enacting a mid-year property tax hike and taking other actions that generated recurring benefits. The operating deficit was more than offset with $1.5 billion in bond proceeds (i.e., deficit financing) from the TFA to cover revenue losses related to the World Trade Center attack.

The City ended FY 2004 with a current-year operating surplus of $511 million—the first such surplus since FY 2000. The surplus reflected a combination of City, State, and federal actions taken to help the City through its fiscal crisis, and also a sharp rebound on Wall Street. Budget balance in FY 2004 was also aided through the use of $1.2 billion in nonrecurring resources.

The City is on course to generate a current year surplus of $1.3 billion in FY 2005, an estimate that excludes some $2 billion in resources that were transferred from prior years. Although spending is projected to grow at a relatively fast rate of 8.3 percent, revenues are expected to grow at an even faster rate of 10.7 percent. The City would have incurred a deficit in FY 2005 if not for $1 billion in budget relief from the State-approved Municipal Assistance Corporation refinancing initiative, as well as $744 million in retroactive airport lease payments from the Port Authority of New York and New Jersey.

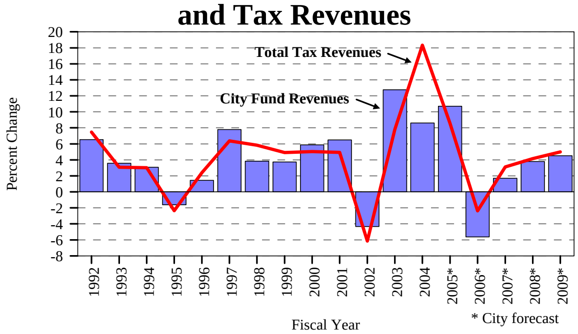
The City is on track to end FY 2006 with a current-year operating deficit of $3.3 billion, which has been masked by the transfer of surplus resources from prior years. The deficit largely reflects the expiration of temporary taxes to help the City through its latest fiscal crisis; and continued rapid growth in nondiscretionary spending. While the deficit will narrow as the City takes actions to help balance the FY 2007 budget, the City is unlikely to generate a current-year surplus in FY 2006—a sign that the City spent more than it took in during FY 2006.

Revenue Trends

While growth in City fund revenues surged in FY 2005—by a projected 10.7 percent—revenues are projected to decline by 5.6 percent in FY 2006 (see Graph 3).[2] A softening economy and the expiration of temporary tax increases contribute to an anticipated 2.4 percent decline in tax revenues. Also, miscellaneous revenues are expected to fall by $1.4 billion from the loss of nonrecurring resources that boosted collections in FY 2005.

Graph 3

Annual Change in City Fund Revenues and Tax Revenues



Note: Assumes implementation of the FY 2006 gap-closing program.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

The May 2005 Plan projects that growth in City fund revenues will resume in FY 2007, averaging 3.3 percent annually through FY 2009. The gain is driven by increases in tax revenues that average 4.1 percent during those years. Much of this growth is anticipated to come from the property tax, as sluggish economic growth dampens gains in nonproperty taxes. Miscellaneous revenues are expected to decline slightly through FY 2008.

Major revenue trends include the following.

- The May Plan assumes that personal income tax collections will decline by $230 million in FY 2006 as a result of the expiration of the high income surcharge, while sales tax receipts will be reduced by $118 million following the expiration of the one-eighth-point rate increase.[3] Although the State budget extended the suspension of the sales tax exemption for clothing items costing less than $110, the City's gap-closing program has proposed the reinstatement of the exemption, at a cost of $230 million.
- Growth in the real property tax—the largest of the City's taxes—is expected to increase to 7.1 percent in FY 2006 as a result of higher assessed values. The $400 rebate for homeowners will be offered again, at a total cost of $256 million. The strength in assessed values carries into fiscal years 2007 through 2009, providing average annual property tax growth of 6 percent during this period.
- Collections for the real estate transaction taxes—the mortgage-recording and real property transfer taxes—surged to record highs in FY 2005 despite the Federal Reserve's short-term interest rate increases, which began last June. Although mortgage rates have remained essentially unchanged since then, the City expects that mortgage rates will soon begin to rise, leading these taxes to decline by over 40 percent in FY 2006—a drop of more than $900 million.
- In FY 2006, the personal income tax is expected to decline by 6 percent because of the expiration of the high-income surcharge, lower capital gains, and a slowdown in economic growth. Revenues increased by 14.7 percent in FY 2005 as wage growth rebounded and as capital gains realizations increased at the fastest rate since 2000.
- Slower projected growth in the economy is expected to reduce growth in business tax revenues, to 0.4 percent in FY 2006, after a 17.4 percent gain in FY 2005.

