Review of the Financial Plan of the City of New York

June 2006

Report 2-2007

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I. Executive Summary

On May 5, 2006, the Mayor released his Executive Budget for FY 2007 and a revised four-year financial plan (the "May Plan"). The May Plan confirms that the City's financial position has improved steadily since the beginning of the fiscal year. The City has accumulated unplanned resources of $5.5 billion during FY 2006, and it plans to use a substantial portion ($2.1 billion) to improve its financial position and to provide supplemental financial assistance to the Health and Hospitals Corporation and the New York City Housing Authority. After taking these actions into account, the May Plan projects a net surplus of $3.4 billion for FY 2006, which the Mayor proposes to use to balance the FY 2007 budget.

Most of the unplanned resources ($3.6 billion) come from tax collections that were much higher than expected as a result of conservative forecasts and an improving local economy that added 49,100 jobs and produced record Wall Street bonuses in 2005. Other developments, combined with spending restraint, resulted in net savings of $1.6 billion in FY 2006. For example, anticipated changes in actuarial assumptions and methodologies have reduced planned pension contributions by a total of nearly $1.5 billion for this year and next year, though the changes are expected to increase contributions in future years.

Among the steps proposed by the Mayor to strengthen the City's financial position is the creation of a health benefits trust fund. New accounting rules require state and local governments to estimate the future liability of post-retirement benefits other than pensions, such as health insurance. Although the City is under no obligation to fund the liability, which could exceed $50 billion, the City intends to deposit $1 billion to the trust fund in each of fiscal years 2006 and 2007 to help pay down these liabilities. As an added benefit, the trust fund could serve as a rainy-day fund, although that is not its intended purpose.

The Mayor has also proposed prepaying $350 million in debt service on Transitional Finance Authority (TFA) bonds that is not due until FY 2008, and deferring the receipt of $454 million in tobacco settlement revenues until FY 2008, when it will be needed. These actions are largely responsible for a 20 percent reduction in the budget gap from the level that had been projected one year ago for FY 2008. In addition, the City had previously allocated $200 million annually to fund the capital program on a pay-as-you-go basis, which reduces the need for borrowing. Nonetheless, debt service is the fastest-growing area of the budget, rising from $3.9 billion in FY 2006 to nearly $6 billion in FY 2010—an increase of more than 50 percent.

New York State and New York City recently took a major step toward resolving the Campaign for Fiscal Equity lawsuit, which was filed in 1993. The State will provide the City's public school system with $1.8 billion from the Dormitory Authority of the State of New York for capital improvements, and will fund half of the debt service on $9.4 billion in bonds that will be issued by the Transitional Finance Authority and the City for this purpose. The State, however, still has not addressed a series of court rulings that call for an increase in operating aid to the City's public school system of between $4.7 billion and $5.6 billion.

Despite these favorable developments, the May Plan projects budget gaps of $3.9 billion in FY 2008 and $4.2 billion in FY 2009 because expenditures, especially debt service and fringe benefits, are projected to grow faster than recurring revenues. Even though our review indicates that revenue collections could exceed the City's forecasts, the additional revenue would not be sufficient to close the projected budget gaps. Moreover, our estimates assume that the current economic recovery will not stall in response to higher interest rates, inflation, and energy costs.

The City faces a number of additional budget risks. The federal government, for example, projects daunting budget deficits, and efforts to close those gaps could adversely affect New York City. The City also could be called upon during the financial plan period to increase its funding for education by a substantial amount as part of any resolution of the Campaign for Fiscal Equity lawsuit. Finally, the May Plan assumes that the next round of collective bargaining will provide employees with annual wage increases of 1.25 percent, which is significantly less than the projected inflation rate.

The City's fiscal condition has improved steadily over the past four years and the City is poised to end FY 2006 with an unprecedented $5.5 billion in unplanned resources. To its credit, the City intends to use a portion of these resources in ways that will strengthen its financial position. The out-year budget gaps, however, remain substantial and the City still faces significant budget risks.

Table 1
New York City Financial Plan
(in millions)

	FY2006	FY 2007	FY 2008	FY2009	FY 2010
REVENUES					
Taxes					
General Property Tax	$12,437	$ 12,972	$ 13,832	$ 14,488	$ 15,165
Other Taxes	19,517	18,943	18,871	19,426	20,359
Tax Audit Revenue	712	509	509	509	510
Tax Reduction Program	- - -	- - -	(256)	(256)	(256)
Miscellaneous Revenue	5,161	4,807	5,147	4,735	4,757
Unrestricted Intergovernmental Aid	490	340	340	340	340
Anticipated Federal Aid	- - -	50	- - -	- - -	- - -
FY 2005 Discretionary Transfer	947	- - -	- - -	- - -	- - -
Less: Intra-City Revenues	(1,432)	(1,307)	(1,305)	(1,307)	(1,307)
Grant Disallowances	(90)	(15)	(15)	(15)	(15)
Subtotal: City Funds	**$37,742**	**$ 36,299**	**$ 37,123**	**$ 37,920**	**$ 39,553**
Other Categorical Grants	1,138	1,111	972	987	992
Inter-Fund Revenues	380	395	373	365	365
Total City & Inter-Fund Revenues	**$39,260**	**$ 37,805**	**$ 38,468**	**$ 39,272**	**$ 40,910**
Federal Categorical Grants	5,785	5,095	5,094	5,090	5,090
State Categorical Grants	9,602	9,804	9,969	10,066	10,182
Total Revenues	**$54,647**	**$ 52,704**	**$ 53,531**	**$ 54,428**	**$ 56,182**
EXPENDITURES					
Personal Services					
Salaries and Wages	$18,790	$ 19,098	$ 19,239	$ 19,332	$ 19,511
Pensions	4,018	4,891	5,614	5,859	5,724
Fringe Benefits	6,634	6,937	6,271	6,582	6,835
Subtotal - Personal Services	**$29,442**	**$ 30,926**	**$ 31,124**	**$ 31,773**	**$ 32,070**
Other Than Personal Services					
Medical Assistance	$4,917	$ 4,935	$ 5,083	$ 5,222	$ 5,376
Public Assistance	2,466	2,198	2,202	2,202	2,202
Pay-As-You-Go Capital	200	200	200	200	200
All Other	14,978	14,916	15,168	15,547	15,863
Subtotal - Other Than Personal Services	**$22,561**	**$ 22,249**	**$ 22,653**	**$ 23,171**	**$ 23,641**
General Obligation, Lease, and MAC Debt Service	3,179	3,975	4,338	4,693	5,066
FY2005 Budget Stabilization &Discretionary Transfers	(2,582)	- - -	- - -	- - -	- - -
FY2006 Budget Stabilization &Discretionary Transfers	3,439	(3,439)	- - -	- - -	- - -
General Reserve	40	300	300	300	300
Subtotal - Expenditures	**$56,079**	**$ 54,011**	**$ 58,415**	**$59,937**	**$61,077**
Less: Intra-City Expenses	(1,432)	(1,307)	(1,305)	(1,307)	(1,307)
Total Expenditures	**$54,647**	**$52,704**	**$ 57,110**	**$58,630**	**$59,770**
Gap To Be Closed	**$ - - -**	**$ - - -**	**$ (3,579)**	**$(4,202)**	**$(3,588)**

Source: NYC Office of Management and Budget

Table 2
OSDC Risk Assessment of NYC Financial Plan

(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
			Better/(Worse)		
Gaps Per May 2006 Plan	**$ - - -**	**$ - - -**	**$ (3,579)**	**$ (4,202)**	**$ (3,588)**
Tax Revenues	200	750	600	500	500
Debt Service Savings	- - -	98	- - -	- - -	- - -
Hiring Delays	25	- - -	- - -	- - -	- - -
Anticipated Federal Aid	- - -	(50)	- - -	- - -	- - -
Uniformed Agency Overtime	- - -	(125)	(100)	(100)	(100)
OSDC Risk Assessment	**$ 225**	**$ 673**	**$ 500**	**$ 400**	**$ 400**
Surplus Roll	(225)	225	- - -	- - -	- - -
Surplus/(Gaps) to be Closed[1]	**$ - - -**	**$ 898**	**$ (3,079)**	**$ (3,802)**	**$ (3,188)**
Additional Risks and Offsets					
Campaign for Fiscal Equity Settlement	- - -	(560)	(1,100)	(1,600)	(2,200)
Wage Increase at Projected Inflation Rate	- - -	(100)	(350)	(650)	(950)

[1] The May Plan includes a general reserve of $40 million in FY 2006 and $300 million annually thereafter. In addition, the Mayor has proposed making an irrevocable $2 billion contribution to a retiree health insurance trust fund, which the City believes it could draw upon in times of need by forgoing its planned annual contribution to the trust.

II. Economic Overview

New York City's economy has remained strong in early calendar year 2006 despite higher energy prices and gradually rising interest rates. Rising interest rates squeezed Wall Street's broker/dealer profits in 2005, but revenues and profits at the largest firms rose sharply because of their diversified operations, and contributed to record year-end bonuses. Recent employment data revisions showed that employment in the City grew more than originally estimated in 2004 and 2005 (by 18,600 and 49,100 jobs, respectively), and the current rate of job growth is strong by post–fiscal crisis historical standards. These job gains pushed the unemployment rate down to 5.8 percent in calendar year 2005, its lowest level since 2000, before the recession. In addition, the real estate market has surged—the average market value of a single-family home, for example, rose by 149 percent to $524,400 between fiscal years 2000 and 2007. While there are signs the market has begun to soften, prices have yet to decline as both commercial and residential supplies are limited and office vacancy rates are improving. Tourism is booming, pushing up hotel occupancy and room rates. Inflation excluding energy and food—so-called core inflation—rose at an annual rate of 3 percent in the City in the first four months of 2006, compared to a 2.5 percent increase in the nation. Energy prices, however, were up in the first four months of 2006 by nearly 21 percent on an annual basis in the City, and by over 23 percent in the nation.