Our review finds that year-to-date strength in nonproperty tax collections will continue into early next year. While we agree with the City that collections from real estate transaction taxes will begin to fall next year, we expect the falloff to occur later than the City forecasts. Overall, we expect tax collections to be higher than the City's forecast by $100 million in FY 2005, $400 million in FY 2006, and $200 million in FY 2007.

Expenditure Trends

City-funded expenditures grew by 9.5 percent in FY 2004, and are projected to grow by 8.3 percent in FY 2005 and by 7.4 percent in FY 2006 (see Graph 4). While the rate of expenditure growth is projected to slow during fiscal years 2007 through 2009, the City's estimates do not include the full

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

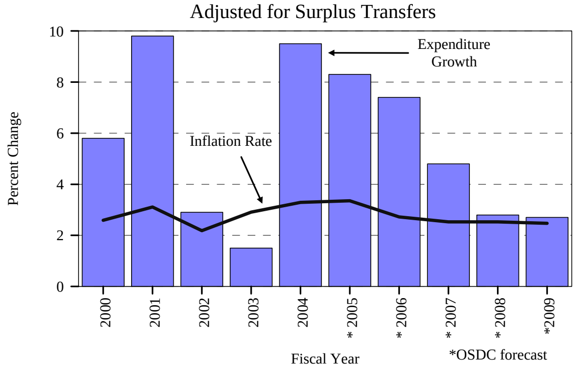
[3] The one-eighth-point decrease in the City sales tax rate is offset by a one-eighth-point increase in the MTA sales tax rate. City taxpayers will still experience an overall reduction in the sales tax rate because a statewide one-quarter-point sales tax surcharge expired on May 31, 2005.

potential cost of collective bargaining or the potential for an increase in City education funding pursuant to a Campaign for Fiscal Equity court ruling or settlement.

Graph 4

Changes in City-Funded Expenditures

Adjusted for Surplus Transfers

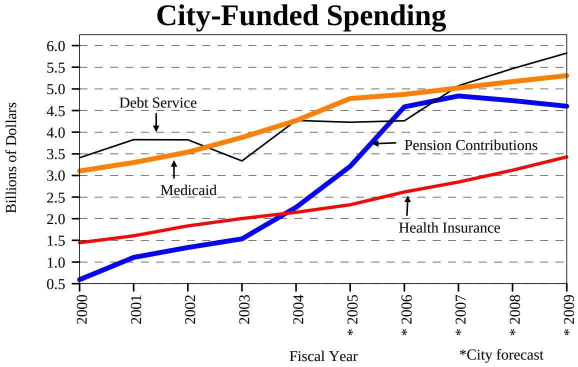


Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

In recent years, the growth in City-funded expenditures has been fueled by nondiscretionary spending. For example, City-funded spending for Medicaid, debt service, pension contributions, and health insurance grew at an average annual rate of 16 percent during fiscal years 2004 and 2005, and is projected to increase by another 12 percent in FY 2006. These costs are projected to consume 48 percent of City fund revenues in FY 2006, compared with 37 percent in FY 2003.

Graph 5

Trends in Nondiscretionary City-Funded Spending



Sources: NYC Office of Management and Budget; OSDC analysis

The rate of growth is projected to slow beginning in FY 2007 with the implementation of State actions to reduce the growth in Medicaid and a small decline in pension contributions.[4] Pension contributions are projected to decline beginning in FY 2008 because the investment shortfalls experienced during fiscal years 2001 through 2003 will have been fully phased in by that time. Graph 5 shows historical and projected growth in these spending categories.

Major expenditure trends include the following.

- Medicaid is projected to total $4.9 billion in FY 2006—an increase of $101 million—and then grow at an average annual rate of 2.9 percent to reach $5.3 billion by FY 2009. Actions taken by the State to slow the growth in Medicaid include a three-year State takeover of the local share of Family Health Plus costs; the enactment of cost-containment measures; and the imposition of a cap on the growth of City Medicaid expenditures.
- Debt service is projected to remain stable at about $4.2 billion during fiscal years 2005 and 2006. Debt service costs, however, are projected to increase by nearly $1.6 billion, or 37 percent, during the following three years, reaching $5.8 billion in FY 2009.

  The debt service burden (debt service as a percent of tax revenues) is projected to rise from 13.7 percent in FY 2005 to 17.2 percent in FY 2009. While the May 2005 Plan includes $200 million annually for pay-as-you-go financing, which we support, in the past the City has used these resources instead to help balance the operating budget.
- Pension contributions are expected to triple between fiscal years 2003 and 2006, reaching $4.6 billion, and are projected to peak at $4.8 billion in FY 2007. These estimates do not reflect the impact of the City Actuary's proposed changes in methods used to calculate City pension contributions, which could reduce planned contributions by $1.3 billion during fiscal years 2005 through 2007 but which could increase costs in future years.
- Health insurance costs for municipal employees are projected to increase from $2.3 billion in FY 2005 to $3.4 billion in FY 2009, an average annual growth rate of 10.2 percent.
- Staffing levels are projected to rise by 7,154 employees between fiscal years 2003 and

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[4] The City's estimates of planned pension contributions do not reflect proposals made by the City Actuary that would reduce contributions during fiscal years 2005 through 2007, but that would increase costs in future years.

2005, including 2,600 contract workers transferred to the City's payroll. Excluding police officers, the May 2005 Plan calls for the addition of 2,373 full-time employees in the mayoral agencies during the last quarter of the fiscal year; this is unlikely to occur. The City expects the workforce to increase by 1,100 in FY 2006, and by 695 in FY 2007.

Other Issues

The following issues could have a significant impact on the City during the Plan period.

Collective Bargaining

The State Public Employment Relations Board (PERB) has declared impasses in the City's negotiations with the Police Benevolent Association (PBA), the Uniformed Firefighters Association (UFA), and the United Federation of Teachers (UFT) for the 2002-2005 contract period.

In March 2005, the City and the PBA concluded binding arbitration hearings, and a decision is expected in June 2005. While PERB arbitration awards are limited to two years, the City and the PBA could agree to a longer settlement. Any agreement with the PBA could set the pattern for agreements with the remaining uniformed employees and the City's teachers.

The May 2005 Plan assumes that uniformed employees and teachers will agree to similar economic terms as those in the agreement with District Council 37, which represents most civilian employees. That agreement provided employees with a $1,000 lump sum payment, effective upon signing; a 3 percent wage increase in FY 2004; and a 2 percent wage increase in FY 2005 to be funded entirely from productivity savings.

Because any agreements may include the 2002-2005 contract period, the City could face large retroactive financial liabilities that will be funded in the year agreements are reached. For example, wage increases at the inflation rate for uniformed employees and teachers for the contract period, without offsetting productivity savings, would cost about $1 billion more than the City has set aside through FY 2005, and would cost an additional $900 million annually thereafter. If wages were to increase each year by an additional 1 percent, the City would incur additional costs of about $550 million during the contract period.

The May 2005 Plan also includes a reserve for the next round of collective bargaining, calculated at about half the projected local inflation rate (annual wage increases of 1.25 percent). If wages increase at the projected inflation rate without any offsetting productivity savings, costs would exceed the reserve by $180 million in FY 2006, $510 million in FY 2007, $800 million in FY 2008, and $1.1 billion in 2009.

Pension Contributions

The February 2005 Plan assumed that the trustees of the City's pension funds would approve changes in the assumptions and methodologies used to calculate City pension contributions in order to reduce planned City-funded contributions by a net of $325 million in FY 2006 and $200 million in FY 2007.