The economic forecasts in the May 2006 Plan have not changed much from the forecasts in February 2006, and the City still assumes that modest economic growth will continue throughout the financial plan period, but with a mild slowdown in calendar year 2007. Thus, growth in the national economy—which heavily influences the City's business sectors—is expected to slow from 3.3 percent in 2006 to 2.5 percent in 2007, but then recover at the long-term trend rate of 3 percent. The City projects that continued increases in interest rates will cause inflation to slow from 2.8 percent in 2006 to 2.2 percent in 2007, but that these increases will also hold back both consumer and business spending. Corporate profits are expected to decline only in 2007. The City's national economic forecast is generally similar to recent projections from Global Insight and the Blue Chip Economic Consensus.

At the local level, the City expects that strong gains from mergers and acquisitions will lift overall Wall Street broker/dealer profits in 2006, and that rising interest costs will reduce profits and bonuses in 2007. Assuming that the economy rebounds in 2008, the City also expects that Wall Street profits will follow the same path, rising throughout the balance of the financial plan period. Because Wall Street's high bonuses and incomes affect the overall rate of wage growth, the City projects

that wage gains will increase in 2006, slow in 2007, and then rise again. The City's employment forecast also follows a similar path and does not show a decline. The Wall Street and tourism-related sectors (e.g., finance and insurance, professional and business services, leisure and hospitality, and retail trade) and the education and health care sector are expected to account for most of the job gains throughout the financial plan period. The City expects sales of residential real estate to fall and prices to decline between 2006 and 2010, but anticipates continued strength in the commercial real estate market.

Despite the generally favorable outlook for the City's economy—there is no expectation of a recession in this financial plan period—the City still faces several major risks. The first is the possibility of a bigger slowdown in consumer spending, which accounts for two thirds of economic activity. With interest rates rising, the housing market has started to cool—and with it, the ability to refinance and tap into rising equity in order to support spending. Consumer debt levels remain high, so rising interest rates increase this burden. A prolonged period of high energy costs could also begin to adversely impact consumer budgets. With demand still high (compounded by strong international needs) and supplies vulnerable to external disruption, energy prices could rise further—with the increases compounded by speculators in the financial markets. Higher energy prices could eventually drive up overall core inflation as the costs of labor (which is in short supply given low unemployment rates) and other commodities rise.

These risks converge with uncertainty surrounding the path of future interest rates. As of mid-May, the Federal Reserve had raised rates 16 times since mid-2004. Long-term interest rates have begun to respond to these changes and are starting to rise. While the markets had expected the central bank to pause in its gradual tightening of rates, recent statements from the Federal Reserve have clouded that possibility and raised uncertainty in the financial markets. The economy was strong in the first quarter of 2006, and inflation—driven by higher energy prices—is recognized as a major threat. Thus, markets have become concerned that the Federal Reserve could raise rates more than necessary and thereby severely dampen economic growth. Such a development would also reduce profitability for the markets, which are already struggling with higher interest costs.

III. Fiscal Year 2006

The City expects to end FY 2006 with about $5.5 billion more in resources than it projected at the beginning of the fiscal year (see Table 3). Most of these unanticipated resources stem from much-higher-than-expected tax collections, changes in pension assumptions and methods, and unexpected one-time savings in the Medicaid program from State actions that capped the growth in the local share of funding this program.

These unanticipated resources have permitted the City to strengthen its financial position and to assist financially troubled City-related public authorities, while still leaving a net surplus of $3.4 billion that has been used to balance the FY 2007 budget without raising taxes or cutting services. As a result of the actions taken by the City over the course of the fiscal year, the budget gap projected for FY 2008 has been reduced by 20 percent, to $3.6 billion. The budget gap projected for FY 2009, however, has increased to $4.2 billion. While the enacted State budget calls for a substantial increase in education aid to the City (for more information see "Department of Education" in this report), the City will realize few other benefits.

A. Revenue Estimates

For the third year in a row, revenue collections have significantly exceeded the City's expectations, with the forecast for FY 2006 now $3.9 billion higher than in the July 2005 Plan.[2] This is a much greater variance than in each of the previous two fiscal years at this point in the financial plan process (FY 2005 revenues exceeded initial expectations by $2.5 billion in the May 2005 Plan, and in FY 2004 the variance was $1.8 billion). As in the previous two years, these additional collections have been factored into the City's revenue base, yielding higher projected collections of $2.7 billion in FY 2007 and nearly $1.6 billion in each of fiscal years 2008 and 2009.

Tax revenues again account for the bulk of this additional revenue, with the current forecast for FY 2006 now higher by $3.6 billion. In general, the City's economy has performed better than expected—creating more jobs, generating more capital gains, and most notably, enjoying a housing boom that has defied predictions of a sharp decline. Major tax revenue changes include the following.

- Real estate transaction taxes (the mortgage-recording and real property transfer taxes) are forecast to be higher by $1.1 billion in FY 2006 and by an average of about $450 million in each of fiscal years 2007 through 2009.

[2] This estimate excludes the impact of the proposed transfer of TSASC and TFA resources to FY 2008.

Commercial transactions remain strong, and the City believes that residential activity is being supported by an increase in refinancings from home owners converting from interest-only mortgages to conventional fixed-rate loans.

Table 3
Financial Plan Reconciliation
July 2005 Plan vs. May 2006 Plan
(in millions)

	Better/(Worse)			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Surplus/(Gaps) Per July 2005 Plan	**- - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**
Revenues				
Real Estate Transaction Taxes	$ 1,149	$ 553	$ 400	$ 382
Personal Income Tax	1,103	877	711	788
Business Taxes	608	471	365	298
Tax Audits	200	- - -	- - -	- - -
All Other Taxes	569	346	205	219
Subtotal	**3,629**	**2,247**	**1,681**	**1,687**
Non-Tax Revenues	266	312	79	76
Agency Gap-Closing Program	92	95	74	74
Anticipated Federal Aid	(50)	50	- - -	- - -
Extension of Property Tax Rebate	- - -	- - -	(256)	(256)
Total	**3,937**	**2,704**	**1,578**	**1,581**
Expenditures				
Collective Bargaining	(666)	(1,088)	(1,188)	(1,188)
Energy Costs	(70)	(139)	(151)	(146)
Education	(94)	(295)	(295)	(296)
Changes in Pension Assumptions and Methods	924	567	(165)	(465)
Medicaid	450	- - -	- - -	- - -
Agency Gap-Closing Program	162	204	146	145
Debt Service	142	152	161	159
General Reserve	260	- - -	- - -	- - -
Savings from Overestimating Prior Years' Expenses	400	- - -	- - -	- - -
State Aid for Collective Bargaining	35	300	337	337
Other Agency Expenses	27	(511)	(418)	(418)
Total	**1,570**	**(810)**	**(1,573)**	**(1,872)**
Net Change During FY 2006	**5,507**	**1,894**	**5**	**(291)**
Discretionary Actions				
Surplus Transfer	(3,439)	3,439	- - -	- - -
Retiree Health Benefits Trust Fund	(1,000)	(1,000)	- - -	- - -
Health and Hospitals Corporation Subsidies	(385)	279	82	(8)
Transitional Finance Authority Debt Prepayment	(350)	16	350	- - -
TSASC Revenue Deferral	(233)	(121)	454	22
New York City Housing Authority Subsidy	(100)	- - -	- - -	- - -
Surplus/(Gaps) Per May 2006 Plan	**$ - - -**	**$ - - -**	**$ (3,579)**	**$ (4,202)**

Sources: NYC Office of Management and Budget; OSDC analysis

- Personal income tax collections are now forecast to be higher by $1.1 billion in FY 2006 and by an average of nearly $800 million annually

thereafter, reflecting a higher base in FY 2006 due to strong wage growth (notably from Wall Street) and strong capital gains realizations (some of which were derived from real estate transactions). Current trends indicate that the City may realize still more revenues from this source.

- Business taxes are expected to be higher by $608 million in FY 2006 and by $378 million, on average, during fiscal years 2007 through 2009. Corporate profitability was strong in calendar year 2005, and contributed to a sizable increase in collections in the spring. In addition, the City expects to realize an additional $200 million in FY 2006 from tax audits stemming mostly from a joint State and City initiative that takes advantage of recent changes in federal regulations concerning tax shelters.

Other significant developments since the beginning of the fiscal year include a $266 million increase in non-tax revenues—$176 million of that amount comes from higher interest income from City deposits as a result of higher interest rates. The City has also shifted its expectation of $50 million in anticipated federal aid from FY 2006 to FY 2007. In addition, the City's gap-closing program includes revenue initiatives in the agencies that are expected to produce $92 million in resources in FY 2006, falling to $74 million by FY 2009. Finally, the City intends to seek State approval to extend the real property tax rebate through FY 2010, at an annual cost of $256 million.

B. Expenditure Estimates

City-funded expenditures are nearly $1.6 billion lower than projected in July 2005 (see Table 3).[3] The difference is largely attributable to lower-than-planned pension contributions associated with changes recently approved by the pension boards ($924 million); savings associated with State Medicaid reforms ($450 million); anticipated savings from prior years' expenses ($400 million); and a drawdown of the general reserve ($260 million). As discussed below, a number of other significant developments occurred during the year.

- Collective bargaining costs are expected to be higher than projected at the beginning of the fiscal year by $666 million in FY 2006 and by about $1.2 billion in subsequent years based on recently negotiated or anticipated agreements. (State education aid to the City increases by $472 million in FY 2007 in the enacted State budget, and the City intends to use $300 million of this amount to help fund the new teachers' contract.)

[3] This estimate excludes $1.8 billion in various planned discretionary actions, which, when included, would increase planned spending by a net of $265 million since the beginning of the fiscal year.

- Energy costs are expected to be higher by an average of $127 million annually during the financial plan period, largely because of increased international demand for oil.
- Education expenditures are expected to be higher by $94 million in FY 2006 and about $300 million annually thereafter, largely because of growth in charter school enrollment, and tuition and transportation costs for privately provided special education.
- Agency actions are expected to generate savings of $162 million in FY 2006, mostly from reestimates, shifting costs to the federal and State governments, and reductions in subsidies to libraries and cultural institutions. Most of these savings are expected to recur.
- Debt service is expected to be lower by $142 million in FY 2006 and similar amounts in subsequent years because the State has agreed to fund half of the Department of Education's capital program; a reduction in short-term borrowing due to the City's large cash balance; and a refunding of high-coupon debt. (These estimates exclude the impact of an initiative that provided assistance to the Health and Hospitals Corporation.)

C. Discretionary Actions

As previously mentioned, the City realized $5.5 billion in unanticipated resources in FY 2006. The City intends to use $2.1 billion of this amount to benefit future years, improve its financial position, and provide assistance to the Health and Hospitals Corporation and the New York City Housing Authority (see Table 4). The remaining $3.4 billion will be used to help balance the FY 2007 budget. In addition, the City had previously allocated $200 million annually to help fund the capital program on a pay-as-you-go basis, which will reduce planned borrowing by $1 billion and produce debt service savings of $144 million through FY 2010.

Table 4
Planned Discretionary Actions
May 2006 Plan
(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
Health Trust Fund	$ (1,000)	$ (1,000)	$ - - -	$ - - -
Health and Hospitals Corporation	(385)	279	82	(8)
Transitional Finance Authority Debt	(350)	16	350	- - -
TSASC Inc.	(233)	(121)	454	22
NYC Housing Authority	(100)	- - -	- - -	- - -
Total	**$ (2,068)**	**$ (826)**	**$ 886**	**$ 14**

Source: NYC Office of Management and Budget

The proposed discretionary actions include the following.

- The City will create a health insurance trust fund for the benefit of current and future retirees, and plans to transfer $1 billion from the general fund to the trust in each of fiscal years 2006 and 2007. Changes in accounting rules will require governments to begin reporting the value of their post-employment benefits other than pensions (these are primarily health care benefits). Although the governments are not required to fund these liabilities, the credit rating agencies, when determining their ratings, will consider the size of these liabilities and how they are addressed. By using some of its available resources to begin funding this liability, the City is working to improve its financial condition. (For more information, see "Health Benefits Trust Fund" in this report.)
- The City will delay the recognition of $454 million in TSASC revenues[4] from fiscal years 2006 and 2007 until FY 2008, when those resources will be needed. (For more information, see "TSASC Inc." in this report.)
- The City will increase its payments to the Health and Hospitals Corporation (HHC) from the level planned at the beginning of the fiscal year, by a net of $385 million in FY 2006. The net change reflects a one-time supplemental Medicaid payment of $575 million in FY 2006 that would be partly offset by a reduction in City subsidies for debt service, fringe benefits, and other needs. (For more information, see "Health and Hospitals Corporation" in this report.)
- The Transitional Finance Authority (TFA) will retain, at the City's request, $350 million in personal income tax revenue in FY 2006, which will be held in escrow until the resources are used to pay debt service on TFA bonds in FY 2008. The transaction is expected to generate $16 million in interest earnings, which will benefit FY 2007, and provide $350 million of budget relief in FY 2008.
- The City will provide the New York City Housing Authority (NYCHA) with $100 million in transitional financing in FY 2006 to help close a large budget gap projected for the current calendar year,[5] while the NYCHA seeks approval from the federal government to implement its gap-closing program. (For more information, see "New York City Housing Authority" in this report.)

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[4] These funds result from the Master Settlement Agreement between attorneys general from 46 states and major tobacco manufacturers.

[5] The City is not legally obligated to help balance the NYCHA's budget.

IV. Annual Operating Results

The City projects a net surplus of $3.4 billion for FY 2006, just short of last year's record of $3.5 billion.[6] The City intends to transfer the surplus to FY 2007 to help balance that year's budget, continuing a practice it has followed in past years. 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 would be obtained by examining the results of current-year operations—the difference between revenues and expenditures incurred in the current year. Viewed from this perspective, the City has recorded significant surpluses over the past three years after three years of losses.

An examination of the results of current-year operations during fiscal years 1996 through 2000 finds that the City ended each of these fiscal years with a surplus, as revenue growth—fueled by the Wall Street boom—exceeded expenditure growth (adjusted for surplus transfers). That pattern changed, however, beginning in FY 2001. As shown in Graph 1, the City spent more than it took in during fiscal years 2001 through 2003 as it faced the budgetary impact of the recession, the Wall Street downturn, and the attack on the World Trade Center. The deficit was masked in those years, both by the City's practice of transferring the prior year's surplus to the following year and by using the proceeds from Transitional Finance Authority Recovery Bonds (i.e., deficit financing), which were authorized by New York State after September 11, 2001.

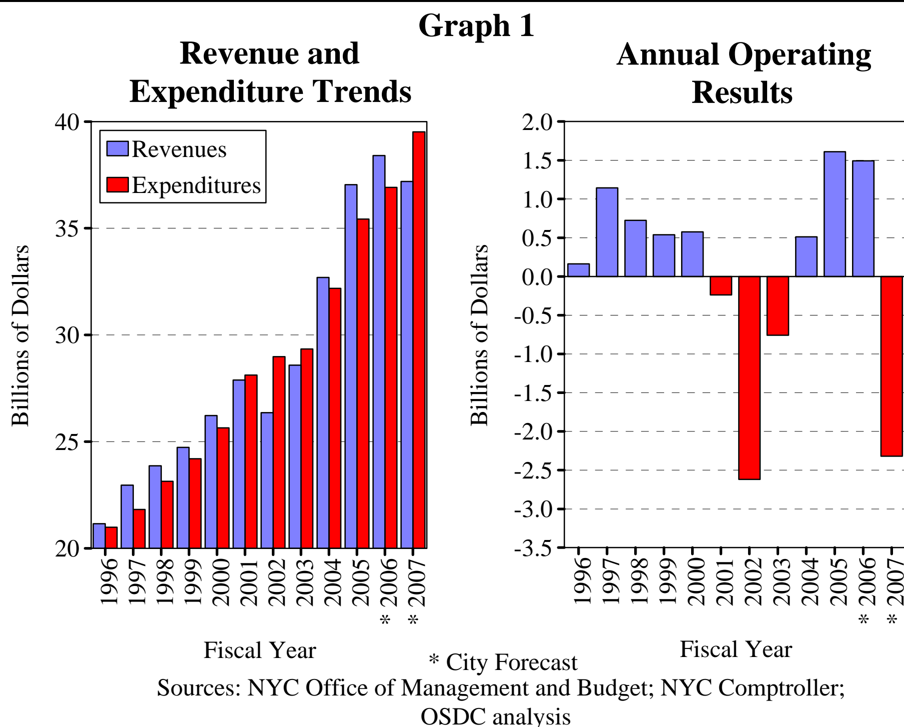
Less than three years after the terrorist attack on the World Trade Center, the City ended FY 2004 with a current-year operating surplus of $511 million—the first such surplus since FY 2000. The surplus was due to a combination of City, State, and federal actions taken to help the City through its fiscal crisis, and an unexpected surge in tax revenues from Wall Street and real estate transactions. Budget balance in FY 2004 was also aided through the use of $1.7 billion in nonrecurring resources.

In FY 2005, the City's fiscal condition continued to improve as evidenced by the growth in the current-year operating surplus to a record $1.6 billion. This outcome was aided by $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. An additional

[6] The City realized unanticipated resources of $5.5 billion in FY 2006, and intends to use a portion of these resources to improve its financial position and assist financially troubled public authorities, which results in a net surplus of $3.4 billion.

$1.9 billion in resources were transferred from prior years to produce the record $3.5 billion budgetary surplus that year.

Graph 1



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

Despite the loss of these nonrecurring resources in FY 2006, which dampened revenue growth, the City is on track to end the year with a current-year operating surplus of $1.5 billion.[7] The practice of balancing the budget one year at a time, however, works only as long as the surplus lasts. While the City has balanced the FY 2007 budget with resources from prior years, current-year expenditures are expected to exceed current-year revenues by $2.3 billion. The current-year operating deficit that is projected for FY 2007 will most likely narrow as the year progresses and the City revises its revenue and expenditure forecasts.

[7] This estimate is different from the City's budgetary surplus in that it excludes resources transferred from prior years, the planned transfer to the proposed retiree health insurance trust fund, and the discretionary actions that transfer TFA and TSASC resources to future years. (The City's assistance to HHC and the NYCHA, while utilizing resources from the FY 2006 surplus, remain a current-year expense because they do not transfer resources to the future.)