The changes anticipated in the February Plan included recommendations made by an independent actuarial consultant—as part of a City Charter–required biennial review—which would have required higher contributions based largely on revised demographics. The estimates were also based on revised methodologies that the City expected its Actuary to recommend and that would have resulted in lower planned contributions.

The May 2005 Plan, however, only recognizes the recommendations of the actuarial consultant and other technical reestimates, which increased planned pension contributions by $141 million in FY 2005, $862 million in FY 2006, $718 million in FY 2007, and by about $450 million annually thereafter.

The Actuary has submitted to the boards of the five actuarial pension funds a proposal that includes both revised actuarial assumptions and methodologies. The proposal requires approval by the boards and elements of the proposal requires approval by the State. If the proposal is approved before June 30, 2005, then pension contributions could be lower than anticipated in the May 2005 Plan by $190 million in FY 2005, $640 million in FY 2006 and $490 million in FY 2007, but higher by $20 million in FY 2008 and $200 million in FY 2009.

Department of Education

The Mayor's Executive Budget allocates $14.1 billion to the Department of Education for FY 2006, excluding pensions and debt service. Of this amount, the City would fund 41 percent[5] and the State would fund 46 percent. State and City contributions are the subject of current debate.

In June 2003, the Court of Appeals upheld a 2001 State Supreme Court ruling that the formula for allocating State education aid was unconstitutional. The lower court subsequently ruled that the State should implement a funding plan that would phase in, over a four-year period, an increase of $5.6 billion in operating aid to City schools. In addition, the court found that the State should provide the City with $9.2 billion over five years for education-related capital projects. The court stated that the State Legislature should determine how the costs are split between the State and the City, but that the burden placed on the City could not be arbitrary or unreasonable.

On April 18, 2005, the Governor filed a notice of appeal and was granted an automatic stay of the order. The appeal is expected to be heard during the court session that begins in October. If the Court of Appeals upholds the lower court ruling, New York City could be required to increase its funding to the Department of Education.

The Governor recommended that the City fund 40 percent of a proposed settlement, while the Assembly Speaker suggested that the City fund 25 percent of a proposed settlement. Thus, it appears likely that the City will be required to increase its education funding by some amount. If the City were required to contribute 40 percent of the additional assistance recommended by the lower court, it would need to increase its contribution by as much as $564 million in FY 2007, $1 billion in FY 2008, $1.7 billion in FY 2009, and $2.2 billion in FY 2010.

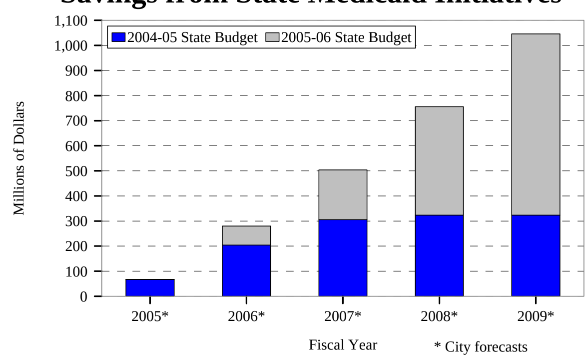
Medical Assistance

The State has taken a number of steps over the past year to help localities with the financial burden of providing medical assistance to indigent people.[6] The State budget adopted in August 2004 included a three-year State takeover of the local share of Family Health Plus. Family Health Plus provides health insurance coverage to adults whose incomes exceed the limits allowed under the Medicaid program, and it has been one of the fastest-growing components of medical assistance. It is estimated that New York City will benefit by about $300 million annually beginning in FY 2007, when the takeover is fully phased in.

The recently enacted State budget will provide localities with additional Medicaid budget relief. The budget includes a number of cost-containment measures and a cap on growth in the local share of Medicaid. These two initiatives are expected to reduce the City-funded cost of Medicaid by $722 million by FY 2009. Together with the takeover of Family Health Plus, the City anticipates budgetary savings of $67 million in FY 2005, $280 million in FY 2006, $504 million in FY 2007, $756 million in FY 2008, and more than $1 billion in FY 2009 (see Graph 6).