V. Revenue and Expenditure Trends

Over the past few years, the City has been able to build large surpluses—both on a budgetary and a current-year operating basis—because revenues have grown at a much faster pace than expenditures, even as expenditure growth has surged as a result of spending pressures in such areas as pensions, debt service, health insurance, and Medicaid. While the City projects a balanced budget for FY 2007, based on the transfer of surplus resources from prior years, it projects budget gaps of $3.6 billion in FY 2008, $4.2 billion in FY 2009, and $3.6 billion in FY 2010.

Revenue growth in recent years has been fueled by an improving economy—reflected in rising employment, higher Wall Street earnings, increased capital gains realizations, and a boom in the real estate market—and temporary tax increases enacted during the recession. Revenue growth, however, is projected to slow dramatically, averaging only 1.4 percent annually during fiscal years 2007 through 2010, as temporary tax increases expire and as the pace of economic growth eases.

Expenditure growth, after adjusting for surplus transfers, is also forecast to slow—but the growth will far exceed the projected growth in revenues, increasing at an average annual rate of 3.9 percent during these years. This estimate, moreover, assumes that municipal employees will receive annual wage increases of 1.25 percent during fiscal years 2007 through 2010, which is about half the projected inflation rate. Although State actions have reduced the rate of growth in Medicaid costs, the City's costs for debt service, pensions, and health insurance continue to grow rapidly.

A. Revenue Estimates

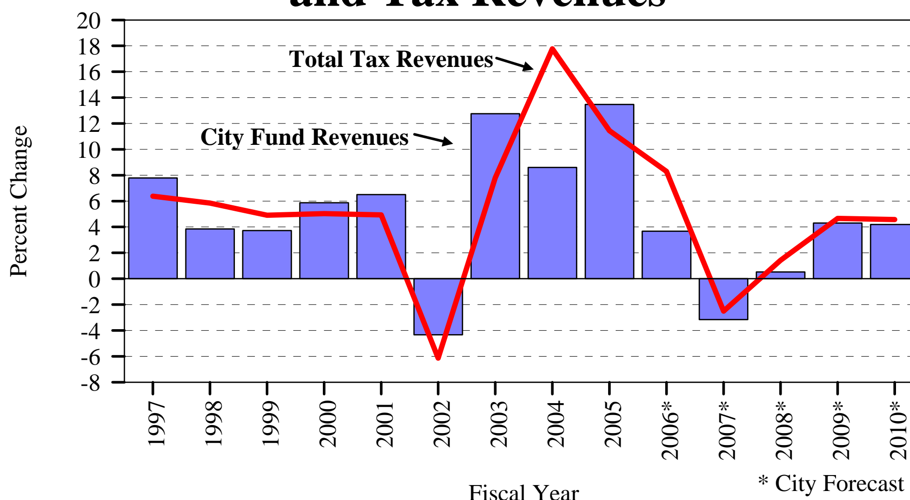
City fund revenues are projected to decline by 3.2 percent in FY 2007 after increasing by 3.7 percent in FY 2006 (see Graph 2).[8] Taxes, the largest component of City fund revenues, are expected to increase by 7.7 percent in FY 2006—after adjusting for almost $200 million in one-time collections from business tax audits—but are then forecast to decline by 1.9 percent in FY 2007. Increased revenues from the real property and sales taxes are projected to be offset by declines in personal and business income taxes and taxes from real estate transactions, caused by an expected slowdown on Wall Street and a retreat in both the number of transactions and the prices in the residential real estate market. Growth in City fund revenues is projected

[8] Our estimates of City fund revenues include the portion of personal income tax revenues dedicated to pay debt service on bonds issued by the Transitional Finance Authority, and revenues dedicated to pay debt service on tobacco bonds. The estimate has also been adjusted for the transfer of TSASC revenues to benefit FY 2008.

to resume during the final three years of the financial plan period, growing by 0.5 percent in FY 2008, 4.3 percent in FY 2009, and 4.2 percent in FY 2010, as tax revenue growth recovers.

Graph 2

Annual Change in City Fund Revenues and Tax Revenues



Note: Assumes implementation of the gap-closing 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

The City's economy has improved dramatically in the last three years, and tax revenues have far exceeded expectations at the start of each fiscal year. These additional collections have been factored into the City's tax base, yielding higher projected collections throughout the entire financial plan period. While the City's economy is forecast to slow somewhat in calendar year 2007 and does face additional risks—in particular from its dependence on Wall Street, as well as risks related to interest rates, energy prices, and the value of real estate—it appears unlikely that City fund revenues would fall to the levels of the most recent recession. The projected slowing in the City's economy, coupled with the expiration of temporary tax increases, is expected to depress tax growth during the early part of this period—virtually all the gains in tax collections are attributable to the real property tax (see Table 5). Nonetheless, our review indicates that the City's revenue forecasts are too conservative and that tax collections could continue to exceed the City's expectations—by $200 million in FY 2006, $750 million in FY 2007, $600 million in FY 2008, and $500 million in each of fiscal years 2009 and 2010.

Table 5
City Fund Revenues
(in millions)

	FY 2006	FY 2007	Annual Growth	FY 2008	FY 2009	FY 2010	Average Three-Year Growth Rate
Taxes							
Property Tax	$ 12,437	$ 12,972	4.3%	$ 13,576	$ 14,232	$ 14,909	4.7 %
Personal Income Tax	7,120	6,752	-5.2%	6,769	7,266	7,673	4.4 %
Sales Tax	4,447	4,528	1.8%	4,590	4,817	5,052	3.7 %
Business Taxes	4,711	4,569	-3.0%	4,494	4,638	4,828	1.9 %
Real Estate Transaction Taxes	2,617	1,753	-33.0%	1,557	1,553	1,602	-3.0 %
Other Taxes	2,631	2,538	-3.6%	2,601	2,647	2,700	2.1 %
Subtotal	**33,963**	**33,112**	**-2.5%**	**33,587**	**35,153**	**36,763**	**3.5 %**
Miscellaneous Revenues	4,045	3,708	-8.3%	3,478	3,519	3,542	-1.5 %
Unrestricted Intergovernmental Aid	490	340	-30.6%	340	340	340	0.0 %
Anticipated Federal Aid	0	50	NA	0	0	0	NA
Grant Disallowances	(90)	(15)	16.7%	(15)	(15)	(15)	0.0 %
Total	**$ 38,408**	**$ 37,195**	**-3.2%**	**$ 37,390**	**$ 38,997**	**$ 40,630**	**3.0%**

Note: Includes the impact of the tax reduction program. Personal income tax includes the portion of such revenues used to pay debt service on bonds issued by the TFA. Audits have been allocated to individual taxes. Miscellaneous revenues have been adjusted for the transfer of TSASC revenues. Totals may not add due to rounding.
Sources: NYC Office of Management and Budget; OSDC analysis

Major revenue trends include the following.

- Real property tax revenues are forecast to increase annually between fiscal years 2006 and 2010, growing at an average annual rate of 4.6 percent. The expected level of revenue growth appears contrary to concerns that real estate values will ease following a period of large market value growth—annual market value growth for all properties in the City has averaged better than 10 percent between fiscal years 2000 and 2006. Growth can be maintained because provisions of State law which limit the amount of annual increases in assessed values for property owners during periods of rapid growth in property values also act to limit the risk to City revenues during periods when the growth in values is more sluggish.
- The largest decline is associated with the taxes on real estate transactions (the mortgage-recording and real property transfer taxes), which are expected to drop by $864 million (33 percent) in FY 2007. Revenues from these taxes have been forecast to decline for several years, but rising property values and only a modest increase in mortgage rates resulted in a strong real estate market in calendar year 2005. Recent data, however, indicate that the expected easing in the market may have finally arrived. The Mortgage Bankers Association reports that at the end of April mortgage interest rates were at their highest level since the middle of 2002,

and that year-to-date mortgage originations have fallen by more than 10 percent from the same period last year. While the number of transactions is falling, home prices have yet to show any sizable correction. Transaction tax revenues are projected to continue declining beyond FY 2007, falling by 11.2 percent in FY 2008 and 0.3 percent in FY 2009 before rising by 3.2 percent in FY 2010. While our analysis indicates that collections could be higher than the City's forecast, we agree that collections are likely to decline in the near term. Despite our higher estimate, revenues from this source are not likely to reach the levels achieved in recent years, which were a major source of the City's budget surpluses.

- Growth in the personal income tax is expected to average 1.9 percent during this period. The rate of increase is held down by a projected 5.2 percent decline in FY 2007 caused by the expiration of the temporary high-income surcharge and lower projected Wall Street profits and capital gains realizations. Collections are projected to increase again as the economy strengthens in 2008.
- Less robust economic conditions are expected to have an impact on the collection of business taxes in FY 2007, which are forecast to increase by 1.1 percent—adjusted for the nonrecurring audit revenue—and then decline by 1.6 percent in FY 2008. The City believes that smaller financial firms have performed much worse than larger firms, and that this has particularly affected the unincorporated business tax.
- Sales tax collections are forecast to increase at an average annual rate of 3.2 percent through FY 2010. While growth is dampened in fiscal years 2007 and 2008 by the projected slowdown on Wall Street, which limits wage increases and therefore consumer spending, the tax continues to grow in response to support from the City's tourism sector (hotel tax revenues are projected to increase at an average annual rate of 3.9 percent in this period).

B. Expenditure Estimates

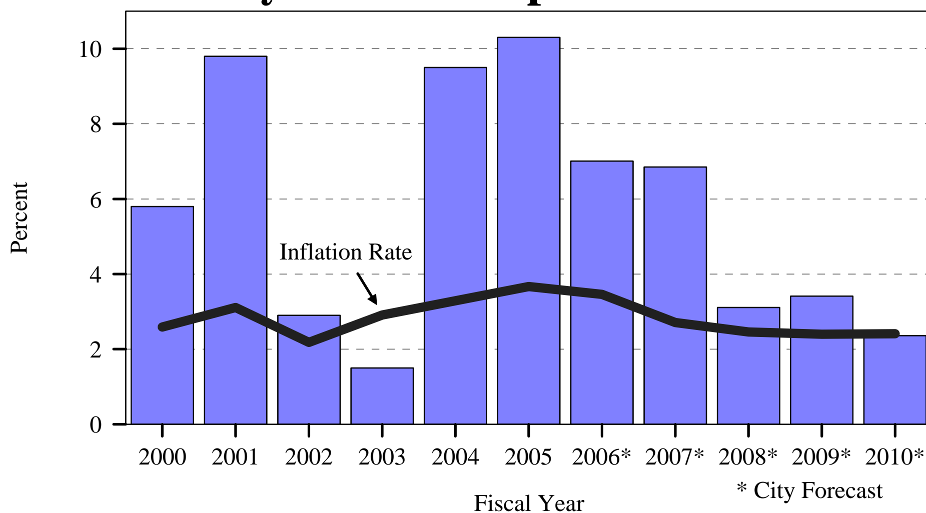
City-funded expenditures—after adjusting for surplus transfers that can mask expenditure trends, and after taking into account Transitional Finance Authority and TSASC debt service—grew by about 10 percent in each of fiscal years 2004 and 2005 (see Graph 3), driven by rapid growth in debt service, Medicaid, pension contributions, health insurance, and the retroactive components of recent labor agreements.

The May Plan assumes that expenditures will rise by 7 percent in FY 2006, but this estimate includes a planned $1 billion discretionary transfer to the City's

proposed health insurance trust fund for retirees. Excluding this transfer, the growth rate would be held down to 4.2 percent in FY 2006, due mostly to extraordinary one-time savings associated with the State Medicaid cap. Expenditures are projected to grow by 6.9 percent in FY 2007[9] because pension contributions, debt service, and health insurance costs are projected to increase at double-digit rates of growth (see Graph 4).

Graph 3

Annual Change in City-Funded Expenditures

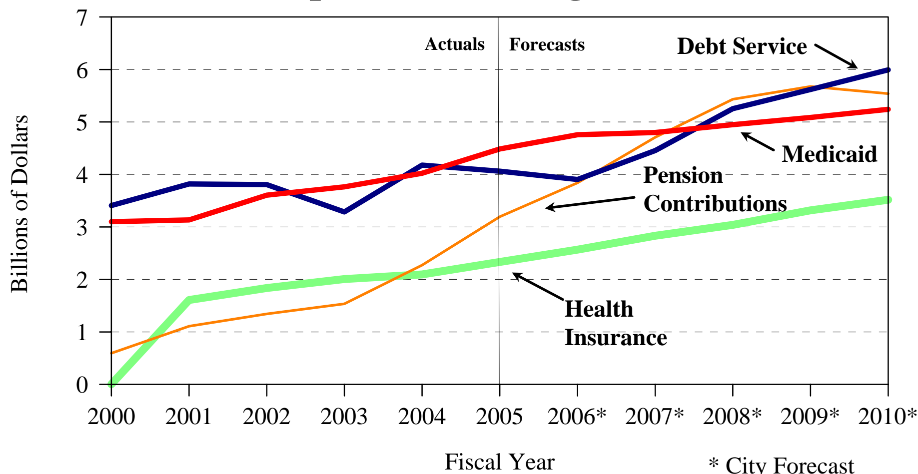


Note: Adjusted for surplus transfers.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

Expenditure growth is projected to average only 3 percent during fiscal years 2008 through 2010 because the May Plan assumes that wages will increase by only 1.25 percent during these years. In addition, the rapid growth in pension contributions since FY 2000 is expected to slow during fiscal years 2008 and 2009, and then decline in 2010. Finally, the State cap will limit the annual growth in the City's share of Medicaid to about 3 percent during these years. Nevertheless, debt service, pension contributions, health insurance, and Medicaid (including payments to the Health and Hospitals Corporation) are expected to consume 50 percent of City fund revenues in FY 2010, compared with 39 percent in FY 2006.

[9] The growth rate would be 7 percent if the planned transfers to the health benefits trust fund were excluded.

Graph 4
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

The City-funded workforce has been growing steadily over the past few years and is projected to reach 258,635 by June 2007, an increase of 2,241 employees over the level projected for June 30, 2006. This estimate assumes that the City will meet its planned hiring targets for FY 2006 during the last three months of the fiscal year—including the addition of 2,088 employees, mostly in health and social services agencies.[10]

Planned additions to the workforce in FY 2007 include 800 police officers, which would increase the police force to 37,838 officers by June 2007. Although the force would still be lower (by 2,916 officers) than the peak reached in October 2000, New York City is the "safest" large city in the nation, according to statistics collected by the Federal Bureau of Investigation. The City also intends to add 400 civilians to the Police Department as part of a consent decree with District Council 37, which stems from a grievance initially filed in 1995 that claimed the Police Department was assigning clerical and administrative duties to able-bodied police officers.

[10] Hiring delays could result in savings of $25 million in FY 2006.

The major factors behind the growth in City-funded expenditures are shown in Table 6 and discussed below.

Table 6
City-Funded Expenditures
(Adjusted for Surplus Transfers)
(in millions)

	FY 2006	FY 2007	Annual Growth	FY 2008	FY 2009	FY 2010	Average Three-Year Growth Rate
Salaries and Wages	$10,782	$11,142	3.3%	$11,337	$11,445	$11,626	1.4 %
Debt Service *	3,903	4,454	14.1%	5,254	5,617	5,993	10.4 %
Medicaid **	3,599	4,015	11.5%	4,165	4,310	4,446	3.5 %
Pension Contributions	3,839	4,710	22.7%	5,432	5,676	5,541	5.6 %
Health Insurance	2,566	2,832	10.3%	3,040	3,316	3,518	7.5 %
Judgments and Claims***	396	442	11.6%	485	538	588	10.0 %
Public Assistance	482	497	3.1%	497	497	497	0.0 %
Pay-As-You-Go Capital	200	200	0.0%	200	200	200	0.0 %
Health Benefits Trust Fund	1,000	1,000	0.0%	---	---	---	NA
Payments to HHC	1,286	849	-34.0%	877	955	975	4.7 %
Energy	606	677	11.7%	679	671	671	-0.3 %
Other	9,257	9,696	4.7%	9,807	9,973	10,163	1.6 %
Total	**$37,917**	**$40,514**	**6.8%**	**$41,773**	**$43,199**	**$44,218**	**3.0 %**

* Includes TFA and TSASC debt service. We have also adjusted the City's estimates for prepayment in FY 2006 of $350 million in TFA debt service that is due in FY 2008.
** Medicaid payments to the Health and Hospitals Corporation are reflected in the "Payments to HHC" category.
*** These estimates exclude about $190 million in annual payments by HHC for medical malpractice suits and other judgments and claims.
Note: Totals may not add due to rounding.
Sources: NYC Office of Management and Budget; OSDC analysis

- Salary and wage costs are projected to increase by 3 percent in FY 2007, reflecting current and anticipated labor agreements, and then to grow at half this rate in subsequent years based on the assumption that municipal employees will receive annual wage increases of 1.25 percent during fiscal years 2007 through 2010. Wage increases at the projected inflation rate would increase the City's costs by $100 million in FY 2007, $350 million in FY 2008, $650 million in FY 2009, and $950 million in FY 2010. Overtime costs in the uniformed agencies are likely to exceed planned levels by $125 million in FY 2007 and about $100 million annually in subsequent years; the budgetary impact could be mitigated by reserves in the Police Department and the receipt of federal grants.
- Debt service is projected to reach $4.5 billion in FY 2007, an increase of 14 percent, and then rise at an average annual rate of 10 percent during the

balance of the financial plan period—reaching $6 billion by FY 2010. Since debt service is projected to grow more rapidly than City fund revenues, it is expected to consume a larger share of revenues, leaving less for other municipal services. The debt service burden (i.e., debt service as a percent of City fund revenues), which averaged 11 percent during fiscal years 2005 and 2006, is projected to reach 15 percent in FY 2010.[11] Our analysis shows the City could realize debt service savings of $98 million in FY 2007 because interest rates on bonds to be issued by the Hudson Yards Infrastructure Corporation are likely to be lower than planned.

- Medicaid is projected to rise by 11.5 percent in FY 2007 because costs in FY 2006 were offset by a one-time savings associated with implementing a State cap that limits the growth in the local share of Medicaid. In subsequent years, the annual growth rate is expected be about 3 percent as the cap is fully implemented. Together with other actions taken by the State in recent years to hold down the growth in the local share of Medicaid, such as a takeover of the local share of the Family Health Plus program, the City is expected to realize cumulative savings of $5 billion through 2010.
- Pension contributions are projected to increase by 22.7 percent in FY 2007, continuing the rapid growth of recent years. While the rate of growth is expected to slow during the next two years and then decline in 2010, contributions will average about $5.5 billion during fiscal years 2008 through 2010. (In contrast, pension contributions averaged about $1.7 billion during fiscal years 2000 through 2005.) The May Plan reflects the impact of changes in actuarial assumptions and methods that defer planned contributions for 2006 and 2007 to future years.[12] The pension funds have earned about 9.3 percent through May 31, 2006, which is slightly better than the actuarial assumption of 8 percent for the year.
- Health insurance costs for municipal employees are projected to grow from $2.6 billion in FY 2006 to $3.5 billion in FY 2010, an average annual rate of 8.2 percent, reflecting the financial plan assumption that health insurance premiums will continue to grow much faster than the local inflation rate. In addition, the City intends to contribute $1 billion in each of fiscal years

[11] The debt service burden is defined as City-funded debt service as a percent of City fund revenues, including amounts to support TFA and TSASC debt service.