Graph 6

Savings from State Medicaid Initiatives



Sources: NYC Office of Management and Budget; OSDC analysis

Metropolitan Transportation Authority

Our recent report (Report 1-2006, *Financial Outlook for the Metropolitan Transportation Authority*) found that new resources approved by the State will help the MTA balance its 2006 operating budget without implementing previously planned service reductions, and will put the MTA on track to balance its 2007 budget—as long as it remains committed to achieving savings from internal management improvements. Nevertheless, the report found that the MTA could face budget gaps in excess of $400 million in 2008 and $1.1 billion by 2010.

The new resources permitted the MTA to fund a new capital program for 2005-2009. Although funded at levels that were considerably lower than

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[5] The City's share grows to 50 percent when associated pension costs ($1.6 billion) and debt service costs ($1.1 billion) are included.

[6] New York is one of 23 states that require localities to contribute to the cost of Medicaid, and the local share in New York State is among the highest.

previously planned, the amended capital program will permit restoration, modernization, and network expansion projects to move forward. The capital program still requires unanimous approval by the MTA Capital Program Review Board.

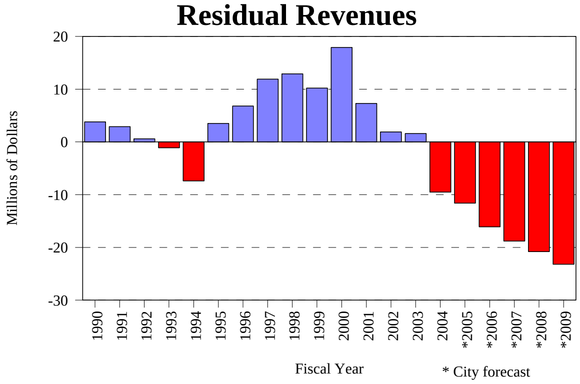
Our report pointed out that the MTA would continue to rely heavily on debt to finance its capital program. Debt service costs would nearly double, from $848.1 million in 2004 to $1.6 billion in 2008, and then rise to $2.2 billion by 2015. The debt service burden is expected to rise from 11 percent of revenues in 2004 to 18.6 percent in 2008, and then to 23 percent in 2015. If the transportation bond act is rejected by voters in November, the MTA may increase borrowing or further scale back the capital program.

Off-Track Betting Corporation

The Off-Track Betting Corporation (OTB) provides legalized pari-mutuel wagering that generates a stream of revenue for the City, the State, and the horse racing and breeding industries. The OTB passes along to New York City both the revenues from a mandated 5 percent surcharge on winning wagers, and its residual revenues.[7]

Graph 7

Residual Revenues



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

Surcharge revenues have remained relatively flat since FY 1996, at about $17 million. In FY 2004, the OTB experienced a loss (i.e., negative residuals) of $9.5 million—its first loss in a decade (see Graph 7). Payment of the surcharge to the City in FY 2004 was made in part from the OTB's cash reserves, which have now been exhausted. OTB finances have continued to deteriorate, and a residual loss of $11.6 million is projected for FY 2005; anticipated losses increase to more than $23 million by FY 2009.

The OTB is managing its cash flow by delaying payment of its monthly surcharge to the City by two months, and delaying a $3 million payment due to the State (thereby incurring a one-time late payment fee of 5 percent and monthly interest charges of 1 percent). OTB management is also considering closing some branches or reducing service hours. Considering the size of the projected losses, more fundamental changes will be needed for the OTB to continue operations.

Ten-Year Capital Plan

The Mayor has issued a $62.4 billion ten-year capital plan for fiscal years 2006 through 2015. The plan would devote $28 billion to restore assets to a state of good repair, mainly in the areas of schools, bridges, and highways; $18 billion to program expansion, primarily of new schools, housing, and water supply systems; and more than $16 billion to replace existing capital assets, mainly water pollution control systems and computer equipment.

In January 2003, the Mayor proposed a ten-year capital program that cut planned spending by $10.9 billion, or 27 percent, to slow down the growth in debt service. The current plan would commit $19.6 billion during fiscal years 2006 through 2009, or $8 billion more than the January 2003 level, and would restore all of the cuts proposed for the ten-year period.

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[7] Residual revenues represent the distribution to New York City after all operating expenses have been paid and all mandated distributions have been made to the racing industry, the State, and other localities.

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