[12] These changes include a one-year lag in calculating contributions, as was recently adopted by the State; the extension of the phase-in period for investment gains and losses, from five to six years; full funding of retiree cost-of-living adjustments; and changes in demographic assumptions. The one-year lag and the cost-of-living adjustment require State approval, which is expected. If the State does not approve the changes, the City Actuary estimates that the amount of planned savings would be reduced by $670 million in FY 2006.

2006 and 2007 to a retiree health benefits trust fund to help fund future liabilities.

- Judgments and claims are expected to grow at an average annual rate of 10.4 percent during the financial plan period as a result of anticipated growth in the number of settlements and in the average size of all awards. The May Plan assumes that the City will not incur any liability arising from the 2003 Staten Island ferry crash or the 2001 World Trade Center (WTC) attack. However, the number of WTC-related claims against the City could increase in the coming years with the onset of WTC-related illnesses and deaths among employees of the City's uniformed agencies; the City expects that such claims will be covered by its captive insurance company.
- Public assistance expenditures are projected to increase by 3.1 percent in FY 2007 based on a projected increase in average benefit levels. As of March 2006, 402,281 persons received public assistance in New York City, a 65 percent decline since the peak month of March 1995. The City projects that the caseload will rise slightly to 411,120 persons by June 2006 and will remain at that level through FY 2007. The May Plan assumes no growth in caseload or costs beyond FY 2007.
- Medicaid payments and subsidies to the Health and Hospitals Corporation (HHC) are projected to total nearly $1.3 billion in FY 2006. This estimate includes a $575 million supplemental Medicaid payment that will enable HHC to leverage an equal amount of federal funds. In succeeding years, the City's payments to HHC will decline because the Medicaid supplement is nonrecurring. (For more information see "Health and Hospitals Corporation" in this report.)
- Energy costs, which include electricity, natural gas, steam, heating fuel, and gasoline, are projected to increase by 11.7 percent to $677 million in FY 2007 and then remain at that level. Strong global demand and uncertainty in some oil-producing nations are causing energy prices to increase.

VI. Semi-Autonomous Agencies

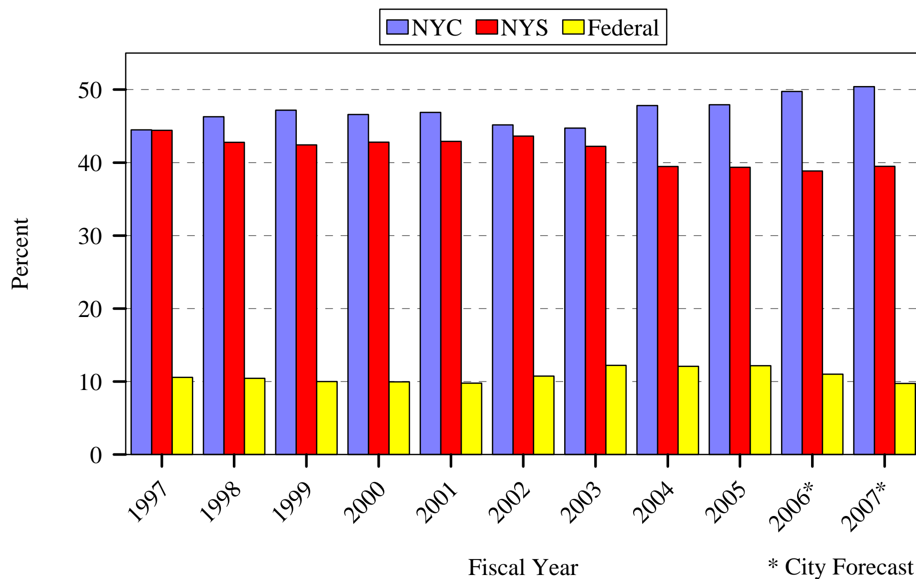
The following public authorities and other entities with a financial relationship with the City could affect the City during the financial plan period.

A. Department of Education

Between fiscal years 2003 and 2006, the amount of resources allocated to educational services has grown by $3.3 billion, an increase of 24 percent. The May Plan allocates $15.3 billion to the Department of Education for operations in FY 2007—an increase of $450 million over the projected level for FY 2006—and another $2.6 billion for pensions and debt service.[13] This estimate largely reflects the impact of the enacted State budget, which increases education aid to the City by $472 million and provides sources of additional funding for the department's capital program.

Graph 5

Education Funding Sources



Sources: NYC Office of Management and Budget; OSDC analysis

In FY 2007 the City will fund 42 percent of the cost of operations; the State will fund 46 percent; and the federal government, private grants, and miscellaneous fees will fund the remainder. When the cost of pensions and debt service is added, the

[13] The May Plan excludes the debt service and the incremental building aid associated with TFA education bonds.

City's share of the budget rises to 50 percent and the State's share falls to 40 percent (see Graph 5). Although the State contribution has grown by 22 percent since FY 2004, the City's contribution has grown at a faster pace. Consequently, the State's share of the total education budget has declined from 44 percent in FY 1997 to 40 percent in FY 2007.

State and City funding for education will continue to be debated as the State attempts to resolve a lawsuit over its system of education finance, *Campaign for Fiscal Equity v. State of New York.* Beginning in 2001, the courts have 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 October 2005, the Governor appealed a court order that operating aid to the City's public schools be increased by $5.6 billion over four years and $9.2 billion in capital budget funding over five years. 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 increase in operating aid of between $4.7 billion and $5.6 billion, and $9.2 billion in capital funds.

Shortly after the latest court ruling, the State and the City reached an agreement that will provide $11.2 billion in capital funding for school construction projects. The State will provide the public school system with $1.8 billion in capital grants from the New York State Dormitory Authority,[14] and will fund half of the debt service on $9.4 billion in bonds to be issued by the Transitional Finance Authority and the City in support of the department's current $13.1 billion five-year capital program.[15] (For more information see "New York City Transitional Finance Authority" later in this chapter). Together, the two contributions from the State represent half of the cost of the department's current five-year capital program.

The plaintiffs in the Campaign for Fiscal Equity lawsuit have stated that the capital improvement plan adopted by the State "satisf(ies) the City schools' constitutionally recognized capital needs," although they have filed an appeal with the Appellate Court to compel the State to fully comply with an earlier Court order to enact a multiyear increase in operating aid.[16] In their appeal, the plaintiffs also seek to clarify whether the court has the authority to compel the State to comply with its

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14 The use of the Dormitory Authority of the State of New York to issue debt to fund education capital projects is inconsistent with the State Comptroller's debt policy and management principles, because such debt has not been approved by the voters in a general referendum as required under the State constitution.

15 The City is already committed to fund $1.8 billion of the department's current five-year capital program with general obligation bonds.

16 *Campaign for Fiscal Equity et al v. State of New York et al,* New York County Index No. 111070/93.

rulings regarding the allocation of education funding. Oral arguments could start as early as September 2006.

The Governor, the Assembly Speaker, and the Senate Majority Leader have suggested that the City should fund part of any settlement. If the City were required to contribute the share of additional assistance recommended by the Governor (40 percent), and if the Court of Appeals ordered the State to increase funding by the maximum of $5.63 billion, the City could be required to increase its contributions by as much as $568 million in FY 2008, $1.1 billion in FY 2009, and $1.8 billion in FY 2010.

In addition, in June and September 2005, the federal government released audits of the Department of Education's Medicaid claims for transportation and speech therapy services. Auditors found $531 million in questionable federal reimbursements, of which the City could be responsible for half. The State is currently reviewing a draft of the third federal audit, which may be released in September 2006. The audit could result in higher City-funded expenditures.

B. New York City Transitional Finance Authority

The New York City Transitional Finance Authority (TFA) was created by the State in March 1997 to help finance the City's capital program after an erosion in real property values caused the City to approach the constitutional debt limit for general obligation (GO) bonds.[17] The TFA, as its name implies, was meant to be a temporary measure until the constitutional debt limit was amended.

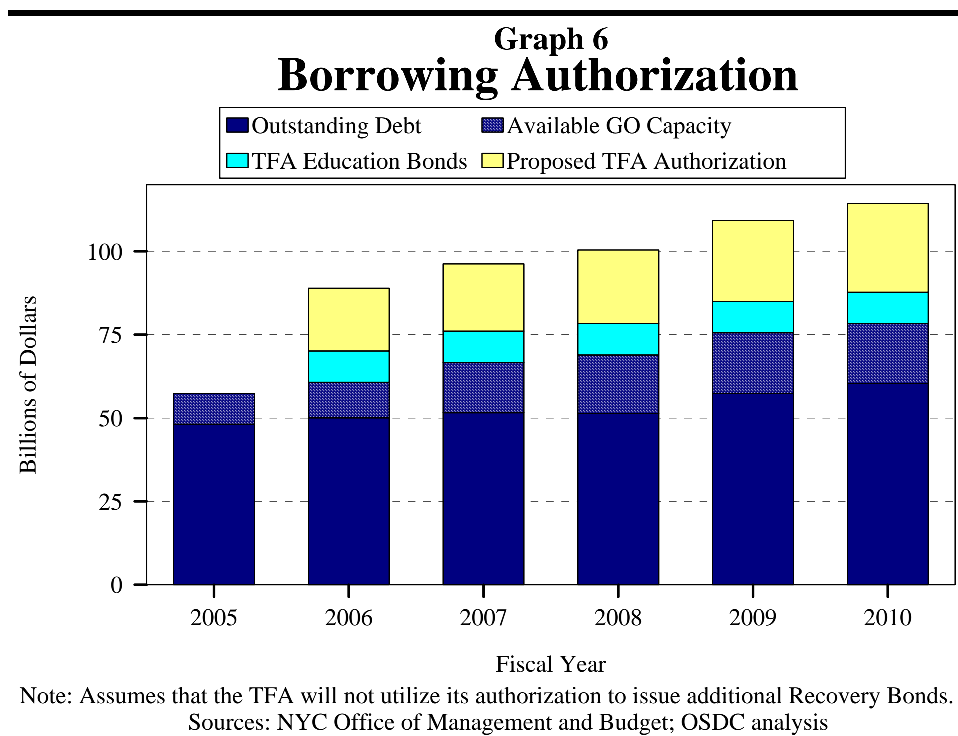
The City has made a number of proposals over the years to increase the TFA's borrowing authority. The City now proposes to replace the existing statutory cap on TFA general purpose bonds with 10 percent of the five-year rolling average of personal income of New York City residents. This would increase the TFA's borrowing authority by $26.6 billion by FY 2010 even though the City is comfortably under the GO debt limit[18] and the State just authorized the TFA to issue up to $9.4 billion in debt for educational facilities, which represent about 28 percent of the City's capital program.

[17] In 1951, the State Constitution was amended to cap the amount of outstanding City GO debt at 10 percent of the five-year average of the City's taxable real property value.

[18] The City's borrowing authority for general obligation bonds under the State constitution is projected to rise from $47 billion in FY 2006 to $66.4 billion in FY 2010 as the growth in real estate values of the past five years is phased in. We estimate that the City's unused borrowing authority will rise from $10.6 billion by the end of FY 2006 to $18 billion by the end of FY 2010.

If the State enacted the City's proposal, the authorization to incur debt on behalf of the City would double in only five years, from $57 billion in FY 2005 to $114 billion in FY 2010 (see Graph 6). Most credit rating agencies already consider the City's debt burden to be relatively high. Outstanding debt represents 14.5 percent of personal income, and Standard and Poor's, for example, considers a burden in excess of 6 percent to be high.

Graph 6
Borrowing Authorization



Note: Assumes that the TFA will not utilize its authorization to issue additional Recovery Bonds.
Sources: NYC Office of Management and Budget; OSDC analysis

Debt funded with resources that would otherwise have been available to the City, such as personal income taxes, sales taxes, tobacco settlement revenue, and State building aid, but that is issued by closely related but legally separate entities, such as the TFA and TSASC, is not subject to the constitutional debt limit.[19] As far back as July 1996, this office commented about exemptions from the constitutional debt limit and the need to recognize the constitutional principle of placing reasonable limits on the amount of debt issued on behalf of a municipality.[20] In 2004, the City suggested that TFA debt be counted toward the existing constitutional debt limit in exchange for raising the TFA's debt cap beyond its statutory limit. The City was clear that it sought

[19] To improve the State's fiscal discipline and to establish a more reasonable measure of debt affordability, the State Comptroller has called for an amendment to the State Constitution that would define State-funded debt to include all debt supported with State resources.

[20] Report 3-7, *Review of the New York City Financial Plan for Fiscal Years 1997 Through 2000*, July 18, 1996.

to obtain the benefits of TFA bonds, which are less costly than GO bonds, without seeking an increase in the overall debt limit. The City's current proposal deviates from its previously stated position.

The TFA reached its issuance cap for general capital purposes in September 2003. (The TFA was initially authorized to issue up to $7.5 billion in debt for general capital purposes, but the authorization was raised in June 2000 to $11.5 billion.[21]) Unlike GO bonds, which are funded with real property tax revenue, TFA general purpose bonds are funded with the City's personal income tax and, if needed, sales tax revenues. TFA bonds have been rated higher than GO bonds, which have reduced borrowing costs, and have provided the City a source of diversification as a financing vehicle, which relieves pressure on GO bonds and also lowers borrowing costs.

In April 2006, the State authorized the TFA to issue $9.4 billion in bonds exclusively to help finance the Department of Education's capital program ("education facilities bonds"). Since the cap is on debt outstanding rather than on debt issued, the TFA can issue additional debt as education facilities bonds come due. Educational facilities comprise 28 percent of the City's overall capital program. The City plans to use $4.7 billion of the authorization[22] to help fund the department's current $13.1 billion five-year capital program, and the balance of the program would be funded with $1.8 billion in capital grants from the Dormitory Authority of the State of New York and $6.5 billion in City general obligation bonds.

The State currently reimburses the City for about half of the debt service on capital projects for school facilities. Under the TFA legislation, the Mayor may assign to the TFA all or any portion of State building aid to back education facilities bonds;[23] and the State pledges not to change the current State building aid reimbursement formula for *approved projects*. The State, however, reserves the right "to amend, modify, repeal or otherwise alter statutes" relating to building aid for *future projects*. State building aid will still be subject to annual appropriation.

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[21] In September 2001, the State authorized the TFA to issue Recovery Bonds in an amount outstanding of up to $2.5 billion to compensate the City for nonreimbursed costs and revenue losses associated with the attack on the World Trade Center. The City issued $2 billion in Recovery Bonds during fiscal years 2002 and 2003, and though it could issue another $545 million under the cap, it has no intention of doing so.

[22] The remaining authorization could be used to help fund future education capital programs.

[23] Additional security will be provided to bondholders in the event of a default in the form of an intercept of State education aid by the State Comptroller.

The City has indicated that it intends to assign to the TFA all of its State building aid, which will total $440 million in FY 2006.[24] It is also expected that incremental building aid will be sufficient to fund the debt service on the TFA educational facilities bonds.[25] If not, the TFA could draw against existing building aid, but that would create a liability for the City's budget. Any building aid above the amounts needed to fund debt service on the bonds would be returned to the City.

C. New York City Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) expects to end FY 2006 with a surplus of $321 million, on an accrual basis, and a cash balance of $874 million—the largest balance in its history. However, HHC projects annual budget gaps of about $1 billion during the City's financial plan period. Although HHC has proposed a gap-closing program, even if the program were successful the budget gaps would remain substantial—$700 million in FY 2007, $351 million in FY 2008, $244 million in FY 2009, and $276 million in FY 2010. HHC plans to draw down most of its cash reserves to balance the FY 2007 budget.

The contrast in financial projections for FY 2006 and subsequent years is attributable to the anticipated receipt in FY 2006 of an estimated $1.3 billion Medicaid enhancement. This enhancement, also referred to as an intergovernmental transfer (IGT), is paid to hospitals and nursing homes that serve a large percentage of uninsured and medically needy patients. The May Plan assumes that the City will provide $575 million in City funds to leverage an equal amount of federal funding for HHC. (The City's actual contribution will depend on the final federal and State determination of the IGT amount.) At the same time, the City reevaluated the need to provide certain other subsidies to HHC, such as debt service and fringe benefits, given the large year-end cash balance projected by HHC for FY 2006. As a result of this examination, the May Plan reduces the City's subsidies to HHC by $198 million in FY 2006, $287 million in FY 2007, and $90 million in FY 2008. While this Medicaid enhancement will permit HHC to balance the FY 2006 budget on an accrual basis and the FY 2007 budget on a cash basis, it does not address the underlying structural imbalance between HHC revenues and expenditures.

[24] Building aid assigned by the Mayor to support TFA education facilities bonds would be subordinate to the payment of certain bonds of the Municipal Bond Bank Agency, the Educational Construction Fund, and, if needed, funding for education bonds that are in default.

[25] We estimate that State building aid would need to increase by $366 million by FY 2013 to cover the debt service on the TFA bonds.

D. New York City Housing Authority

The New York City Housing Authority (NYCHA) is a New York State public benefit corporation that provides subsidized rental housing to low- and moderate-income New York City residents. The NYCHA is projecting large budget gaps beginning in calendar year 2006 because the combination of rental income and financial support from the federal, State, and City governments is insufficient to cover operating expenses. In past years, the NYCHA has balanced its budget by drawing down reserves and by using federal resources designated for capital improvements. Although using federal grants in this manner is permitted, it is an ill-advised long-term strategy.

The NYCHA operates 179,117 units, including 21,000 units that were constructed by the State and the City. Over the years, the City's subsidy to the NYCHA has declined from an average of more than $110 million in fiscal years 1987 through 1994 to almost nothing in FY 2005. In December 2005, the NYCHA projected budget gaps of $182 million in calendar year 2006 and about $174 million annually in subsequent years. According to NYCHA officials, the cost of maintaining its units accounts for about half of the projected budget gaps.

Although the City is under no legal obligation to provide any additional assistance, the Mayor has proposed providing the NYCHA with $100 million in transitional assistance to help balance its 2006 budget. To close the remaining gap projected for 2006 and to close the budget gaps projected for future years, the NYCHA will seek additional federal assistance, raise rents on higher-income tenants, and implement a number of management initiatives.

Table 7
NYCHA Gap-Closing Program
(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
NYC Transitional Aid	$ 100	$ - - -	$ - - -	$ - - -
Federal Funding Flexibility	39	78	23	8
Management Actions	24	31	51	41
Rent Increases	15	38	53	60
Federal Section 8 Vouchers	4	23	50	67
Total	**$ 182**	**$ 170**	**$ 177**	**$ 176**

Sources: New York City Housing Authority; OSDC analysis

As shown in Table 7, federal actions are expected to generate about $43 million in 2006, $101 million in 2007, and about $74 million in subsequent years. In the short term most of the resources would come from increased flexibility in the

use of certain federal grants by applying for the federal Moving to Work demonstration program (MTW), which is designed to reduce reliance on public housing. Participation in this program would enable the NYCHA to combine its federal grants (Section 8, operating, and capital grants) and ease many of the regulations that define how the NYCHA can use federal funds, but participation may have programmatic implications. In addition, the NYCHA is seeking federal approval to offer new Section 8 vouchers to 8,400 tenants in State and City facilities who presently receive no subsidy for maintenance and operations from the federal, State, or City governments.

The NYCHA is also seeking federal approval to raise the maximum rent it can charge so that it can raise rents for tenants who spend less than 30 percent of their household income on rent. The NYCHA proposes to phase in rent increases of 10 percent, 20 percent, and 40 percent over two years, depending on tenants' household income. This will raise the rent for approximately 27 percent of NYCHA residents.

In addition, the NYCHA has proposed a number of management initiatives, including development fees on NYCHA-owned land ($10 million annually in 2006, 2007, and 2008); higher user fees for parking and electrical appliances; staff reductions; energy efficiencies; and consolidation of management offices. The NYCHA will have little alternative but to draw down its reserves to balance the 2006 budget if it does not receive federal approvals.

E. New York City Off-Track Betting Corporation

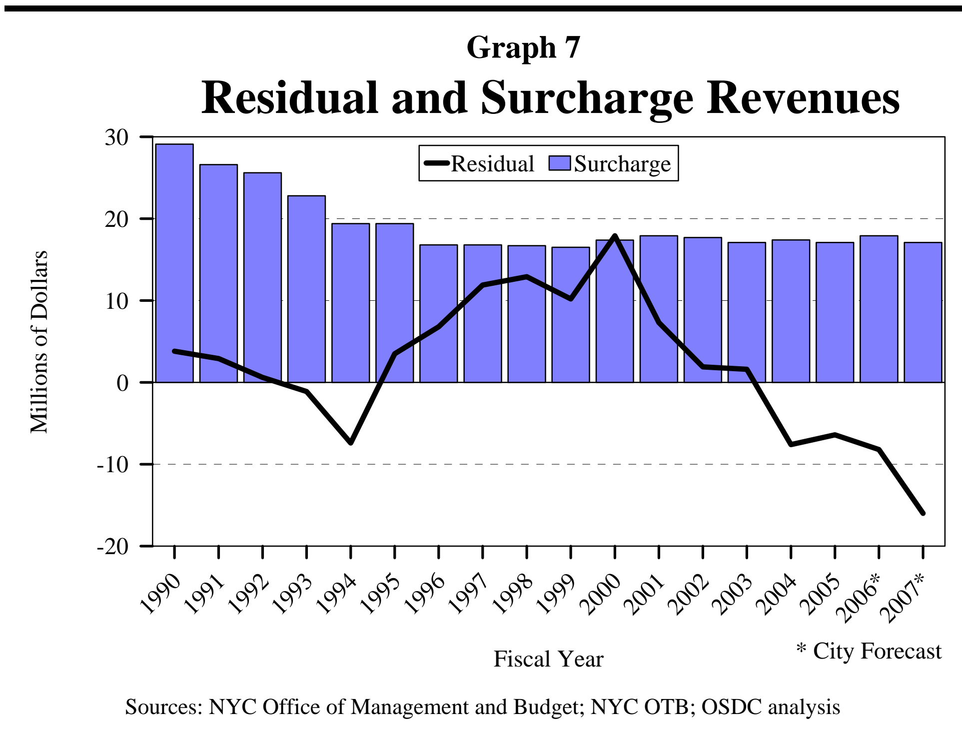
The Off-Track Betting Corporation (OTB) is a public benefit corporation that provides legalized pari-mutuel wagering that generates revenue for the City, the State, and the horse racing and breeding industries. The OTB typically provides New York City with revenues from a 5 percent surcharge on winning wagers, as well as residual revenues, which are any funds left over after the payment of all operating expenses and all statutorily mandated distributions to the racing industry, the State, and other localities.

The OTB projects that for FY 2006 it will collect $1.08 billion in "handle" (total bets received), which will be the largest handle in its history and an increase of 5 percent over FY 2005. The handle growth is largely due to the temporary closing of the Yonkers Raceway, an OTB competitor that is expected to reopen by the end of calendar year 2006. As a result of the unanticipated handle growth, the OTB projects that its mandatory surcharge payments to the City will increase, to total $17.9 million

in FY 2006 (up from the $17.6 million projected in February 2006) and $17.1 million in FY 2007.

While the OTB has taken steps to reduce costs and improve operating efficiency, its distributions to the City, State, and racing industry still exceed its net operating income. In FY 2006, the OTB will pay $8.2 million more in distributions than it will earn in net operating income (see Graph 7), and by FY 2010 this difference will rise to $22.6 million. In order to preserve cash, the OTB has delayed making some of its payments. As of March 31, 2006, the OTB was three months behind in its statutorily mandated distributions to the City.

Graph 7



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

In its February 2006 Plan, the City suggested a number of actions that the State could take to improve the OTB's finances, such as changes to the system that distributes OTB revenue to governmental entities and the racing industry, so that the OTB is not required to distribute more than its total net revenue after operating expenses. According to OTB officials, it is unlikely that the State will take such actions this year.

F. Health Benefits Trust Fund

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement 45, which requires governmental entities to calculate and report their current and future obligations for post-retirement benefits other than pensions in a manner similar to their accounting for pension obligations. These other post-retirement benefits include health insurance, supplemental welfare benefits, and Medicare Part B, all of which the City currently funds on a pay-as-you-go basis. Of these benefits, health insurance for retirees accounts for the majority of these expenses. New York City is required to comply with GASB 45 in its FY 2008 financial statements.

Although the new accounting rules do not require governmental entities to fund these liabilities on an actuarial basis, the credit rating agencies, when determining their ratings, will undoubtedly consider the size of these liabilities and how they are addressed. The City is working with the Actuary to determine the magnitude of its liability. Preliminary estimates put the value in excess of $50 billion.

In February 2006, the Mayor proposed that the City establish a health benefits trust fund, and the May Plan assumes that the City will contribute $1 billion to the fund in each of fiscal years 2006 and 2007 to pay down these unfunded accrued liabilities. The initial $2 billion contribution would be invested and the principal and interest would be dedicated to retiree health benefits. In addition, the City intends to annually contribute an amount equal to the projected cost on a pay-as-you-go basis, which is expected to grow from $1 billion in FY 2006 to $1.8 billion by FY 2010. All deposits would be irrevocable and would only be used to pay for these post-retirement benefits. Although the details of the trust fund have yet to be worked out, the City may be able to forgo its planned pay-as-you-go contribution to the trust fund, which would free up resources for other purposes. Thus, the trust fund could also serve as a rainy-day fund, although that is not its intended purpose.

G. TSASC Inc.

In 1998, 46 states and six other federal entities reached an agreement with major tobacco manufacturers to settle all past, present, and future smoking-related claims. Under the Master Settlement Agreement (“the Agreement”), the manufacturers are required to make payments of $206 billion to the participating states over a 25-year period (known as “tobacco revenues”), and agree to abide by more stringent advertising restrictions and to fund educational programs, among other things.

In November 1999, the City created TSASC Inc., to issue bonds that would be backed with the City's share of the tobacco revenues and that would help fund the City's capital program. Under the bond covenant, any tobacco revenues in excess of the amounts needed to fund debt service on the bonds were transferred to the City. In 2003, the downgrade of major tobacco companies below investment grade resulted in a "trapping event." This required TSASC to reserve a portion of tobacco revenues that would otherwise have flowed to New York City, in order to provide additional security to bondholders. Through FY 2005, the City has received $897 million in excess tobacco revenues.

In February 2006, TSASC refinanced all of its outstanding bonds to eliminate the trapping event, which also freed up the resources that had been placed in reserve. Although the City could take possession of these reserve funds and other tobacco revenues that it is owed, the City has decided to defer the receipt of $454 million until FY 2008, when the resources will be needed.

Importantly, a new agreement stipulates that the City will no longer receive revenues in excess of the amounts needed to fund debt service on TSASC bonds; instead, the City will receive a set share of tobacco revenues (62.6 percent). While in the short term the City will receive about the same amount each year as it received under the old agreement, future transfers could decline if tobacco payments to the states are substantially reduced.

Tobacco manufacturers are permitted to reduce their payments to the states if an independent mediator determines that the Agreement was a significant factor contributing to a loss in market share of more than 2 percent. Recently, several participating tobacco manufacturers, including two of the three major tobacco manufacturers, deposited $781 million of their scheduled payments for April 2006 in a "disputed payment account" rather than transferring the funds to the states. New York and other states have begun legal action to release the disputed funds to the participating states.

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